Selling to an ESOP

Eleventh Edition

NCEO NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

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Christopher J. Clarkson
Ronald J. Gilbert
Stacie Jacobsen
Corey Rosen
Paige A. Ryan
Kenneth E. Serwinski

The National Center for Employee Ownership
Oakland, California

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The National Center for Employee Ownership
1629 Telegraph Ave., Suite 200
Oakland, CA 94612
(510) 208-1300
www.nceo.org

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Preface

Myths and misconceptions prevent many owners of closely held businesses from considering selling their companies through an employee stock ownership plan (ESOP). For many such owners, ESOPs have advantages in terms of tax, financial, and intangible issues that no other transaction method can offer.

The alternatives to an ESOP sale, while appropriate for some business owners, may not be feasible or may have disadvantages that make them unpalatable to others. For example, a sale to a third party often results in protracted negotiations with someone who does not view the corporation in the same way the owner does and who may have no concern for the welfare of the employees, the community, or the legacy of the company. Third-party sales rarely allow the owner to sell a partial interest and may impose substantial constraints on the seller. An initial public offering (IPO) is available to only a select group of companies in the U.S. and imposes time constraints on when the owner can "sell out" after the IPO. Management buyouts are intriguing, but the actual nuts and bolts of making them happen, especially financing, will derail many such transactions.

An ESOP can provide a market for a closely held business, which can be sold to the ESOP either as a going concern or in stages. The ESOP also provides significant tax incentives for the selling shareholder, the corporation that establishes the ESOP, and the employees of the corporation. Additionally, companies that combine broad-based employee ownership (as through an ESOP) with employee participation programs tend to show substantial performance gains.

This book is designed to educate owners, managers, and advisors of closely held businesses on selling to an ESOP. The 11th edition updates and reorganizes the material to reflect the current legal, valuation, and investment environment that companies and their owners will face as they evaluate and negotiate ESOP transactions. A new chapter at the end compares an ESOP sale to other exit strategies.

We at the NCEO hope that you enjoy this book and that it inspires you to evaluate carefully the benefits of employee ownership through the use of an ESOP. Visit our website at www.nceo.org for more information and resources on ESOPs.

Chapter 1

Should You Sell to an ESOP?

Corey Rosen

Bob Moore, the owner of Bob's Red Mill, had built his provider of whole-grain flour and other products into an iconic national brand. He could have sold to any number of buyers, but that just didn't seem right. So on his 81st birthday, he made an announcement to his 200 employees. The company would now be theirs, thanks to an employee stock ownership plan (ESOP). "It's been my dream all along," he said, "to turn this company over to the employees, and to make that dream a reality is very, very special to me. This is the ultimate way to keep this business moving forward. I get to spend every day with our many loyal and long-time employees who will now share in ownership, and it just thrills me to know they will be joined by many new faces over the years."

The story was picked up by CNN, PBS, and the wire services and soon appeared all over the country. To the media, what Bob Moore did seemed extraordinary, but, in fact, it was just one more example of a now very commonly used approach for owners of closely held companies to deal with business transition.

The ESOP worked great for both Bob and the employees. As of 2020, Bob is still actively involved at age 91, and his company has grown to almost 600 employees.

There are close to 200,000 companies like Bob's in the U.S. One of the most difficult problems for owners of closely held businesses is finding a way to turn their equity in a business into cash for retirement or other purposes. The decision to sell is more than an economic one, however. After putting years of his or her life into a business, an owner develops a strong feeling of identity with the company. At the same time, the owner often has a sense of loyalty to the employees and would like to see them have a continuing role in the company. Still other owners only want to sell some ownership, or to buy another owner out. Selling a partial interest in a company is very hard to do. Redemptions and sales to employees are possible, but must be done in expensive after-tax dollars.

For some business owners, the answer to these problems will be to turn over the company to an heir, sell to managers, or sell to a competitor. But many owners do not have heirs interested in the business or managers who have both the interest and the money to buy the company. The right outside buyer can be hard to find. Even if they can be found, they may want to buy the company for its customer lists, technology, or facilities, or may just want to put a competitor out of business. As the next chapter shows, the offers these outside buyers make are often not nearly as good as they may seem.

For many owners like Bob, selling a business is about a lot more than how much it sells for. These owners are proud of the legacy they have created and want it to be preserved. They want to reward the people who helped build it and often, like Bob, would like the option to stay involved at some level or another.

For the right company, ESOPs can be a very attractive and tax-favored way to meet all of the owners' personal and financial goals. In an ESOP, employees do not have to use their after-tax dollars to buy company stock (and almost never do). Instead, the company can make tax-deductible contributions out of future profits the employees help create to enable an employee stock ownership trust to buy the owner's shares. Congress has been generous with tax benefits for ESOPs, as explained below.

There is a lot of flexibility in how a sale to an ESOP proceeds. It can be all at once, as at Bob's, or gradual, for as little or as much of the stock as desired. For the employees, no contributions are required to purchase the owner's shares. The owner can stay with the business in whatever capacity is desired. The plan is governed by a trustee who votes the shares, but the board of directors appoints the trustee, so changes in corporate control are usually nominal unless the plan is set up by the company to give employees more input at this level. The ESOP can be financed in several ways: by periodic, discretionary cash contributions; by money borrowed from an outside lender; or by a note the seller takes from the ESOP. However the ESOP is financed, the company contributions to the plan are still tax-deductible.

In return for these substantial tax and planning benefits, ESOPs do need to meet certain requirements that ensure the benefits of the plan are provided in an equitable manner to employees, rules much like other employee retirement plans. ESOPs are not a way to provide ownership to specific people, nor can they allocate ownership based on merit or some other discretionary formula.

ESOPs are not for every company. If you cannot live with their legal requirements, you need to look at alternative approaches to transition. If your company is not now or will not soon be profitable enough to fund its ongoing obligations and the nonproductive expense of buying out an owner, an ESOP just won't work. If you do not have successor management, the company will have difficulty paying off an acquisition debt it takes on and probably will not get a loan anyway. ESOPs also are more complicated than other benefit plans, and come with significant legal, administrative, and valuation costs, although these costs are a great deal less than what a business broker would charge. Contrary to what you might have heard, however, ESOPs do not work best only if you are in a certain industry, are fairly large (ESOPs can work in companies with as few as 10 or 20 employees), or have certain kinds of employees. Nor do they require, as noted above, that employees will now run the company.

Advantages of Selling to an ESOP

Much of what you will read and hear about ESOPs, including this book, talks about the tax and financing advantages of ESOPs. But for Ken Baker, CEO of New Age Industries, an ESOP-owned manufacturer in Pennsylvania, that misses the point. For Baker, the decision was much more about legacy, community, and employees. He wanted to make the transition out of ownership over time so he could stay with the company as long as he wants, so that the employees who helped him build the business could become the owners of New Age and not the employees of another buyer (or even lose their jobs), to give employees a reason to care about the success of the company, and keep the company a contributing part of the community. Selling to another buyer just seemed wrong.

Most business owners thinking about selling to an ESOP feel the same way when we at the NCEO talk to them, although it's certainly not a requirement to be a good ESOP candidate. But as readers go through the tax and financial issues involved with the ESOP decision, Baker's reminder that there is more to business transition than money is worth remembering.

The good news for owners who do want to sell to an ESOP, and whose companies are the right fit, is that good intentions can be rewarded with significant financial advantages. For the large majority of companies, selling to an ESOP is a better deal for sellers than selling to outside buyers, even when they offer a premium. Some of the major financial benefits are listed below:

- *Tax deferral of capital gains:* When owners of C corporation shares meet specific requirements in connection with selling their shares to an ESOP, they may defer capital gains taxes and possibly avoid them entirely if the qualified replacement property they buy with the proceeds of the ESOP sale becomes part of their estate. A more detailed explanation of these rules is in the next section.
- *Partial sales*: Most private investors are not willing to buy partial stakes in private companies, while an ESOP is well suited to a partial sale or a series of sales that culminate in the original owner selling his or her entire ownership interest.
- *Using pretax dollars:* ESOPs are the only way the company can use *pretax dollars* to buy out current owners. If a company buys shares back from an owner outside of an ESOP, it will need to use after-tax dollars. Any buyer other than the company will also be using cash on which tax has already been paid, effectively increasing the cost to the buyer. If a seller will be retaining partial ownership of the company, this tax benefit will increase the value of the seller's remaining shares. In many cases, the ESOP sale will yield a comparable or better after-tax return than other sales, especially when all contingencies are considered.
- *S corporation tax shield:* When an S corporation sponsors an ESOP, a portion of its income is no longer subject to federal income tax. So if an owner of an S corporation sells part of the ownership to an ESOP, the company will pay lower taxes going forward, enhancing future profits. A 100% ESOP-owned S corporation pays no federal

income tax, so if an S corporation becomes 100% ESOP-owned and the sale to the ESOP is seller-financed, the seller's likelihood of repayment will be higher than in the case of a 100% sale to an ESOP in an equivalent C corporation.

Beyond Financial Benefits for Sellers

- *Timing*: An ESOP allows sellers to sell at their own pace, retaining whatever role they prefer in the company. That may mean sellers stay on as managers, consultants, and/or board members indefinitely or they may gradually withdraw to a more limited role. Other owners leave day-to-day management immediately after selling shares to an ESOP. While it is possible for other transaction structures to allow flexible timing, it is not typical and generally the subject of difficult negotiations.
- *If there are multiple owners, the ESOP can buy shares only from those who want to sell:* When there is more than one owner, one may be ready to sell and, perhaps, retire, while others may not be ready. Outside buyers do not want partners in most cases, so everyone has to sell. If an inside buyer purchases the stock, it is all with after-tax dollars.
- *The company will retain its identity:* Many owners have worked hard and long to build a good name for their company. Seeing it vanish into another company, and, in some cases, move outside the community, can be painful.
- *Even after you sell, you can stay involved:* Many former owners retain a board seat or some other involvement with the company for some period of time.
- *Employees who helped build the company now own it:* Many owners have a strong sense of loyalty to their employees and hate the idea of their becoming employees of another company, where they might not be treated well and often would be asked to leave. That is especially true at the senior level.
- *With the right culture, ESOPs improve corporate performance*: ESOP companies with a high-involvement work culture where employees

regularly participate in decisions about how their work is done and that share a variety of company performance metrics with employees perform substantially better than non-ESOP companies. For a detailed look at how this works, see my book *Beyond Engagement: How to Make Your Business an Idea Factory* (see www.nceo.org/r/beyond).

- *ESOPs can add substantially to employee retirement security and reduce employee turnover:* ESOP participants end up with about 2.2 times the retirement assets as employees in 401(k) plans and have significantly lower turnover rates.

Tax Deferral for the Sellers (the Section 1042 "Rollover")

Owners of stock in closely corporations who have held that stock for at least three years before the sale to an ESOP can defer taxation on their gain by reinvesting in what is called "qualified replacement property." No capital gains tax is then due until these new investments are sold. If some are sold, then the tax is pro-rata to that portion of the portfolio. In any case, the basis for calculating future capital gains tax is the basis in the ownership interest that was sold to the ESOP. If the taxes are held until death, the basis is stepped up, but estate taxes would apply. You may often hear of this benefit referred as a "1042 transaction" because Section 1042 of the Internal Revenue Code (the "Code") governs it. There are several requirements to get this special treatment:

1. The company must be a C corporation at the time of sale.
2. Corporations cannot sell to an ESOP and elect Section 1042 treatment, but partnerships, limited liability corporations (LLCs), estates, taxable trusts, and individual owners can.
3. Ownership interests must have been held for at least three years before the sale to the ESOP. The shares sold to the ESOP do not qualify if they were acquired as part of an employee benefit plan or through certain types of stock options. If a company is an S corporation, LLC, partnership, or sole proprietorship, and then converts to C status before the sale to an ESOP, the owner's prior holding period counts toward the three-year limit.

4. The ESOP must end up owning at least 30% of the total value of shares or 30% of each class of shares in the company after the sale. Any subsequent sales qualify as well. You may hear some ill-informed advisors say that *all* ESOPs must own at least 30% of the stock. That is not the case. The 30% rule is relevant only if the seller wants to defer taxation.
5. Proceeds must be reinvested in qualifying securities, defined as stocks and bonds of U.S. corporations that do not earn more than 25% of their income from passive investment. You cannot invest in mutual funds, government bonds, and other securities that do not meet these tests and still get a deferral.
6. Any direct family members (brothers, sisters, children, parents, spouses) of the selling shareholder(s) and any more-than-25% owners (as of the sale date) cannot receive an allocation in the ESOP of any of the shares that are subject to the deferral.
7. If within three years of the sale, the total number of shares held by the ESOP is less than the total held immediately after the Section 1042 acquisition of stock by the ESOP trust, or the value of the trust's ownership drops to below 30% of the value of all the shares in the company, then the company pays a 10% excise tax. There are exceptions to this rule, however, for changes in ownership due to certain distributions of shares to participants or a tax-free exchange of securities in another company (typically, as part of a sale of the company).[1]

Because of these rules, if a seller is using a seller note and getting paid over time, the seller has to find a way to come up with the face value of the sale within 12 month of the transaction to take full advantage of the deferral. This can be from funds the seller already has or, more commonly, from the seller borrowing money to buy specially designed long-term bonds called "ESOP notes." This is discussed in chapter 5, "Investing After You Sell Your Business to an ESOP."

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1. Code Section 4978(d).

Potential Disadvantages of Selling to an ESOP

Even in companies where ESOPs are appropriate, they do impose some burdens.

- *Setup and operational expenses:* The company must pay legal costs to set up the plan and to keep it current and compliant. Administrative costs include both the expense associated with an outside administration firm and the cost in staff time of monitoring the administration firm and providing it with the necessary data. Before the ESOP transaction and annually thereafter, the company must pay for an independent valuation of its stock. An ESOP will probably cost at a minimum $80,000 to $150,000, and could be quite a bit more to set up and run the first year and, for most companies with under a few hundred people, about $25,000–$35,000 annually if they have internal trustees and about $20,000 more if they have external trustees. These costs are typically lower than the costs of selling to another company, however, and the tax benefits of an ESOP on an ongoing basis are far larger than the costs.
- *Demands on cash:* The vast majority of companies will need to contribute more to their ESOPs than they would have contributed to retirement plans without an ESOP in order to buy out a meaningful amount of stock. When there is an ESOP loan, the company will have little if any flexibility in terms of reducing this demand on cash or managing the timing of payments. Companies are also responsible for repurchasing shares from former participants, which often amounts to buying back 2% to 5% of shares yearly in mature ESOP companies.
- *Regulatory scrutiny:* Both the IRS and the U.S. Department of Labor may investigate ESOPs, causing a burden in the demands they make and a risk of penalties or costly measures to cure any defects they may find. The number of companies affected is very small relative to all ESOPs, but the potential remains.
- *Purchase price:* The ESOP will pay fair market value for shares based on what a financial buyer would pay, but it will not be able to match a synergistic price that a strategic buyer might offer.

- *Fiduciary risk:* The trustee of the ESOP is held to strict standards of fiduciary responsibility, which may impose costs on the company in the form of insurance for fiduciaries or litigation by unhappy plan participants. The risk may be borne by an inside trustee (often a company officer) or an outside fee-based trustee. While successful litigation by plan participants is rare, companies need to understand their exposure and take steps to minimize risk.
- *Lack of flexibility in certain areas:* While ESOPs are flexible in many ways, they are subject to legal constraints. ESOP rules require that contributions be allocated based on relative compensation (counting amounts up to $285,000 as of 2020; this figure is indexed annually for inflation) or some more level formula. Moreover, everyone who has worked for 1,000 hours in a 12-month period must be in the plan (with certain exceptions, such as employees covered by a collective bargaining agreement). The ESOP rules do not allow companies to direct allocations within the plan to reward specific employees.

Financing an ESOP Sale

ESOPs can buy any percentage of the company the owner wants to sell. Many ESOPs are designed to be permanent minority owners, but more commonly an ESOP buys a partial interest as a first step in a gradual series of transactions leading to a majority interest or 100% ownership.

ESOPs can be financed by an outside loan, a seller note, company cash contributions, dividends (in C corporations) or distributions (in S corporations), or, rarely, employee contributions. These approaches can also be combined. The sale can also involve non-ESOP buyers, such as investors and/or managers who buy stock in the conventional way. ESOPs can buy all or a part of the stock in a company. Often, ESOPs are done in stages, buying some stock now and some after the first acquisition is paid for.

Mechanics of Leveraged ESOP Financing

In a leveraged ESOP, the ESOP borrows money to buy shares. In the typical transaction structure, the loan is made to the company. The company then reloans the funds to the ESOP. The terms of the two loans do not have to be identical. The "inside" loan (from the company to the ESOP) may be repaid over a longer period of time if that helps the company stay within the contribution limits or helps spread the annual contributions so most of the benefits of the ESOP are not captured in the first several years, but remain available to future employees as well.

Stock acquired by the plan goes into a suspense account. As shares are paid for, they are released to employee accounts. The amount paid for by company contributions can be released based on the percentage of principal repaid or the total principal plus interest repaid (the latter method is required for loans of 10 years or longer). Dividends or distributions can also be paid and would release additional shares (the mechanics of this are discussed in the section below on rules relating to participants).

Bank Financing

Outside lenders, such as banks, look for much the same collateral they would seek in a conventional loan, but if a seller is selling to an ESOP, there is insufficient collateral, and the seller is electing Section 1042 treatment, they may also ask for the seller's qualified replacement property investments (the stocks and bonds the seller buys with the proceeds of the sale) to be pledged against the loan.

Bank loans are typically five years, but can be shorter or longer. They are usually done on a quarterly equal amortization basis. Pricing on ESOP loans has typically been 300 to 600 basis points above LIBOR, usually with a fixed rate. Lenders typically look for an EBITDA coverage ratio for the loan between two and three times EBITDA, depending on the perceived reliability of earnings.

Collateral requirements vary, but typically are about 80% of accounts receivable and 50% for inventory. Real estate and other hard assets ratios vary widely.

A major benefit of bank debt is that when seeking to defer taxes on the gains from the sale, the requirement for reinvesting within 12 months of the sale is much easier to meet with bank debt, which provides the money up front. Seller notes are paid over time, but sellers cannot just reinvest the proceeds from each sale and then reinvest that.

For instance, when Barclay Water Management wanted to finance the ESOP's acquisition of the remaining 70% of the company shares, it approached a number of local banks. It found a warm reception and was able to get a loan at a very favorable rate. The bank was not willing to finance the entire transaction, however, so the remainder of the financing came from an ESOP note.

Seller Financing

Sellers often just take a note to finance an ESOP. As discussed later in this chapter, this raises special issues for sellers wanting to take advantage of the Section 1042 tax deferral, but those issues can be managed. Seller notes could be directly to the ESOP or to the company and then reloaned to the ESOP (the latter provides more flexibility). The seller can charge an arms-length equivalent interest rate that takes into account the level of risk involved (many sellers voluntarily agree to a somewhat lower rate, however). As with bank loans, there can be covenants about how the company uses its funds to make sure the loan obligation is honored before other possible expenses. In some cases, the seller may take a lower interest rate than would otherwise be the case in return for warrants representing the fair market value of the forgone interest. Warrants give the seller the right to buy X number of shares at the selling price for Y number of years into the future. They can be thought of as buying a stock option with the value of the forgone interest. When the warrants are exercised or come due, the company buys them back. Expert advice is needed to determine a fair value for the warrants, and trustees must determine the overall fairness of the transaction. Warrants give the sellers a chance for a greater upside return and ESOP's lower risk, but they must be priced fairly and treated by the company as an emerging repurchase obligation.

Many owners find seller notes especially attractive in environments where bank lending is restrictive and returns on alternative investments uncertain. The note itself can be an attractive investment, paying an interest rate above what could be achieved through bonds. At the same time, the seller is selling ownership and can reinvest the gains.

Bob's Red Mill (discussed at the beginning of this chapter) was sold this way, with Bob taking a note for 100% of the stock. He was repaid partly with an interest rate somewhat below what a market rate would be and took warrants to make up for the calculated present value of the loss, adjusted for risk, in their place. The calculation of just how many warrants should be awarded in a structure like this involves a lot of assumptions and calculations, and must be done by a qualified expert and the results approved by the ESOP transaction trustee. In Bob's case, the growth of the company worked well for him, but had the company not done well, his warrants would have been worthless.

Company Cash Contributions

The company also can finance the acquisition by making tax-deductible discretionary cash contributions to the plan. These can be used to buy shares or can be held and invested until they reach a sufficient level to buy a target number of shares. The ESOP cannot hold only cash forever, however, without the IRS saying at some point that the plan is not an ESOP. Advisors generally say two or three years is fine, but more than that can raise issues.

Brother and sister Lars and Marisa Wulff started their pet store chain, Mud Bay, in Washington State in 1988. From the outset, they designed it to be a different kind of place, with well-trained employees, a great and participative working environment, a focus on healthy products for pets, and an innovative approach to supply chain management and marketing. It worked—the company has grown rapidly ever since and was named Pet Business Magazine's Pet Business retailer of the year in 2015. It now has more than 50 stores.

The Wulffs are too young to retire, but they wanted to start sharing ownership as part of their business philosophy. So in 2014, they set up an ESOP. Each year, a percentage of profits is contributed to the plan, which turns around and buys shares.

At EEA, an Austin engineering firm that now is majority ESOP-owned, owner Mike Hart has used a combination of cash contributions and periodic seller notes to gradually buy more of his shares. As an S corporation, the company has also made required distributions pro-rata to what Mike gets. That cash in the plan can now be used to buy additional shares.

Participation by Managers, Other Employees, or Outside Investors

In a few ESOPs, managers may put in some of their own money to buy shares, and/or outside investors can become buyers outside of the plan to provide needed equity. In these cases, financial advisors need to help structure the transaction so that these investors are treated fairly. It is also possible for these buyers to purchase equity interests other than stock, such as warrants. This may be done if the company wants to become 100% owned by the ESOP and convert to S status. As described below, this would allow the company to avoid paying federal and usually state income tax.

Even less commonly, employees can put some of their own money into the plan by moving assets from another plan (usually a 401(k) plan or profit sharing plan). The plan's fiduciary could unilaterally decide to move some portion of either employer- and/or employee-contributed assets into the ESOP, but this means moving money out of diversified investments into a single investment. If that investment does poorly, or even fails to do as well as a prudently created portfolio would, the fiduciary can be sued for misusing employee assets. To avoid this problem, some companies give employees a choice about whether to move their profit sharing funds into the ESOP, usually allowing them to move part or all of them. The first potential problem this creates is that not enough funds may be moved. The second is that the employees are making an investment decision in doing this. This will trigger securities law issues that can require expensive compliance. Most ESOP advisors, therefore, recommend that at most 15% to 30% of profit sharing assets be moved to an ESOP, and that the decision be made by the fiduciary with appropriate advice from independent financial experts. Even then, the funds should only be moved if there is good reason to believe the company's stock will be a good long-term investment relative to other investments. It is also safer to move only employer-contributed funds. Moving employee-contributed funds would likely trigger securities law issues, and the IRS has, to date, not looked favorably on this approach.

Rules for ESOPs

Company Contributions to the Plan Are Tax-Deductible, Within Limits

Generally, money the company contributes to the ESOP to be used to purchase shares from an owner is tax-deductible, whether the contribution is made periodically in cash or the trust borrows money and the company puts cash into the plan to enable the trust to repay the loan.[2] There are two sets of limits, however. First, there are limits on the total amount that can be contributed. All ESOP companies can make tax-deductible contributions of up to 25% of the aggregate "eligible pay"[3] of employees in the plan (or plans), regardless of whether the ESOP is leveraged or not, or in a C or S corporation. This 25% limit, however, includes all of a company's contributions to its defined contribution plans (ESOPs, stock bonus plans, profit sharing plans, and 401(k) plans), with the exception of leveraged ESOPs, which can actually ignore other plans, as explained below. Contributions to defined benefit plans do not count toward this limit. In C corporations, when there is an ESOP loan, only contributions used to repay principal count toward the 25% of pay limit; in S corporations, contributions to pay both principal and interest count.[4] Distributions of earnings used to repay an ESOP loan in S corporations do not count toward the 25% limit, nor do dividends used for this purpose in C corporations.

Second, there are limits on how much can be added to any one employee's account each year, called the "maximum annual addition." This cannot exceed the lesser of 100% of any plan participant's pay or $57,000 in 2020 (this figure is indexed annually for inflation in $1,000 increments). In C corporation ESOPs, dividends used to repay a loan do not count toward the annual addition limit, nor do contributions used to pay interest. Employee deferrals (except for "catch-up" contributions

2. Contributions to the plan for other purposes are deductible as well, such as contributions of shares or straight cash contributions to provide a cash account for employees in the plan.
3. Code Section 401(a)(17).
4. Code Section 404, especially Section 404(a) for contributions to defined contribution plans generally and Section 404(a)(9) for contributions to repay an ESOP loan.

by those aged 50 or older) also count toward the annual addition limit. Annual additions thus include practically all employer and employee contributions to defined contribution plans. In S corporations, interest payments and forfeitures of unvested account balances count toward the annual addition limits, but distributions do not.[5]

All of these requirements refer to "eligible pay." Eligible pay is the total payroll used in calculating the above limits, excluding pay over $285,000 per employee (as of 2020; this figure is indexed annually for inflation). Some people who work for you will not be in the plan, so their pay does not count; others may be in the plan but are not eligible to receive an allocation of stock.[6]

These limits rarely raise issues, however. In C corporation ESOPs, if there is a leveraged ESOP, it is possible to have separate 25% limits for the leveraged ESOP and for other defined contribution plans, including a non-leveraged ESOP. That means a company could contribute up to 50% of eligible pay to its defined contribution plans.[7] As noted above, dividends (in C corporations) and distributions used to repay ESOP loans (in S corporations) also do not count toward the limits. Finally, ESOP companies usually set up a leveraged ESOP so there is a loan from a lender to the company that is reloaned to the ESOP. This so-called "inside" loan can have longer terms than the "outside" (lender to company) loan, thus spreading the needed contributions to repay a loan over a longer period of time.

Dividend Deductibility

In C corporations, "reasonable" dividends[8] on ESOP-held stock that are used to repay an ESOP loan, that are passed through to participants, or are reinvested by participants in company stock in the ESOP are tax-deductible.

