

EMPLOYEE STOCK OWNERSHIP PLANS:
HOW TO TRANSITION OUT OF YOUR BUSINESS
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If your business is like most other closely held businesses, you have a few primary shareholders owning all of the company's stock. These may be a single owner, several minority shareholders or a majority shareholder (usually the founder and/or owner) and a few others. While the initial ownership structure may be generally beneficial for company leadership in the short term, in the long term, it may pose succession issues and various adverse tax consequences. What happens when an owner wants to retire? How does the company fund buyouts? How should transfer to the next generation occur? What if a shareholder wants to sell their stock and leave the company, but there are no buyers? What happens to a shareholder's stock in the event of difficult internal conflicts? These questions, and many more, can potentially be solved by the creation of an Employee Stock Ownership Plan (ESOP).

An ESOP is a special tax-qualified pension plan in which the assets are invested in the employer's stock. With an ESOP, the employer contributes shares to the Plan and contributes the money for its employees to buy stock. Not only does this give the employees of a company a greater financial stake in the company, but it also creates a market through which shareholders leaving the company can effectively sell their shares to fund retirement, sever business ties, or simply improve their personal liquidity. Moreover, ESOPs have a favorable tax structure, allowing for sellers to defer taxes that would be required under other kinds of succession plans.

We helped our client (“the Company”) develop an employee stock ownership plan (ESOP) for his contracting business. The ESOP was structured to include all full-time employees meeting certain age and service requirements of the Company. Employees would not individually purchase shares in the ESOP; the decision was made that the ESOP plan would borrow money to buy stock, with the Company repaying the full loan over time. This way, there were significant tax benefits for the Company, the employees, and the sellers.

The owner, who is entering his late 70's, wanted to begin to exit the business and withdraw his investment for retirement. The owner's family, which still had a few second generation family members involved in the Company, had agreed that this was the best way to preserve the owner's investment and allow the Company to enter the next chapter of its existence. An independent valuation of the company determined the value to be \$20 million. Based on the ESOP structure, the owner received a \$20 million buyout for all of his stock in the company, but retained working control of the business (the deal stated he would remain CEO for a period of three years, before the CFO would succeed him). Another advantage to the ESOP was that the owner was able to sell the company without searching for a buyer. The ESOP established new ownership; the employees, who ranged from 34-55 years of age. The transaction allowed the owner to liquidate his most valuable asset, while the employees were able to benefit from the increased value of the company moving forward.

The end result of creating an ESOP often includes: increased performance of the employees (due to their new personal interest in the company); increased profit margins (individuals become more realistic with their budgeting and project management tasks); increased productivity

(employees feel a greater sense of accountability); and, the family exited the business with assurance that the owner would be compensated for a lifetime of work.

The deal was favorable to all parties; through a leveraged ESOP buy-out (as previously detailed, which utilizes a bank loan to pay out the owner after an independent valuation), the transaction was completed successfully. This type of deal is common because few companies have the cash on hand necessary to fund a significant buy-out. Employee contributions are then routed to purchase stock in the ESOP. This enables employees to use pre-tax dollars to contribute to the ESOP—an ESOP is the only way to do this tax-free. Over time, the ESOP paid off the bank loan, and the employees owned the company. The employees will receive their full benefits and distributions when they leave the Company (there can be partial distributions prior to that, based on a request process).

Since the stock purchase was completed with pre-tax dollars, it reduced the cash flow required to fund the buy-out by a considerable amount and increased the value retained in the business. ESOPs pay no federal income tax, yielding another benefit for the employees (this increase of value remains in the Company); however, profit distributions to participants (when employees cash out their shares) are taxable income. We structured the ESOP to purchase back shares at an appraised fair market value—which provided employees with financial security for the future.

Other benefits of using an ESOP as an exit strategy included: it allowed the Company to continue to operate intact; it enabled employees to build value in ownership of the Company; and it provided the owner with a way to cash out his investment, while transitioning the Company into its next phase. The result of establishing an ESOP was extremely positive for both the Company and the owner.

If you do have proven operational performance, as well as stable cash flow, a qualified second-tier management team, and a large enough payroll to fund the ESOP and/or the loan necessary for a leveraged plan, then an ESOP could very well be beneficial for you.

Additionally contractors need to consider the effects of the ESOP on their surety credit and overall financial structure. By working with your surety and banking partners while developing the plan, an ESOP plan can be structured to everyone's satisfaction.