7th Annual Vermont Employee Ownership Conference
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An Introduction to Employee Ownership

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VEOC
Vermont Employee Ownership Center

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Goals of the Presentation

- Give an overview of ESOP and Employee-Owned Co-operatives so you can understand the basics
- Answer your questions!

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What is an ESOP?

- “Employee Stock Ownership Plan”
- Company funded - no employee contributions
- Employees do NOT own the stock; stock is held in trust
- Qualified retirement plan under IRS

What is a Worker Co-op?

- A worker cooperative is a business owned and controlled by its employee members for their common good
- In a worker cooperative, membership is generally limited to those who work in the business
- Ownership is direct, not indirect

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Why Use An ESOP or Co-op:

- To make a market for <u>part</u> of the owners' stock
- To defer payment of capital gains taxes
- To enable owners to sell shares while maintaining control of the company
- To motivate, retain and reward employees
- To make a more democratic workplace
- To borrow where the interest <u>AND</u> principal payments are tax-deductible (only in ESOP)

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ESOP Ownership

- Shares purchased by the ESOP are owned in a trust, not by plan participants; eligible employees are “beneficiaries” of the trust

- An independent trustee represents the interest of ESOP participants.

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Co-op Ownership

- Shares purchased by members in a co-op are owned directly by the members
- The members vote on a one person-one vote basis

Primary Roles of an ESOP or Co-op in Succession Planning

To help owners create cash and liquidity

To help manage the succession and continuity of the business

To reward the people that have helped grow the company

In the ESOP, to do so in a controlled and tax efficient manner

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Which to Choose - - ESOP vs. Co-op
Some Key Factors

- Size of Company
- Costs (start up and maintenance)
- Decision making (share voting vs. one person/one vote)
- ESOP income is share based and in Co-op it is labor based
- ESOP is a retirement plan – defers the economic benefit
- There are significant tax differences; while both can use the Section 1042 tax deferral, but only an ESOP-owned company can be tax free

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ESOP Succession Plans – Forms

- Pay as you go ESOP
- Pre-fund ESOP
- Bank-financed ESOP
- Seller-financed
- Combination of Redemption and ESOP Stock Purchases
- Combinations of the foregoing
- See Appendix for more detail!

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Capital Gains Tax Deferral Overview

- Legislation passed by Congress in 1986 provided a tax incentive for shareholders of private businesses to sell stock to an ESOP
- §1042 of the Internal Revenue Code
- Shareholders can defer indefinitely paying federal capital gains taxes on the sale of stock to an ESOP subject to certain requirements
- Some states also recognize §1042 for deferral of state capital gains taxes

S Corporation ESOPs

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S Corporation ESOPs: Background

- Prior to 1998, S corporations could not have an ESOP as a shareholder
- S corporation ESOPs do not qualify for capital gains tax deferral, however…..
- Some clients will convert from an S corporation to a C corporation to receive the favorable capital gains treatment, still……
- Half of our clients transact as S corporations where the selling shareholders immediately pay the capital gains tax
- There are unique tax benefits for S corporation ESOPs

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S Corporation ESOP Tax Benefits

- S corporation shareholders are responsible for paying for their pro rata share of the company's tax liability
- An ESOP is a non-tax paying shareholder and is exempt from paying federal income taxes
- As an S corporation shareholder, the ESOP is not required to pay its pro-rata share of the company's taxes
- ESOP can use distributions it receives to pay debt rapidly

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The S Corporation ESOP Home Run

- An S corporation that is 100% owned by an ESOP
- Company is exempt from federal and most state income taxes
- Cash flow used to rapidly retire debt
- Once debt is paid, company is a “cash cow”

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The S Corporation ESOP <u>Grand Slam</u>

- Shareholders sell 100% of C corporation stock to an ESOP
- No capital gains tax due for selling shareholders
- Company converts from a C corporation to an S corporation after the ESOP transaction
- Company is now tax free

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ESOP Stock Appraisals

- ESOP trustee hires a third-party, independent appraiser as an advisor
- Appraiser should be experienced in the industry and in valuing stock for ESOP transaction purposes
- The trustee is ultimately responsible for ensuring that the ESOP did not “overpay” for the stock
- ESOP stock includes a “put” feature
- ESOP stock must be reappraised annually

