



12 Benefits of
Incorporating an ESOP
in Your
Business Exit Strategy

ESOP Defined

- An employee stock ownership plan (ESOP) is a qualified retirement plan that buys, holds, and sells company stock for the benefit of the employees, providing them with an ownership stake in the company.
- Since ESOPs are qualified retirement plans, they must satisfy the requirements of the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA).
- An ESOP is a defined contribution retirement plan. It is a stock bonus plan designed to invest primarily in qualifying employer securities.
- An ESOP is the only retirement plan that can borrow money from the company to purchase shares without creating a prohibited transaction.
- An ESOP is subject to the same vesting, eligibility, coverage, and other compliance testing requirements as other qualified retirement plans.

ESOP Basics

- The company pays costs, not employees.
- An ESOP provides employees with an ownership stake in the company.
- The ESOP trust purchases stock on employees' behalf.
- Employees do not own stock directly.
- Employee voting rights are normally limited to major company decisions, as required by law.
- ESOPs can be a tax-advantaged tool for financing growth.
- An ESOP can be an important tax savings device.

ESOP Facts

- There are approximately 7,000 ESOPs in place in the U.S., covering 13.5 million.
- ESOPs are found in all industries. The overwhelming majority of ESOP companies are privately held and do not file public reports with the SEC.
- Approximately 4,000 ESOP companies are majority-owned by the ESOP.
- A 1986 NCEO study found that employee ownership firms that practice participative management grow 8% to 11% per year faster with their ownership plans than they would have without them.

(Source: NCEO)

ESOP Facts

- Companies with ESOPs and other broad-based employee ownership plans account for well over half of Fortune Magazine's "100 Best Companies to Work for in America" list year after year.
- At least 70% of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the employer securities held by the ESOP trustee.
- Earnings attributable to the ESOP's ownership share in S-Corporations are not taxable.
- ESOPs can be as small as 15 employees and as large as several thousand employees.

(Source: NCEO)

An ESOP Exit Strategy Increases After-Tax Proceeds (1 of 2)

- When a business is sold to a third party, the buyer generally prefers to purchase a company's assets rather than its stock for liability and tax reasons. Selling to an ESOP is always a stock sale which is more favorable from a tax standpoint than a traditional asset sale. When analyzing the purchase price, it is essential to consider the after-tax proceeds when comparing an ESOP transaction sale to a third-party sale.
- In a stock sale, the seller is generally eligible for long-term capital gains treatment at the current long-term capital gains rate. The top capital gains rate is currently 20% plus the additional 3.8% Medicare Tax on Unearned Income above a certain threshold as a result of the Health Care and Education Reconciliation Act of 2010.
- In the more common third-party sale alternative, the asset sale, some or all of the sales proceeds are generally taxed at the higher ordinary income rate. The top ordinary income tax rate is currently 39.6% plus the additional 0.9% FICA tax above a certain threshold as a result of the Health Care and Education Reconciliation Act of 2010.

An ESOP Exit Strategy

Increases After-Tax Proceeds (2 of 2)

- If a sale involves a C-Corporation, a stock sale to an ESOP may offer you additional tax savings. A C-Corporation asset sale may be subject to double taxation since the company pays taxes on the gain from the sale of the asset, and, in addition, the seller pays taxes when a dividend is subsequently paid.
- There are additional ways to increase the after-tax proceeds in a sale to an ESOP by
 - receiving full payment at fair market value,
 - tax deductions,
 - obtaining additional value for the seller via ESOP participation and synthetic equity, and
 - selling to an ESOP obtaining a 10-12%+ rate of return on seller-financed amounts, if any.
- There is an alternative ESOP sale, the Section 1042 sale to an ESOP, that allows the seller to defer or avoid altogether the taxation on the sale to an ESOP.

