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Business Succession Planning With ESOPs

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Disclaimer

Information contained herein is of a general nature and should not be acted on without seeking professional guidance. ESOP laws are complex; specific recommendations and courses of action are dependent on a thorough review of facts and circumstances.

ESOPs Becoming A Preferred Succession Vehicle

- ✓ Significant positive changes in tax law over the years
- ✓ Significant wealth transfer anticipated to occur over next 10 plus years
- ✓ Owners looking to preserve company legacy and culture and reward employees
- ✓ ESOPs can offer a win-win-win situation

What If You Could...

- ✓ Create permanent succession plan and preserve company legacy?
- ✓ Provide shareholder liquidity by selling stock tax-free?
- ✓ Reduce or eliminate future corporate income taxes?
- ✓ Retain control of company?
- ✓ Reward long-term employees and executive management?

What is an ESOP?

- ✓ Employee Stock Ownership Plan
- ✓ Qualified, defined contribution plan
 - ❖ Invests primarily in sponsor company stock
 - ❖ Company stock is held on behalf of employees/participants in ESOP trust
 - ESOP trust is legal shareholder
- ✓ Two types
 - ❖ Leveraged
 - ❖ Non-leveraged
- ✓ Governed by IRC and ERISA, with oversight by IRS and DOL

Asset vs. Stock Sale (*Non-ESOP and ESOP*)

	<u>Asset Sale</u>	<u>Stock Sale (Non-ESOP)</u>	<u>Stock Sale (ESOP with 1042 rollover)</u>
Gross Sales Price	\$20,000,000	\$20,000,000	\$20,000,000
Taxes Due – Corporate Level (40%)	\$8,000,000	\$0	\$0
Taxes Due – Individual Level	(21%) <u>\$2,520,000</u>	(21%) <u>\$4,200,000</u>	N/A <u>\$0</u>
Net Sales Proceeds to Individual	<u>\$9,480,000</u>	<u>\$15,800,000</u>	<u>\$20,000,000</u>

Note: This example illustration assumes no cost basis in assets under asset sale scenario and no cost basis in stock under stock sale scenario

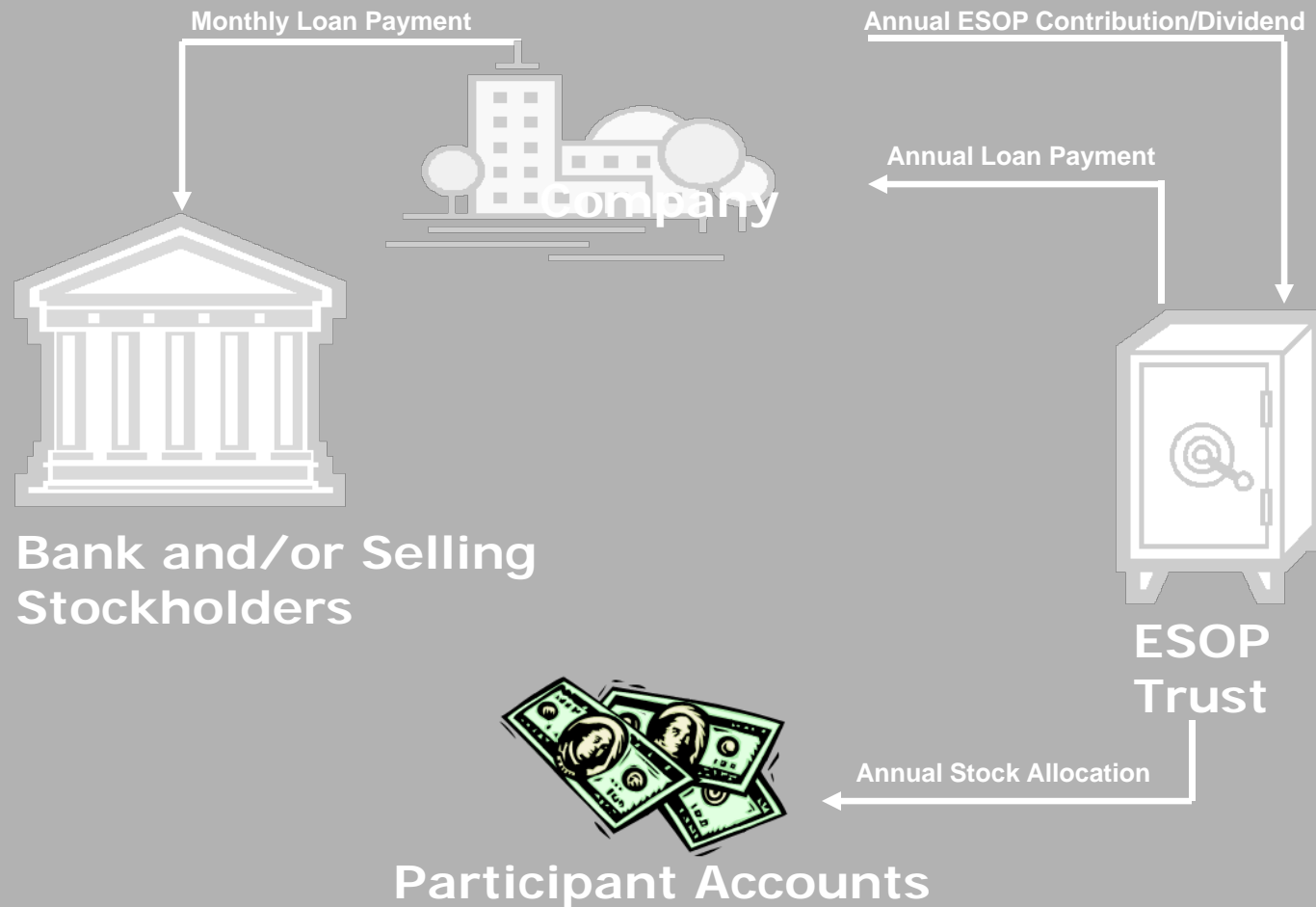
What is a Leveraged ESOP?

