

# Ownership Structures and Incentive Programs for Design Professional Firms

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## Corporate Structures and Incentive Programs for Design Professional Firms

### Ownership Structures

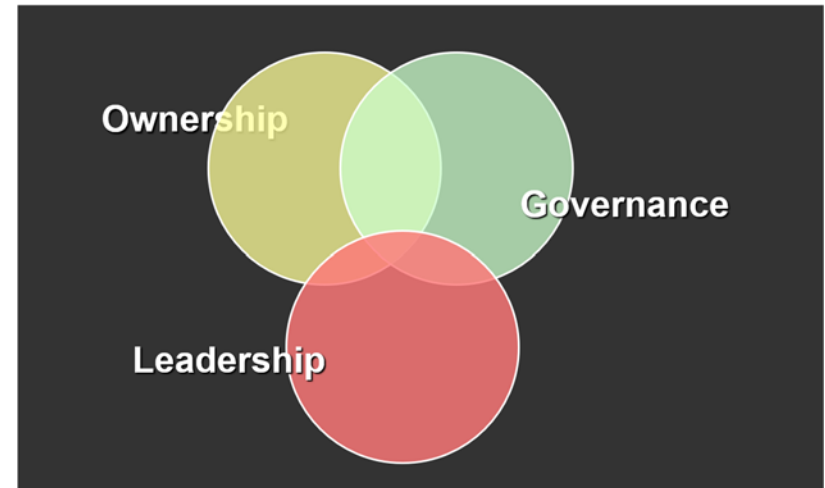
How best to structure the ownership of an architecture, landscape architecture, engineering or other type of design professional firm depends upon the owners' strategic goals. Ownership structures are, in large part, driven by 1) State Practice Acts, 2) owners' desires to limit their personal legal liabilities, 3) tax treatment, and 4) desired governance and decision making.

Within most structures, there are numerous options for governance frameworks and for incentive and compensation programs. The chart on the following page outlines the most common ownership structures and information about each structure.

Entity options in most states include Sole Proprietorships, General Partnerships, Limited Liability Partnerships (LLP), Professional Corporations (PC), Professional Limited Liability Companies (PLLC), S Corporations, and C Corporations<sup>1</sup>. C corporations and S corporations are generally subject to the same body of substantive corporate laws of the state where the corporation is formed or is doing business; however, they are taxed differently. S Corporations are also limited to 100 shareholders, while C Corporations are not subject to any limits.

#### Note:

The information contained in this report is intended as a general resource and should not be construed as legal or accounting advice. Readers should consult qualified legal and accounting professionals in the State(s) in which they conduct business before applying information herein to their practices or specific circumstances.



*In most types of entities, firms maintain latitude about who is involved in ownership, in governance and in leadership roles.*

It is important to note that ownership, governance and leadership often overlap but do not necessarily coincide. For example, not every owner within a firm, regardless of ownership structure, needs to be involved in every aspect of firm governance. Likewise, not everyone involved in firm governance needs to be an owner. And not all senior leaders need to be involved in either ownership or governance. In smaller firms, ownership, governance and leadership often align, while larger firms typically function better with a more streamlined governance model that does not involve all owners or leaders.

<sup>1</sup> Some states such as New York permit the formation of "Design Professional Corporations" comprised of a mix of differently licensed design professionals as owners.



