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Ownership Transitions: An Employee Stock Ownership Plan as a Succession Tool

An article by Hugh E. Reynolds, CPA

An employee stock ownership plan (ESOP) is an attractive option for business owners as an alternative to selling a business using a management buyout or outright sale.[1] With current favorable tax laws and numerous benefits for stakeholders, business owners looking to transition ownership may want to consider an ESOP.

What Is an ESOP?

ESOPs are tax-qualified retirement plans similar to traditional profit-sharing plans and subject to most of the same *Employee Retirement Income Security Act of 1974* (ERISA) requirements. Unlike other qualified retirement plans, however, an ESOP must primarily invest in employer stock, and the ESOP can borrow money to buy employer stock. An ESOP can be used to purchase shares and can make significant stock purchases. It is common for an ESOP to purchase 100 percent of the company stock in one transaction.

In an ESOP, the participants (employees) are beneficial owners of the business. The actual owner of the ESOP is the ESOP's trust. A trustee is appointed by the company's board of directors to represent the interests of the participants.

Potential tax incentives for the seller and the company make ESOPs desirable arrangements for business owners looking to transition their businesses. If an owner sells C-corporation stock to an ESOP and meets certain requirements, he or she can defer the capital gains tax on the sale of the stock. Contributions to an ESOP are tax deductible. In addition, if the company post-transaction is an S corporation – a pass-through entity in which the income from the corporation passes through its shareholders – effectively the company no longer pays federal and most state income taxes on income attributed to the ESOP-owned shares. This can be a big advantage because it provides additional cash flow to pay debt – cash that otherwise would not be available under other business ownership succession plans such as a management buyout structure.

How an ESOP Transaction Works

Prior to the ESOP transaction, the board of directors appoints a trustee to represent the ESOP during the transaction. Often, the board appoints an institutional trustee. However, an individual also may act as trustee. In general, the seller or another company insider should not serve as trustee for the ESOP transaction. Once appointed, the trustee will hire advisers to the ESOP, such as an attorney and financial adviser (valuation firm), to assist with negotiating the transaction terms and determining if the transaction is fair.

Post-transaction, the trustee continues to have responsibilities, including annually determining the year-end stock value and voting the shares. ESOP employees can directly vote their allocated ESOP shares on a few issues, such as recapitalization or liquidation and sale of substantially all the company's assets.

ESOP transactions can take many forms. However, post-transaction it is typical that the company, seller, and ESOP will have the following characteristics:

- The consideration a seller would have received from the sale of his or her stock is a combination of a seller note with the company and cash.
- The company will have a note payable to the seller and may have other debt obligations resulting from the transaction.
- The ESOP trust will have shares of stock and a note payable to the company. The note payable to the company typically will have a much longer term than the seller note and any other debt obligations resulting from the transaction.
- The shares of stock held by the ESOP's trust will be held in suspense, which means the shares are within the ESOP's trust but are not yet allocated to participants. The stock is released as the note with the company is repaid. For instance, if the note has even amortization of principal and interest over 20 years, each annual note payment results in 1/20th of the total shares purchased being released from suspense and allocated to participants.

Each plan year after the transaction, the following will occur:

- The company will deposit into the ESOP trust a contribution or a combination of contributions and dividends in the amount of the note payment the ESOP trust owes the company.
- The ESOP will make the note payment to the company.
- Stock then will be released from suspense and allocated to the participants.

Main Benefits of ESOPs

ESOPs provide numerous benefits to the seller, the company, and its employees.

Benefits for Seller

- The seller controls timing of the transaction.
- The seller receives a fair price.
- The seller can sell stock when he or she wants to sell it.
- The seller can continue to be involved in the management of the company.
- The company's legacy is preserved.

Benefits for Company

- The probability of management continuity is increased.
- The company can more easily meet post-transaction debt obligations due to the ESOP's unique tax incentives (in particular, the income tax exemption for ESOP-held stock of an S corporation).
- After the post-transaction debt obligation is repaid, the company gains a competitive advantage, as an S corporation no longer pays taxes on income attributed to shares held by the ESOP.
- According to various studies spanning more than two decades, ESOP companies tend to be more profitable and have less turnover, and their employees take fewer sick days than employees of similar non-ESOP companies.

Benefits for Employees

- Employees will keep their jobs and work for the same company.
- Employees can share in the wealth accumulation that comes from accumulating ESOP shares and future increases in the fair market value of the ESOP shares. Due to the tax benefits enjoyed by the ESOP company, if the company remains profitable, the wealth accumulation can be significantly higher than what employees would accumulate in a traditional, qualified employer retirement plan.

