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Selling to an ESOP:
A Step-by-Step Guide

VEOC
Vermont Employee Ownership Center

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Agenda

- Ownership Transition for Privately-Owned Companies
- Common ESOP Transaction Structure Examples
- C Corporation ESOPs
- S Corporation ESOPs

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Ownership Transitions for Privately-Owned Companies

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Liquidity and Succession: Some Common Goals

- Maximize after-tax proceeds
- Control timing of succession and transfer
- Shareholder/officer ongoing role as executive
- Diversify personal wealth
- Legacy

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Liquidity & Succession Alternatives

External buyers

- Strategic
- Financial
- IPO

Internal Buyers

- Family
- Management
- Partner (Redemptions & Buy-Sells)
- ESOP

Liquidation

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ESOP Basics

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What is an ESOP?

- "Employee Stock Ownership Plan"
- Qualified retirement plan under IRC
  - Regulated by US DOL and IRS
  - Company funded benefit - no employee contributions
  - Assets held in a Trust; employees do NOT own the stock directly
  - Intended to be invested primarily in company stock
- Only qualified retirement plan that can borrow money
- Tax efficient and controlled means of selling stock

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Why Use An ESOP?

- ***Shareholder Liquidity***: Create a market for <u>part</u> of the owners' stock
- ***Shareholder Tax Minimization***: Defer payment of capital gains taxes
- ***Corporate Tax Minimization***:
  - Effectively create interest <u>AND</u> principal payments tax deductions
  - S corporation ESOP federal income tax exemption
- ***Succession Planning***: Shareholders can sell shares while maintaining control of the company
- ***Legacy***: Maintain company's independence
- ***Employees***: Motivate, retain and reward employees

Business Owner Objectives?

- **Legacy**
- **Employee concern (family)**
- **Control / maintain day-to-day**
- Diversification
- Avoid / Reduce Income Tax (Seller & Company)
- Control of deal structure
- Additional retirement plan for employees
- Increase employee productivity / employee incentive
- Not ready to golf / leave company
- Value / purchase price certainty
- No ownership transition alternatives – close the doors
- Liquidity
- Remove unwanted shareholders / reduce large number of shareholders

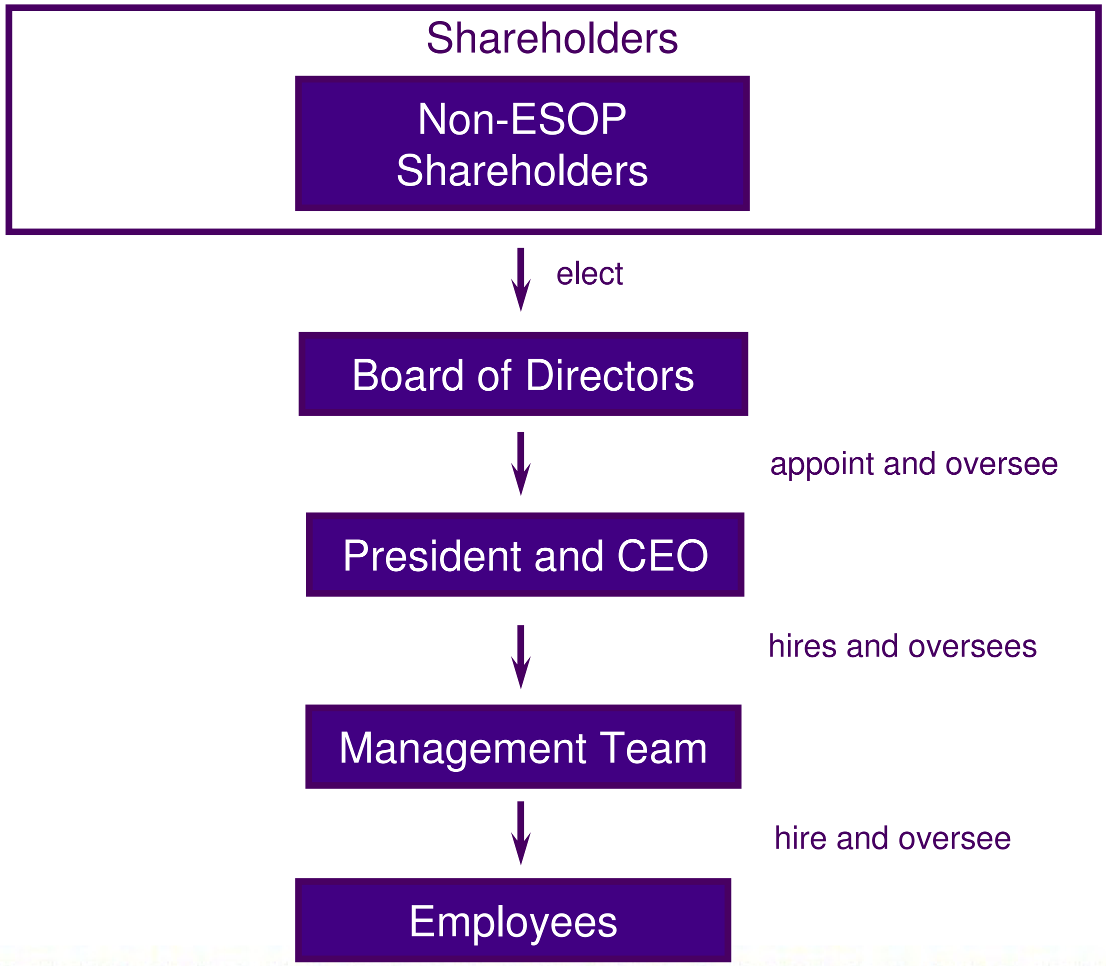
ESOP's Primary Roles

- Help owners convert paper wealth into cash and liquidity
- Help manage the succession/continuity of the business
- Reward the people that have helped grow the company
- Transition in a *controlled* and *tax efficient* manner