**Ownership Structures for Design Professional Firms** (see notes on following page)

	<b>Sole Proprietorship</b>	<b>General Partnership</b>	<b>Limited Liability Partnership</b>	<b>Professional Limited Liability Company</b>	<b>Professional Corporation</b>	<b>S Corporation General Business Corporation (Note 1)</b>	<b>C Corporation General Business Corporation</b>
<b># of Owners</b>	Maximum of 1 (Note 2)	Minimum of 2	Minimum of 2	Minimum of 1 (Note 3)	Minimum of 1	Minimum of 1, maximum of 100	Minimum of 1
<b>Classes of Owners</b>	No	No	No	Yes	Yes (Note 4)	No	Yes
<b>Limited Liability (Note 5)</b>	No Owner liable for all business debts Owner liable for his/her own wrongful acts or omissions Owner liable for wrongful acts or omissions of employees (if made in the course of their employment)	No (Note 6) General Partnership and Partners are personally liable for all business debts Partners can agree to indemnify one another with respect to partnership liabilities Partners are liable for negligent acts or omissions of the general partnership, other partners and employees (if made in the course of their employment)	Yes (Note 7) An LLP is responsible for its debts and obligations. Partners are not personally liable for the LLP's debts except to the extent of his/her own negligence or if he/she has provided a personal guaranty. Individual partners (members) are not personally liable for negligent acts or omissions of employees except to the extent of the Partner's (Member's) own negligence or failure to comply with security requirements.	Yes A PLLC is responsible for its debts and obligations. Partners are not personally liable for the PLLC's debts. Individual partners (members) are not personally liable for negligent acts or omissions of employees except to the extent of the Partner's (Member's) own negligence or failure to comply with security requirements.	Yes A professional corp. is responsible for its debts and obligations. Shareholders are not personally liable for the corporation's debts.	Yes An S-Corp. is responsible for its debts and obligations. Shareholders are not personally liable for the corporation's debts.	Yes A C-Corp. is responsible for its debts and obligations. Shareholders are not personally liable for the corporation's debts
<b>Management and Control</b>	Owner completely responsible for all decisions.	All partners have equal rights based on ownership % unless agreement provides otherwise.	All partners have equal rights based on ownership % unless agreement provides otherwise.	May be decentralized and managed by all members or centralized in a Board of Managers, Board of Directors or Management Committee comprised of appropriately licensed persons.	Centralized in Board of Directors. All officers and directors must be appropriately licensed persons.	Generally, centralized in Board of Directors although may have a Management Committee and specific decisions may be subject to shareholder approvals.	Generally, centralized in Board of Directors although may have a Management Committee and specific decisions may be subject to shareholder approvals.
<b>Income Taxation on Profits (Note 8)</b>	Passed through to owner	Passed through to individual partners.	Passed through to individual partners.	Passed through to individual members.	A Professional Corporation may elect to be taxed as either an S Corporation or as a C corporation	Passed through to individual shareholders.	Taxed at the corporate level, and at the shareholder level as dividends
<b>Licensing (Note 19)</b>	N/A	N/A	All partners must be appropriately licensed in the applicable profession.	All members and managers must be appropriately licensed in the applicable profession.	All shareholders, officers and directors must be appropriately licensed in the applicable profession.	N/A	N/A
<b>Minimum Insurance Rqmts.</b>	No	No	Varies by state	Varies by state	Varies by state	No	No
<b>Transferability of Interests</b>	Ownership is freely transferable	Can transfer right to economic interest without consent of others, but cannot transfer right to participate in management and control absent consent of other partners as specified in Partnership Agreement	Can transfer right to economic interest without consent of others, but cannot transfer right to participate in management and control absent consent of other partners as specified in Partnership Agreement	Can transfer right to economic interest without consent of others, but cannot transfer right to participate in management and control absent consent of other members as specified in Operating Agreement	Absent a Stock Buy-Sell or other agreement, shares are freely transferable. Most agreements restrict ownership transfers.	Absent a Stock Buy-Sell or other agreement, shares are freely transferable. Most agreements restrict ownership transfers.	Absent a Stock Buy-Sell or other agreement, shares are freely transferable. Most agreements restrict ownership transfers.
<b>Continuity</b>	On incapacity, withdrawal, or death, sole proprietorship ends, but conservator, heirs or estate may continue the business.	For Partnerships with no definite term, the withdrawal, incapacity, or death of a partner will not cause dissolution unless agreement provides otherwise, although the transfer of 50% or more of the equity interests in any 12-month period could cause termination of the entity for tax purposes (Note 10)	For LLPs with no definite term, the withdrawal, incapacity, or death of a partner will not cause dissolution unless agreement provides otherwise, although the transfer of 50% or more of the equity interests in any 12-month period could cause termination of the entity for tax purposes (Note 10)	For LLCs with no definite term, the withdrawal, incapacity, or death of a member will not cause dissolution unless agreement provides otherwise, although the transfer of 50% or more of the equity interests in any 12-month period could cause termination of the entity for tax purposes (Note 10)	Withdrawal, incapacity, or death of a shareholder does not affect corporation's existence as long as one shareholder remains	Withdrawal, incapacity, or death of a shareholder does not affect corporation's existence as long as one shareholder remains	Withdrawal, incapacity, or death of a shareholder does not affect corporation's existence as long as one shareholder remains.
<b>Operating Documents</b>	N/A	Partnership Agreement	Limited Liability Partnership Agreement	Operating Agreement	Articles of Incorporation, Bylaws, Shareholder or Stock Buy-Sell Agreements	Articles of Incorporation, Bylaws, Shareholder or Stock Buy-Sell Agreements	Articles of Incorporation, Bylaws, Shareholder or Stock Buy-Sell Agreements
<b>Conducting Business in Other States</b>	Generally limited to licensing issues.	Generally limited to licensing issues.	May present a problem if other states do not recognize LLPs for type of design professional.	May present a problem if other states do not recognize PLLC for type of design professional	Some states require licensed design professionals to form PCs and do not permit General Business Corporations to offer or provide professional services	All 50 states recognize corporations, although each state will have differing requirements re: licensing of officers, directors and shareholders.	All 50 states recognize corporations, although each state will have differing requirements re: licensing of officers, directors and shareholders.



