ESOPs and Business Transitions: Structuring a Win-Win-Win Succession Plan

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Agenda

• Introduction
• History/why is ESOP good for American business and business-ownership transitions
• ESOP basics and most common tax strategies
• Selecting a structure
• Financing an ESOP
• Valuation and feasibility
• Moving forward
• Assembling a team and defining responsibilities
• Functions of the trustee
• Recordkeeping
• Summary and debunking ESOP myths
• Conclusion and open to Q&A
History and Current Bills in Congress

• Positive ESOP legislation is put to Congress every year since 1989.

• Today: 115th Congressional session (2017-2018) Bipartisan Bill to support ESOP awareness.
  
  o S.1589 and H.R. 2092, known as *Promotion and Expansion of Private Employee Ownership Act*.
  o July 19, 2017, Introduced by Senators Pat Roberts (R-KS) and Ben Cardin (D-MD) – It has 22 sponsors (10 Republicans and 12 Democrats)
  o Seeks to amend TRA ’86 and the Small Business Job Protection Act to expand availability of ESOPs in S-Corporations, extend the deferral of capital gains taxation to qualified sellers of S-Corp shares, protect the SPA certification of companies that establish ESOP, and extend technical assistance to support sales to ESOPs.
  o The main change, if passed, is the expansion of the tax-deferred/tax free provision of IRC Section 1042 to S-Corporations. Currently, the tax deferral for gains attributed to the sale of a company to an ESOP is only available for C-Corporation owners.

To review the background and text of the bills, go to:
Why Is ESOP Good for American Business?

* Statistics show: difference in post-ESOP to pre-ESOP performance

Annual sales growth  +2.4%
Annual employment growth  +2.3%
Annual growth in sales per employee  +2.3%
More likely to stay in business than non-ESOP companies
More likely to offer more benefits than non-ESOP companies

(The relative growth numbers might seem small at first glance, but projected out over 10 years, an ESOP company with these differentials would be a third larger than its paired non-ESOP match)

*2000 Study by Douglas Kruse and Joseph Blasi of Rutgers University

• Job retention versus job creation
Using ESOP for Ownership Transition

• You are a company owner and need an exit strategy

• You are a company owner who desires to share the benefits of growth and success with your employees and leave a positive LEGACY versus a third-party sale of your life’s work

• Private companies need a flexible market to buy out owners

• Family needs liquidation for the distribution of inheritance in the case of an owner’s death

• Management needs a proven way to draw and retain talent

• Your company is PROFITABLE and needs tax-saving strategies
What Is an ESOP?

1. Liquidity Strategy
   Owners can sell a fractional amount or the entire company to an ESOP.
   It’s a more controllable and friendly process compared to a third party sale.
   Provides continuity of corporate culture and company legacy.

2. Tax Efficiency
   Debt is repaid with pre-tax dollars.
   100% ESOP-owned S-Corporation does not pay taxes.
   Capital gains deferral on C-Corporation transactions if certain criteria.

3. Retirement Plan
   The ESOP is an ERISA-protected retirement plan.
   Value within participants account grow tax deferred.
   Company is responsible for repurchase of all stock when employees leave.
What Is an ESOP?

Qualified retirement plan, with three key differences

- Can borrow money
- Can engage in transactions with parties in interest
- Is required to invest primarily in the stock of the sponsoring employer
ESOP Pros and Cons

- Controllable transaction
- Shorter transaction timeline
- Ownership culture/retirement benefits
- Retains and attracts key employees
- Flexible financing arrangements
- Significant tax incentives

- ERISA fiduciary responsibility
- Perceived complexity
- Full liquidity unlikely
- Non-productive debt on balance sheet
- Repurchase obligation if not monitored
- Ongoing administrative costs

ASPPA
How Does an ESOP Transaction Work?

1. Outside Loan from Bank to Company
2. Inside Loan from Company to ESOP
3. Cash + Seller Note from Seller to ESOP
4. Stock from ESOP to Seller
How Does an ESOP Work (Post Transaction)?

- **Bank**
- **Company**
  - Outside Loan Payments
  - Contribution/Dividend
  - Seller Note Payments
  - Inside Loan Payment
  - Stock Allocations
- **ESOP**
- **Employees**
ESOP Tax and Economic Benefits

C-Corp ESOPs have significant tax benefits
Some motivating factors:

- Capital gain tax deferral when 30 percent or greater sold to ESOP
- Seller must own stock for at least three years
- Must be C-Corp. at time of deal
- Seller (or any descendants) cannot participate in ESOP if 1042 is elected
- Tax basis of shares become tax basis of QRP
- Permanent tax deferral (upon death, stepped-up benefit to estate)
- Tax is deferred as long as QRP is held. Seller can time triggering of capital gains.

