A BUSINESS GUIDE TO ESOP

AN INSIDE LOOK AT EMPLOYEE STOCK OWNERSHIP PLANS

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ESOP 101: WHAT OWNERS NEED TO KNOW ABOUT EMPLOYEE STOCK OWNERSHIP PLANS

One of the biggest decisions a business owner can make is how they want to handle the succession of their company. While many employees can retire and move on with their life, an owner has to consider several things, including who is going to succeed them and how this succession will impact their company.

Picking the right succession plan for you depends on your specific situation. If you're looking for a more controlled succession that allows you to phase out of the company when you're ready, an Employee Stock Ownership Plan (ESOP) might be the best choice for you.

Why Should You Choose an ESOP?

There are a variety of special attributes about an ESOP that make it attractive to certain business owners who are doing succession planning or other ownership transitions. One of the biggest benefits is that an owner can continue to maintain some control even after selling the company. An owner selling a third party runs the risk of having to answer to a new boss as soon as the purchase agreement is signed.

Nobody wants to be told how to run their business. With an ESOP, an owner has an ability to dictate their role with the company post sale. An ESOP can allow owners to determine their own retirement timeline. This means you can still play a sales role, serve as an advisor, or do anything else that allows you to stay active in you company while you ease yourself away when you're ready to retire.

Another benefit of an ESOP is that it's a relatively private process. A third party sale means that you'll have several prospective buyers digging through your information. With an ESOP, you'll hire a trustee and negotiate transactions without disclosing sensitive information to multiple suitors, some of whom may be competitors.

ESOPs also have several financial benefits. Selling shares in a privately held company to an ESOP allows a business owner to diversify their wealth and lower their financial risk. There are also some tax advantages to using an ESOP, as payments to the ESOP to buy stock can be tax deductible. That makes it easier to sell to an ESOP from a cash flow standpoint. Additionally, owners selling shares of a C-corporation to an ESOP can defer capital gains on the sale proceeds when selling 30% or more of their ownership interest. As an S-Corporation, the company can avoid having to fund the payment of Federal income taxes post transaction, which creates additional cash flow to finance the purchase price.

Who are the Best Candidates for an ESOP?

To help figure out who is best suited for an ESOP, think of who you want to run your company after you retire. An ESOP allows you to pass your business on to the employees who have helped you build it. This means that all of your employees will be able to buy stock in the company and be even more invested in its success than before while you get to dictate the process.

However, an ESOP is not for everyone. Since an ESOP puts your employees in control, it's important that you have a strong management team to carry on your legacy and keep the business profitable. However, you'll have more freedom to groom the right team to succeed if you don't have to worry about third party buyers taking over and telling you what will happen.

Additionally, good candidates for an ESOP include companies with large enough employee headcount to allocate shares in a way that does not create a burdensome repurchase liability as employees leave the company.

There's also the matter of whether or not any children may succeed you. If you have a child, or multiple children, who plan on taking over after you retire, you would be better suited with other succession planning options. However, children are not always guaranteed to be either willing or suited for a leadership role. If this is the case, your children can still be part of the successor group with an ESOP and you can feel comfortable that your business is in the right hands.

Exactly What is an ESOP?

At its core, an ESOP is a qualified retirement plan designed to invest primarily in the stock of the corporate employer. Since it’s a qualified plan, there are some qualified rules that the company will have to follow.

One big difference between an ESOP and other succession plans is that the ESOP cannot pay more than fair market value. As a trust, your ESOP would have a trustee that would negotiate each transaction and annual administration of benefits based on an independent appraisal. Their appraisals occur before each transaction and on an annual basis.

Since an ESOP is a trust with potential tax benefits, there are some legal nuances to the plan. However, there are ESOP experts who can help guide you through the plan and prepare your business for the future.

When Should I Start the ESOP Process?

Business owners should start planning for succession around five years before they’re ready to be done. It will normally take an ESOP five years to get healthy enough to allow you to start curtailing your role and make sure you get paid. However, starting the ESOP process doesn’t mean that you have to be out after that five-year window. You can stay on long past the ESOP becomes healthy and ease out of your role at your own pace.