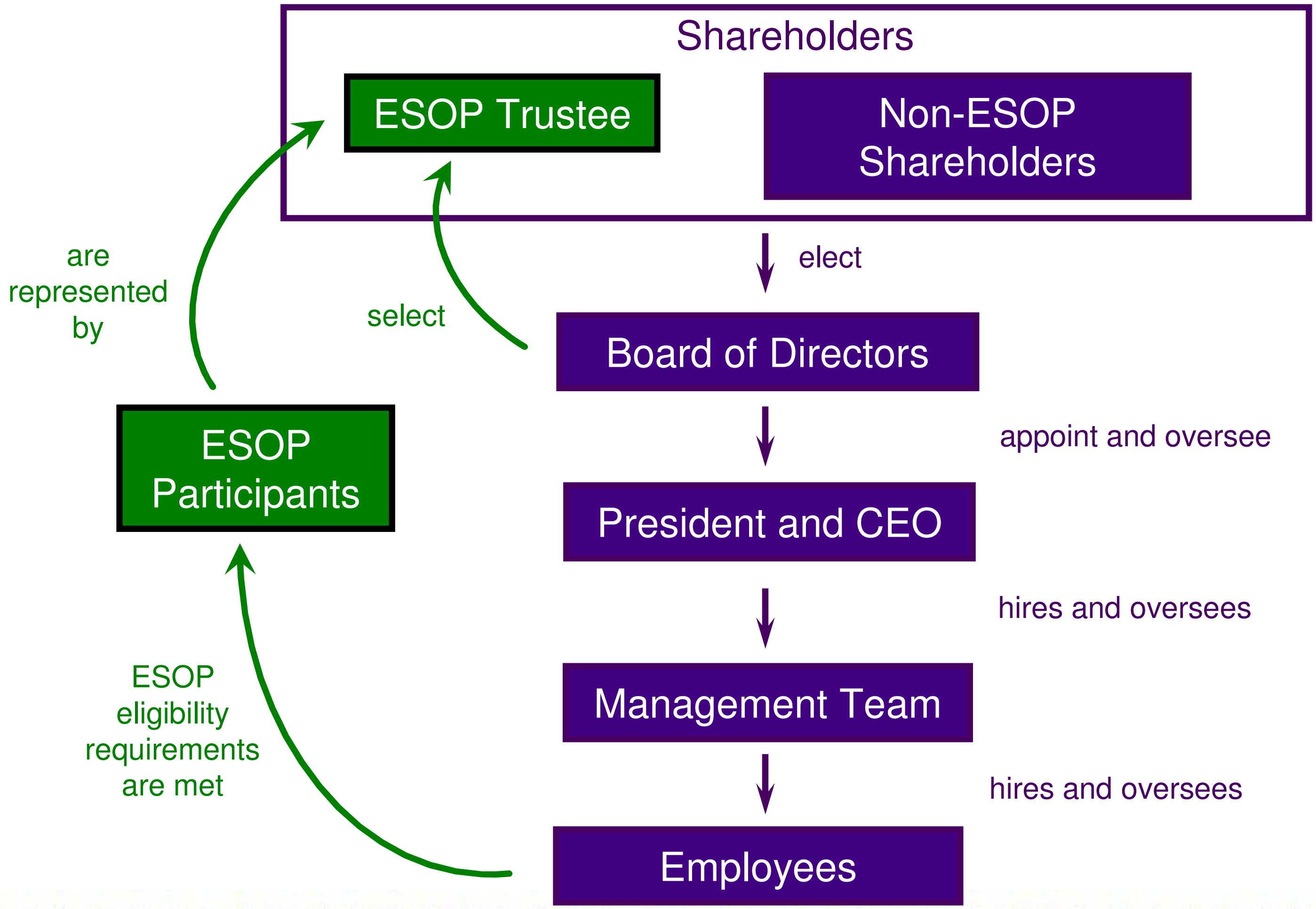
ESOP Trust Ownership: Beneficial vs. Direct Ownership

- Shares purchased by the ESOP are owned in a trust, <u>not by plan participants</u>
  - Eligible employees are "beneficiaries" of the trust
- An independent trustee represents the interest of ESOP participants

XYZ, Inc. Structure Pre-ESOP



XYZ, Inc. Structure After ESOP



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Common ESOP Misperceptions

- Participants own and vote the stock
  - Untrue unless you are a public company or shareholders get to vote on a major issues (which does not include voting for the Board)
- Participants are entitled to company financial statements
  - Untrue, unless you are a public company
- All of the company's stock must be sold to an ESOP
- A company has to be a C corporation to sponsor an ESOP
- A company has to use debt to sell stock to an ESOP

Situations Not Befitting an ESOP

- No successor management
- Owner only wants a few people to own the company
- There may not be enough "Es" to "SOP"
- Owner's price is "opportunistic"

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Where Do You Start?

- Conferences like this are a good start.
- NCEO books and websites
- Ask what do you want?
- What can work for you and your company?

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The Forming ESOP Process

- Consider a transaction study
- Creates the book for the Trustee
- Sets the transaction in motion.

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The Forming ESOP Process

- An ESOP Trust is established
- An ESOP Trustee is appointed (Internal or External)
- An outside appraisal of the company
- The owners sell their stock to the Trustee and possibly the Company
- The Trustee and the Company issues notes to the owners or owners receive cash
- The owners get an employment contract and non compete agreement

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Living the ESOP

- Every month the ESOP is paid down and the old owners get a check
- At the end of each year:
  - A new appraisal is done on the company
  - Stock is distributed to eligible employees
  - Stock is distributed at original sale price but assumes new price in employee account.
- A company meeting is held and everything is explained

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Some Common ESOP Transaction Examples

Typical ESOP Transactions: Case Study Assumptions

- XYZ Corp. has two shareholders, Jim who owns 80% and Pat owning 20%
- XYZ is profitable and has a payroll of approximately $8 million
- The company’s book value is $10 million
- Earnings (EBITDA) average approximately $3 million per year
- FMV is $15 million

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Case I: Non-Leveraged ESOP

- Jim is seeking to sell his stock over several years as he approaches retirement
- XYZ Corp. would prefer to remain <u>debt-free</u>

