

ESOP Design for Privately Held Companies



Building profitable enterprises through employee ownership

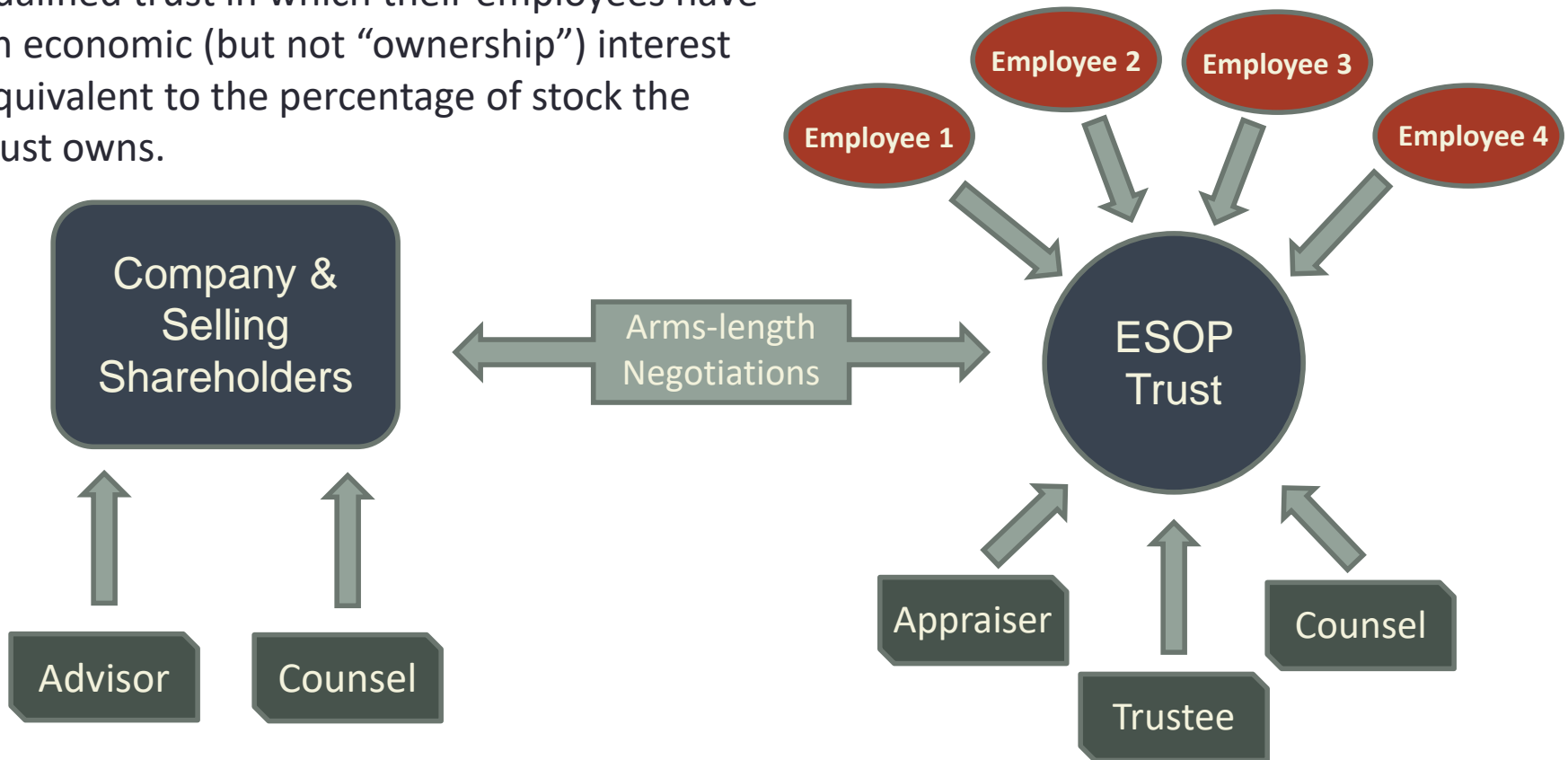
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What is an ESOP?

- Employee Stock Ownership Plan:
A unique, tax-qualified defined contribution retirement plan designed to invest primarily in the stock of the sponsoring employer.
 - Can borrow money
 - Engage parties of interest
- ERISA law, regulated by the DOL and IRS
- Congress

...What is an ESOP?

A tax-efficient buyout vehicle that enables owners to sell all or part of their stock to a qualified trust in which their employees have an economic (but not “ownership”) interest equivalent to the percentage of stock the trust owns.



...What is an ESOP?

- A confluence of 3 major areas of law:
 - Tax
 - Corporate
 - ERISA

Why Consider an ESOP?

- Ready market for shares—exit at fair market value
- Significant cash at closing
- Potential capital gains tax deferral
- Substantial corporate tax savings
- Preserve legacy
- Retain operational control
- Retain & reward employees & key management
- Confidential transaction



C Corp ESOPs

- ERISA (1974)
- Capital gains tax deferral (§ 1042)
- Unique Tax Deductions
 - Deductible dividends used to repay ESOP debt

S Corp ESOPs

- *Small Business Job Protection Act (1996)*
 - § 1361(c)(6): Certain exempt trusts permitted as S shareholders
 - All tax-exempt trusts subject to UBIT
- *Taxpayer Relief Act (1997)*
 - § 512(e)(3): ESOPs exempt from UBIT
- 100% ESOP Owned...
- C to S transition

Corporate Benefits

- Increased cash flow
 - Funds shareholder buyout
 - Bonuses, salary expansions
 - Business growth opportunities, acquisitions
- Employee-owner culture—highly motivated workforce
 - 4-5% increase in productivity at inception [1]
 - Attraction and retention: ESOP employees have 58% longer tenure [2]

[1] Joseph Blasi, Douglas Kruse, and Dan Weltmann (2013). "Firm Survival and Performance in Privately Held ESOP Companies."

[2] NCEO Report, With support from the W.K. Kellogg Foundation (2017).

Employee Benefits

- S ESOP participants have more than 2x the average retirement balance of Americans nationally (\$170,326 vs. \$80,339)

S Corp ESOPs and Retirement Security

Nancy Wiefek, Ph. D., Nathan Nicholson, 2018

- No cost to employees, “sweat equity”
- Favorable tax treatment on retirement distributions



Transaction Design: How Much To Sell?

- Partial or 100% Sale
 - Tax Benefits
 - 1042 (C corp)
 - Tax-free income (S corp)
 - Flexibility!
- Ultimately, ESOP design and culture driven by goals of sellers

Transaction Timeline

A typical ESOP transaction with outside financing takes approximately 3-4 months to complete. A minority ESOP or a 100% ESOP transaction with limited or no outside financing can reduce the overall timeframe.



ESOP Resilience During the Recession

Phillip Swagel & Robert Carroll, 2010

- S ESOP employment growth in 2008 in various industries: +1.9% (-2.8% in non-ESOP firms)
- Wages per S ESOP employee in 2008: +5.9% (3.2% for non-ESOP firms)
- Growth of revenue in S ESOP firms in 2008: +15.1% (-3.4% for all private industry)

ESOP Candidates

- Owners are desirous of taking advantage of ESOP benefits
- Profitable, growing business
- Not excessively leveraged
- Employees are an important part of the value of the business





“I can't help but believe that in the future we will see in the United States and throughout the western world an increasing trend toward the next logical step: employee ownership. It is a path that befits a free people.” - *Ronald Reagan, Speech on Project Economic Justice, 8/3/87.*

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