Qualified Replacement Property (QRP)

Proceeds must be invested in QRP within one year after closing

QRP may include:

- U.S. stocks and bonds
- No passive income investments (i.e., REITS, mutual funds)
- No government entity or partnership interests
ESOP Tax and Economic Benefits

S-Corp ESOPs have compelling economics

Some motivating factors:

- 100 percent S-Corporation ESOP does not pay taxes
- Transaction debt (principal and interest) can be repaid with pre-tax earnings
- Sellers can participate in newly established ESOP
- No investment restrictions
- ESOP counts as one shareholder
- No capital gains tax deferral to sellers
<table>
<thead>
<tr>
<th>ESOP Tax Strategies</th>
<th>Pre-Tax LBO</th>
<th>Tax-Free Stock Sale</th>
<th>Tax-Exempt Corporation</th>
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<td><strong>Pre-Tax Leveraged Buyout</strong></td>
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<td><strong>Tax-Exempt Corporation</strong></td>
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<td>S-Corporation Only</td>
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<td>No Tax on Corporate Income</td>
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*Tax Subsidies Encourage ESOPs*
## ESOP Tax Strategies

### $10M Sale of Stock

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<tr>
<th></th>
<th>MBO or Leveraged Recap</th>
<th>ESOP</th>
<th>ESOP Tax Savings</th>
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<tr>
<td><strong>Proceeds to Shareholders</strong></td>
<td>$7.62M(^1)</td>
<td>$10.0M</td>
<td>$2.38M</td>
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<tr>
<td><strong>Cost to Company</strong></td>
<td>$10.0M</td>
<td>$6.6M(^2)</td>
<td>$3.4M</td>
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<td>$5.78M (57.8%)</td>
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1. Assumes 23.8 percent federal tax on sales proceeds
2. Assumes 34 percent federal corporate tax rate
ESOP Tax Strategies

### Tax-Free Stock Sale

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<th>Tax Rate</th>
<th>0%</th>
<th>23.8%</th>
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<td>6.0</td>
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<td>6.5</td>
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<td>7.0</td>
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### Taxable Sale

- **ESOP Sale**: $10,000,000
- **Taxable Sale**: $13,123,359

### Capital Gain (Taxed at 23.8%)

- **Net to Seller**: $10,000,000
ESOP Tax Strategies

Tax-Exempt Corporation

- Only available to S-Corporations
- 100 percent ESOP-Owned Corporation

“NO TAX ON CORPORATE INCOME!”
## ESOP Tax Strategies

### $10M Sale of Stock

<table>
<thead>
<tr>
<th>Tax on Company’s Income&lt;sup&gt;1&lt;/sup&gt;</th>
<th>MBO or Leveraged Recap</th>
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<th>ESOP Tax Savings</th>
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<tr>
<td></td>
<td>$792,000&lt;sup&gt;2&lt;/sup&gt;</td>
<td>$0M&lt;sup&gt;3&lt;/sup&gt;</td>
<td>$7.92M&lt;sup&gt;4&lt;/sup&gt;</td>
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1. Annual corporate earnings of $2MM
2. 39.6 percent tax rate
3. Company operates as 100 percent ESOP-owned S-Corporation
4. $792,000 per year for ten years
Consideration should be given to all impacted parties.

**Company Concerns**
- Unproductive debt on balance sheet
- Board composition
- Management succession

**Seller Expectations**
- Cash at close
- Value expectations
- Corporate legacy

**ESOP Trustee Concerns**
- Adequate consideration
- Relative fairness
- Dilutive impacts
The seller’s objectives are usually the focal point of structural considerations.
Financing an ESOP

The least expensive form of debt
Level of financing will depend on company cash flow, borrowing base, and liquidity requirements of the seller

Senior Bank Debt

Subordinated or Mezzanine Debt

This debt can be costly
If the seller’s goal is to maximize liquidity at close, a form of subordinated/mezzanine debt will be required

Seller financing can be flexible
Seller has the ability to finance entire transaction. Seller financing returns may be difficult to replicate in the public markets

Seller Financing

Cash or 401(k) Rollover

Unique funding mechanisms
Employees may have an option to rollover a portion of their 401(k) to fund the ESOP purchase
Financing an ESOP

**Transaction Process**

1. Bank loans $ to company, creating the external loan.
2. Company loans $ to ESOP to fund the purchase, creating the internal loan.
3. ESOP uses proceeds to purchase shares from seller.
4. Purchase shares are held in “suspense” as collateral for the internal loan.

**Leveraged ESOP Flow of Funds**

- **Bank** loans to company, creating the external loan.
- Company loans $ to ESOP to fund the purchase, creating the internal loan.
- ESOP uses proceeds to purchase shares from seller.
- Purchase shares are held in “suspense” as collateral for the internal loan.
Financing an ESOP

**Employee Allocations**

1. Company makes pre-tax contribution to ESOP trust

2. ESOP receives contribution and immediately repays the internal loan causing a release of shares

3. Company receives funds from the ESOP and pays back the external loan

4. The resulting flow of funds provides a tax deduction to company with no impact to cash flow
Valuation and Feasibility

What Makes a Company a Good ESOP Candidate?