## Ownership Structures for Design Professional Firms

### Notes:

1. In some states, licensed design professionals may not form a general business corporation.
2. A husband and wife may be treated as a sole proprietorship for tax purposes.
3. Check specific state law.
4. PCs are permitted to have different classes of shareholders; however, this will disqualify the PC from pass-through tax treatment.
5. Most state laws provide that general partners are jointly and severally liable for all tortious acts of their co-partners acting within the scope of their actual or apparent authority, and jointly liable for all other general partnership debts and obligations. In contrast, partners in an LLP are not personally liable for the tortious acts of co-partners or for the LLPs debts and obligations solely by virtue of their status as partners.
6. Limited liability means an owner is not personally liable for the entity's debts, liabilities and obligations solely due to the person's status as an owner. Regardless of the entity type, every individual will still be liable for damages caused by his or her own negligence. Owners who are also employees may be entitled to indemnity under the applicable state's Labor Code. Owners in other entities may be entitled to indemnity pursuant to agreement or the entity's governing documents.
7. To mitigate the public's concern as to the limitation of liability of licensed professionals, most states require LLPs to maintain some form of security against potential errors and omissions claims. The LLP must maintain this security at all times during which it transacts business. For example, California Corporations Code § 16956 (a) (3) (A) - (D) California architects practicing as an LLP must maintain security which may consist of any one or a combination of: 1) professional liability insurance policies with minimum annual aggregate limits of \$100,000, multiplied by the number of licensed persons rendering professional services on the LLP's behalf, up to a maximum of \$5 million, but in no event less than \$1 million even if there are fewer than five licensed persons; or 2) a trust, bank escrow, cash, or other similar and relatively liquid assets in an amount of at least \$100,000, multiplied by the number of licensed persons rendering professional services on behalf of the LLP, up to a maximum of \$5 million, but in no event less than \$1 million even if there are fewer than five licensed persons. In lieu of the above, an LLP may annually file a statement with the Secretary of State certifying that it has a net worth equal to or exceeding \$10 million as of the most recently completed fiscal year.
8. Notwithstanding pass-through tax treatment, for state tax purposes in most states, an LLP, PLLC and corporation are subject to an annual franchise tax for the privilege of doing business as an LLP, PLLC or corporation.
9. Information specified in this chart is for domestically formed entities. Depending on the state, different rules may apply for entities formed in one state that qualify to do business in a different state as a "foreign" registered entity.
10. State laws vary. Some state laws may provide that dissolution will occur unless the partners owning a specified percentage of the partnership interests vote to continue the partnership within a specified timeframe.

