EMPLOYEE STOCK OWNERSHIP PLANS

Is an ESOP Right for Me?

Owners of closely held businesses who are considering transition of ownership may consider Employee Stock Ownership Plans (ESOPs) as an alternative to more traditional transition opportunities. ESOPs are attractive to many business owners, and have significant benefits for owners, the businesses and employees. However, ESOPs also have drawbacks.

A better understanding of the advantages and disadvantages of ESOPs can help any business owner determine if a partial or total sale to an ESOP is a solution that makes sense. And that owner needs professional advisors who have been through the process many times.

WHAT IS AN ESOP?

An ESOP is a qualified employee benefit plan that is structured to primarily invest in employer stock. The first step to establish an ESOP is to set up a trust to purchase stock from the owner(s). After the ESOP trust is established, the ESOP borrows money from an outside lender to buy all, or a portion, of a business. The ESOP repays its loan through periodic pre-tax contributions made by the company. As the loan is paid down, shares are released from collateral, and allocated to eligible employees based on their level of compensation. The longer an employee works for the company, the more shares that are allocated to his/her account, and the more the employee becomes vested in his/her account, and thus in the company.

ADVANTAGES

ESOPs create a ready market for business owners looking to transition ownership, and offer many ongoing advantages, such as:

- Owners have more control over the transaction when selling to an ESOP, as compared to an external sale—there are no competitors doing diligence on the business, and far less disruption.
- Selling a company to an ESOP provides for continuity in the company's workforce and operations. This may be particularly important for an owner who has worked hard alongside his/her employees to build the company over many years.

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- ESOPs boost employee morale. It has been proven in studies that when employees have a vested interest in the success of the company, they tend to work harder, and stay longer. The result is that ESOP-owned companies tend to have lower turnover in their workforce, and higher productivity from their employees.
- Selling to an ESOP can create significant tax benefits for both the selling owner and the company. The loan taken by the ESOP to buy the company is repaid by the company with pre-tax dollars. There are additional benefits, which vary depending on the corporate structure. In the case of a C-Corp, the owner can defer capital gains taxes that stem from the sale of the company. This is particularly important in an era of higher capital gains taxes. In the case of an S-Corp, the ESOP's share of earnings is tax-exempt.
- In addition to being great transition tools, ESOPs are great tools for creating liquidity. Selling a minority share to create necessary liquidity does not prevent an owner from selling the company to an external buyer in the future.

DISADVANTAGES

While ESOPs have tremendous upside, they also have drawbacks. Understanding the disadvantages of ESOPs is as important as understanding the advantages in determining whether selling to an ESOP makes sense. First and foremost, ESOPs are employee benefit plans, which are governed by ERISA and the Tax Code. Compliance with these laws creates a level of complexity that other transition opportunities may not. In addition to the regulatory complexity, which requires seasoned advisors, business owners should also consider the following:

- ERISA requires that ESOPs be financial buyers. As a result, business owners are not likely to receive the sale price that a strategic buyer might offer.
- Lenders almost always require some portion of the financing to be provided through seller notes, so it may take longer for a selling shareholder to realize all of the proceeds of the sale.
- ESOPs require annual valuations and third party administrators, which creates additional, but not prohibitive, cost.

CONCLUSION

ESOPs are challenging to create, and determining whether an ESOP is the right tool requires a sophisticated analysis. However, in the right scenarios and with the right planning, ESOPs can be a highly effective transition tool, and can have a profound impact on a business. When structured correctly and appropriately, the advantages of ESOPs can far outweigh the drawbacks. Benesch, Friedlander, Coplan & Aronoff can walk you through the pros and cons of an ESOP and help you establish a framework for an ESOP that is effective and impactful on your business.

MORE INFORMATION

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