ESOP

LET THEM EAT CAKE!

OR, HAVE YOUR CAKE AND EAT IT, TOO?

BY CHRISTOPHER A. KRAMER

Let's face it, you've been running the company a long time. Maybe you started or bought into it, or were lucky enough to inherit it. Maybe you've been the person most responsible for its success.

Do you ever lie awake at night and wonder why no one cares as much about your business as you do? You may have tried to motivate some of your key people by promising them bonuses, with little impact to the business in the end. You may be thinking what life could be like if you could just take some chips off the table.

Perhaps you have thought about selling the company, or have even been down that road. You may have concerns—the process, taxes, your corporate culture, and what will happen to your people if you sell to a big public or, God forbid, private equity fund. Maybe your concern is about your legacy and the reputation you have built over the last 30 years. Or it may be more about what people will say about you if you "sell out."

Well, what if I told you there was a way to sell your company, possibly tax-free, and not disrupt the corporate culture one bit? What if I told you that you could sell your company to a "friendly" buyer, one who would not steal your sensitive information if the deal goes south, who would keep everything intact and actually *push* for a generous benefit program? A buyer who would encourage and even *require* employee engagement.

There is a way to accomplish all of this, and the way to do it is through an employee stock ownership plan, or ESOP. In short, an ESOP is a vehicle to sell your company on a tax-advantaged (tax-free) basis to your employees. You end up with many of the benefits of a sale to a third party—and if you structure it right, a whole lot more. Your employees end up with a long-term benefit that will usually far exceed any other retirement savings they could possibly accumulate on their own, and the opportunity to impact their own financial future each and every day.

Before I get into the details, let's quickly review a partial list of the pros and cons of other ways in which you can try to exit your business:

SALE TO A THIRD PARTY

PROS

- You will generally get most of your money upfront.
- You will generally be free to do what you want in a short period of time.
- You may get a premium price, depending on your niche.

CONS

- Potentially risky and protracted process (i.e., exposing your deepest, darkest secrets to a buyer that may back out).
- Payment of capital gains tax at least, and potentially higher rates if you are a C corporation or the buyer shifts the purchase price that results in ordinary income.
- No control over what happens post-transaction.
- Usually results in disruption to corporate culture or displacement of employees.

SALE TO A FAMILY MEMBER

PROS

- None I can think of.
- OK, maybe you preserve your home life.

CONS

- Offspring will rarely take company to the next level.
- Kids generally don't have your skill set, so getting paid is risky.
- Talented executives may resent you for it and separate from the business.
- No tax advantage unless you gift some or all of the company to them—and gifting the business doesn't get you any cash.

"When put into practice and used to full advantage, an ESOP is a living, breathing retention-, motivation-, and wealth-building tool that can literally transform an organization."

SALE TO YOUR MANAGEMENT TEAM

PROS

- They are familiar with the business and see its potential.
- Streamlined, less risky due diligence.
- They are motivated to make the deal work.

CONS

- Management teams generally don't have any money.
- No tax advantages.
- Could sour relationship if deal craters.
- The decision-making process (which ones and how much?).

In many cases, one of the above strategies will be the best alternative for you to exit. But in many other cases, these strategies leave something to be desired. In some cases, they can be disastrous. So what, then, is this ESOP alternative, and how does it work?

Succinctly put, an ESOP is a tax-advantaged vehicle to exit your business. At its most basic level, it is a structure, vehicle, trust, or legal entity that is memorialized in a document. When put into practice and used to full advantage,

an ESOP is a living, breathing retention-, motivation-, and wealth-building tool that can literally transform an organization.

From the seller's or owner's perspective, the ESOP provides maximum flexibility. The ESOP can purchase all or part of the equity of the owner, either now or in the future. As such, an ESOP can be an incredibly effective way to buy out a partner or shareholder when there are different goals and objectives. Some owners sell a minority interest to the ESOP, use it to motivate employees, and sell the rest later when the value has gone up. Other owners sell 100 percent to the ESOP in one transaction to maximize the full effect of the tax advantages. Before we illustrate what is possible with an ESOP through a few examples, let's review the primary advantages—and disadvantages—of using an ESOP as an exit vehicle.

ADVANTAGES

1. The transaction *can* be structured as completely tax-free to the seller. Yes, you can sell your stock to an ESOP, and *never* pay any tax on the gain. Now, of course, there are a number of strings attached to this, but it's perfectly legal and has been vetted and approved by the IRS over the last 42 years.

The first requirement is that your company has to be organized as a C corporation. (If you are an S corporation, you can always revoke the S election to facilitate the transaction). Next, the ESOP has to buy at least 30 percent of the company. Lastly—and here's where it gets a little tricky—you have to reinvest the proceeds into "qualified replacement property." QRP is basically stocks or bonds of U.S.-based companies—i.e., no mutual funds, international, or real estate holding companies.

