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ESOP – Is it Right for your Business?

Is an ESOP right for your business? In the appropriate circumstances an ESOP offers a multitude of economically superior ways to accomplish numerous important objectives. These objectives might be desired by a company's owners, management team and other employees, and include, among others:

- Selling either the entire company or partial ownership of it
- Rewarding and incentivizing employees
- Facilitating a business divorce
- Financing business expansion
- Tax deferred diversification of all or a portion of concentrated and illiquid share ownership in the company into a portfolio of publicly traded stock and debt securities and
- Charitable giving objectives.

What is an ESOP? "ESOP" is an acronym for Employee Stock Ownership Plan. An ESOP is a qualified retirement plan that has a mandate to invest primarily in the stock of the corporation that adopts it.

Another feature of ESOPs that distinguishes them from other retirement plans and makes them attractive in many circumstances is their ability to borrow funds to purchase employer securities. Often this leveraging is done in two parts – one is a loan to the company by an outside lender, secured by the equipment and other collateral of the company. The second part is a "mirror" loan by the company to the ESOP, secured by the shares being purchased from the shareholders. (Often the selling shareholders carry a portion of the purchase price with subordinated debt that yields a market rate return.) The company makes annual tax-deductible cash contributions to the ESOP which trigger the release of shares to participants' accounts, while at the same time the ESOP returns the cash to the company as payment on the ESOP's mirror loan. The company then has that cash available to make payments on its loan to the outside lender.

This mechanism can provide substantial retirement and ownership benefits to the employees, and yield superior economic results for all of the other parties. In some cases an ESOP can permit transactions to occur that otherwise would not be economically possible.

Why and how are the results offered by an ESOP economically superior? Because Congress has endowed the ESOP, the company and qualifying selling shareholders with tax incentives to subsidize and encourage their use. These tax incentives include:

1. No tax to the seller upon the sale of qualifying corporate stock to the ESOP, in what is known as a "1042

rollover." There are many conditions that must be met, including that the ESOP company must be a C corporation, the ESOP must end up owning at least 30 percent of the company, and the seller must invest the proceeds of the sale in qualifying public stock or debt securities.

2. Reduced or eliminated corporate tax liability. This is true particularly where the ESOP company is an S corporation. This is because as a tax-exempt entity itself, the ESOP is exempt from tax on the earnings of the S corporation that are passed through to it. Like all participants in 401(k) and other qualified retirement plans, ESOP participants will eventually pay federal income tax on their distributed benefits from the ESOP, but at the time the ESOP company produces the income, it is not subject to federal or Colorado income tax.

As a trade-off for all of these tax subsidies, Congress insists on some rules. The essence of these rules is that ESOPs must meet all of the IRS's requirements for broad-based retirement plans, as well as the fiduciary and other rules of the federal Department of Labor. The contours of these requirements are set forth in thousands of pages of statutes, regulations, governmental pronouncements and case law. A discussion of these technical requirements is beyond the scope of this article.

The complexity of the rules means that all parties (the company, the ESOP trustee and the selling shareholders) need experienced professional advisers both when the ESOP is established and for ongoing maintenance and operation. Not surprisingly, this also means that ESOPs involve ongoing financial expense and administrative time. In many cases, however, this expense is more than offset by the substantial cultural and economic advantages ESOPs can bring to the table.

How do you know if your company might be a good candidate for a leveraged ESOP? It might be, if it has all of the following characteristics:

- Predictable (and ideally increasing) operating cash flows, sufficient to service both the ESOP's debt as well as to fund benefits of retiring employees as they are paid out of the ESOP
- Best corporate governance practices or a willingness to adopt them, including among others audited financials and one or more independent directors
- A strong management team that supports the ESOP and is incented to remain with the company and drive its success
- A commitment to developing a culture of employee ownership, sharing information with the employee owners and getting them involved in the day-to-day decisions affecting their work.

If your company is lacking any of these characteristics, an ESOP might not be right for you. But if your company has them, an ESOP might be worth exploring. A good place to start is with an ESOP exploration committee or a feasibility study.

It has been estimated that since 1974 more than 4,000 corporations are majority-owned through an ESOP and thousands more are partially owned.[1] These companies have realized that an ESOP is a powerful mechanism to transfer ownership to a company's employees, and at the same time deliver remarkable tax benefits to the company and its existing owners. An experienced ESOP adviser can help you with the next steps. •

[1] "Leveraged ESOPs and Employee Buyouts," Fifth Edition, National Center for Employee Ownership (Fifth Edition, p.1).

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