Solution

"Pay-as-you-go" ESOP

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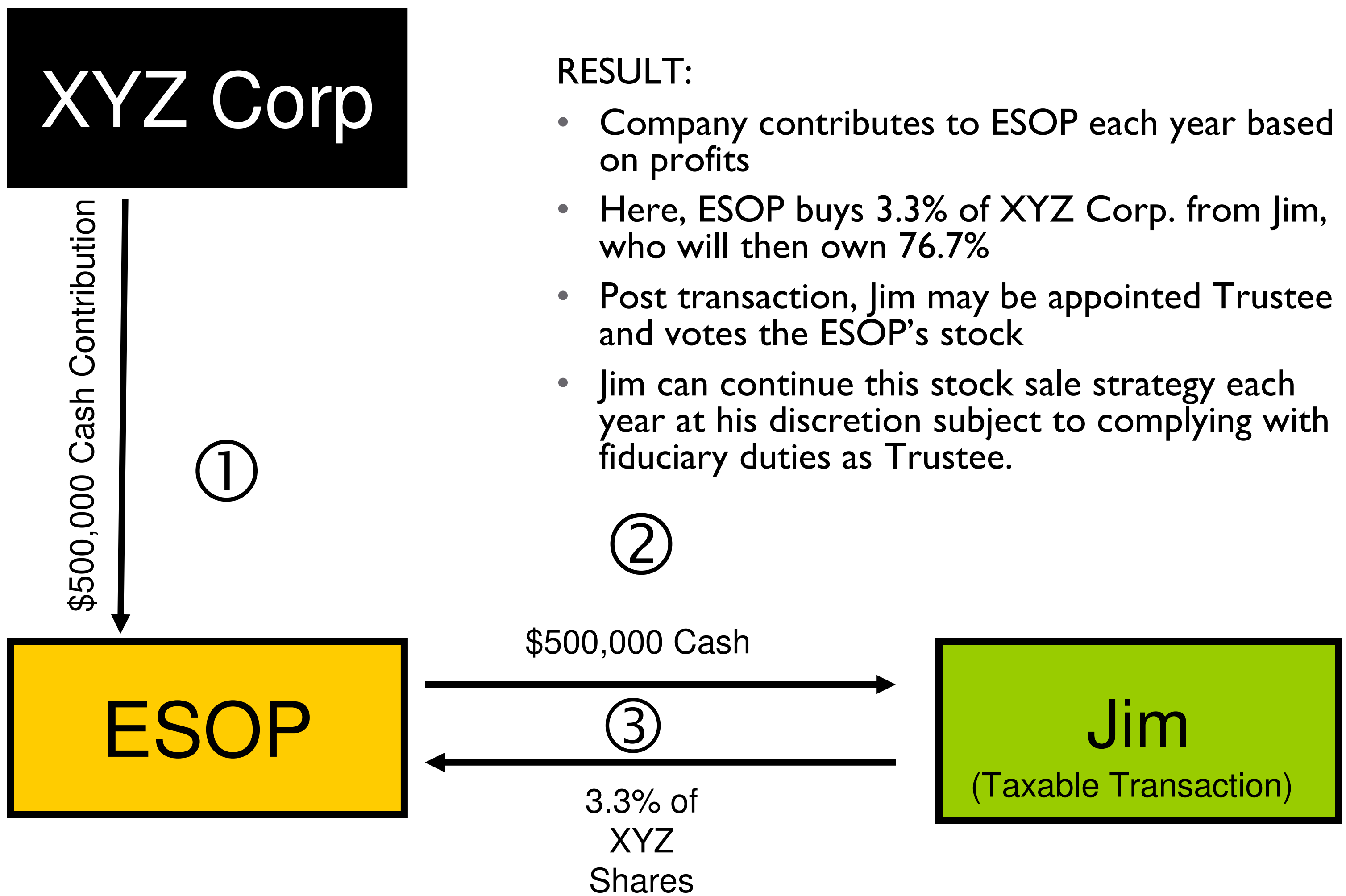
Pay-as-You-Go ESOP

RESULT:

- Company contributes to ESOP each year based on profits
- Here, ESOP buys 3.3% of XYZ Corp. from Jim, who will then own 76.7%
- Post transaction, Jim may be appointed Trustee and votes the ESOP's stock
- Jim can continue this stock sale strategy each year at his discretion subject to complying with fiduciary duties as Trustee.



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Case II: Non-Leveraged ESOP

- 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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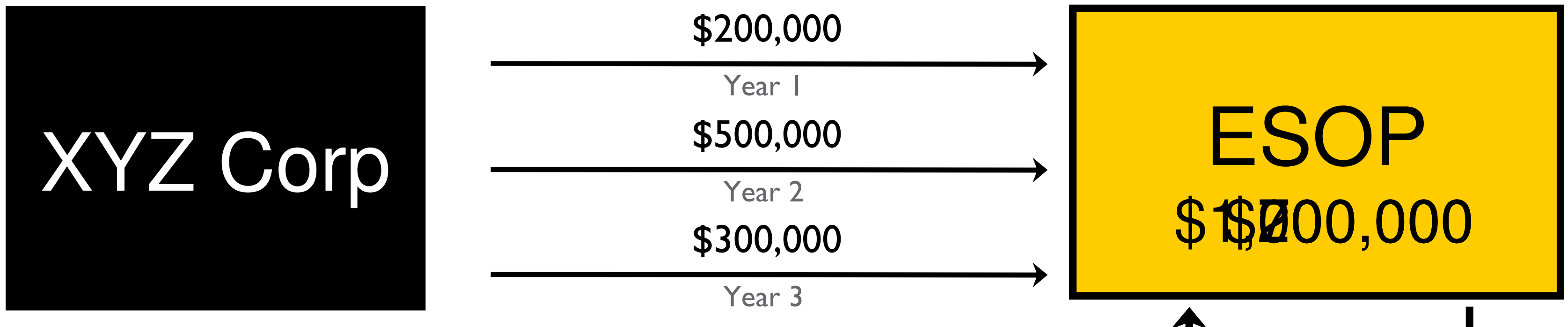
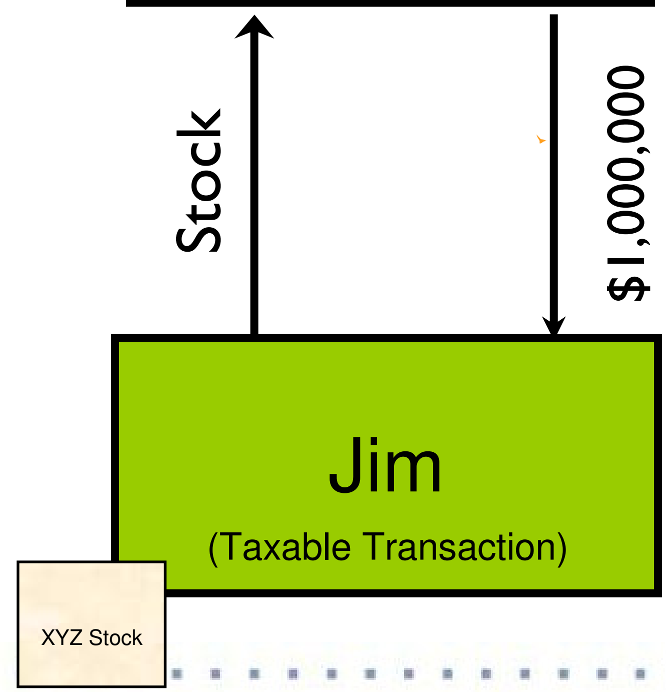
Pre-Funding the ESOP





RESULT:

- Company receives tax deduction contributions each year, thereby reducing tax bill
- ESOP accumulates $1,000,000 (+) of cash over three years
- Jim sells 6.7% of stock to ESOP after Year 3

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Case III: Partial Leveraged ESOP Transaction

- Jim wishes to sell a large percentage, ***but not all***, of his stock to the ESOP
- Jim does not want to pay capital gains taxes
- The company has “debt capacity”