Which Companies Are Good ESOP Candidates?

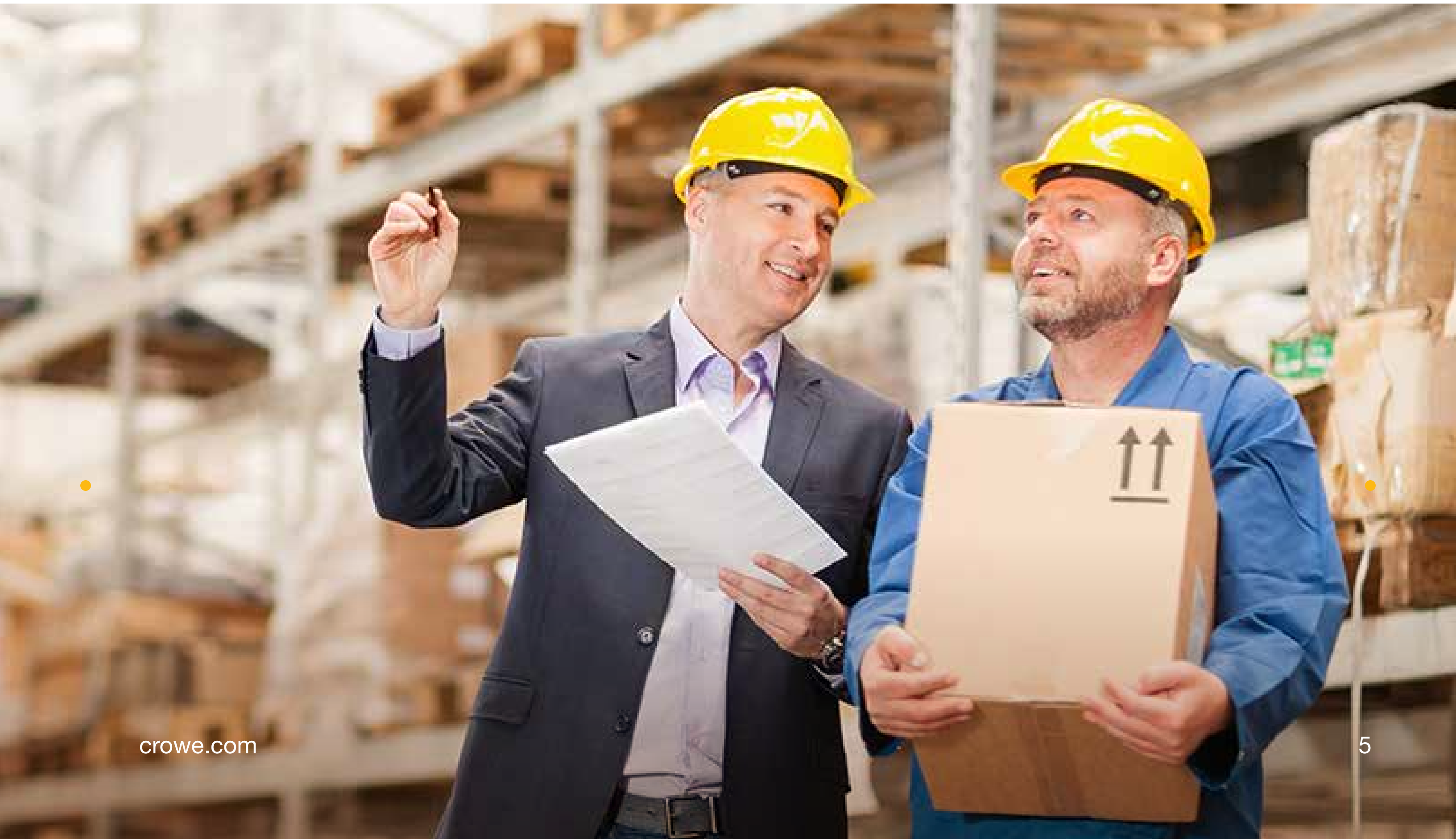
Almost any for-profit business could become an ESOP company. However, certain attributes make some businesses better ESOP candidates than others.

