ESOPs: Myths, Methods, and Mistakes

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Introduction

As baby boomers toe the retirement line, company ownership and succession planning becomes a necessary topic on the discussion table. There isn't always an easy answer here – all business owners have different priorities when it comes to handing over the reins – but some options are more elegant and effective than others. ESOPs, or employee stock ownership plans, provide a compelling alternative, selling company ownership to employees while also offering an avenue for corporate financing and business perpetuation.

The Ins & Outs of ESOPs

An ESOP is a form of benefit plan that provides an ownership benefit to current employees, but what exactly does that mean?

Effectively, ESOPs are a form of qualified defined-contribution plan, offering tax benefits to the selling shareholders and to the Company. As a rule, these plans are required to invest primarily in shares of common stock of the plan's sponsor.

The rudimentary structure of an ESOP is quite basic. Current ownership sells shares to a trust for the benefit of the employees, and these shares are then allocated to employees based on their relative salaries. Over time, shares vest, providing long-term employees with a valuable stake in the business. Upon leaving the company, employee participants must sell all shares back to the plan for a cash equivalent. Repurchased shares can be voided or later reissued to other plan participants.

On the surface, an ESOP is a straightforward form of employee benefit plan, but underneath, it can be so much more, providing numerous perks like:

- The potential for significant tax deferral/tax savings on the sale of the company.
- Providing significant tax advantages to the sponsoring company post transaction.
- A means for providing liquidity for owners based the owner's desired timeframe.
- Retained company legacy and independence.
- Captured and enhanced employee loyalty.

Selling to an ESOP can be accomplished in either leveraged or non-leveraged options. Non-leveraged ESOPs function primarily as an employee benefit, but leveraged plans can allow the selling shareholder to obtain cash immediately through third-party financing or, if desired, finance the sale himself/herself allowing the owner to obtain a higher rate of return than he/she could obtain from investing the sales proceeds in CD's or money market accounts.

Post-acquisition contributions made by the Sponsoring Company to the Employee Stock Ownership Plan are 100% tax deductible. This in effect allows the debt financing (whether third-party or seller financed) to be repaid in pre-tax dollars.

ESOP-owned companies can also have a strategic advantage when management desires to grow by acquisition of other targeted entities. The Sponsoring Company can issue additional shares to the ESOP and in essence, finance the acquisition of the target company on a tax-advantaged basis.

Breaking Down the Misconceptions

As of 2015, the National Center for Employee Ownership (NCEO) estimates that there were nearly 7,000 plans in operation within the United States.