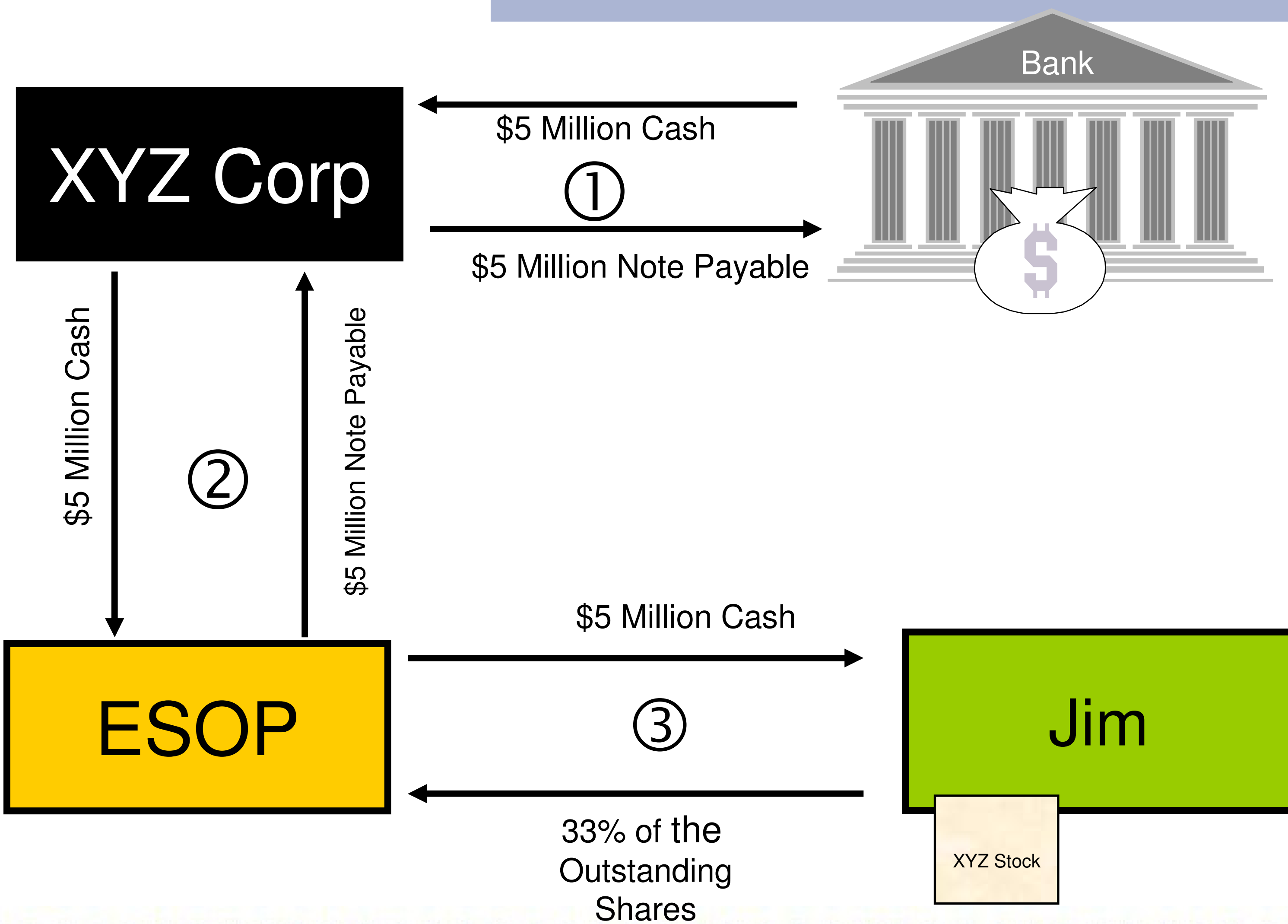
Solution

The Partially Leveraged ESOP

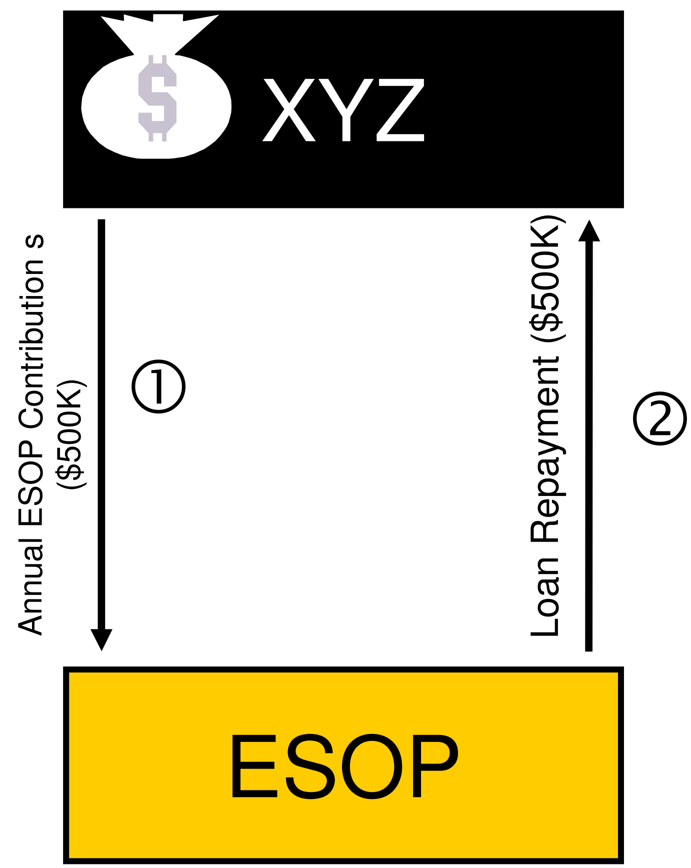
Partial Leveraged ESOP

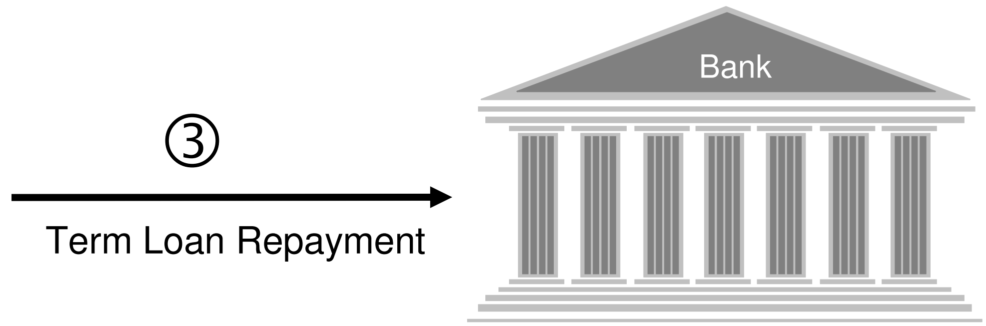
- The ESOP purchases 33% of XYZ's stock from Jim for $5 million
- The stock purchase is financed with a $5 million loan, which will be repaid over time

