Ownership Succession Planning With an Employee Stock Ownership Plan

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An employee stock ownership plan (ESOP) is a qualified retirement plan which is designed to hold stock of the company which sponsors the plan as its primary asset for the benefit of the company's employees. According to the ESOP Association, there are over 11,500 employee-owned companies in the United States covering approximately 10 million employees with more than $600 billion in employee asset value. The significant majority of these companies are closely held, privately owned businesses that formed an ESOP as a vehicle for ownership succession, as opposed to public companies that implement employee-ownership programs as a pure employee benefit and retention tool. Although ESOPs have been around for decades, favorable tax laws and numerous success stories have increased their popularity.

The first thing any business owner needs to do when thinking about ownership succession is to determine what his or her objectives are in initiating a sale of the company. A business owner may want to get top dollar from the sale of his company and may not be concerned about what happens with his business and employees after they sell it, such as the company being gobbled up and integrated into a larger company with the resulting job losses by longtime employees or relocation of the business and the effects on the local community. In those cases, selling the business to a competitor or a financial buyer like a private equity firm may be the best alternative.

However, many business owners look at their business as their baby -- something the owner built, nurtured and grew through their own blood, sweat and tears. This type of business owner is typically interested in seeing his company continue to grow and evolve in the future -- maybe not with their full or any involvement, but with employees who have been loyal and dedicated for many years. This business owner will be looking to receive a fair price, for the sale of their business, but may not necessarily looking for the highest price in order to meet the objective of preserving the "legacy" of the business and rewarding loyal, hard-working employees for years of service. Some other business owners may need to get some liquidity for family needs or to start planning for retirement, but still want to continue to be involved in the operations of the business. For these sorts of business owners, using an employee stock ownership plan (ESOP) can be an effective way to transition ownership of their company.

The flexibility of the ESOP transaction alternative is attractive in many respects when an owner is exploring exit strategies. A sale of a company to a third party generally is "all-or-nothing" where the purchaser acquires 100 percent of the assets or stock of the company, the new management group assumes control of the company and, in most cases, the selling owner ceases to be employed with the company immediately or within several months after the deal closes. However, the company's owners may want to consider a multi-stage transaction whereby he or she sells a minority interest today and the remainder at a later date. Therefore, ESOPs are often the only viable option for company owners seeking partial liquidity since most strategic and financial buyers will only want to acquire a controlling interest in the company.

An ESOP which does not have to purchase all of the company's stock in a single transaction. A common ESOP deal structure involves selling a minority interest (typically between 30% and 50%) to an ESOP with the remaining portion retained by the owner or a few members of the key management team. In a transaction using an ESOP, the business owner is dealing with employees who are used to the owner being involved in the company's operations so they will be willing to facilitate this transaction on a timetable acceptable to the owner. In addition, most ESOP transactions are contingent on the owner staying around to help facilitate the transition. This owner retention may be needed because the new employee management team may need to learn how to act like owners and this transition may take some time. The ESOP alternative also provides the company's current owners with a level of comfort that a transaction will be completed that does not exist when there is a third-party buyer and also that the ESOP will be in place to acquire the remainder of their stock when they are ready to retire.

An ESOP transaction has unique tax benefits to both the selling owner and the company. In comparison to other liquidity alternatives, the ESOP structure is often the most tax efficient structure for the selling owner. The business owner may be able to permanently defer all capital gains taxes on the transaction. Under section 1042 of the Internal Revenue Code, a seller of C corporation stock can defer capital gains taxes of the sale of stock to an ESOP if the ESOP purchases at least 30% of the outstanding common stock and the seller reinvests the sale proceeds into certain qualified replacement property consisting of stock and bonds of U.S. operating companies. If the seller retains this replacement property until death the seller's heirs will get a stepped up basis in the replacement property and avoid all capital gains on the original sale. For S corporations, the company can be converted into a C corporation prior to the transaction to permit the current owners of the firm to take advantage of the tax deferral opportunity.

The ESOP structure can significantly reduce or even eliminate a company's income tax burden. Annual contributions to the ESOP are a fully tax-deductible expense so an ESOP company can indirectly fund both the principal and the interest payments on an ESOP's debt service with pre-tax dollars. Generally, these contributions are limited to 25% of total qualified company payroll. Furthermore, while the annual contributions to the ESOP are tax deductible for all companies, the most significant tax benefits are accomplished when an ESOP owns 100% of the common stock of an S corporation. Income from an S corporation is passed through to the owners of the entity, but since an ESOP is a qualified retirement plan that is exempt from all federal and most state income taxes, the benefit creates significant savings. Therefore, a company that is an S corporation and wholly ESOP owned has a significant competitive advantage because the company can use the enhanced cash flow to be more cost competitive on bids, accelerate debt repayment, expand through acquisitions, and attract new talent.

Demographic information shows that many business owners are approaching normal retirement age. Many companies are owned by original founders of the company or a small group of management. Many of these founders and senior members of management, as they approach retirement age, are beginning to consider exit strategies, some of which have undesirable tax and operational impacts on the ongoing business. Owners that are interested in financing flexibility, tax savings, and the opportunity to exit the business over time should consider the ESOP approach. An ownership culture established through employee-ownership can lead to greater loyalty and willingness to work hard, all while giving the company a tax-efficient tool to attract and retain employees.

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