

Why Not An ESOP?

There are many reasons a business owner would not want to adopt an Employee Stock Ownership Plan, or ESOP. ESOPs are not the favorite tool of most transaction professionals, so we hear little about them except the bad press associated with companies like United Airlines and the Tribune Company ESOP transaction engineered by Sam Zell. But for many business owners, an ESOP is an unbeatable tool for financing the business or funding a buyout.

Here are some of the frequently heard ESOP objections:

- **An ESOP is too complicated and expensive.** An ESOP is a profit sharing plan that is set up to invest primarily in employer stock. This means that ESOP contributions can be made in the form of shares of company stock and that an ESOP can buy company stock from shareholders or the company itself. Because ESOP transactions involving company stock have to be conducted at an appraised fair market value, annual valuations by an independent appraiser are required. Is this a deal killer? It shouldn't be for most transactions, especially in light of the unique ESOP advantages.
- **I want to sell my business, not adopt another retirement plan.** An ESOP is a retirement plan, but it also is a financing tool that allows a business owner to sell stock to the ESOP in a tax-advantaged transaction. This is because an ESOP can borrow money to buy company stock. In a leveraged transaction, the ESOP borrows money to buy company stock. The loan is secured by the company's guarantee and a pledge of the purchased stock. The company then makes cash contributions to the ESOP and the ESOP in turn uses the cash contributions to repay the loan. Because the company's ESOP contribution is fully deductible for tax purposes, the ESOP in effect allows the company to deduct not only interest on the securities acquisition loan but also loan principal. That cannot be done with conventional financing.
- **I want to finance my business, not adopt another retirement plan.** The ESOP can also be used to purchase stock from the company. If the ESOP borrows money to do this, the loan can be repaid in a tax subsidized transaction which allows the company to borrow money and repay the loan (both principal and interest) with tax deductible dollars.
- **An ESOP provides benefits in the form of company stock, which means my employees will become shareholders with access to financial information about the company and a right to vote on company business.** ESOPs do measure benefits in shares of company stock, but employees seldom have shares distributed to them. Further, any "pass through" voting rights on company stock owned by an ESOP only apply to major transactions, such as the sale or liquidation of the company. For most ESOP-owned companies, business decisions continue to be made by the board of directors or a management designated committee appointed to run the ESOP.

- **An ESOP may be a great way to borrow money for my business, but what's in it for me as a business owner?** ESOPs feature some of the greatest tax advantages in the Internal Revenue Code. If you own an S corporation, and the ESOP acquires all of the company stock, the company's business will operate free of federal income tax because the ESOP is tax exempt. Most states, like Illinois, will also permit such S corporation ESOPs to operate free of state income tax. If the company is a C corporation and you have owned your stock for at least three years, you can defer capital gains tax on the sale of your stock to the ESOP so long as you sell at least 30 percent of the outstanding shares and you invest the proceeds in "qualified replacement property." There is, of course, some additional tax reporting. Unincorporated businesses (limited liabilities, partnerships and sole proprietorships) can convert to C corporations for this purpose.
- **So, the big catch is "qualified replacement property"?** Not really, because qualified replacement property is broadly defined to include stocks and bonds of any domestic operating company. That definition encompasses most of the publicly traded securities and mutual funds that are available to private investors – in other words, the same investments you probably already own in your personal portfolio.
- **So, if you can sell a C corporation to an ESOP in a tax deferred transaction with tax-subsidized financing, why doesn't everyone do that instead of selling to an outsider or doing a leveraged buyout for current management?** In many cases, there's no objective reason. But most lenders, business brokers and professionals do not have much ESOP experience and tend to recommend more conventional transactions.
- **So, if my usual advisors are not comfortable in recommending an ESOP, how do I figure out if a leveraged ESOP makes sense for my business?** You can engage a consultant to perform an ESOP feasibility study – for a hefty fee. You can also get a fairly good idea of whether a leveraged ESOP makes sense by considering the total value of your company based on an independent appraisal, the amount an ESOP lender is willing to loan on the basis of company or other assets, and your company's total aggregate payroll, because deductible ESOP contributions used for loan repayments will be limited to 25 percent of aggregate payroll (the 25 percent limit applies only to the principal portion of loan repayments by C corporations).
- **If I'm considering selling my business in the next few years, is there any business reason not to use an ESOP?** If there is a management team in place to properly run the company after you sell your stock to an ESOP, then an ESOP makes sense if the company's assets and payroll are sufficient. The management team could include you in a continuing but perhaps reduced capacity. Or, if you choose to withdraw from company management entirely, it could be the team that you have recruited and relied on in the past.

Most ESOPs are sponsored by small and medium sized companies for one or more of the reasons mentioned above. And many ESOP sponsors find that, beyond the unique ESOP tax advantages, the most important ESOP advantage turns out to be improved employee morale and productivity. If an ESOP might make sense for you, consider first talking to a business owner who already has an ESOP. There are over 500 ESOP sponsors in the Chicago area, and most of them have been successful over many years in using an ESOP to accomplish important business and financial goals.

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