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## Corporate Structures and Incentive Programs for Design Professional Firms

### Tax Considerations

C corporations are subject to double taxation with income tax assessed at both the corporate and individual shareholder level. In contrast, S corporations, along with Sole Proprietorships, General Partnerships, LLPs and LLCs, are pass-through income tax entities; these entities report their income on an entity tax return but do not pay tax at the entity level. Instead, income taxes are assessed and paid at the individual level; shareholder, sole proprietor, partner or member.

In general, C Corporations are more common in larger firms due to their taxation requirements at both the corporate and individual level and/or firms established before around 1990 when tax codes provided more favorable treatment. S Corporations are generally more common with small and mid-size firms.

Many smaller A/E firms elect to be taxed under Subchapter S of the Internal Revenue Code. As an S Corporation, all of the Corporation's taxable income at the end of each fiscal year is allocated and "passed through" to its Shareholders based upon each Shareholder's proportionate ownership of the Corporation's shares. This is so regardless of the actual cash distributions that a Shareholder receives. Thus, Shareholders in an S Corporation may be required to pay taxes on "phantom income" that they do not actually receive. In some instances, this might be attributable to the retention of cash within the Corporation for capital expenses or improvements that must be depreciated over time and cannot be fully deducted as a business expense in the year the expense is incurred or the outlay of cash for expenses that are not deductible by the Corporation as ordinary and necessary business expenses, e.g., fifty percent (50%) of meal and entertainment expenses.

S Corporation Shareholders who own two percent (2%) or more of the Corporation's outstanding shares may also be ineligible to participate in certain tax advantaged employee benefit programs such as Section 125 cafeteria plans. This may include lack of eligibility to participate in these programs for the entire fiscal year even though shares will not have been owned for the full year. This may then require an adjustment to amounts the new shareholder had previously designated to be deducted from his or her payroll on a pre-tax basis.

While 2017 Tax Cuts and Jobs Act reduced the tax rate for C corporations to a flat rate of 25%, it also gave favorable treatment to pass-through entities allowing them to deduct 20% of their business income (Qualified Business Income deduction), with certain limitations. A Specified Service Trade or Business (SSTB) is not able to take advantage of this deduction in the same way that a taxpayer whose business income is not from an SSTB can use the deduction. However, A/E firms are eligible (exempt from SSTB). There can be some limitations on the deduction based on an individual / household's total taxable income. The limitation is calculated based on wages paid during the year and the firm's basis in qualified business property. In general, the deduction provides a clear tax advantage to most A/E pass-through entities. Owners should consult with a tax professional to determine the best corporate structure for their firm based on their own personal circumstances.



## Corporate Structures and Incentive Programs for Design Professional Firms

### Corporate Incentives

In order to compensate and incentivize senior employees, design professional firms use a variety of incentives depending upon their firm structure, size, and goals. Incentives are used to attract talent, as a reward for performance, as an incentive to remain at the firm -- or all three. The incentives outlined below work for firms that are structured as corporations with ownership represented by shares of stock. Many of these incentives could be structured to work in a PLLC. The only incentive outlined below that would work for a sole proprietor or general partnership would be to create an incentive compensation program that provides for separate bonus pools or a Non-Qualified Deferred Compensation plan.

Benefits of Offering Stock	Challenges with Offering Stock
Gives employees an ownership stake in the firm and provides strong incentives to remain with the firm, serve as a leader, and make decisions based on what is best for the long-term success of the firm.	Usually requires an incoming shareholder to purchase stock, which must be both affordable and attractive. Incoming shareholders must have the financial ability and willingness to assume risk.
Facilitates ownership transitions for existing stockholders who have limited time horizons for retirement.	Only viable for senior or key employees with whom existing shareholders are comfortable bringing on as a long-term "partner".
Helps align long-term financial interests and encourages stockholders to increase the financial value of the firm.	Dilutes equity interests of existing shareholders.

The type of incentives that a firm can offer its employees is often driven by the entity structure. The most attractive incentive programs for senior employees whom the firm wishes to reward, retain, and incent often include stock ownership of some kind, whether it is standard common stock, restricted common stock, phantom stock, stock appreciation rights (SAR) or an Employee Stock Ownership Program (ESOP).

