

Owner Planning an Exit? Have You Considered an ESOP?

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As the Baby Boom generation continues aging, within the next two decades, the U.S. will witness a huge wave of business owners looking to sell their privately held companies.

The most common exit strategy for a private business owner is an outright sale to a third party. The 100 percent sale is usually a clean break (unless there is an earn-out or seller financing is involved), and a private sale often provides the highest available price for the company. However, it's often not so simple. Sometimes a suitable third-party buyer is not available. Also, the objectives of an owner may go beyond the almighty dollar.

A second proposition might be counter-intuitive; however, sometimes non-monetary objectives come into play. Objectives might include: ensuring that the management team has a fair shot at taking over the reins, buying out some, but not all shareholders; allowing the owner to transition out of day-to-day management over several years rather than all at once; protecting the legacy and mission of the business so it can continue indefinitely; and ensuring that employees will not be left in the dust once the company's ownership passes hands.

A solution that allows a private company shareholder to achieve some or all of these objectives while providing shareholders with needed liquidity is the sometimes-overlooked Employee Stock Ownership Plan, or "ESOP." An ESOP is overlooked as a viable option because its pros and cons are either unknown or misunderstood.

About ESOPs

An ESOP is an employee retirement plan that can buy stock of the company sponsoring the plan. However, more than just a new employee benefit plan, an ESOP

can be a "win-win-win" solution for the shareholder, the company and the employees. The government provides tax benefits to the ESOP as an incentive to assist private company shareholders with the ownership transition while also providing a potentially lucrative retirement benefit to the company's employees.

The ESOP essentially is an "inside" buyer of stock. It can buy as little or as much of the company's stock as the shareholders desire. Best of all, the ESOP stock purchase can be structured so that the selling shareholders can defer capital gains taxes on the sale of stock to the ESOP, and the company can take a tax deduction for both the interest and the principal of the debt that the company borrows to fund the transaction.

Structured properly, ESOPs provide owners with both liquidity and succession at a controlled pace, while simultaneously creating an employee benefit where the future payoff to the employees is based largely on the success and productivity of the business. And although the employees retirement benefit is dependent on the value of the stock, companies are not required to provide corporate financial information to the employees other than in extraordinary circumstances.

Good ESOP candidates are companies that are consistently profitable and typically have revenue in excess of \$7.5 million. An ESOP is especially appropriate in a business where the owner is seeking to make a gradual transition out of the business or where some shareholders are seeking liquidity, while others prefer to retain ownership and control.

The ESOP provides a flexible internal "market" for stock because any shareholder can sell

stock in one or more transactions. Many companies being their plan with shareholders selling a minority interest to the ESOP in an initial transaction and, at the discretion of the shareholders, they sell another block of stock a few years later, after debt incurred in the initial transaction is paid down.

There is a common misperception that S corporations cannot sponsor ESOPs. ESOPs became eligible to buy and hold S corporation stock in 1998. As a pass-through tax entity, S corporation income that is attributed to an ESOP is effectively exempt from federal income taxes. Because the ESOP is a shareholder and also a retirement plan, the ESOP does not pay federal income taxes (similar to 401(k) plans, which do not pay taxes on investment income).

For example, if an S corporation generates \$10 million in taxable income, a shareholder owning 40 percent of the stock would be responsible for paying taxes on \$4 million of income. If the ESOP is the 40 percent shareholder, the ESOP pays no taxes on the taxable income. The Holy Grail of tax efficiency occurs when the ESOP owns 100 percent of the S corporation, as the company's income is effectively exempt from federal income taxes.

The benefits of an ESOP can be substantial, especially for shareholders who want to diversify away from their privately owned business in a controlled, tax-efficient manner. However, they may not be appropriate in all situations. As with any financial transaction, a fair amount of education and analysis is required to determine if it will be an appropriate fit. Private business owners contemplating this strategy will be well advised to seek out a seasoned professional firm that specializes in ESOPs.

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