Selling to an ESOP: A Step-by-Step Guide

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• Ownership Transition for Privately-Owned Companies
• Common ESOP Transaction Structure Examples
• C Corporation ESOPs
• S Corporation ESOPs
Ownership Transitions for Privately-Owned Companies
Liquidity and Succession: Some Common Goals

• Maximize after-tax proceeds

• Control timing of succession and transfer

• Shareholder/officer ongoing role as executive

• Diversify personal wealth

• Legacy
Liquidity & Succession Alternatives

External buyers
- Strategic
- Financial
- IPO

Internal Buyers
- Family
- Management
- Partner (Redemptions & Buy-Sells)
- ESOP

Liquidation
ESOP Basics
What is an ESOP?

- “Employee Stock Ownership Plan”
- Qualified retirement plan under IRC
  - Regulated by US DOL and IRS
  - Company funded benefit - no employee contributions
  - Assets held in a Trust; employees do NOT own the stock directly
  - Intended to be invested primarily in company stock
- Only qualified retirement plan that can borrow money
- Tax efficient and controlled means of selling stock
Why Use An ESOP?

- **Shareholder Liquidity**: Create a market for part of the owners’ stock
- **Shareholder Tax Minimization**: Defer payment of capital gains taxes
- **Corporate Tax Minimization**:
  - Effectively create interest AND principal payments tax deductions
  - S corporation ESOP federal income tax exemption
- **Succession Planning**: Shareholders can sell shares while maintaining control of the company
- **Legacy**: Maintain company’s independence
- **Employees**: Motivate, retain and reward employees
Business Owner Objectives?

- Legacy
- Employee concern (family)
- Control / maintain day-to-day
- Diversification
- Avoid / Reduce Income Tax (Seller & Company)
- Control of deal structure
- Additional retirement plan for employees
- Increase employee productivity / employee incentive
- Not ready to golf / leave company
- Value / purchase price certainty
- No ownership transition alternatives – close the doors
- Liquidity
- Remove unwanted shareholders / reduce large number of shareholders
ESOP’s Primary Roles

- Help owners convert paper wealth into cash and liquidity
- Help manage the succession/continuity of the business
- Reward the people that have helped grow the company
- Transition in a **controlled** and **tax efficient** manner
ESOP Trust Ownership: Beneficial vs. Direct Ownership

• Shares purchased by the ESOP are owned in a trust, **not by plan participants**
  – Eligible employees are “beneficiaries” of the trust

• An independent trustee represents the interest of ESOP participants
XYZ, Inc. Structure
Pre-ESOP

Shareholders

Non-ESOP Shareholders

elect

Board of Directors

appoint and oversee

President and CEO

 hires and oversees

Management Team

 hire and oversee

Employees
XYZ, Inc. Structure After ESOP

Shareholders

ESOP Trustee

Non-ESOP Shareholders

elect

Board of Directors

appoint and oversee

President and CEO

hires and oversees

Management Team

hires and oversees

Employees

ESOP Participants

are represented by

ESOP eligibility requirements are met
Common ESOP Misperceptions

• Participants own and vote the stock
  – Untrue unless you are a public company or shareholders get to vote on a major issues (which does not include voting for the Board)

• Participants are entitled to company financial statements
  – Untrue, unless you are a public company

• All of the company’s stock must be sold to an ESOP

• A company has to be a C corporation to sponsor an ESOP

• A company has to use debt to sell stock to an ESOP
Situations Not Befitting an ESOP

- No successor management
- Owner only wants a few people to own the company
- There may not be enough “Es” to “SOP”
- Owner’s price is “opportunistic”
Where Do You Start?

