

IS AN ESOP RIGHT FOR YOUR COMPANY?

Tom, age 49, owns an HVACR business with 30 employees. Tom's personal financial advisor is concerned that most of his net worth is tied up in the business and has suggested that Tom begin to diversify. Likewise, the company's legal counsel is concerned with the company's succession plan. Tom believes there are several employees that could succeed him in the business given more time to learn the business and work together. He doubts, however, that these employees could raise the money necessary to buy him out. Tom needs to consider an ESOP.

An ESOP (employee stock ownership plan) is an employee benefit plan which primarily invests in employer stock, thereby making the employees of a company the beneficial owners of the stock in that company. Since the ESOP is an employee benefit plan, it is subject to certain rules contained in the Internal Revenue Code and ERISA (Employee Retirement Income Security Act).

One of the most common uses of an ESOP is to buy the stock of an owner in a closely held company. An ESOP can provide a market for the equity of a shareholder of a closely held company and provide benefits and job security for employees in the process. The owner may be retiring or may be staying in the business but selling his shares to the ESOP to diversify his personal assets (e.g., have some personal liquidity rather than maintaining most of his net worth in the closely held business).

Selling shares to an ESOP does not happen overnight. Careful, thoughtful and planning and analysis are required. The process is very similar to selling the business to a third party; except the third party in this transaction is the ESOP.

The first step in selling shares to an ESOP is to conduct a feasibility study. The purpose of the feasibility study is to determine whether the company can afford the ESOP loan payments and distribution payments to the participants. The feasibility study requires an in depth analysis of the company's financial health and prospects for growth as well as consideration of the stability of the company's workforce.

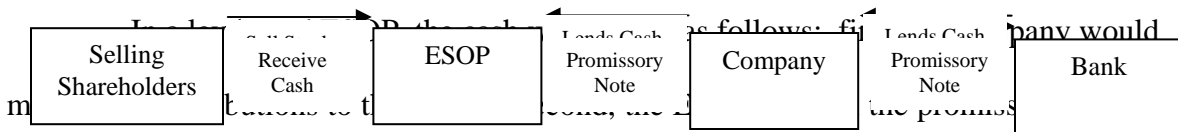
Once the feasibility study is complete and reviewed, the company must hire an independent or transactional fiduciary to represent the ESOP. This is to assure that the ESOP is treated fairly in the stock purchase transaction. The fiduciary will conduct due diligence and negotiate the terms and price of the purchase of stock. The ESOP may only purchase the shares for "adequate consideration" as defined by the Department of Labor and Internal Revenue Service. Adequate consideration is determined, in part, by (1) an independent appraisal prepared by a qualified ESOP independent appraiser hired by the fiduciary and (2) the fiduciary reviewing the independent appraisal to insure that reasonable assumptions were made by the appraiser and that the independent appraisal is accurate, complete, reasonable and complies with the Department of Labor and Internal Revenue Service rules.

The sale of the shares can be structured in various ways. The selling shareholders can simply sell the shares and obtain capital gains tax treatment on the sale. Alternatively, Section 1042 of the Internal Revenue Code permits owners of closely held companies (which are taxed as C corporations) to incur no taxable gain on the sale of stock to an ESOP. However, there are numerous restrictions and conditions that apply in order to obtain this favorable tax treatment. For example, if the selling shareholder elects

Section 1042 treatment, he cannot be a participant in the ESOP. It is not necessary for an owner to sell all of his stock to the ESOP, although a complete sale is not uncommon.

The sale of the stock to an ESOP may be leveraged or non-leveraged. In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust, which will enable the trust to pay off the loan; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. The leveraging will be used to buy out the stock of the former owners and the ESOP will acquire those shares.

Two tax incentives make borrowing through an ESOP extremely attractive to companies. First, since ESOP contributions are tax deductible, the corporation is able to deduct principal payments as well as interest payments from taxes. This can cut the cost of financing to the company significantly. Second, dividends paid on ESOP stock of a C corporation whether passed through to employees, reinvested by employees for more company stock, or used to repay the ESOP loan are also tax deductible. This provision of federal tax law may increase the amount of cash available to a company compared to one utilizing conventional financing. The following is a schematic of a leveraged ESOP:



company. When the shares are paid, they are allocated in the ESOP to the plan participants. Third, the company pays on the promissory note to the bank.