- ✓ ESOP borrows money to acquire company stock (very similar to traditional leveraged or management buyout, except significant tax advantages!)
- ✓ Used most commonly as part of a succession plan
- ✓ Can be used to acquire a portion or 100% of company's outstanding stock

How Does a Leveraged ESOP Work?



How Does Debt Get Repaid?



Valuation and Fairness Opinion

- ✓ ESOP Trustee engages independent appraiser to assist in determining
 - ❖ ESOP Trustee does not pay more than fair value (ESOP is not a strategic buyer and cannot pay strategic value)
 - ❖ Overall transaction is fair from a financial point of view
- ✓ Independent valuation firm prepares valuation which is only shared with ESOP Trustee

Company Loan Financing

✓ Bank financing

- ❖ Bank considers collateral, cash flow and strength of management
- ❖ Will have more cash flow under ESOP scenario

✓ Seller financing

- ❖ Subordinated to bank financing
- ❖ Typically increases company flexibility

✓ Combination

How Do I Sell My Stock Tax-Free?

- ✓ Covered under IRC Section 1042
- ✓ Requirements include:
 - ❖ Generally must have held stock for at least 3 years
 - ❖ Must be C corporation on date of sale under current tax law
 - ❖ ESOP must own 30% or more of company after sale
 - ❖ Must reinvest in qualified replacement property (QRP) within 12 months from date of sale

How QRP Works

- ✓ Essentially stocks or bonds of domestic operating companies (mutual funds, municipal bonds, etc. do NOT count)
- ✓ Sale of QRP during lifetime triggers income tax
- ✓ If hold QRP until death, receive “step-up” in basis of QRP and income tax vanishes

QRP Alternatives

- ✓ Portfolio of qualifying stocks or bonds
- ✓ Other privately held companies
- ✓ ESOP bonds!
 - ❖ Floating rate notes issued by highly rated companies
 - ❖ Long maturity and call protection (30-60 years)
 - ❖ Put provisions
 - ❖ Generally not a good investment under normal circumstances, except...