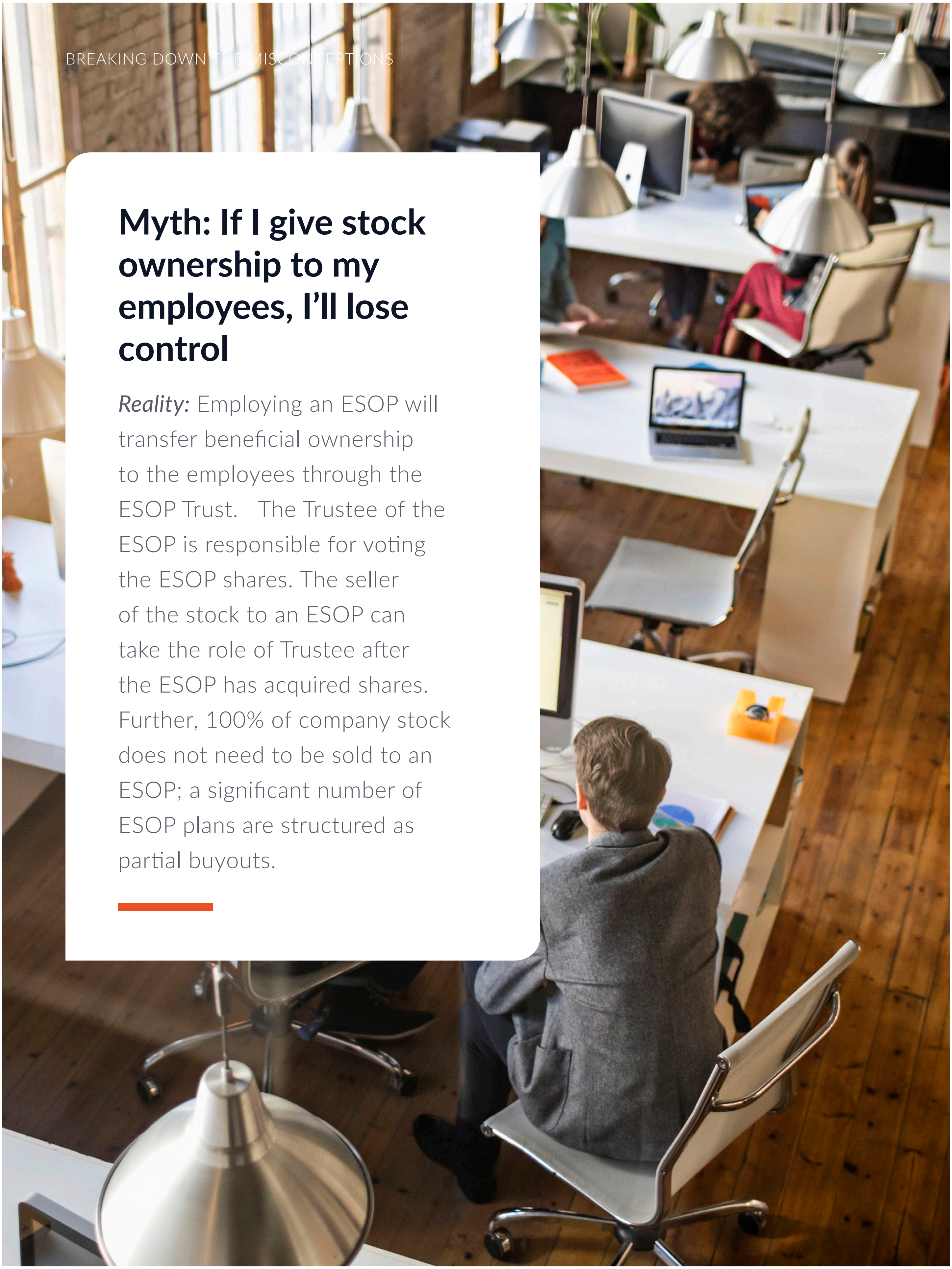
Despite the advantages of ESOPs, many companies do not truly understand the basics involved in owning and operating an Employee Stock Ownership Plan. Unfortunately, many misconceptions still linger. Let's try and break some of them down:

Myth: Only C-Corps can set up ESOPs

Reality: This was true historically, but with the passing of legislation in 1999, C-Corps are no longer the only form of business structure that can establish an ESOP. Now both C-Corps and S-Corps are eligible, regardless of size or current ownership. In fact, 100% owned S-Corp ESOPs are very popular due to the fact that they become tax-free for purposes of federal income taxes.

Myth: ESOPs aren't worth it because they're expensive

Reality: An ESOP won't be free to set up, but when considered against the cost required to take the average company to market (investment banking/brokerage fees, accounting fees, legal fees) can be significantly less expensive. In addition, there is an annual cost of administering the ESOP, but the tax benefits afforded ESOP-owned companies can more than exceed the cost of annual administration.



Myth: If I give stock ownership to my employees, I'll lose control

Reality: Employing an ESOP will transfer beneficial ownership to the employees through the ESOP Trust. The Trustee of the ESOP is responsible for voting the ESOP shares. The seller of the stock to an ESOP can take the role of Trustee after the ESOP has acquired shares. Further, 100% of company stock does not need to be sold to an ESOP; a significant number of ESOP plans are structured as partial buyouts.