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5. Code Section 415 discusses the issues raised in this paragraph.
6. This includes people who have not yet met your eligibility rules, people who are excluded from the plan (see the section on eligibility later in this chapter), and, for owners taking advantage of the tax-deferral features of selling to an ESOP in a C corporation, those who by law cannot get any of the stock in the ESOP that is subject to the tax deferral (the owners who elect the tax deferral, certain family members, and more-than-25% shareholders).
7. PLR 200436015.
8. Code Section 404(k).

When C corporation dividends or S corporation distributions are used to repay an ESOP loan, the money put into the plan releases shares that have not yet been paid for, which are then allocated to employee accounts. Dividends or distributions that are paid on shares already allocated to employee accounts (those that have been paid for) release shares pro-rata to the percentage of shares held in each account; dividends or distributions paid on shares not already paid for can release shares to participant accounts based on relative account balances or on the company's usual allocation formula (most commonly, relative pay). Dividends or distributions on allocated shares used to repay an ESOP loan must be used to release shares with a value at least equal to the dividend or distribution.[9] Most companies use the latter approach to avoid a variety of potential problems beyond the scope of this discussion.

Cash that accumulates from required S corporation distributions in an ESOP that owns less than 100% of the company is often used to buy more shares from the seller.

Tax Treatment for Plan Participants

As with participants in other qualified retirement plans (401(k) plans, profit sharing plans, etc.), employees are not taxed on anything the company puts into the plan, nor any appreciation in its holdings, until they receive a distribution, and, even then, they can roll that into an IRA if they are still at an age where they are eligible to do that.

Many owners find seller notes especially attractive in environments where bank lending is restrictive and returns on alternative investments uncertain. The note itself can be an attractive investment, paying an interest rate above what could be achieved through bonds. At the same time, the seller is selling ownership and can reinvest the gains.

How Much Can the ESOP Pay? The Annual Valuation Requirement

The sale to an ESOP is not like a normal negotiation between a buyer and a seller. The ESOP cannot pay more than fair market value. In a

9. Code Section 404(k)(2)(B) (for C corporations); Code Section 4975(f)(7) (for S corporations).

public company, this is determined by the market; in the much more common case of a closely held company, it must be determined by an independent, outside appraiser. The ESOP can pay less than fair market value. ESOP appraisals must be updated at least annually. This statutory requirement is necessary to provide appropriate pricing for repurchasing shares from employees, tax reporting, accounting, calculating the values in employee accounts, and many other purposes.[10]

The appraiser should be hired by and work for the ESOP trust only and is required to provide a valuation based on the perspective of a financial buyer. The ESOP trustee must determine, based on this outside advice, whether the price is within the fair market value. "Independent" means that the appraiser can have no other business relationship with your company. Some companies hire an appraisal firm to do a preliminary valuation to determine whether the price the ESOP might pay is in an acceptable range, or to determine what can be financed, but that should not be the firm hired by the trustee to do the appraisal for the ESOP. The Department of Labor has strongly indicated it believes the firm doing the preliminary valuation is conflicted if it stays on to be the valuation firm for the ESOP transaction, so either a new firm should be hired or the trustee should hire the appraiser at all phases of the transaction. The appraiser should have expertise and experience in ESOP valuations (the NCEO's website at www.nceo.org features a Service Provider Directory of these and other ESOP experts).

The ESOP appraiser determines what a willing third-party *financial* buyer would pay for the ownership being sold.[11] (See the following chapter on valuation for details on the valuation process.) This distinction is important. A financial buyer determines what to pay based on the future free cash flow or earnings of the company and any marketable assets. A *synergistic* buyer, such as a competitor, may look at these same assets and earnings and offer more because of presumed synergies between the two companies that could enhance the combined earnings of the merged companies beyond what each of them separately would add up

10. See Code Section 401(a)(28)(C) and Treas. Reg. Section 54.4975-11(d)(5).

11. While no final regulations have ever been specifically issued for ESOP valuations, appraisers generally rely on the standards of value outlined in Revenue Rulings 59-60, 1959-1; 65-193, 1965-2, and 77-287, IRB 1977-33.

to. If this number is significantly higher than what the ESOP can pay, some sellers will be unwilling to go the ESOP route.

The price the ESOP can pay will depend, in part, on whether it purchases control. Control is a nuanced concept in ESOP appraisals. It is not simply a matter of whether the trust owns a majority of the shares. If the company is structured so that the seller retains significant control rights, such as a seat on the board, covenants on how money can be used, the right to prevent a sale of the company even if holding a minority interest, and other constraints on full control, the control premium will be reduced. Shares will also be subject to a liquidity discount, as all private company shares are, but it is a much smaller number than in non-ESOP companies, often 5%.

Because the valuation is so critical to the whole process, sellers who may be sensitive to the results should get a preliminary valuation before going much further in the ESOP process. For reasons detailed in the chapter on valuation, it is preferable that this be a different firm than the one ultimately doing the full-scale appraisal. This preliminary valuation will provide a brief report and a range of possible values.

Rules Relating to Participants

ESOPs have an exceptionally powerful set of tax incentives. In return for these incentives, companies must follow rules designed to make sure that the benefits of an ESOP are fairly allocated to employees, that the assets are protected from other competing interests, and that employees actually get their benefits.

The rules have eight basic parts: eligibility, allocations, vesting, diversification, distributions, the repurchase obligation, governance, and disclosure.

Eligibility

The rules for participation in an ESOP are largely the same as for other qualified employee benefit plans (pensions, profit sharing, etc.).[12] The rules provide several tests to assure plans meet minimum anti-discrim-

12. Code § 401(a), particularly 401(a)(3), (4), (6), and (26), and Treas. Reg. § 1.401(a).

ination requirements. Virtually all ESOP companies, however, cover at least all full-time employees (1,000 hours of service or more in a year) 21 years of age or older with at least one year of service. Employees covered by a collective bargaining agreement can be excluded from coverage, provided the company bargains in good faith about whether they should be included. These are minimum requirements; companies can include more employees (such as including part-time people or more recent hires).

The law does provide some additional exceptions. For example, the ESOP can include only employees in a separate line of business, such as a division or subsidiary, that has 50 or more employees. This will not apply, however, if the intent is to get around the coverage rules. For example, a plan could not just cover a division set up of management people and exclude a division that just has nonmanagement employees.

An alternative approach provides three tests for coverage. To use this approach, a company applies percentage tests to at least a minimum employee group. This group must include all employees age 21 or older who have completed at least 1,000 hours of service in a plan year, but it can exclude nonresident aliens, employees in a separate line of business with 50 or more employees, and employees covered by a collective bargaining agreement. After the exceptions have been taken, the tests can be met if:

1. At least 70% of non-highly compensated employees[13] are covered, or
2. The percentage of non-highly compensated employees who are covered is at least 70% of the percentage of highly compensated employees covered, or
3. There is a classification system that does not discriminate in favor of highly compensated employees, and the average benefit percentage (generally, the percentage of compensation contributed to all qualified retirement plans) for the covered non-highly compensated

13. A "highly compensated employee" is defined by Code Section 414(q)(1)(B) as someone who in the preceding year (1) owned more than 5% of the company or (2) received more than $130,000 in compensation (as of 2020; this figure is adjusted annually for inflation), and, if the employer chooses, or, at the employer's option, was in the top 20% of employees ranked by compensation.

group is at least 70% of that contributed to the covered highly compensated group.

Although these alternative tests are available, they are very rarely used in ESOPs. The kind of exclusion the rules provide is both contrary to the spirit most ESOP companies are trying to set up and may cause practical problems if the effect of these formulas is to limit the eligible compensation in the ESOP to a number not large enough to support the needed annual contributions and/or annual additions to employee accounts.

Once employees are eligible, there will be plan entry dates when employees will join the plan. This could be once a year or more often.

Allocations to Participants' ESOP Accounts

The ESOP cannot discriminate in favor of more highly compensated employees.[14] Most companies allocate stock based on compensation (typically defined as the amount on the employee's W-2 tax form), plus elective deferrals under Section 401(k) plans and cafeteria plans. That is, each participant in the plan gets a percentage of the total shares allocated equal to that participant's percentage of total eligible pay. Eligible pay excludes pay in excess of $285,000 per year as of 2020, as noted above. While W-2 compensation is the norm, compensation could also be defined to exclude bonuses or other "add-ons" to pay, provided the effect is not to push allocations toward more highly paid people. At least two-thirds of all ESOPs allocate on relative pay. Companies can create more level formulas, however, such as by lowering the maximum eligible pay or giving points for seniority. Any formula, however, needs a fail-safe provision that anyone who is a "highly compensated employee" (defined above under "Eligibility") cannot get more than what a relative pay formula would provide. In a non-leveraged ESOP, allocations are made when the contributions are made; in a leveraged ESOP, as noted above, shares are released as the loan is repaid.

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14. Code Section 401(a)(4); several safe harbors, such as relative pay, are set out in Treas. Reg. Section 1.401(a)(4)-2.

If an employee leaves before being fully vested, any assets in that employee's accounts are reallocated to other employees based on the company's normal allocation formula.

Using Distributions or Dividends to Repay ESOP Loans

When C corporation dividends or S corporation distributions are used to repay an ESOP loan, the money put into the plan releases shares that have not yet been paid for, which are then allocated to employee accounts. Dividends or distributions that are paid on shares already allocated to employee accounts (those that have been paid for) release shares pro-rata to the percentage of shares held in each account; dividends or distributions paid on shares not already paid for can release shares to participant accounts based on relative account balances or on the company's usual allocation formula (most commonly, relative pay). Dividends or distributions on allocated shares used to repay an ESOP loan must be used to release shares with a value at least equal to the dividend or distribution.[15] For example, say the ESOP has acquired 1,000 shares. After two years, 300 shares have been paid for and allocated to employee accounts. Mary's ESOP account has 5% of these shares (i.e., 15 shares), and she receives 4% of the company's eligible pay. A dividend is paid that is large enough to buy another 100 shares. Mary's account gets 5% of these additional shares (i.e., five shares) because her account had 5% of the previously allocated 300 shares. For the other 700 shares that are in the suspense account, Mary's account can either get another 5% (35 shares), based on her relative account balance (5% of the previously allocated 300 shares), or another 28 (4% of 700), based on her having 4% of the eligible pay. Most companies use the relative pay approach for unallocated shares to avoid a variety of potential problems beyond the scope of this discussion.

Vesting

Vesting must be 100% completed after three years of service with the company ("cliff vesting") or can start at not less than 20% after the sec-

15. Code Section 404(k)(2)(B) (for C corporations); Code Section 4975(f)(7) (for S corporations).

ond year of service and grow by at least another 20% per year until full vesting at 100% after six years. Vesting can be faster. Service before the ESOP can be counted (or not). A company could also give one year of vesting for every two years of prior service or some other formula, so long as it is applied to everyone.[16] If the plan is "top-heavy," meaning more than one third of the benefits go to highly compensated employees, faster vesting is required.[17]

Diversification

Plan participants must become eligible to diversify up to 25% of the shares in their account balances on the first day of the plan year following the end of the plan year in which they reach age 55 and have completed 10 years of participation in the plan.[18] At that point, the participant has 90 days to decide whether to diversify. For each of the next four years, at the start of the plan year, the employee has an additional 90-day period to elect to diversify. At the beginning of the sixth year, the percentage that can be diversified grows to a cumulative total of 50%. For the shares that employees choose to diversify, companies can pay out their value directly to the employee (where they would be subject to the put option described under the repurchase of shares), transfer the funds into a 401(k) or other qualified plan account the employee holds, or retain them in the ESOP and invest them in diversified assets.

Distributions

Rules for benefit distributions to ESOP participants or their beneficiaries are somewhat more complicated than rules for other defined contribution plans.[19] If an employee leaves because of death, retirement, or disability, distributions normally must start during the plan year following the plan year in which the event occurs, unless the participant elects otherwise. For all other cases, distribution must start within six

16. Code Section 411.
17. Code Section 416.
18. Code Section 401(a)(28)(B).
19. Code Section 401(a)(13) and (14).

years after the plan year of termination, unless the participant elects otherwise. Companies can always start distributions sooner. Companies need to have a written distribution policy. Ideally, these policies set the maximum times for distributions to begin, but allow some flexibility to be exercised in a nondiscriminatory fashion (the NCEO has sample policies).

However, if there is an outstanding ESOP loan, distributions to terminating employees do not have to start until the plan year after the plan year in which the loan is repaid.[20] There are certain exceptions to this for death and retirement, and the interaction of this rule with distributions made in installments is more complicated. The law applies this rule only to C corporations. While there is no logical reason why S corporations should not be able to condition distribution timing on the repayment, a literal reading of the law does not allow it.

In addition to the ESOP distribution rules given above, there are general rules that apply to all qualified plans. When there is a conflict between the ESOP distribution rules and the general distribution rules, the result that produces an earlier distribution applies. Under the general rules, distributions must start no later than the 60th day after the end of the plan year in which the later of these events occur: (1) the participant reaches age 65 or, if earlier, the plan's normal retirement age; (2) the participant's service terminates; or (3) the participant reaches the 10th anniversary of participation in the plan.

Once the distribution commences, it can be paid out in stock or in cash in a lump sum or in installments. S corporations and companies whose bylaws or charter require that all or substantially all the shares be held by the ESOP and/or employees can require the distribution to be in cash. The company and/or ESOP may maintain a right of first refusal on the shares. One installment option would be to pay out at least 20% or more of the total account each year. The value of the stock portion of the ESOP account and any invested other assets (by this point, there is often invested cash as well) would vary with the market, with the ESOP share value based on the most recent appraisal. Alternatively, the company can agree to pay for the value of the entire account at distribution at the then-current fair market value, but do so in installments with interest

20. Code Sections 409(o)(1)(B) and 401(a)(14).

and adequate security in at least equal installments over five years. For very large distributions (as of 2020, balances over $1,150,000; this figure is indexed annually for inflation), one additional year can be added for installment payments for each additional one-fifth of that number.

Finally, a general retirement plan rule mandates that greater-than-5% owners who reach age 72 and terminated employees who reach this age must start taking distributions no later than the April 1 after the calendar year in which they reach that age.

Repurchase of Shares

In closely held companies, when employees do receive a distribution in stock, they also receive a "put" right, meaning the company must repurchase the shares at fair market value.[21] The company can fund the ESOP to do this, but the ultimate obligation to make sure it happens rests with the company. If the shares are repurchased by the company, they can be retired or recontributed over time to the ESOP. Companies have a right of first refusal on the shares, and S corporation ESOPs and companies whose bylaws require that all or substantially all the stock be owned by employees (in the ESOP or outside of it) can require that the employee actually take the fair market value of the shares in the distribution, not the shares themselves.

Some people have argued that this repurchase obligation means the company has to buy back its own stock twice. In fact, all closely held companies always have a 100% repurchase obligation all the time, no matter how often they or anyone else buys the shares. ESOPs pay this out in annual pieces, non-ESOP companies in periodic large chunks. The repurchase obligation is something ESOP companies need to plan for in advance, including doing projections of the obligation and having a plan to handle it.

Plan Governance

ESOPs are governed by a trustee appointed by the company's board. The trustee is normally either an outside institution with trust experience,

21. Code Section 409(h); Treas. Reg. Section 54.4975-7(b)(10); DOL Reg. Section 2550.408b-3(j).

most commonly a bank or trust company, an officer of the company, or a trust committee, usually made up of officers and/or employee representatives. The trustee normally is also the fiduciary—the person who is legally responsible for decisions concerning the plan. However, the board, a CEO, or anyone else who makes decisions for the plan causes someone to make a decision about the plan, or, in some cases, provides misleading information to someone making decisions about the plan can also be a fiduciary. Put differently, it is anyone who exercises control over plan assets, directly or indirectly.

There are a number of fiduciary decisions. Setting up the plan, revising its rules, and terminating the plan, however, are notably not among them. Fiduciaries must act for the "exclusive benefit of plan participants,"[22] meaning when there is a conflict between participant interests and other interests, the participant interests, as defined by their investment interest in the plan, must be favored. Specific fiduciary duties do include the following:

1. Buying and selling plan assets, including employer stock.
2. Hiring qualified advisors.
3. Determining that the ESOP is paying no more than fair market value.
4. Assuring that the plan is operated in accordance with plan documents and the Employee Retirement Income Security Act of 1974 (ERISA); if the two conflict, ERISA rules govern.
5. Making sure the terms of any ESOP loan are reasonable.
6. Voting and/or directing the tendering of shares in the trust for which the plan and the law do not require pass-through voting.
7. Deciding whether to follow participant voting or tendering directions on unallocated or undirected shares.
8. Responding to legitimate offers to purchase the company.
9. Acting to protect plan interests with respect to corporate actions that could harm the interests of plan participants.

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22. Code Section 404(a)(1).

The trustee decides how to vote the shares, including voting for who is on the board, most of the time. The law does require, however, that voting rights in closely held companies must be passed through on all allocated shares (vested or not) to plan participants on their allocated shares for certain limited issues, most importantly the sale of all or substantially all the assets of the company (but not the stock), mergers, and recapitalization of stock. In most ESOP companies, there is never a required vote pass-through. Companies can voluntarily pass through greater voting rights.[23] In public companies, participants must be able to direct the voting of their shares on any issues put to shareholder vote.

Disclosures and Benefit Statements

ESOP companies have only limited disclosure requirements. When a plan is first adopted, participants must be notified before the end of the first plan year that a new plan is in place. Plan participants also must get a summary plan description describing the rules of the plan and rights of participants. They must have an ongoing right to inspect the plan document. On an ongoing basis, the most basic disclosure requirement is to provide a statement of benefits to participants. The statement must include at least a statement of the participant's accrued benefit (account balances in a defined contribution plan such as an ESOP), a statement of vested benefits and/or a statement of when benefits will become vested, and a description of the information used to compute benefit accruals. The administrator must also furnish a summary annual report (SAR) each year to all participants or beneficiaries receiving benefits under the plan. The SAR is a very abbreviated summary of the activity of the plan and must be presented in a form provided by the Department of Labor regulations. When employees are eligible to diversify shares or get distributions, employers must provide them with appropriate notifications and explanations.

Note that none of this requires the disclosure of any kind of financial information about the company (income statements, salaries, the valuation report, etc.), board minutes, government filings other than the Form 5500 report on plan participation and assets (and then only

23. Code Section 409(e).

if the participant requests it), etc. The disclosure rules for ESOPs are essentially parallel to those for any other kind of retirement plan. Effective ESOP companies, however, voluntarily choose to share a great deal of information on corporate performance, although almost never on salaries.

S Corporation Issues

ESOPs in S corporations have a particular and powerful tax advantage. While it might seem that these advantages would only apply to smaller companies because of the 100-owner limitation for S corporations, the ESOP actually counts as one shareholder, no matter how many participants there are. A principal difference in tax benefits is that sellers to an ESOP in an S corporation cannot get a tax deferral on their gains from the sale. Moreover, when the ESOP is leveraged, interest and principal payments on the loan count toward the contribution limits.

On the other hand, earnings attributable to the ESOP are not taxable.[24] What literally happens is that the ESOP gets a Schedule K-1 like any other shareholder. But its tax rate is zero, so it pays no tax on the income attributable to it. So if an ESOP owns 30% of an S corporation's stock, 30% of its profits are effectively not subject to federal, and, almost always, state income tax. In a 100% ESOP-owned corporation, this means no income tax is due from the shareholder (the ESOP). As a result, many S corporations with ESOPs are 100% ESOP-owned.

If an S corporation makes distributions to its owners so that they can pay their taxes (or for any other reason), the ESOP still must get a pro-rata share. This is an S corporation requirement, not an ESOP requirement. These distributions are allocated to employee accounts based on each participant's relative share of the total shares in the ESOP for shares that have been allocated. For shares still held in a suspense account in a leveraged ESOP, the distributions can attach in the same way or be allocated based on the normal allocation formula. In 100% ESOP-owned S corporations, there is no need to make distributions because the owner—the ESOP trust—pays no taxes. As a result, it is

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24. The provision allowing an ESOP to be an S corporation shareholder is Code Section 1361(c)(6); the provision exempting the ESOP from taxable obligation on company profits is Code Section 512(e)(3).

very rare for these companies to make distributions, instead retaining the money for other purposes.

If a company does convert from C to S status, usually after an ESOP sale, it is subject to built-in gains taxes for 10 years. These are taxes due on appreciated assets should the company be sold. If an S corporation converts to C status before an ESOP sale, usually to afford the owners the opportunity to take the Section 1042 tax deferral, it cannot convert back to S status for five years.

Whether to convert to C status before setting up an ESOP depends on several factors, primarily (but not exclusively) including the basis of the seller's shares (in some S corporations where sellers have been paying their own taxes and not taking distributions, the basis may be very high) and whether there are other non-selling owners who want to retain the S status.

The ability to avoid taxes predictably drew scam artists who tried to design ESOPs in a way that their benefits could be captured by just a few people in a company or for sole proprietors, partners, or other owners of small businesses with no employees. Just as predictably, the IRS and Congress cracked down. The result was a set of "anti-abuse" rules for S corporation ESOPs.[25] These are far from perfect—they catch some very small companies that really do want to share ownership broadly. Most of these are very small (typically 15 employees or fewer), but they can catch larger companies that do not structure their plans properly.

The rules have two steps:

1. First, determine who as an individual owns 10% or more, or as part of a family owns 20% or more, of the "deemed-owned shares." Deemed-owned shares are (1) shares allocated to an individual in the ESOP, (2) the individual's pro-rata share of unallocated ESOP stock, and (3) any claims on ownership (such as stock options, restricted stock, phantom stock, stock appreciation rights, and certain deferred compensation arrangements). These claims on ownership such as stock options are called "synthetic equity," that is, benefits that have some of the attributes of real ownership but are not actually direct ownership. Anyone is this group is considered a "disqualified person." Family members include spouses, lineal ascendants or

25. Code Section 409(p) and Treas. Reg. Section 1.409(p)-IT.

descendants, siblings and their children, and the spouses of any of these family members.

2. Second, determine whether disqualified persons own at least 50% of all shares in the company. In making this determination, ownership is defined to include:
    a. shares held directly (in contrast with step 1 above)
    b. shares owned through synthetic equity, including the equivalent equity value of any deferred compensation paid out after more than 2.5 months after the compensation award is granted
    c. shares allocated to the individual's ESOP account
    d. the individual's pro-rata share of the unallocated shares owned through the ESOP

If disqualified individuals own (or are deemed to own) at least 50% of the stock of the company, then the company has a "nonallocation year" and is subject to penalties. In the first nonallocation year, there is a 50% tax on the fair market value of shares allocated to all disqualified individuals even if no additional allocations are made to those individuals that year (in other words, the tax applies simply if disqualified individuals own, or are deemed to own, more than 50% of the company in the first year).

In addition, disqualified persons may not receive allocations from the ESOP during nonallocation years without a substantial tax penalty. If such an allocation does occur, it is taxed as a distribution to the recipient and a 50% corporate excise tax would apply to the fair market value of the stock allocated. If synthetic equity is owned, a 50% excise tax would also apply to its value as well.

Finally, both an allocation to a disqualified person and the accumulation of ownership or deemed ownership of 50% or more of the stock constitute a prohibited allocation, and the plan would no longer be an ESOP.

These rules may seem dauntingly complex, but if your company has more than 15 employees (and possibly as few as 10), good plan design can prevent these events from happening. In the worst case, if they are about to happen and cannot be avoided, a company can just convert to C status.

Reinvesting the "Rollover" on a Section 1042 Tax-Deferred Sale

As explained above under "Tax Benefits," owners who sell to a C corporation ESOP and qualify under the rules described above for the Section 1042 tax-deferred treatment must invest ("roll over") in "qualified replacement property" (QRP) to receive the deferral. (Chapter 5 of this book discusses this issue in detail, so only the basics of investing in QRP are described here.)

QRP consists of stocks, bonds, debentures, warrants, or other debt or equity instruments issued by U.S. operating corporations that receive not more than 25% of their income from passive investments (that is, from income from investments in other things than their own business). U.S. companies are companies controlled by U.S. firms, not simply companies with operating units in the U.S. and listed on U.S. stock exchanges (Schlumberger or Food Lion, for example, would be foreign firms). Mutual funds, U.S. government bonds, and municipal bonds, for example, do not qualify. Securities of banks and insurance companies are specifically designated as "operating corporations" that qualify as QRP. The company whose securities are purchased as QRP can be public or private and can be owned by the seller to the ESOP. It cannot be owned by the company sponsoring the ESOP, however.

The seller must purchase QRP within the 15-month period starting 3 months before the sale and ending 12 months afterward. The seller must obtain a notarized statement of purchase indicating which securities have been purchased within 30 days after the securities are purchased. In addition, the seller must file an irrevocable statement of election on or before the tax return due date for the tax year in which the sale occurs. This election must describe the securities sold to the ESOP, the sale date, the adjusted basis of the shares, the amount for which they sold, the identity of the ESOP that purchased the shares, and information about the sale of securities to other parties than the ESOP if the sale was part of a larger transaction. Finally, there must be a statement of consent by the company to the election. These forms are not available from the government, but most brokerage firms, ESOP advisors, or law firms handling the Section 1042 transaction will have their own version of the forms.

The seller pays no tax on the gains from the sale to the ESOP until any of these new investments are sold, at which point the basis would be the original basis of the owner in his or her company. The basis held in QRP until death would be stepped up at that time. The seller could also donate QRP to a charity at the full value, not the value after tax. This means the charity gets more and the owner gets a bigger tax deduction.

For most people, advisors tell us the ideal QRP portfolio would consist of 30 to 50 or so investments of varying risk, all of which are designed to be long-term holds (albeit you can always sell any part and pay the tax). Bonds should be noncallable because once called, tax is due.

If a seller loans to an ESOP, the rollover is a little more complicated. The reinvestment of gains has to occur during the 15-month window described above. If the seller has that much cash available from the first installment payment and other sources, this can all be used—the IRS does not track the source of the reinvestment funds. But if the seller is using only the installment payments, after the 12-month post-sale period, further installments would not be eligible. To resolve this issue, there are now special "ESOP notes," as mentioned earlier in this chapter. These are variable-rate, very long-term, noncallable bonds that the seller can borrow money from a lender to buy (usually with a 10% or 20% down payment). These qualify as QRP. As the loan to buy the QRP is repaid, the seller can, if desired, use that to margin other investments.

