

USING AN ESOP AS YOUR EXIT STRATEGY FROM A CLOSELY HELD CORPORATION

The recession has put quite a damper on merger and acquisition activity in the past couple of years. The uncertainty of the future and lack of credit has made companies leery to take on expansion or pursue available targets. If you are a closely held corporate owner looking to retire or begin to be phased out of the business, you may be lacking a suitor able to assist you in that regard. However, there is one group of potential purchasers you may have overlooked—your loyal employees. By the use of an “employee stock ownership plan”, or ESOP, you can obtain tax and other benefits for yourself, your company and your employees when you sell your company to an employee benefit plan owned by your employees.

An ESOP is an employee benefit plan that is designed to invest primarily in the stock of the company that sponsors it. An ESOP can own any percentage of the company’s stock—from a minority percentage to the entire company. The stock is actually held in trust for the benefit of the employees and each participant becomes a beneficial owner of the stock allocated to their individual account. The stock is generally managed by a trustee, who can be an outsider or someone currently associated with the company.

Where a buyer is lacking, an ESOP can be formed to purchase the stock of a shareholder who wishes to exit the business. This can be done over time or in one transaction. It can be seller- or outside-financed. Therefore an ESOP can also

become a way to raise capital where a shareholder is looking only for a minority investor.

The benefits of such an arrangement for the selling shareholder are many. First, as mentioned above, the trust becomes a willing buyer for stock that may not have a ready market. There is control from day one over the eventuality of the transaction, something you will not have with an outside investor or purchaser. Second, with C Corps, the selling shareholder (provided at least a 30% interest is sold to the ESOP) can defer the taxation of the gain on his stock by rolling the proceeds over to a qualified investment under Internal Revenue Code Section 1042. (S Corps must currently revoke their S election to obtain this benefit, but a bill pending before Congress could bring this benefit to S Corps as well.) This deferral can even be stretched to make the sale a non-taxable event, if the qualified replacement property is held until death so that it receives a step up in basis. Third, an ESOP is the only type of employee benefit plan that is permitted to borrow money, so this can bring outside financing to the table. Fourth, but certainly not least, the selling shareholder can obtain the intangible benefit of knowing that he is rewarding employees for a job well done and selling to a buyer that is not likely to dismantle what he has built over the years. In fact, the departing owner can remain on the board to insure he continues to have some say over the future of the company.

The benefits to the employees are several as well. The ability to become “owners” of a company is a wealth creation event that serves to better their lives for many years to come. Also, the employees receive deferred income taxation of amounts contributed to their accounts. Taxation does not occur until they take a distribution, which generally does not occur until they retire or otherwise leave the company.

Finally, the arrangement is usually of great benefit to the company. Being a qualified employee benefit plan, the trust shareholder pays no income tax. This means that profit which would be paid to the IRS stays with the company. In fact a 100% ESOP owned S Corp pays no federal income tax at all since there is no taxation at the corporate level either. (Federal taxes are only paid by the participants taking a distribution from the plan.) C Corps can deduct all the interest and an amount of principal (up to 25% of qualified compensation) paid to discharge an ESOP loan. ESOP companies have been found to have great growth potential. This is due to these tax benefits and the fact that employees are invested in the growth of the company. In fact, nearly 90% of ESOP companies outperformed the stock market in 2008, according to a survey conducted by the Employee Ownership Foundation, an educational foundation formed to fund studies on employee ownership business models. In a year in which most companies found their income shrinking, ESOP companies reported a 58% increase in revenues in 2009, according to that same survey. The benefits to employees of ESOP ownership can also attract outside talent to your company which further contributes to

growth. Therefore as long as it is managed properly, an ESOP company has great sustainability. The factors described above, combine to make the ESOP company a strong one.

These benefits come with a few cautions and requirements that must be taken to ensure that the ESOP is formed and operated properly. First it is incumbent upon the company that a proper valuation is made of the company’s stock. Shareholders cannot merely agree to establish a value with the management of the company. A licensed appraisal company must make a fair market valuation of the company to protect the tax benefits and the fiduciaries involved. ESOP companies must also be prepared for the increased administrative costs involved in operating as an ESOP. The trust must obtain a yearly valuation of the company’s stock and the plan must retain a third party administrator to maintain records and prepare reports for the IRS. (Most ESOP companies find these administrative expenses are offset by the tax savings they have from the arrangement.) Finally, an ESOP company must manage its eventual repurchase liability—that is the obligation it has to make distributions under the plan to retirees and those that leave the company. Preparing for those cash flow needs is essential to maintaining the sustainability of the ESOP for years to come.

Nevertheless, despite these added administrative practices an ESOP company must employ, the benefits far outweigh the burdens. If you are interested in learning more about establishing an ESOP for your company, please contact an attorney in our business and corporate practice area for more information.