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Best ESOP Candidates

- Is at top of its profession
- Is profitable and growing
- Finances its own growth
- Not overleveraged
- Has good financial reporting
- Has a deep and broad management team

Co-op Structure

- Board is elected on the basis of one person, one vote (direct).
- Labor is pooled
- Management structure can be hierarchical – being a co-op doesn't need to imply broad involvement in all decisions.
- Patronage dividends on basis of labor, taxable to members
- Good alternative if ESOP proves too costly
- Also can be used in large-scale businesses

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Co-op Structure

- Easier, cheaper to setup
- Good fit in company with collegial culture
- Financial benefit to employees can be sooner
- Employees can become equal shareholders without draconian tax effects

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Membership Structure in a Worker Cooperative

- Membership is open to all eligible employees after a period of years
- Members can own only 1 share
- Members who leave must sell their share back to the company
- Profits are shared equitably among members, usually on the basis of hours worked

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Membership

- Typically, to be eligible for membership an employee must:
  - Work a minimum number of hours;
  - Have worked for a probationary period;
  - Be approved by the existing members;
  - Pay a Membership Fee (affordable but meaningful).
  - Specific requirements in your bylaws

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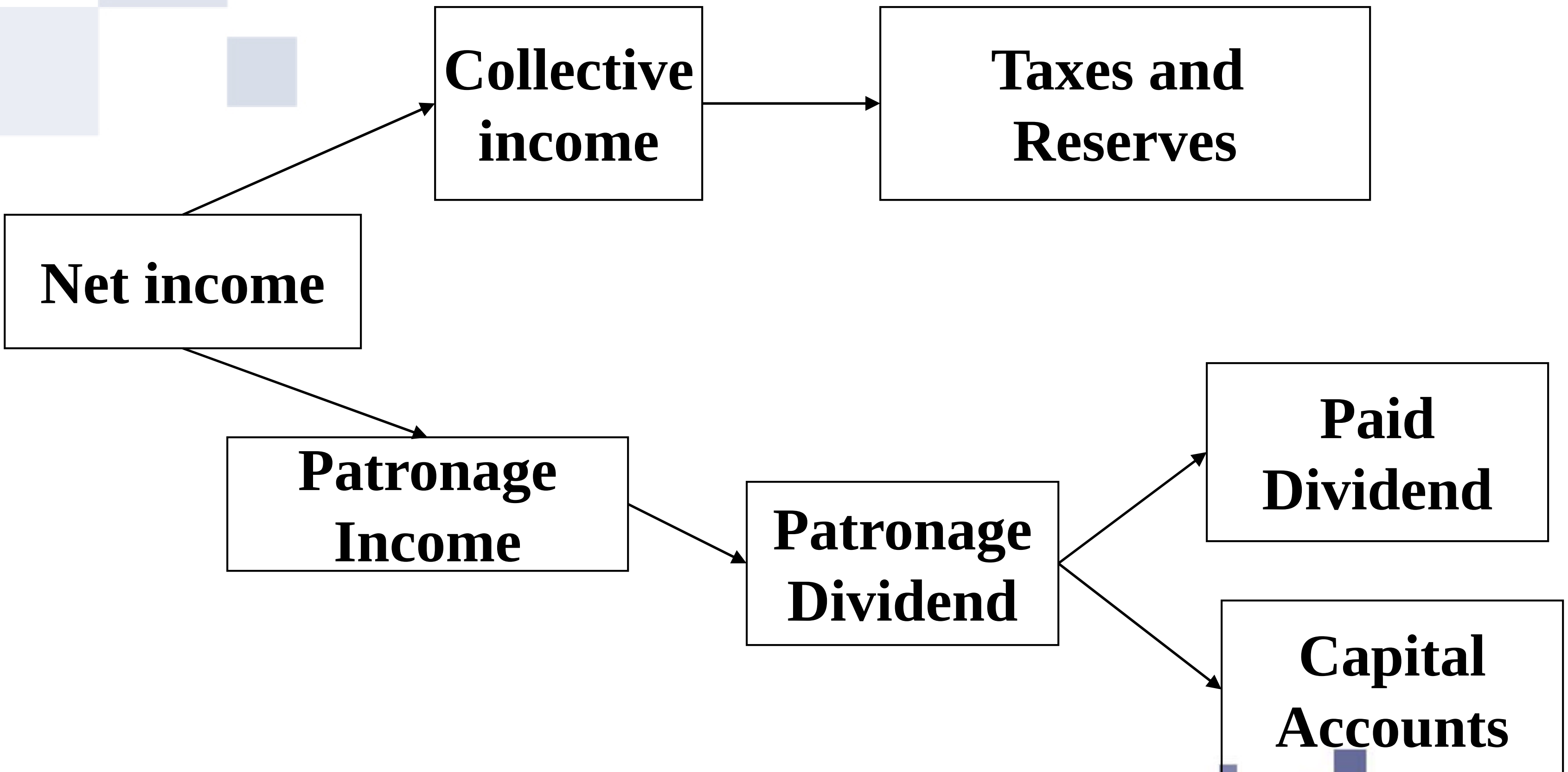
Patronage Dividends



