

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs): A BUSINESS SUCCESSION PLANNING TOOL WORTH CONSIDERING

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WHAT IS AN ESOP?

An ESOP is a powerful business succession plan. It provides a means for a business owner to transfer ownership of a company to his or her employees while still retaining some control and value in the business.

ESOPs offer significant financial and tax advantages to all involved parties, and are governed by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) to ensure the protection of retirement funds and compliance of all company sponsors.

WHY CONSIDER AN ESOP?

- It provides a powerful, flexible mechanism for planning a company's future.
- Departing owners can sell their shares in the company to the ESOP.
- ESOPs offer special tax benefits to selling shareholders, employees, and the company as a whole.
- When key employees seek to buy the company but lack sufficient financial resources, ESOPs enable them to attain shared ownership.
- All eligible employees become beneficial owners of the company's stock, which is highly motivating. The business often thrives with the ESOP because the company's profitability directly affects the employees.
- ESOPs provide a reasonable strategy for passing on a family business when the family is no longer involved.

HOW ESOPs WORK: A MAGNIFICENT SEVEN STEP-BY-STEP OVERVIEW

1. The company sets up an ESOP trust to hold annual contributions. This trust must be qualified under the Internal Revenue Code.
2. The company contributes new shares of its own stock or cash to buy existing shares into the trust. These contributions are tax-deductible.
3. The shares held or purchased by the ESOP trust must be valued by an independent appraiser to determine their fair market value.
4. Shares are allocated to individual employee accounts annually based generally on employee compensation.
5. Employees become beneficial owners of the company stock and must be fully vested in three to six years. (See Below, "HOW DOES THE EMPLOYEE ALLOCATION WORK?")
6. ESOPs must be operated for the exclusive benefit of the plan participants.
7. Annual updated share valuations are required for plan administration purposes.

LEVERAGED ESOPs

One way companies can finance the purchase of company stock by the ESOP is to borrow from an outside lender.

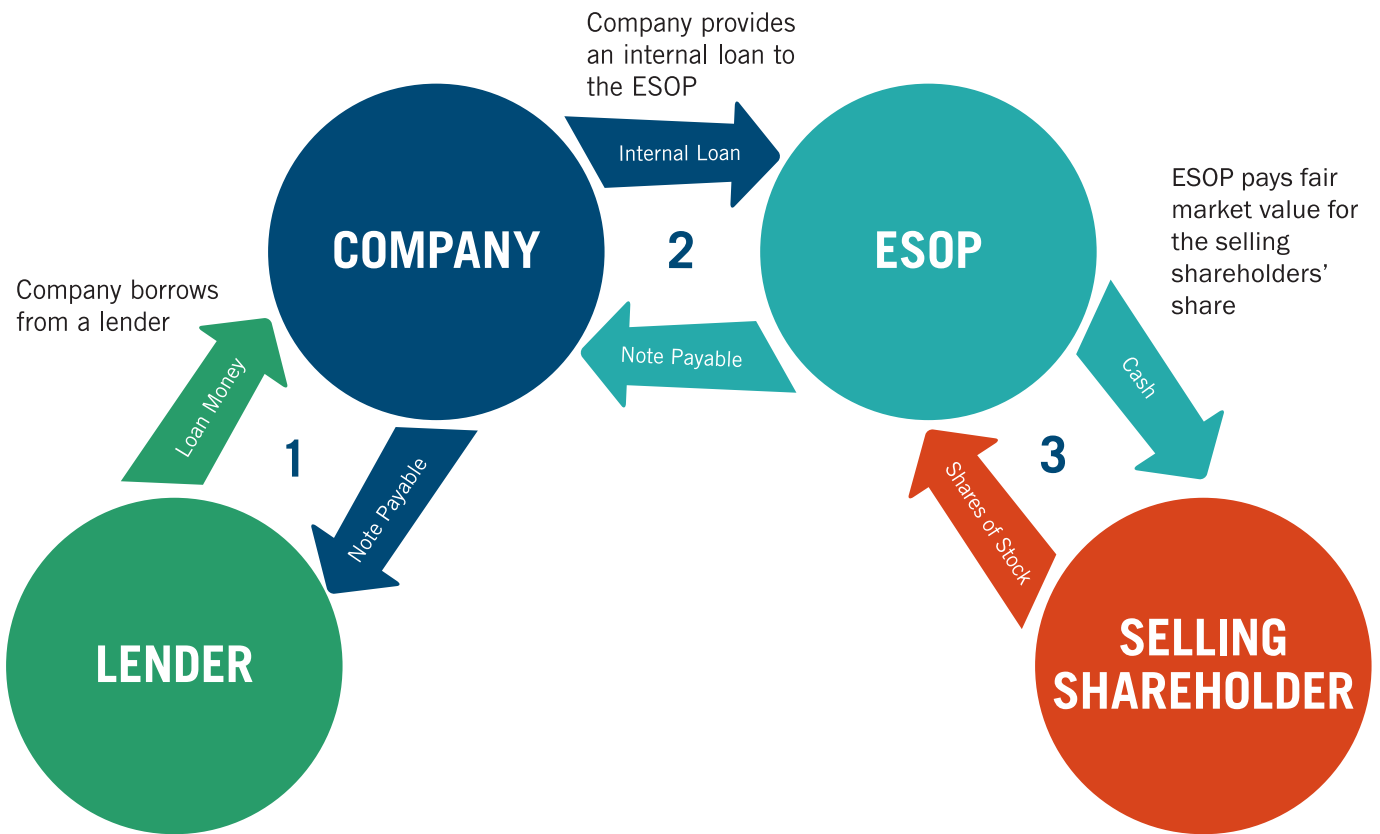
HOW DOES THE EMPLOYEE ALLOCATION WORK?

