INSIDE public accounting TOP 100 FIRMS 2023

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EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FAQ

About Brown Edwards

Brown Edwards is a full-service regional accounting firm with offices in Virginia, West Virginia, and Tennessee, and is included in Inside Public Accounting's list as one of the top 100 firms in the United States and a Top 50 Construction Accounting Firm as compiled by Construction Executive magazine.

brownedwards@becpas.com
www.becpas.com

What is an ESOP?

An ESOP, which stands for employee stock ownership plan, is a qualified retirement plan (similar to a 401(k) plan) set up as a trust fund, where current and future employees receive beneficial ownership in the company over time.

Unlike a 401(k) plan, however, employees typically are not required to contribute to the ESOP. In addition to providing retirement benefits for employees, an ESOP can be used as an exit or liquidity vehicle for the owner(s) of the company and can provide tax benefits to both the company and the selling shareholders as well as an additional retirement benefit for employees.

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What is the difference between a leveraged ESOP and non-leveraged ESOP?

An ESOP can be either non-leveraged or leveraged. In a non-leveraged ESOP, shares or cash (which can later be used to purchase non-ESOP shares from the sellers) are contributed to the ESOP. Once contributed, these shares are then allocated to employees' accounts based on their salary, tenure or a combination of both. The company receives a tax deduction for the fair market value of the shares or the cash contributed to the plan, subject to limits.

An ESOP is the only qualified retirement plan in the United States that can borrow money. This allows for a leveraged ESOP transaction. In a leveraged ESOP, shares of stock are purchased by the ESOP with a note from either the company or the selling shareholders. As the note is repaid, shares are released to the employees' accounts. The note repayment is tax-deductible, subject to limits. The shares will typically be subject to vesting. When an employee leaves the company, the employee will be paid out in return for his or her shares, either in a lump sum or over several years.

In both scenarios, the employee is the beneficial owner of those shares (and thus receives benefits from the shares), whereas the ESOP trust owns the shares and is the sole shareholder. The trustee has a fiduciary duty to protect the retirement benefit of the employees. The trustee does not insert themselves into the day-to-day operation of the business nor do they typically sit on the board of directors. Instead, their role is to ensure any corporate action taken is in the best interest of the employees.

