

# Is an ESOP Right for Your Company?

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## What Is An ESOP?

ESOPs (Employee Stock Ownership Plans) can be an incredible corporate financial tool but, they are not for everyone. Generally, ESOPs are most effective for companies that are profitable, tired of paying taxes to the government, have a market value of \$2,000,000 or more and, employ 20 or more employees. ESOPs are a very tax efficient method of accomplishing certain corporate and personal goals.

An ESOP is a tax qualified plan similar to a pension or profit sharing plan. What distinguishes an ESOP from other plans is that its mandate is to acquire company stock of the sponsoring corporation and it is allowed to borrow money to acquire that stock. Armed with these two small differences from other tax qualified plans, the ESOP can become a financial tool for the corporation. In fact, the IRS has called the ESOP “the ultimate tool of corporate finance”.

ESOPs are most commonly used to create a private marketplace for shares of departing owners of successful private companies, to motivate and reward the employees who have helped build the company or, to take advantage of numerous substantial tax incentives.

The Section 1042 stock sale to an ESOP provides tremendous tax advantages for both the company and for the selling shareholder. The selling shareholder can permanently defer all capital gains tax on the sale of stock to the ESOP. The company receives a tax deduction for contributions to the ESOP which provides the ESOP with the cash to purchase the stock from the selling shareholder.

Some companies should not, or do not want to, borrow money.

## The War Chest ESOP

Many times the owners of the corporation are not ready to sell any part of the company immediately but are considering a number of exit plans in the future. The “War Chest” approach allows the corporation to make tax deductible discretionary contributions of cash in an amount of up to 25% of eligible payroll to the ESOP and get an immediate tax deduction in the year

of the contributions. By contributing cash to the ESOP the corporation is using monies that would otherwise be sent to the government. The continuing accumulation of cash creates a “War Chest” that will be used at a later date to buy some or all of stock from selling shareholders and owners without creating debt on the corporate balance sheet. This strategy can also be used to supplement a leveraged ESOP discussed below.

### **The Leveraged ESOP**

An ESOP can be leveraged in which case a loan is obtained from a lender. The lender makes a loan to the corporation which in turn loans the same money to the ESOP. Tax deductible contributions are made by the corporation to the ESOP in an amount intentionally designed to equal the principal and interest due to the lender. When the contribution is received by the ESOP it uses the cash to pay its loan debt service to the corporation. The corporation receives its money back and pays its debt service to the lender. This method creates a tax deduction for both principal and interest payments. As an example, in the 40% company tax bracket the after tax cost to repay \$10,000,000 of loan principal would be \$6,000,000; a tax savings to the company of \$4,000,000. Under this method of ESOP the loan must be booked as a liability. The key to this strategy is that principal is tax deductible.

### **The Non-Leveraged ESOP (Stock and /or Cash Contributions)**

Many companies should not borrow money. Immediate current tax deductions can be created by contributions to the ESOP of newly issued authorized stock. While this is dilutive to the outside shareholders, the tax savings is anti-dilutionary.

Cash contributions to the ESOP, as discussed earlier, creates an immediate company tax deduction without a major impact on the financial statements. The cash in the ESOP can accumulate tax free and after a few years this ESOP “War Chest” can be used to augment the purchase of stock from either the company or an outside shareholder.

### **The Flexibility of ESOPs**

ESOPs are very flexible in that they can be used to simultaneously accomplish any combination of the following strategies, just to name a few:

- § Creation of a liquid marketplace for closely held stock which provides a tax advantaged exit strategy for shareholders under Section 1042.
- § Defer or eliminate federal and state capital gains taxes on sale of stock via Section 1042.
- § Sell some or all of your privately held stock, pay no Capital Gains tax and, still maintain control of the corporation.
- § Repay and deduct the principal portion of corporate debt with tax deductible dollars.
- § Buy out minority or majority shareholders with tax deductible dollars and tax free to the sellers.
- § Motivate and reward employees and attract and retain good management.
- § Assist a shareholder to diversify his or her personal net worth.
- § ESOP purchases of stock are deductible to the corporation.
- § Transfer the business to a son, daughter or management group with huge tax advantages and guarantee the perpetuation of the company.
- § Sell the company to an outside buyer with significant tax advantages to both buyer and seller.
- § Cash out investors with pretax dollars and tax free to the investors.
- § Corporate acquisitions can be done with tax deductible dollars.
- § Current long-term debt can be refinanced via the ESOP providing the corporation with tax deductible principal, as well as interest, for debt repayment.
- § Dividends, if paid through an ESOP for debt service, are deductible to the corporation.
- § Recover C corporation income taxes paid over the prior two years.

