EMPLOYEE PROFIT SHARING PLANS and EMPLOYEE GAINSHARING PLANS IN OWNER MANAGED BUSINESSES

An employee profit sharing plan ("EPSP") is an arrangement under which an employer pays a portion of its profits to those of its employees who are members of the plan, or to a trustee to be held or invested for the benefit of those employees who are members of the plan.

An employee gainsharing plan ("EGSP") is similar, except payment to the plan or to the employees is tied to more than company profits. Gainsharing payments are linked to achieving other measurable business goals or activities which lead to improved profitability, such as quality standards.

In either case, a truly motivating EPSP or EGSP requires careful, thorough and ongoing planning and implementation, especially if the employer is a typical owner managed business.

Please note that this article has been written from the perspective of the owner/manager of private business in Ontario with sales in excess of $1,000,000.00 and more than five employees, although some of the thoughts expressed can apply to smaller businesses. In addition, the emphasis is on "performance" driven versus "retirement" driven plans.

This article was written as an introduction only to a complex strategic, human resource, tax and legal issue. Generalizations can never be applied to any specific situation, and appropriate tax, legal and human resource advisors should be consulted before any specific employee profit sharing plan is implement.

The Use of EPSP and EGSP Plans in Owner Managed Businesses

Employee Profits Sharing Plans can be used in owner managed businesses in a number of ways, including:

- To provide a performance based retirement plan for the company employees.
- To establish base pay scales at the low end of the range for overhead control purposes, with the opportunity for employees to do significantly better if the company does better.
- To provide a performance based mechanism for the employees to become more involved in and committed to the business, especially to those values, attitudes and practises which foster profitability.

Employee Gainsharing Plans can be used in similar ways and for similar purposes, with the added focus on improving those activities which lead to profitability, as opposed to dependence on profitability alone.

Special Considerations for EPSPs and EGSPs in Owner Managed Businesses

Owner managed businesses, by their very nature, are not easy candidates for EPSPs or EGSPs. I suggest this for several reasons:

<u>Control</u>: Most owner managed businesses stay small enough that the owner can control all major decisions, and many not so major ones as well. There is nothing wrong with this. However, this approach does not work well with EPSPs or EGSPs. For these plans to work well employees must both believe and experience how what they do and how well they do it impacts the company's bottom line. If the owner manager is making all the decisions and directing how everything is done, this feeling of connection will be lost and the employees will simply consider the EPSP or EGSP as a discretionary bonus by another name.

<u>Encouraging Employee Involvement</u>: Most owner managers are very private people when it comes to sharing of information and consulting their employees. This is an extension of that control-oriented personality. Yet for an EPSP or EGSP to work the employees must have intimate knowledge of the company's financial situation and how it makes money. Without true understanding of how the company makes money, and how much the company is making, employees will never be connected to the plan and will not adopt the spirit necessary for the plan to succeed in the long run. Most owner managers are extremely reluctant to provide this kind of education and information to their employees, and even more reluctant to allow their employees to have a say in how company goals are met.

The Need For Connection

The key to developing and implementing a good performance driven EPSP or EGSP is "connection", both the plan's "connection" to the goals of the business and the employees' "connection" to the plan.

<u>Long Term Company Needs</u>: The plan must connect with the long term (five year) needs and goals of the company, as determined by its owner. Once implemented, an plan may be hard to take away. Therefore the plan must be considered a long term human resource strategy.

<u>Short Term Company Needs</u>: In addition, the EPSP must connect to the company's immediate needs (one to two years) as determined by the owner, both profit and non-profit based needs. From an profit sharing plan perspective, the emphasis on profits could overlook opportunities to improve the company by improving activities and results that are not directly profit related (such as answering the telephone in three rings or less). On the other hand, from a gainsharing perspective, it is possible to improve performance in a target area (such as answering the phone in three rings or less) without significantly improving the bottom line. This can really hurt, as the company may have to pay out performance based bonuses even though no extra profits were generated to cover these payments. The plan should balance these needs, produce real financial return on investment, and be flexible enough that it can be adjusted every year as experience is gained and new issues arise.

Employee Intangibles: All good employees are motivated by the opportunity to make a difference, to be part of a team, and to accomplish something more than making a salary. A good EPSP or EGSP must connect to this intangible by linking what each employee does and how well they do it to meet the company short term goals and generate profits for all employees to share in. Everyone, from the company receptionist to the senior management, must believe they can and do have an affect on the success of the plan. This may require setting group or individual strategies and goals that are not directly related to profit, or not directly related to what other people are doing, but reflect things those employees do have some control over (e.g. how quickly client service calls are answered and dealt with, or "on time" delivery standards).

