Succession planning using employee stock ownership plans

ESOPs may provide value to your closely held business

Prepared by:

Anne Bushman, Senior Manager, Washington National Tax, RSM US LLP
anne.bushman@rsmus.com, +1 202 370 8213

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With baby boomers reaching retirement age, many entrepreneurs are facing the decision of how to plan for the exit from their closely held businesses. This second article in a series focused on the use of compensatory devices in succession planning looks at the use of employee stock ownership plans (ESOPs) for succession planning purposes and provides an overview of how an ESOP works and when it should be considered.

What is an ESOP?

ESOPs in their current form have been around for the better part of 40 years. It is estimated that approximately 7,000 ESOPs exist, covering about 13.5 million employees.[1] Despite the lengthy history and the large number of workers participating in these plans, not all advisors are comfortable with the ESOP concept, and thus an ESOP may not receive as much consideration as it should in succession planning discussions.

In the simplest terms, an ESOP is a qualified retirement plan, similar to a profit sharing or 401(k) plan that a company would sponsor. The ESOP itself is a trust for legal purposes and is set up to meet the applicable requirements in section 401,

1 National Center for Employee Ownership: analysis of the 2011 PPP Research File made available by the Department of Labor and ESOP (Employee Stock Ownership Plan) Facts.

which then qualifies it as a tax-exempt entity for federal tax purposes. The qualification requirements include provisions for eligibility, vesting, distributions, nondiscrimination, etc. Once employees meet the eligibility requirements, they become participants in the ESOP, with accounts held on their behalf as beneficiaries of the trust. In general, an employee receives the value in his or her account upon a separation event from the company (i.e., retirement, death, disability or other termination). From a tax perspective, the corporate sponsor receives a current deduction for stock and/or cash contributions to the plan, because the contributions represent an employee benefit expense. As with other retirement plans, employees do not report income and pay tax on the benefit until it is distributed to them in the future.

Middle Market Insight:
Is your business organized as something other than a corporation? If yes, it does not mean you cannot use an ESOP, but it does mean you will have to incorporate the business first. If structured properly, this incorporation can be done tax-free. Consult with a qualified tax advisor prior to incorporation and implementation of the ESOP to ensure your goals can be met.

While an ESOP has siilarities to other qualified retirement plans, it also has unique characteristics that set it apart. The first differentiating factor is that an ESOP must be primarily invested in employer securities in order to qualify as an ESOP. In general, this means the ESOP holds stock in the corporate sponsor, rather than offering a diversified selection of investment funds like a 401(k) plan. Although at first blush this concentrated investment focus may seem unfavorable for employees, research shows that ESOPs actually out-performed 401(k) plans in 15 of the 20 years from 1991-2010 and were less volatile in all of the periods studied.[2]

In addition to limiting its investments to the corporate sponsor's securities, an ESOP is distinguishable from other retirement plans due to an exception from the prohibited transaction rules for loans to a qualified retirement plan. If the debt transaction is structured properly to ensure the statutory and regulatory requirements are respected, the exception allows an ESOP to borrow money in order to buy employer stock. When debt is used, the lender holds the stock as collateral on the loan. Over time as the loan is repaid, collateral (employer stock) is released accordingly and allocated to participant accounts.

The consequences of these unique factors—the ESOP's investment in employer securities and ability to borrow money to fund the purchase—affect all parties involved and play a part in each of the uses for ESOPs described below.

Uses for ESOPs

Ownership transition. An ESOP's investment in employer securities provides an avenue for transitioning ownership. Rather than selling the company to an outside party, the shareholder(s) planning to exit actually sells the interest to the ESOP (effectively, to the employees).

This aspect is particularly attractive to owners of closely held businesses with a limited pool of outside buyers. Closely held businesses may become so successful that the value of the company could begin to limit the number of potential buyers in the market that can afford to purchase the business. In addition, many outside buyers may be hesitant to buy only a portion of the business at a time because of concerns about not having control. An ESOP can solve each of these problems. It creates a potential buyer for the stock, and it can be structured to purchase any portion of the shares that owners desire to sell. The ESOP may be more likely to buy a minority interest than an unrelated party would be, and the ESOP's ability to borrow money allows it to buy a large portion of stock as well if the owner desires to sell more than the company can currently fund.

Even with abundant potential outside buyers, a shareholder may want to consider selling to an ESOP, not only based on the company and employee benefits discussed below, but also based on other factors that may benefit the selling shareholder. An ESOP is overseen by a trustee with a fiduciary requirement to act for the sole benefit of the employees' investments. Nonetheless, negotiations with an ESOP may be less burdensome than negotiating a sale with an outside party. The selling shareholder or the company (or both) usually chooses the service providers who are involved in the transaction, and the process can be less burdensome than the due diligence process outside parties would undertake. However, the price the ESOP pays for the stock will need to be approved by an independent appraiser.

