

*GBQ's professionals have worked with hundreds of companies that have employee stock ownership plans ("ESOPs"). We are deeply involved in the ESOP community and frequently speak on ESOP-related topics. Based on our experience, below are some of the most common questions we've been asked regarding ESOPs:*

### 1. What is an ESOP?

An ESOP is an employee benefit plan, similar to a 401(k), which allows the employees of a company to become beneficial owners of stock in that company. As a benefit plan, ESOPs are governed by the U.S. Department of Labor. Several features make ESOPs unique as compared to other employee benefit plans. For example, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. According to the ESOP Association, there are currently over 11,000 ESOPs in place in the U.S.

### 2. What are the ideal company characteristics for an ESOP candidate?

ESOP-owned companies can come from a variety of different industries, sizes, and ownership structures. Companies that form the most successful ESOPs typically have the following characteristics:

- Enterprise value of \$1MM to \$1B
- Strong leadership team
- Low leverage / available debt capacity
- Domestically-based employees
- Profitable
- Stable and motivated employee base
- Owner(s) desiring a succession plan
- Owner(s) desiring liquidity / diversification

### 3. Why is an ESOP such an attractive option to selling shareholders?

An ESOP is an excellent tool for shareholders to:

- 1) Achieve liquidity by selling illiquid company stock;
- 2) Diversify their wealth so their fortunes are less dependent on company performance;
- 3) Realize certain income tax benefits that may not be available through a sale to a third party;
- 4) Sell the company in a manner that typically requires less time, money, uncertainty, and effort than a sale to a third party;
- 5) Construct a customized succession planning strategy by allowing shareholders to transition ownership according to their desired time frame;
- 6) Preserve a company's legacy as an independent entity;
- 7) Reward, motivate, and retain key company employees; and
- 8) Do all of the above while retaining managerial control of the company.

### 4. What are the two most discernible advantages for ESOP-owned companies?

ESOP-owned companies enjoy particularly favorable income tax treatment, which can greatly enhance cash flow. During repayment of an ESOP loan, companies may deduct for tax purposes both principal and interest payments. Further, because an ESOP is a qualified retirement plan, it is exempt from paying federal income taxes. Therefore, if an ESOP company is structured as an S-corporation, where federal income taxes are paid at the shareholder level, a 100% ESOP-owned S-corporation would effectively be exempt from

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paying federal income taxes. Aside from the tax benefits of the ESOP structure, studies have shown that ESOP companies tend to outperform non-ESOP companies, particularly when the ownership benefits of ESOPs are clearly communicated to participants. A study by the University of Pennsylvania found that employee-owned companies experience increased productivity, profitability, and longevity.

### **5. How much time is normally needed to establish the suitability and feasibility of an ESOP?**

The initial suitability of an ESOP can typically be established after a few discussions between ESOP advisors and the company's shareholder(s), while the actual feasibility can be determined within a few weeks. Actual timelines are dependent on the availability of necessary information and the responsiveness of shareholders/management.

### **6. What are some prevalent oversights or mistakes made in an ESOP transaction?**

Some of the most common mistakes result from engaging professionals who lack ESOP expertise. For example, the valuation of a company for the formation of an ESOP is fundamentally different from valuations for other purposes. Companies/shareholders who are considering ESOPs as a potential succession planning tool should only engage individuals who are active with ESOPs, including valuation firms, attorneys, banks, record keepers, and trustees.

### **7. For a 100% shareholder who wants to retire within the next five to ten years, can an ESOP be an effective succession planning tool?**

Yes. Most shareholders will sell at least 30% of the company's equity to an ESOP in the initial transaction (due to potential tax and other benefits of this structure). Many will also choose to sell less than 50% initially in order to retain voting control of the company. The outstanding shares can be sold to the ESOP at a later date, possibly in connection with the shareholder's retirement.

### **8. Can a shareholder(s) sell 100% of a company to an ESOP all at once?**

Yes. A transaction of this nature typically requires both bank and seller financing. The selling shareholder(s) receive cash proceeds upfront (usually equal to the amount financed by the bank), with the remainder paid through the repayment of the seller note (typically over a five to seven year period). The seller(s) are also able to earn interest on the amount financed through the seller note, which provides an additional source of income for them.

### **9. How is the purchase price determined for a sale to an ESOP?**

Like most merger and acquisition transactions, the sale of company stock to an ESOP is a negotiated transaction between two or more parties. An ESOP trustee negotiates the purchase price on behalf of the ESOP, which is prohibited from paying greater than "fair market value" for the company's stock. Fair market value is defined by the Employee Retirement Income Securities Act (ERISA). An expert business valuator will nearly always be hired to assist the trustee in determining the fair market value of the company's stock, and it is extremely important to use a valuator who is familiar with the unique characteristics of ESOPs.

