THE ESOP OPTION - IS IT FOR YOU?

I received a call from Mr. Smith today. We had talked on the phone a month or so ago when he asked if I "do ESOPs." I confessed that I don't specialize in ESOPs -- I represent business owners in maximizing value and minimizing risk in the sale of private companies. He was friendly and we chatted further. He shared a little about his situation, and inquired about the private merger and acquisitions market. I then wished him luck as he hung up to pursue the ESOP option. I had a hunch that I'd hear from him again ... and I did. But let's get back to that first conversation.

I learned that Mr. Smith is a long-time business owner and is well into retirement age without a succession plan. He has always enjoyed running his business and is in fine health for his age, which is probably why he has not felt pressure to "get something going." But as he said, times are changing. Mr. Smith worries about not being as sharp as he used to be and the risk of falling behind the competition. He also would like to spend more time with his grandkids; he's always wanted a "family ranch," as he called it. Maybe the time to "cash out" is now, he said, then added: With an ESOP, I can sell to my employees, who've earned it, and avoid paying all my money to Uncle Sam."

Why did I expect to hear from him again? Well, the ESOP seems to fit a very narrow group of business owners, and it was an unlikely option for Mr. Smith based on what I learned about him and his business. His motives were valid, but he had not yet looked into the details. Let's take a minute to do just that...

Congress created the Employee Stock Ownership Plan (ESOP) in an effort to preserve the economic stability of communities and encourage a wider distribution of wealth. It is basically a tax incentive program designed to make a sale to employees more attractive. These incentives are provided to sellers, buyers, and even bankers who finance ESOP transactions. An ESOP, therefore, is a means by which a business owner may "sell" the company to its employees and receive tax benefits for doing so.

How does it work? Typically, the company's ESOP takes out a loan to purchase the owner's stock. The company, in turn, contributes a portion of its monthly pre-tax profit to the ESOP to pay off the debt and allocates paid-for shares to the employees' accounts. As such, the owner's stock in the company is "purchased," over time, by the company and distributed to the employees -- pretty good deal for the employees.

The advantages of the ESOP begin with the ability of the seller to defer capital gains taxes if the proceeds from the sale are invested in domestic corporate securities within 12 months. Next, company payments to the ESOP to repay debt borrowed, both principal and deductible. Finally, employee ownership company performance.

There are strings attached, however. First, the company must be a C-Corporation, an entity that is found in diminishing numbers today. Strong cash flow will be required to obtain ESOP financing and repay ESOP debt. Next, 25 percent of the stockholders and family members of the

seller must be excluded from the ESOP, while all employees with 1,000 hours on the job must be allowed to participate.

Those who have installed an ESOP will tell you that the costs can be significant. Legal fees for initial set-up can run from \$13,000 to \$100,000. And costs associated with the required annual valuation and ongoing reporting and record keeping can easily run \$10,000 per year. Finally, the first 49 percent of the owner's shares are valued and purchased at a minority discount of around 30 percent, wiping out the tax savings on nearly half of the sale. Oh, and banks require the seller to personally guarantee the ESOP debt -- so much for cashing out!

In summary, it's hard to argue with the concept of selling to employees for significant tax savings, but when we look into the details, we find strict rules and requirements, which eliminate most business owners lured by the prospect. Our owner who was hot on the ESOP, Mr. Smith, found this to be the case. Remember -- he wants to retire and needs cash for that "ranch." In addition, it turns out that his son is active in the business and wishes to stay on. Mr. Smith was looking for a way to maximize the value of his business, but an ESOP wasn't the answer for him. Is it for you? Read on.

ADVANTAGES OF ESOP TO THE BUSINESS OWNER

- Sellers may eliminate capital gains tax if the proceeds from their sale of stock are invested into U.S. securities within 12 months
- Company payments to ESOP to repay principal and interest are tax-deductible
- > Employee ownership may improve company performance

DISADVANTAGES OF ESOP TO THE BUSINESS OWNER

- ▶ Healthy cash flow is required to obtain ESOP financing and repay ESOP debt
- Annual allocation to single employees limited to \$30,000
- Company must be a C-Corporation
- Family members of seller and 25 percent of stockholders must be excluded from ESOP
- ESOP is a defined benefit pension plan -- company is obligated to buy back stock of departing employees
- If high numbers of employees are near retirement age, company may not be able to afford to buy out vested employees when they retire (company must reserve for stock buy-outs)

- Experienced mid-level management must be in place if owner wishes to depart after buyout
- Annual contribution to ESOP may not exceed 25 percent of payroll. Companies with preponderance of low wage earners may be unsuitable
- Banks will require seller to personally guarantee debt or take on subordinated debt for the amount of uncollateralized bank debt
- Legal fees can run from \$13,000 to \$100,000 for initial set-up
- All employees who have worked 1,000 hours must be allowed to participate
- > Once initial appraisal is obtained, it must be used, whether value is too high or too low
- Companies with net losses will lose tax benefits of ESOF payments
- Administrative costs can be significant for such items as annual valuation, buy back of departing employee stock, IRS and Labor Department review and reporting requirements, etc.
- Even though ESOP trustee votes ESOP share on most issues, issues involving merger, sale, or liquidation must be approved by majority of shareholders
- Terminated and retired employees may keep their stock shares if they wish, which, over time, could result in material ownership share outside the company
- Annual financial results must be shared with all ESOP participants
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