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Considerations in Sharing Net Income

- Collective account a key source of working capital: important especially for growth or capital intensive companies, or during startup phase
- Tax rate generally lower on individual accounts
- Limitations usually set on when individual accounts are distributed – longer times help finance company, delay payout to worker-owners
- Often payout cycle set to avoid obligations growing too large

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Summary

- A number of different avenues available
- Different businesses have different needs

Questions?

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South Mountain Company

SOUTH MOUNTAIN COMPANY is an integrated development, architecture, building, energy services, and consulting company serving the island of Martha's Vineyard and nearby locations.

Since 1975, we have enjoyed a rewarding adventure - a shared odyssey among employees, collaborators, clients, and community. Change has been constant, but we are always tied to a stable mooring - the island where we're located, where we work, and where we live.

- www.southmountain.com

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John Abrams

- JOHN ABRAMS is cofounder and CEO of South Mountain Company, a 34-year-old employee owned design/build and renewable energy company in West Tisbury, Massachusetts. John's book *COMPANIES WE KEEP: Employee Ownership and the Business of Community and Place,* was published by Chelsea Green Publishing in 2008. He serves on the Island Housing Trust and Island Affordable Housing Fund boards, the Green Building Advisor, and the steering committee of Island Plan, which is working on a 50 year plan for the island of Martha's Vineyard. John and his wife Chris live in a cohousing neighborhood designed and built by his company.

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Stephen Magowan

- Stephen Magowan is a shareholder in Steiker, Fischer, Edwards & Greenapple, P.C. and SES Advisors, Inc., ESOP and equity professionals providing legal, financial and administrative expertise around employee ownership, ESOPs and other equity tools, business succession and capital strategies issues. Steve focuses his practice on the formation of ESOPs and worker-owned co-operatives and is based in his firms' Burlington, Vermont office. He is the author of a chapter on board governance called "Governing the ESOP Company: Fiduciary Issues and Practical Solutions" in the upcoming book, "The ESOP Company Board Handbook" to be published this summer by the National Center for Employee Ownership.

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APPENDIX SLIDES

Common ESOP Succession Plans

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Case I

- Jane owns 51% and is seeking to sell her stock over several years as she approaches retirement
- XYZ Corp. would prefer to remain debt-free