Let's go back to Tom's situation, described in the beginning of this article. The company hired an independent fiduciary to negotiate the sale of Tom's shares to the

ESOP. Because Tom is continuing in the business and has an interest in its future success, Tom decides against the 1042 treatment. Tom will pay capital gains tax but will also participate in the ESOP. Tom believes his participation in the ESOP is meaningful to the employees and sends the employees the message that they are all in this together. Since Tom did not take 1042 treatment, he also agreed to seller finance the sale to give the ESOP a longer term to payoff the debt than the proposed bank financing (10 years vs. 7 years) and a lower interest rate than the bank financing (7.5% vs. 8%). Since Tom was being paid over 10 years, he agreed to sell all his shares to the ESOP.

The company, now 100% owned by the ESOP, elects to become a subchapter S corporation. This means that there will no longer be any tax at the corporate level – all of the company profits pass through to the owner. Since the owner is an ESOP, which is tax exempt, no income tax is paid on any of the company's profits! Through this process Tom has increased the company's cash flow by 35% (the amount that would otherwise be paid out in federal taxes).

The success of an ESOP depends, in part, on company philosophy and employee involvement. Considerations in adopting an ESOP should include, how will the employees view the sale? Employee communication and involvement early in the process is key. There are many organizations that assist businesses with employee communications. Among these organizations include: The ESOP Association, NCEO (National Center for Employee Ownership), and the Ohio Employee Ownership Center at Kent State University.

Tom involved those key employees identified early on in the entire process so that the transaction was a group effort and group success. The company utilized services

from some of the organizations mentioned above to assist with employee communication and education. The company's key employees continue to serve on the trustee and administration committees and attend annual ESOP workshops and seminars. These actions are furthering the goal of developing Tom's successors within the business.

Once an ESOP is established, it is important for to maintain successful management. Therefore, many ESOP companies will implement a management incentive program. Frequently, nonqualified deferred compensation plans are implemented to maintain key management (golden handcuffs) and/or to cover those individuals that are not receiving comparable benefits provided in a pre-ESOP retirement plan. The existence of the ESOP does not prevent the company from continuing existing nonqualified plans or implementing new ones.

When considering an ESOP, it is never too early to consider the ESOP repurchase obligation. Since the participants cannot sell their closely held stock on an open market, the ESOP/company must provide the market and repurchase the shares. The cost for repurchasing the shares must be factored into whether an ESOP will work in a particular company. Consideration must be given to the repurchase obligation projections for death, disability, retirement, diversification and other termination for the next 10 to 15 years. What is the company's workforce composition? Is there high or low turnover? Can the company handle the obligation and still maintain desired growth? Too large a repurchase obligation in proportion to available cash flow can stifle a company's ability to modernize and compete in the long term. The corporation can adopt a funding plan within the ESOP or outside the ESOP, such as accumulating cash inside the ESOP, the

company purchasing life insurance on participants with high account balances, pay-as-you-go, or establish a sinking fund.

Consideration should also be given to the impact on the company's other retirement plans. Will the company continue providing benefits in the other retirement plans? This will depend on company philosophy, cash flow and Internal Revenue Service deduction limits. Most companies discontinue company contributions in other retirement plans and treat the ESOP as the replacement. However, the companies do maintain the 401(k) plan, permitting deferrals but scale back matches.

Finally, there are special S corporation ESOP considerations. Analysis has shown that the long-term tax savings generated by S corporation ESOP companies can be significantly greater than for some C corporations. Due to the tax-free nature of the S corporation ESOP, there are complicated calculations that must be performed each year to ensure that the ESOP benefits a broad range of employees and that the ownership is not concentrated in the hands of a few employees.

ESOPs are beneficial for both the selling shareholders and the employees if done right. Education and communication are vital to the ESOPs success. ESOPs work best for companies with 20 or more employees, with revenues sufficient to warrant the added ESOP expense and for companies which desire to foster an ownership culture.

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