Partially Leveraged ESOP



Paying Off The Debt





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

Case IV:
100% ESOP Buyout

- Jim and Pat sell 100% of their XYZ stock to the EOSP for $15 million
  - The stock purchase is financed with a $7.5 million bank loan and $7.5 million subordinated seller note, with warrants
- Selected managers participate in a Management Incentive Plan that is tied to the value of equity
  - This benefit is in addition to their ESOP participation

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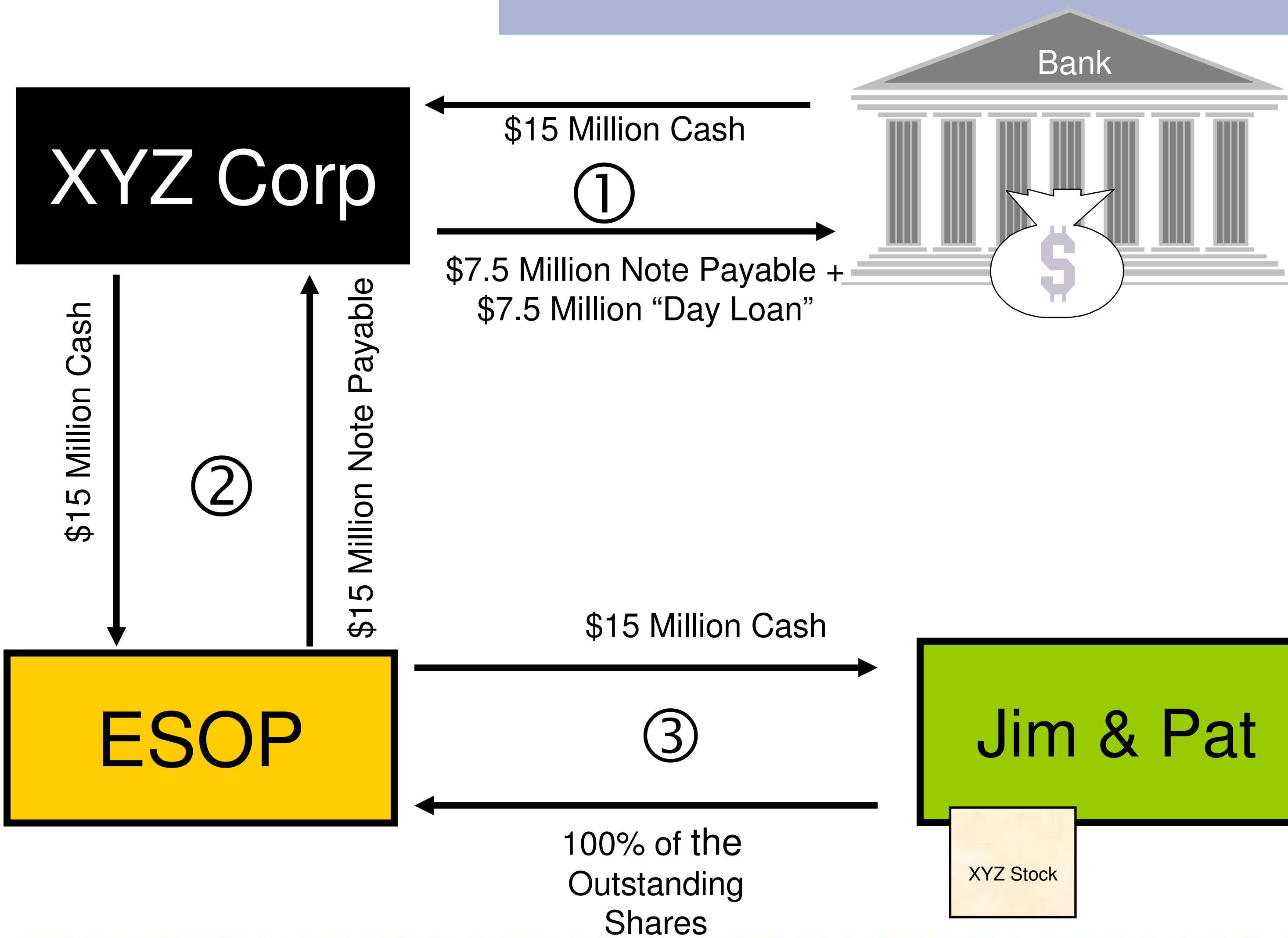
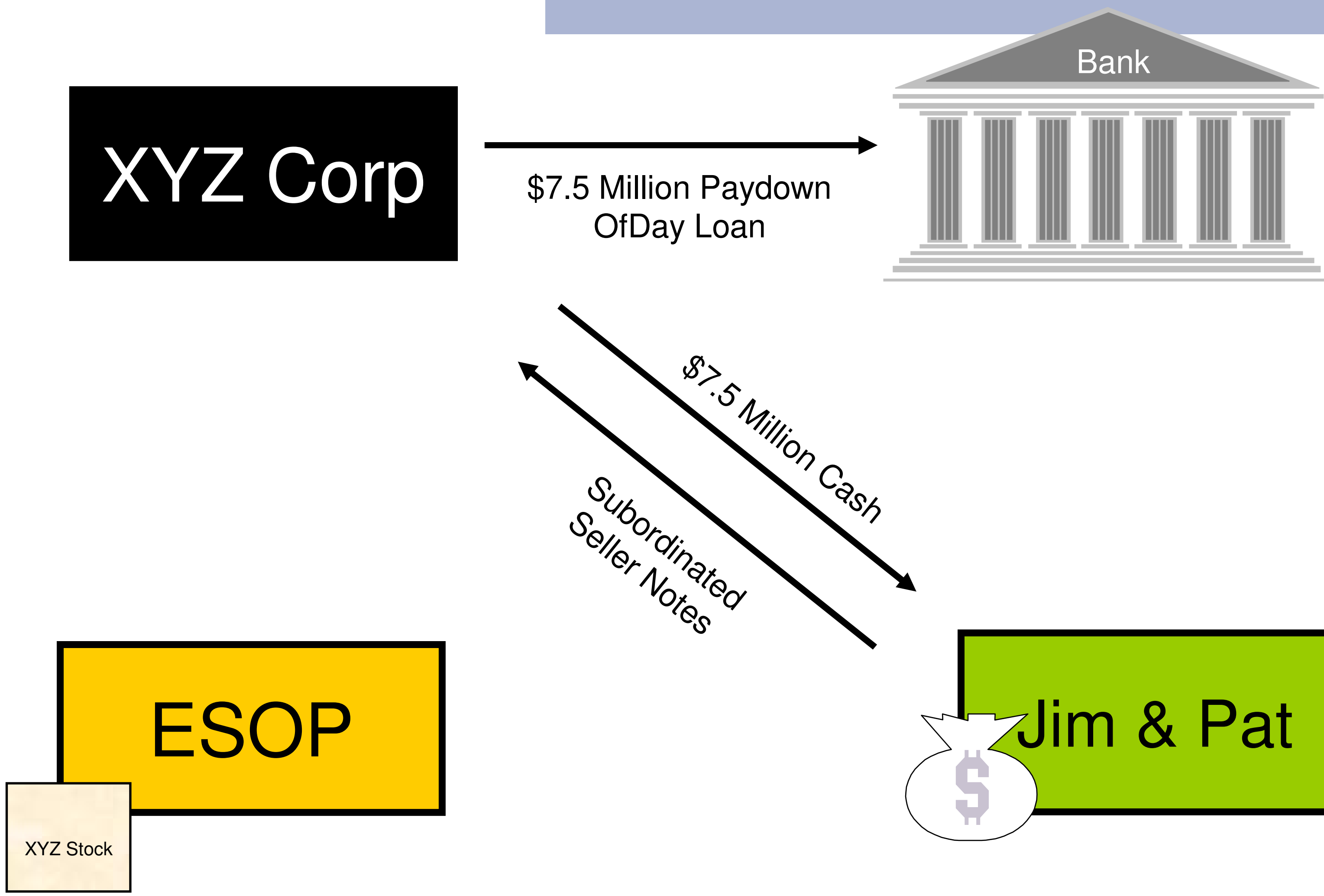
100% Leveraged ESOP



