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ESOP: The Ideal Business Transition Option

By: Daniel M. Zugell, CLU, ChFC, LUTCF and Samuel A. Landman J.D., LL.M.

With 10,000 baby boomers (those born between 1946-1964) turning 65 each day for the next two decades, it is no surprise that most are looking to retire. According to a recent Price Waterhouse Coopers report, 62% of the U.S. companies planning to monetize their business will do so within the next 5-6 years. It is projected to be the biggest transfer of wealth in U.S. history, estimated at $15 trillion or more over the next 15 years. Many baby boomer owned companies fall into this category and are considering how to transfer their business and enjoy the fruits of decades of hard work.

Employee Stock Ownership Plans also referred to as ESOPs are continuing to gain strong momentum as baby boomers look to transfer their businesses in a way that best suits their families' goals and objectives. Most are family businesses whose goal is to perpetuate the business into the next generation or key management, but giving the business away is not a viable option especially when the next generation often cannot afford or even borrow the purchase price.

The owner also faces considerable taxation on stock sale proceeds including capital gains tax on the gain portion of the sale proceeds. As of January 1, 2013, the federal capital gains tax burden on a selling shareholder increases from 15% to 20% plus an additional state tax burden of 5.4% on average. Additionzally, the recently passed health care legislation imposes a 3.8% tax on the gain portion of a business sale effectively making the combined federal and state capital gains rate on a sale of a business 29.2%.

ESOPs have unique procedural and tax benefits that are NOT affected by the tax law changes effective January 1, 2013. Some ESOP structures may not be subject to the underlying affected capital gains or income taxes at all. ESOPs are one of the best and most tax efficient ways for a business owner to transfer a business and often provide the most "net" after-tax proceeds than any other transfer method.

ESOPs Defined:

In practical terms, an ESOP is a highly tax advantaged, immediate or gradual exit strategy for business owners wanting liquidity or to take everything off the table. The ESOP is "ready and willing" buyer of the seller's stock that keeps out unrelated third parties and allows corporate control to remain unchanged. It retains the seller's existing perks while simultaneously providing significantly heightened retirement benefits to all eligible employees who will have a beneficial ownership interest in the stock sold to the ESOP.

An ESOP is a defined contribution, tax-qualified retirement benefit plan under Internal Revenue Codes 401(a) and 4975(e)(7) and overseen by the Internal Revenue Service and the U.S. Department of Labor designed to invest "primarily in employer stock".

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How an ESOP Works:

Only ESOPs are allowed to borrow the funds required to buy the desired shares at fair market value from the selling shareholder. Typically, the ESOP borrows funds from a bank or the seller takes back a note. The company makes tax-deductible contributions to the ESOP which uses the funds to repay the loan incurred to buy the stock until the debt is repaid. The shares purchased by the ESOP are allocated to the employees of the company in proportion to their compensation as the loan is repaid.

Seller Advantages:

- The selling shareholder may indefinitely defer/ eliminate all capital gains on the sale proceeds
- The seller enjoys an immediate buyer of some or all of the seller's stock at fair market value
- The seller can retain personal salary, perks, benefits and control without interference of outside interest until ready to hand over the reigns
- The seller retains personal and corporate legacy in the town in which he cares about and contributed to

Corporate Advantages:

- The company receives a dollar for dollar income tax deduction on the entire stock sale price
- An ESOP company can be 100% federal and state income tax exempt
- ESOP companies outperform their peers with increased productivity and higher return on investment

Employee and Community Advantages:

- The employees enjoy enhanced retirement benefits of company stock with no out of pocket costs
- An ESOPs orderly internal transfer of the company creates a more stable and reliable community employer than the intentions of an outside buyer
- The company remains an important contributor to the community's social and economic fabric

Governance and Control:

Stock ownership and control are not synonymous in an ESOP company. The shares outside the ESOP appoint the Board which names the ESOP Trustee, in an ESOP company. Usually, an ESOP Trusteed is a "Directed Trustee", voting as the Board directs without the input of the employees. Employees have no minority shareholder rights, access to financial information or voting rights. Therefore, control is able to be maintained by a 1% owner even if the ESOP owns the remaining 99%. Easily and affordable, control can be transitioned by gifting or selling the 1% in this example.

ESOP's Legacy Full Circle:

The majority of owners want their children and/ or key management to eventually run and own the business, but they cannot afford to purchase the business nor obtain adequate financing. ESOP's "Legacy Full Circle" increases direct ownership to the next generation over time without personal financing and the potential of conflicting goals and interference by outside unrelated parties. As employees leave the company for any reason, the company may repurchase the shares from the participants and retire the shares into treasury. This reduces the overall outstanding shares and increases the percentage of ownership that is held outside the ESOP by the children and/or key management. In theory, when the last share is repurchased and retired, the shares held outside of the ESOP represent 100% of the value of the company.

In summary, an ESOP is a ready, willing and able buyer and a highly-advantaged business transition tool that is often overlooked due to perceived complexity or lack of knowledge and understanding. An ESOP may be the ideal method to transfer a business on the seller's timeframe to the next generation without the interference and costs of outside parties. With the capital gains rates increasing dramatically, baby boomer business owners owe it to themselves to explore their options and the impact of waiting too long to learn the facts and take action.

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