Memorandum

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To: Sirote Clients Date: August 1, 2019

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RE: Employee Stock Ownership Plans – Helping Owners Achieve Liquidity

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The sale of stock of a company to an employee stock ownership plan (ESOP) is an often overlooked and underutilized technique for allowing the owners of a closely held corporation to diversify their investments. The sale to an ESOP creates a liquidity event for the owners without the need to give up control to an unrelated buyer. It also provides reduced tax consequences compared to other liquidity events and can be a very useful succession planning tool.

Background

An ESOP is a type of defined contribution benefit plan, similar to a 401(k) plan, but designed to purchase and own stock of an employer. ESOPs are unique in that they are the only employee retirement savings plan that the law permits to use leverage to acquire employer stock.

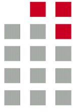
ESOPs have been around for decades, and, based on recent data, there are more than 11,000 companies in the United States that are owned in whole or in part or completely by an ESOP.

Achieving Liquidity

One of the most important issues for owners in a closely held business is determining how to achieve liquidity for the owners of the business. This liquidity event usually takes the form of a sale to an unrelated third party. Since it can be difficult to sell a minority interest in a privately held company, the end result, in most such cases, is the loss of control by the owners.

In some instances the owners may work for a brief period of time during the transition period to new management, but these arrangements are usually short lived due to differences in management philosophy between the founding owners and the new owners.

But what if you could have your cake and eat it too? Well, you can.



ESOPs are particularly beneficial to owners who desire to sell a minority interest in their company while maintaining control and continuing to work for the organization. As an additional bonus, it is possible to defer capital gains associated with the sale indefinitely.

Transaction Structure

In a leveraged ESOP, the ESOP or its corporate sponsor (the Company), borrows funds from a financial institution or other qualified lender (which may include the owners) to acquire the stock of the Company. The Company usually gives the lender a guarantee that it will make contributions to the ESOP that will enable the ESOP to amortize the loan on schedule. Occasionally, the lender may prefer that the Company borrow the funds directly and make a loan back to the ESOP.

ESOP financing can also be used to make acquisitions, buy back publicly-traded stock, or for any other corporate purpose such as divesting a division or providing new capital for expansion or capital improvements by purchasing new shares of stock in the company.

Two tax incentives make borrowing through an ESOP extremely attractive to businesses that might otherwise never consider financing their employees' acquisition of stock. First, since ESOP contributions are tax deductible, a company that repays an ESOP loan is permitted to deduct principal, as well as interest, from taxes. This can significantly cut the cost of financing to the company, by reducing the number of pre-tax dollars needed to repay the principal (which will vary depending on the company's tax bracket). Second, dividends paid on ESOP stock which are passed through to employees or used to repay the ESOP loan are tax deductible, if the ESOP sponsor operates as a C corporation. If the ESOP sponsor is an S corporation, on the other hand, dividends may be used to pay the ESOP debt, but there is no tax deduction as the S corporation pays no corporate income tax. This provision of federal tax law may increase the amount of cash available to a company compared to conventional financing.

Benefits

The primary benefit of selling company stock to an ESOP is that the owners are able to maintain control of their business. They are also able to preserve the legacy of their company after they exit the business. Oftentimes, when a third party acquires the company, the new owner will seek to rename or relocate the business, terminate employees, move or shut down operations, change the character or focus of the company, etc. With the sale of company stock to an ESOP, the owners can achieve liquidity while maintaining the company's independence. In addition, the owners of the company can still be active in the management of the business following the sale of company stock to the ESOP.

Finally, the sale of company stock to an ESOP generally involves a shorter and less complicated transaction than a typical third-party M&A transaction.

Conclusion

There may be some regulatory hurdles to overcome as with any change in control situation involving a company, but the use of as ESOP is a viable option that should be considered when seeking liquidity. In dealing with the applicable IRS regulations, a company should consult with professionals who have experience with ESOPs before pursuing such a transaction. While ESOPs have grown in popularity over the past several years, too few business owners and their advisors consider them when they seek liquidity or as part of a succession-planning process. We have a team of professionals who have experience with ESOPs that can assist with these and other M&A transactions.