Employee Tangibles: Finally, a EPSP or EGSP must connect to the employees' tangible needs. Ultimately the plan must be financial rewarding, both in theory and in practice. The employees must not only be motivated by the *opportunity* to profit, but must actually achieve a reasonable amount of financial reward from the plan as well.

The Need for Fairness

As well as making good "connections", the plan must be perceived as "fair" if the employees are going to be positively motivated. There are two major ways that fairness is assessed.

Between Owners and Employees: Implementing the plan is going to require opening the company books to the employees. They will see what the plan does for them. They will also see what the plan does for the owners. This has volatile possibilities. The history of labour relations always comes down to what constitutes a "fair return on investment" to owners compared to what constitutes a "fair return on labour" to the employees. The employees will have to educated on return on investment, and the owners will have to ensure that the plan does not produce unfair results in favour of the owners themselves.

Among Employees: The other major area of "fairness" the plan must take into account is the distribution of plan monies among employees. The plan must be perceived as fair in how it determines who participates in the plan, how much each person can earn, and what they have to do earn their share. Many plans take into account the goals that the employees have to achieve as a group to "earn" their profit share. Just as much care needs to be taken in considering in how individuals participate in the results of the plan, otherwise the distribution of shares to potentially "undeserving" employees will spoil the impact of the plan for everyone.

Tax Issues, Deferred Profit Sharing Plans, RSPs and Group RSPs

When implementing an EPSP or EGSP, the employer has a chance to do some basic tax planning that may or may not affect the complexity and perceive value of the plan to its employees.

Basic Plan: A "basic" plan is not registered under the *Income Tax Act* ("ITA"). The monies paid to the plan are deductible to the employer as an employment expense, but must be fully allocated among the participating employees. Each employee's share is taxed in that employee's hands as employment income in the year that the employer takes the deduction. If the funds are held by a trustee and invested on behalf of the employees, then: all profits from the plan in each year are allocated to the participating employees and taxed in their hands in that year; employees are permitted to contribute funds to the plan for pooling of investment purposes; and the employee does not pay tax when he or she receives funds from the plan as the taxes will already have been paid. There are more complexities, but the essence is that there is no tax deferral to the employees participating in the plan and the plan must distribute enough funds to each employee in each year for them to cover their tax liability.

<u>Deferred Profit Sharing Plan</u>: One method for generating a tax deferral for the employees is to set up a Deferred Profit Sharing Plan ("DPSP"). A DPSP is a specific kind of EPSP registered under the *Income Tax Act* ("ITA"). Employer contributions must be tied to profits, are deductible in the year they are made, and are paid to a trustee on behalf of the employee members in the plan. The employer contributions are allocated to specific employees when they are made, but the employees do not pay tax on their allocated share until they take the funds out of the plan. This results in a tax deferral to the employees. In addition, if the funds remain pooled for investment purposes, then the profits from investment are also accumulated on a tax deferred basis, and taxes are not paid by the employees until the funds are disbursed. In this way, a DPSP works just like an RSP. In fact employer contributions may reduce each employee's annual RSP contribution limit; and each employee must withdraw its share of the plan by the time they turn sixty-nine. There are other technical requirements. Professional advisors will be required to implement a DPSP. However, this mechanism does result in a tax deferral to the employees and can be used as an alternative to a company pension plan. Please note that employees can not contribute to a DPSP, and only employer contributions go into the plan.

<u>RSPs</u>: Another tax deferral mechanism available to plan developers is the use of RSPs. Quite simply, the employee's shared from an EPSP or EGSP could be paid directly into his or her RSP. While their allocation will still be taxable, they will have a corresponding RSP contribution resulting in a tax deferral as long as the individual RSP limits are maintained.

<u>Group RSPs</u>: Finally, some employers do something similar by implementing a Group RSP for their employees. A typical arrangement would require each employee to make a minimum contribution to an RSP in their name through a group RSP program (e.g. 2% of gross salary). This is deducted by their employer from their regular payroll and remitted directly to the fund manager. This also permits the employee to immediately get the tax benefit for the amount of the deduction, reducing the source deductions taken from that paycheque. The employer then matches the employee's contribution, to a maximum percentage (e.g. 2% of gross pay). The employer gets the immediate deduction as an expense and the taxable benefit to the employee is tax deferred because it counts as an RSP contribution. The EPSP or EGSP then provides that plan payments are made directly to the same employee RSP as often as the plan pays out (quarterly, semi-annually or annually). The employer gets deduction for the contribution. The contribution is added to the employee's income from employment but the employee gets a tax deferral because it counts as an RSP contribution. The Group RSP is administered through a trustee (e.g. Investors Group) which manages the RSPs. Some plans provide that the contributions are "locked in" for a minimum period of time, to give a "retirement planning" element to the program. This kind of arrangement can be a "win, win" for the employer and the employee, and can allow smaller companies an opportunity to provide a "retirement plan" for its employees that is linked to

company and individual performance as opposed to being a flat percentage or salary or guaranteed future income. In addition, other variations on this program are possible.