An ESOP Exit Strategy Increases Cash Flow by Eliminating Income Taxes

- S-Corporation ESOP companies are not subject to income taxation (federal and most states), increasing cash flow and providing the company with a competitive advantage. S-corporations pass through their corporate income to their shareholders for federal income tax purposes. The shareholders receive an IRS Form K-1 and report the flow-through of the income on their personal tax returns based on their individual federal and state income tax rates.
- As a result of the Small Business Job Protection Act of 1996, ESOP trusts are eligible S-Corporation shareholders. The new S-Corporation shareholder, the ESOP trust, is a tax exempt entity not subject to income taxes. The Taxpayer Relief Act of 1997 and IRC Section 512(e) repealed the application of unrelated business taxable income (UBTI) for ESOPs effective for taxable years beginning on or after January 1, 1998.
- This is a very powerful tax advantage that provides the cash flow to fund the purchase of the company from the selling shareholders. Once the debt has been paid the additional cash flow provides a company with a competitive advantage over their non-ESOP counterparts.

An ESOP Exit Strategy Pays for Itself (1 of 2)

- The tax savings achieved by selling to an ESOP will provide the funding for most or all of the sale of the company to the ESOP.
- The portion of income attributable to an S-Corporation owned by an ESOP is not subject to federal (and most state) income taxation. S-corporation shareholders generally receive dividends each year sufficient to pay their estimated taxes on their portion of the company's income reported on IRS Form K-1. The payment of dividends by the company can represent a significant cash outlay for the company.
- In the case of a 100% ESOP-owned company, there are no estimated tax payments and therefore there is no need to pay dividends. This cash flow savings provides a powerful advantage by freeing up cash flow to fund most of the purchase of the company by the ESOP from the business owner.

An ESOP Exit Strategy Pays for Itself (2 of 2)

- The following is an illustration of what a typical company would look like:

	Before ESOP	After ESOP
EBITDA	\$1,000,000	\$1,000,000
Estimated Taxes (40%)	(400,000)	
Estimated ESOP Debt Service*		(424,768)
Available Earnings after ESOP Debt Service	\$600,000	\$575,232

- In addition to the minimum scheduled payments, some or all of the available earnings after ESOP debt service can be applied to the debt service at the discretion of the Board of Directors. In the example above, if most of the remaining earnings were applied to ESOP debt service the full loan could be paid in less than 6 years (without considering additional earnings created by the ongoing growth of the company).
- The cash flow savings above are one of the reasons that selling to an ESOP is the most cash and tax-efficient business exit strategies available to business owners.

An ESOP Exit Strategy Can Provide Seller 10-12% Rate of Return & Manages Investment Risk (1 of 3)

- Selling 100% of the company is the most cash and tax-efficient solution because selling to an ESOP increases cash flow by eliminating income taxes and ultimately pays for itself.
- In addition to bank financing, seller financing a portion of an ESOP sale can help manage a business owner's investment and inflation risk. Additionally, it can provide a steady and healthy ROR (the ROR could exceed 10-12% or more).

An ESOP Exit Strategy Can Provide Seller 10-12% Rate of Return & Manages Investment Risk (2 of 3)

- Many business owners have found the overall ROR of a seller financed ESOP more favorable than the investment alternatives of real estate and the stock market in today's economic environment. If lending conditions or the liquidity needs of the business owner change, then the option for the company to obtain financing for all or a portion of the debt is still available.
- We are finding that business owners who have no or limited immediate liquidity needs are opting to structure the transaction to seller finance most or all of the entire transaction. This approach protects the company by avoiding the bank's many restrictive covenants and providing a more flexible and friendly lending partner for the company. At the same time, the business owner gets to enjoy a steady and healthy ROR (the ROR could be 10-12% or more) while managing their investment and inflation risk.

An ESOP Exit Strategy Can Provide Seller 10-12% Rate of Return & Manages Investment Risk (3 of 3)

- This ROR is obtained through a combination of an interest rate on the seller note and synthetic equity. The synthetic equity provides an opportunity for the business owner to continue to share in and be compensated for the future growth of the company and can be paid using many different instruments including:
 - stock options or stock warrants,
 - PIK (payment in kind) loans,
 - and/or stock appreciation rights (SARs).
- There is a lot of flexibility in determining the makeup of the interest rate and synthetic equity instruments. Variables include the facts and circumstances of each situation and the liquidity objectives of the business owner.

An ESOP Exit Strategy Provides Value Beyond After-Tax Sale Proceeds (1 of 2)

In addition to the Higher After-Tax Return, selling to an ESOP can provide ways to capture additional consideration and benefits for the selling shareholder above and beyond the sale proceeds.