100% Leveraged ESOP



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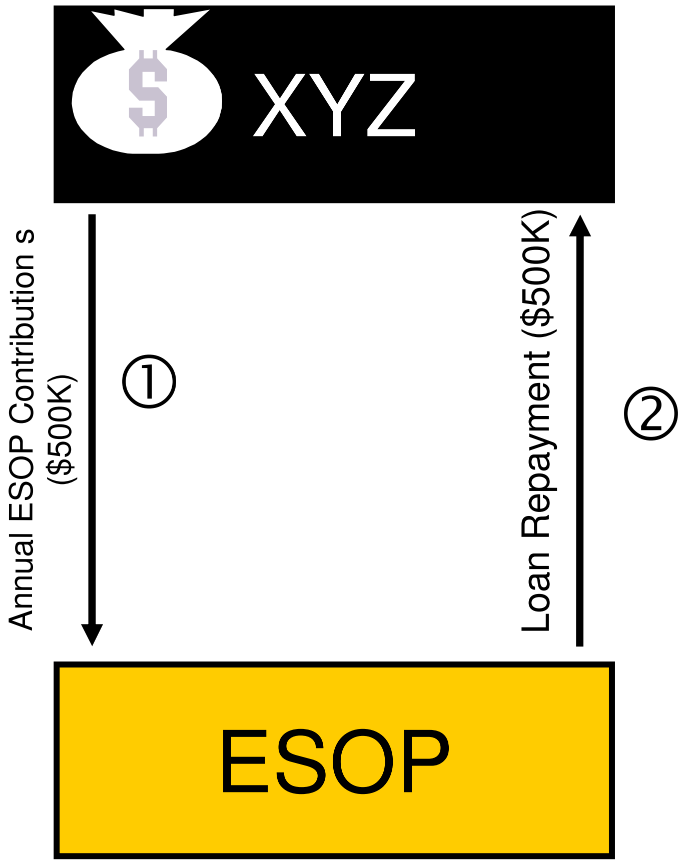