### Standard Corporate Stock

For S and C corporations, offering shares of capital stock in the corporation recognizes the contributions of key employees and often helps retain top talent. By acquiring stock, an employee becomes an owner of the company with financial rewards closely tied to the firm's performance and with voting rights generally tied to the amount of stock held relative to other shareholders. This generally requires a cash investment by the employee who is buying stock, although the stock may be offered at a minority discounted price and/or the firm may issue a stock bonus, cash bonus, salary increase and/or financing options to help fund purchases.

This form of incentive is generally only given to the most senior employees with whom existing shareholders wish to elevate to an ownership position. Therefore, it is more limited in use than some of the other incentive programs. It also requires that the incoming stockholder have the financial wherewithal to purchase an ownership stake in the firm unless the firm is prepared to issue a stock bonus, a cash bonus and/or a financing plan to partially or totally fund the purchase.



## Corporate Structures and Incentive Programs for Design Professional Firms

### Different Classes of Corporate Stock

In order to incentivize employees as owners, firms can issue non-voting stock to employees. As the holder of non-voting stock, an employee will not have the right to vote as a shareholder; however, he or she will share in the firm's profits and proceeds. As a part-owner with the right to share in the profits, the employee will be more invested in the firm and, in theory, work harder to achieve results that he or she will ultimately share with the other owners.

While the employer may recognize the benefit of having employees share in the profits of the firm as an equity owner, employers tend not to want these same employees to have the exact same rights in the stock as the firm's founders. The easiest way to distinguish the founders from other employee-owners is to limit the voting stock to the founders. This structure generally keeps management at the founder level since the shareholders elect the Board of Directors. These employee owners of non-voting stock would still receive a pro rata share of profits paid as a dividend together with all of the common-stock owners.

A corporation can issue two or more classes of stock. For example, a business may offer Class A and Class B stock, where Class A stockholders are given voting rights in elections for the Board of Directors, but Class B stockholders do not get a vote. For S corporations, the IRS requires the Class B stock to have identical rights to distributions and liquidation proceeds. State laws generally are liberal when it comes to allowing corporations to issue different classes of stock shares. Differences between classes of stock can be significant and these differences tend to affect the value of each class of stock.

Benefits of Different Classes of Stock	Challenges with Different Classes of Stock
Allows employees to obtain an ownership stake without giving them voting rights. The firm may continue to be managed by a Board comprised primarily of its founders or existing Class A shareholders.	Usually requires the incoming shareholder to purchase stock. Therefore, they must have the financial ability and willingness to do this absent a bonus.
Can be used for a larger pool of employees than standard voting stock.	May cause the corporation to become ineligible to maintain S corporation status.
Avoids dilution of voting interests.	

### Phantom Stock and Stock Appreciation Rights

A phantom stock plan is an employee benefit plan that gives selected employees (generally senior management) many of the benefits of stock ownership without owning actual shares of stock. This is sometimes referred to as phantom stock, shadow stock or synthetic equity.

Rather than receiving actual shares of stock, the employee receives a right to future compensation that is linked to the value of the corporation's shares. The value of each "share" of phantom stock tracks the price of the firm's actual stock and can increase or decrease in value over time. Phantom stockholders may also receive compensation equivalent to dividends paid to holders of common stock. After a period of time, the cash value of the phantom stock is distributed to the participating employees.



## Corporate Structures and Incentive Programs for Design Professional Firms

Stock appreciation rights (SARs) are similar to phantom stock-based programs and are most commonly made available to upper management. Often, SARS programs function as part of a retirement plan. The value of each SAR unit equals the appreciation in the calculated value of the firm's stock between the date the SAR unit is granted and the date the SAR unit is paid. Thus, SARS provide increased incentives to increase the value of a firm.

Generally, phantom stock programs have no inherent restrictions regarding their use, thereby providing an organization with flexibility. Most phantom stock programs can also be changed at the leadership's discretion.

Phantom stock and SARs may qualify as a form of deferred compensation plan. As such, these programs must meet the requirements of Internal Revenue Code Section 409A. These plans must be properly vetted by an attorney, with all of the pertinent details specified in writing.