Some sellers will choose simply not to take the rollover, however, even if they qualify. Some people believe tax rates will go up eventually, so it is better to pay the tax now (most advisors I have talked to say the math on this rarely works out, however). Others may prefer to invest in things that do not qualify as QRP, such as government bonds or mutual funds. Still other sellers may wish to avoid taking the rollover so they or others who would be excluded under Section 1042 (certain relatives and more-than-25% owners) can participate in the ESOP if they work for the company.

Steps to Setting Up an ESOP

If you have decided an ESOP is worth investigating, there are several steps to take to implement a plan. At each point, you may decide you have gone far enough and that an ESOP is not right for you.

Get Educated

The more you know about ESOPs, the better you will be able to control the process at every step and not have to rely solely on what advisors tell you. The NCEO has a variety of ways to do this, including seminars, webinars, an annual conference, this and other publications, and, for NCEO members, the right to call or email us at any time for advice. We also can refer members to ESOP company leaders to talk to.

Determine Whether Owners Really Are Willing to Sell to an ESOP or Would Rather Try to Find Another Buyer

Seller reticence can come up in a number of ways. The first is whether company owners are primarily interested in getting the highest price possible. An ESOP may offer that, especially if the owner figures in potential tax benefits, but, as noted earlier, in some cases there may be one or more synergistic buyers out there who could offer an even better deal (or at least one or more owners perceives this to be the case). A second barrier can be that the company's culture just is not the right fit. If one or more owners just don't like the idea of employees becoming owners "for free," or they really only want to give ownership to certain people, or they cannot imagine ever doing any of the kinds of ownership culture things that make ESOP companies really successful, as discussed toward the end of this chapter, then implementing an ESOP may not be the best thing to do.

Have a Preliminary Valuation Performed

You may want to have a preliminary valuation done first to see whether the range of values produced is acceptable. Even if you are determined to proceed with an ESOP at a lower price, however, the data from the valuation will allow you to assess more specifically how much money is needed to fund the plan.

Conduct a Feasibility Study

This may be a full-blown analysis by an outside consultant, replete with market surveys, management interviews, and detailed financial projections, or it may simply be a careful business plan created in-house. Generally, full-scale feasibility studies are needed only where there is some doubt about the ESOP's ability to repay the loan. Any analysis, however, must look at several items. First, it must assess just how much extra cash flow the company has available to devote to the ESOP, and whether this is adequate for the purposes for which the ESOP is intended. Second, it must determine whether the company's eligible payroll is large enough so that contributions within the annual limits can repay the ESOP loan in a reasonable time or, in, a non-leveraged purchase, will buy enough stock each year to satisfy the sellers (note, however, that this is very rarely a problem). Remember to include the effect of other benefit plans that will be maintained in these calculations. Third, estimates must be made of what the repurchase obligation will be and how the company will handle it. Finally, it must make a preliminary assessment of how the ESOP will be financed (seller financing, outside financing, ongoing cash contributions, etc.) and whether this financing is available.

Hire an ESOP Attorney

If these first steps prove positive, the plan can now be drafted and submitted to the IRS. You should carefully evaluate your options and tell your attorney just how you want the ESOP to be set up. This could save you a considerable amount of money in consultation time. The IRS may take many months to issue you a "letter of determination" on your plan, but you can go ahead and start making contributions before then. If the IRS rules unfavorably, which rarely happens, normally you just need to amend your plan.

In locating an attorney or any other ESOP professional, keep in mind that many people will claim to have expertise in this area, but relatively few actually do. The NCEO's website has a Service Provider Directory to help people find providers (we do not endorse these providers, however). You should interview at least three professionals in each area and ask each one for a list of prior ESOP engagements. Look for evidence of involvement in ESOP organizations, speaking and writing on the topic, and referrals from ESOP clients.

Arrange Financing

We have already discussed the various means to finance a plan. Remember, these can be combined. If enough financing cannot be found to buy all the stock that is for sale, consider doing a smaller purchase in the first round and buying more later.

Establish a Process to Operate the Plan

A trustee must be chosen to oversee the plan. A process should be set up, preferably with employee involvement, to communicate the new plan to employees. Finally, to be really effective, a process should be set up to find ways to get employees more involved as owners by making it easier for them to share ideas and information.

Creating an Ownership Culture

You can set up an ESOP just as a benefit plan with no implications for corporate culture, but the research is definitive that companies that create (or already have) what we at the NCEO call an "ownership culture" vastly outperform those that do not. Starting in the 1980s, study after study has shown that employees generally like being owners. The more shares they own, the more committed they are to their company, the more satisfied they are with their jobs, and the less likely they are to leave. The size of the company, line of business, demographic characteristics of the employees, seniority, job classification, presence or absence of voting rights or board membership, percentage of the company owned by employees (as opposed to the size of the annual contribution), and many other factors do not have any impact on these attitudes.

But job satisfaction and even motivation do not automatically translate into performance. The key is not just for employees to like what they do, and do it more carefully or energetically (both of which can make a small difference in overall company performance, but only a small one, it turns out), but to be able, as owners, to contribute better ideas and information on how the company can make more money. The companies that make this happen, the research shows, have three characteristics:

1. They regularly share information about how the company is doing overall, and they break it down into measurements and goals at the work level.

2. They provide structured opportunities for employees to share ideas and information, such as teams, ad-hoc committees, defining jobs to give individuals more individual authority, and company-wide and/or other functional unit meetings. Just having an "open-door" policy is far from enough (virtually every company has an open-door policy, it seems).
3. They provide training for employees on ownership and participation issues, including extensive communications about how the plan works.

The structure of participation varies from firm to firm, but basically boils down to employees forming groups to share information, generate ideas, and make recommendations.

At Phelps County Bank in Rolla, Missouri, the ESOP was at first a sleepy benefit plan. Then Emma Lou Brent, the bank's CEO, read that for an ESOP to work, employees must receive substantial annual contributions and have a chance to share their ideas and information on a regular basis. So Brent increased the ESOP contribution to 25% of pay per year and started an employee involvement program based on a "problem-buster committee." Employees formed a committee to solicit input on what issues were causing difficulties. Brightly colored "problem alerts" were then circulated to ask for ideas on how to solve them. Often, the solution was to form an ad-hoc team of people who thought they had something to contribute. The system has grown over the years and now includes extensive training in bank management for all employees. The result is that the company's stock has gone up much faster than the increase in costs; in fact, Phelps has been one of the best-performing banks in its class for years, and employees typically leave with accounts in the mid-six figures.

At Springfield ReManufacturing in Springfield, Missouri, employee owners are taught to read detailed financial and production data. Meeting in work groups, they go over the numbers and then figure out ways to improve them. Employees are given monthly 110-page financial statements to digest. A waste of time? Springfield's stock went from 10 cents a share when it started its ESOP in the early 1980s to over $650 in a recent (2019) valuation. Employment is up from 130 to 1,400.

Other approaches include employee advisory committees to management, eliminating levels of supervision while giving nonmanagement employees more authority, meetings between management and randomly selected groups of employees, suggestion boxes, and anything else companies can imagine to get people involved.

None of this is easy to do, but the results consistently have demonstrated the worth of the effort. As a result, participative management has become the hottest topic in ESOPs. Not an ESOP conference goes by without repeated imprecations, from consultants and experienced companies alike, to get moving in this area.

Best Practices for Implementing an ESOP

ESOPs must comply with a variety of rules, but there still is considerable flexibility in how they can be designed. Below are some of the most common options that people can overlook.

- *You can share ownership outside the ESOP in a variety of ways:* If you want specific people to buy shares in the company beyond what they would get in the ESOP, you can have them buy shares at fair market value or a discount (the discount is taxable). The company can loan them the money, or they can purchase shares out of future bonuses. You can put a restriction on these shares so that they cannot take possession of them until they meet certain performance and/or seniority targets (these shares are called "restricted stock"). You can also make outright grants of shares, again with the options on restricting the right to take possession until they fully vest based on seniority, performance, or both. You can give employees stock options, phantom stock, or stock appreciation rights. If you do not want them to own actual shares, phantom stock and stock appreciation rights would work, as would warrants with a mandatory redemption feature before exercise. If you do grant equity (as opposed to having it purchased), it should be in line with what can be justified by individual performance. Excessive grants can raise issues with the ESOP.
- *You can structure the ESOP loan over a longer period of time than the company loan:* I mentioned earlier that the loan to the ESOP can

be longer than the loan to the company to buy the shares. As noted above, this can help you stay within contribution limits or function to spread benefits more gradually over time. Many ESOPs have a five- to seven-year loan. If all the stock is allocated over this time, what happens as new employees come on board? If any shares are repurchased or reallocated, they can get some of those, but their ESOP contributions would be very limited. Usually, at that point, companies start putting in cash contributions to the plan unless there are more shares to buy, leaving new employees with few shares and mostly cash, and senior employees with the opposite. A longer internal loan schedule will spread out the share release more. There are no specific limits on just how long this can be, but the effect should not be to make the needed annual contributions below a fairly robust level (I would suggest at least 7% or 8% of pay). Also, there should be a provision to start paying people out after a reasonable time even if the loan is not fully repaid (10 years seems reasonable).

- *Your distribution policy can be flexible:* While you should make it possible to pay people out as late as the law requires, a good distribution policy will have a provision providing for faster distributions if cash is available. The policy must be carefully written to make sure it is nondiscriminatory and meets various other rules, but this is a common approach. Waiting the maximum time to make distributions is not always a good idea, such as when the stock value is rising faster than your cost of money or you would rather not have former employees benefitting from stock value increases. You can also "segregate" accounts of former employees by buying out their shares, but not paying them out the cash that is reinvested in the plan until later. That means former employees don't benefit from (or take the risk of) holding stock, but do not have the incentive to terminate an immediate payout might provide.
- *Take ownership culture seriously:* It is easy to get wrapped up in all the technical and financial issues of an ESOP and put off communications and culture until later. But the sooner you get started on these issues, the better off you are. If the culture does not support the notion of employees as owners, eventually the employees may become cynical about the ESOP, even if it is a good benefit.

- *Explain, don't sell:* When you do tell employees about the ESOP, try not to make it a sales pitch. Explain the benefits and the risks, as well as what is in it for sellers and the company. We at the NCEO have found employees are much more responsive to this approach. Over time, if the ESOP is successful, then it is time to celebrate.
- *Call us:* The NCEO does not set up plans, but our staff has a great deal of experience in the area. If you are an NCEO member, we can give you objective feedback on any issue you are likely to face.
- *Be patient:* The process will take time and more of your involvement than other ways to sell a company usually do. ESOPs are not for everyone, but if they work for you, the investment is well worthwhile.

When ESOPs Are Clearly Not the Right Choice

Given the competing advantages and disadvantages, some companies will require financial modeling by an expert to determine whether an ESOP is viable. In some circumstances, though, a simple checklist can identify a company as a bad candidate for an ESOP. Some situations in which an ESOP is highly unlikely to be a good fit are listed below.

- *The company is very small (typically less than 10 to 15 employees):* First, implementation costs may be greater than potential tax benefits. Second, if the company is an S corporation, anti-abuse rules aimed at preventing a small number of people from getting the bulk of the ESOP benefits may make an ESOP impossible even if all employees are in the plan. The company could convert to C status, however.
- *The current owner's primary concern is to maximize his or her proceeds from the sale, and a strategic buyer is willing to offer a substantial premium:* This is a common and valid reason for a company to choose not to adopt an ESOP, but a strategic sale does not work in all circumstances. For example, if a company has multiple owners, all must be looking to get out entirely. Where there is a single owner, that owner may only want to sell part of his or her ownership. In addition, the strategic buyer's premium must be large enough to offset the ability of a seller to a qualifying ESOP to defer taxation

on the gain by reinvesting in other securities under Section 1042. Finally, the buyer's offer must not contain unacceptable contingencies or uncertain financing.

- *The company lacks reliable cash flow:* When an ESOP is buying out an owner, the cost is a nonproductive expense. Companies need to assess whether they have the available earnings for this. ESOPs are not usually good choices for struggling companies and are often difficult in companies that experience wide year-to-year swings in earnings.
- *Capable successor management is not in place:* Especially when the seller is a key manager, committed management is necessary to obtain an outside loan as well as to help assure that the company will be able to pay for the plan over time.
- *The company is not a C or S corporation:* LLCs, partnerships, and other such forms of business cannot adopt ESOPs without first converting to C or S corporation status.
- *Family members or executives want a major share of the company:* As discussed above, an ESOP cannot be used to transfer ownership to specific people. Additionally, when a seller to an ESOP elects the Section 1042 tax deferral, the seller, certain family members of the seller, and more-than-25% owners cannot receive ESOP allocations of any shares from the Section 1042 transaction. Individuals can buy or, within reasonable limits, be given shares outside the ESOP, or be given equity rights such as stock options or stock appreciation rights. If the goal is to transfer most of the ownership to a select group, then an ESOP is not appropriate.

Conclusion

Employee ownership is not the right solution for every business owner seeking to sell. There are a great many owners of closely held companies, however, for whom an ESOP would be a great solution but who either do not know about the plan or whose advisors tell them all sorts of things that are not true, whether out of ignorance or a fear of losing a client because the advisor does not handle ESOPs. Many sellers to ESOPs would tell you that the ESOP was just what they were looking for.

They get a fair price, good tax benefits, and the satisfaction of knowing they did the right thing.

Chapter 2

Understanding ESOP Valuation

Corey Rosen

Why Do You Need a Valuation?

There is a T-shirt in the Exploratorium museum in San Francisco with a picture of Albert Einstein in a policeman's hat. The legend on the T-shirt says "186,000 miles per second. It's not just a good idea, it's the law." If you want to have an ESOP in a closely held company, an independent, outside valuation is not just a good idea, it's the law. You must have an appraiser figure out what a willing buyer would pay a willing seller, assuming both have all the relevant information they need to make the transaction. The law is designed to make sure that the ESOP does not pay more than fair market value when it buys shares from a non-ESOP participant shareholder and that ESOP participants are paid fair market value when selling their shares back to the ESOP or the company.

Congress created this requirement to make sure that ESOP trusts are operated for the benefit of participants. Buying shares from an owner at an inflated price puts the company at risk and benefits the owner's interest at the expense of the plan participants. Many people call us at the NCEO, saying "Why can't we just use book value?" or some other formula, or perhaps the price they got in an offer from another buyer. Book value is simple, but it usually understates the real worth of ownership in most businesses. Most businesses are worth some multiple of their expected future earnings—earnings that are generated not just by assets, but by such intangibles as reputation, expertise, contacts, innovative ideas and processes, etc.

Other owners say they know that in their industry, businesses sell for an average of x times earnings or some other multiple. But your business is not likely to be average. If in using a formula you come up with a value that is just a few percentage points higher or lower than a more accurate assessment of your company's value, the costs will be much greater than the cost of a valuation. For instance, if your formula is off 3%, and your value is $2 million, then the formula is either costing you (if it is too low) or the ESOP (if it is too high) $60,000, many times the cost of an independent appraiser.

In addition, you are not simply selling your company when an ESOP buys the stock. You are selling shares in the company, and that is an important distinction. For instance, if you are selling a minority interest, the price per share is lower than if you are selling a controlling interest, because control has value. Even if you are selling a controlling interest, shares can have a discount for lack of marketability.

Because of all these factors, only a qualified appraiser can determine the right number. To make sure that the appraiser is working for the interests of employees, the law requires that the appraiser be independent, and the U.S. Department of Labor (DOL) and the courts have argued the best way to assure that is for the appraiser to be hired by the ESOP trustee (not the board, the company, or the seller) and report to the trustee.

Business owners sometimes worry that this appraised price will not be what they think they deserve or can get elsewhere. If you have a truly synergistic buyer interested in your firm, this might be true, although even then contingencies placed on the sale and less favorable tax treatment can make a lower sale price to the ESOP still a better deal. Truly synergistic buyers, however, are far less common than sometimes thought and account for a distinct minority of sales.

An independent appraisal is also essential to convincing employees that an ESOP is a good thing for them. If they believe that the ESOP is overpaying for its shares—that it is just a clever way, for instance, for the owner to take money out of the company on a tax-preferred basis—then employees are going to be very skeptical about the plan.

An independent valuation can be also be critical if there are multiple owners. If one sells for too high or too low a price, an artificial benefit or cost is created for one party or the other. In many ESOPs, sales are done in stages. Too high a price in the first stage means the shares the seller continues to hold are worth less and the company may be put in unnecessary financial danger.

Finally, having an appraisal can be a useful business planning tool. After all, the appraiser's report, which typically runs 75 pages or so, is all about comparing your business both to other businesses and to other uses for the money invested in your company. It thus provides a detailed benchmark to determine how you are doing and what elements of your strategy can be changed to improve equity value.

Who Hires the Appraiser?

The appraiser is hired by and reports to the trustee of the plan, not the seller or the board. Most trustees do not want the seller even to see the valuation report; some do not want board members to see it either, although on an ongoing basis, boards do normally get the valuation report or at least a detailed summary because it is so critical to understanding the business. While in practice the appraisal fees are normally paid for by the company, it is important that the contractual relationship be between the trustee and the appraiser. Thus, the recommendations directed to "you" below about hiring an appraiser are addressed to the ESOP trustee, and in particular an internal trustee (i.e., a company employee or committee) as opposed to an external trustee whose business it is to know these matters.

The fact that the appraiser's client is the ESOP trust, no matter who actually writes the checks to cover the fees, has important implications. First, the letter of engagement should clearly specify that the appraiser is working for the ESOP. Second, it means the appraiser is not trying to find the highest price that can be justified or, as in some tax-oriented appraisals, the lowest. Third, it should remind everyone involved that the point of the appraisal is to protect the interests of the ESOP participants by ensuring the ESOP does not pay more than fair market value in any purchase from an outside seller and that employees are paid fair market value for company shares in their ESOP accounts.

Many business owners have confidence that the appraised value will be one they are willing to sell at, often because their motivation in selling to an ESOP is only partly financial and they believe the price will reasonably reflect what their business is worth. Some sellers want to get an idea about what the ESOP will pay before doing a deal, however, and they or the company may hire an appraisal firm to determine a value on the same basis an ESOP appraiser would. That same firm may also provide advice on deal structure (seller financing, warrants, bank debt, cash in the company, etc.). If the firm is a qualified ESOP appraiser, its number will usually be within about 10% of what the appraiser hired by the trustee will determine. It is important to understand, however, that this firm should not be the same firm the trustee hires because that represents too much of a conflict.

When Must an Appraisal Be Performed?

The appraisal must be done before any sale to the ESOP. After the plan is set up, the law requires appraisals to be done at least annually, but there may be circumstances that require a more frequent appraisal. The law also requires that ESOP transactions be conducted at the current fair market value as of the date of the transaction. In practice, the appraisal comes in and it takes some time to complete the transaction, but the price would be at the appraised number.

If the ESOP is buying shares from an owner or the company, for instance, it should try to time its purchase to coincide with the most recent appraisal as closely as possible. On an ongoing basis, in an ideal scenario all transactions related to plan distributions (such as a departing employee selling shares back to the company or the plan) occur at a specific annual date that is timed as closely as possible with the annual appraisal. In practice, what this usually means is that the appraiser provides a report on a regular schedule and the plan administrator closes the plan year as soon as possible after that. That window is usually within a few months but may be longer. Statements are then mailed to employees, and transactions are completed as soon as administratively possible following the closing.

For distributions to employees, however, plans can also state that distributions will occur as of the most recent appraisal, even though that could be up to one year old. If this is done consistently, it is normally acceptable unless there is reason to think there has been a very significant upward or downward movement in share price in the interim. In that case, the trustee may ask the appraiser for a “drop-down” letter to state that the most recent appraisal is still valid or, if this is not the case, suggest an update be performed.

Who Performs an Appraisal?

The law requires an independent, outside appraisal from someone who is customarily in the business of doing business appraisals. There has never been a precise definition of what "independent" is, however. Clearly, some people are excluded—your board, your attorney, your brother-in-law, your CFO, your CPA, or anyone else with a direct financial relationship with the company. But what about your CPA firm (but not the person doing your books), or the valuation advisor who is affiliated with your attorney? Many people argue that if your CPA firm is large and can establish a "firewall" separating its audit and valuation sections, then that is acceptable. Others contend that even this is risky. Similarly, some people say you can use firms affiliated with your advisers (such as a valuation firm that pays a fee to your attorney for referrals), but most experts would argue that is not a wise policy.

We at the NCEO strongly suggest that you pick a firm that has no other business relationship with your company than the appraisal itself. Almost all the lawsuits that result in major judgments involving ESOPs concern valuation. The law looks primarily to process, not results, in determining whether the appraisal was fair to the ESOP. An appraisal done by a truly independent, qualified firm establishes a degree of credibility not possible any other way. With any other firm, there is always the possibility that the appraisal was done with an eye toward getting or keeping the company's business for the other parts of the firm or the affiliated parties involved in other parts of the transaction. The costs will rarely be lower in using someone not truly independent, so it is best to err on the side of caution.

In the past, the decision on whether a valuation firm that has done work for the firm before the ESOP could be hired by the trustee was a matter of disagreement, but that has changed. The DOL has been very clear on this issue in recent years and is very skeptical of appraisers who have any other relationship with the company. Appraisal firms that have done work unrelated to the ESOP should be excluded. A more difficult issue is whether an appraisal firm that is hired to do a preliminary appraisal for ESOP purposes can be used for the full-scale ESOP appraisal for the ESOP transaction. A preliminary appraisal can help a company decide whether to do an ESOP and to plan for financing it. Tim Hauser, a deputy assistant secretary at the DOL, has argued that this is "road testing" the appraiser to see if a high enough price can be obtained, and says the DOL wants companies to use a different firm for the transaction than for the preliminary appraisal, one hired by the trustee. Using a separate firm adds somewhat to the cost, but it also means the preliminary appraisal may come to a somewhat different conclusion of value than would be obtained from the firm that will ultimately do the ESOP appraisal, albeit the difference is likely to be small. Given the litigation and/or DOL investigation risks of using an appraiser who has done work for the company or the seller, and the fact that ESOP valuation professionals usually come to very similar conclusions of value, we strongly recommend that the ESOP appraisal firm have no other existing or prior relationship with the seller or the company.

The other major issue in determining whether an appraiser is qualified is competence. Here there are two areas to evaluate. The first is general business appraisal competence. Anyone can be a business appraiser. No specific degree and no licensing procedure is required by states or other entities. The appraisal industry does try to be self-regulating, however.

There are a number of organizations, offering a wide variety of designations, that provide some kind of business appraisal certification. Among these are the American Society of Appraisers (ASA), the National Association of Certified Valuation Analysts (NACVA), the Institute of Business Appraisers (IBA), and the American Institute of Certified Public Accountants (AICPA). Each organization provides some kind of technical education program providing certification designations. There are so many designations now that they can become quite confusing. It is worth asking an appraiser what designations he or she has and what was required to obtain them, but making comparisons on designations alone may be difficult.

In addition to these qualifications, you should also look at experience, in-house training requirements for the firm, whether the appraiser has spoken or published on the subject, and, of course, references.

Business appraisal competence is not enough, however. As will become clear later, there are many ESOP-specific issues. These issues can have a dramatic impact on the final valuation. Your appraiser should be able to demonstrate specific experience and expertise in ESOPs. Ask for a list of ESOP clients and call them. Find out whether the appraiser belongs to the relevant professional organizations (the NCEO and the ESOP Association), regularly attends professional conferences on the subject, and has spoken or written on ESOP-specific issues. If the appraiser claims to have ESOP expertise but does not meet these criteria, look elsewhere.

How Do You Find a Good Appraiser?

As noted above, an appraiser may be chosen by the seller, board, or trustee for advice on what the ESOP might pay, as well as possibly on deal structure. The trustee will hire the appraiser for the ESOP. In both cases, the criteria for selection are the same, although an independent trustee who does ESOP work often will have a list of appraisers it works with.

Both the NCEO and the ESOP Association maintain lists of appraisers and other ESOP professionals that are available to members. Neither group endorses the people listed in the guides, but at least this provides assurance that the appraisers are involved in the relevant professional organizations. Most active ESOP appraisers will appear on both lists. Your other professional advisors usually will also have recommendations, and you should ask other ESOP companies whom they have used.

One issue to decide is whether to pick an appraiser from a large or small firm. Large firms typically have an appraisal reviewed by one or more other staff members and may have additional credibility should there be a legal challenge. Some small firms, however, have excellent reputations and also may provide for internal reviews. Generally, large firms charge more, but this is not always the case. While there is not a right or wrong answer here, size per se is probably not a critical issue when comparing firms of comparable price, competence, and compatibility.

In picking an appraiser, it is wise to interview at least two or three candidates. You will find that there are significant variations in price, experience, and appraisal philosophy. The first two are obvious things to look for, but the third may seem a little confusing. Why ask about philosophy?

Different ESOP appraisers have different approaches to key appraisal issues, such as discounts for lack of control or liquidity (these are discussed below), or in their general appraisal approach (such as whether they rely more on earnings multiples or on comparable companies). These will have a potentially significant effect on value. Initial assumptions tend to get locked into your ongoing ESOP appraisal. It will always arouse suspicion if, a few years after the first ESOP appraisal, you decide you are unhappy with the approach and choose someone else who comes in with a different set of assumptions. Your business won't have changed, but ESOP participants and the IRS may now see a very different appraisal number. At best, you have a serious communications problem; at worst, you have a lawsuit or problem with the government.

To head off such complications, the ESOP trustee or the person who will become the trustee should interview appraisers beforehand. If the ESOP trustee decides down the road that the appraisal is in some way potentially faulty, the best approach is to hire a third party to do a review of the appraisal report (but not redo the appraisal). This is fairly inexpensive. If the review is positive, then things can continue; if not, the trustee may seek some changes in approaches by the appraiser or decide to hire an alternative firm (but not the one doing the diagnostic).

These interviews must be designed to find out what approaches are going to be in the best long-term interest of the ESOP and its participants. The goal is not to find the appraiser who will come up with the highest price. Instead, the trustee should be looking to assure, as best as possible, that the appraisal will support the long-term viability of the plan and that the appraisal will use methodologies that are generally accepted by the appraisal community and the regulatory authorities. That means the price will not be so high as to endanger the company's ability to pay for it nor so low that the current sellers will not want to sell. The appraisal assumptions and procedures must also assure that future participant distributions will be at their proper value. The ultimate price must fit within the range of what reasonable appraisers could agree is not more than fair market value.

