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ESOP CONNECT

ESOPS: THE IDEAL SOLUTION

Employee Stock Ownership Plans, or ESOPs for short, are gaining momentum as baby boomers look to transfer their businesses in a way that best suits their families' goals and objectives. Many are family businesses that would like to perpetuate the business into the next generation or key management, but giving the business away is not a viable option and the next generation often cannot afford or even borrow the purchase price.

Owner's also face considerable taxation on stock sale proceeds including capital gains tax on the gain. Unfortunately, the new Trump Tax Plan passed as of January 1, 2018 left the federal capital gains tax burden on a selling shareholder completely untouched at 23.8% (20% plus the 3.8% Affordable Care Act of 2010 imposed tax on the gain portion of a business sale) on top of the applicable state capital gains rate.

ESOPs have unique procedural and tax benefits, all of which are still in play after the recent tax reform. Certain ESOP structures may not be subject to the underlying affected capital gains or income taxes at all. Therefore, ESOPs are one of the most tax efficient ways for an owner to transfer a business and often provides the most "net" after-tax proceeds to the seller than any other sale transfer method.

EMPLOYEE STOCK OWNERSHIP PLANS DEFINED

In practical terms, an ESOP is a highly tax advantaged, immediate or gradual exit strategy for business owners desiring liquidity or to simply take "chips of the table". The ESOP is a "ready and willing" buyer of the seller's stock that keeps out unrelated third parties and allows corporate control to remain unchanged. It retains the seller's existing perks while providing significantly enhanced retirement benefits to all eligible employees who will have a beneficial ownership interest in the stock sold to the ESOP.

Technically, an ESOP is a defined contribution, tax-qualified retirement benefit plan under Internal Revenue Codes 401(a) and 4975(e)(7) and overseen by the Internal Revenue Service and the U.S. Department of Labor designed to invest "primarily in employer stock."

HOW AN ESOP WORKS

Only ESOPs are allowed to borrow the funds required to buy the desired shares at fair market value from the selling shareholder. Typically, the ESOP borrows funds from a bank or the seller takes back a note. The company makes tax-deductible contributions to the ESOP, which uses the funds to repay the loan incurred to buy the stock until the debt is repaid. The shares purchased by the ESOP are allocated to the employees of the company in proportion to their compensation as the loan is repaid.

SELLER ADVANTAGES

- The selling shareholder may indefinitely defer/eliminate all capital gains on the sale proceeds.
- The seller enjoys an immediate buyer of some or all of the seller's stock at fair market value.
- The seller can retain personal salary, perks, benefits and control without the interference of outside interests until ready to hand over the reigns.
- Seller retains personal and corporate legacy in the town in which he cares and substantially contributed.

CORPORATE ADVANTAGES

- The company receives a dollar for dollar income tax deduction on the entire stock sale price
- An ESOP company can be 100% federal and state income tax exempt
- ESOP companies outperform their peers with increased productivity and higher return on investment.

EMPLOYEE AND COMMUNITY ADVANTAGES

- The employees enjoy enhanced retirement benefits of company stock with no out of pocket costs.
- An ESOP's orderly internal transfer of the company creates a more stable and reliable community employer than the intentions of an outside buyer.
- The company remains an important contributor to the community's social and economic fabric.

CORPORATE PERFORMANCE

ESOPs have been studied in depth for nearly 35 years. These studies have proven that ESOPs can dramatically increase company performance in many areas. They foster an "ownership culture" in the company, which can make employees feel and act more like owners and less like employees. Other benefits ESOPs may provide are:

- Increased profitability of the company.
- Decreased costs, such as Workers Compensation, Re work, General expense levels and loss due to negligence or theft.
- Increased return on assets.
- Increased retention and fewer turnovers of good employees.
- Greater ability to recruit new employees
- Significantly increased retirement benefits.

ESOP'S LEGACY FULL CIRCLE

Many owners want their children and/or key management to eventually run and own the business, but they cannot afford to purchase the business nor obtain adequate financing. ESOP's "Legacy Full Circle" increases direct ownership to the next generation over time without personal financing and the potentially conflicting goals and interference of outside unrelated interests. As employees leave the company for any reason, the company may repurchase the shares from the participants and retire the shares into treasury. This reduces the overall outstanding shares and increases the percentage of ownership that is held by outside the ESOP by the children and/or key management. In theory, when the last share is repurchased and retired, the shares held outside the ESOP represents 100% of the value of the company.

In summary, an ESOP is a ready and willing buyer and highly tax-advantaged business transition tool that is often an overlooked due to perceived complexity or lack of knowledge. An ESOP may be the ideal method to transfer a business on the seller's timetable to the next generation without the interference and costs of outside parties. Baby boomer business owners around the country owe it to themselves to explore their options and the impact of waiting too long to learn the facts.