Risks vs. Rewards

ESOPs can be very valuable for your business, but they aren't necessarily perfect for everyone; there are pros and cons to consider from an employer and an employee perspective. Downsides may not necessarily stand in the way of moving forward, but as with any strategic change in your business, understanding risks vs. rewards is always a good thing.

As an Employer

As an employer, ESOPs carry some major rewards. Primarily, they are extremely effective as an exit plan, allowing owners to transfer ownership as quickly or slowly as desired. Anywhere from 1% to 100% of owner-held stock can be sold to an ESOP and on virtually any schedule. Transitions are more likely to be smooth, as ownership will be moving to those already involved in operations, keeping company culture intact. The tax benefits here are immense as well, as an ESOP is a tax-exempt trust.

Despite the upsides, some of these advantages are circumstantial. Businesses without strong management or without a history of consistent financial results may not benefit from keeping ownership within the company, and tying up cash flow by acquiring company stock may be costly. Additionally, prices of shares are limited to a fair market value, potentially costing a company when strategic value could yield greater gains.

As an Employee

As an employee, receiving ownership in a business is rarely a bad thing. An ESOP offers no cost to employees, providing a retirement nest egg and a vested interest in furthering successful company performance. Benefits are tax deferred, growing unencumbered until retirement or termination.

However, no investment is guaranteed. An ESOP is only valuable if the plan's sponsor is valuable. Failure of an ESOP company can be devastating, resulting in job loss and worthlessness of any ownership accrued. As a way to mitigate these risks, many companies using ESOPs also provide other forms of retirement savings, like 401(k)s.

How Does It Work?

Selling to an ESOP

Selling to an ESOP is quite literally a transfer of ownership. This process is generally an alternative to selling to a third party buyer, providing a way for an existing owner to bow out completely. While there's no right or wrong answer to business transference, the differences can be distinct. Before moving forward with seeking a buyer or selling to an ESOP, knowing what to expect is key.

Selling can be a slow process. Keeping ownership in-house is usually preferred but determining who understands and can support the current business plan is tricky. Former owners who maintain leadership roles within a company can stay in control, continuing to manage until stepping down is appropriate. The due diligence that goes into setting up an ESOP is often comprehensive, requiring feasibility studies and professional valuation, but rarely relies on in-depth forensic analysis. ESOPs also allow owners to maintain a minority interest; 100% of ownership does not have to transfer to the plan.

Selling to a Third-Party Buyer

Selling to a third-party buyer is a much less flexible process. Third-party buyers, in most cases, want to purchase the whole company, and all at one time. While there may be room to negotiate leadership, this is not guaranteed and some third-party buyers will want to restructure a company, replace current employees, and rewrite business plans. The due diligence required will increase as well; companies will have to provide full, detailed, and accurate records with nothing to hide. Also, most financial buyers require the sellers to finance part of the sale.

The Right Time to Use ESOPs

Operating a business isn't a venture best left to chance. Instead, every decision must be carefully weighed and evaluated. ESOPs are the same, as succession planning is a very individualized process. Companies most likely to benefit often have:

- Steady performance, stable cash flows, and CPA prepared financial statements.
- Solid and experienced upper and middle management.
- Significant taxable income to take advantage of tax benefits.
- Private ownership.
- A commitment to employee ownership and investment.

The merits of ESOPs can be industry-specific as well. More often than not, shared capitalism is seen in manufacturing and construction operations, as well as financial and services firms. This is due largely to the composition of these kinds of companies. Operations tend to be very steady, cash flow is appropriate to cover the cost of the acquisition, and the successful company culture can continue. While not as common, ESOPs can find a home in larger businesses, striving to create a work environment that fosters longevity even among low-level employees.

Tips & Tricks for a Successful ESOP

As of 2015, the National Center Starting an ESOP isn't the kind of business decision that should happen overnight. The right steps now can make a big difference later, especially when it comes to a successful implementation. Here are some best practices to get started:

1. Evaluate Your Team

Not all businesses are right for an ESOP, and your management team can play a big role in that. If turnover is high, management is new and still caught in a learning curve, or if management is not interested in leading the Company's future, this approach may not be right for an exit plan. Other owners, if any, are also a consideration. If your co-owners are not interested in an employee stock plan, even if you are the majority owner, an ESOP may not be an option.