Admittedly, these are somewhat vague guidelines, but ESOP appraisal is an art, not a science. While the process cannot be exact, however, it can and must be informed. A careful discussion with the appraiser about these issues prior to engagement can avoid confusion and unhappiness down the line. Note, however, that the appraiser may (appropriately) say that an initial discussion does not provide enough information to make an assessment of which approaches will work best.

Is the Appraised Price the One the ESOP Pays?

Once the appraiser has provided a report saying what fair market value is, that is not the end of the story. Many people incorrectly assume that this is the price that the ESOP must pay. Instead, the law requires that the ESOP cannot pay *more* than this price when purchasing shares from a seller. Indeed, it is the responsibility of the ESOP trustee to negotiate the best price possible, which sometimes will be less than the appraised value.

This negotiation might take a number of tacks. In a few cases, the seller prefers to sell for a lower price, usually because of concerns about the ability of the ESOP to repay the loan or just because the owner wants to be generous. In others, the trustee argues that tax benefits to a seller to an ESOP should come partly back to the ESOP in the form of a lower price. It is the ESOP, after all, that justifies the lower price as a result of its tax advantages. In still other cases, the ESOP trustee is simply bargaining for a better deal and, given the lack of other options the seller may have, is able to exert some leverage.

These scenarios all envision using an ESOP to buy shares from an existing owner. Sometimes an ESOP acquires new shares, such as when it borrows money to purchase shares to help finance growth, or when it accepts contributions of shares. In these cases, the trustee has less negotiating leverage because the contributions to the ESOP are diluting other owners, not buying their shares. Still, the size of a loan might be such that a lower price is needed to fit within legal requirements, or owners may wish to add another bargain element for the ESOP.

In an ongoing ESOP, participant shares are always purchased at the appraised value. You cannot, for instance, offer to pay a participant a lower price for an earlier distribution.

Opinions on Deal Structure

In addition to providing a valuation, the appraisal firm might be asked by the trustee to opine on deal structure. A significant minority of ESOP transactions are financed by seller notes in part or in full. In their simplest form, these notes carry an interest rate, usually determined based on the level of risk of that loan compared to senor bank debt. Some seller notes, however, also have warrants. A warrant is the right for someone (here, the seller) to purchase x number of shares at y price (here, almost always the fair market value for the company, as determined by the ESOP appraisal) for z number of years. Sellers take a lower interest rate in return for this right. Conceptually, what is calculated here is the present value of the forgone reasonable rate of interest expressed as the present value of the option to buy shares at today's price for some years into the future.

Say that Louise and her advisors conclude that a fair interest rate is 8%. But Louise is willing to take 4%. The note is for seven years. Say that that means Louise is giving up a cumulative $1 million in interest as a result. That has a present value of about $750,000. Louise now can trade that for the right to buy a number of shares at the current appraised price equal to $750,000 for the next seven years. If they go up in value, Louise will have the company cash them in and make money; if they go down, they have no value.

Pricing warrants involves a lot of math and a lot of assumptions. The appraiser may be asked by the trustee to determine if the pricing is fair.

In a much smaller number of cases, the company will seek outside equity investors. Now the appraiser may be asked to determine whether the deal they are getting is fair relative to the deal the ESOP trust is getting.

What Does the Appraiser Need from You?

In preparing an appraisal report, the appraiser will need a lot of data from you. The more precise and well prepared these data are, the better (and possibly cheaper) the appraisal will be. The following list indicates the key items appraisers generally need, although there may be other things requested:

- Financial statements, typically for the last five to ten years, preferably audited (but many smaller companies will present only reviewed statements). Income statements, balance sheets, cash flow and capital statements, and any explanatory footnotes or other material are included.

- Budgets or projections
- List of subsidiaries, if any
- Leases and contracts
- Compensation schedules
- Prior appraisals
- Dividend history and expectations
- Legal documents
- Prior sales or offers
- Shareholder list
- ESOP documents
- Operational information, such as sales by customer, patents, departmental budgets, competitors, etc.

In addition to a review of these documents, the appraiser will want to interview management and possibly board members, suppliers, customers, advisors, or anyone else deemed to have critical information. One or more site visits will be arranged. During these interviews, any significant issues that could materially affect operations, such as a pending environmental liability, a new competitor, management changes, or a patent expiration, for instance, should be thoroughly discussed.

It is important that your financial forecasts be realistic and well-justified. Forecasts that are built from the bottom up, vetted by multiple people, and reconciled are better than those just made by the CEO or the CFO. Forecasts should be stress-tested for possible increases or decreases, and that information shared with the appraiser. Excessively optimistic forecasts underlying appraisals have been a key element in ESOP litigation.

What Is in the Appraisal Report?

Valuation reports typically run from 50 to 90 pages. The report will cover several issues. The basis for the appraisal of the company as an enterprise should be thoroughly explained and justified (for instance, if the appraiser chose to use an earnings ratio as a key element, why that was more appropriate in this case than some other methodology). Then there should be a discussion of any discounts or premiums applied to that value for the shares the ESOP is purchasing. Again, a thorough explanation of assumptions and rationale should appear. The data used for making the determination should be outlined, and any weightings or judgments used in assessing these data should be elaborated. Any special factors that affect valuation findings, such as a change in management that could reduce future value, should be covered. Reports usually also include a number of charts and tables showing different indications of value based on different methods.

In addition to these matters, the report should follow the guidelines included in the Department of Labor's proposed regulations concerning valuation. Among other things, these include a discussion of the business, its markets, and general economic considerations affecting value. The company's book value should be considered, along with any goodwill or other intangible assets and the company's dividend-paying history and capacity. The price of similar companies, if any, should be provided. Finally, issues relating to marketability and control concerns need to be reviewed. The trustee needs to show that the process for selecting an appraiser has been thorough and resulted in the selection of a legitimate ESOP valuation expert. The trustee must also show that the financials provided to the appraiser are accurate and realistic, not best-case scenarios. In ongoing valuations, the appraiser should be able to demonstrate how the repurchase obligation has been factored into the final price.

The final valuation will be a blending of these issues. Because there is no formula for valuations, however, each report will be different.

Steps in the Valuation Process: What Is Fair Market Value and How Is It Calculated?

In calculating how much the ESOP can pay, the first step is to determine how much the business is worth as an entity. There are three basic approaches used to determine this: the asset approach, the market approach, and the income approach.

Asset Approach

This is the simplest approach and one many closely held companies already use to value their shares for purchases by key employees. It is also the least used method in ESOP appraisals. In this approach, a company is assessed based on either the liquidation value of its assets or its adjusted book value. The adjusted net asset methodology approach takes the balance sheet and transforms it from an accounting document to an economic one. For instance, an asset may be fully depreciated on the balance sheet, but still have resale value on the market. Liabilities may not appear on the balance sheet because they are contingent, such as a possible environmental issue (cleaning up a landfill, for instance). Inventories also need to be adjusted for what they could currently sell for in the market. Any accounts receivable and payable not on the balance sheet need to be considered. Any intangible, but marketable, assets (such as a trade name) need to be assessed.

While these methods are simple, they are also usually wrong. People usually want to buy a business because it can yield them a return on their investment; the ESOP always looks at a purchase this way. While a company's assets are part of what creates an income stream in a company, they are only part of it. All sorts of other factors—expertise, reputation, contacts, processes, labor practices, and other issues—condition how much a company can make. The asset approach has even less relevance when only a minority stake is being sold because minority owners cannot force a liquidation of assets.

There are a few companies, however, where the asset approach may show up as one of the weighted factors. You may also see asset value added back into the final calculation of value where there are assets that could be liquidated in a way that would have a positive effect on cash flows, or are worth materially more than the reported amounts on the balance sheet. For instance, if you own a building that has substantial value in a high-cost neighborhood, but could relocate to a lower-cost area without damaging cash flow, that extra value may be added back to the final value. That could also be true for cash on the balance sheet in excess of projected needs, more commonly measured as excess working capital. To the extent that cash (working capital) or other assets are "excess," i.e., not required to generate a given level of earnings, their market value will generally add to the value estimated through earnings measures.

Market Approach

The next approach is to see what, if any, evidence there is of how much people would pay for stock in the company or comparable companies. There may be, for instance, a history of stock sales in the company, or there could be other valid offers. These offers, however, do not necessarily establish a value that the ESOP can pay.

The market approach can use the guideline company method or the merger and acquisitions method. The guideline company method estimates the value of a business by comparing the subject company to publicly traded ownership interests in comparable, or guideline, companies. The merger and acquisition method is based on an estimate derived from the value of the sale of a controlling interest in comparable companies involved in mergers and acquisitions, most of which will be private firms, often sold for private equity investors. In either case, multiples of earnings paid by investors are used to create multiples that would apply to your company.

The methods have limitations. The offers in the M&A data are for control and possibly for synergistic control. As discussed below, control premiums in ESOPs, if they exist, are more nuanced than in these markets. If the offer is from another company with a synergistic interest in the target company, it is not a useful comparison because the ESOP valuation assumes a financial buyer. If International MegaCompany can gain operating efficiencies, or eliminate competition, by buying Pete's Pizza Parlors, they will pay more for Pete's than would a buyer who could not capture these efficiencies. The ESOP is always a *financial* buyer; it must be able to justify its purchase based on the return that investment yields as a stand-alone company, although heavy acquisition activity in a given industry may influence market pricing upward and should be considered.

Better data are available from public companies (the guideline company method), but here several complicating issues arise. First, many public companies have multiple lines of business. Second, they are almost always larger, and often much larger, than the company being appraised. Third, they may have very different capital structures than closely held companies. These and other differences make direct comparisons difficult. Most business appraisers are experienced in dealing with these complications, however, so the data on stock prices in these companies can yield useful insights about the typical ratios (such as share price to annual earnings) that can be applied, with appropriate adjustments, to provide benchmarks for applying multiples to the company being valued. When using public companies, the indicated value for the company being appraised is a minority interest, freely marketable value because the share prices of the publicly traded companies represent small minority interests in the public company.

However a market approach is constructed, a company's earnings may be "normalized" to reflect how another buyer would operate the business. This is discussed in more detail below in the section on the income approach to valuation.

Income Approach

A third set of methodologies falls under the income approach. The basic theory behind these methodologies is that a buyer is looking to make a reasonable return on an investment over an acceptable period of time, given the relative risk of the investment. A theoretical willing buyer is looking at a variety of investment choices. There are safe ones with low returns (CDs, T-bills, etc.), somewhat riskier ones with higher returns (stocks and bonds), and still riskier ones with the highest returns (individual companies). It has to be this way: the higher the risk, the greater the return an investor will demand. In buying a company, then, the investor needs to know two basic things: what the risk is and what the income flow is that will result from the investment. There are a number of ways to conceptualize these factors, but the two most common are referred to as capitalization of free cash flow and discounted cash flow.

Capitalization of free cash flow method: With the capitalization of free cash flow (FCF) method, the appraiser develops an estimate of the company's sustainable level of free cash flow. This is usually based on history and estimates of what future FCF will be. FCF is defined as follows:

	Net income
+	Non-cash charges (such as depreciation)
–	Increases in working capital
+	Additions to long-term debt
–	Payments of long-term debt
–	Capital expenditures
=	Free cash flow (FCF)

Free cash flow is normally used because that is the basis from which an investor can earn a return from the investment either in the form of dividends or investment of the FCF back into the business for future growth. However, some appraisers prefer other variations on the future income theme, such as earnings before interest, taxes, and depreciation.

After these numbers are determined, they are adjusted to reflect nonrecurring items and special considerations. For instance, there may have been a large one-time expense that lowered earnings (and thus FCF) in a prior year, or an anticipated one-time expense in the future projections. Very commonly the pay and perquisites of executives or other employees needs to be adjusted to reflect what the market rates for these individuals are, unless these practices will remain in place after the transaction. If the CEO is making $700,000 a year and has a company-paid vacation to France every year, the appraiser might determine that these expenses would be substantially reduced if someone else bought the company. This excess is added back to earnings if the levels of compensation will not continue into the future. Similar adjustments to earnings and cash flow are typically made before applying multiples in the market approaches as well. After analyzing historical and potential earnings, the appraiser will determine a single figure called "representative earnings."

Finally, a capitalization rate is applied to these representative cash flows. The concept here involves some complex math, but the basic idea is simple. The appraiser is trying to determine what the present value of a future stream of sustainable FCF is. The rate is derived by subtracting the expected long-run rate of FCF growth from the company's discount rate. The discount rate, in turn, reflects the rate of available risk-free investments and the risk adjustments appropriate for the fact that this is an equity investment made in a company of a certain size (there is less risk in a large company) with specific risk concerns.

For instance, an appraiser might determine that in a particular business, the expected FCF growth rate is 6% per year. The discount rate is 25%. The capitalization rate is now 19%, and this is divided into expected FCF to determine the company's value. If the next year's (or sustainable) FCF is $3 million, the company would be worth $3 million divided by .19, or $15.8 million before considering appropriate discounts or premiums. The underlying concept here is that the investor is looking to obtain a return on investment that justifies the risk. In this case, the return would be 19% on the expected annual FCF.

Discounted cash flow approach: A similar approach is the discounted cash flow method. Here the discount rate (25% in this case) is applied to a measure of FCF. Theoretically, all the earnings could be paid out this way to justify the investment, and this would provide a benchmark for determining value. Again, annualized free cash flows are determined; these are then discounted back to the present at the required rate of return or discount rate. The appraiser will add a terminal value at the end of the forecast period to complete the analysis.

The choice of method will depend on the degree to which past earnings are the best predict of future earnings. Discounted cash flow will be used when a good case can be made that the future forecasted earnings are more indicative of what the company will make.

The discount rate is determined by a weighted average cost of capital calculation. In simple terms, this is the rate of return the hypothetical buyer needs. The weighted average cost of capital is a way to look at the various components a buyer should think about in calculating that. The buyer would want to know what interest rates are (debt capital), what the yield is on equity investments (the cost of equity capital), how much the equity in the company is relative to equity plus debt, and the tax rate of the buyer, not the ESOP company. The buyer's tax rate may not be the same as the target company. That is especially true in an S corporation ESOP where part or all of the income is shielded from tax. The buyer cannot be presumed to be an S corporation ESOP but must, instead, be presumed to pay a normal corporate tax rate. That means the after-tax earnings of an S corporation will be reduced when applying the tax rate of the hypothetical buyer. In addition, a company risk factor is usually added of between 1% and 3% to reflect the additional return the buyer will need for investing in a company with this risk profile.

With either method, the value of each year's projected earnings over the next five years is progressively discounted, and the residual value of all future years after that is added. These out years become so highly discounted that they can be estimated as a lump sum. The total of these numbers is the enterprise value. Debt is subtracted from that, then divided by the number of shares. That value may be further adjusted for lack of control, lack of liquidity, and the repurchase obligation, as discussed below.

The discount rates vary over time and with a variety of factors. In recent years, discount rates of 12% to 20% have been common.

What Discounts or Premiums Apply to ESOP Value?

Whether or not any discounts and/or premiums apply to the indicated values derived using the valuation methods described above depends on numerous factors. In ESOP valuations, discounts generally fall into two categories: liquidity and control. These are discussed in more detail below. But before knowing whether to apply a discount, it first must be determined whether or not the valuation is being conducted on a controlling interest (or enterprise) basis or a minority interest basis. Then, depending on the method and data used within the valuation method, appropriate discounts and/or premiums are applied. Similarly, whether to apply a liquidity discount depends on whether the comparisons used to determine value are based on liquid or illiquid interests in companies.

Liquidity and Repurchase Obligation Issues

If you buy shares in IBM, you can sell them any time and get your money in three days. If you buy stock in Sally's Computers, there is no ready market for the shares. You might not be able to sell them for years, and you may have to settle for less than market price if you need the money and no one is eager to buy. This lack of marketability creates a discount over the price for the sale of otherwise comparable shares in a public company or shares in a closely held company about to be sold (because in this case there is immediate liquidity). So in any closely held company selling shares other than in a total sale, there is a discount over what the price would be for publicly traded shares, usually in the range of 20% to 40% depending on the circumstances, such as any restrictions on the sale of stock, buy-sell agreements, prospects of an initial public offering, dividends, or the availability of other buyers.

Many ESOP appraisers contend that the presence of the ESOP mitigates or even eliminates this discount. ESOP rules require that departing employees have the right to put their shares back to the company (or have the company fund the ESOP to do this) at fair market value. This seems to eliminate the lack of marketability.

The reality is more complicated, however. First, there must be some assurance that the company can really muster the cash to repurchase the shares. Second, the put option does not belong to the ESOP, for which the appraisal is being made, but the participants in the plan. Third, the put option applies only in a limited window of time and only when people leave the company or can diversify their accounts. That is hardly the equivalent to owning shares in a public company.

Appraisers argue back and forth on the legal and practical issues involved here. The typical discount for lack of marketability in an ESOP company, according to NCEO studies, is 5% to 10%.

In some appraisals, the liquidity discount is where the repurchase obligation is reflected. In that case, setting a liquidity discount should not simply consist of picking some round number that seems reasonable. The obligation of a company sponsoring an ESOP to buy back shares from departed ESOP participants represents a future use of nonproductive assets. This obligation means money is not available for other uses. If the company "recycles" the shares, either by contributing cash to the ESOP to buy the stock or by buying the stock directly and recontributing it to the ESOP immediately or over time, then the number of outstanding shares remains the same, while the discounted future cash flow per share declines by the magnitude of the obligation. This should produce an iterative set of calculations. The obligation will lower value, but the new lower value means a lower future obligation.

The calculations keep being repeated until a solution is found. The resulting number should be a precise one, just as other elements of the valuation are, not just a "best guess."

On the other hand, if the company redeems shares and does not recontribute them, then the number of shares drops proportionately to the decreased future cash flow, producing a neutral effect on share value but reducing enterprise value.

An emerging (and we think better) practice for the repurchase obligation, however, is to calculate the amount of the obligation over the coming years that is in excess of what the company would normally pay for benefits. This results in lower projected earnings. That results in a lower value, which makes the repurchase smaller, so the calculation is run again (and again and again in what is called an iterative process) until a solution is found. This calculation is affected by how much cash is in the ESOP, recycling versus redemption policies, and other factors.

In some cases, the ESOP trust already has considerable cash, often because the company is an S corporation and has an ESOP that has received ongoing distributions, or because the company has contributed cash in addition to stock. In effect, these transfers have already accounted for the repurchase obligation in lower earnings than otherwise would have been the case, so an additional discount is not needed.

Including the repurchase obligation in the valuation requires the appraiser to have a copy of a repurchase analysis. Companies that do not go through this process, and do not require the appraiser to factor it into the final result, will overpay for the shares, endangering the future ability of the company to grow or to honor its repurchase obligation.

Lack of Control (Minority Interest) Discounts and Control Premiums

In most ESOP valuations in the past (and some still today), a company with a minority ESOP would be valued with a discount for lack of control and would get a premium when the ESOP went over 50%. The value of this was largely a matter of judgment from the appraiser. That approach has changed, however, and, especially if you are a minority ESOP, you are likely to see a more complex and possibly mathematical calculation.

The ESOP community is adopting a firmer and simultaneously more nuanced position regarding the attributes and value of "control" in ESOP transactions and valuations. Under a more nuanced framework, the appraiser typically starts by determining a value for the enterprise as a whole based on the supposition that regardless of how much the ESOP owns, the company will endeavor to use its assets in a financially responsible and optimal way. The premise is that similar to that applied to public companies, where there is rarely a singular controlling owner and the business is operated with the objective of maximizing shareholder outcomes. Executives and managers in public companies who fall short of achieving shareholder objectives on a standalone basis, whether due to suboptimal results or industry disruption (among other reasons), may find their businesses exposed to strategic events, including mergers, acquisitions, and/or divestitures, whereby the new or successor business is expected to provide superior investor outcomes that result primarily from enhanced cash flows. In contrast, if an industry player perceives opportunity in a business combination with a lesser and/or optimizable target, there will be strategic acquisitions aimed at enhancing value outcomes for all (i.e., 1 + 1 = 3). When these events occur and the underlying pre-transaction values are compared to the transaction values, there is almost universally a measurable value premium. Generally, this premium results from the expectation that cash flows and the resulting investor outcomes from a business combination will be superior to that of a standalone going concern, even under the presumption that the standalone enterprise is already reasonably optimized.

The increasing, if not consensus, view of the ESOP valuation community is that the use of control premiums in their legacy form and magnitude likely result in valuations that reflect efficiencies and/or synergies associated with strategic control value. In doing so, these valuations likely reflect value in excess of fair market value and are thus at risk for being labeled "prohibited transactions" using conventional ESOP regulatory interpretations. If an ESOP valuation contains explicit strategic treatments to cash flows or the implied equivalent by way of an excessive control premium, the value is likely overstated and potentially problematic for the transaction and/or the ESOP's future sustainability. While such synergies and efficiencies might be available in a marketplace of motivated investors, such treatments are not directly relevant to fair market value in the normal course of an ESOP company that remains an independent going concern on a standalone basis.

If a closely held ESOP company whose valuation begins with a financial control model for the company as a whole (or something constructively similar) has an ESOP that owns less than a controlling interest, then the valuation for ESOP purposes may require discounting to reflect the additional value captured in the underlying model. But the economics of control can get foggy and require nuanced understanding and careful consideration. For example, company bylaws may require a supermajority for certain decisions. So even a majority ESOP trustee may not have full control, and there could arguably be some potential discount for that, but not as much if the ESOP had no control rights at all.

Another critical issue is that the DOL has been skeptical about the argument that an ESOP trustee has full control even with supermajority or 100% ownership. For instance, if the seller is on the board, does that mean the seller retains some control? In itself, it probably does not, especially if the seller is no longer the CEO and there are outside board members. But what if the seller is the CEO and the majority of board members are his or her employees? Or what if the seller has covenants on the ESOP loan restricting the use of cash flow before a seller note is paid? These factors and others might lead to an analysis of partial control. The challenge of quantifying the effects of governance and differentiating values as a result of form over economic substance is not unique to ESOP valuations and quite frankly may never be fully resolved. The remedy for overcoming the questions surrounding control and its varying shades of gray are likely in the substance of the transaction terms and consideration, thus removing as many doubts as possible about the pro forma economics and cash flows that will affect the ESOP company's performance after an ESOP transaction.[1]

The Impact of Leverage on Valuation

If the ESOP borrows money, it will have an impact on valuation. The interest expense on the new debt the company now has taken on to fund the ESOP will show up on the balance sheet and, in any event,

1. Tim Lee of Mercer Capital contributed valuable editorial suggestions on this section.

represents a significant non-productive expense. While this generally will not reduce value dollar-for-dollar (there are ESOP tax benefits, the company may grow, and there is a discount for the future value of money), it will reduce the post-transaction value. This effect will disappear as the loan is repaid.

This impact is important for two reasons. First, employees need to understand why this drop occurs. Their own account values start at the lower value and thus are not reduced by the debt (unless the loan is to a previously existing plan), but they need to understand the issue to avoid communications problems. Other owners will also see their share price drop, of course. If they plan to sell before the ESOP loan is repaid, this could present a problem. In some cases, companies arrange for pro-rata sales from owners to avoid this issue.

S Corporation Issues

When the ESOP trustee receives a statement of the pro-rata share of earnings on which taxes would be paid each year, the trustee can ignore it. ESOPs do not have to pay tax on their share of the S corporation's earnings. Clearly, S status with an ESOP can enhance earnings, yet, just as clearly, a potential willing buyer would be unlikely to maintain the ESOP. So from that buyer's standpoint, the future earnings would be unaffected by this special tax benefit. As a result, the standard practice in ESOPs is to not "tax effect" the earnings. However, over time, the tax savings will help the company grow faster and more profitably.

Conclusion

The requirement to have an ESOP appraisal is designed to assure that the ESOP process is fair to all parties involved. While many business owners would prefer to set their own prices using a formula or a number derived from prior offers, these simplistic approaches rarely result in the price the ESOP would pay as a financial buyer. ESOP trustees, as well as owners, managers, and employees of ESOP companies, need to understand the valuation process well.

Chapter 3

Financing the Leveraged ESOP

Kenneth E. Serwinski

Borrowing money to finance a leveraged employee stock ownership plan (ESOP) can be a challenge for closely held companies. Most successful business owners have learned that debt management over a long period of time can be quite demanding. Financing a leveraged ESOP actually recapitalizes the company, which is necessary to fund this exit strategy for existing shareholders. The bottom line is that the business owners are replacing equity with nonproductive debt. The strategy behind structuring a good transaction is to minimize the effects on the balance sheet and cash flows with thoughtful determination of working capital and capital expenditure needs. There is an overriding assumption in this process that the financial information available is good information. Before considering structuring issues, one should understand some of the credit criteria necessary to obtain this type of loan.

The Four C's of Lending

When deciding whether to grant a loan, lenders often base their decision on what are commonly known as the four C's of lending: character, cash flow, collateral, and capital.

Character

In evaluating an ESOP's feasibility in a closely held business, an honest assessment of the existing management is necessary. The success of an ESOP will be determined by management's ability to protect the operating model and preserve a culture that will allow the new ESOP company to thrive. Inexperienced or weak management could hinder the establishment of a successful ESOP.

When reviewing a phased ESOP transaction, one must consider the expected future involvement of the current business owner. In a phased ESOP transaction, the owner remains involved while creating an employee ownership environment and discovering new managerial talent. Many companies establish an ESOP to give quality management personnel the opportunity to demonstrate themselves as the owner's true successor. As a control transaction occurs, the lender places greater emphasis on the depth of management than on the involvement of the former owner. In the case of a 100% transaction, there is a mandate for a high level of confidence that the successor management is sound.

Finally, lenders look to the credit history of both the owner and the company to understand the true character of each. A poor credit payment history, combined with litigation problems, would certainly turn off most lenders.

Cash Flow

Most successful ESOPs result from successful companies. Strength of cash flow emanates from a sound operating model and good financial information. To analyze the effects of an ESOP loan on the company, advisors tend to look for good historical trends of profitability and cash flow. More importantly, one should study realistic projections of the company and its profitability during the course of the loan's amortization period. Projections can be difficult to rely upon; however, most companies can project the next two years' performance with some reliability. Because the ESOP loan, which represents nonproductive debt, is being put in place, the debt service coverage that most lenders look for would be in the range of 1.25 to 1.75 times cash flow. This is an indicative range. Some aggressive lenders may agree to a lower multiple for the first two years of the loan and establish a provision for a larger cushion over time.

