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Effective Succession Strategy: Employee Stock Ownership Plan (ESOP)

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An Employee Stock Ownership Plan (ESOP) can provide significant benefits to shareholders, management and employees of a privately owned business.

An ESOP can:

- Be an excellent financial alternative for business owners rather than selling their business to a third-party, such as a private equity group or strategic buyer,
- Offer certain tax benefits while providing business owners liquidity, diversification and enhanced retirement benefits,
- Facilitate the financing of corporate transactions and provide employees with an ownership interest in their employer and a valuable retirement benefit,
- Maximize the economic and estate planning benefits compared to alternative options.

Sale Scenarios

An ESOP can be utilized as a creative solution for business owners who are wanting to retire from direct involvement of their company but also wish that the company continue in the hands of family members or employees who have a similar personal and emotional investment in the company. An owner who has spent years building a successful company may not be interested in selling his/her company to an unrelated third party.

In many cases, third party sales can be difficult due to the business owner's relationships being the main source of new business. Potential buyers may want significant earnouts, claw backs or other egregious purchase covenants.

As an alternative to selling to an outsider, such as private equity or a strategic buyer, an owner may consider selling to an ESOP. This strategy enhances their own personal security with the proceeds from the sale while concurrently maintaining significant ownership of the business. Additionally, through the ESOP strategy, an owner will share his/her ownership interest with others who have been managing or working in the company over the years and who, therefore, share a similar emotional investment in the business.

If a succession management team is not in place, the ESOP can be used as a tool to trigger a tax-advantageous monetization event while simultaneously preparing family members or a new management team to succeed the owner over a given time horizon such as three-, five- or ten-year period. If this next generation proves they can handle the management of the business, the owner can retire and get paid again from the payment of his/her ESOP interest, which can often be significant. If not, the company can then be sold to a third party. Both scenarios offer the owner, family members, management and employees incremental value due to the ESOP ownership interest and if structured properly, can result in a tax-free sale.

The government provides significant tax incentives for ESOP-owned companies. Many studies show that these plans outpace 401(k) plans as a source of retirement income for participants and can outperform the S&P 500 in year-over-year investment returns.

Combining an ESOP with a 401(k) plan can offer significant benefits to the owner and employees. Surprisingly, the total number of ESOPs – and the employees they cover – has not grown substantially in recent years.

There are a number of reasons for the slow growth of ESOPs, but most industry pundits point to a reputation hangover from the misuse of the plans by bad companies and a lack of understanding of the complex workings of ESOPs as the most likely barriers to adoption. Some have argued that there has been significant growth in ESOPs, but point out that many successful ESOPs are sold to third parties by successor management teams to monetize the business and de-risk the ESOP participants, thereby keeping the number of ESOPs at a level number in the United States at around 6,500.

Tax Benefits of an ESOP

An ESOP is a tax-qualified retirement plan that invests primarily in stock of the sponsoring employer and meets several other conditions.

An ESOP can potentially eliminate U.S. taxation on a business going forward. The trade-off for this tax planning approach is that the employer must share ownership with some or all non-shareholder employees. The ability to eliminate federal tax is the result of changes made in 1998 to the Internal Revenue Code (IRC) that exclude from federal tax the earnings of a Subchapter S corporation (S corporation) allocable to an ESOP. These provisions were added by Congress to incentivize employee ownership. Under current law, an S corporation that is owned 100% by an ESOP will not incur any federal taxes (or unrelated business income tax). Since an S corporation can have retained earnings, the ability to have such retained earnings grow tax-free represents a powerful vehicle.

Most states follow the federal statue and don't tax ESOP S corporation earnings. In many instances, such significant tax benefits allow for a quicker monetization of the business with better economics than a third party sale to either a private equity or a strategic buyer.

Many ESOPs are structured to defer the gain on a sale of a company to an ESOP. This is called an IRC §1042 exchange transaction. A shareholder who sells employer stock to an ESOP may defer recognition of capital gain if the ESOP owns at least 30 percent of the corporation after the transaction and the sales proceeds are reinvested in securities or bonds of domestic operating companies. The seller must have held the stock being sold to the ESOP for at least three years prior to the sale.

