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Business Transaction Marketplace

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Selling to Employees Using an ESOP

In the December 2009 Issue of *Business Transaction Marketplace*[SM], we began the discussion of the most common internal transferees (buyers) of a privately held company – Employee Stock Ownership Plans (ESOPs) being one of them.

An ESOP might be a good fit in these situations:

- There is no family member with the talent and capital to take over the business
- There is only a limited number of third-party buyers
- The business owner wants to reward loyal employees, and retain the corporate culture and identity
- The business owner wants to stay involved after the sale, and is also willing to sell a partial interest
- Obtaining the highest price for the stock is not the business owner's sole motivation

In this issue of *Business Transaction Marketplace*[SM], we'll discuss ESOPs as a business ownership transfer strategy.

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What is an ESOP?

An ESOP is a qualified, defined contribution employee benefit plan that invests primarily in the stock of the sponsoring company. The sponsor creates a trust fund for the benefit of its employees, commonly funded initially by contributing company shares or annual cash contributions to the Plan.

The three most common uses of ESOPs are: 1) buying the stock of a retiring owner (No. 1 reason); 2) an extra employee benefit plan; and 3) a source of capital for growth, making acquisitions, etc. It's estimated that there are approximately 11,000 ESOPs in the US, 95% of which are sponsored by a privately held company.

ESOP Advantages

Tax Deferred Rollover. If an ESOP acquires at least 30% of the stock, the selling shareholder(s) are eligible for a tax deferred §1042 rollover reinvestment of the sales proceeds into *qualifying replacement property* (i.e. stocks, bonds and other US *securities*).

Favorable Corporate Tax Savings. ESOP contributions are tax deductible by the sponsor, just like contributions to any other qualified retirement plan. In the case of payments made to service the debt in a *leveraged ESOP*, the sponsor can obtain the following tax deductions: a) up to 25% of eligible payroll to service debt principal; b) dividends paid to service debt principal; and c) interest expense associated with the ESOP debt. One of the most significant tax savings is that an ESOP can be an S Corp shareholder, thus sheltering any income tax from S Corp earnings allocated to the ESOP.

Employee Motivation. ESOPs can be an important means to motivate employees and increase productivity. Greater productivity hopefully produces larger profits, which in turn increases the value of the company, and the future retirement benefits for the employees.

Source of Capital. An ESOP can purchase (or the company can make non-cash contributions of) newly issued shares, and thus generate new capital for the company on a tax-deductible basis.

ESOP Disadvantages

Repurchase Liability. ESOPs are required by law to have a *put option*. This enables departing employees with vested shares to put their shares either to the company or to the ESOP in order to gain liquidity. This emerging liability grows over time as shares vest with the employees – becoming even larger as the value of the company grows.

Fiduciary Liability. An ESOP must have one or more trustees responsible for the operation of the Plan for the exclusive benefit of the participant employees. Independent fiduciaries may be preferred, but normally key managers or employees are placed in the position of ESOP trustees. Trustees must be aware of possible conflicts of interest which may arise between the ESOP, the company, the bank, or the selling shareholders.

Administrative Cost and Complexity. ESOPs are more complex and expensive to operate than most other types of retirement plans. Legal, accounting and appraisal fees are normally highest the first year – often in the $40-50,000 range. The company will incur ongoing costs with an independent plan administration firm to handle the ESOP accounting. In addition, there is an annual requirement for an independent appraisal; more frequent appraisals if the ESOP engages in transactions with insiders.

Selling Shareholder Loan Guarantees. The qualified lender in a *leveraged ESOP* often takes possession of the selling shareholder's rollover investments as additional collateral for the ESOP loan. The selling shareholder's collateral may be released as the ESOP loan is paid down.

Setting up an ESOP

Assuming the purpose of the ESOP is to buy out a retiring owner's interest, here are some suggested steps to implement an ESOP:

1. Educate Yourself. Attend workshops on ESOPs to understand better how they work; weigh the advantages and disadvantages of implementing an ESOP. Discuss the idea with other stakeholders (other owners, management and family) to see if an ESOP will create problems down the road. Talk to other executives/business owners who have used ESOPs to buy out owners.
2. Conduct a Preliminary Valuation. Having a preliminary valuation done on the company before implementing an ESOP is critical. If the value of the stock is too low, the business owner(s) may be unwilling to sell. Alternatively, if the value is too high, the company may be unable to afford the purchase.
3. Conduct a Feasibility Study. This may be done by an outside consultant, or carefully performed in-house. The study will rely on the preliminary valuation, and should look at the following: a) assess how much operating cash flow the company has available to devote to the ESOP; b) determine if the company has adequate payroll in order for ESOP contributions to be deductible; and c) estimate what the repurchase obligation will be and how it will be handled in the future by the company and the ESOP.
4. Hire an ESOP Attorney. If the first three steps are positive, discuss your objectives and options with an ESOP attorney. If an ESOP continues to be a viable ownership transfer strategy, the attorney can then begin drafting the Plan that will be submitted to the IRS in obtaining a determination letter.
5. Obtain Funding. The ESOP can be funded from several sources to include: a) annul company cash contributions; b) bank borrowings; and c) seller financing. Rollover monies from other retirement plans and employee contributions are possible, but with caution because of the need to be in compliance with securities laws.
6. Establish the Governance to Operate the Plan. This will include having a board of trustees (insiders and maybe outsiders), an ESOP attorney, a plan administrator, and an outside valuation firm.

Free ESOP Feasibility Checklist

If you would like to receive a one-page *ESOP Feasibility Checklist*, send an email message to darne@arne-co.com – subject line "ESOP Feasibility Checklist" – and we'll email it to you.

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