DOES AN ESOP MAKE SENSE FOR MY SUCCESSION PLAN?

As a business owner, you have to make many decisions, including how, and when, it's time for you to move on from your business. The process of stepping away from your company can be difficult, but proper planning can ensure that you and your business will not only survive the process, but thrive for years to come.

Once you decide that you're ready to plan for exit, you have to decide exactly how you want to go about the process. There are different routes you can choose, including:

- Sell to the management team
- Transfer ownership to your children
- Sell to a competitor
- Sell to a private equity firm
- Sell to an ESOP

Fluctuating around 10,000 total plans in the U.S., Employee Stock Ownership Plans (ESOP) can be a viable choice and depending on your business' situation and structure can offer substantial tax savings, among other benefits. However, ESOPs are not for everyone and careful planning and consideration are required.

Like any big business decision, you need to do your homework on succession planning to determine what's best for you and your company.

What Makes an ESOP Different

At the most basic level, an ESOP is simply an employee benefit plan (similar to a 401(k) plan) that allows employees to effectively own stock in the company. ESOPs offer special perks, but they can have their downsides depending on what you're looking for. There's plenty to learn about ESOPs, so make sure you balance the pros and cons to figure out if they're the right fit.

ESOPs offer financial advantages

There can be substantial tax savings associated with selling to an ESOP. For example, a C Corporation shareholder that sells at least 30% of their shares to an ESOP can roll over the proceeds into other qualified investments and defer capital gain taxes under the provisions of Sec. 1042. Any potential gain on the sale is deferred until the newly purchased, qualified investments are sold.

The tax benefit of selling stock of an S Corporation are mostly realized by the company as ESOPs are qualified plans and therefore not subject to pass through income taxes. This tax savings can also benefit the seller, as increased cash flow can be used to speed repayment to the seller in leveraged situations.

Another potential tax advantage that can be realized by the company is receiving tax deductions for interest as well as principal repayments on ESOP loans.

ESOPs work best for certain types of companies

The size of the company does matter for an ESOP. You need to have a reasonable size, workforce, and payroll to be able to support an ESOP. Do to administrative cost and anti-abuse rules it would be difficult for business worth less than $2 million with less than 20 employees to be a feasible ESOP.

Additional characteristics that make a ESOP candidate include a good history of cash flow, solid successor management teams, debt capacity, relatively low employee turnover and a business that is not overly cyclical.

ESOPs can help owners have a say in what happens to their company

One of the main advantages of an ESOP is that it allows you to protect your business and your legacy. If you sell to an outside party, they typically want to buy control. Passing on control allows the buyer to have free reign to do whatever they want with your company, which could include changes to the workforce and irrevocably changing the foundation that you built. You will also have a boss.

You can structure the transition so that you still have some level of control and/or involvement in day-to-day operations. One potential way of doing this is selling shares to an ESOP in steps. This would include not selling 100% of the business up front and playing a role while you phase yourself out of the company. In a few years, you can sell additional shares and create your own pace for departure.

Alternatively, you could sell 100% of the Company to an ESOP, but retain a seat on the board. The general idea is having the ESOP as the owner allows for greater flexibility in how and when you transition out of the business.

ESOPs can reward employees

When you choose to exit your business through an ESOP, it basically gives your employees ownership of your business. As such, it creates a stock-based incentive oriented retirement program that can help retain and empower your workforce.

Since an ESOP involves your employees, it’s critical that they buy in to the process for long-term success. This can be a challenge because you may present this to employees and they may not understand how an ESOP works. Good communication and a receptive workforce can be a key part of the ESOP process.

Find a Good Succession Planning Partner

Selling your business can take a while, regardless of who you sell to. A typical transaction can take six to nine months. We suggest starting the succession planning process three to five years before you actually want to sell your business.

Apple Growth Partners has a dedicated team focused on valuations, feasibility and advisory activities for organizations pursuing or looking to enhance Employee Stock Ownership Plans. We manage 60-70 reoccurring ESOP's annually and complete approximately five new transactions or evaluations each year. We will guide you through the ESOP formation decision, plan design and process and valuation activities.

For more information, contact us online or at 330.867.7350.

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