If you are satisfied with a *deferral* of tax, you can simply reinvest the proceeds into your favorite stocks or bonds and ride off into the sunset. As long as you hold the stocks or bonds, you will preserve the deferral, and if your investments outlive you, you will never pay the tax. Pretty nifty, right? But what if you don't want to hold the stock you bought for another 30 years? Well, when you go to sell it, or "rebalance" your portfolio, you will trigger the gain and have to pay the tax. So, what's the solution?

If you want the transaction to be tax-free, buy what's known as a floating-rate note—the ultimate form of qualified replacement property. Basically, it's a 40- or 50-year bond, so it is almost guaranteed to outlive you—unless you are a 30-something, in which case, why are you selling the company? The rate on the note "floats," which means it usually sells at or near face value, as opposed to most bonds, whose value rises or falls as interest rates change. Since it sells at about face value, you can use it as collateral and borrow up to 90 percent of the face amount. You'll receive interest on the bond but owe interest on your loan—they are usually structured for these amounts to offset one another. Thus, you can "monetize" upward of 90 percent of the value of your company and never pay tax on the sale. Assuming the bond outlives you, your estate will get a stepped-up basis to the face amount of the note, and thus gain is eliminated.

2. The company gets to deduct interest payments *and* principal payments on funds used to effect the purchase. The mechanism for this to be true is that most ESOPs are structured whereby the company loans money to the ESOP—either from funds on hand or money borrowed from a bank. These funds are then used by the ESOP to buy the stock from the selling shareholder. Alternatively, the seller "loans" funds directly to the ESOP by agreeing to sell stock to the ESOP in the form of seller notes. The ESOP obtains cash from the company in the form of contributions that it then uses to repay the borrowed funds. Since these contributions, subject to certain payroll limitations, are tax-deductible by the corporation, any debt used to fund an ESOP purchase is effectively repaid with pre-tax dollars (i.e., fully deductible).

3. After the company is 100 percent owned by the ESOP, the company becomes 100 percent tax-free. That's right, 100 percent tax-free. In other words, the company can use the 40 percent corporate tax it used to pay—or distribute to the shareholders in the case of an S corporation—and use it to reinvest in the company. Alternatively, it can pay down debt faster, make bigger contributions to the ESOP, make acquisitions, or do just about anything it wants that enhances value. In other words, 100 percent ESOP-owned companies have a *huge* advantage over their competitors, thanks to Uncle Sam—and when was the last time the government gave you any help, much less an advantage?

4. Employee motivation and behavior improves when they have a stake in the outcome. As if the advantages referenced above weren't enough, consider that a number of studies show that ESOP companies outperform their non-ESOP counterparts in just about every measure. The main reason for this relates to tying employee behavior to performance. When you show employees how they make a difference and back it up with real economic benefits that they can see, the results can be incredible. The ESOP world is full of examples of rank-and-file employees retiring from their ESOP companies with much greater account balances that they would have had from a 401(k) match or other retirement plan.

DISADVANTAGES

Like the old economics adage says, "There is no such thing as a free lunch." So, what's the catch? Well, first and foremost, you can't easily sell your stock to an ESOP and simply walk away. Why? Because the

HP

ESOP itself does not start out with any money of its own, which means that you as the seller, or potentially the company, or both, will generally have to borrow money to get a deal done. Thus, you will generally get repaid over a period of time. While you will get a fair rate of interest—or in some cases a very substantial rate of return if the transaction is highly leveraged—you are going to have to be willing to stomach some amount of debt.

Second, all employees will participate in the ESOP according to their W-2. Thus, an employee making $100,000 will get twice as many shares allocated to their account as a person making $50,000. So, if your goal is to get a disproportionate incentive into the hands of a few key people, a supplemental plan (like phantom stock or stock appreciation rights) will have to be implemented.

Third, you will have third-party oversight in the form of the IRS and Department of Labor, as an ESOP is a qualified retirement plan under the Employee Retirement Income Security Act (ERISA). If done correctly, this is not an overly burdensome issue, but it cannot be ignored. Similar to the rules that govern your 401(k) plan, an ESOP will have eligibility requirements, vesting, etc., and you can't discriminate or exclude specific people in an ESOP in favor of others.

In closing, approximately 9,000 companies across the United States have adopted ESOPs. Many have been in existence since ERISA was passed in 1974. If you are thinking about exiting your business and you haven't considered an ESOP, it might be a good idea to learn more about it. As it relates to your employees, you can "let them eat cake." Or, if you are open-minded, don't like to pay taxes, and are willing to stick around for a few years after a transaction, you really can have your cake and eat it, too, through an ESOP. Check next month's issue for a more detailed dive into how an ESOP actually works in practice.

Christopher A. Kramer *is managing director at Strategic Equity Group. He may be reached at 714-380-3300 or* ckramer@segco.com. ■

OM
Partners