Good ESOP candidates are companies that:

- Have a long-term history of profitability
- Have good corporate governance and strong internal controls
- Have a strong management team and succession plan for management
- Do not have a concentration of business with just one or a couple of customers
- Currently are making contributions to qualified retirement plans
- Have owners who want to maintain the company's legacy
- Have owners who are willing to have a transition period into retirement after selling the business

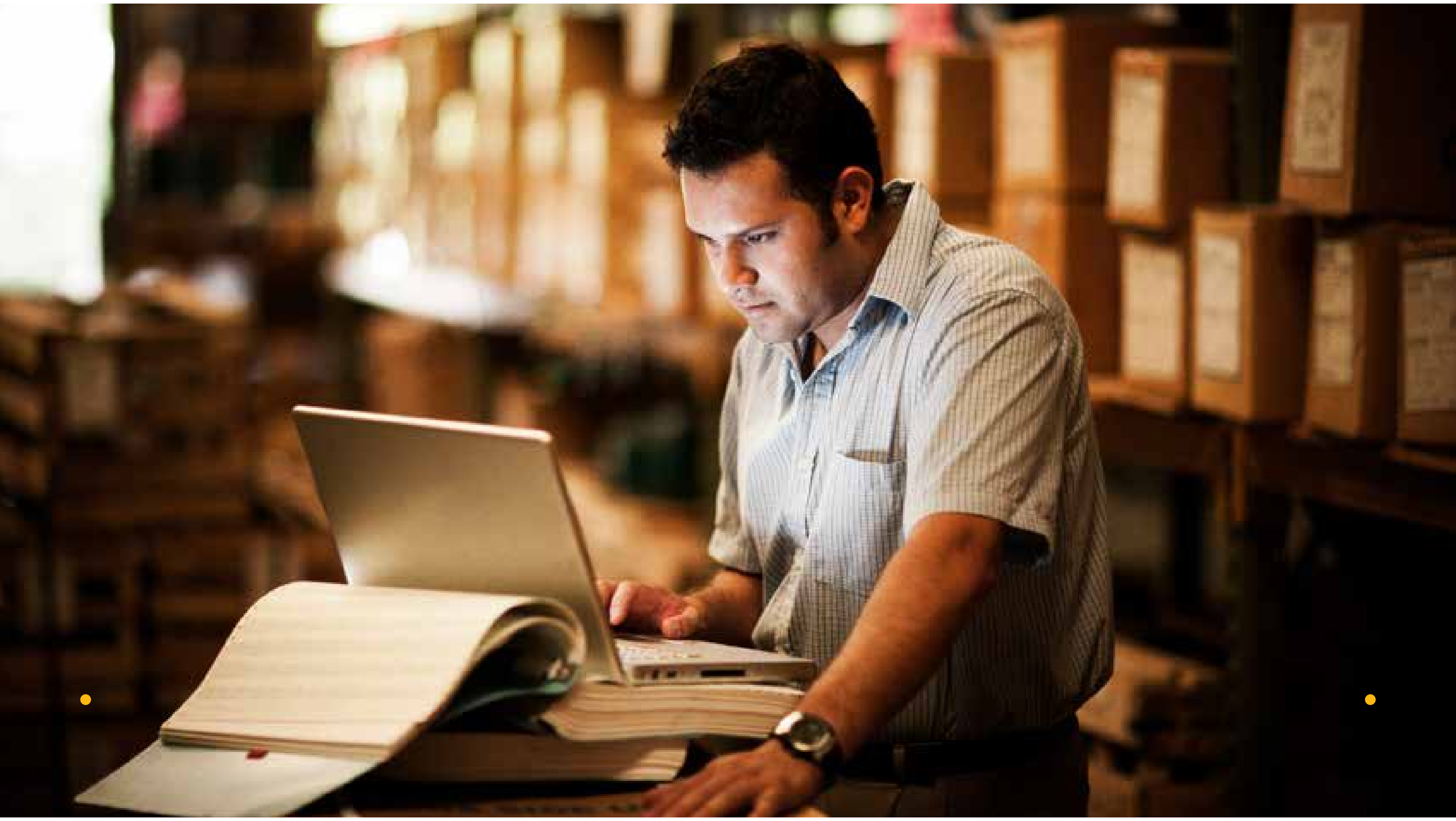
Poor ESOP candidates are companies that:

- Are in financial distress
- Have poor corporate governance and poor internal controls
- Have highly cyclical earnings
- Do not have good management succession plans
- Have weak management
- Have poor management-employee relations
- Lack other buyers
- Lack adequate employee compensation bases
- Have poor relationships with lenders



Seek Professional Advice

ESOP transactions are complex and carry many unique fiduciary risks. Business owners considering an ESOP structure should work with professionals with significant expertise who can provide guidance throughout the process and contribute to a successful transaction.



Learn More

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[1] For more information on maximizing financial gain upon retirement by implementing a well-planned transition strategy, see the Crowe article, "Ownership Transitions: Four Common Paths," https://www.crowe.com/insights/asset/ownership-transitions-four-common-paths

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