- Profitable and Growing
- Strong Management Team
- Solid Operating Model
- Desire for Independence
- Debt Capacity
- Looking for Tax-Favored Exit
The valuation and feasibility study will be completed in order to gauge the likelihood of a transaction taking place.
The Valuation Process is 45 to 60 days

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<td>Due diligence</td>
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<td>Review assumptions with management</td>
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<td>Prepare deliverables</td>
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<td>Present conclusions</td>
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Valuation and Feasibility

**Investors expect profit**
- Looking at historical profits can be a useful indication, but change happens and profit tends to shift
- Investors are buying the future; not the past
- Risk of achieving profit expectations should be considered

**The outside world has an impact too**
The stock market reflects:
- Fundamental performance
- Market perceptions
- Macroeconomic/industry factors
- M&A/financing markets

Company Valuation = Internal Company Factors + External Market Factors
Valuation and Feasibility

Larger businesses will lead to larger multiples

- Tested business models
- Stronger processes and controls
- Geographic presence is larger
- Customer diversity

Size provides security

Management depth

Economies of scale

Higher

Lower
The Feasibility Study

- Analyzes post-transaction effects
- Does the proposed structure "work"
- Scenario testing and structure changes
- Presented to ESOP Trustee
Deciding to Move Forward

There are a number of both economic and non-economic factors that can impact the seller’s decision.

A successful transaction may not be defined as getting the highest price.

Factors that impact a decision:
- Price/valuation
- Legacy
- Employee well-being
- Community
- Sustainability
- Cash at close or fixed income
- Equity participation
- Indemnification
- Escrow/earn-outs/claw-back

There are a number of both economic and non-economic factors that can impact the seller’s decision.
Transaction Roles

Corporate Team

- Selling shareholder
- Financial adviser
- Accounting firm
- Corporate counsel
- Special ESOP counsel
- Third-party administrator
- Lender

ESOP Team

- ESOP trustee
- ESOP financial adviser
- ESOP legal counsel
Transaction Responsibilities

Corporate Team

- Manage transaction process
- Produce requested information
- Provide access to management
- Raise external financing
- Structure transaction
- Make initial offer
- Produce legal documentation

ESOP Team

- Due diligence
- Valuation/feasibility
- Review/negotiate offer
- Produce ESOP legal documentation
- Fairness opinion
- Post-deal implementation
- Annual ESOP valuation

It is essential that management has minimal distractions and remains focused on the business during the transaction process.
Functions of the Trustee

**Duties**
- Exclusive Benefit Rule
- Prudence Rule
- Plan Document Rule

**Transactions**
- Act with sole discretion
- Engage experts
- Negotiate solely in the best interests of participants

**Board of Directors**
- Monitor board actions
- Monitor company financials and performance
- Attend shareholder and board meetings

**Annual Share Value**
- Hire valuation advisers
- Conduct due-diligence discussion
- Finalize share value
- Coordinate with TPA

**Vote Shares of Company Stock**
- Vote Board of Directors
- Determine pass-through voting

**Custody Assets**
- Accept employer contributions and collect income on plan assets
- Issue certified statements
- Reconcile plan allocation and participant statements to trust holdings

**Plan Administration and Distributions**
- Prepare and deliver participant distributions
- Prepare applicable tax withholding and reporting
- Provide certified annual trust statements
ESOP Recordkeeping

Quality ESOP administration and recordkeeping is critical

- Promotes the employee ownership culture
- Enhances the acceptance of the ESOP

Therefore, it is important to partner with a TPA that brings ESOP expertise to the team

- Assistance and education from an experienced professional
  - Plan sponsor
  - Employee-owners
- Communication strengthens the ownership culture
ESOP Recordkeeping

Unique ESOP plan features

Different tax-deduction limits
• Compared to other types of qualified retirement plans
• C- and S-Corp differences
• C-Corp dividends

Funding the ESOP
• Form of employer contributions
• Earnings on company stock investment
  o C-Corp dividends
  o S-Corp distributions

ESOP loan repayments
• Funding and allocation formulas
• Method of releasing shares from suspense account
• Effects on participant accounts

Diversification
• Statutory
• Enhanced
ESOP Recordkeeping

Unique ESOP plan features

Participant account tracking and testing
- Leveraged/non-leveraged shares
- Tracking stock tranches (pre- and post 1986 stock, by transaction terms, other reasons)
- IRC 1042 – prohibited allocations
- IRC 409(p) – S-Corp anti-abuse

Distributions
- Timing
- Form of payments (lump sums or installments)
- Cash or stock
- Redemption or recycle

Cost-basis recordkeeping
- C-Corp
- S-Corp

Pass-through voting
Typical ESOP Myths Debunked

*In general:*
- “Control” will *not* be lost.
- Trustee will *not* become involved in routine governance.
- Employees or trustee will *not* have a seat on a board.
- Management structure will *not* change.
- Trustee does *not* become involved in management.
- Stock valuation, compensation, and/or corporation’s financial statements are *not* required to be disclosed.
- Corporation will *not* be less attractive to potential buyers.
- Corporation can “go public” later.
Conclusion: Although there are some concerns that must be addressed, when an ESOP is a good fit for a company, the benefits typically far outweigh the costs. Over time, the return on the ESOP as an investment of the company is often celebrated as a WIN-WIN-WIN for all.

Questions?

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