### **10. How is the value of a privately-held ESOP company determined?**

There are three common approaches to valuing privately-held businesses – a market approach, an income approach, and an asset approach. The market approach estimates value by analyzing pricing relationships (i.e., multiples) associated with market transactions involving similar companies. The income approach estimates value based on a company's future earnings capacity. The asset approach estimates value based on the net assets owned by a company. A valuator will use some combination of these methods in issuing a valuation opinion.

### **11. What is the total implementation cost of an ESOP?**

Implementation costs vary widely depending on transaction size and the team of advisors chosen; however, ESOPs can be implemented for \$100,000 to \$200,000 on smaller, straightforward deals, and for 3-5% (or less) of transaction size for larger and/or more complex deals. The cost in transaction fees for a sale to an ESOP is almost always lower than a sale to a third party.

### **12. How can the company's shareholder(s) limit their fees until they know for sure that an ESOP is a good fit?**

Often the first step in a contemplated ESOP transaction is a feasibility study and preliminary valuation. These services are typically sought first in order to ensure that an ESOP structure is viable and the company can be sold at a price that is in line with shareholder expectations. The cost of this feasibility study and preliminary valuation is typically modest relative to the total fees in a transaction.

### **13. Is there any way for the selling shareholders to defer the taxable gain that results from selling the company?**

Allowed under Section 1042 of the Internal Revenue Code, selling shareholders may elect to defer the capital gains tax that would otherwise result from a stock sale. The 1042 election currently is only available to shareholders of C-corporations. Additionally, to qualify an ESOP must own 30% of the company stock following the sale, and the seller(s) must reinvest sales proceeds in "qualified replacement property" (essentially, the stocks and bonds of domestic operating companies). The seller(s) must also have held the company's shares for three years prior to the sale to the ESOP.

### **14. Our company is an S-corporation; how can the shareholder(s) have the same deferral of income tax on the sale proceeds that are available for C-corporations?**

The deferral of capital gains taxes on sale proceeds is only available where the company is a C-corporation at the time of the sale. Often, an S-corporation will revoke its S election to become a C-corporation prior to the sale to the ESOP to gain the benefits of the 1042 rollover. The company would be unable to make another S-corporation election for five years. We note that Congress may eventually revise this legislation to allow S-corporations to be on equal footing with C-corporations in this regard.

### **15. In the scenario described in question #14, should the company switch back to an S-corporation after five years?**

Most likely, yes. The most common reasons why companies forego the benefits that result from conversion to an S-corporation are: (a) the ESOP owns a small interest, (b) the

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company reports minimal profitability, and/or (c) converting to an S-corporation would trigger a sizable tax liability.

**16. Is it possible to restrict the ownership of ESOP shares to certain employees such as key managers or family members of the selling shareholder(s)?**

No, ESOPs are subject to the same regulations that govern other qualified retirement plans with respect to coverage and non-discrimination, and generally all full-time employees participate (seasonal and temporary employees may be excluded). The share allocation of ownership within the ESOP is generally determined by some combination of relative compensation and employee tenure.

**17. If an ESOP will not allow for employee discrimination, is there another way to reward certain employees?**

The company can also use “phantom” stock or other equity-based compensation to reward key employees; however, these programs reduce the company’s common stock value (and therefore reduce what the ESOP can pay). Management often decides it is easier to reward key employees by simply increasing compensation. Lastly, it is important to remember that under the ESOP share allocation rules, the largest number of shares will go to the highest-compensated, longest-tenured employees.

**18. Who is “in charge” of the company after an ESOP transaction? Do the employees collectively run the company?**

There is no required change to a company’s management structure after an ESOP transaction. As ESOP participants, employees are not automatically entitled to any managerial-level benefits.

**19. What are the rules regarding disclosing an ESOP company’s financial information to its employee owners?**

The ESOP trustee, not the employees that are represented by the trust, is the only party that has the right to obtain financial information of the company. The company is only required to share with ESOP participants the ESOP’s annual 5500 filing and a summary annual report (which summarizes the information contained in the 5500 filing). However, some ESOP companies choose to disclose much more to their employees, and this transparency often promotes trust within the company and leads to improved performance.

**20. Who votes the shares held in the ESOP, and is this voter controlled?**

The trustee of the ESOP usually votes the shares held in the ESOP. However, where state law requires a shareholder vote for reorganization, recapitalization, merger, or sale of substantially all of the company’s assets, the participants are instructed to direct the trustee how to vote their allocated shares. The trustee, who ultimately has voting authority, may be an individual(s) inside or outside the company. When an external trustee is retained, sometimes his/her vote is directed by the board of directors. However, giving an external trustee the authority to vote can be useful protection from fiduciary liability (especially related to potential conflicts of interest in a transaction).