- § Reduce or eliminate estate taxes with ESOP planning techniques.
- § Increase employee productivity.
- § Corporate acquisition of real estate with pre-tax dollars.
- § Tax free cash out with deductible dollars in a divorce.

### **Is My Company Large Enough for an ESOP?**

There is no quick easy answer to this question. The answer is based on a number of factors such as the purpose and complexity of the ESOP structure and, an analysis of the costs to implement and maintain an ESOP compared to the benefits that will be derived from the ESOP. Every ESOP is specific to the sponsoring company as every owner has different goals.....There are no Cookie Cutter ESOPs.

### **ESOP design consideration must be given to:**

#### **1. The tax bracket of the corporation.**

If you are not paying taxes, or are in a very low tax bracket some of the tax advantages to the company will diminish. Tax savings realized by the selling shareholder may still make an ESOP worthwhile.

#### **2. The payroll of the corporation.**

Contributions to an ESOP are limited in most instances to 25% of eligible company payroll. A \$2,000,000 payroll can allow contributions of up to \$500,000 on a tax deductible basis. If the company has an existing 401(k) plan both the employer and employee contributions to the 401(k) plan may be an offset to the 25% contribution limitation.

Union employees can be excluded (or included) from the ESOP as a collective bargaining unit. As such, the union compensation would also be excluded from the eligible payroll calculation. However, many ESOPs include union members.

#### **3. Annual contributions to the ESOP compared to expense to maintain the ESOP.**

A \$500,000 deductible contribution to the ESOP will generate a \$200,000 tax savings in the 40% company tax bracket. If the annual cost to maintain the ESOP is \$10,000, as an example, the cost to maintain the ESOP is justified by the annual tax savings generated by the ESOP. Conversely, if the tax savings generated by the ESOP is only \$50,000 the ESOP may not be justified when compared to implementation and maintenance expenses of the ESOP.

#### **4. Analysis of the alternatives to accomplish the same goal as an ESOP.**

There are many ways to skin a cat and an ESOP may or may not be the best approach. If, for example, a shareholder wants to sell some stock to the ESOP under Section 1042 the capital gains tax on the stock sale can be deferred and, the corporation receives tax deductions for contributions to the ESOP to purchase the stock. This exit strategy could be compared to selling the business through a business broker and the seller paying the capital gains tax. Both the after tax cost to the corporation and the after tax net proceeds to the seller need to be understood. Other alternatives to be considered would include an insurance funded strategy, a management buy-out or, a Section 162 bonus plan. Depending on the strategy the proceeds to the seller will be received as either taxable capital gains or as ordinary income. Corporate funding of the approach may or may not be tax deductible to the corporation.

#### **5. The type of industry of the business.**

Every industry has different characteristics. ESOPs are generally industry neutral with a few exceptions, such as law firms and doctors wherein licensing is a concern. Of the top 100 ESOPs in the United States, by number of employees, 13 are in supermarkets, 10 are in manufacturing, 8 are in engineering, 7 in construction, 3 in drug stores and the rest are scattered in everything from a hat maker to a vegetation management company.

#### **6. Other Existing Tax Qualified Plans in the Company.**

Many companies already have profit sharing and/or 401(k) plans and the design of an ESOP must take other tax qualified plans into consideration. 401(k) plans can operate side by side with an ESOP or combined with the

ESOP. Company 401(k) matching contributions could be diverted to the ESOP to augment cash flow requirements for required debt service on a new ESOP loan used to purchase stock. SIMPLE IRAs prohibit the creation of any other tax qualified plan in the company. Therefore, the transition from a SIMPLE IRA to an ESOP must be coordinated carefully.