Last but not least, because this is nonproductive debt, the company needs to satisfy its ongoing working capital and capital expenditure requirements. Thus, the company must have access to further credit if it cannot finance growth internally. The key is to structure a deal that will allow the company to continue to grow despite the addition of ESOP debt. The combination of understanding historical trends and future projections, along with adequate debt service coverage and access to additional credit, are important factors in structuring an ESOP loan that will not "kill" the company.

Collateral

The company generally must make collateral available for any loan it makes, including an ESOP loan. The lender, which always requires a second "way out" of a loan, will liquidate this collateral if chronic cash flow shortfalls occur and insolvency is a possibility. Once the collateral is known, its strength must be determined. Most businesses in a manufacturing environment have accounts receivable, inventory, equipment, and real estate available as collateral. Some of those assets, however, may already be used as collateral for the working capital, lines of credit, equipment loans, or real estate mortgages. If, however, some of the longer-term assets, such as equipment and real estate, are unencumbered, such assets might make reasonable forms of collateral to many lenders. Ideally, long-term loans should always be collateralized with these fixed assets.

If, as in the case of service businesses, there are limited fixed assets available for collateral, other alternatives may need to be considered. The most prominent alternative in service businesses is the pledging of Section 1042 replacement securities. (Section 1042 of the Internal Revenue Code allows the owner of a closely held C corporation to defer taxation of gains on stock he or she sells to an ESOP if the ESOP owns 30% of the company's stock after the sale and the selling shareholder reinvests, or "rolls over," the proceeds in qualifying replacement securities.)

Capital

After addressing whether the company has enough management infrastructure to make an ESOP loan work, whether the company has enough cash flow to handle the debt, and whether the lender feels comfortable with the collateral available, the next task is to understand the company's capital base. Adding an ESOP term loan will significantly affect the company's balance sheet and leverage, as tables 3-1 and 3-2 below illustrate. Table 3-1 demonstrates that the company has total liabilities of $8 million against a net worth of $6 million, producing a leverage ratio of 1.33 to 1.

After the $3 million ESOP loan is implemented, the total liabilities increase to $11 million, and there is a contra hit to equity of a similar dollar amount increasing the leverage from 1.33 to 1 to 3.67 to 1 (table 3-2).

Table 3-1. Balance sheet before stock purchase ($3,000,000 loan to buy 33% of outstanding shares)

Current assets	$8,000,000	Current liabilities	$5,000,000
Fixed assets	6,000,000	Long-term liabilities	3,000,000
Total assets	$14,000,000	Total liabilities	$8,000,000
		Net worth (assets – liabilities)	$6,000,000
		Leveraged ratio	1.33 to 1

Table 3-2. Balance sheet after stock purchase ($3,000,000 loan to buy 33% of outstanding shares)

Current assets	$8,000,000	Current liabilities	$5,000,000
Fixed assets	6,000,000	ESOP loan	3,000,000
Total assets	$14,000,000	Long-term liabilities	3,000,000
		Total liabilities	$11,000,000
		Net worth (assets – liabilities)	$3,000,000
		Leveraged ratio	3.67 to 1

ESOP Loan Structure

From the previous discussion, one can understand that structuring an ESOP loan can be quite challenging. Not only is the impact of the ESOP loan an issue; one must also be concerned with future working capital and capital expenditure needs so as not to encumber the company in such a manner that future growth is prohibited. ESOP loans are usually structured as follows:

Loan. A loan can be made either to the company or to the ESOP trust. Most lenders prefer to make ESOP loans to the company, since the loan then becomes a direct obligation of the company. The company in turn will make a loan at substantially the same terms and conditions to the ESOP trust. The internal loan amortization will most likely be different from an external loan and dictate share allocation and employee retirement benefits. A minority of lenders would consider loaning directly to the ESOP trust, but only if the company guaranteed the loan.

Amortization. ESOP loans typically have amortization periods of from five to ten years, with five- to seven-year full payout terms being the most popular. Most lenders are quite reluctant to go longer than ten years, and even then, there will probably be a balloon payment after year five and certainly after year seven.

Collateral. Lenders may ask for collateral that ranges from Section 1042 replacement securities to receivables, inventory, equipment, and real estate.

Covenants. The imposition of covenants is directly related to the level of debt inside the company. It is not unusual, however, for lenders to have covenants for minimum cash flow coverage or debt service along with covenants for net worth to be kept at certain levels. Additionally, restrictions may be placed on seller note principal payments, dividend payments, amounts of capital expenditures, and bonus and compensation limits for existing shareholders.

Guarantees. Selling shareholders often must give personal guarantees, which can be a sticking point for them. The quality of collateral and the level of cash flow may determine whether and to what degree personal guarantees are necessary. Some guarantees cover collateral shortfalls. For example, if a borrower seeks a $2 million ESOP loan and the bank, understanding the liquidation value of the assets being pledged, finds that the borrower is a half million dollars short in collateral, the bank will require a limited guarantee only up to that half million dollars. When Section 1042 rollover securities are pledged, the quality of the collateral is such that some lenders will forgo the personal guarantee to obtain 100% liquid collateral. Interestingly, in the case of 100% transactions (or movement to 100%), personal guarantees are not required. Though this seems counterintuitive, this is because the company has been sold in its entirety. Sellers are not asked for guarantees because there is no consideration for them to do so.

What the Lender Will Ask For

Ideally, the lender, in considering the proposal for an ESOP loan, will look for at least three to five years of historical financial information as well as projections. Financial statements must, at a minimum, be reviewed; preferably, they should be audited. In addition to financial statements, the lender will look for pro forma projections for both the income statement and the balance sheet. Providing the projections is just the beginning. Notes to those projections should include the assumptions underlying them. For example, where improvements in operating margins that have not occurred in the past are projected into the future, the reason for the improvement must be revealed. These pro forma projections must also include potential cost reductions, which can occur in many ways. Perhaps the selling shareholder is willing to reduce his or her salary to enhance the cash flow position. Alternatively, the company and its employees may decide to freeze or cut back wages to make the ESOP work.

Finally, the lender will ask for a report on available collateral. This will include an accounts receivable aging; an inventory breakdown, if appropriate, between raw materials, work in process and finished goods inventory; a fixed assets schedule; and appraisals of fixed assets as well as of the availability of the Section 1042 rollover securities as collateral.

The Borrower's Perspective

Although we have been reviewing what a lender might consider important in making an ESOP loan, it is appropriate to consider the borrower's perspective as well. ESOP financing has significant advantages over traditional forms of debt. The owner has probably looked at other exit strategies and determined that they are not appropriate for his or her particular company. There are few exit strategies available to the business owner, namely:

- *An initial public offering.* Taking the company public is not a complete exit strategy for the business owner. It can, however, be a phased exit strategy for the right kind of business.
- *Selling the business outright.* Selling the business to a third party is a definite consideration for many business owners. However, most buyers of a business do not pay completely in cash. They may pay a significant portion of the price, somewhere between 40% to 70%, as a down payment, but some form of seller financing may be required. Thus, the business owner becomes a partner with a buyer he or she does not really know.
- *Recapitalization for a family or management buyout.* To fund a family or management buyout, a significant amount of debt, either senior debt or senior/subordinated debt, may be required to effect a transfer of ownership. This can incur significant levels of debt, with the amortization of the loans being made with after-tax dollars.
- *Recapitalization using an ESOP.* This is a tax-advantaged form of recapitalizing the business for shareholders to realize value and liquidity. Because the ESOP is a qualified retirement plan, the company can make contributions to the ESOP on a pretax basis. This feature allows for amortizing the ESOP loan, both principal and interest, on a tax-deductible basis.

What Should the Borrowers Look For?

Borrowers must find lenders experienced in ESOP financing. Lenders and their counsel who are inexperienced with ESOPs need a tremendous amount of "handholding" to effect the transaction. This handholding can get very expensive in terms of time and dollars. When evaluating proposals from lenders, terms and conditions play a significant role. Look for favorable terms in amortization schedules, collateral, and guarantees. Rates and fees are certainly important, but realize that the lender is actually being asked to finance a leveraged buyout of existing shareholders and that rates and fees may reflect that level of risk. Be sure to take an active role in the selection of bank counsel that will document the financing transaction. If legal counsel is not familiar with the various nuances of ESOP financing, do not allow the bank to engage their services. Demand experienced counsel; doing so will significantly control your legal costs.

Alternative Financing Strategies

As a general rule, owners of closely held businesses shy away from leveraging up the balance sheet of their company. Thus, the idea of a leveraged ESOP scares them. There may be other alternatives that still allow owners to consider a leveraged ESOP. Some companies have significant amounts of corporate cash or marketable securities. Such a company can self-finance a leveraged ESOP. Companies with this type of cash and investments on hand, however, are rare.

With business owners wary of capital markets, a significant number of ESOPs have used seller financing to either partially or fully fund the transaction. Seller notes can take much less time to set up than bank loans and can be less costly because the bank often requires additional and sometimes costly additional paperwork (and legal fees that may go with it). Because banks often ask sellers to pledge personal assets for the note anyway, many sellers see seller notes as carrying no greater risk.

In a typical seller-financed transaction, the seller takes a note from the company (which then reloans it to the ESOP, much as in a bank loan structure) at a stated rate of interest that reflects not more than what an equivalent arms-length loan would pay given the risk. Interest rates range from a low of the minimum applicable federal rate (AFR) published by the Internal Revenue Service up to a rate of 8%, with the majority falling in the 4%–6% range. The terms of the two loans do not have to match. For a variety of reasons, it is preferable for the seller note not to be made directly to the ESOP, most notably that there is a lot more flexibility in the case of default and how rapidly shares get released from the ESOP suspense account. A 2011 NCEO survey indicated the notes were typically in the 5% to 8% range, but will vary with market conditions. The company issues a note to the ESOP and makes contributions to the trust to repay it. The seller note will be subordinated to any senior lender. Seller-financed notes can be "refinanced" with a third-party lender at any time during the payback period should the company decide it is prudent.

In some cases (perhaps as many as 20%, according to the NCEO survey), the seller notes have a more complex structure. Seller notes can be structured with 10- to 20-year amortization schedules and a balloon payment, for example. Interest rates can reflect competitive market rates, and the yield on the notes can be enhanced with a warrant feature. (In this context, a warrant is essentially a right to purchase a fixed number of securities at the value they have at the sale to the ESOP for some number of years into the future.)

The warrant is a financial instrument that gives the warrant holder the right, but not the obligation, to participate in the performance of the underlying security. When the warrants are issued, a strike price is set. The strike price may be the underlying stock price at the time of the transaction. These traditional warrants act as a kind of sweetener that allows the issuer (company) to offer a lower coupon rate. Over time, the warrants build value as the stock price increases (i.e. current stock price - the strike price = warrant value). The value of the warrants will be paid to the holder on the expiration date.

A seller would receive a coupon rate of interest on the note with the warrant, providing a market rate of return reflective of a note subordinated to a lender or bonding company. Hence, the mechanics for the seller are to take part of his or her payment on the note in the form of interest and part in a warrant, in effect receiving current return in interest and future consideration in warrants for x number of shares at the time of the sale and receiving the right to buy those additional shares at that price for some number of years into the future (usually not exceeding 10 years). The seller would actually never do that; instead, the company would repurchase the right before it is exercised. These equity "kickers" can provide note holders with total yields in the low double digits, between 10% and 14% in most cases. Returns will always be reflective of the current market. Seller notes are not an all-or-nothing proposition. For example, a bank might finance part of the total package, with the seller note subordinated to the bank loan (and, therefore, potentially having a higher rate of return than if it is the only financing).

This type of financing creates a unique opportunity for both the company and the seller. The company can be the recipient of a financing package that is unlikely to be available through commercial banks. The seller gets a rate of return that is better than what could normally be obtained in other interest-bearing investments. The company can leave its relationship in place with the bank so that it continues to retain working capital lines of credit as well as other forms of capital for growth. The noteholder will, of course, need to subordinate its interest to that of its bank. The seller can also defer taxation on the gains made from the sale, as described in the chapter on using the Section 1042 tax-deferred "rollover" that appears later in this book.

There are negatives in providing seller financing: limited or no immediate liquidity, the risk of loss of principal, and the need to remain tied to the business if a full exit is desired. However, the positives of reducing the lead time for the transaction, lower transaction costs, repayment flexibility should cash flow issues arise, and achieving a fixed income component with market-level returns can be very appealing to sellers.

Much has been written about the use of assets in existing retirement plans to partially fund a leveraged ESOP to reduce the amount of debt required to complete a transaction. Often, in closely held businesses the shareholders themselves function as trustees of 401(k) and profit sharing plans. The idea of converting a portion of those assets into "equity" in a leveraged ESOP is difficult from a fiduciary standpoint. Keep in mind that they are selling shareholder-trustees of these retirement plans; as fiduciaries, they are acquiescing to the use of funds that are currently invested in a wide variety of debt and equity instruments that will now be invested in employer securities. This creates not only a fiduciary concern but also perhaps an elimination of an employee benefit. There have been cases involving existing retirement plans where a portion of those plans' assets have been converted to an ESOP. Although no one has indicated what might soften fiduciary responsibility when a selling shareholder is a trustee, there may be a conflict-of-interest concern if a shareholder-trustee uses more than 10% to 20% of the retirement plan assets in a new leveraged ESOP. It should also be noted that since you are asking the participants of diversified qualified retirement plans to shift their assets to this concentrated employer security plan, significant financial disclosure will need to be made in order for plan participants to make a sound investment decision. This is not particularly palatable to most companies.

Many business owners try to accomplish as much as possible in a first-phase transaction. A very viable alternative is to scale back the size of the initial transaction to ease cash flow concerns. This also allows the company to continue growing even if the thought of leverage scares the business owner. Another possibility is for the company to initiate an unleveraged ESOP in which contributions for purchasing any employer's securities can be made. This allows the company to begin setting aside monies for the actual stock purchase at a later date. Then, when the selling shareholder is ready, the stock can be purchased either on an unleveraged basis, or on a leveraged basis that uses less debt than would be necessary on an unleveraged basis.

Conclusion

Leveraged ESOPs are viable alternatives as exit strategies. This form of recapitalization has excellent tax advantages not only for selling shareholders, but also for the company sponsoring the plan. The ability to pay back loans with pretax dollars is a tremendous advantage in any type of leveraged buyout. It is important, however, that a financial advisor structure the transaction so it does not encumber the business in a way that inhibits future growth. Structured properly and with great care to allow for amortizing the loan satisfactorily, the leveraged ESOP is a powerful tool in managing the transition of a business to the next generation, thus providing effective business succession planning.

Chapter 4

ESOP Feasibility

Ronald J. Gilbert and Paige A. Ryan

Whenever the subject of ESOP feasibility is discussed, the following basics will always or should always be examined:

- Is the valuation acceptable to the selling shareholder(s) and to the ESOP trustee?
- Will the cash flow of the company support the debt needed to acquire the block of stock being offered to the ESOP as well as future capital needs?
- Can the divergent interests of various shareholders be accommodated through the ESOP?
- Will the repurchase obligation costs associated with the buyback of stock from departing ESOP participants in a closely held company be manageable?
- At what level of ESOP ownership are current shareholders comfortable?
- Will the corporate governance issues, including adding outside directors in the case of a majority ESOP, be acceptable to current controlling shareholders?
- Will the required ESOP contributions fall within the allowed limitations?

In addition to these basic items, we recommend that a number of other factors be examined in a feasibility study to identify red flags early in the process, which may indicate that an ESOP is not feasible or that a better option exists. The feasibility process begins with general discussions to develop an understanding of owner and corporate objectives;

ESOP tax benefits; ESOP mechanics, including financing; and qualified plan requirements and limitations. It is also important to understand the costs associated with assessing, implementing, and operating an ESOP. This process includes understanding the specifics of each stage of the process, including the preliminary analysis, and the issues addressed by the initial feasibility study, including transaction design, plan design, management incentives, fiduciary and ESOP management issues, special S corporation ESOP considerations, and creating an ownership culture. Each of these topics is addressed in the discussion below.

Tax Benefits

ESOPs often provide substantial tax advantages to the company, selling shareholders, and employees.

Tax-Deductible Principal Repayment[1]

Contributions used to make ESOP loan principal payments are tax-deductible to the corporation.

Tax-Free S Corporation Income[2]

Income attributable to stock owned by an S corporation ESOP is not subject to federal tax. This benefit may not be available for companies with approximately 15 or fewer employees, due to Code Section 409(p), and may not be feasible for companies with a larger number of employees.

Tax-Deductible C Corporation Dividends[3]

Dividends on C corporation ESOP stock that are "passed through" the ESOP to participants or used to repay ESOP loans may be tax-deductible to the corporation. These dividends are not counted in the normal contribution limit of 25% of payroll.

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1. Internal Revenue Code ("Code") Section 404(a)(9).
2. Code Sections 409(p) and 512(e)(3).
3. Code Section 404(k).

Contributions May Be Reimbursable Under Federal Government Cost-Plus Contracts[4]

Under certain types of federal government contracts, the company is reimbursed by the federal government for the ESOP contribution. Both cash and stock contributions are allowable costs, and thus are reimbursable. There is no distinction between S corporation and C corporation ESOPs. The Cost Accounting Standards Board (CASB) issued a final ruling in May 2008 that applies to federal government contractors that sponsor ESOPs. The effective date of 48 CFR Part 9904 was June 2, 2008. It amends Cost Accounting Standards (CAS) 412 and 415, which clarified that the contractor's cost shall be measured by the contractor's contribution. The CASB did not use the GAAP approach in SOP 93-6, which measures compensation expense for a leveraged ESOP based on the fair market value of shares released in a year.

Section 1042 "Tax-Free" Rollover Benefit and Eligibility

The major benefit for an eligible shareholder selling stock to an ESOP sponsored by a closely held C corporation is the "tax-free" rollover under Code Section 1042. However, a significant tax benefit is derived only if there is a substantial difference between the basis in the selling shareholder's stock and the selling price to the ESOP. Most shareholders in closely held companies have a low basis in their stock, and thus most of the selling price of their stock is subject to capital gains taxes. The ability to defer this tax by a sale to the ESOP is therefore very attractive. Assuming a long-term federal capital gains rate of 20%, and up to 23.8% with the Medicare surtax, and assuming a state capital gains rate of 9%, this tax benefit would be worth approximately 25% to 33% of the selling price, or a minimum of $250,000 for every million dollars of the ESOP transaction.

However, to the extent that the stock being sold to the ESOP had a basis equal to or greater than the selling price, there would be no capital gains tax liability. If the basis were only slightly below the selling price, the amount of capital gains tax would be minimal. Thus, the first item on our "preliminary assessment" or "pre-feasibility" checklist is to look at the basis of stock versus the selling price.

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4. Federal Acquisition Regulation Section 31-205.6.

An example of shares that frequently have a basis near the current fair market value of the stock is stock acquired through the distribution from an estate of a deceased shareholder. Thus, children who have recently received stock from the estate of one or both of their parents typically enjoy little or no tax benefit from selling that stock to an ESOP. If the "tax-free" rollover is elected, and the qualified replacement property (bonds or stocks of U.S. operating corporations) is held until death, the estate, under current tax law, receives a "stepped up" basis at death. The effect is that the capital gain tax is extinguished. In this scenario, the capital gains tax is never paid.

Eligibility

- Stock with a holding period of less than three years, stock of publicly traded companies, S corporation stock, and "Section 83b" stock is not eligible for tax-free rollover treatment.
- Stock acquired in connection with employment is generally not eligible for tax-free rollover treatment. An example would be stock purchased by an employee through a corporate-sponsored stock option program. Stock distributed from a retirement plan, such as a 401(k) plan or an ESOP, also is ineligible for tax-free rollover treatment.
- If the corporation is publicly traded, its stock is ineligible for tax-free rollover treatment. This includes stock listed on the New York Exchange, AMEX, or NASDAQ. Being listed on an electronic exchange may make the shares ineligible for tax-free rollover treatment. C corporations are specifically prohibited from electing Section 1042 treatment.
- Only voting common stock with the highest dividend rights or convertible preferred that is convertible into voting common stock with the highest dividend rights is eligible to be sold for tax-free rollover treatment.

If, however, a shareholder holds stock that is ineligible for "tax-free" rollover treatment, it may be possible to have a tax-free recapitalization that converts the existing ineligible stock (nonvoting common, straight preferred, etc.) into eligible stock. The details that determine whether such a recapitalization can be accomplished on a tax-free basis go beyond the scope of this chapter. Shareholder approval of such recapitalization is normally required. If such a tax-free recapitalization can be accomplished, the holding period of the old security prior to conversion is normally "tacked on" and can be used to satisfy the three-year holding period required for tax-free rollover treatment. It is not generally necessary to start the "holding period" clock over again after a conversion.

If the selling shareholder who is eligible for "tax-free" rollover treatment elects this treatment and the sponsoring company consents to the treatment, then certain shareholders are prohibited from receiving ESOP allocations on any stock subject to the tax-free rollover election. This group of stockholders includes selling shareholders, their immediate family members, and any more-than-25% shareholders. There is a one-year "look back" in determining this percentage. Furthermore, attribution rules apply. For example, the son of a shareholder owning 75% of the company's stock is deemed to own 75% of the company stock by attribution; thus, he is ineligible to receive ESOP allocations on stock sold to the ESOP if the seller of that stock made the tax-free rollover election. There is a narrow exception that allows family members to receive ESOP allocations, but the exception does not apply to the attribution rules. Hence, in most cases family members end up being excluded completely from receiving ESOP allocations.

In smaller companies, especially those with a heavy concentration of family member employees, this allocation prohibition may be a reason for selling shareholders to pay capital gains tax on the sale to the ESOP. If this occurs, sellers and family members may then receive allocations of stock in the ESOP, and the ESOP allocations would over time "make up" for some of the capital gains tax that was paid. Without the participation of family members, the covered payroll eligible to receive allocations may be reduced to such a low level that it would not be possible to make the necessary contributions to repay ESOP debt without substantially exceeding the ESOP contribution limits.

The exclusion of certain shareholders from ESOP allocations is not normally a problem in larger companies. To the extent that the corporation would want to make these excluded shareholders whole, it could do so through some type of nonqualified deferred compensation agreement or cash-bonus program that would provide the excluded employee with a future benefit equal in value to the benefit that would have been allocated under the ESOP.

Post-Transaction Decrease in Value

Another issue to be addressed with a leveraged ESOP is the so-called "post-deal drop" in value. In most ESOP transactions, the per-share value of the stock declines after the leveraged ESOP transaction is completed. ESOP appraisers recognize that the corporation then has additional debt and the requirement to service that debt may mean decreased net earnings after the ESOP loan is in place. However, the post-deal drop in value is normally recovered as ESOP debt is repaid. Thus, its biggest impact will most frequently be in the years immediately following the leveraged ESOP transaction.

Financing

The next issue for many ESOPs is how to finance the transaction. Can the company, in fact, borrow sufficient funds to enable the ESOP to acquire stock from the selling shareholders? Funding the ESOP's purchase of shares and serving the associated debt is the company's responsibility, through contributions and dividends to the ESOP. If supporting the financing burden is too heavy for the company to bear, there are a number of strategies to consider to make the ESOP feasible.

Seller Financing

To the extent that bank financing is unattractive or not available to acquire all of the shares offered to the ESOP, and higher-interest mezzanine debt is not available or not desired, a frequently considered alternative is seller financing. This means that the selling shareholder holds a note from the ESOP for some or all of the transaction amount. If a bank provides some of the debt, the seller note is, in almost all cases, subordinated to a bank loan.

Newly Issued Stock

Another alternative to solving the financing issue is the sale of newly issued stock to the ESOP, which can be in combination with the sale by existing shareholders. These newly issued shares count in determining the percentage of stock owned by the ESOP and thus can be used to partially satisfy the 30% requirement needed for the tax-free rollover. Newly issued shares sold to the ESOP generate working capital for the company, which can be used for expansion, repaying existing debt, etc.

Of course, issuing new shares means dilution. Thus, the current shareholders and the company's board of directors must be comfortable with the level of dilution caused by the issuance of new stock. In some circumstances the dilutive impact can be reduced by the use of a convertible preferred stock, or a "super common" stock in a C corporation, but this also complicates the capital structure of the company.

The ultimate test of the dilutive impact of the new share issuance is determined by the return on capital the company ultimately receives. In the words of a finance professor, "If the company uses the capital productively, the shareholders will be very pleased that they were diluted, but if the company squanders the funds, the shareholders will have quite a different attitude!"

Above (or Below) the Contribution Limit

While it is normally understood that other qualified retirement plans, such as a 401(k) plan, must be taken into account when calculating the 25%-of-payroll contribution limit for ESOPs, there are some other assumptions that are made that may be erroneous.

Interest Exclusion

In C corporations, interest is usually excluded from the 25%-of-payroll limit when contributions are made to repay ESOP debt. In S corporations, however, contributions to repay interest on ESOP debt are included in the 25% limit.

Above 25%

More than one potential ESOP was almost or actually never created because of a lack of understanding of how contributions significantly in excess of 25% of covered payroll could be made to the ESOP.

As discussed above, interest is usually excluded from the 25% limit in C corporations. To the extent that 25% is still insufficient to service loan principal, dividends are the answer. Reasonable C corporation dividends can be paid on stock held by an ESOP. To the extent that the dividends are paid on stock acquired with the proceeds of an ESOP loan, those dividends may be used to repay the ESOP debt used to acquire those shares. Additionally, such dividends are excluded from the 25% of payroll limitation and are tax-deductible for C corporations. Reasonableness of C corporation dividends is determined by a number of factors, including industry averages and return on investment. However, if the ESOP owns a convertible preferred stock, or super common stock, the dividend will be determined primarily by the market indicators—for example, a typical dividend paid on similar issues of preferred stock. If, for example, the ESOP appraiser determines that for the preferred stock to be valued at par, it needs to pay a 6% dividend, and the value of the preferred stock held by the ESOP is $1 million, then the preferred stock will pay a $60,000 per year preferred dividend that is excluded from the 25% of payroll limitation.