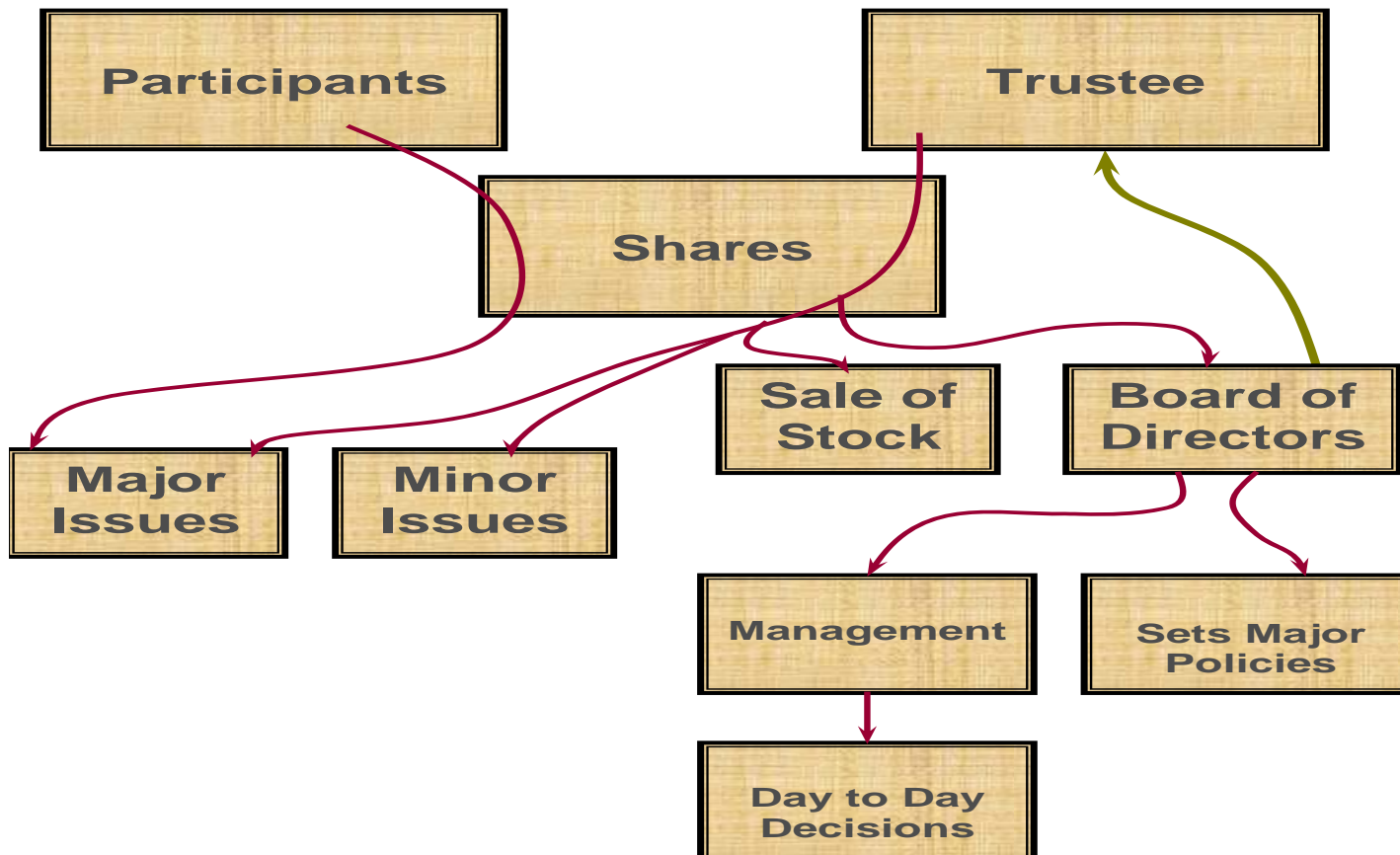
Benefits of ESOP Bonds

- ✓ Designed to outlive the buyer and go into estate, eliminating income tax
- ✓ Can generally margin up to 92% (although involves carrying cost)
- ✓ Provides flexibility