## **7. Regular C Corporation, Sub-Chapter S Corporation or LLC.**

In all the applications of an ESOP only one approach, a Section 1042 tax deferred sale of stock to the ESOP, requires that the company be a C Corporation. For all other ESOP applications the company can be either a C or an S Corporation. Should the members of an LLC desire to take advantage of opportunities afforded by an ESOP the LLC will need to convert to either a C or S Corporation. Consultation with CPAs and tax advisors are necessary in order to determine when and why an entity should convert to a C or S Corporation as there are specific conversion rules.

## **8. S Corporation M-2 (AAA) Accounts**

If the company is an S Corporation and needs to convert to a C Corporation the existence of any M-2 (AAA) account needs to be analyzed. The AAA account is earnings on which the taxes have already been paid. On conversion to a C Corporation the AAA account is re-characterized into retained earnings. An existing AAA account could be paid out to the owner over a period of time or, the owner could take back a promissory note from the corporation in the amount of the AAA account. The latter would have an impact on the valuation of company stock.

## **9. The Control Issue**

The shareholder(s) outside of the ESOP normally need to maintain their control of the company. The shareholder owning more shares than the combined shares of the remaining shareholders will maintain control by appointing himself/herself as the ESOP Trustee which votes the share held by the ESOP. Pre-ESOP if there are three shareholders at 66%, 20% and 14%, the 66% shareholder could sell 30% of his/her stock and still maintain control of the company. The selling shareholder would have 36% of the stock individually owned which is greater than the combined percentage of the 20% and 14% shareholders. As such he/she would appoint himself/herself as ESOP Trustee. The selling shareholder would vote his/her remaining 36% held individually and, as ESOP Trustee would also

vote the 30% of stock inside the ESOP thereby voting a total of 66% of the stock.

## **What to Look For and Potential Pitfalls**

Structuring a properly designed ESOP can be fraught with potential pitfalls. ESOPs are a complicated subject and mis-information or incorrect plan design can disqualify your plan and your tax deductions. Frequently, those looking at an ESOP for the first time don't know what questions to ask or, whom to ask.

The first step is to hire an ESOP Design Specialist who can bring all the required components together. To successfully implement an ESOP you will need the ESOP Design Specialist to coordinate the valuation firm, an ERISA attorney, an administrator, and a lender, with the shareholders of the company, the IRS, corporate officers and management and other company advisors such as the outside CPA.

As with any type of industry the ESOP industry has good players and bad players – be careful who you select as your ESOP Design Specialist and thoroughly check out their references.

The ESOP Design Specialist can bring to the table lenders (not all banks understand ESOPs), an ERISA attorney (who has done 1,000's of ESOPs), a stock valuation firm which understands ESOPs (valuation is an art, not a science) and an administrative firm that specializes in ESOPs (most don't).

The ESOP design coordinator should be able to take what is a complicated process, explain the ESOP's mechanics and procedures, advantages and disadvantages and, make it easy for the company owner to understand. Additionally, an ESOP Design Specialist should have a history of unwinding "bad ESOPs" and a history of telling potential clients that an ESOP is NOT suitable for their situation.

Beware of ESOP Designs using cookie cutter documents and unusually low implementation and design fees. Some ESOP Design Specialists quote low fees for implementation and then "run up the bill" for other services that are essential to the continued success of the ESOP.

ESOPs are not for everyone. Many ESOPs should not have been adopted as they would never accomplish their goals. Terminating and unwinding a

poorly designed ESOP is expensive and can result in serious consequences for the Corporation and shareholders.

Beware of ESOPs that sound “too good to be true” There are types of ESOP structures that have been declared illegal by the Department of Labor and IRS, unfortunately as of the writing of this article some of these structures are still being implemented. Some of these structures while not illegal are also overly creative and are stretching the DOL and IRS regulations.

There are components of ESOPs that must by law be separate and distinct. One of the most common conflict of interests is that the Valuation Company is affiliated or owned by the ESOP Design Specialist, Client’s CPA firm or, Client’s bank. By law the valuation firm must be a 3rd party independent firm with no financial ties to any of the above entities. ESOP Valuations are very different to any other type of valuation method and the valuation firm must have prior ESOP experience.

ESOPs fall under ERISA (same as 401(k) Plans). Violations of ERISA Laws carry serious penalties and consequences for trustees and sponsoring companies.

A trusted ESOP Design Specialist can easily guide you through these complicated waters.

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