The mechanism for deferring gain on the sale is a reduction in the seller's basis in the replacement property purchased with the proceeds of sale of stock to the ESOP. If all the proceeds are reinvested, the basis reduction equals the gain on the sale and is allocated among the items of replacement property in proportion to their cost. If some proceeds are not reinvested, gain is recognized only to the extent that the proceeds exceed the reinvested amount and the deferred gain reduces basis. The seller will then recognize the deferred gain when he/she disposes of the replacement property in any transaction other than a tax-free reorganization (with some exceptions), a transfer by reason of death, a gift, or the sale of the property in another §1042 transaction.
In a §1042 transaction, the business owner and family members cannot participate in an ESOP. This strategy generally makes sense for a very old or sick business owner. However, given the low capital gains rate environment, some argue that paying capital gains today makes more sense if tax rates increase in the future thereby allowing more flexibility of the owner to re-invest sales proceeds without the restrictions of §1042. Of course, each situation should be reviewed carefully.

Another design approach for an ESOP company would be to add the ESOP to an existing 401(k) plan or create a new 401(k) plan with an ESOP component. This approach allows the owner to monetize their business interest while also permitting the owner to participate in the ESOP which can allow for a material tax deferral or tax-eliminated retirement benefit of the ESOP ownership interest.

401(k) plans integrated with ESOPs have been around for many years and are commonly used by publicly registered companies, but there has been an increased trend in such use for private companies. 401(k) plans can be structured utilizing a pre-tax approach or a Roth account approach whereby the investment in ESOP equity is taxable today but the retirement benefit that is paid out after the later of five years or age 59-1/2 is totally tax free. If the ESOP equity interest is included in a 401(k) plan such an approach may produce superior economic benefits as compared with a §1042 transaction, offer more investment flexibility and better align all stakeholders (the owner, family members, management team and workers).

Estate Planning – Creating Liquidity and Diversifying

It is likely that a business owner's biggest asset is their company, which is not generally a relatively liquid asset. When the time comes for estate taxes to be paid on the owner's estate, unless other provisions have been made, the business may have to be sold to pay estate taxes. Rather than waiting for the eventuality of a possible forced sale in such a situation, a business owner can create current liquidity while at the same time retaining management control of their company by selling their interest in the company to an ESOP.

By selling the company stock to an ESOP, a business owner can create immediate liquidity and retain management control of the company through participation in the ESOP. When the owner is ready to retire, he/she can get paid from the ESOP or initiate a sale of the company to a third party. Thus, a sale to an ESOP is an ideal planning mechanism for an owner's gradual secession from a company in a way that allows him or her to diversify their own portfolio and prepare for retirement in a tax-favorable manner while at the same time providing a benefit to employees which may, in turn, positively affect the health of the company.

The ability of a business owner to sell company stock to an ESOP and use the proceeds to diversify his or her portfolio enables the owner to treat their heirs equally even if they will not all inherit company stock equally. For example, if an owner believes that an heir is not interested in being involved with the business, is not well-suited for the business, or would disagree with another, more competent heir as to how the business should be run, he/she may wish to leave such heir assets that are equal in value to the company stock left to another heir. Thus, in order to avoid family feuds between heirs over a family business, an owner who has diversified his/her assets by selling to an ESOP can treat heirs fairly by leaving them property of equal value, whether it is shares in the family business, the ESOP, or shares in another investment.

If an heir works in the business, an ESOP could provide one of the best estate planning tools in the country to eliminate gift and estate taxes to parents who are running the business.

Characteristics of a Good Company for an ESOP

The characteristics of a good company for an ESOP include:

- A desire for ownership diversification and wealth creation,
- A growing, profitable business with strong cash flow,
- A financially healthy business is best-suited to implement an ESOP and
- An ownership group that is not reluctant to allow additional shareholders – their employees – to share in the company's equity.

An ESOP cannot save a highly indebted business or one with a poor business model, but it can be a powerful succession planning tool for a well-managed company.

Building Retirement

An ESOP may be just the right tax/legal vehicle for those who own a business, want financial security and want to leave behind a legacy. So, plan now and explore an ESOP that can achieve both goals.

Contact Us

If you have any questions about ESOPs, please contact your PKF O'Connor Davies client engagement partner or:

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