Tax Benefits to Company

- ✓ Earnings of an S corporation attributed to the ESOPs ownership are not subject to federal and state income tax (exception for certain states)
 - ❖ Therefore, 100% ESOP owned S corporation generally pays no income tax
- ✓ Principal on acquisition loan is tax deductible through contributions and/or dividends made by company to ESOP
 - ❖ C corporation
 - Contribution used to service debt limited to 25% of eligible payroll PLUS interest
 - Not limited by contributions made to other plans
 - Dividends paid to ESOP which are used to service debt are generally tax-deductible
 - ❖ S corporation
 - Contribution limited to 25% of eligible payroll INCLUDING interest and contributions made to other plans
 - Dividends/distributions generally can be used to service debt but are not tax-deductible

Company Organization with 100% ESOP



Benefit to Employees

- ✓ Eligible employees (i.e., generally 21 years of age and 1 year of service) can participate
- ✓ Shares released annually based on repayment of ESOP loan
 - ❖ For example, approximately 1/15th of total shares allocated annually assuming 15 year loan with equal payments
- ✓ Shares allocated based on compensation (subject to IRS limits)
- ✓ Participants receive annual statements reflecting number of shares of stock allocated to their account and stock value
- ✓ Either 6 year graded or 3 year cliff vesting from date ESOP is formed
- ✓ Except for death, disability or normal retirement, terminated vested participants receive cash for value of stock once ESOP loan is repaid

What Makes a Good ESOP Candidate?

- ✓ Owner looking to create a legacy company, and willing to carry some of the financial risk (i.e., seller notes) for a period of time
- ✓ Strong management with commitment to employee ownership
- ✓ Company has equity value of \$5 million or greater
- ✓ Pays significant amount of income tax
- ✓ Stable cash flow
- ✓ Sufficient employee/payroll base (i.e., generally 50 or more employees)

100% ESOP Owned S Corporation *Illustration of Tax-Free Growth*

✓ Assume following:

- ❖ ABC Company earns \$1 million per year
- ❖ ABC Company earns 5% on every dollar reinvested
- ❖ ABC Company tax rate is 40%

<u>Year</u>	<u>Compounded After-Tax Growth</u>	<u>Compounded Tax-Free Growth</u>
5	3,281,000	5,664,000
10	7,085,000	12,892,000

100% ESOP Owned S Corporation *Tax Advantage in Acquisitions*



Advantages:

- Tax Exempt
 - No Federal or State Income Tax
- 40% to 46% More Cash Flow than Competitors

Opportunity to Create Peace of Mind

- ✓ Opportunity to coordinate ESOP transaction with
 - ❖ Estate planning
 - ❖ Wealth planning
 - ❖ Asset protection
 - ❖ Charitable giving

Risk Planning With ESOPs

- ✓ Fiduciary Risk
 - ❖ Fiduciary insurance
 - ❖ Independent corporate trustee
- ✓ Repayment of Seller Note
 - ❖ Key man life insurance
- ✓ Repurchase liability
 - ❖ Proper structuring
 - ❖ Repurchase liability study
- ✓ S corporation abuse rules

Transaction Advisors

- ✓ Company financial advisor and quarterback
- ✓ Corporate counsel
- ✓ Independent ESOP trustee (negotiates purchase price and other transaction terms on behalf of ESOP)
 - ❖ Counsel to ESOP trustee
 - ❖ Financial advisor to ESOP trustee
 - Performs appraisal on behalf of trustee
 - Appraisal is not shared with Sellers or Company
 - Appraisal is based on financial investor, not strategic
- ✓ Bank and bank counsel

Typical Transaction Timeline

- ✓ Initial discussions
- ✓ Day 1 – Decision to move forward with ESOP Structure Recommendations Study
- ✓ Day 30 – ESOP Structure Recommendations Study completed and presented to Company
- ✓ Day 31
 - ❖ Begin preparation of formal forecast and business plan, if necessary
 - ❖ ESOP trustee's financial advisor begins appraisal process
- ✓ Day 40 – Presentations to prospective lenders
- ✓ Day 55 – Select lender(s)
- ✓ Day 56
 - ❖ ESOP trustee and it's advisors begin due diligence process
 - ❖ Transaction documents begin to be drafted
- ✓ Day 85 – Final terms, including purchase price, negotiated and agreed to
- ✓ Day 90 – Close transaction