A Beginner's Guide to ESOPs

Why Your Employees Might Be Your Best Succession Plan

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When you are gone, who will carry the torch?

Chances are, you have been giving this question some thought lately. You might be discussing options such as selling to a competitor or to a third party.

Maybe you have even discussed selling the business to a group of key managers. After all, your employees are the group of people who know your business better than anyone else, and they have nearly as deep an interest in its success as you do.

But here is the deal: Many of these key employees do not have the funds to buy you out. So for most business owners, the line of thought ends here. After all, you cannot give them the money to buy you out ... can you?

Actually, an Employee Stock Ownership Plan (ESOP) can allow you to accomplish a transition to your employees because it enables them to borrow the funds to buy the business in a tax-efficient manner. And because of its tax advantages, an ESOP transaction could reap greater after-tax proceeds than might be possible from a third-party buyer who is willing to pay a premium.

This beginner's guide is designed to only scratch the surface of ESOPs, which are complex structures that depend on your specific situation. If you have any questions, or would like to discuss next steps, we encourage you to contact us for a no-obligation consultation.

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What is an ESOP?

"Does this mean I will be working for my employees?"

"I will make less money on an ESOP sale than if I sell to a third party, right?"

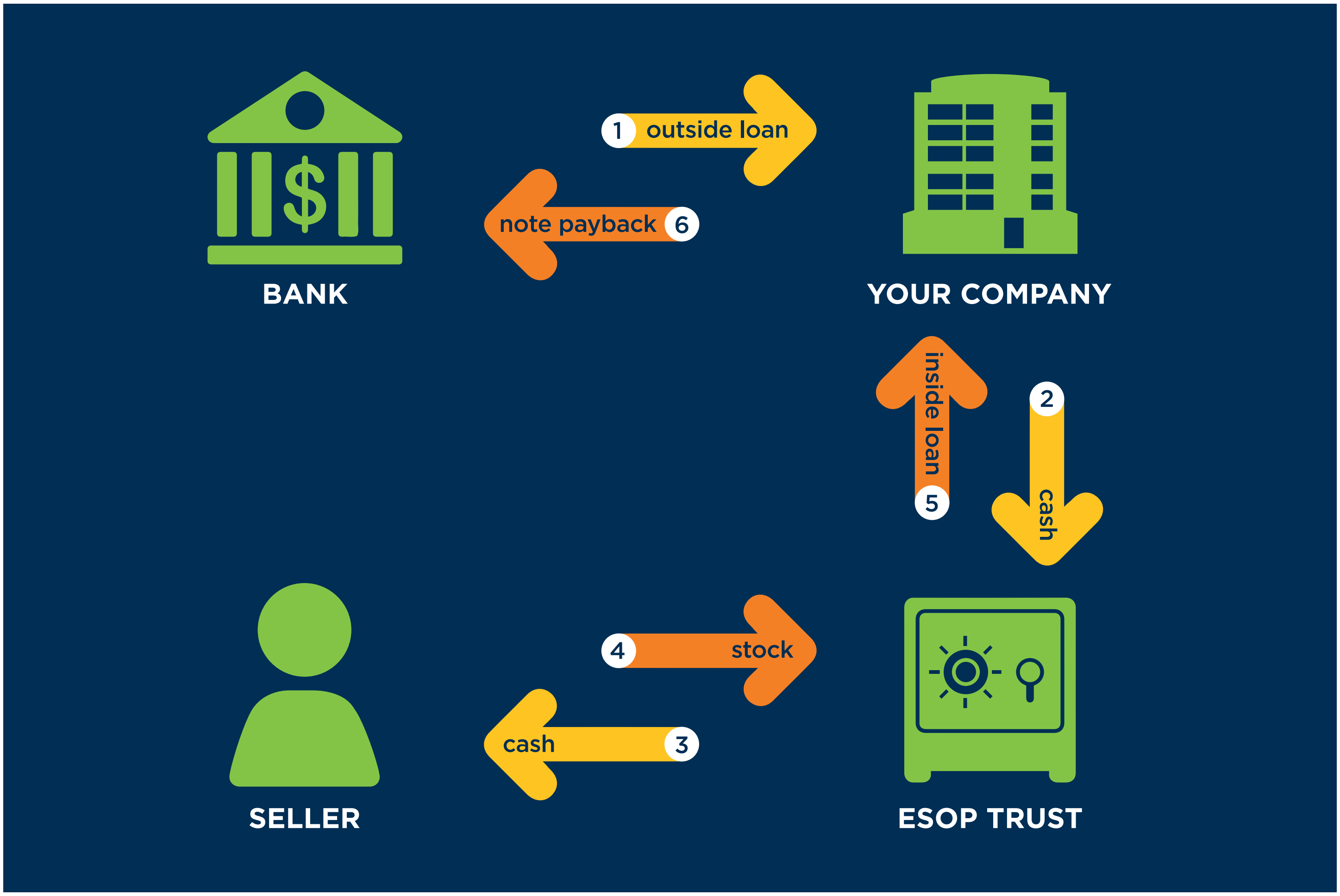
What is an ESOP (and what is it not)?