2. Perform a Feasibility Analysis

Sometimes, owner expectations and reality aren't exactly aligned. A feasibility analysis helps settle these issues, allowing you to evaluate whether an ESOP is truly the right choice for your business. Feasibility analyses can take several forms: some companies have the resources to perform a comprehensive overview in-house, while others choose to hire an outside consultant. In general, most studies consider factors including but not limited to cash flow, sufficient payroll to make deductible contributions, and the potential effects on existing benefit plans.

3. Conduct a Valuation

Business valuation isn't as simple as taking a look at your revenue and making an educated guess. Public companies can handle this fairly easily – after all, the public stock carries a value – but it may be a little hard to nail down a true number for fair market value in the private sector. A qualified ESOP appraiser should be used for this purpose, providing an unbiased, third-party basis upon which to move forward. The ESOP trustees must engage the appraiser if they wish to use that appraiser in a future transaction.

Common Mistakes & How to Avoid Them

ESOP implementation can be as easy or as hard as you make it. The setup process will take some time and effort, but avoiding these mistakes can help you get your plan off the ground without major incident.

1. Jumping in Too Soon

Structuring an ESOP is more like a marathon than a 100-meter dash. Make sure every step is accounted for, and plan carefully for as long as necessary. Prior to moving forward, it's important to do some detailed research on reporting obligations to the IRS and SEC if relevant and explore Department of Labor requirements to ensure you won't miss a beat.

2. Choosing the First Funding Option

How to fund a leveraged ESOP is always a factor for due diligence. The first financing option isn't always the right choice – although that's not to say it won't prove to be the best. Take time to do your research, and choose the right lender or investor for your unique needs as opposed to what seems easiest.

3. Skipping Professional Assistance

Setting up an ESOP without professional assistance can be a grave error. Rather than going with your gut, make sure you have an attorney and a CPA by your side to help you ensure every last detail is covered. Without the practice and understanding what a pro can provide, it's very easy to go in the wrong direction and miss some of the regulatory controls required for proper setup.

4. Maintaining Control

Transferring ownership sounds an awful lot like giving up control, and that's something many business owners don't want to do right away. However, with an ESOP, moving away from steering the ship is often a gradual process.

Selling to an ESOP and giving up a say in the business do not have to go hand in hand. Ownership doesn't necessarily mean voting rights, and in the case of an ESOP, the trustee of the trust is the voter, not each individual member. This allows an existing owner to continue to have a say, with or without 100% control. Except in instances mandated by law, like mergers, trustees generally do not have to take input from shareholders of the ESOP, either.
In some cases, the trustee can be appointed as a directed trustee, only voting when directed to by the board of directors.

By selecting the trustee of the plan and continuing to maintain a directorship role, it's entirely possible for owners to continue to have a say without staying completely entrenched in the business. For this reason, ESOPs are often the choice for those who are ready to take steps toward retirement slowly and over time. With an ESOP on the table, there's no need to be all in one day and all out the next.

Moving Forward

Succession planning is a big part of business ownership. If you don't want to let the chips fall where they may, setting up an ESOP can be a great way to pass the torch on your own schedule. Coupled with tax benefits and an opportunity to leverage capital financing, a well-structured plan can be a strong option under the right circumstances.

If you're looking for a way to phase out of business ownership, establishing an ESOP can be the perfect opportunity to reward employees and transition out on your own schedule. However, making it from concept to reality is easier said than done. When you need a resource to assist with valuation, structuring or implementation, GBH CPAs is prepared to help you find the ideal solution for your business. With decades of experience in ESOP consulting, auditing, and more, we're happy to help you come to the right conclusion for you.

Get Started Setting Up Your ESOP

TALK TO AN EXPERT

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