In addition, a unique tax-deferral option exists for shareholders who sell C corporation stock to an ESOP. If the ESOP owns at least 30 percent of the corporation after the sale and the seller reinvests the proceeds in qualifying replacement securities, the seller can elect to defer tax on the sale until the replacement securities are disposed.

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Are you interested in deferring tax on the sale of your business? While the idea of tax deferral may be extremely attractive, a number of factors need to be considered, including current and potential future capital gains rates. In addition, sellers (and related parties and 25 percent shareholders) electing tax deferral who are employees of the company cannot receive allocations from the ESOP with respect to those specific shares for the longer of 10 years or the period any debt used to purchase those shares is outstanding. The deferral option may be particularly beneficial for older shareholders who reinvest the proceeds and hold the replacement securities until their death. In such a case, the replacement securities would receive a step-up in basis at the time of death, and any appreciation realized on the original stock sold to the ESOP and the replacement securities effectively escapes income tax permanently. If your business is currently an S corporation, the S election may be revoked prior to the sale in order to use this benefit.

2 National Center for Employee Ownership: [Are ESOPs Too Risky to be Good Retirement Plans?]

Employee benefit. As discussed above, an ESOP is a qualified retirement plan, which provides employees value in the future. An ESOP also has other unique advantages to employees. First, an ESOP is generally entirely funded with employer contributions, allowing the employees to receive the benefit without contributing their own money to the plan. In most cases, employers discontinue their 401(k) match in order to fund the ESOP, but employees can still contribute to a 401(k) plan, which gives them access to a diversified retirement plan.[3]

In addition to these financial benefits, ESOPs may provide intangible benefits to employees. One such benefit is a greater chance that the employees' day-to-day environment will be relatively unchanged after an ownership transfer. Compared to an ESOP sale, selling to an outsider increases the risk that the new owners will replace management and/or current employees or otherwise drastically change business operations. In most cases, if selling shareholders are currently holding upper-management positions, successor managers will already have been identified and put in place before the ownership change occurs to help make the sale to the ESOP more seamless.

Another employee value enhancer provided by an ESOP relates to the culture created when employees own the company. If this value is properly communicated to employees, they may feel a greater sense of loyalty toward the company and understand the impact their actions may have on their own financial positions as owners of the company. Thus, greater employee engagement may lead to a potential increase in corporate growth. Also, the ESOP may be a good recruiting tool to help the company attract future employees. Many ESOP companies experience greater employee productivity and lower turnover rates, which not only benefits the company's performance, but also increases employee job fulfillment.[4]

Corporate finance tool. As referenced above, ESOP stock purchase transactions may involve some amount of debt financing. Most often, the company incurs debt from an outside party and then loans that money to the ESOP to purchase the stock. The company then contributes cash to the ESOP, generally annually, as an employee benefit (and receives an associated tax deduction). Since the ESOP purchased the stock with money borrowed from the company, it uses the annual contributions from the company to fund its loan payments to the company. The company then makes its payment on the outside debt. Thus, while the outside debt affects the corporate balance sheet and the terms of the two loans may or may not match, the principal amount of the loan effectively ends up being deductible over time (i.e., due to company's annual contributions to the ESOP).

An alternative to receiving financing from an outside party is for a selling shareholder to seller-finance all, or a portion of, the ESOP's purchase of his or her stock. If the selling shareholder does not need the full amount of cash from the sale, using seller financing allows for installment sale treatment on the sale so that tax can be paid over time as proceeds are received. In addition, the seller would receive interest income over the period of the loan. Seller financing is also used in larger ESOP transactions in which the corporation cannot leverage such a large portion of its equity from an outside party. The seller could then make up the difference through an additional loan to the corporation.

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Borrowing money to purchase the stock may seem like a negative because it creates a liability at the same time a supposed benefit is created. However, in addition to the financial benefit described, the release of stock to employees being tied to the ESOP's loan payments allows the company to align its interest of providing a certain level of employee benefit with the seller's interest of liquidating stock. The exiting shareholder can sell the desired portion of stock, and the company can still manage the employee benefit level by choosing the terms of the ESOP loan. In the absence of the debt controlling the release of shares to employees, one or the other interest would have to take precedence. Either the selling shareholder would sell the amount of desired stock, dictating the amount of employee benefit, or the desired level of employee benefit would dictate how much stock a shareholder could sell at a given time.