As the ESOP's internal loan is repaid, the shares are

released from the ESOP's Trust-held suspense account and allocated to individual participant accounts. Allocations in the ESOP are generally allocated to participant accounts based on a ratio of their individual compensation to the total of all eligible plan participants' salaries.

There are limits on the amount of contributions that can be made to the ESOP on an annual basis.

Leveraged ESOP Flow Chart



WHAT ABOUT VESTING?

As employee-participants continue to work at the company they vest in the shares that are allocated to their individual ESOP accounts. "Vesting" refers to the period during which employees must work before they achieve full, irrevocable entitlement to their benefits. Employees must be 100% vested within three to six years using one of the following methods:

- **Cliff Vesting** provides for 100% vesting after three years.
- **Gradual Vesting** affords 20% vesting per year beginning after year two.

TAX DEDUCTIBILITY OF LOAN PAYMENTS

One of the most beneficial and unique aspects of using an ESOP for the purchase of company stock is the pre-tax payment of the financing. That is, both the principal and interest paid by the sponsoring company are tax-deductible.

In general, companies can deduct up to 25% of eligible payroll contributed to their defined contribution plans, which include: ESOPs; 401(k) plans; profit sharing plans; and stock bonus plans. This is a combined limit that aggregates all these plans.

C CORPORATION VS S CORPORATION

There are different annual tax-deductible contribution limits depending on a company's tax status, namely whether it is an S or C Corporation.

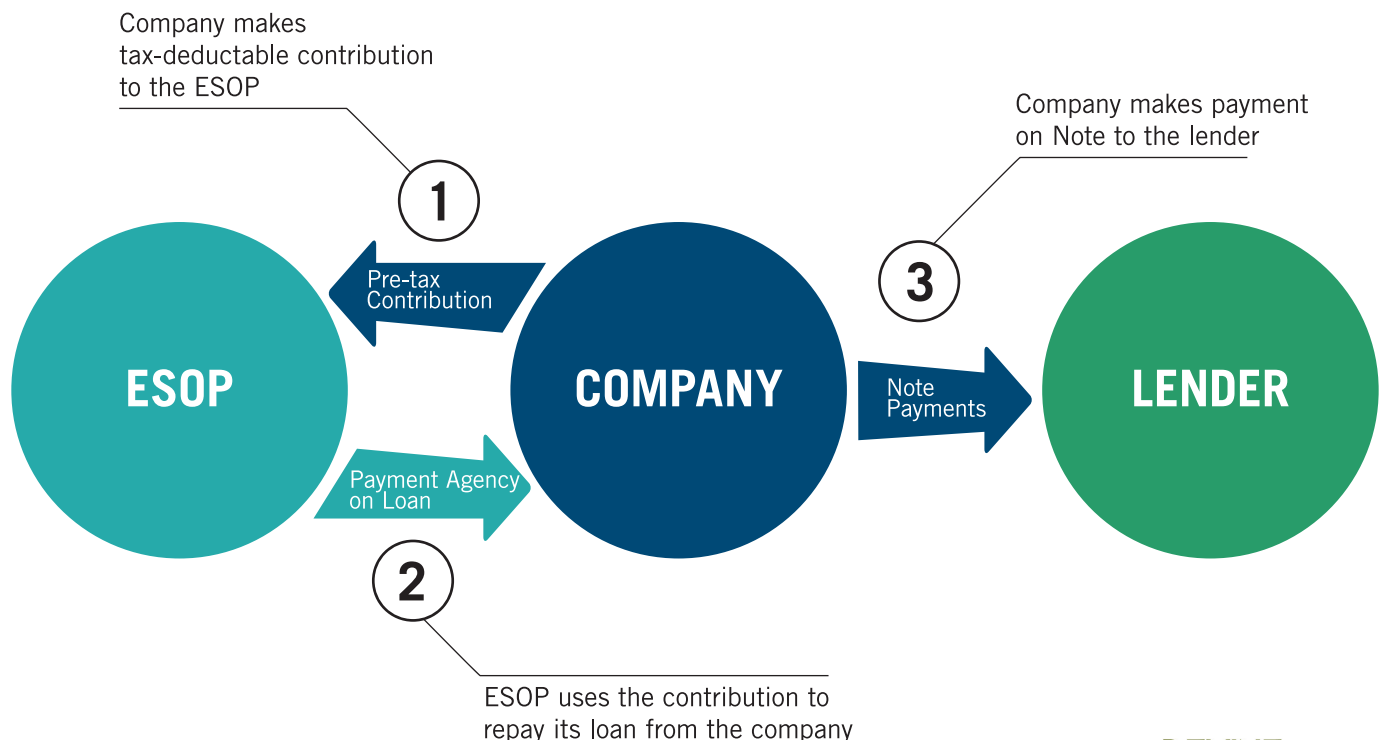
C Corporation Policies

- Leveraged ESOPs in a C corporation are allowed a separate 25% contribution level to repay the principal on an ESOP loan.
- As with any corporate loan, interest expense is fully deductible and does not count towards this 25% contribution limit.
- Reasonable levels of cash dividends paid on ESOP stock used to repay the loan or passed through to participants are also fully tax-deductible.