An ESOP is first and foremost a qualified retirement plan, similar to a 401(k). Where it differs from other retirement plans is that it invests primarily in the sponsoring employer's stock.

Before we dig into the details of how ESOPs work, let us clear up some of the biggest misconceptions.

"Does this mean I will be working for my employees?"
No. Ownership and control are two related but distinct concepts. In an ESOP transaction, you sell your stock in the company (or a portion of it), but you can retain control of business decisions for the company.

"I will make less money on an ESOP sale than if I sell to a third party, right?"
Not necessarily. This misconception stems from the fact that the sale price of an ESOP must be set at fair market value, which might be lower than the value assigned by a buyer who has a strategic interest in your company. However, because of the unique tax advantages, net proceeds from an ESOP can actually be greater than they would be from a sale to an outside buyer. Frequently, the cost of creating an ESOP is less than the cost incurred in selling to a third party.



How is a typical ESOP structured?

Let us take a look at how a typical ESOP transaction works. First, your company forms a trust that will own the company shares on behalf of the plan beneficiaries (i.e., the employees).

But the ESOP Trust has no money with which to buy your company's shares. Where does the ESOP Trust turn for the funds to purchase those shares? To your company! Because an ESOP is permitted to borrow funds in order to acquire company stock, your company makes an "inside," or "related party," loan to fund the buyout.

Your company does not have excess cash sitting around to make this loan, so it goes to a bank for an "outside" loan that is secured against the assets of the company.

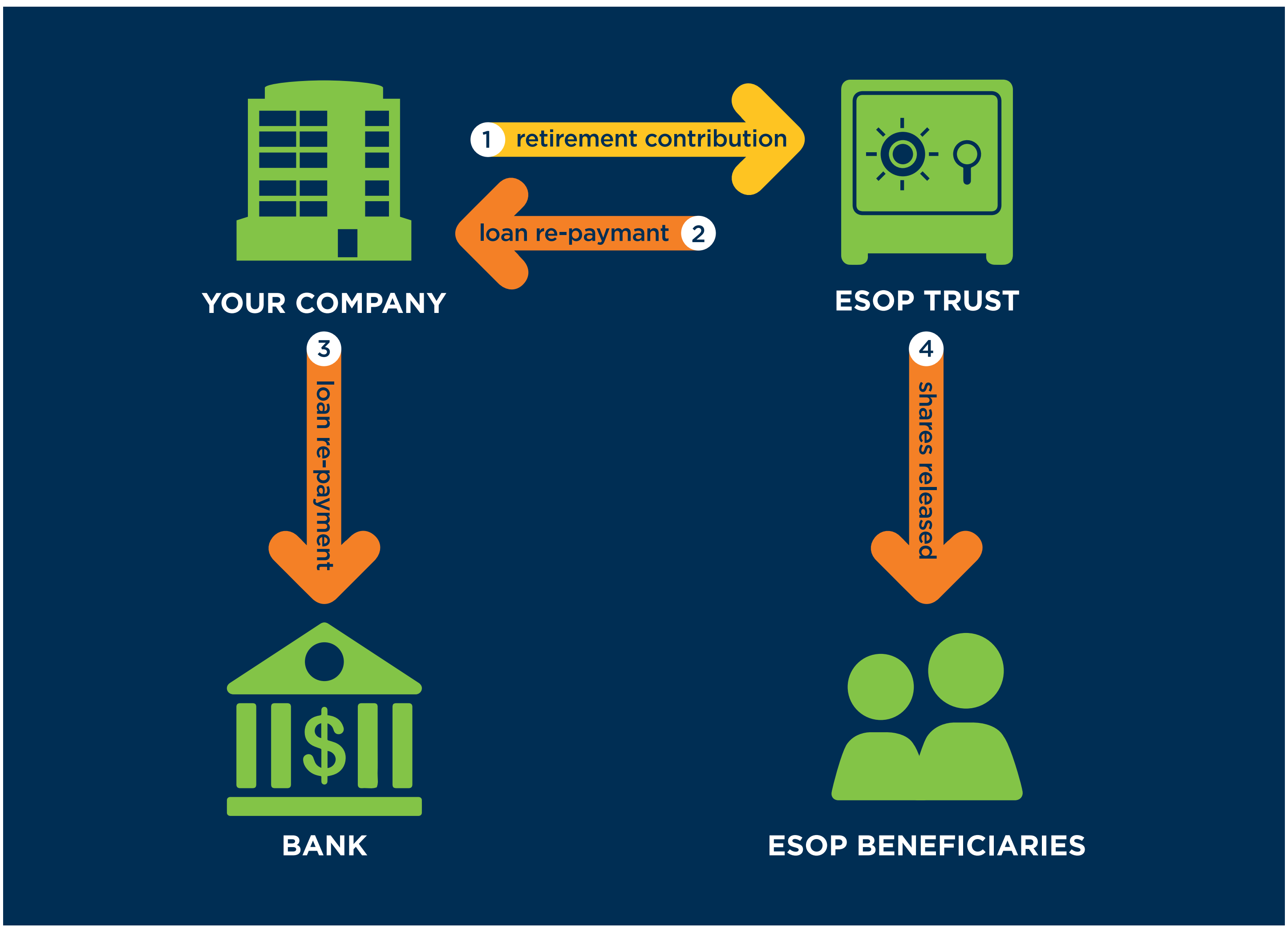
Here is a quick recap of the money trail so far: At this point, cash has traveled from the bank to your company to the ESOP Trust. Next, the ESOP Trust uses that cash to buy stock from your company's shareholders. ESOP regulations dictate that an ESOP must purchase *corporate stock*—not partnership or LLC members' units.