Other ESOP-related tax incentives exist as well. C corporations may be able to deduct dividends paid to the ESOP, depending on how those dividends are allocated and used. C corporations may also benefit from increased contribution limits for certain ESOP contributions, which allows them to transfer greater benefits to employees if the business or owners desire. S corporations do not have those advantages, but since S corporations generally pay no tax at the corporate level and the ESOP is tax-exempt, this structure essentially allows any portion of the S corporation owned by the ESOP to escape current income taxation. The increased cash flow from tax savings can help the company grow more quickly than without the ESOP.

Is an ESOP right for you?

If the ESOP benefits sound attractive, how do you determine if an ESOP would be a good fit for you? The determination is one that should be made carefully, because ESOPs do require initial and annual costs, as well as professional oversight and administration.

3 Id. Analysis by the National Center for Employee Ownership shows that the average employer contribution to ESOPs is higher than with section 401(k) plans, and ESOP companies are slightly more likely than non-ESOP companies to have a section 401(k) or pension plan.

4 National Center for Employee Ownership: Research on Employee Ownership, Corporate Performance, and Employee Compensation.

Middle Market Insight:
Are you concerned about the upkeep an ESOP might require? In general, think of it as similar to the administration of another retirement plan you probably already offer your employees. ESOPs are regulated by the Department of Labor and the IRS, and a proper appreciation for the strictness of the rules is required in order to ensure the benefits can be maintained. An ESOP may require slightly more administration than other retirement plans because employee communication efforts will likely increase, and valuations are required at least annually to set the price at which stock transactions (sales and purchases with the ESOP) occur. While the rules can be cumbersome, there are many qualified advisors who can assist with ESOP issues and help with the compliance requirements. In addition, although the costs of implementing and maintaining an ESOP are not insignificant, the financial effects can be modeled prior to implementation and going forward to allow the company to project such costs and have a level of comfort that the benefits outweigh those costs.

Before moving forward with an ESOP, a primary factor to consider is the desire of current shareholders to decrease company ownership. As discussed above, an ESOP can own any percentage of the stock. Accordingly, it is not necessarily important whether all, or only some, shareholders are interested in beginning to exit or whether those desiring to exit wish to do it all at once or over time. However, unlike some other shareholder compensatory devices, the ESOP does supply benefits to employees through ownership in the company and thus cannot be effective unless existing shareholders are willing to decrease their equity share in the business. As discussed above, the transition can be done with a sale of stock to the ESOP by a shareholder (which may be financed by the company). Alternatively, the corporation can contribute newly issued stock to the ESOP, which would dilute the current shareholders' ownership, but would not require a sale.

Another important factor is the financial condition of the sponsoring corporation. Because many corporations assume outside debt to finance ESOP transactions, the corporation needs to have a strong balance sheet to ensure an outside lender will be willing to lend the company the needed funds. In addition, historical profitability and future growth potential are financial indicators that support that an ESOP will be feasible. Without these factors, the company may not be able to make the required contributions to the ESOP, and the benefit provided by the ESOP will not significantly benefit employees if the company's equity has little value.

On the employee side, the composition of the workforce should be considered. Most importantly, the company should have a good, strong workforce in place that it is interested in retaining. High turnover rates will make administration of the plan more difficult and costly. While a minimum number of employees are usually needed to make the costs of implementing the plan worth it, generally this number is fairly low, and companies with at least 20 employees can still consider an ESOP. In addition, because the allowed level of company contributions to the plan depends on compensation limits defined by tax rules and fewer employees generally means lower payroll costs, a company with few employees may not be able to efficiently transfer as much of the company ownership as desired.

Finally, company culture should be considered. An outside lender will want assurance that competent managers are in place to ensure the viability of the company and the ultimate repayment of the debt. Aside from running the business, these managers need to be supportive of the employee ownership culture. Those working in upper management or serving on the board of directors for a company with an ESOP need to be willing to work with the ESOP trustee and be accepting of employees having a voice in the company as indirect owners with an increased stake in company performance.

Conclusion

Overall, if a company is financially stable, has a culture that supports employee communication and participation, and has shareholders who desire to transition ownership, an ESOP should be evaluated. The first steps in evaluating the ESOP option would be discussions with management and owners and a feasibility study to determine the estimated cost to the company. Qualified advisors should be consulted throughout implementation and ongoing operations to ensure compliance with the rules and to achieve all of the benefits. If managed properly, an ESOP can be an extremely effective succession planning tool.

Future articles in this series will discuss other compensatory devices that can be used in succession planning, such as other retirement plans and equity compensation methods. Each of these devices has some similarities to an ESOP, but an ESOP is definitely a one-of-a-kind tool for transferring ownership in closely held businesses.

Also see other articles in this series, Exit strategies using compensatory techniques: Succession planning tools for owners of closely held businesses.

+1 800 274 3978
www.rsmus.com

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