ESOP Account Balance

- In many cases the business owner will take advantage of the opportunity to sell to an ESOP while retaining control of the company or remain employed with the company.
- The seller will likely be the employee with the highest compensation in the company and be eligible to participate in the ESOP.
- The seller would then receive annual ESOP allocations (usually the largest ESOP allocations) of the stock that was sold to the ESOP.
- This would accumulate in an ERISA-protected benefit that would be paid after the seller leaves the company.

NOTE: This option is not available to business owners who elect to Sell Stock to an ESOP in an IRC Section 1042 Tax Deferred Sale

An ESOP Exit Strategy Provides Value Beyond After-Tax Sale Proceeds (2 of 2)

Synthetic Equity

- The terms of a sale to an ESOP often include a synthetic equity instrument to provide an additional payment and incentive for the seller to remain employed and engaged, to grow the company, and quickly pay off the ESOP external debt. Synthetic equity may also be warranted to provide additional consideration when the seller is financing part or all of a transaction, particularly when the seller is assuming subordinated debt.
- Synthetic equity is defined by the IRS as *“any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future”*.
- Stock Appreciation Rights (SARs) are one of the most common types of synthetic equity due to the flexibility offered to meet the company's objectives and provide employees with the value of a stock award without requiring the purchase of the instrument.

NOTE: It is also important to understand the impact that synthetic equity has on the IRC Section 409(p) Anti-Abuse Testing.

An ESOP Exit Strategy Provides Full Payment at Fair Market Value

- Another benefit is that the seller is allowed to sell to an ESOP for full fair market value of the company (but not more than fair market value) as determined by an independent appraiser. The protection provided by the Internal Revenue Code to engage an independent appraiser protects the ESOP participants and ensures that the full fair market value of the company is used in the determination of the sale price.
- While this means that a strategic or synergistic buyer has the potential to offer more (before taxes) than an ESOP (if you can find such a buyer), it also means that **the ESOP is able to consistently offer fair market value**, something other non-synergistic buyers may not be offering.
- If you do find a third-party buyer to sell at the price you are looking for, they will be motivated to protect their new investment. As a result, third-party sales will likely involve escrow payments, holdbacks, earn-outs, and/or employment agreements. Selling to an ESOP for full payment minimizes these alternatives.

An ESOP Exit Strategy Enables Business Owners to Defer/Avoid Taxation on the Sale Proceeds

There is an alternative ESOP sale that allows the seller to Defer/Avoid Taxation in an **ESOP Section 1042 Sale**.

- In a Section 1042 sale, if the business owner:
 - (1) makes the appropriate election,
 - (2) sells enough C Corporation company stock so the ESOP owns at least 30% of the company after the transaction, and
 - (3) invests (a.k.a. rollover) the sale proceeds in qualified replacement property (QRP) within the replacement period (3 months prior to 12 months after), then any gains are deferred until the QRP is liquidated (and then taxed at long-term capital gains rates).
- If the seller still holds the QRP at death, then the QRP will receive a step-up in basis and taxation will be avoided altogether.
- Deferring or avoiding taxes will ultimately increase the after-tax sale proceeds. This is a powerful business transition and succession planning strategy that will become more valuable as capital gains increase.

An ESOP Exit Strategy Creates Internal Market & Built-In Buyer In 60-90 Days

- The lack of a qualified buyer creates a problem for many business owners, especially in our current economic environment. This can especially be a problem for small business and businesses located in rural areas or specialized industries.
- An ESOP creates an internal market and “built-in buyer” who is able and ready to purchase some or all of the stock of the company from the business owner at fair market value.
- While a more realistic time frame is three to six months, a properly planned straightforward ESOP transaction can take place in 60-90 days if the seller is committed to selling to an ESOP and is willing and able to respond quickly and make timely decisions.
- If you are comparing your business transition alternatives, you should contrast this with the timing to find and sell to a third party. Preparing a company to sell on the market could itself take three to six months; the sale could take six months to two years or longer.