Solution

"Pay-as-you-go" ESOP

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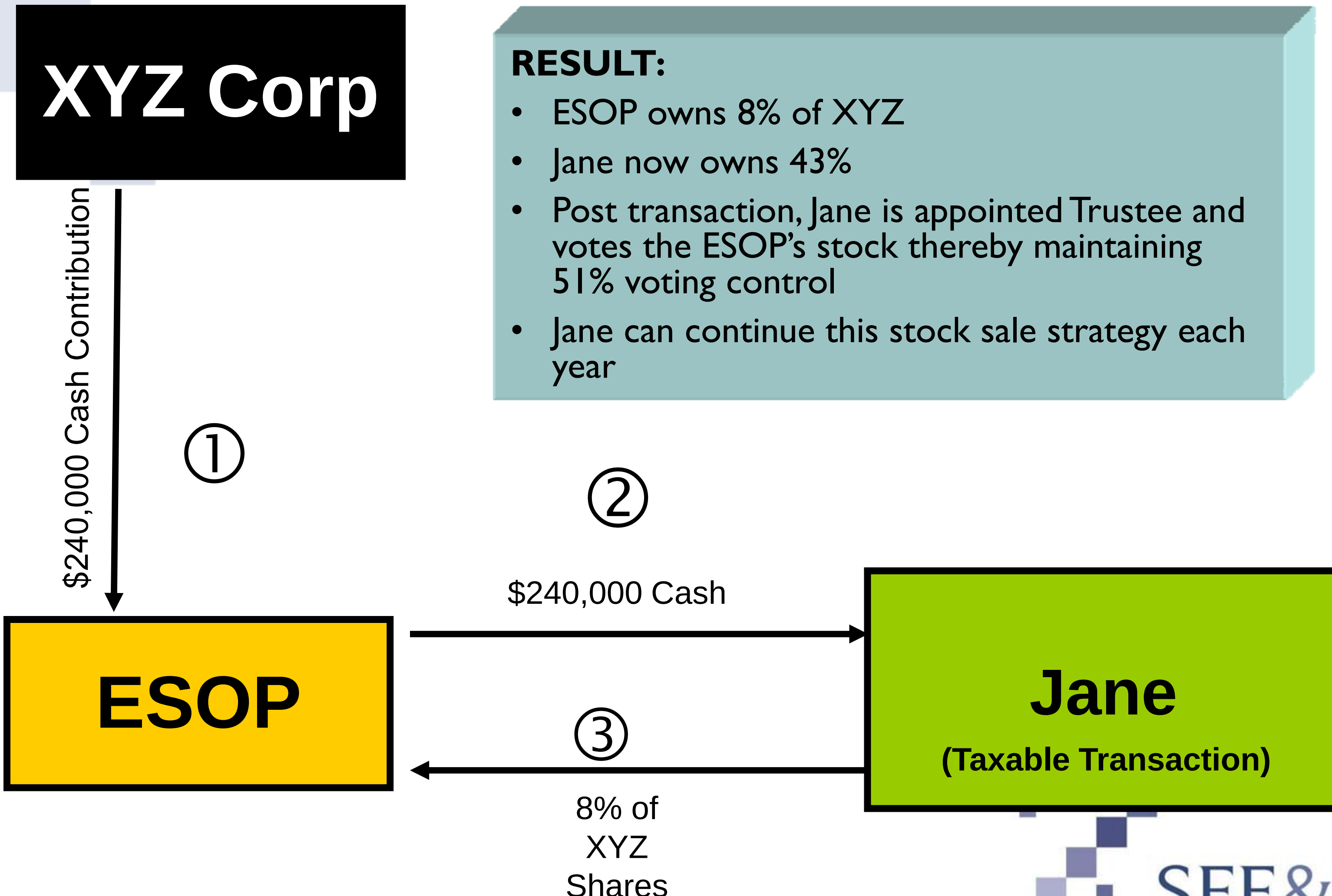
Pay-as-You-Go ESOP

RESULT:

- ESOP owns 8% of XYZ
- Jane now owns 43%
- Post transaction, Jane is appointed Trustee and votes the ESOP's stock thereby maintaining 51% voting control
- Jane can continue this stock sale strategy each year



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Case II

- The company has just experienced several financially challenging years, but the company’s prospects are now much brighter
- Jim would prefer waiting to sell stock until the share price has improved
- Company wants to immediately reduce income taxes

Solution

Pre-Funding the ESOP

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Cash II Solution: Pre-Funding the ESOP

XYZ Corp

$200,000
Year 1

$500,000
Year 2

$300,000
Year 3

$1,000,000
ESOP

Stock

$1,000,000

Jim
(Taxable Transaction)

RESULT:
- Company receives tax deduction for contributions each year, thereby reducing tax bill
- ESOP accumulates $1,000,000 (+) of cash over three years
- Jim sells 33% of stock to ESOP after Year 3

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Case III

- Jane wishes to sell a large block of stock to the ESOP
- Jane does not want to pay capital gains taxes
- The company has “debt capacity”

