Employee Stock Ownership Plan (ESOP) Advantages for Ownership Transition

Business owners are increasingly turning to ESOPs as a corporate finance tool to provide for liquidity and ownership transition. For the business owner, an ESOP is a way to create liquidity, preserve company independence, protect wealth, diversify assets, plan for an orderly and phased transition, and defer taxes. For employees, an ESOP is a company-funded retirement plan that offers an ownership stake in the company. For the company, an ESOP is a way to finance ownership transition in a tax-favored transaction. But what exactly is it?

What is an ESOP?

Employee Stock Ownership Plan (NOT a Stock Option Plan)

- Tax-qualified retirement plan created as part of the Employee Retirement Income Security Act ("ERISA") in 1974
- Regulated by U.S. Department of Labor and Internal Revenue Service
- Usually a company funded benefit - no employee contributions
- Company stock held in a trust; employees do NOT own the stock directly
- Tax efficient and controlled means of selling stock

There are approximately 12,000 ESOP companies nationwide, covering more than 13 million employees (data provided by NCEO – www.nceo.org).

How is the ESOP Different from Other Retirement Plans?

ESOPs are similar to other retirement plans such as 401(k) and profit-sharing plans, but they have several distinguishing characteristics:

- Unlike other plans, which are required by law to diversify their assets, ESOPs are **required** to invest primarily in the stock of the employer company.
- Unlike other retirement plans, ESOPs can borrow money to fund the purchase of a block of employer stock and repay this debt with tax deductible future employer contributions.

Therefore, ESOPs can be used by business owners to create an internal market to sell a block of company stock. The ESOP can purchase all or a portion of a company's stock in one or more transactions, depending on the goals of the shareholders. For business owners who want liquidity and diversification in stages, an ESOP may be an ideal approach.

Tax Advantages.

The government provides special tax incentives to spur creation of ESOPs. For example, ESOP purchases of stock from shareholders are made using tax-deductible dollars. In addition, shareholders who sell to an ESOP can defer capital gains taxes on the sale if the ESOP owns more than 30 percent of outstanding company shares, the company is a C

corporation, and the selling shareholder purchases “replacement” stocks or bonds issued by domestic operating corporations.

Unlike other S corporation shareholders, if an ESOP is a shareholder of a company that is an S corporation, the ESOP does not pay federal taxes (or state taxes in most cases) on its share of corporate income. A company which sponsors an ESOP that owns 100 percent of the company’s stock becomes effectively tax-free because, as an S corporation, the company pays no corporate income tax, and the ESOP, as a tax-exempt shareholder, pays no individual income tax on the corporation’s income. S corporation income tax benefits can also enable favorable financing for ESOP transactions.

How an ESOP Works.

The ESOP is a qualified pension trust. It acts on behalf of employees to purchase stock from shareholders or the company. An ESOP can use cash contributed to the trust by the employer to purchase company stock or it may borrow money from the company (which the company often borrows from a bank) to fund stock purchases In addition, some or all of the ESOP purchase price may be structured as seller financing.

ESOP transactions are generally organized by the company CEO and/or board of directors on behalf of company shareholders. The ESOP is managed by a Trustee, which can be a company employee or an outside institution. The board and/or the shareholders negotiate the terms of the transaction with the ESOP Trustee.

ESOP transactions are not “name your own price.” An ESOP Trustee must have an <u>independent</u> appraiser determine the fair market value of the shares of company stock to be purchased by the ESOP and cannot pay more than <u>fair market value</u> for the shares.

Good ESOP Candidates Have Many of the Following Characteristics:

- Steady non-cyclical growth prospects
- Stable cash flow
- Company’s earnings (or adjusted earnings that recognize post-transaction compensation changes) are at least $500,000
- Company’s appraised fair market value is at least $3,000,000
- Company has 25 or more employees and a relatively stable payroll base
- Owners are interested in remaining involved in the business
- Owners have a long-time horizon—not seeking immediate cash payment in full
- Owners are concerned about employees and the future of company and are motivated by "legacy" or mission goals in addition to cash
- Company is not an attractive target for a strategic buyer willing to pay significant premium.

Structured properly, ESOPs provide business owners with both liquidity and succession at a controlled pace, while simultaneously creating an employee benefit based largely on the success of the business. Numerous studies confirm that ESOP companies generally

outperform their non-ESOP counterparts, measured by both productivity and profitability. Participation in an ESOP gives employees a "piece of the action."

If you are looking for an exit strategy that offers fair value for your company ownership, doesn't require an immediate sale to a third party, and rewards the people who have helped build your business, consider an ESOP. It may be the right "win-win-win" strategy for the company, the shareholders and the employees.

Next Steps.

The first step in accomplishing an ESOP transaction is to analyze your company's financial information, revisit your business plan, and determine what you want to accomplish with the ESOP. The goal of this feasibility analysis, accomplished with or without outside professional help, is an approximate valuation of the company and an ESOP transaction design that will meet your reasonable and achievable goals and objectives.

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