In addition, the IRS stated in Private Letter Ruling 200436015 (June 9, 2004) that the 25% limit on contributions to repay the principal on a leveraged ESOP's loan in a C corporation is separate from the 25% limit for contributions to other qualified defined contribution plans. (This applies only to C corporations.)

S corporation dividends or "distributions" also can be used to repay ESOP debt. These are not restricted by the definition of "reasonableness," as in C corporations. These distributions are excluded from the contribution limits, which helps a company overcome the 25%-of-payroll limitation. However, unlike C corporation dividends used to repay ESOP debt, S corporation distributions are not tax-deductible. Distributions paid on financed shares may be used to repay ESOP debt. Any cash in the ESOP derived from previous S corporation distributions may be used by the trust to satisfy the ESOP repurchase obligation or to purchase newly issued shares from the corporation. Because S corporation distributions on leveraged stock can be used to repay ESOP debt, ESOP contributions in some S corporations may be considerably less than those required for equivalent C corporation transactions.

Costs

Costs are sometimes cited as a reason not to implement an ESOP. While costs should certainly be considered and understood before undertaking an ESOP, they are rarely a barrier for profitable companies paying taxes, are generally significantly lower than investment banker or business brokerage fees, and in virtually all cases are far outweighed by the tax savings.

The costs of assessing the feasibility of an ESOP, adopting an ESOP, selling stock to the ESOP, and operating an ESOP on an ongoing basis can vary substantially. The variance in fees is driven by the complexity of the transaction structure, the choice of advisors, and the financing structure. Costs are generally broken up into three phases, which include first, feasibility; second, implementation; and third, ongoing costs.

Feasibility Costs

In addition to fees for the ESOP consulting firm, feasibility costs will include the cost of time for corporate executives involved in the analysis. Corporate counsel and CPAs may also participate in this phase of discussion and exploration. A preliminary appraisal is typically obtained to provide a range of value, and this may in some cases also involve appointing an independent trustee. Additional direct costs are associated with engaging an ESOP consulting firm to run a detailed feasibility study, which should include an assessment of cash flow, tax savings, shareholder positioning, financing alternatives, repurchase obligations, employee benefit levels, and to what extent these areas are affected by plan design decisions. Feasibility costs can vary from minimal to $40,000 or more, depending on the advisory team engaged and the process used.

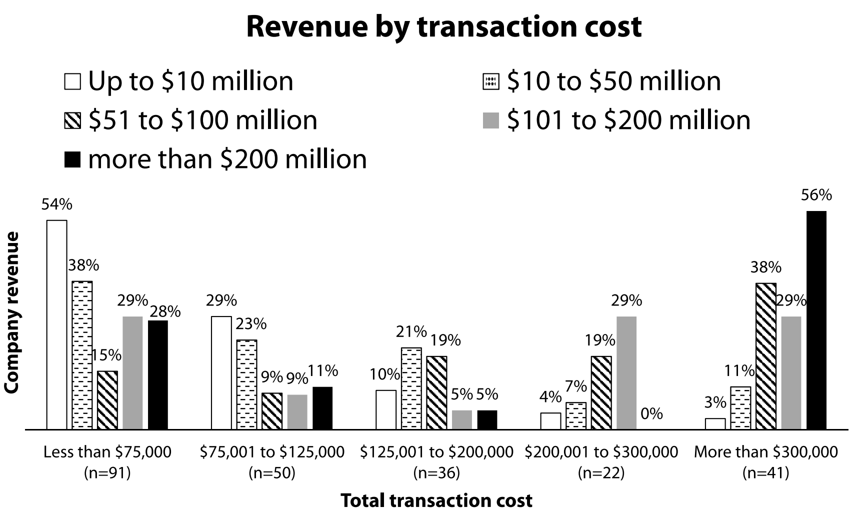
Implementation Costs

This is definitely the area where considerably greater cost is incurred versus other types of retirement plans. Executives today are most familiar with 401(k) plans, for which prototype plans are the norm. Because banks and insurance companies aggressively seek to manage the money of employee participants in such plans, they subsidize other services. Unless such a "subsidy" exists through ESOP service firms providing ongoing recordkeeping services or seeking to fund the repurchase obligation with insurance products, then the true costs of implementing an ESOP will be charged by the practitioners involved in the implementation. As a result, the costs of implementing a typical leveraged ESOP, including an independent stock appraisal, independent trustee, legal documents, and employee communications typically approach or exceed $100,000. However, costs will vary with the experience of the consultants involved, the complexity of the transaction, and sources of financing. Larger and/or more complex ESOP transactions can substantially exceed this estimate.

The NCEO's 2015 ESOP Transaction Survey found that transaction costs, including an independent stock appraisal, independent trustee, feasibility study, legal documents, and employee communications could vary from under $75,000 to more than $300,000 (figure 4-1).

Ongoing Costs

Occasionally the "tail wags the dog." That is, companies fear the ongoing costs of operating an ESOP. In fact, operating an ESOP requires a



Approximately how much did the transaction cost in total? (This would include legal, administrative, feasibility, valuation and trustee fees, and any other fees associated with the transaction paid by the company.)

Figure 4-1. Higher company revenue is associated with higher transaction costs. Source: NCEO 2015 ESOP Transaction Survey.

similar level of expenditure as operating just about any other qualified retirement plan, including a 401(k) plan, plus an annual independent appraisal fee, and possibly a fee for an independent or directed trustee. Costs for the independent appraisal usually range from $10,000 to $25,000 per year and even more for large or complex situations. Independent trustee fee minimums may be as low as $10,000 to $15,000 per year. Third-party administrative fees are typically in line with 401(k) administrative fees, with minimal additional costs due to specialized compliance testing. Many companies also set aside funds to support activities of a communications committee, discussed later in this chapter.

The Preliminary Analysis

Many companies considering ESOP feasibility determine rather quickly that it is a "go or no go." That is, they decide, after speaking to one or two advisors, or leadership of companies that have ESOPs, that either the ESOP will definitely work for them or it definitely will not work. On many occasions over the course of the past 40 years, we have seen these assumptions prove to be erroneous upon closer examination. Even companies with well-established ESOPs that are contemplating a second-stage transaction will sometimes miss a key point. That "point" can turn out to make all the difference in the world.

A preliminary assessment can be a great first step and is frequently performed on a no-cost or minimal-cost basis. By reviewing basic information provided by the company, including projected earnings and a general idea of the ESOP objectives, an experienced ESOP consultant can quickly identify any red flags that would rule out the ESOP and can quickly determine whether there is a reasonable probability of achieving shareholder and corporate objectives with the ESOP.

The Full Feasibility Study

A comprehensive feasibility study provides a decision package for the shareholders, the company's board of directors, and both shareholder and corporate professional advisors to use as a blueprint for an informed decision regarding the ESOP.

Both the technical and practical factors are identified, discussed, and assessed in a comprehensive feasibility study. On the technical side, ESOP contribution limits, the existence of other qualified retirement plans such as 401(k) plans and their relationship with the ESOP, and the company's future status as either a C corporation or an S corporation are carefully examined.

On the practical side, a comprehensive feasibility study conducts a detailed review under multiple scenarios of the company's projected cash flow and its ability to repay ESOP debt, the lenders' collateral requirements, and the projected ESOP repurchase obligation as compared with the company's future cash flow projections.

The feasibility study will also provide a detailed stockholder equity analysis showing the impact on all shareholders, current sellers, family, and management. It can also examine the impact of various management incentive plans that could interact with the ESOP strategies being evaluated.

The ESOP repurchase obligation is carefully examined and illustrated over at least a 10-year period to cash out vested employees eligible for an ESOP distribution; this analysis is sometimes overlooked by companies when installing and operating ESOPs. These projections for retirement, diversification, "other" terminations, and death and disability, can often influence the size of the ESOP's ownership of the company with respect to whether it can handle the ESOP repurchase obligation and still maintain desired growth. The study can show not only comparative transaction structures and sizes but also compare the results of choosing C corporation versus S corporation status, which often produces widely disparate results because of the different tax treatments of the two corporation types. The Tax Cuts and Jobs Act (TCJA) of 2017 made ESOPs more attractive in 2018 and beyond for many companies due to the lowering of the federal C corporation tax rates to 21%.

The ESOP design and implementation should be executed only after careful evaluation of the full feasibility study by the company and all its advisors. The focus of all concerned—as is the case with all well-designed ESOPs—is to ensure the best strategy possible is chosen because it affects the selling shareholders, the company, other shareholders and employees. In many cases, because of the extraordinary tax benefits over several years that are available only to S corporations, the choice will be an S corporation strategy. In other cases, the study will reveal that the size of a desired transaction needs to be reduced after review of the repurchase obligation analysis.

Is a comprehensive ESOP feasibility study (as opposed to an internal, or abbreviated study) really necessary? It depends primarily on whether the parties making the decision have sufficient information to definitively and authoritatively answer a number of questions.

Below are questions that address most, but not necessarily all, of the important issues that determine the feasibility of an initial or "second stage" ESOP transaction. These issues and the many more outlined below will determine whether or not a company needs an external feasibility study.

Transaction Design Characteristics

1. ***Corporate status?*** An ESOP may only be adopted by a C corporation or an S corporation. (There is one private letter ruling (PLR) for an LLC, with very specific facts.) If the company is an LLC, careful consideration must be given, based on tax and legal advice, as to whether to convert to a C or S corporation.

2. ***What is the target percentage of stock for the ESOP to acquire?*** This is sometimes driven by the desire of selling shareholders in closely held C corporations to qualify for the Section 1042 "tax-free" rollover, which requires that the ESOP own a minimum of 30% of the outstanding stock of the corporation on a fully diluted basis after the acquisition. Which shareholders qualify for the Code Section 1042 tax-deferred rollover, as well as the need to buy out specific shareholders or to avoid selling stock at a minority discount, also may affect the target percentage to be acquired by the ESOP.

3. ***When will the stock be acquired?*** ESOPs can "warehouse" cash contributions for a relatively short period of time before the ESOP acquires stock. However, loan proceeds must be used immediately by the ESOP to acquire stock. Many ESOPs purchase shares in two or three stages over a period of five to ten years or more.

4. ***Will the stock be paid for in a lump sum or in installments?***

5. ***Will this be a leveraged or non-leveraged transaction?***

6. ***If leveraged, what is the preferred length of the loan?*** If the ESOP is leveraged (i.e., a loan is made from a bank, another financial institution, or a private equity group), the lender normally will require repayment over a period of five to seven years. (The company-to-ESOP loan may be for a longer term than the bank-to-company loan.) Some or all of the qualified replacement property (from a C corporation Section 1042 transaction) or other securities may be required as collateral for the loan.

7. ***Length of the ESOP loan?*** ESOP transactions may be structured through a variety of methods, resulting in external notes between the company and lenders or sellers ("external notes," sometimes called "company notes") and a note between the company and the ESOP (an "internal note" or sometimes called "ESOP note"). With this approach, the company has the flexibility to repay the lender more rapidly if excess cash is available, while maintaining an ESOP note amortization schedule that is amortized by the annual contributions and C corporation dividends or S corporation distributions made by the company. To give the company more flexibility, the ESOP note may be structured over a longer period and should also allow prepayment.

8. ***Who sells what percentage?*** Where there are multiple owners, if one owner sells first in a leveraged ESOP transaction, the other owners will normally see an immediate decline in their stock value.

9. ***Will there be more sales to the ESOP in the future?*** Considering the possible timing of future sales to the ESOP following the first transaction may well influence the design of the transaction and duration of the financing between the company and the trust. Future sales to the ESOP can be desirable in that they tend to even out the contributions to the trust and should lessen the possibility of inequitable future allocations of stock to newer employees.

10. ***Which transaction design yields the greatest tax savings?*** Accelerating ESOP contributions will reduce taxable income but increase

the benefit expense to the corporation due to the fact that ESOP shares will normally be allocated more rapidly to the accounts of ESOP participants. Additionally, for a closely held company, the ESOP repurchase obligation may become larger more quickly when contributions are accelerated. The transaction design with the greatest tax savings is not always the most desirable. Allocating too many shares to participants in a relatively short time frame sometimes leads to an unfortunate situation of two classes of employees—those who were present at the first transaction with large ESOP accounts and employees who were hired later, after the loan was repaid, with much smaller accounts.

11. ***How does the transaction design affect benefit policy?*** A quicker repayment of the direct or internal ESOP loan means employees at the early stage of the ESOP may get higher levels of benefits than employees at a later stage. By spreading out payments, contributions can be more balanced over time, but tax benefits would be delayed. This is one reason why the company loan to the ESOP is frequently longer than the company loan from the bank.

12. ***Should a discount for a minority position be applied?*** If the ESOP will initially acquire less than 50% of the company's stock, then appraisers will apply a discount for minority interest. A number of factors determine the magnitude of this discount; however, we generally see discounts of between 5% and 15% of the value of the company.

13. ***Will the accounting treatment of ESOP debt cause the company to violate existing loan covenants or create bonding problems?*** Generally accepted accounting principles (GAAP) require that the full amount of the ESOP debt be a reduction to the company's book value. Knowledgeable banks will adjust loan covenants. The reaction of bonding companies varies widely.

14. ***What is the accounting expense to be recognized by the company when it repays an ESOP loan, and why is it different from the cash expense?*** Expense that must be recognized in a leveraged ESOP under GAAP is the fair market value of the shares released

from the ESOP suspense account in a given year. The amount of cash contributed by the corporation to repay ESOP principal is ignored in computing the GAAP expense, and the GAAP expense can differ significantly from the tax expense.

15. ***Will the accounting treatment of the ESOP debt have an unacceptable effect on bonding, other needs, or loan covenants?*** The financial statement impact of the ESOP is of particular concern to companies that are publicly traded, are contemplating an IPO, or require bonding.

16. ***Should the company use the fair market value or the cost basis of shares to determine the size of its annual contribution to employee accounts?*** The plan can specify either method or can call for using the lower of the cost basis or fair market value.

17. ***Does the company generate enough cash flow to fund the ESOP?*** A profitable company can normally afford to fund the ESOP purchases because of the significant tax savings involved, which can exceed 40%.

18. ***Will the plan comply with Internal Revenue Code contribution limits?*** Contribution limits are normally 25% of covered payroll; however, companies can increase funding to the ESOP, depending on a number of variables. Company contributions to any other defined contribution plans, such as a profit sharing or 401(k) plan, reduce the contribution limit. This includes corporate contributions but not employee deferrals to 401(k) plans. Interest is usually excluded from the 25% of payroll limitation in a leveraged C corporation ESOP. "Reasonable" dividends on common or preferred stock in C corporations as well as S corporation distributions also are excluded from the 25% limitation. Other factors affecting plan contribution levels include the allocation basis (see above) as well as allocating ESOP shares to plan participants at a slower rate than would normally occur due to the repayment of ESOP debt. The issue of contribution limits is a complex area that can make or break the feasibility of an ESOP. The 2017 bill limits net interest deductions for businesses to 30% of EBITDA (earnings before interest, taxes, depreciation, and

amortization) for four years, at which point the limit decreases to 30% of EBIT (not EBITDA). In other words, starting in 2022, businesses will subtract depreciation and amortization from their earnings before calculating their maximum deductible interest payments.

19. ***How many classes of stock are permitted?*** The ESOP must own either the best class of common stock as to voting and dividend rights, convertible preferred stock that converts to the best class of common, or any class of publicly traded common stock. Convertible preferred or "super common" stock may be used because the larger dividend that can be paid may be necessary due to Internal Revenue Code contribution limits (see above). Convertible preferred stock could be counter-dilutive for stockholders outside of the ESOP. Super common stock is sometimes a viable alternative to convertible preferred stock if an adequate investor rate of return in multi-investor ESOP transactions is a critical issue. As will be seen later, S corporations are limited to one class of stock.

20. ***Other shareholder or management concerns?*** These could include passing some percentage of stock to other individuals, maintaining a certain percentage of stock ownership in the hands of certain shareholders, or the unwillingness of enough shareholders to sell stock to the ESOP to ensure a 30% stake so that eligible shareholders could elect the Section 1042 rollover.

21. ***Will there be enough capital available for planned growth and expansion?*** The debt that the corporation is repaying in a leveraged ESOP can reduce or eliminate any additional debt capacity. As a result, capital to expand, acquire other companies, etc., may not be available when needed. As ESOP debt is repaid, shares are allocated to accounts of ESOP participants. This means a growing repurchase obligation for a closely held company. If this repurchase obligation is not properly anticipated and planned for, funds that would otherwise be used for growth and expansion may be claimed by the "buyback" obligations that the company has for participants who retire, die, become disabled, terminate for other reasons (see below), or become eligible for diversification at age 55 with 10 years of participation in the ESOP.

22. ***Who can loan to an ESOP?*** Banks and other financial institutions, sellers, private equity groups, and the sponsoring corporation can be lenders.

23. ***Will warrants be issued?*** According to the NCEO 2015 ESOP Transaction Survey, 27% of ESOP transactions in which seller notes were used had warrants or other stock rights attached to seller notes that were issued to subordinated note holders. These subordinated notes would generally be subordinated to the bank line of credit and other current or future bank financing. Because of the subordinated position, note holders are generally entitled to a higher rate of return. This can be accomplished with a higher interest rate or with a lower interest rate and cash-settled warrants. Cash-settled warrants are typically structured to become exercisable and for payout to begin upon repayment of the seller note. This payout may be structured so that it does not create a second class of stock in an S corporation and so that payments are taxed under current tax law as capital gains. The current rates of return vary based on transaction and market specifics. Companies often issue warrants with the right to pay out over three to five years at the market rates of interest in effect at the time of payout. Warrants have an impact on the valuation analyses.

24. ***Are other sources of ESOP capital available?*** These sources, while rare, can include the use of the assets of other qualified retirement plans, such as profit sharing plans; wage reductions (or forbearance); or employee investments through a 401(k)/ESOP. All of these approaches introduce a considerable degree of complexity and additional fiduciary risk to the ESOP equation.

Plan Design Details

25. ***Who, if anyone, is excluded from the ESOP?*** As discussed above, selling shareholders electing the "tax-free" rollover are excluded from ESOP participation, along with certain family members and more-than-25% shareholders. Certain classes of employees may or may not be excluded depending on a number of variables. Employees who are members of a bargaining unit that bargains for retirement benefits may be excluded from participation in the ESOP. (An

ESOP, like any other qualified retirement plan, can be the subject of collective bargaining.) Occasionally, small percentages of non-union employees who are in a separate line of work, perhaps in a subsidiary company, are excluded from participation in the ESOP. Any employee with less than 1,000 hours in a year or less than one year of service can be excluded, but there is no requirement to do so. Companies may want to expand the number of eligible employees to increase eligible payroll, which in turn increases contribution limits. In some plans, expanded eligibility may be cut back after a few years if the plan specifies this at the outset.

26. ***How can sellers and family members excluded from ESOP participation be "made whole"?*** Nonqualified deferred compensation agreements can be used for this purpose. The corporation promises to pay a supplemental benefit to individuals who are excluded from the ESOP. Cash bonuses are also an option. It is important to keep in mind, however, that these cash payments must be reflected in the projections, may affect the transaction value, and may affect Section 409(p) S corporation ESOP anti-abuse compliance testing.

27. ***What happens to the following:***

    401(k) plan, if any?

    Section 401(k) plans should be retained—and are by the vast majority of ESOP companies—because they provide a cushion of diversification for ESOP participants and build a stronger retirement position for all employees. Additionally, 401(k) assets are comprised primarily, or exclusively, of employee deferrals.

    Profit sharing plan, if any?

    Discretionary company contributions to a qualified profit sharing plan or 401(k) plan are often, but not always, shifted to the ESOP.

    Defined benefit pension plan, if any?

    While defined benefit plans are increasingly rare in the private sector, such a plan may stay in place along with the ESOP under certain circumstances.

28. ***What voting rights do ESOP participants have?*** ESOP participants have limited required voting rights in closely held companies, but companies can go beyond these if desired. Most ESOP companies do not provide additional voting rights to ESOP participants, such as voting for the board of directors.

29. ***Other ESOP plan design features, including:***

    Vesting

    Vesting must be completed in three years (for "cliff" vesting) or six years (for "graded" vesting). Credit is normally given for prior service.

    Distribution alternatives

    Deferring ESOP distributions and/or making ESOP installment distributions over the maximum periods allowed by law will reduce for a period of time the cash necessary to meet a closely held company's repurchase obligation. However, for a company whose stock is growing in value, this policy ultimately increases the cost of the repurchase obligation. Many companies attempt to balance the cash-flow requirements of early distributions with a policy that accelerates to some extent ESOP distributions, especially after some or all of any ESOP acquisition debt has been repaid.

    Allocation formula

    The "safe harbor" ESOP allocation formula is based strictly on covered compensation, with the current maximum allowed by law for allocation purposes being $285,000 (as of 2020, and adjusted for inflation annually). Alternatives include a formula that gives some credit for prior service combined with additional points for compensation, provided that the formula is not discriminatory.

30. ***Do competitors have ESOPs?*** If there is a strong track record of ESOP performance in a company's industry, it will be easier to gauge how to expect the ESOP to perform from a motivational and financial perspective.

31. ***Do employees in this industry expect to be equity owners? If so, will what they get from the ESOP be sufficient? Will certain em-***

ployees need additional ownership? Many companies provide additional equity incentives to key employees (see question 33 below).

32. ***Are there union employees? If so, will they be treated the same as all other employees or differently?*** Union members may generally be excluded from the ESOP. An ESOP, like all other qualified retirement plans, is subject to collective bargaining. See question 25 above.

Management Incentives

33. ***Will there be additional stock-based or synthetic equity incentives for management? If so, will such incentives take the form of stock options, a stock bonus, a stock purchase plan, stock appreciation rights (SARs), restricted stock, or a combination of one or more of the above?*** Frequently, an ESOP is paired with one or more of these equity-based incentive plans to maximize equity incentives for key employees, with stock appreciation rights being used most frequently in S corporation ESOPs. Will any of these incentives create a failure of the anti-abuse provisions under Code Section 409(p) and the regulations issued by the IRS related to S corporation ESOP companies? See question 57 below.

34. ***What other nonqualified plans (such as nonqualified deferred compensation) will be coordinated with the ESOP?*** The existence of the ESOP does not prevent the company from continuing existing nonqualified plans or implementing new ones. Nonqualified deferred compensation plans are sometimes implemented to cover those that are excluded under the Section 1042 "tax-free" rollover rules.

35. ***What is the long-term impact of dilution, if any, of stock-based plans and synthetic equity plans?*** By definition, dilution occurs any time new stock is issued. These "synthetic equity plans," such as stock appreciation rights (SARs) or phantom stock, can be value-dilutive because they reduce company earnings. The impact on the per-share value of the stock due to the impact of these plans should be carefully considered.

Fiduciary and ESOP Management Issues

36. ***Will the ESOP trustee be "internal"?*** The board of directors can appoint an internal trustee (but someone other than one of the sellers) for an ESOP transaction. According to the NCEO 2015 ESOP Transaction Survey, approximately 56% of the respondents used an outside institutional trustee or outside individual trustee for the ESOP transaction. There are significant fiduciary responsibilities and risks associated with serving as an ESOP trustee that may justify the cost of outside fiduciaries. Potential conflicts of interest can arise, and sellers to an ESOP should never be trustees acting on behalf of the ESOP at the time when the ESOP transaction is consummated. Those who are or are considering being an internal trustee should attend one of the growing number of industry training programs for internal trustees.

37. ***If external, will the ESOP trustee be independent or directed?*** An outside trustee may be directed as to the voting of the shares held in trust. An ESOP committee that may be appointed by the board, elected in some manner, or formed by some combination of the two would direct the trustee as to the voting of the shares in the ESOP. Both the trustee and the ESOP committee bear fiduciary responsibility unless an independent fiduciary is directing them.

38. ***If independent, will the trustee serve for the transaction only or both for the transaction and on an ongoing basis?*** Independent ESOP trustees may be appointed by the board of directors for a specific ESOP transaction, either the initial ESOP purchase of stock, a subsequent purchase of stock, or the sale of stock by an ESOP. Except for these specific transactions, individuals are sometimes appointed by the board to serve as ongoing trustees.

39. ***If the trustee is directed, will shareholders/management serve as the ESOP committee?*** The ESOP committee, frequently comprised of management and/or current or former shareholders, can direct the trustee as to the voting of shares held in the ESOP.

40. ***Completing an ESOP transaction and operating as an ESOP-owned company requires a team of advisors. Who will be the following?***

    ESOP consultant or "quarterback"

    Independent valuation firm

    ESOP trustee

    ESOP attorney

    ESOP lender (for a leveraged ESOP that is not seller-financed)

    ESOP third-party administrator

    The quarterback may be one of the other parties listed above, such as the attorney, but frequently is a separate advisor.

41. ***What role will the following professional advisors play in the process?***

    Corporate attorney

    Personal attorney

    Corporate accountant

    Personal accountant

    Personal financial advisor

    Personal estate planning attorney

    Insurance agent

    Investment banker

    Benefit consultant

    Other key advisors

42. ***When and where will employee communications occur?*** Announcing an ESOP should be a special celebration. Many companies take employees off-site or have the meetings held after hours. Remote office locations are a special challenge. Recording and distributing a DVD, conducting a webinar, and videoconferencing are frequently used tools.

The ESOP Repurchase Obligation

43. ***What are the repurchase obligation projections for death, disability, retirement, diversification, and "other" terminations for the next 10 to 15 years?*** As discussed above, a careful study of this obligation often influences the percentage of ownership of the company by the ESOP.

44. ***Can the company handle the obligation and still maintain desired growth?*** Too large a repurchase obligation in proportion to available cash flow can stifle a company's ability to grow and compete in the long term.

45. ***Is the percentage of distributions to "other" terminations—i.e., those who quit or are fired—too high?***

    If yes, what measures will reduce this problem?

    Proper design of ESOP eligibility criteria, such as entry age and vesting schedules and a deferred and/or installment distribution policy, can assist, but the root problem may require careful study of the company's retention system.