- Conferences like this are a good start.
- NCEO books and websites
- Ask what do you want?
- What can work for you and your company?
The Forming ESOP Process

- Consider a transaction study
- Creates the book for the Trustee
- Sets the transaction in motion.
The Forming ESOP Process

- An ESOP Trust is established
- An ESOP Trustee is appointed (Internal or External)
- An outside appraisal of the company
- The owners sell their stock to the Trustee and possibly the Company
- The Trustee and the Company issues notes to the owners or owners receive cash
- The owners get an employment contract and non compete agreement
• Every month the ESOP is paid down and the old owners get a check

• At the end of each year:
  – A new appraisal is done on the company
  – Stock is distributed to eligible employees
  – Stock is distributed at original sale price but assumes new price in employee account.

• A company meeting is held and everything is explained
Some Common ESOP Transaction Examples
Typical ESOP Transactions: Case Study Assumptions

- XYZ Corp. has two shareholders, Jim who owns 80% and Pat owning 20%
- XYZ is profitable and has a payroll of approximately $8 million
- The company’s book value is $10 million
- Earnings (EBITDA) average approximately $3 million per year
- FMV is $15 million
Case I: Non-Leveraged ESOP

- Jim is seeking to sell his stock over several years as he approaches retirement
- XYZ Corp. would prefer to remain debt-free

Solution

“Pay-as-you-go” ESOP
RESULT:

- Company contributes to ESOP each year based on profits
- Here, ESOP buys 3.3% of XYZ Corp. from Jim, who will then own 76.7%
- Post transaction, Jim may be appointed Trustee and votes the ESOP’s stock
- Jim can continue this stock sale strategy each year at his discretion subject to complying with fiduciary duties as Trustee.
Case II: Non-Leveraged ESOP

- The company has just experienced several financially challenging years, but the company’s prospects are now much brighter.
- Jim would prefer waiting to sell stock until the share price has improved.
- Company wants to immediately reduce income taxes.

**Solution**

Pre-Funding the ESOP
RESULT:

- Company receives tax deduction contributions each year, thereby reducing tax bill
- ESOP accumulates $1,000,000 (+) of cash over three years
- Jim sells 6.7% of stock to ESOP after Year 3
Case III: Partial Leveraged ESOP Transaction

- Jim wishes to sell a large percentage, *but not all*, of his stock to the ESOP
- Jim does not want to pay capital gains taxes
- The company has “debt capacity”

**Solution**

The Partially Leveraged ESOP
Partial Leveraged ESOP

- The ESOP purchases 33% of XYZ’s stock from Jim for $5 million
- The stock purchase is financed with a $5 million loan, which will be repaid over time
Partially Leveraged ESOP

1. $5 Million Cash

2. $5 Million Cash

3. $5 Million Cash

33% of the Outstanding Shares

XYZ Corp

ESOP

Jim

Bank

$5 Million Note Payable

XYZ Stock
1. Company makes **tax deductible** contribution to the ESOP
2. ESOP uses the contribution to repay its loan from company
3. Company repays Financial Institution
Case IV: 100% ESOP Buyout

- Jim and Pat sell 100% of their XYZ stock to the EOSP for $15 million
  - The stock purchase is financed with a $7.5 million bank loan and $7.5 million subordinated seller note, with warrants
- Selected managers participate in a Management Incentive Plan that is tied to the value of equity
  - This benefit is in addition to their ESOP participation
$7.5 Million Note Payable + $7.5 Million “Day Loan”

$15 Million Cash

XYZ Corp

$15 Million Cash

$15 Million Note Payable

ESOP

$15 Million Cash

Jim & Pat

100% of the Outstanding Shares

100% Leveraged ESOP
Bank

XYZ Corp

$7.5 Million Paydown OfDay Loan

$7.5 Million Cash

Subordinated Seller Notes

ESOP

Jim & Pat

XYZ Stock

100% Leveraged ESOP
1. Company makes tax deductible contribution to the ESOP
2. ESOP uses the contribution to repay its loan from company
3. Company repays Financial Institution
1. Company makes tax deductible contribution to the ESOP
2. ESOP uses the contribution to repay its loan from the company
3. Company repays Sellers