The Basic Questions

What follows is a series of questions that can be used as a template for developing an EPSP or EGSP:

- Why are you doing it?
- Do you want a profit sharing plan, a gainsharing plan, or a hybrid of the two?
- To what extent is employee retirement planning part of what you are doing?
- Will you be distributing the money directly to the employees, or to a trustee on their behalf?
- What outside advisors are you going to use?
- To what extent are you going to involve employees or other internal advisors in developing, implementing or managing the plan?
- Who will be developing, implementing and managing the plan?
- What long term company goals will the plan be connecting to? Are they realistic, challenging and achievable? How will they provide return on investment in the plan itself?
- What short term company goals will the company be connecting to? Are they realistic, challenging and achievable? How will they provide return on investment in the plan itself?
- Are these goals measurable? When and how will they be measured? How will the results of these measurements be communicated?
- How do you want to define "profits"? Pre-tax profits is typical. However what role will amortization/depreciation and interest costs bear in your definition?
- How much "profit" will be allocated to the plan? 10% to 20% is typical. Or will it be tied to profit increases only? Will there be a cap of some kind? What checks and balances will be there, if any, to prevent unfairness one way or the other?
- What goals or standards must be met before you contribute the profit share to the plan? Does there have to be a direct improvement in profitability? Who will decide if these requirements have been met? How will disputes be resolved?
- How will the plan be funded? From cost reductions, profit improvements or something else?
- What employees will be included in the pool? Do all employees participate, or key managers only based upon position, or those who meet a certain seniority criteria?
- How will participating employees share in the risk as well as the rewards of the company? Asked another way, what will the participating employees sacrifice in order to be able to participate in the plan?
- How will the employees "connect" to company goals as set by the owner?
- What feedback program will be implemented in that regard, if any? Who will manage it?
- How will the pool be divided between individual employees? Will there be a seniority factor? Will there be other group or individual factors? Will these factors change as short term goals change? Who will determine whether an employee has met the requirements? How will disputes be involved?
- Will there be ceilings or caps on how much an individual employee can get? (e.g. percentage of salary)
- How will the plan interact with base salaries, commissions, bonuses or other benefits?
- Will management shares be linked to what their department employees get? You can make one employees share a percentage of what his or her team gets, so that the managers rewards are directly related to how well they coach their team.

- How often will the employer make contributions to the plan?
- How often will distributions be made to individual employees?
- Will a DPSP be involved?
- Will a Group RSP be involved?
- Will a trustee be used?
- Will you have non-cash alternatives? Non-cash alternatives include RSP contributions, vacation vouchers, electronic goods, increased company benefits, extra days off with pay.
- What education program will the company develop around the plan and the company goals it is meant to address? Who will manage it?
- What kind of renewal/flexibility program will there be? Who will manage it?
- How will you keep the plan simple yet deal with all of these issues?

Closing Thoughts

For owner managers looking to develop a performance based method of contributing to an employee retirement fund, a Group RSP profit sharing plan or Deferred Profit Sharing Plan is an excellent way funding such a commitment.

For owner managers looking to focus their employees on real attitude and behaviour changes that will benefit the company shareholders and its employees, a gainsharing plan is an excellent tool to consider.

For owner managers looking to get industry leading loyalty, productivity and commitment out of their employees, an EPSP or an EGSP is an alternative to discretionary bonuses that should be considered.

However, in the long run, it is not the plan itself but the process the company goes through to develop, implement and maintain a truly “win, win” plan which will provide the greatest benefit to the owner manager and his or her employees. This process will require the owner manager to reconsider his or her role in the company, set long term and short term goals for the company, and educate and involve the employees in setting and meeting company objectives. In the end, a well thought out and implemented EPSP or EGSP should bring the owner manager and his or her employees into a closer business relationship based upon common goals, a common vision, shared information and mutual respect and commitment.

Note: Please see a companion article written by Phil Thompson on Employee Share Ownership Plans (ESOPs).