Employee Buyouts and Succession Planning

Michael Hermes

An employee buyout might provide a sensible alternative to satisfying a small business owner's plan for selling their business. In the event a family member or a third party has little interest in purchasing the interest, an employee buyout might be an effective substitute. In some cases, an employee buyout can be the owner's succession plan from the very beginning. The employees typically understand the business and the circumstances that led to the proposed buyout, which often makes negotiations easier. Regardless of the situation, it is a practical option that should be considered when the owner has groomed a capable management team.

An employee buyout can offer a few potential advantages. Foremost, the owner's interest in the business will be acquired by employees who will preserve their positions in the business and maintain its autonomy. In addition, the owners have a way to reward their employees by giving them the opportunity to own the business that they helped build. The employee buyout group gains greater control over the future of the business and the opportunity to profit from its familiarity with the business's operations.

One strategy for completing an employee buyout is a stock redemption. In a stock redemption employee buyout, a management group acquires the stock or assets of a company, usually with the aid of external financing. The selling shareholders may then be paid over a term of years with a corporate note funded by future business earnings. This combined sale-redemption is eligible for capital gain treatment, provided the two transactions are pursuant to a single plan and accomplished in reasonable time proximity.

Another transaction to consider is a nonqualified stock option plan. Under a nonqualified stock option plan, the employee group receiving the stock may recognize ordinary income (for both regular tax and AMT) for the stock received, unless the stock is restricted. Stock is restricted when it is subject to a substantial risk of forfeiture and not transferable. Stock is subject to a substantial risk of forfeiture if the rights to its full enjoyment are conditioned, directly or indirectly, upon the future performance, or lack of performance, of substantial services by the employee. Stock is transferable if the employee can transfer any interest in the stock to any person other than the employer, and the transferee's rights in the stock are not subject to a substantial risk of forfeiture. Therefore, the stock is not transferable if the employee can sell, assign, or pledge his interest in it to any person other than the employer but the other person is required to give up the stock or its value if the event causing the substantial risk of forfeiture occurs. The company gets a tax deduction equal to the amount of ordinary income recognized by the employee. If restricted stock is received upon exercise of an NQSO, the employee's ordinary compensation income and the employer's compensation deduction are recognized when vesting occurs unless the employee makes a Section 83(b) election. The amount of income and the corresponding deduction are the stock's value when it vests over the amount, if any, of the option.

An employee buyout is not an easy process, and the most common characteristic of successful employee buyouts is early planning. If the owners have been effectively preparing for an employee takeover, the likelihood of success is much greater than if a hasty decision becomes necessary.

For more information on effective business succession planning, contact one of the tax professionals at Zinner & Co. LLP.