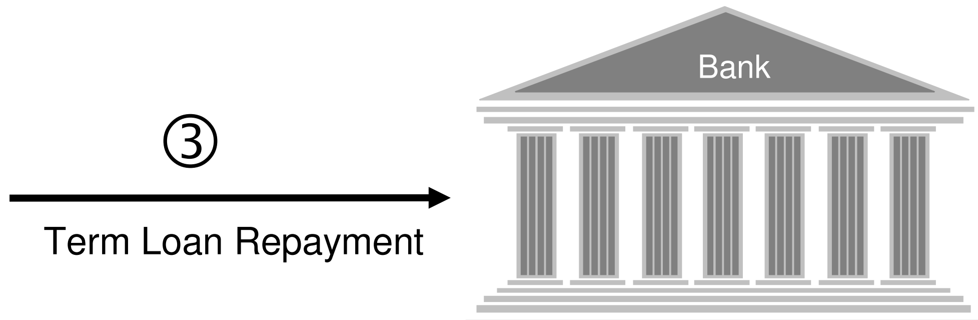

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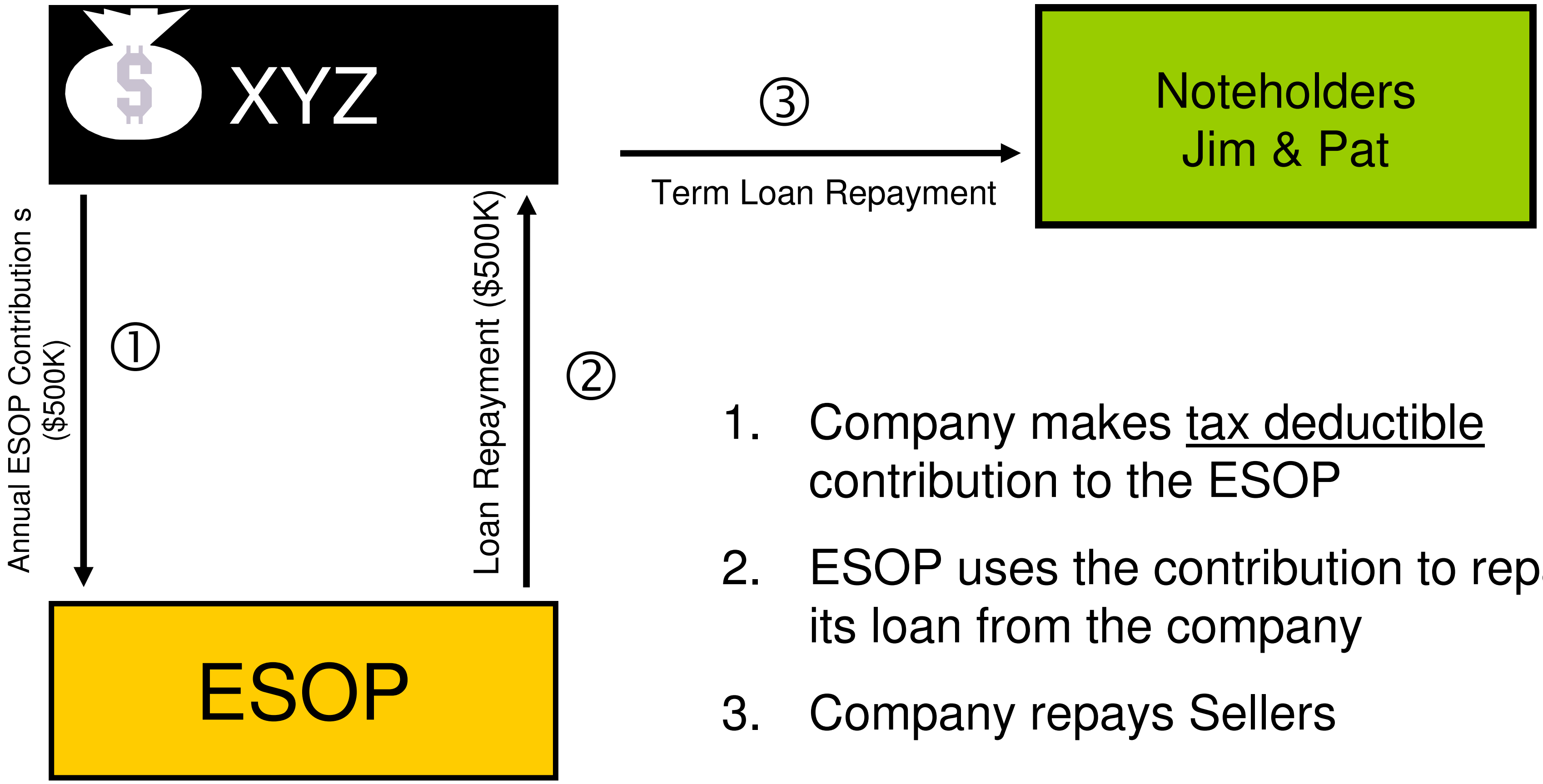
Paying Off The Debt



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

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Seller Note Characteristics

- Seller notes yield between 19% and 14% depending on the market rates
- Part of the yield is made up of a “current pay”, or interest income
- The balance of the yield is made up of stock warrants, or a right to buy stock at a certain price, for a certain period of time
- The amount of warrants is determined by the amount of interest income and the total targeted yield on the note

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Management Incentive Plans

- Key managers are awarded synthetic stock incentives
- This ownership is not direct ownership of stock, which limits complexity, but conveys economic value based on company performance
- Non-qualified plan that can be designed from "whole cloth"
- KEY: needs to be tied to increased equity value so ESOP is not overly diluted
- Generally the value of these plans is 10-15% of the fully diluted equity

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Results

- Jim & Pat have locked in their value at $15 million, having collected $7.5mm in cash at closing
  - Seller note warrants could bring in additional value
  - No capital gains taxes due (C corps only)
- Jim & Pat can remain employed as officers / employees if they wish
- Selected managers could have a claim on equity value through synthetic equity
- Employees will receive new retirement benefit that is tied to the success of the company
- The company has eliminated federal and (most) state corporate income taxation

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C Corporation ESOP Advantages

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Capital Gain Tax Deferral Rules

- Company has to be a C corporation at time of transaction
- S corporations still can do ESOPs, but no capital gains tax benefit (more on this later)
- ESOP's ownership must be ≥30% to qualify for the capital gains tax benefit (if ESOP owns less than 30%, capital gains tax will be due)
- Seller must reinvest the proceeds in "Q*ualified Replacement Property"* within 15 month window
- Stock sold must have a 3-year holding period

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Qualified Replacement Property

Eligible*

- Common Stock
- Convertible Bonds
- Corporate Fixed Rate Bonds
- Corporate Floating Rate Notes (FRN)

Not Eligible

- Municipal Bonds
- U.S. Government Bonds
- Mutual Funds
- Foreign Securities
- REITs
- Bank CDs

*Eligible issuer must have:

- Securities of a corporation that is incorporated in the U.S.
- More than 50% of its assets used in the active conduct of a trade or business
- No more than 25% of its gross income from passive sources

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Seller Capital Gain Tax Deferral: QRP Considerations

- Issue: If any QRP is sold, the pro rata deferred capital gains tax becomes due
- Implications:
  - The QRP portfolio cannot be actively managed
  - Minimize callable securities
- Solution: Purchase an "ESOP Bond"

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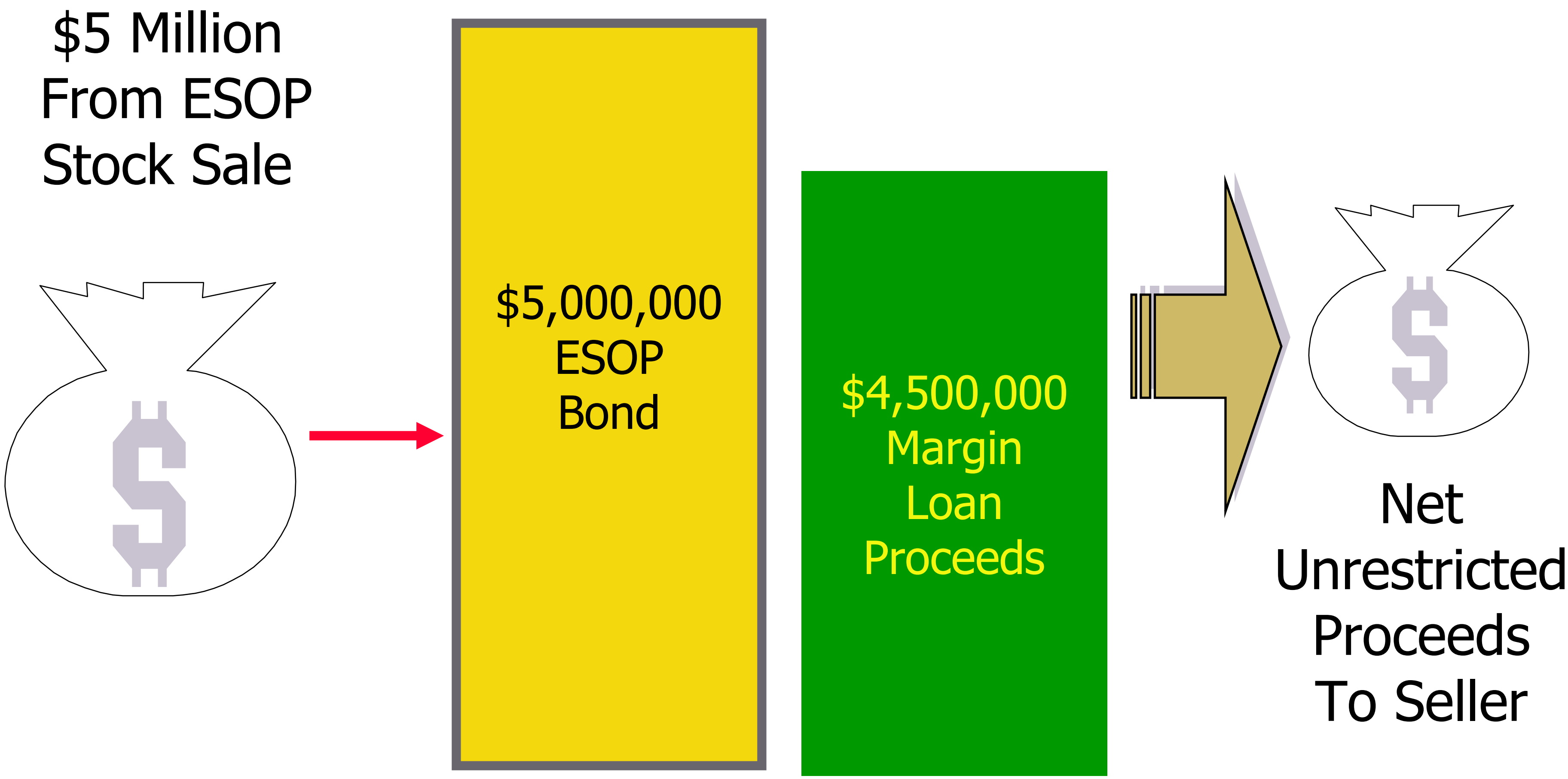
ESOP Bond