**21. Our company is highly acquisitive. Does an ESOP offer any potential advantages in this area?**

Yes. Because of the extremely beneficial tax treatment on ESOP contributions (which allow a company to finance a transaction with pre-tax cash flows), many ESOP companies choose to use the ESOP as a corporate acquisition vehicle. Additionally, employees/shareholders of the target company may be uniquely willing to help facilitate a transaction due to an eagerness to participate in the ESOP.

**22. If a company has unstable cash flows, could this potentially derail an ESOP?**

Companies that exhibit uneven financial performance are likely to be subject to greater fluctuations in valuation, and may also be incapable of committing a large cash payment every year to the ESOP. However, companies of this nature may take certain precautions that allow them to have successful ESOPs, such as setting aside sufficient cash to fund repurchase obligations.

**23. What are the ESOP participation guidelines for new employees, and is there a vesting period?**

ESOPs have the same eligibility requirements and vesting rules as other qualified plans, including requiring employees to be at least 21 years old with one year of service at the company. The most conservative permitted vesting schedules are a three-year cliff schedule (100% vesting after three years) and a six-year graded schedule (20% vesting each year after the first year). While these two schedules are the most common, some companies choose to adopt vesting guidelines that are more beneficial to plan participants.

**24. In today's lending environment, are companies able to secure bank financing for an ESOP transaction?**

While the availability of credit changes over time, savvy lenders recognize the cash flow benefits of the ESOP ownership structure. Many sellers also elect to self-finance the ESOP transaction, which can be mutually beneficial to the company and the selling shareholder(s). In this scenario, the selling shareholder(s) are entitled to the same rights as typical debt-holders (i.e., in terms of liquidation preference, a fair interest rate, etc.).

**25. How does the ESOP borrow to fund a share purchase?**

Since banks and other lenders are often unwilling to lend directly to an ESOP (which is typically formed with no material assets), two separate loans are used to facilitate an ESOP transaction. The company will borrow funds from the lender, and will in turn lend these funds to an ESOP (which will then use these funds to buy shares from the selling shareholder or shareholders).

**26. Is it possible for a terminated employee to "roll over" a distribution, or would this be considered a taxable event?**

The terminated employee may roll over the distribution to another qualified retirement plan. If the employee decides to receive a cash distribution instead, it would create a taxable event.

### **27. Do older employee participants in ESOPs have the ability to diversify their accounts by investing in assets other than the company's shares?**

Yes, laws require that an employee who is at least 55 years old (and has been a plan participant for at least 10 years) has the right during their next five years to diversify up to 25% of their ESOP account, and then during the sixth year they may diversify up to a total of 50%. A company could also offer a more generous diversification policy by allowing participants to diversify at an earlier age and/or with less years of service. Most companies that adopt ESOPs also provide 401(k) or other retirement plans to ensure ongoing diversification of employee retirement funds.

### **28. What are the most common reasons why some ESOP companies are not successful?**

Ultimately, an ESOP company will be most successful if the ownership benefit is fully recognized and understood by employees. Aside from that, the most common reason ESOP companies fail is the same reason non-ESOP companies fail – an unexpected deterioration of business conditions, as was experienced by many companies during the recent economic recession. The formation of an ESOP creates financial obligations for the Company in the form of share repurchase liabilities and debt repayments (in a leveraged transaction). A deterioration of company performance decreases the ability for a company to meet these obligations. However, we note that these obligations are similar to those created by other succession planning-type transactions, including buy-sell arrangements or other programs.

### **29. What is the most common misconception regarding ESOPs?**

Many shareholders are reluctant to sell their shares to an ESOP because of their misconception, and perhaps the misconceptions of their professional advisors, that sales to ESOPs are not financially advantageous and that the seller is effectively "leaving money on the table" with this type of transaction. On the contrary, selling shareholders can often realize higher net proceeds with an ESOP sale than with a traditional transaction due to: advantageous capital gains tax treatment resulting from a stock sale, the potential ability to collect a steady stream of income through principal/interest payments on a seller-financed note, and/or the potential ability to participate in the ESOP and accumulate new shares.

### **30. Does the government or any state-sponsored organizations offer any incentives to encourage the formation of ESOPs?**

Aside from the well-documented income tax benefits, organizations in certain states (including Ohio and Indiana) have developed programs that reduce the cost of forming an ESOP (by offering funding for feasibility studies, incentives for banks to lend for ESOP transactions, and various other programs). There are various other organizations that provide education on ESOPs.

**We would be happy to speak with you.**

To learn more about ESOPs and whether it may be the right solution for your company, contact a member of our ESOP valuation team using the contact information below:

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