# How an ESOP Can Benefit Your Business, Your Employees, and Your Net Worth

### Key Takeaways:

- An ESOP is a tax-qualified retirement plan that enables employees to acquire some (or all) of your company's stock over time.
- One major reason to consider ESOPs: They can potentially provide companies and owners with some impressive breaks on income taxes and capital gains taxes.
- Your goals, the size of your business and your timeline to transfer ownership should factor into your decision whether to use an ESOP.

Lots of entrepreneurs deeply value their employees and see them as instrumental in their companies' ongoing success. If that describes you, there's a way you can potentially encourage your employees to generate even better results for your business: include them in your succession plan and save a bundle in taxes.

The key to pursuing those goals is an employee stock ownership plan, or ESOP.

ESOPs offer a number of advantages that can help business owners cut their income tax and capital gains tax bills, better motivate employees to enhance the company's success, and effectively transfer ownership of the business when it's time to move on.

Intrigued? You should be. ESOPs aren't the right choice for all entrepreneurs—but if you're a good match, an ESOP could potentially help fuel a bright future for your company, your employees and your own personal wealth.

## HOW AN ESOP WORKS

An ESOP is a tax-qualified retirement plan that enables employees to acquire some (or all) of your company's stock over time. As a result, the employees become beneficial owners and the company becomes partially (or entirely) employee-owned.

To set up an ESOP, your company establishes an employee stock ownership trust and annually contributes cash or company stock directly to it. Because an ESOP is a retirement plan, contributions of cash or stock are tax deductible—and employees do not pay tax on their shares until they start receiving distributions (more on that later). Employees have accounts within the ESOP, and shares are allocated to these accounts. Contributions build up in the ESOP over time, with the amount of stock each person receives usually varying based on factors such as salary, years of service or job title.

When vested employees leave or retire, the company must offer to buy the shares back from them at the most recent determined share value. Distributions can come in a lump sum or as installment payments, depending on the ESOP's design.

ESOPs are unique in some ways relative to other employee benefit plans. For example:

- ESOPs are the only type of plan allowed to invest primarily in the stock of the employer that sets up the plan.
- An ESOP can borrow money on employer credit to buy the owner's shares. The company then makes contributions—also tax deductible—to the plan, which serves to repay the loan. This can help a company use an ESOP as a corporate finance tool.
- Unlike with a plan such as a 401(k), employees don't use payroll deductions or their own contributions to buy stock.

## SIGNIFICANT TAX BENEFITS FOR OWNERS

ESOPs can potentially provide companies and owners with some impressive breaks on income taxes and capital gains taxes. For example:

- **Deductible ESOP contributions.** Annual cash contributions to the ESOP generally are tax deductible up to 25 percent of covered payroll (which also includes employer contributions to other defined contribution plans).
- **Deductible principal and interest payments.** As noted, an ESOP provides a unique ability to borrow money to buy your shares. If an ESOP does so, your business's contributions to the trust that pay back the loan are also tax deductible. That means you can fund both the principal and the interest payments on an ESOP's debt service obligations with pretax dollars.
- **Tax-free income.** ESOPs in some cases pay no federal income taxes—at all. Example: If you have an S corporation and 100 percent of its stock is owned by the ESOP, the corporation's income passes through to the ESOP. Since the ESOP is a tax-exempt retirement plan, it won't pay any federal income taxes. By avoiding any type of tax obligation on the company's income, you potentially free up lots of cash for other purposes.
- **Deferred capital gains taxes.** If you own a C corporation and sell at least 30 percent of your stock to an ESOP, you can defer paying capital gains tax on the profit. To do this, however, you must elect a Section 1042 exchange and reinvest the stock sale proceeds in "qualified replacement securities"—which can include publicly traded stocks and bonds. That means you won't be hit with a gain until you sell those replacement securities.