Solution

The Leveraged ESOP

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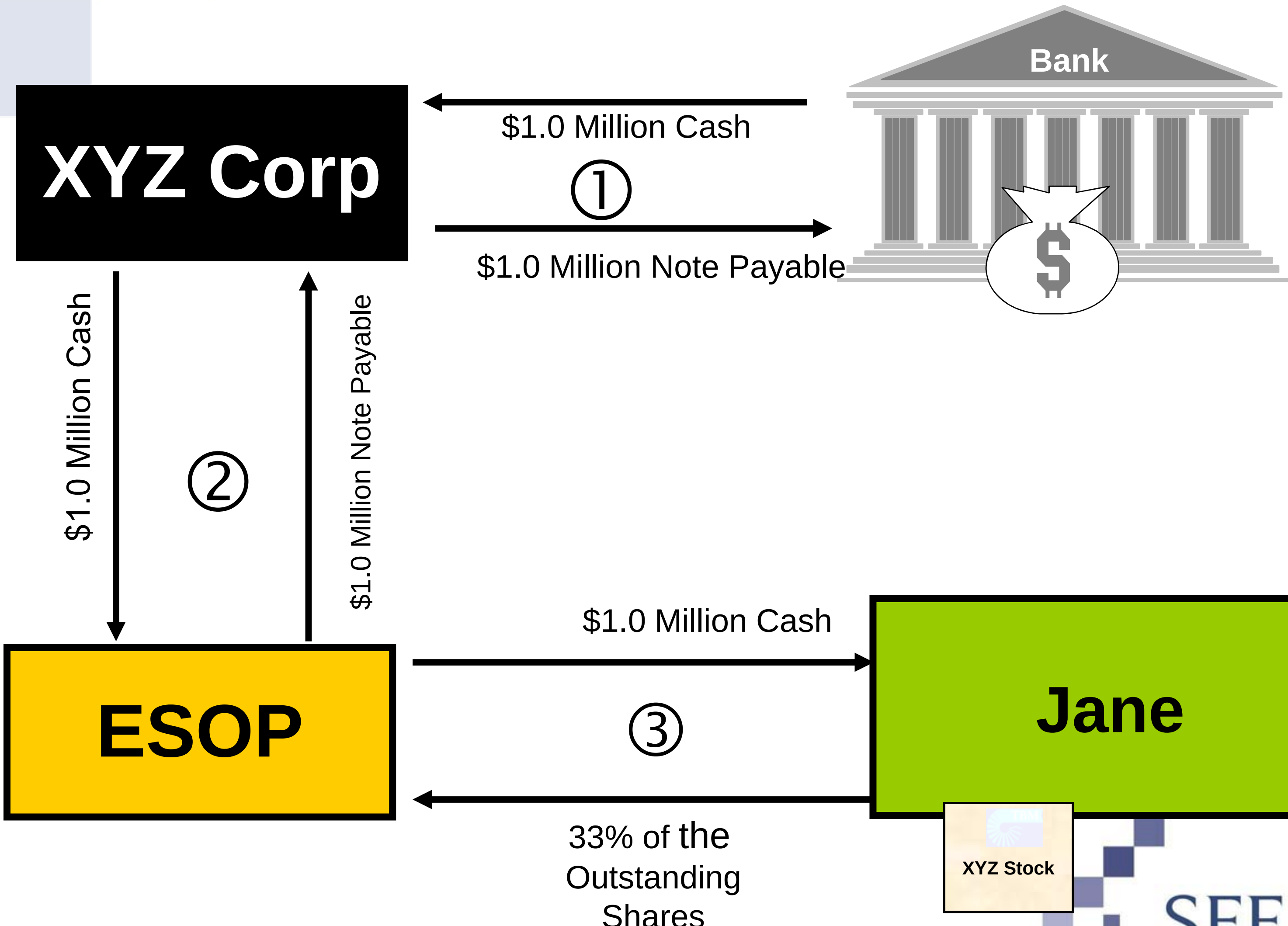
Leveraged ESOP: Bank Financed