Benefits of Stock and SAR Programs	Challenges with Stock and SAR Programs
Offers employees the ability to share in the firm's success without giving the employee an actual equity stake in the business. This avoids dilution of equity interests.	If used as a deferred compensation plan, must involve counsel to ensure they meet applicable IRS rules.
No shareholder rights to inspect the firm's books and records. .	Information relating to the value of the firm's stock must still be provided.
Employee does not attain the rights of a minority shareholder, such as the right to vote.	
Fewer restrictions regarding their use, allowing greater flexibility.	
No "buy-in" or upfront investment required from the participant.	





## Corporate Structures and Incentive Programs for Design Professional Firms

### Non-Qualified Deferred Compensation Plans

Non-Qualified Deferred Compensation (NQDC) plans are a popular benefit for shareholders and senior employees allowing them to defer a much larger portion of their compensation, and to defer taxes on the money until the deferral is paid. Unlike a qualified plan, where benefits are segregated from the employer's general assets, an employee's deferred compensation in the NQDC remains part of the employer's general assets and is subject to potential loss. The plan essentially represents a promise by the company to pay the employee at a pre-determined future date.

For the firm, NQDC plans are a useful way to reduce the value of the Company and make a purchase of shares more attractive and affordable to incoming shareholders. A NQDC will lower the value of the firm as the plan becomes an unfunded liability on the firm's balance sheet thereby reducing the firm's net worth. This reduction in firm value, in turn, reduces the per share value of the firm's stock to the extent the firm's valuation includes a component based on book value.

A NQDC plan obligates the Company to make compensation payments at designated times in the future and may also include interest payments. A NQDC plan has two major advantages:

1. The Company is able to deduct the deferred compensation payments in the year they are made, similar to current year wages or bonuses, thereby lowering the taxable income of all then-current shareholders. While the Corporation will pay all applicable Social Security and Medicare taxes at the end of the calendar year in the year in which the Deferred Compensation was allocated, the shareholders will realize significant tax savings over time.
2. The employee-shareholder receiving the deferred compensation will be taxed in the calendar tax year in which compensation is actually paid.

A NQDC plan must meet the requirements of Internal Revenue Code Section 409A. The plan must be properly vetted by an attorney, with all of the pertinent details specified in writing.

Benefits of NQDC Plans	Challenges with NQDC Plans
Offers employees the ability to receive a portion of their compensation at a later date, and therefore, defer taxes on that compensation until it is received.	Must involve counsel to ensure they meet applicable IRS rules.
Provides a means for shareholders to take value out of the firm in the form of a promise of future payments thereby reducing the firm value and stock price, making it more attractive and affordable to incoming shareholders.	NQDC plans involve some risk to the recipient as they represent an unfunded obligation of the firm.
When the deferred compensation is paid, it becomes a deduction for the firm lowering taxable income in that year.	Social Security and Medicare taxes must be paid at the time of deferral.



## Corporate Structures and Incentive Programs for Design Professional Firms

### Leadership Bonus Pools

Another mechanism to provide incentive compensation to senior employees without offering actual ownership is by establishing a separate bonus pool. These pools are often at the discretion of a firm's owners, Board or Compensation Committee. Effective leadership bonus pools are structured to:

- Promote a merit-based culture that aligns with the firm's core goals and is both flexible and transparent
- Attract, retain and reward highly effective leaders
- Recognize contributions to the three areas of practice: Getting the Work, Running the Business, and Doing the Work
- Reward owners for their contributions, investments and risks associated with ownership
- Encourage constructive input and ongoing accountability between leadership team members

Bonuses for senior leadership are generally higher as a percentage of salary and are often tied to a separate set of metrics than bonuses for other employees. These metrics may be more closely tied to firm, work group or individual profitability, performance, business development and business generation, longevity, and/or other management objectives.

Firms may also set-up multiple pools with one pool allocated for all employees tied to firm profitability and other pools tied more specifically to metrics pertinent to specific roles, responsibilities and/or specific initiatives.

