Selling to Your Employees Through an ESOP

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An Employee Stock Ownership Plan (ESOP) is a very flexible, tax-advantaged tool in succession planning. It can be combined with other ownership succession strategies including majority family ownership or a management buyout.

A sale to an ESOP has four main advantages (a more detailed explanation of each follows):

> ***Fair market value:*** The selling shareholder can sell the stock for the fair market price, this is especially significant when the owner wants to sell a minority interest, perhaps in a long term staged sale. Minority interests are seldom marketable to other purchasers.
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> ***Reduced finance cost:*** Financing a stock purchase through an ESOP reduces costs because the ESOP can buy the stock with pretax dollars. This means that the company must earn a dollar to buy a dollar of stock, rather than earning $1.48 to pay $0.48 in taxes and have a dollar to buy stock.
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> ***Employee job security:*** The ESOP can help to make employees feel secure through the difficult transition of leadership. Further, since they will share in the future success of the business, they are motivated to help the transition go smoothly and make the business successful in the future.
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> ***Avoid capital gains taxes:*** Through a sale to an ESOP the selling shareholder can defer capital gains taxes -- and perhaps to avoid them all together.
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> ***Control:*** Since the business remains closely held, control is still in the hands of the current shareholders.

Owners of closely-held companies who seek liquidity for their stock can use an Employee Stock Ownership Plan (ESOP) to create a ready market for their shares. This can be especially useful to cash out minority shareholders who wish to turn their stock into cash. The ESOP is attractive because the business remains closely held and in the control of current shareholders, while it allows for a tax advantaged payout for otherwise unmarketable shares. As with other forms of leveraged buy-outs, it will probably be necessary to provide collateral on the ESOP loan in the form of company assets. Thus the same assets can not be leveraged for other purposes.

What follows is a more in depth look at each of these advantages.

Control: While a sale to an ESOP will share ownership with the employees, it is a unique form of ownership. The shares are held in a trust for the employees until they leave the company. Consequently, the trustee of the ESOP exercises most of the “ownership rights” over the stock. The trustee is appointed by the company. The trustee must act in the interests of the ESOP participants and must give the ESOP participants the chance to vote their stock in shareholder issues regarding a merger, liquidation or a major sale of assets.

Tax advantages: There are two main tax breaks related to the ESOP.

> *For the business:* The business is able to repay debt used to acquire stock in the ESOP in pretax dollars. The loan payments take the form of a contribution to the ESOP. The ESOP is a qualified retirement plan for the employees and therefore, is a pretax expense. The ESOP then pays off the loan. This means that the business needs to commit one dollar of pretax earnings to pay for one dollar of debt repayment. In traditional financing, the business must commit $1.48 of pretax earnings to pay $0.48 in taxes and have one dollar to repay debt.

For the shareholder: The selling shareholder can take advantage of a tax free rollover of his or her investment. If, after the sale, the ESOP owns at least 30% of the outstanding stock in the company, and the owner has held the stock for more than three years, he or she can take advantage of the "1042 rollover." The 1042 rollover allows the selling shareholder to defer capital gains taxes on the proceeds of the sale, as long as he or she reinvests those proceeds into domestic operating businesses within a year. In this way, a sale to the employees can provide the **best after-tax price** to the seller. Here is how the tax computation works:

For example: Fred put $100,000 into his company and now has stock worth $1,100,000. If Fred sold it to someone else, he would have a taxable capital gain of $1,000,000 (current value minus the original investment). Fred's capital gains tax on this amount will be $200,000, leaving him $800,000 to spend or invest. If Fred sells the same stock to his employees through an ESOP, and he invests the proceeds in domestic operating companies, the capital gains tax is deferred until he sells the replacement securities. In this way, Fred is able to invest a full million dollars, rather than the after tax $800,000. If Fred chooses not to sell the new investments he will not pay capital gains taxes (when the stock passes to the estate, the basis increases to current value.) Thus, the business was sold and capital gains taxes were fully avoided. In this case, Fred has saved $200,000 in federal taxes on the capital gains (based on a 20% capital gains tax.) His estate will, of course have to pay estate taxes, unless other plans have been made to deal with that.

A summary of the requirements that must be met to take advantage of the 1042 rollover follows:

1. The company stock must have been held by the selling stockholder for at least three years.

2. Immediately after the sale, the ESOP must own at least thirty percent (30%) of the total outstanding stock of the company.

3. Sale proceeds must be reinvested in "qualified replacement properties" within 15 months of the sale to the ESOP. This "reinvestment period" begins three months before the date of the sale and ends twelve months after the date of the sale.

4. If the replacement property is sold, you must pay capital gains taxes on the proceeds. The capital gain on which the tax is calculated will be the *original basis* for the company stock. In the example above, this means that Fred's capital gains tax would be based on the current value of the investments, perhaps $1,500,000 minus the original basis of $100,000. The capital gain would be $1,400,000 and the tax (at 20%) would be $280,000. If the replacement securities pass into Fred's estate, the deferred tax liability goes away. His heirs could sell the replacement properties without capital gains tax. Of course, regular estate taxes apply to the rollover securities.

The rollover securities can be contributed to various trusts which can provide a range of possibilities for assigning beneficiaries and reducing taxes.

Reduced finance cost: A stock purchase through an ESOP reduces costs because the ESOP can buy the stock with pretax dollars. The ESOP is a qualified retirement plan for the employees. Contributions made to the ESOP are accounted for in the same way as contributions to standard retirement plans. Therefore, payments on the stock acquisition loan take the form of contributions to the ESOP and are made from company earnings before taxes. In this way, principal payments for stock acquisition are tax deductible to the company. This means that the company must earn a dollar to buy a dollar of stock, rather than earning $1.48 to pay $0.48 in taxes and have a dollar to buy stock in other methods of finance. Despite that benefit, it is likely that company assets will be required as collateral on the loan.

ESOP stock purchase
Employee job security: The ESOP can help make employees feel secure through the difficult transition of leadership. Further, since they will share in the future success of the business, they are motivated to help the transition go smoothly and make the business successful in the future. ESOPs in some companies have been credited with helping improve company performance and profitability.

The ESOP purchase takes place in three stages: First, the company establishes an ESOP and goes to a bank to get a loan for stock acquisition **(1).** (Company assets are used as collateral.) The company then makes a "mirror loan" to the ESOP **(2).** The ESOP uses the loan to purchase the stock from the original owner or his/her beneficiaries. **(3).**

After the stock is in the ESOP, the loan payments need to be made. Again, these payments are accounted for as contributions to a qualified benefit plan. The company makes contributions to the

ESOP **(1).** The payments are large enough to pay the principal and interest on the loan. The ESOP uses the contribution to repay the bank **(2).** As the loan is repaid, shares of stock are allocated into the individual accounts of ESOP participants **(3).**