S Corporation Policies

- S corporations pay no federal income tax on the earnings allocated to the ESOP's share ownership as the ESOP is a tax-exempt entity (and most state income taxes mirror this). This explains why there are far more ESOP-owned S Corporations around today!
- There is a 25% limit on tax-deductible company contributions which applies to the combination of principal and interest paid on the ESOP loan (whether the ESOP is leveraged or not).
- Aggregate contributions to 401(k)s and other

Repaying Loans with Pre-Tax Dollars



defined contribution plans will count towards this limit as will the interest paid on the ESOP loan.

- Distributions on shares in the S corporation paid to the ESOP can be used to repay an ESOP loan without limit. This is the case for both allocated and unallocated shares in the ESOP Trust, and results in significant tax savings.
- For example, applying a 35% combined federal and state tax rate to an ESOP purchase of \$2 million of shares, the company realizes a tax savings of \$700,000, or 35% of \$2 million. As they are benefit plan expenses, these costs are all tax-deductible.

C CORPORATIONS CAN DEFER TAXATION USING THE SECTION 1042 “ROLLOVER”

Under Section 1042 of the Internal Revenue Code, the owner of closely held C corporation stock can defer the capital gains tax on stock sold to an ESOP. This capital gains tax deferral benefit became particularly advantageous starting in 2013. Various changes in our tax laws increased the maximum federal income tax for long-term capital gains from 15% to as much as 23.8% depending on the applicable tax bracket.

In terms of tax savings, this means that if the shareholder(s) of the company sold \$2 million worth of stock to a newly formed or existing ESOP, they could defer \$476,000 of capital gains tax under the Section 1042 Rollover rules. In addition, many States that impose their own capital gains tax will be eligible for additional deferment under Code Section 1042.

Another significant advantage of the 1042 Rollover involves estate planning. It is possible to avoid the recognition of capital gains forever if a seller holds the qualified replacement property acquired in the 1042 Rollover until death. In such cases, the qualified replacement property is passed to the decedent's estate on a stepped-up tax basis. This can effectively eliminate the original deferred capital gains tax on the company stock sold to the ESOP.

WHAT ABOUT S CORPORATIONS AND DEFERRED TAXATION?

The Section 1042 Rollover is not available for S corporation ESOPs, but there's an easy fix. The company can revoke its S corporation status to become a C corporation without delay. There is no required length of time during which a company must be a C corporation to receive the tax deferred benefits, so seller(s) of newly minted C corporation stock can avail themselves of the Section 1042 rollover benefits right away.

CONCLUSION

There are many advantages that a leveraged ESOP can provide to a closely held company and its owners. Here are our top four:

1. **PRE-TAX DOLLARS:** The company is able to finance the acquisition of its shareholders' stock using pre-tax dollars as a result of ESOP loan payments.
2. **DEFERRAL OF CAPITAL GAINS TAX:** The seller can defer capital gains tax (potentially forever) on the sale of C corporation stock to the ESOP.
3. **RETENTION OF INCOME TAX PAYMENTS:** S corporations allow the company to retain income tax payments as a result of the ESOP's stock ownership.
4. **EMPLOYEE MOTIVATION:** The employees gain a motivating retirement benefit that can potentially increase the value of the company by leveraging an ownership mentality.

As with any complex corporate finance structure involving the Internal Revenue Code and ERISA, it is important to get qualified and experienced professional advice and assistance before considering an ESOP as your company's perpetuation solution. Penalties for violating Code and ERISA requirements can be serious but are easily avoided with the proper planning and advice.

ABOUT THE AUTHORS

CHUCK COYNE is a Managing Director of Empire Valuation Consultants, LLC, a national independent business valuation firm with offices in New York City, Rochester, NY, Boston, MA, San Francisco, CA, and West Hartford, CT. He has been providing privately held companies with business valuations, ownership succession planning assistance, mergers and acquisition assistance and ESOP feasibility analysis, transaction structuring, and quarterbacking for over 30 years. Chuck is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers and has an MBA in Accounting from the University of Hartford.

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TABITHA CROSCUT is a shareholder and chair of the ESOP Team at Devine Millimet, with a national practice focused on ESOPs as succession and employee compensation strategies. In addition to counseling clients regarding transactional, compliance and fiduciary issues with respect to their ESOPs, she has represented companies, sellers and trustees in ESOP stock purchase transactions ranging from under a million dollars to over four hundred million dollars.

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