XYZ ESOP Noteholders
Jim & Pat

Paying Off The Debt
Seller Note Characteristics

- Seller notes yield between 19% and 14% depending on the market rates
- Part of the yield is made up of a “current pay”, or interest income
- The balance of the yield is made up of stock warrants, or a right to buy stock at a certain price, for a certain period of time
- The amount of warrants is determined by the amount of interest income and the total targeted yield on the note
Management Incentive Plans

• Key managers are awarded synthetic stock incentives
• This ownership is not direct ownership of stock, which limits complexity, but conveys economic value based on company performance
• Non-qualified plan that can be designed from “whole cloth”
• KEY: needs to be tied to increased equity value so ESOP is not overly diluted
• Generally the value of these plans is 10-15% of the fully diluted equity
Results

• Jim & Pat have locked in their value at $15 million, having collected $7.5mm in cash at closing
  – Seller note warrants could bring in additional value
  – No capital gains taxes due (C corps only)
• Jim & Pat can remain employed as officers / employees if they wish
• Selected managers could have a claim on equity value through synthetic equity
• Employees will receive new retirement benefit that is tied to the success of the company
• The company has eliminated federal and (most) state corporate income taxation
C Corporation
ESOP Advantages
Capital Gain Tax Deferral Rules

- Company has to be a C corporation at time of transaction
- S corporations still can do ESOPs, but no capital gains tax benefit (more on this later)
- ESOP’s ownership must be ≥30% to qualify for the capital gains tax benefit (if ESOP owns less than 30%, capital gains tax will be due)
- Seller must reinvest the proceeds in “Qualified Replacement Property” within 15 month window
- Stock sold must have a 3-year holding period
Qualified Replacement Property

Eligible*
- Common Stock
- Convertible Bonds
- Corporate Fixed Rate Bonds
- Corporate Floating Rate Notes (FRN)

Not Eligible
- Municipal Bonds
- U.S. Government Bonds
- Mutual Funds
- Foreign Securities
- REITs
- Bank CDs

*Eligible issuer must have:
- Securities of a corporation that is incorporated in the U.S.
- More than 50% of its assets used in the active conduct of a trade or business
- No more than 25% of its gross income from passive sources
**Seller Capital Gain Tax Deferral: QRP Considerations**

- **Issue**: If any QRP is sold, the pro rata deferred capital gains tax becomes due
- **Implications**:  
  - The QRP portfolio cannot be actively managed  
  - Minimize callable securities  
- **Solution**: Purchase an “ESOP Bond”
ESOP Bond

- Issued by AAA and AA credits
- Long term:
  - Typically a 50 year maturity
  - Non-callable for 30 years
- Floating rate interest paid quarterly using LIBOR
Unlocking the QRP Lockup

$5 Million From ESOP Stock Sale

$5,000,000 ESOP Bond

$4,500,000 Margin Loan Proceeds

Net Unrestricted Proceeds To Seller
S Corporation
ESOP Advantage
S Corporation ESOP Tax Benefits

- S corporation shareholders are responsible for paying their pro rata share of the company’s tax liability
- An ESOP is a qualified, tax-exempt trust similar to a 401(k) trust
- As an S corporation shareholder, the ESOP is not required to pay its pro rata share of the company’s taxes
- ESOP can use distributions it receives to pay debt rapidly
- This company is exempt from paying federal and most state income taxes
Assumptions
- S Corp generates taxable income of $1,000,000
- S Corp makes a $500,000 distribution to its shareholders pro-rata

S Corp

ESOP
(40% Shareholder)

Jim
(60% Shareholder)

IRS

Tax Payment

$200,000 Loan Pmt.

$200,000 Distribution

$300,000 Distribution

$200,000 Loan Payment
Do ESOPs Really Increase Employee Productivity
Best ESOP Candidates?

- Are profitable and growing
- Can finance their own growth
- Are not overleveraged
- Have good financial reporting
- Have a deep and broad management team
Steps in ESOP Transaction

- Feasibility Study (Transaction Analysis)
- Financing
- Appraisal
- Plan Design
- Legal Documentation
- Closing
- IRS Determination Letter
Thank You
For Your Time Today.

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