An ESOP Exit Strategy Enables Business Owners to Sell While Retaining Control of the Company

- One reason business owners put off succession planning or even contemplating the thought of selling their business is because they are not ready to retire. They legitimately worry about the loss of control of handing over the company to a third party.
- Selling to an ESOP enables a business owner to sell all or a portion of the company, providing a business owner with liquidity and diversification, while at the same time retaining control of the day-to-day operations of the company.
- An ESOP company, like any other corporation, is governed by the **Board of Directors**. In cases where the business owner prefers to maintain control, they would continue to serve in their capacity as company President and Chairman of the Board. This approach also allows the business owner to facilitate the business transition process and transfer control gradually and orderly.
- If the business owner is also seller financing a transaction, additional control protections would be contained in the loan covenants.

An ESOP Exit Strategy Provides Liquidity & Diversification

- Business owners can build a significant amount of wealth in the company they have invested their life creating and growing. Unfortunately, this value is accumulated in an otherwise illiquid asset, preventing a business owner from enjoying the fruits of his or her labor. There is also the risk of having a large portion of wealth tied up in a single concentrated stock position.
- Selling all or part of the company to an ESOP provides a business owner with both liquidity and diversification. This option can provide almost immediate access to all or a portion of a business owner's personal wealth that is currently tied up in their illiquid business. It also reduces the investment risk of having all of their wealth in one closely held investment and enables the business owner to build a more diversified portfolio.
- If all or part of the transaction is seller financed, the rate of return on the seller note can help further expand the diversification of their portfolio and further reduce their investment and inflation risk.

An ESOP Exit Strategy Is Always a Stock Sale That Transfers Assets & Liabilities (1 of 2)

- When a business is sold to a third party, the buyer generally prefers to purchase a company's assets rather than its stock, whereas the seller would rather sell the stock. The decision of asset sale or stock sale is often subject to the negotiation process and is an important consideration when developing your business exit strategy. A very powerful benefit of selling to an ESOP as part of your business succession plan is that an ESOP transaction is always a stock sale. This is generally more favorable from a tax standpoint than a traditional asset sale.
- In addition to the tax benefits, a stock sale is generally more favorable from a legal standpoint as well.

An ESOP Exit Strategy Is Always a Stock Sale That Transfers Assets & Liabilities (2 of 2)

- By using an ESOP to acquire the company, the assets and liabilities of the company (both known and unknown) are transferred as part of the sale. The legal title of assets will not need to be separately transferred (in an asset sale the legal title would likely need to be transferred). Important legal contracts in the name of the company, such as leases, employee-related agreements, and vendor contracts, will generally continue to be in effect after the sale of stock (in an asset sale, the contracts will likely need to specifically provide for assignment of the contracts without consent).
- The business owner is able to walk away from many risks inherent to ownership, including existing contractual obligations, taxes, employee benefit plans, or potential future liabilities, even if the business owner retains control of the company after the sale to the ESOP.

An ESOP Exit Strategy Saves Local Jobs, Strengthens Community, Rewards Employees, & Preserves Company Legacy (1 of 2)

- When a small business is put up for sale to a third party, particularly in rural areas, local jobs and the other benefits are at risk. Since an acquiring business may not have ties to the local community, they could liquidate the assets of the company or relocate the company operations to a different location. This obviously has negative consequences for the employees and the community as a whole.
- Selling to an ESOP significantly increases the likelihood that a company will remain locally owned, jobs will remain in the local community, and the legacy of the company will continue. This local ownership exists, not only while the business owner still retains control after selling to an ESOP, but also after transitioning control of the company to the next generation of leadership.

An ESOP Exit Strategy Saves Local Jobs, Strengthens Community, Rewards Employees, & Preserves Company Legacy (1 of 2)

- In addition to protecting jobs and the impact of the dollars spent in the local community, small businesses provide stability and many other financial and social benefits.
- Many owners would prefer to sell to their employees to reward the loyalty that helped build the business.
- In doing so, the owner preserves the company's legacy they have built.

CONTACT US

If an ESOP sounds like an alternative you would like to explore in more detail you can:

- call us at (920) 659-6000,
- request a [No-cost Feasibility Analysis](#) by visiting our website at www.esoppartners.com, and
- get more information on our [One Stop ESOP Blog](#).