46. ***How can the cost of the repurchase obligation be managed and deferred?*** An ESOP company must adopt a distribution policy. The policy can defer the payout from one to five years depending on the reason for terminations. This "smooths" cash flow and precludes a situation wherein employees with large ESOP accounts are tempted to "take the money and run." The ESOP rules pertaining to "other" terminations allow companies to wait five years before payments must begin, and then balances can be paid out in equal annual installments over a five-year period. However, if a company's stock price is rising faster than its after-tax cost of money, delaying repurchases only increases the cost. Thus, the company must balance the need to defer distributions long enough so as not to tempt vested employees to leave to receive a benefit payment against the need to begin the payout process soon enough to reduce the long-term costs.

47. ***Will the repurchase obligation be funded? If so, how and when?*** Many closely held companies will fund their repurchase obligations

from annual cash flow by contributing, on a tax-deductible basis, the necessary cash to the ESOP in order to distribute cash to departing participants. This approach relies on the uncertainty of future cash flow. It also causes the ESOP repurchase obligation to grow as the repurchased shares are allocated to the remaining participants' accounts. This can create problems for established ESOP companies in which two classes of ESOP participants emerge: some with large stock account balances and some with small stock account balances.

The decision in a given year whether to have the corporation redeem departing participant shares or recycle shares within the ESOP has long-term implications of counter-dilution for the non-ESOP shareholders, taxes to the company, and the ultimate size of the ESOP. A detailed analysis of stockholder equity and ESOP repurchase obligation in the full feasibility study quantifies the differences.

A corporate funding plan that establishes reserves on the balance sheet to address this obligation is a wise decision—the sooner, the better. An earmarked corporate investment account can be established. Professional management should be considered for accounts in excess of $1 million. Properly structured life insurance programs have been used effectively by some companies. These funds should be retained in the company, as opposed to the ESOP, for several reasons, including the fact that it may be necessary for the company to occasionally use them for other purposes.

Having a professionally managed cash reserve fund in the corporation is another option that many companies use.

In S corporations, as explained in the next section, there may be a buildup of cash resulting from tax savings and other distributions into the trust that will greatly facilitate ESOP repurchase planning.

48. ***Should funds be accumulated in the ESOP or in the company to satisfy repurchase obligations?*** The repurchase obligation is a corporate obligation, not a trustee one. Funds can be accumulated in both the ESOP and the corporation to satisfy the repurchase obligation. Where the funds reside and what the amount is are dictated by a number of variables. However, companies should be cautioned that accumulating large sums of cash in the ESOP for the

repurchase obligation can create problems for companies in crisis situations such as the financial crisis of 2008–2009 or the COVID-19 crisis. Funds residing in the ESOP are the property of the ESOP trustee, and while they can normally be used to satisfy the repurchase obligation, there can be situations where the trustee is reluctant to use the funds to satisfy the repurchase obligation or refuses to do so. If a crisis has resulted in the expectation that the company's share value will decline significantly in the current year, and the repurchase obligation is based on the prior year's valuation (as of December 31 for most ESOP companies), which is substantially higher, the ESOP trustee may not be willing to acquire shares at a value that the trustee expects has declined significantly.

Special S Corporation ESOP Considerations

49. ***What is the long-range impact of tax savings in an S versus C corporation ESOP?*** Analysis has shown that the long-term tax savings generated by S corporation ESOP companies can be significantly greater than for some C corporations, although there has been less of a difference since the Tax Cuts and Jobs Act of 2017, which lowered the C corporation tax rate to 21%.

    ESOPs in S corporations currently offer no Section 1042 tax deferred sale opportunity and are subject to reduced limits on the tax-deductible amounts that can be contributed to the ESOP. However, these drawbacks are mitigated by several factors. Because the ESOP's portion of stock owned in an S corporation is exempt from federal (and most state) income taxes, a profitable company may use these savings to make ESOP distributions to the trust that are not restricted by "reasonableness." This will often offset the lower deductible limits and can result in an ESOP loan being repaid faster than for a C corporation. In some companies, large ESOP accounts for selling shareholders will offset a significant portion of the capital gains tax paid in the ESOP transaction.

50. ***How much, if any, of company income must be distributed to the ESOP?*** The ESOP must receive its proportional share of all S corporation distributions made to shareholders.

51. ***What can the ESOP trustee do with cash that accumulates in the trust?*** The ESOP trustee may use these funds for the acquisition of more ESOP shares, either from the company (to create capital) or from shareholders, and/or to satisfy the ESOP repurchase obligation. Cash payments to participants through the ESOP resulting from S corporation distributions are possible, but they are not considered a viable option under current tax law. In addition to being subject to ordinary income tax, there is an illogical 10% excise tax on such cash S distributions made to ESOP participants.

52. ***How can these funds promote company and shareholder objectives?*** A carefully developed plan can maximize the use of savings in a manner that will balance the sometimes-competing objectives between different shareholders.

53. ***What will be the future value of the shareholders' accumulated adjustment accounts (AA accounts)?*** A desirable benefit of the S corporate structure is that non-ESOP shareholders retain individual accumulated adjustment accounts that represent their share of retained earnings on which they have already paid taxes. Since the board may make pro-rata distributions to shareholders at any time, on a tax-free basis, it is important to track the value of these accounts for major shareholders as part of the long-term stockholders' equity analysis. The ESOP will also receive its fair share of any distribution.

54. ***Will stock be voting and/or nonvoting?*** S corporations are restricted to one class of stock. However, with proper design, it may be possible to permit both voting and non-voting stock to achieve particular objectives of the shareholder(s) and the corporation. The ESOP can only own voting stock.

55. ***What are the effects of the built-in gains and last-in, first-out (LIFO) recapture taxes compared to the tax savings available to S corporation ESOPs?*** Depending upon a particular corporation's accounting methods and if and when the C corporation is sold, making the S election may not result in significant additional taxes. A thorough multi-year stockholder equity analysis will illustrate

whether the special tax savings available to an S corporation will outweigh these costs.

56. ***What are the implications of the selected plan on the possibility of creating two categories of employees over the long term, i.e., the "haves" and the "have-nots"?*** Due to the special features and tax savings associated with S corporation ESOPs, serious imbalances could occur in stock accounts among new versus older employee groups if a company does not plan for the long run. While established C and S corporation ESOPs have managed this problem for many years with tools such as plan modifications, releveraging, and rebalancing, this requires careful planning.

57. ***What is the impact of Section 409(p) "anti-abuse" S corporation rules?*** While S corporation ESOPs enjoy immense tax benefits, these come with increased regulation. These regulations include a test that incorporates "anti-abuse" rules under Section 409(p) of the Internal Revenue Code. These rules attempt to ensure that the regulatory intent of ESOPs, the diversification of wealth by creating broad-based employee ownership, is achieved. The test includes most nonqualified equity compensation, and includes but is not limited to warrants, options, stock appreciation rights, and Section 409A deferred compensation arrangements. Before implementing the ESOP, an experienced third-party administrator needs to run this 409(p) test. On an ongoing basis, the third-party administrator should run the test as needed to ensure ongoing compliance. The 409(p) test must be complied with each day of the year, and it is important to emphasize that 409(p) testing is critical to the success of an S corporation ESOP.

The complete answers to most of the questions above relating to S corporations can come only from a comprehensive financial analysis.

Creating an Ownership Culture

58. ***What is the importance of creating an ownership culture in an employee-owned company?*** Although the answers to the above questions are important, the question pertaining to how well the

management-employee team is creating a culture change within the organization may provide the biggest payoff to ESOP companies. Some companies install an ESOP primarily for financial reasons, such as a tax-deferred sale for shareholders and tax-favored financing for the company. Many of these companies never develop the partnering message of the risks and rewards to complement the rights and responsibilities of stock ownership. Research indicates that those companies that have effectively communicated employee ownership—thereby creating and enhancing an ownership culture among employees—have reaped the greatest success from their ESOP strategy.

Most ESOP companies eventually make some progress in communicating the impact of employee ownership. However, stellar ESOP companies achieve their full potential by creating a long-term ownership culture, stimulating creativity and innovation among all participants. The psychological reward for employees whose personal innovations and ideas have been recognized by all to improve the organization is quite immediate and contagious.

Conclusion

Once you have answered all the above-listed questions, plus some others that your corporate attorney, accountant, or other key advisor(s) will raise, you may be ready to move forward with implementing an ESOP! Many shareholders, board members, and key management individuals have found the best approach to answer these critical questions is to engage a specialist to conduct a detailed feasibility study that will provide a "decision package" regarding an ESOP strategy or transaction that will truly facilitate shareholder, company, board, and management objectives.

Chapter 5

Investing After You Sell Your Business to an ESOP

Christopher J. Clarkson and Stacie Jacobsen

To the owner of a successful business, the company represents much more than a workplace: it is his or her life's work. Hence, the decision to sell is often fraught with emotion. Sellers may struggle with issues such as ceding control, preserving their legacy, or deciding what to do each morning.

A host of financial issues add to sellers' uncertainty. Business owners who have relied on the relatively stable earnings of their private companies must now live off the far less predictable returns from the capital markets. Ultimately, how sellers choose to invest may make the difference between success and failure in meeting their goals and securing their financial future.

In this chapter, we explore the key tax and investment planning questions faced by sellers to an employee stock ownership plan (ESOP)[1] and provide a framework for making thoughtful decisions by examining a hypothetical case similar to several we have encountered and answering the hypothetical clients' questions.

Essential Facts of the Case

John and Jane, a 64-year-old married couple in Los Angeles, are in the process of selling their business so that they can retire. Their company

1. The authors work in Bernstein's Wealth Strategies Group. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

has produced stable profits, benefiting from a committed management team and hardworking employees. John initially considered selling to a strategic buyer, but he decided not to because many employees would have lost their jobs. Eventually, his strong desire to reward employees led John to sell the company to them through an ESOP.

Sales to ESOPs sometimes occur in stages, often with the seller financing part of the deal by accepting a note. For the sake of simplicity, however, we assume that John and Jane are selling 100% of the business to the ESOP for $10 million in cash.

Like many business owners, John and Jane have long dedicated most of their financial resources to building the company. Over the years, however, they managed to save around $1 million in liquid assets, including $600,000 in qualified retirement accounts through the company's 401(k) plan. They would like to spend around $225,000 per year after taxes and inflation in retirement. Only a portion of that budget will be covered by Social Security when they turn 66 and 4 months.

The couple has one adult child who has a successful career outside the business. John and Jane were generous with his education but aren't overly concerned about maximizing his inheritance. They've discussed leaving something to charity in their wills.

While excited about this new phase of their lives, John and Jane are also anxious about the transition. They have a number of critical questions:

- Will we be able to meet our spending needs?
- How do we choose an asset allocation that balances our need for return with our desire for safety?
- What is a 1042 election, and should we make one to defer tax on the sale?
- If we make the 1042 election, how should we invest the proceeds?
- What are our options for donating to charity?

Will It Be Enough?

For many sellers, the single most important question is the first: "Will we be able to meet our spending needs?" Investors have reason to be concerned: The headwinds to a secure retirement are strong. Increased longevity means a portfolio must last longer: For a 64-year-old couple, there's a 50% chance that one of them will live past age 91.[2] Taxes continue to take a high toll, with the highest federal tax rate for long-term capital gains and qualified dividends at 23.8%, and the top rate on investment income at 40.8%. State taxes can add as much as 13.3%. Inflation has been dormant for many years but could awaken in the years ahead. And interest rates are now very low, which makes bond investing a challenge.

John and Jane need an investment plan that can withstand these headwinds. To stress-test a plan for long life, high inflation, and poor markets, we use a financial modeling tool that starts from today's conditions and simulates 10,000 plausible paths for the economy, inflation, and a wide range of financial asset classes.[3] From there we determine the probability of various investment outcomes.

We believe a plan should succeed even if markets are hostile and the investor lives a long life. We model 10,000 different futures and look for plans that would achieve the investor's goals in at least 90% of them. That conservative standard is prudent, in our view.

Defining Core Capital

Our first step in formulating a plan is to determine how much "core capital" the investor needs. This is the amount of capital required to fund after-tax spending needs, through hostile markets, for the rest of the investor's life, even if he or she lives longer than expected.

How much core capital do John and Jane need? John would prefer a conservative approach to investing, so let's suppose they choose to invest 20% of their portfolio in globally diversified stocks and 80% in bonds. In that case, we estimate John and Jane would need a portfolio of $7.4 million today to sustain their $225,000 after-tax spending through hostile markets and a long life. Again, that is a very conservative estimate. If markets are typical, they would leave behind a sizable legacy, even after decades of spending from the portfolio.

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2. Social Security 2010 mortality tables.
3. This is the Bernstein Wealth Forecasting System, described in a bit more detail at the end of this chapter.

This should be comforting news to John and Jane. The combination of their existing $1 million in liquid assets and the after-tax proceeds from the sale will fund a portfolio well above their core capital benchmark.

How Do We Choose an Asset Allocation?

John and Jane's core capital requirement is driven largely by their age, spending level, and asset allocation. They need a portfolio that provides enough return to meet their spending needs but will allow them to sleep at night.

For many business owners, choosing an asset allocation is like navigating through uncharted waters. Entrepreneurs build wealth by focusing their expertise and capital in their business ventures. They often prefer to tackle the familiar risks facing their company over the uncontrollable risks of investing in the capital markets. Quantifying the likely impact of their investment choices can help sellers better understand their tolerance for risks beyond their control.

If John and Jane are willing to increase their exposure to stocks to 40% of the portfolio, they could reduce the core capital required from $7.4 million to $6.8 million (table 5-1). The higher expected return potential of stocks would allow them to meet their needs with a smaller nest egg while building a greater legacy. By year 30, when John and Jane turn 94, we estimate their portfolio would be worth $2.4 million more in typical markets with the 40/60 allocation.

John and Jane might be tempted to pursue even greater wealth creation potential by investing in a portfolio with 60% in stocks and 40% in bonds, but as the bottom row in table 5-1 illustrates, adding stocks increases the risk of sizable losses along the way. Here we define risk as the probability that the portfolio will undergo a peak-to-trough loss of at least 20% at some point over the next 30 years. In our experience, such a large, short-term loss is hard for most investors to tolerate.

While the portfolio with 40% in stocks has a fairly low risk of incurring a 20% peak-to-trough loss, raising the stock allocation to 60% ups the odds to over 1 in 2. John and Jane felt this was too much risk for them; it runs counter to their objective of preserving wealth. When

Table 5-1. Trading off risk and return for three asset allocations

Asset allocation	20% stocks/80% bonds	40% stocks/60% bonds	60% stocks/40% bonds
Required core capital	$7.4 million	$6.8 million	$6.2 million
Median wealth: year 30	$6.6 million	$9.0 million	$11.3 million
Probability of peak-to-trough loss ≥ 20%	3%	21%	55%

Projections are based on the Bernstein Wealth Forecasting System as of December 31, 2019. See *Notes on Bernstein Wealth Forecasting System* at the end of this chapter.

Median wealth values assume the seller pays federal and California state long-term capital gains tax on the sale of the company to the ESOP. See the discussion later in this chapter regarding the ability to defer tax under Internal Revenue Code Section 1042.

Data do not represent past performance and are not a promise of actual future results or a range of future results.

they weighed the trade-off between creating a larger legacy and facing a higher risk of a large loss, they embraced the portfolio with 40% in stocks and 60% in bonds.

The current investment environment is challenging, but we believe investors can navigate the landscape by following a few key tenets:

- Adopt a sound investment plan tailored to their needs and circumstances.
- Remember that bonds remain key diversifiers, even though their returns are likely to be low for the next few years.
- Don't abandon foreign stocks, despite recent turmoil overseas. U.S. stocks have outperformed their foreign counterparts in eight of the last ten years. Stronger U.S. stock market returns in recent years have left foreign stocks at lower valuations.
- Diversifying beyond traditional stocks and bonds can reduce risk without reducing returns.
- Active risk management and investment selection can help mitigate the impact of challenging market conditions.

What Is the 1042 Tax Deferral?

It is no secret that taxes take a big bite out of the income of higher earners. Still, some business sellers are surprised by how much taxes reduce the sale proceeds. The top federal long-term capital gains tax rate is 20%, and the 3.8% net investment income tax applies to gains on the sale of C corporation stock, even if the shareholder actively participates in the business. There may also be state capital gains taxes. John and Jane live in California, where the state capital gains tax rate can reach 13.3% and taxpayers can pay tax on gains at a top rate of 36.6%.

Fortunately, selling to an ESOP may allow John and Jane to defer these taxes or even avoid them entirely. Internal Revenue Code Section 1042 provides that owners who meet certain requirements and sell their company shares to an ESOP can defer the capital gains tax on the shares sold to the ESOP.

The rules surrounding Section 1042 are complex, and the seller should obtain the advice of experienced legal and tax counsel, but generally, to be eligible for 1042 treatment:

- the company must be a closely held C corporation;[4]
- the seller must have held the company stock for at least three years before the date of sale;
- the shares must not have been acquired in a distribution from a qualified retirement plan, stock option plan, or any other Section 83 compensatory stock plan; and
- immediately after the sale, the ESOP must own at least 30% of the outstanding stock and must adhere to rules limiting the allocation of that stock to the seller, family members, and more-than-25% shareholders.

John and Jane are clearly eligible for a 1042 tax deferral. Now, they must meet some additional requirements to defer the tax on the sale:

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4. While S corporation shares may be sold to an ESOP, they do not qualify for the 1042 tax deferral. In certain cases, it may be advantageous for shareholders to terminate the company's S election status in order to sell C corporation shares to the ESOP.

- The seller must reinvest the proceeds into "qualified replacement property," or QRP, defined in plain English as stocks and bonds issued by U.S. operating companies.[5] QRP does *not* include government bonds such as U.S. Treasuries and municipal bonds, foreign stocks, REITs, and mutual funds.
- The seller must reinvest the proceeds of the sale into QRP within a period beginning 3 months before the date of sale and ending 12 months after.
- The seller must file the appropriate documentation with his or her tax return.[6]

Voila! If they take all these steps, the cost basis from the closely held C corporation shares sold to the ESOP will "roll over" into the newly purchased QRP, and the potential tax from the sale will be deferred at least until the QRP securities are sold. At that point, the embedded gain would be realized. Sellers may be able to avoid the tax entirely by holding the QRP until death, when the replacement property would receive a step-up in cost basis.

The Buy-and-Hold Dilemma

Aversion to paying tax is powerful, so the idea of buying and holding a diversified portfolio of stocks and bonds designated as QRP may be very appealing. After tailoring the asset allocation to meet their risk profile, sellers who invest in QRP typically want to sell as little as possible, in order to defer tax indefinitely.

But applying this strategy to the entire proceeds of a sale is risky: It means maintaining a static portfolio as the market evolves. In 1958 the average company inside the S&P 500 Index could expect to stay there for

5. Technically, QRP are securities issued by domestic operating companies that do not have passive income exceeding 25% of gross receipts for the preceding taxable year, that have more than 50% of their assets in an active trade or business, and whose securities are not issued by the ESOP sponsor corporation or a corporation under its control.
6. Filings include an irrevocable statement of election, a statement of corporate consent, and notarized statements of purchase of QRP.

61 years. By 2016, the average tenure was down to 24 years.[7] Purchasing a portfolio based on a market index today inherently favors stocks that have performed well in the past—but they may not perform well in the future, as table 5-2 shows. A long-term investor must be able to adapt to the accelerating pace of change in today's world.

Table 5-2. Passive investing in cap-weighted indexes is risky

Date	1980	1999	2006
Component	Energy	Technology	Financials
Share of S&P 500	27.0%	29.2%	22.3%
Subsequent two-year sector performance	–51.1%	–56.2%	–63.6%

Source: FactSet, Standard & Poor's, and Bernstein
Past performance does not guarantee future results.

Buy-and-hold bond strategies are also risky. Even if Fed tightening is slow, interest rates will eventually rise in the U.S. That would cause prices of long-duration bonds to decline significantly. While buy-and-hold investors may not be troubled by these "paper" losses, they are likely to be less than thrilled with their fixed coupon payments in a few years if they have locked in today's historically low interest rates.

An Active Approach to Investing in QRP

There is a technique, however, that allows John and Jane to diversify their portfolio broadly, manage it in response to changing market conditions, and/or spend some of their principal without onerous tax consequences. To accomplish all of this, they would buy corporate floating-rate notes (FRNs) that qualify as replacement property (QRP) and hold them for many years. The couple can borrow against these bonds to fund a liquid portfolio at full basis that can be actively managed without the restrictions of Section 1042. Financial institutions lend against these specialized securities at a loan-to-value ratio as high as 90%, but since the credit crisis, loan-to-value ratios have typically been lower, often in the 75% to 80% range.

7. Richard Foster, "Creative Destruction Whips through Corporate America," Innosight Executive Briefing, Winter 2012. Scott D. Anthony, et al., "2018 Corporate Longevity Forecast: Creative Destruction Is Accelerating," Innosight Executive Briefing, February 2018.

The FRNs are highly specialized to serve as both QRP and as collateral for a loan. Typically, FRNs are very long-term bonds with maturities of 30 to 50 years and not callable for many years because the deferred tax becomes due when the bond matures or is called. The interest paid by the bonds floats along with a benchmark interest rate, usually with quarterly resets. The current benchmark, the London Interbank Offered Rate (LIBOR), is being phased out in 2021 and replaced by the Secured Overnight Financing Rate (SOFR). The floating-rate coupon keeps the price of the bonds relatively stable and results in increasing cash flows in a rising interest-rate environment (and decreasing cash flows in a falling interest-rate environment).

Most FRNs are issued by highly rated companies and carry put options allowing the holder to sell the bond back to the issuer at close to par value on each anniversary date, if the bond's credit quality worsens materially. Issuers include established companies, such as Procter & Gamble, 3M, UPS, Colgate-Palmolive, and certain banks.

The FRN market is small and relatively illiquid, so it takes time to build a portfolio with even a handful of names. Thus, it is imperative for sellers to begin building a QRP portfolio as quickly as possible after closing the sale to meet the 12-month investment deadline.

The cost of this arrangement is that the FRNs generally pay an interest rate below LIBOR (or its successor rate), while the monetization loans typically charge an interest rate above this benchmark rate. In other words, investors pay a spread or annual "cost of carry" to finance the deferral of capital gains tax. Furthermore, at least 10% of the sale proceeds will return only the FRN interest rate, since the banks will lend no more than 90% against the FRNs' value. Finally, transaction costs on FRNs can be significant. Sellers must carefully consider the impact of these costs, especially for sales under $5 million.

The benefit is that they could defer 36.6% in federal and California capital gains tax, potentially forever.

When Sellers Finance the ESOP

For simplicity's sake, we assumed above that John and Jane sold the company to the ESOP for cash, but most ESOP transactions involve seller financing for at least some portion of the deal. This means that the seller agrees to accept payment over time, with interest. While this offers a number of advantages to sellers and makes larger deals possible, it creates credit risk: If the economy weakens or the business weakens for some other reason, the ESOP may not be able to make payments on the seller note. This was the case for several ESOP deals during the recession after the credit crisis of 2008.

Seller financing can also raise practical hurdles to making a 1042 election. Let's say John and Jane provided seller financing for 60% of the transaction and received 40% of the $10 million sale price in cash up front. In this case, the deal wouldn't provide enough cash to purchase $10 million of QRP within the 15-month window to make full use of the 1042 deferral.

But John and Jane could borrow money to buy the FRNs, as in the example above,[8] and repay the bank loan as they receive payments from the ESOP on the seller's note. In this way, FRNs also can help sellers to clear the practical hurdle to making a 1042 election that seller financing erected.

Should We Take the 1042 Deferral?

To help John and Jane evaluate the trade-off between paying the tax and electing to take the 1042 deferral, we project their wealth under both scenarios. In each case, the 64-year-old couple has $1 million in liquid assets, including $600,000 in a 401(k); they sell 100% of the business to an ESOP for $10 million; they have $0 cost basis in the stock; and they want to spend $225,000 per year after taxes.

In Scenario A, they pay the capital gains tax on the sale and reinvest the proceeds in a portfolio with 40% in stocks and 60% in bonds. In Scenario B, they use the proceeds of the sale to purchase $10 million of FRNs with an average coupon of LIBOR minus 0.3%, and they use the FRNs as collateral to borrow $9 million at an interest rate of LIBOR

8. FRNs purchased in the secondary market are immediately eligible to collateralize a loan. FRNs purchased as new issues are subject to additional regulations. The institution selling the new issue FRN cannot lend against the FRN for 31 days. Thus, new issue FRNs must be purchased with cash or funds borrowed from another source.

Table 5-3. An active 1042 strategy can significantly boost wealth

	Scenario A: pay tax	Scenario B: active 1042 strategy
30-year wealth in typical markets	$9.0 million	$13.1 million
30-year wealth in hostile markets	$2.9 million	$5.1 million

Projections are based on the Bernstein Wealth Forecasting System as of December 31, 2019. See *Bernstein Notes on Wealth Forecasting System* at the end of this chapter.

Data do not represent past performance and are not a promise of actual future results or a range of future results.

plus 0.9%, for a 1.2% cost of carry. They reinvest the $9 million from the loan in a portfolio with 40% in stocks and 60% in bonds.

Table 5-3 shows that in either scenario, John and Jane are likely to increase their liquid wealth, even after spending from the portfolio for the next 30 years. If they decide to pay the capital gains tax on the company sale, we project that they will accumulate $9.0 million in typical markets. If markets are hostile, we project that there is a 90% chance that John and Jane will have at least $2.9 million remaining at age 94.

But the active 1042 reinvestment strategy offers a clear advantage. We project that in 30 years, John and Jane will accumulate $13.1 million in typical markets and $5.1 million in hostile markets.[9] Both outcomes are more than 40% higher than the related projection for paying tax now.

To put this in perspective, we calculated the pretax sale price John and Jane would need to negotiate today in a taxable sale in order to accumulate $13.1 million in 30 years (the same wealth achieved by selling to the ESOP). We estimate that they would need to sell the company for $11.9 million before taxes, or 19% more than the $10 million the ESOP would pay, to achieve the same wealth in 30 years.

In our analysis, the benefit of deferring the tax on the sale of the company shares to the ESOP clearly outweighs the annual cost of carry and the cost of investing 10% of the proceeds in a low-coupon FRN. The active 1042 reinvestment strategy essentially finances the tax deferral,

9. This assumes the FRNs are held for the entire 30 years and receive a step-up in cost basis when John and Jane die. If they sell the FRNs, the embedded capital gains tax comes due.

while providing liquidity and freedom to manage the capital. At this transaction size, we think it is wise to make use of the 1042 election and deferral, when possible.