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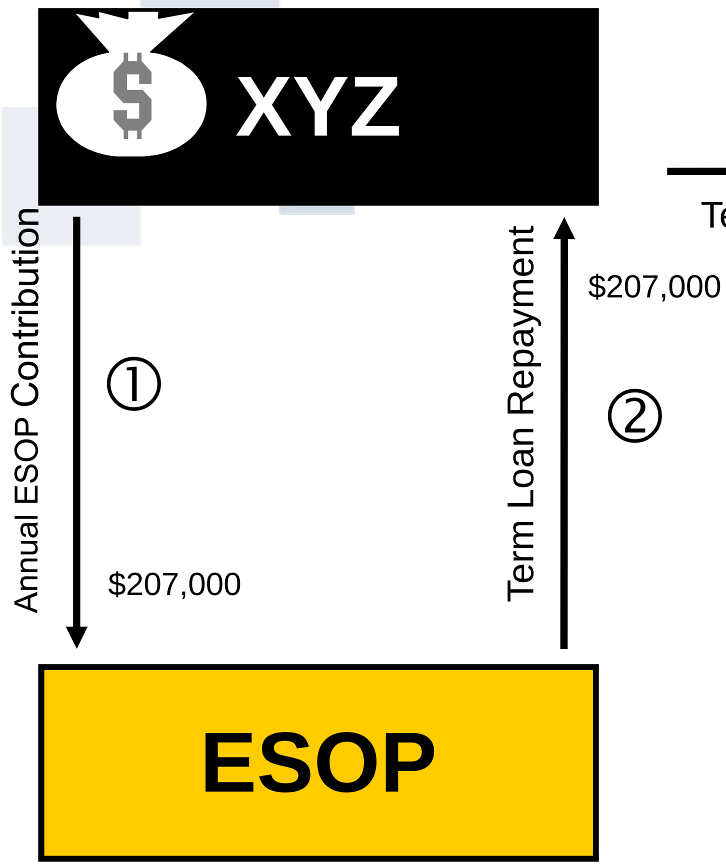
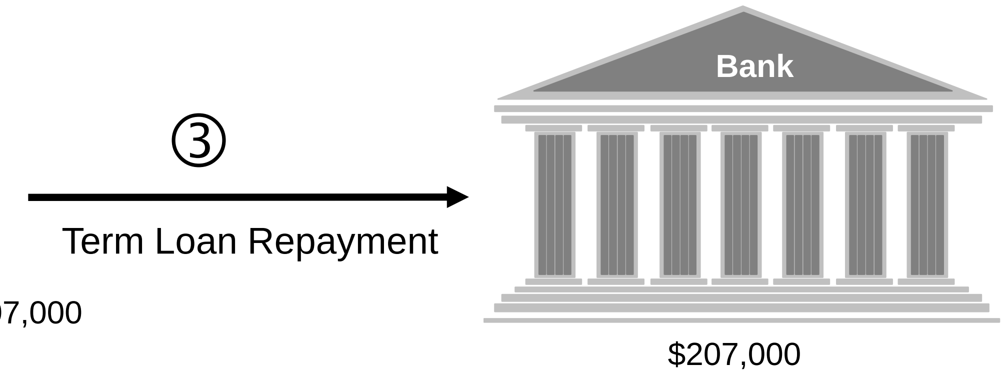
Paying Off The Debt





1. Company makes <u>tax deductible</u> contribution and dividends to the ESOP
2. ESOP uses the contribution to repay its loan from company
3. Company repays Financial Institution

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Case IV

- Same as Case III but...

  ...the company does not borrow from a bank

Solution

Seller Financed ESOP

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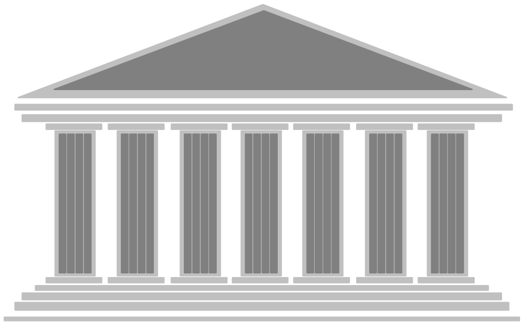
Seller Financed ESOP