## A STRONGER BUSINESS

Pop quiz: Who works harder—owners or employees? By giving employees a stake in your company, you can potentially significantly boost their motivation to do what's best for the business at every step. Consider a study by Rutgers, which found that ESOPs appear to increase sales and sales per employee by about 2.3–2.4 percent per year over what would have been expected absent an ESOP.

Having an ESOP that gives ownership interests to employees can also potentially help you recruit and retain top talent. Employees won't pay income tax on stock put into their ESOP accounts until they take distributions—typically when they leave the company or retire. If they take distributions prior to age 59½, they'll generally have to pay a 10 percent penalty in addition to the income tax, but they can roll the money into an IRA or another qualified plan and continue the tax deferral.

## SMOOTHER SUCCESSION PLANNING

Given ESOPs' ability to help the selling shareholders defer or even avoid capital gains taxes, as highlighted above, it shouldn't come as a surprise that they are important parts of many entrepreneurs' succession planning efforts. Today, there are roughly 6,500 ESOPs in the U.S., according to the National Center for Employee Ownership.

That said, there are other reasons ESOPs make for good succession vehicles for some entrepreneurs. Selling to an ESOP can potentially lead to a smoother, less volatile transition as compared with selling to strategic buyers. Employee retention, for example, may be more stable when it's the staff themselves who are taking over. An employee sale might also reduce the amount of presale preparation you need to do in advance of the transition.

There are also more intangible reasons to go the ESOP route. For example, some entrepreneurs want to be assured that their businesses will pass on to people they know and trust, and in whom they've instilled their business values. These and similar goals may be just as important as—or more important than—getting the absolute maximum possible sale price.

## DOES AN ESOP MAKE SENSE FOR YOU?

As powerful as these benefits may be, that doesn't mean ESOPs are the ideal option for all entrepreneurs. You'll want to assess your goals and your situation—both personally and as a business owner—to determine whether you should even consider an ESOP.

These are some of the most important factors to consider:

1. **Goals.** A crucial issue to weigh is whether you want to sell your business to your employees in the first place. Do you have the talent in place to ensure your company is well run after you're gone—or would you need to recruit new staff, or invest resources to get existing personnel up to speed? If you conclude that employees shouldn't take the reins someday, an ESOP won't be the right move.
2. **Your company's size and financial picture.** The size and revenue of your business must outweigh the cost of setting up the ESOP, which might run you $50,000 or more. There are no magic numbers here, but it's likely you'll need at least 25 employees and annual EBITDA (earnings before interest, taxes, depreciation and amortization) of around $3 million or more to make an ESOP financially viable. Larger firms also often have easier access to financing for the purpose of buying shares.
3. **Liquidity issues.** If the value of your company's stock rises significantly, it's possible that the ESOP won't have enough money to repurchase stock when employees retire—particularly if multiple employees retire around the same time. That could put a significant financial strain on the company.
4. **Your succession planning timeline.** It's generally recommended that transitioning ownership via an ESOP be done over a period of five or even ten years. If that

timeline sounds too long to you, an outright sale to a third party will likely be much faster and enable you to cash out quicker.

5. **Payout.** Legally, an ESOP cannot pay more for your company's shares than their fair market value as determined by an independent valuation specialist. If you sell to a third party, there is an opportunity to get more than the estimate from the independent valuation. Therefore, a key consideration should be weighing maximum potential payout against selling to dedicated employees who may know and share your business values.
6. **Your business's structure.** In general, ESOPs can be set up only in C or S corporations (not partnerships or most professsional corporations).

## CONCLUSION

If an ESOP sounds intriguing, consider working with an ESOP professional who can conduct a feasibility study to see what this type of plan and transaction might look like in your specific business. You may discover that you're a good fit for an ESOP—or that you could be by taking a few action steps in the right direction. Most of us lead very busy lives and feel like we're continually juggling multiple priorities and demands on our time. But as you make plans for your future, it's important to take a step back from all those daily responsibilities and really consider the road ahead.