Benefits of Separate Incentive Bonus Pools for Firm Leaders	Challenges with Separate Incentive Bonus Pools for Leaders
Financially rewards leaders without giving them an actual equity stake in the business. Does not dilute equity interests.	May not satisfy employees who desire to attain an ownership stake.
Has no inherent legal or accounting restrictions.	May create incentives that reward short-term goals
Does not require full disclosure of actual profit numbers.	May lead to morale challenges during years of lesser performance

Recent studies have shown a significant shift occurring in the architecture and related industries in how firms are paying bonuses to their employees. The trend is to move away from purely discretionary plans and toward structured incentive plans that focus on firm-wide goals while retaining some discretionary components that reward individual performance. If desired, firms need not disclose their actual profit numbers when using structured bonus plans; communicating the bonus pool as a percentage of an annual or other periodic goal could be sufficient. Firms also have discretion with the degree of transparency on most structured bonus plans. Some plans allow key employees to look up performance on a pay table and identify their award percentage next to the achievement percentage. Other plans entail management staff or supervisors meeting with each key employees to discuss individual performance and associated rewards.



## Corporate Structures and Incentive Programs for Design Professional Firms

### Employee Stock Ownership Plan (ESOP)

An ESOP is a tax-qualified deferred compensation plan that provides a firm's entire eligible workforce with ownership interests in the firm. In an ESOP, which are typically formed as a separate legal entity or a trust, firms provide employees with indirect stock ownership with no upfront cost to the employees. ESOP's originate and remain affiliated with a specific, sponsoring corporation primarily through the ESOP's whole or partial ownership of that corporation.

According to the National Center for Employee Ownership, as of 2017 there are roughly 7,000 employee stock ownership plans in the U.S. covering about 14 million employees. And even though, since the beginning of the 21st century there has been a decline in the number of plans, the number of participants has increased. The Center estimates that around two-thirds of ESOPs are used to provide a market for the shares of a departing shareholder of a profitable, closely held firm. Most of the remainder are used either as a supplemental employee benefit plan or as a means to borrow money in a tax-favored manner.

In order to create an ESOP, a firm sets up a trust for its employees and contributes a combination of cash to buy stock of the firm, contributes the firm's shares directly into the ESOP, and/or has the ESOP borrow money to buy the firm's stock. If the ESOP borrows money to fund the purchase of stock, the firm will then make future contributions to the ESOP to enable it to repay the loan. The firm's contributions to the ESOP in the form of cash or stock create a tax deduction for the firm.

Amounts held in the ESOP are allocated to individual accounts for each eligible employee participant; allocations are usually based on the salary level of the participant. The ESOP plan documents will describe eligibility criteria, specify a methodology for determining when and how contributions will be allocated to each employee's account, outline vesting requirements and specify when and under what conditions an employee will receive distributions from the ESOP. ESOP proponents say the vesting requirements incentivize employees to remain with the firm. Employees pay no tax on the firm's contributions to the ESOP until they receive a distribution in respect of the stock when they leave or reach a specified retirement age. At the time of an employee's departure from the firm or upon reaching retirement age, the employee will receive a certain number of the firm's shares which, depending on the plan provisions, are then either sold in the market or back to the firm.

The tax advantages associated with ESOPs can be significant for the selling shareholders and for the firm. Provided that the ESOP owns 30% or more of the firm's stock and the firm is a C corporation at the time of sale, shareholders of a private firm selling their shares to an ESOP can defer taxation on their gains by reinvesting in qualified securities of other companies. According to a 2015 article published by *DesignIntelligence*, this "rollover" serves as a deferral of capital gains taxes, allowing the shareholder to defer paying these taxes until ultimate liquidation of the rollover investment assets.

However, there are limitations on the rollover investments and the advice of seasoned tax and investment professionals is critical in the utilization of this strategy. This deferral of income taxes makes ESOPs a favored approach of firm founders.