Where do the retirement funds come from?

Now that the ESOP Trust owns some or all of your company's stock, it must begin to pay back the inside loan it took out to purchase those shares, and your company must begin to fund the retirement plan. The beauty of the ESOP is that the same pool of money is used to accomplish all of those objectives.

Here is how it works: Your company makes retirement plan contributions to the ESOP Trust. Because the ESOP is a qualified retirement plan, similar to a 401(k) plan, your company can deduct those contributions on its income tax returns. The ESOP Trust then uses those retirement plan contributions to repay its inside loan to your company, which uses those same funds to repay its outside loan from the bank.

So in essence, your company's tax-deductible contributions to the ESOP are being used to pay off the loan that was taken out to set up the ESOP.



What are the advantages of ESOPs?

Tax Advantages

You can see why we say that the structure of an ESOP can make it a more tax-advantaged alternative to a traditional third-party sale.

An ESOP offers tax advantages on several levels.

- Your company: The money contributed to the qualified retirement plan (and that is used to repay its loan) is tax deductible.
- Shareholders of C corporations: The shareholders who sold their shares to the ESOP can defer capital gains tax payments on those proceeds.
- ESOP Trust: If your company is taxed as a sub-S corporation, then its earnings are not subject to federal tax. Employees will then be taxed on the distribution from the ESOP, if not rolled into an IRA.

Employee Attraction and Retention

Because employees only receive company shares as long as they are employed by the company ("You must be present to win!"), they have a strong incentive to stay. An ESOP can also present a compelling way to attract employees—especially high-level executives who seek a sense of ownership. And retaining that group of motivated management team members is one of the most critical factors in the success of an ESOP (see below).

Employee Ownership Culture

Employees who stick around are valuable, but only if they act in ways that increase the value of company. To encourage the development of a culture that empowers employees and rewards them for taking an interest in the success of the asset that they now own, share company performance data in ways that emphasize how each work group contributes to the success of the company.

Is an ESOP right for my company?

Will an ESOP work for your company? Some of the most important determinants of an ESOP's success are:

- ☐ Capable management team to succeed owner(s)
- ☐ Unused debt capacity
- ☐ Adequate employee size

The management team's ability to lead directly influences the ongoing profitability of the business, which in turn determines the ESOP's ability to repay its debt. If your company does not have a strong management team, or if key members are leaving, part of the ESOP transaction might include building a more formal management structure.

Your company's ability to borrow money is another linchpin in a successful ESOP transaction. Aside from the fact that excess debt can reduce the value of the shareholders' stock, a heavily leveraged company also has limited debt capacity with which to fund a buyout.

Some additional characteristics that might indicate an ESOP is right for you include:

- ☐ Owner approaching retirement
- ☐ Profits to support ESOP debt service
- ☐ Company size (more cost-effective benefits)
- ☐ Motivated by tax advantages
- ☐ Motivated by "ownership culture" advantages
- ☐ Desire to buy out a minority shareholder
- ☐ Limited third party / strategic buyers in market

What should I do next?

For more information about this complex but useful structure, we encourage you to contact us for a no-obligation consultation.

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