- Issued by AAA and AA credits
- Long term:
  - Typically a 50 year maturity
  - Non-callable for 30 years
- Floating rate interest paid quarterly using LIBOR

Unlocking the QRP Lockup



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S Corporation
ESOP Advantage

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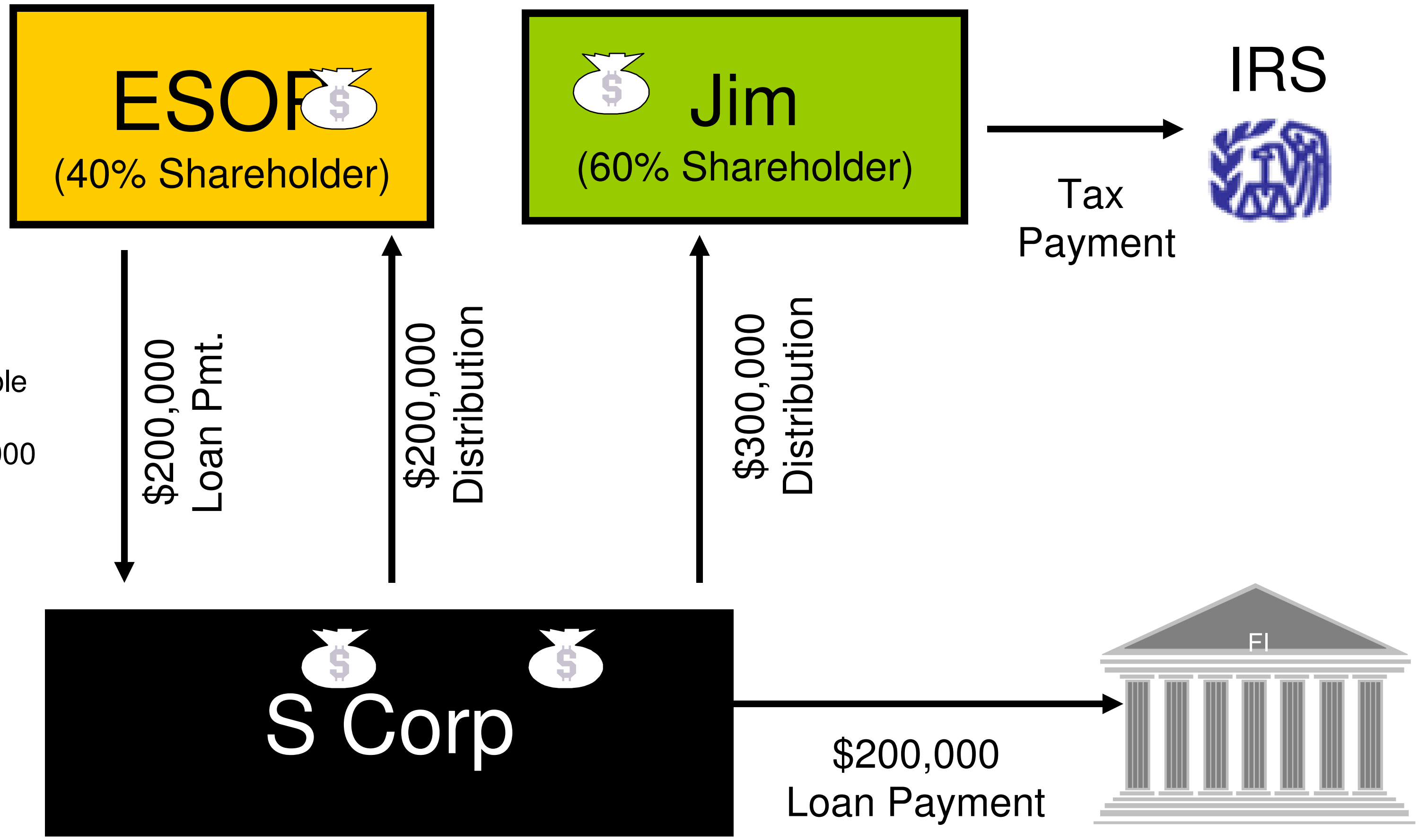
S Corporation ESOP Tax Benefits

- S corporation shareholders are responsible for paying their pro rata share of the company's tax liability
- An ESOP is a qualified, tax-exempt trust similar to a 401(k) trust
- 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
- This company is exempt from paying federal and most state income taxes

S Corporation Distributions with ESOPs

<u>Assumptions</u>

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



Do ESOPs Really Increase Employee Productivity

Best ESOP Candidates?

- Are profitable and growing
- Can finance their own growth
- Are not overleveraged
- Have good financial reporting
- Have a deep and broad management team

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Steps in ESOP Transaction

- Feasibility Study (Transaction Analysis)
- Financing
- Appraisal
- Plan Design
- Legal Documentation
- Closing
- IRS Determination Letter

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Thank You
For Your Time Today.

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