What Are Our Options for Donating to Charity?

Like many business owners, John and Jane wanted to share their good fortune with charitable causes dear to them. While working on the sale, they began to wonder what charitable-giving strategies to consider and whether to implement them before closing the deal.

It's wise to raise these questions early. If John and Jane were selling their company to a third party, there would be a material advantage to making the charitable donation before closing the sale. When donating cash to charity, the donor receives a charitable income tax deduction for the value of the cash donation. For a donor in the 40% income tax bracket, donating $10,000 would save $4,000 in income tax, reducing the effective cost of the donation to $6,000. But if the donors give company shares with a cost basis of 0, they also avoid the embedded capital gains tax on the sale, reducing the effective cost of the gift even more.

For a 1042 sale to an ESOP, however, there's typically no advantage to making a charitable donation before closing the sale: QRP with a low-cost basis can be given to charity at any time. In some cases, it may be advantageous to donate company shares before the sale to the ESOP, especially if the shares are ineligible for 1042 treatment. Sellers should not contribute the shares to charity on the understanding that the ESOP will buy the stock at a prearranged price, because the ESOP trustees can't be compelled to do so. It's important to discuss these issues with qualified tax and legal counsel.

For John and Jane, the issue wasn't the timing of the gift, but the best vehicle to use. They considered two vehicles that are attractive today and would potentially fit their situation: a donor-advised fund and a charitable remainder trust.

A donor-advised fund is an account that the donor creates with a sponsoring charitable organization. The donor funds the account with cash or securities that can be sold and reinvested in a tax-free environment. Over time, the donor uses these funds to make grants to charities. The donor-advised fund can be an excellent way to pre-fund charitable gifts the donor intends to make over the next many years, while receiving an income tax deduction today.

In a charitable remainder trust (CRT), by contrast, the donor contributes low-basis assets to a trust that can sell and reinvest without immediate tax consequences, and the trust makes a taxable distribution to the donor each year. The donor receives an upfront charitable income tax deduction based on the actuarial value of the assets that will pass to the charity at the termination of the trust, which usually occurs at the death of the donor and spouse.

John and Jane chose to use the CRT because it gave them greater confidence that they could meet their retirement spending needs and because it offers very attractive tax benefits.

Today's high, progressive tax rates[10] make CRTs more attractive. While selling a valuable low-basis asset would almost certainly push business sellers into the top bracket, a CRT can spread this gain over many years of distributions. As California taxpayers, John and Jane can save nearly $80,000 in tax by running $1 million of realized capital gains "through the brackets," instead of paying top marginal rates.[11]

To estimate how much the CRT would help John and Jane, we assumed that they sell the $10 million business to the ESOP and make a 1042 election, choose the active 1042 reinvestment strategy for only 75% of the sale proceeds, and contribute the other 25%, or $2.5 million of low-basis assets, to a CRT. We also assumed that the couple is willing to take more risk inside the CRT than in their personal portfolio to maximize cash flow: they decide to invest 70% of the trust assets in stocks and 30% in bonds. We then evaluated CRTs with three different unitrust payout rates: the 5% minimum, 8%, and the 10.6% maximum allowable for people their ages.

As table 5-4 illustrates, the CRT would increase their median projected personal wealth in year 30, regardless of the payout rate. With

10. Joint filers do not reach the top federal capital gains tax bracket until taxable income exceeds $496,600, and the 3.8% net investment income tax does not apply until modified adjusted gross income reaches $250,000.

11. Paul Lee and Steve Schilling, "CRTs Are Back (in Four Delicious Flavors)," *Trusts & Estates,* October 2014, p. 31.

Table 5-4. CRTs benefit the donor and the charity (M = million)

	Pay tax	Active 1042	75% active 1042; 25% CRT with 5% payout	75% active 1042; 25% CRT with 8% payout	75% active 1042; 25% CRT with 10.6% payout
Year 30: median personal wealth	$9.0M	$13.1M	$13.26M	$14.07M	$14.14M
Charity	$0	$0	$3.37M	$1.35M	$0.6M
Total wealth	$9.0M	$13.1M	$16.63M	$15.42M	$14.74M
Years to median crossover; active 1042 strategy			29 years	24 years	22 years

Projections are based on the Bernstein Wealth Forecasting System as of December 31, 2019. *See Notes on Bernstein Wealth Forecasting System* at the end of this chapter.

Median wealth values assume the seller pays federal and California state long-term capital gains tax on the sale of the company to the ESOP.

All calculations of permissible payouts and associated tax deductions for the CRT are according to Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder.

Data do not represent past performance and are not a promise of actual future results or a range of future results.

the 5% CRT, the personal wealth advantage is quite small, but for the 8% CRT it grows to nearly $1 million.

When we add in the trust assets that will pass to charity, the total wealth created with the CRT strategy increases meaningfully. The 5% CRT maximizes the charitable remainder and total wealth created (since less money goes to the couple). Over 30 years, the 5% CRT produces 27% more wealth than the ESOP 1042 strategy alone, and 85% more wealth than paying the tax on the upfront sale.

A CRT is not right for everyone. The decision to fund the CRT is irrevocable, and it takes time to accumulate greater personal wealth. It often requires two to three decades before the donor's personal wealth "crosses over" the value that he or she could expect without the CRT, as table 5-4 also shows. Still, for the business owner with some charitable intent, a CRT can be a very attractive option.

Tying the Plan Together

After evaluating all of their options, John and Jane decided that the tax deferral benefit of the 1042 election was worth the effort. Despite the annual financing cost, the active 1042 investment strategy is expected to increase their wealth by $4.1 million. They also chose to use some of their QRP assets to fund a CRT, which would pre-fund a charitable legacy and provide cash flows they could use to meet their annual spending needs. Surprisingly, the gift to charity won't come at the expense of the legacy to their son. In time, they will likely accumulate greater personal wealth by funding the CRT.

Selling a business, to an ESOP or otherwise, can be complicated and laden with emotional concerns. For some owners, investing the liquid proceeds is a source of anxiety. Too often, the question of how to invest the proceeds is delayed until after closing. Though a portfolio can't be built until the proceeds have been received, the investment planning process should start much earlier. Critical tax and investment decisions will affect the ability of a transaction to meet the financial objectives of the seller. As John and Jane found, careful planning and quantitative analysis can help maximize the benefit of selling to an ESOP.

Notes on Bernstein Wealth Forecasting System

Bernstein's Wealth Forecasting System uses Bernstein's research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indices, not Bernstein portfolios), as well as their unpredictability. Asset class projections in this paper reflect the initial market conditions as of December 31, 2019. Globally diversified equity portfolios comprise an annually rebalanced mix of 21% U.S. diversified stocks, 21% U.S. value stocks, 21% U.S. growth stocks, 22% developed international stocks, 7.5% emerging-market stocks, and 7.5% U.S. small-cap and mid-cap stocks. Bonds are modeled as intermediate-duration in-state municipals and intermediate-duration taxable bonds.

Chapter 6

Alternatives to Selling to an ESOP

Corey Rosen

Some business owners decide to sell to an ESOP without considering other options. These owners have made a decision that the legacy, tax, and/or flexibility advantages of an ESOP make it the only route they want to explore. Many other owners, however, want to compare how an ESOP compares to other sale options. This chapter looks at the principal alternatives: selling to insiders directly, selling to another company, and selling to a private equity firm.

Selling Directly to Insiders

Some businesses can be sold to insiders, usually key managers, but in some firms, especially those with many professional employees such as engineers and architects, ownership will be offered more broadly. There are a few common approaches:

- *Employees purchasing shares directly with money they currently have or can borrow:* While this is the simplest approach, it is also the most challenging. The money is all after-tax. Say you have a $5 million company and 10 key employees each agree to buy $500,000 worth of stock. If they are in a combined state and federal tax bracket of 30%, they would each need $714,000 in pre-tax income to buy the shares. Only rarely will this be feasible.
- *Employees buying shares over time:* A second option is for employees to buy shares over a number of years. This assumes that the seller is willing to wait to be fully paid. The share price could be pegged to the original price or vary each year (the more likely scenario).

- *Employees buying shares out of bonuses:* Many professional and some other firms provide substantial annual bonuses to at least key people and maybe more broadly. SpawGlass Construction in Texas, for instance, paid a significant bonus based on profits every year to every employee, and each year gave them the option of taking some or all of that to buy shares from owners who wanted to sell. Eventually, they decided to set up an ESOP to buy everyone out. The money used to buy the shares is after-tax. This approach is less painful for employees, and more are likely to participate, but the process will normally take many years before a complete sale is possible.
- *Seller notes:* The most common approach is a seller note. Here the seller enters into agreements with each purchasing employee to buy shares at the price at the time of offer (unlike annual purchases by employees, which are normally at that year's value) to be financed by a note from the seller to be repaid over some number of years. The interest rate can be whatever the seller and buyer agree to, but if it is below the applicable federal rate (about 2.7% as of 2020), the value of the lower rate is taxable. Again, the funds used to pay the note are pretax.

In all of these transactions, the seller qualifies for capital gains treatment.

In any approach, a critical issue is the price of the shares. Unlike the case with an ESOP, there is no statutory requirement for a valuation. The price is the subject of negotiation between buyers and sellers, or the company sets a price and employees can take it or leave it. In many cases, companies have formulas to set the price, often based on book value or some multiple of earnings. There are some downsides to not having a valuation, though. First, at least in our experience at the NCEO, the sale price is usually artificially low. That is good for employees and makes the deal more practical, but sellers are giving up a potentially significant dollar amount. On the other hand, if the company does poorly, employees may contend they were overcharged and potentially sue, arguing that sellers used an excessively optimistic approach. An outside valuation resolves these issues.

Another potential concern is securities laws. Any offer to sell stock is potentially a securities law issue, but the typical transactions of this sort can avoid these problems. Securities laws exist at the state and federal level. Each state has its own rules, although there are broad similarities between states. Securities laws are a large and complex subject, but their two key elements are registration and disclosure. Registration means the filing of documents with the state and/or federal securities agencies concerning the employer whose stock is being sold. Sales to key employees would be exempt from this requirement under a number of different rules. If you are selling to employees broadly, there are registration procedures for limited annual offerings of stock to employees that can be done for a low cost. Details of this issue are beyond the scope of this chapter, so consult your attorney.

Disclosure refers to providing information to buyers about what they are getting, similar to but frequently less detailed than what would be in a prospectus. At times, there are specific state and federal rules about what needs to go in these documents, including objective discussions of risks, the financial condition of the firm, officers' and directors' salaries, and other information. In the absence of requirements for the registration of the securities, disclosure is intended to satisfy the anti-fraud requirements of federal and state laws. While strict compliance with the law may not always require a full disclosure, including audited financials, officer and director salaries, and detailed descriptions of an investment's risk, among other things, it is prudent to discuss what you must and should disclose with an attorney. For instance, you may find that you are offering stock only to key people and that no disclosure is required because they are presumed to be sufficiently knowledgeable about the company. It may still be prudent, and also fairer to employees, however, to disclose key financial issues, risks, and opportunities.

Finally, it is worth comparing where key employees might end up in an ESOP versus an individual buyout. While there are an infinite number of scenarios, it makes sense to compare what the effect of the net financial impact of selling to an ESOP would be on key employees versus their buying stock directly. To make this comparison, you can use an approach like the one in table 6-1. It assumes the same price in each approach. The company is assumed to have 100 employees.

In this example, the key people actually come out ahead in the ESOP, but, of course, each company will be different.

Table 6-1. ESOP versus individual buyout

	Direct purchase	ESOP	Notes
Value of the company	$5 million	$5 million	
Pretax dollars required for purchase	$7.14 million	$5 million	ESOP purchase is pretax
Value of stock at 8% growth for 10 years in non-ESOP case; 10% in ESOP case	$10.8 million	$12.97 million	A 100% ESOP-owned S corporation pays no corporate income taxes, so its growth rate should be better, other things being equal. This estimate is simply for illustration.
Percentage of shares (bought in direct sale; allocated in ESOP sale)	100%	15%	Because stock is allocated by pay, higher paid people get more. This percentage varies by company payroll and size, but this would be a reasonable guess for a company this size.
Percentage of shares held after 10 years	100%	20%	Forfeited shares are reallocated, and key people are likely to stay longer and thus get more.
Additional equity rights	None	10%	Many ESOPs provide synthetic equity for key employees, usually in the range of 5% to 15% of total share value.
Value of shares after 10 years	$7.14 million	$3.9 million	Assumes total shares and equity rights come to 20% plus 10%.
Net gain minus amount invested	$2.14 million	$3.9 million	

In talking with advisors, we at the NCEO have found that relatively few businesses outside professional firms have sold directly to employees, largely because of the financial challenge it presents.

Sale to Another Company

A more common option is a sale to another company, often a competitor. Many business owners believe that they can get a substantial premium in doing so. It is not clear just how realistic this is for ESOP candidates. The NCEO surveyed ESOP advisors to ask how many of their clients could have sold for a 20% premium, a number that would at least significantly overcome the tax advantages possible in an ESOP where the seller defers tax on the gain. About half the advisors said only 2% to 5%; the other half said 25% to 40%. The bifurcation may reflect their roles—lawyers were on the low end, while investment bankers, who are often hired by sellers who think they can get a significant premium, are on the high end. Either way, only a minority of sellers will get a large premium. Note that this premium often comes with contingencies, terms, conditions, representations, warrants, employment agreements, and other requirements that may make the sale price less than what it seems. For instance, the nominal offer may be for a 30% premium, but a portion of that may be contingent on meeting future sales targets. ESOPs do not have these requirements.

In selling to another company, sellers should factor in the tax deferral available with an ESOP sale. Say again you are selling for $5 million. Assume that you reinvest the full $5 million in qualified replacement property with a return of 8% per year. After 10 years, you now have $10.8 million. Assume all that is gain because your original basis was zero. Assume the $10.8 million is taxed at 25%, so $8.1 million is left in the ESOP sale.

Now assume you sell for $6 million to another buyer. If that is taxed upfront at a combined state and federal rate of 25%, that leaves $4.5 million. That turns into $9.7 million 10 years later if also invested at 8% gains per year. That is then taxed at 25%, leaving $7.25 million. In other words, even at a 20% premium, the seller comes out behind.

That is not all there is to the story, however. The ESOP seller can only invest in stocks and bonds of U.S. operating companies; the seller to another company can invest in anything. An ESOP sale often involves a seller note, especially if the sale is for 100% of the stock. That puts the seller at risk until the loan is repaid; a sale to a third party may have some contingencies, but much, if not all, of the price is paid up front.

Table 6-2 looks at some key points of comparison between selling to an ESOP and selling to another company other than tax issues.

Table 6-2. Selling to an ESOP versus selling to another company: key non-tax issues

	ESOP	Sale to another company
Key legal documents	• ESOP plan document • Trust agreement • Lender agreements • Corporate resolutions • Stock purchase agreements • Corporate governance agreements • Employee contracts/ management incentives	• Detailed selling memorandum • Sale agreement (similar to stock purchase) • Noncompete agreements (often) • Liens, escrow, security agreement, and personal guarantees • Corporate resolutions • Employee contracts/ management incentives
Feasibility studies and preparation	Feasibility studies assess whether the company has sufficient payroll and cash flow to buy the desired amount of stock. Can be performed internally or with expert advice. Forensic due diligence rarely needed.	Companies must prepare a detailed and accurate description of the firm and its finances, prospects, and risks. Buyers will want to do a forensic due diligence investigation, and sellers should do the same to assess the financial soundness of the buyer and the terms of the offer.
Valuation	Outside appraisal required; valuation based on fair market value.	In smaller deals, outside appraisal not required but recommended; in larger deals price usually set by controlled auction.

Table 6-2. Selling to an ESOP versus selling to another company: key non-tax issues

	ESOP	Sale to another company
Terms and risks	Plans can be structured in a variety of ways: • Flexibility in financing. • Rules for operating the plan must comply with ERISA, but there is lots of flexibility in design. • Escrow may be, but usually is not, required.	Buyers will typically have multiple contingencies: • Earnouts often required, often in the 10% to 20% range. • Escrow held back. • Purchase price adjustments in companies that underperform post-transaction may be required based on working capital or earnings requirements. • Buyers prefer to purchase assets, with potential tax and liability implications for sellers. • Financing may fall through.
Time to sell	Once the seller has decided on doing an ESOP and its basic structure, four to six months.	Median formal offer to sale time is 10 months for companies in the small to mid-market range.
Role of seller post-transaction	Flexible depending on seller interests.	Buyer will usually determine role in smaller deals; in large deals role is usually negotiable.
Role of employees post-transaction	Determined by ESOP company.	In many cases, to achieve required synergies, some employees are laid off.
Sale of minority interest	ESOPs can buy any percentage of stock from any number of sellers.	Buyers almost invariably want to buy the entire company.
Success rates	If an ESOP is determined to be feasible, only rarely do transactions fall through once a decision to proceed has been made.	Overall, only about 25% of privately held businesses put up for sale are sold, and only about 50% of businesses with 100 or more employees are sold.

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	ESOP	Sale to another company
Transaction costs	• For most closely held companies, between $60,000 and $100,000, with a minority in the $100,000 to $200,000 range. • A small number of ESOPs will require investment banking assistance to raise financing, adding to costs. • No broker fees should ever be paid in an ESOP • The ESOP pays the diligence, financing, and legal fees.	• Legal costs may be somewhat lower. • Feasibility and due diligence comparable to or higher than ESOPs, and considerably higher in larger deals. • Legal costs are similar for smaller sales and much higher for large sales. Appraisal costs, if needed, would be similar. • The buyer usually pays the diligence, financing, and legal fees. Broker success fees are generally between 5% and 12% of the sale price in sale prices under $5 million and drop as low as 1% to 3% in larger transactions.

Selling to a Private Equity Firm

The amount of money in private equity firms has soared in recent years, and more closely held companies are selling to these buyers. There are no good data on just how often this occurs, but, overall, private equity funds own about 8,000 companies. This includes venture backed start-ups and public companies or public company divisions sold to private equity companies. A reasonable guess is that a few hundred potential ESOP candidates a year are sold to these buyers, although this translates into only a very small fraction of the estimated 150,000 to 175,000 companies that in theory could be sold to an ESOP.

Private equity sales will raise most of the same issues as sales to another buyer in terms of taxes, transaction complexity and process, and costs. What is less certain is the impact a private equity buyer will have on the company and the employees. A major difference, however, is that other company buyers usually are looking for a long-term fit; private equity firms are looking to sell in three to seven years, often to another private equity firm.

Data on the impact of private equity company purchases are mixed. Some studies point to improved R&D spending and improved financials; other say that the acquired firms end up with fewer employees and under-investment as private equity firms seek to maximize EBITDA in order to improve the prospects for resale. In talking to business owners considering an ESOP, the perception is almost universal, whether accurate or not, that a sale to a private equity firm will mean that some employees will lose their jobs and that wages and benefits will at best be closely monitored and at worst reduced. There are some private equity firms, however, that do offer at least some ownership awards to at least some (usually key) employees. Over the years, we at the NCEO have talked to some business owners who were so unhappy with what a private equity firm did to their company that they bought it back and later sold it to an ESOP.

It is also clear that private equity firms almost always offer a substantial premium on the price of the company, even though they are usually financial, not strategic, buyers.

Deciding Which Route to Take

For those owners for whom price is not a paramount consideration, it may not make sense to pursue other potential buyers, and most sellers to ESOPs do not. Where a seller is concerned about price and believes a substantial premium is possible, it makes sense to hire a firm that is experienced in both ESOP and non-ESOP sales. These firms, usually investment bankers, will solicit other bids to compare to the ESOP and lay out the pros and cons of each approach. Most often, they charge a success fee of 1.5% to 3% of the sale price, with higher fees more likely in smaller transactions. Most of these firms are looking for a minimum deal size, often at least $10 million but often higher.

If your company is smaller than that, then it makes sense to work with an accountant and attorney experienced in both ESOP and non-ESOP sales. They will not seek out other buyers, but you may have received tentative or serious expressions of interest or can hire a business broker specializing in smaller deals. These brokers often will discourage you from doing an ESOP, however, because the buyer pays their fees, and it is hard to justify charging for “finding” the ESOP as a buyer. Nonetheless, they can often (but not always) provide potential other buyers.

About the Authors

Christopher J. Clarkson is a senior vice president and director in Bernstein's Wealth Strategies Group. Based in Los Angeles, he has expertise in a variety of complex investment planning issues, including selling a business, diversification of concentrated stock and option portfolios, retirement planning, multigenerational wealth transfer, and philanthropy. Clarkson is a frequent lecturer to groups of tax and legal professionals at continuing education institutes, estate planning councils, charitable organizations, and major accounting and law firms throughout the western United States. He joined Bernstein in 1995 and has been a member of the Wealth Strategies Group since 1998. Clarkson earned a BA with high honors in business/economics from the University of California, Santa Barbara, and is a Chartered Financial Analyst charterholder.

Ronald J. Gilbert ("Ron") is the cofounder and president of ESOP Services, Inc., an international consulting firm specializing in ESOP transactions. The firm has offices in Virginia, Maryland, and San Diego, with clients throughout the U.S. and internationally. Ron holds a BS from the Mclntire School of Commerce at the University of Virginia and a master of financial services from The American College. He currently serves on the ESOP Association's board of governors and its Legislative and Regulatory Advisory Committee, and on the board of directors of three ESOP companies. He is a former NCEO board member. Ron has spoken in nine countries and also has authored many articles on ESOPs. He is a coauthor and coeditor of *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation,* the most comprehensive work on the subject. Ron was instrumental in obtaining the first IRS private letter ruling sanctioning an international ESOP for a U.S.-based company. Before cofounding ESOP Services, Inc., Ron was a vice president of Kelso & Company in San Francisco, working with Louis Kelso, the "father" of the ESOP.

Stacie Jacobsen is a vice president and director in Bernstein's Wealth Strategies Group. Based in Bernstein's Los Angeles office, she works closely with high-net-worth clients and their professional advisors on a variety of complex planning issues, including multigenerational wealth transfer, philanthropy, liquidity events, and retirement planning. Jacobsen joined the firm in 2001 and began working in the Wealth Strategies Group in 2004. Jacobsen earned a BS in business administration with an emphasis in finance from the University of Colorado, Boulder, and an MBA from the Marshall School of Business at the University of Southern California.

Corey Rosen is the NCEO's founder and former executive director and now is its senior staff member. He cofounded the NCEO in 1981 after working for five years as a professional staff member in the U.S. Senate, where he helped draft legislation on employee ownership plans. Before that, he taught political science at Ripon College. Corey has spoken on various subjects related to employee ownership all over the world with government, business, and union leaders, and he is regularly quoted in leading magazines and newspapers. He has appeared on national television and radio programs and also has authored four books on employee ownership, plus more than 100 articles for various business, academic, and professional publications. He has authored or coauthored several of the NCEO's practical and research publications. He holds a PhD in political science from Cornell University.

Paige A. Ryan, using over 25 years of experience in the field of equity compensation and employee ownership, is a driving force behind the consulting services for ESOP Services, Inc., a national consulting firm that assists private and publicly owned companies in designing and implementing successfully employee stock ownership plans. She specializes in working directly with business owners to help them analyze and understand the ESOP's impact on the company, shareholders, and employees, focusing on the financial aspects of cash flow, tax savings, shareholder liquidity, and employee benefits. A member of the National Center for Employee Ownership and the ESOP Association, Paige speaks frequently on the topic of ESOPs; teaches a graduate course titled "Topics of Corporate Governance: Techniques of Equity Compensation" for the University of California; and writes on the subject. Paige holds a master of international business from the University of San Diego and a bachelor of arts from California State University, Long Beach.

Kenneth E. Serwinski is the cofounder and chairman of Prairie Capital Advisors, Inc., a middle market investment bank and financial advisory firm specializing in ownership transition and the implementation of exit strategies. He has advised companies on over 400 ESOP transactions. Prairie Capital Advisors' expertise in ESOPs includes valuation, structuring, financing, and managing the ESOP process. The firm also provides a varied menu of services for mature ESOP companies.

About the NCEO

The National Center for Employee Ownership (NCEO) is a nonprofit organization that has supported the employee ownership community since 1981. Our mission is to help employee ownership thrive. We have more than 3,000 members because we help people make smart decisions about employee ownership, with everything from reliable information on technical issues to helping companies reach the full potential of employee ownership.

We generate original research, facilitate the exchange of best practices at our live and online events, feature the best and most current writing by experts in our publications, and help employee ownership companies build ownership cultures where employees think and act like owners.

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- The right to contact the NCEO for answers to questions.

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What Is an ESOP, and Should You Sell Your Business to One?

Myths and misconceptions prevent many owners of closely held businesses from considering selling their companies through an employee stock ownership plan (ESOP). For many such owners, ESOPs have advantages in terms of tax, financial, and intangible issues that no other transaction method can offer.

The alternatives to an ESOP sale, while appropriate for some business owners, may not be feasible or may have disadvantages that make them unpalatable to others. For example, a sale to a third party often results in protracted negotiations with someone who does not view the company the same way the owner does and who may have no concern for the welfare of the employees, the community, or the legacy of the company. Third-party sales rarely allow the owner to sell a partial interest and may impose substantial constraints on the seller. An initial public offering (IPO) is available to few companies and imposes time constraints on when the owner can "sell out" after the IPO. Management buyouts are intriguing, but the actual nuts and bolts of making them happen, especially financing, will derail many such transactions.

An ESOP can provide a market for a closely held business, which can be sold to the ESOP either as a going concern or in stages. The ESOP also provides significant tax incentives for the selling shareholder, the corporation that establishes the ESOP, and the employees of the corporation. Additionally, companies that combine an ESOP with employee participation programs tend to show substantial performance gains.

This book is designed to educate owners, managers, and advisors of closely held businesses on selling to an ESOP. It describes how ESOPs work and what the basic rules are; how valuation works in an ESOP transaction and during the ongoing operation of the ESOP; financing and feasibility; and the tax-deferred Section 1042 rollover, which has benefitted many selling owners over the years. The final chapter discusses alternatives to an ESOP sale. Armed with this book, you will be able to make a more informed decision about selling to an ESOP.

NCEO

1629 Telegraph Ave., Suite 200
Oakland, CA 94612
(510) 208-1300
www.nceo.org

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