INVESTMENT BANKING

ESOP

VALUATION

ADVISORY

# PCE | INVESTMENT BANKING

## ESOPs as a Hedge Against Rising Tax Rates


**WILL STEWART**

wstewart@pcecompanies.com
407-621-2100 (main)
407-621-2124 (direct)


Today is one of the most interesting times in recent history to be the owner of a privately-held business as these owners find themselves experiencing a rebound in the domestic economy but facing an uncertain tax environment. The question that many business owners are asking themselves is do we monetize some or all of our company today and capture the increased value of the business and lower tax rates or do we stay invested and realize further value appreciation but risk a higher tax environment. While the path becomes clear for many business owners, many remain in a quandary. The answer for these individuals may lie somewhere in the middle where they can monetize some of their investment in the current low tax rate environment, keep significant ownership for future appreciation and reduce their corporate and individual tax profiles. These are all achievable goals by executing a sale of a portion of their company to an Employee Stock Ownership Plan (ESOP).

### Tax Environment

Most people agree that tax rates are not going to be lowered anytime in the near future and few believe that they will remain at their current levels. Most significant tax rates are scheduled to rise on January 1, 2013 as the tax cuts that were extended in 2010 sunset. The table below shows the legislative tax increases. In addition, certain levels of personal income will be subject to a 3.8% tax on unearned investment income that was part of the health care reform legislation passed in 2010.

| Tax | 2012 Rate | 2013 Rate[1] | |
|---|---|---|---|
| | | Stand-Alone | With Health Care Reform Tax |
| Capital Gains | 15.0% | 20.0% | 23.8% |
| Qualified Dividends | 15.0% | 39.6%[2] | 43.4% |

Focusing on capital gains rates, if a business owner sold a business and incurred a $50.0 million gain in 2013 instead of 2012 then they would pay $4.4 million more in taxes. This means that a business owner would have to count on an increase in the value of their business of more than 10% in 2013 just to break even on the net proceeds they would receive in 2012.

## ESOP as a Buyer

In today's environment, one of the key benefits of selling to an ESOP is that it is a buyer of stock instead of assets. This ensures that the seller will receive capital gains treatment on proceeds. While most other M&A transactions are structured as asset sales and subject to higher personal income taxes.

As a tax exempt entity, the ESOP also lowers the overall tax profile of the Company. Contributions and dividends paid to the ESOP are deductible on the Company's financial statements, lowering the Company's taxable income. This flow of money to the ESOP is also not taxed at the ESOP level which means that the ESOP can use every dollar that it receives. In the early years of an ESOP, this is money that can be used to repay the debt incurred in the initial ESOP transaction. Additionally, the ESOP brings numerous intangible benefits as a buyer. There are several studies published separately by the University of Pennsylvania, Rutgers University, and Georgetown University that examine the effects of broad based ownership on employees. All of these studies point to greater productivity of employees which most often led to ESOP-owned companies outperforming their peers. This outperformance helps the original owners realize continued appreciation in the value of their stock, if they kept some ownership in the ESOP transaction.

## The Current Opportunity for Business Owners

Many business owners are not ready to sell their entire company today but are rightfully concerned about the effects a rising tax environment could have on their personal wealth and their company's future. The opportunity exists today to sell a minority stake in the Company to an ESOP and receive the lower capital gains treatment that we know exists in 2012. This way the business owner receives personal wealth diversification, while sharing ownership benefits with their employees. This strategy also leaves a significant stake in the owner's hands for continued appreciation in the years to come. Finally, an ESOP lowers the overall tax profile of the business heading into what looks to be a higher tax environment. While taxes are one of the only sure things in life, there is no reason to pay more than your fair share.

[1] *Reflects rates if no congressional action is taken*
[2] *Assumes highest personal tax bracket*