## Corporate Structures and Incentive Programs for Design Professional Firms

Benefits of ESOPs	Challenges with ESOPs
Tax advantages for both employees and divesting shareholders.	Upfront and ongoing expense of plan creation and administration including legal and accounting costs and annual appraisal. An ESOP may not make financial sense for smaller firms.
Strengthens firm culture and may enhance employee retention.	Some employees might choose to remain at a firm solely for ESOP investment reasons.
Encourages employees to take more interest in and ownership of a firm's financial performance.	Funding, debt service and repurchase obligations could place pressure on a company's cash flow.
If the ESOP is the 100% shareholder of an S-Corporation, all income of the firm is tax-deferred. This enhanced cash-flow provides a distinct advantage over time allowing the firm to reinvest in the business and reduce debt.	The unique structure of ESOPs might make it complex to unwind, to sell an ESOP company and/or to raise outside capital for an ESOP company.
Provided that the ESOP owns 30% or more of the firm's stock and the firm is a C corporation at the time of sale, shareholders of a private firm selling their shares to an ESOP can defer taxation on their gains by reinvesting in qualified securities of other companies.	

For all firms, contributions made to the ESOP are tax deductible. In the case of a leveraged ESOP, the firm makes tax deductible contributions to the ESOP that enable the ESOP to satisfy the debt incurred to purchase shares. This means both the principal and interest payments made to a bank or selling shareholder essentially become tax deductible payments.

Another major advantage of an ESOP is available to firms who are or convert to an S corporation. Earnings distributed to the ESOP in respect of its stock ownership in an S corporation are not subject to income tax. However, earnings distributed in respect of stock must be distributed on a pro rata basis. Thus, if other S corporation shareholders receive a distribution to aid in the payment of taxes flowing from the corporation to its shareholders, the ESOP must receive its pro rata share of any such tax distributions. However, the ESOP gets to keep its portion of the tax distribution to satisfy debt payments or fund the repurchase of participant shares.

Taken to its extreme, if the ESOP owns 100 percent of the S corporation shares, all of the firm's income is tax-exempt, and the firm can forgo tax distributions, retaining the cash to reinvest in the business. (When ESOP participants receive a distribution from the ESOP, he/she pays income tax on the value of the distribution.) Over time, this enhanced cash flow can provide a firm with a significant competitive advantage, allowing for accelerated reduction of debt, greater capital investment/acquisitions, and enhanced employee benefits.

Costs for establishing an ESOP vary, but initial expenses for smaller firms are reportedly as low as \$25,000 and annual maintenance and required appraisals for an ESOP reportedly as low as \$10,000 to \$15,000 per year. More complicated structures for firms larger than a few hundred employees reportedly push the start-up costs to a higher range of \$50,000 to \$100,000 with annual maintenance and appraisal fees of \$15,000 to \$30,000.



## Corporate Structures and Incentive Programs for Design Professional Firms

	Standard Corporate Stock	Different Classes of Corporate Stock	Phantom Stock and SARs	Non-Qualified Deferred Compensation	Separate Bonus Pools	ESOP
<b>Ownership in Firm</b>	Yes	Yes	No	Not Required	No	Indirect
<b>Investment Risk</b>	Yes, including cash invested	Yes, including cash invested	No	Yes, the plan represents an unfunded obligation of the firm.	No	Contributions allocated to participant's account may be at risk to the extent the firm's stock value declines.
<b>Individual Liability</b>	No	No	No	No	No	No
<b>Tax Implication Arising from Distributions</b>	Varies based on type of corporate entity.	Varies based on type of corporate entity.	Ordinary income tax.	Ordinary income tax at the time the deferral is paid.	Ordinary income tax.	Allocations are tax deferred as part of a tax qualified retirement plan.
<b>Tax Implication Arising from Receipt of Proceeds from Sale of Stock</b>	Ordinary income or capital gains.	Ordinary income or capital gains.	N/A	N/A	N/A	Tax on sale by founders or selling shareholders may be tax deferred.

**Note:**

The information contained in this report is intended as a general resource and should not be construed as legal or accounting advice. Readers should consult qualified legal and accounting professionals in the State(s) in which they conduct business before applying information herein to their practices or specific circumstances.

## Ownership Structures and Incentive Programs for Design Professional Firms

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