XYZ Corp



$1.0 Million Note

ESOP

Jane

XYZ Stock

33% of the Outstanding Shares

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Paying Off The Seller Note

XYZ

Annual ESOP Contribution

①

$207,000

ESOP

②

Term Loan Repayment

$207,000

Jim

1. Company makes <u>tax deductible</u> contribution and dividends to the ESOP

2. ESOP uses the contribution to repay Jim's seller note

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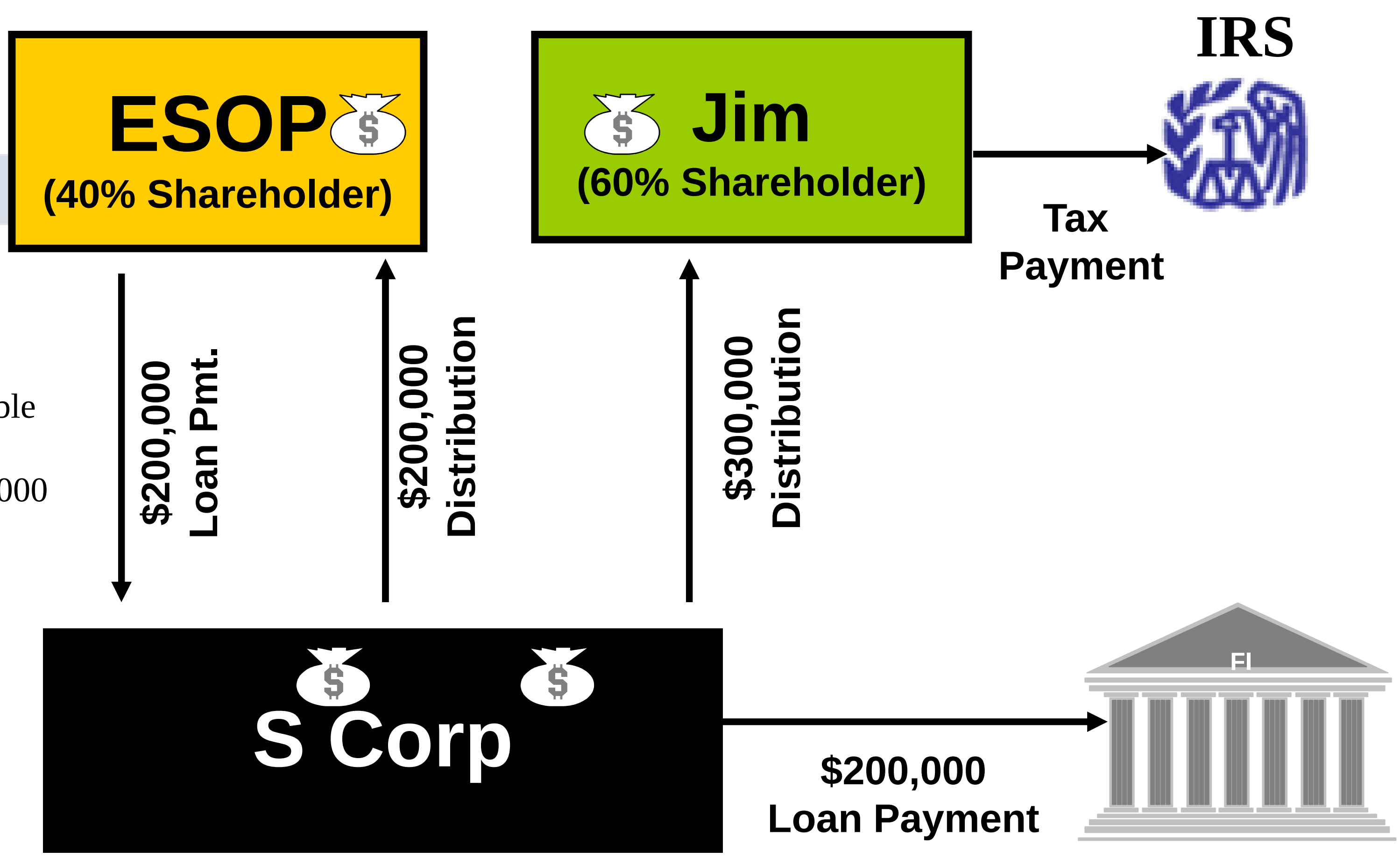
Tax Treatment on Seller Note

- Interest Earned will be taxed at ordinary income rates

- Principal will either be:
  – Taxed at capital gains tax rates on an installment basis

  – Deferred using ESOP bonds, if Company was a “C” corporation at time of sale

S Corporation Distributions with ESOPs



Assumptions

- S Corp generates taxable income of $1,000,000
- S Corp makes a $500,000 distribution to its shareholders pro-rata

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Seller Financed Co-op Sale