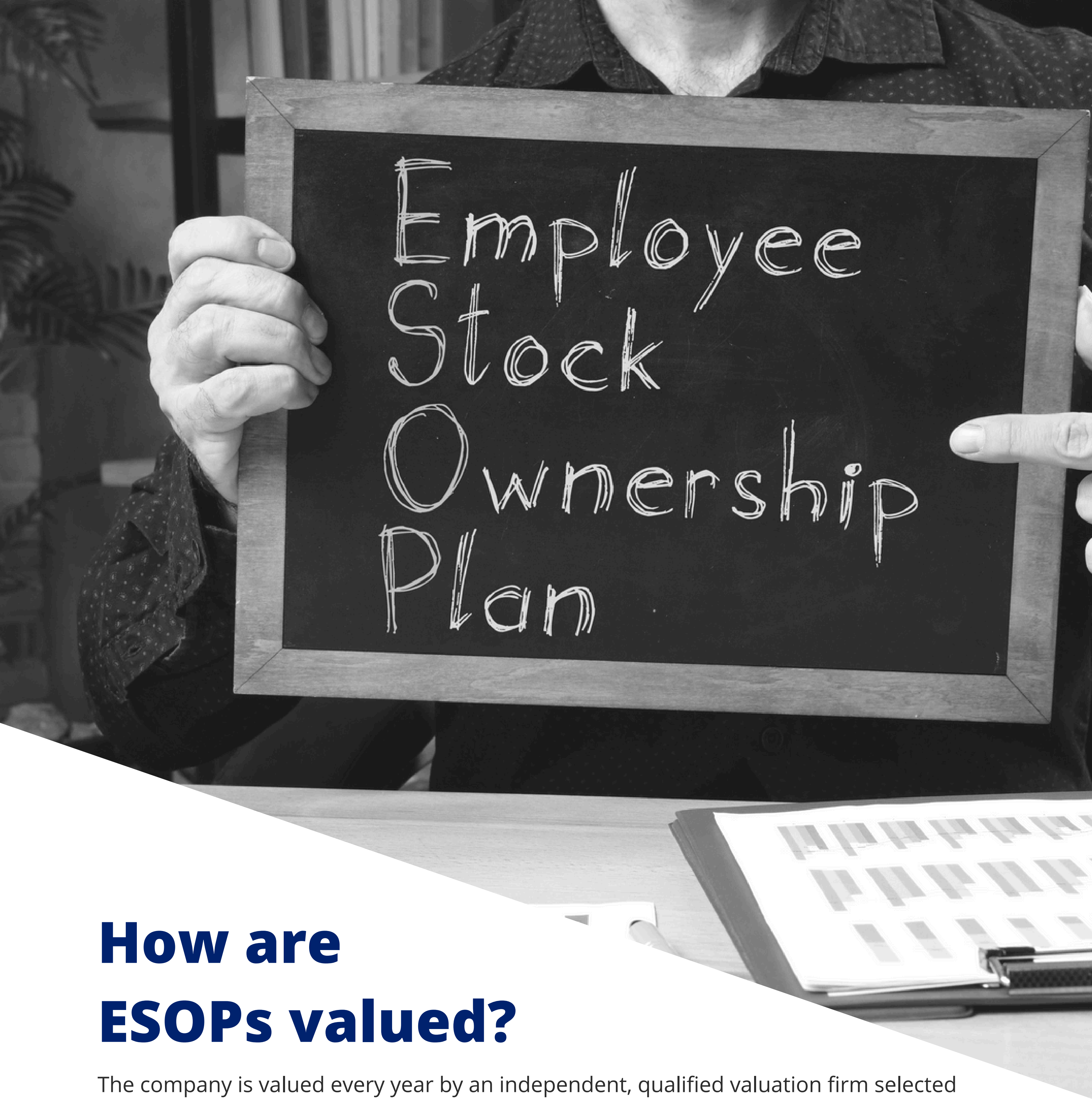
How is an ESOP created?

An ESOP is created when the shares of a company are sold to an ESOP trustee via a negotiated process that considers not only the agreed upon fair market value of the company, but other relevant deal terms such as financing, management incentive plans, board composition, ESOP benefit levels and indemnity agreements.

In many cases, an advisor is hired to represent the seller(s) to manage the sales process from start to finish and to facilitate a successful sale. The advisor will first undertake an initial study that includes a modeling assignment to evaluate whether an ESOP is feasible. Once feasibility is determined and the decision is made to move forward, the advisor can assist with facilitating a capital raise for the transaction, entity restructuring, plan design and the negotiation with the trustee team and sources of capital.

Does the business owner have to sell all of the company to the ESOP?

An ESOP allows the business owner, or selling shareholder, to decide how much of the business to sell and the timeline for ownership transition. Sometimes, the owner will initially sell a minority interest then complete a second-stage transaction at a later date. The sales timeline is completely at the discretion of the selling shareholder. Often, the benefits of a 100%-owned ESOP are too appealing to forgo. In addition, as noted below, to take advantage of a 1042 tax-free rollover the owner must sell enough shares to meet the 30% ESOP ownership requirement.



How are ESOPs valued?

The company is valued every year by an independent, qualified valuation firm selected by the trustee. The valuation is used to assess the company's annual share price and subsequently the value of each ESOP account for each employee. The company is valued at fair market value, which is the price at which a willing buyer and a willing seller would agree upon. In transactions that include a management incentive plan and warrants, the value of each are typically tied to the annual valuation of the underlying shares.

How does the value of the company compare when selling to an ESOP vs. another buyer?

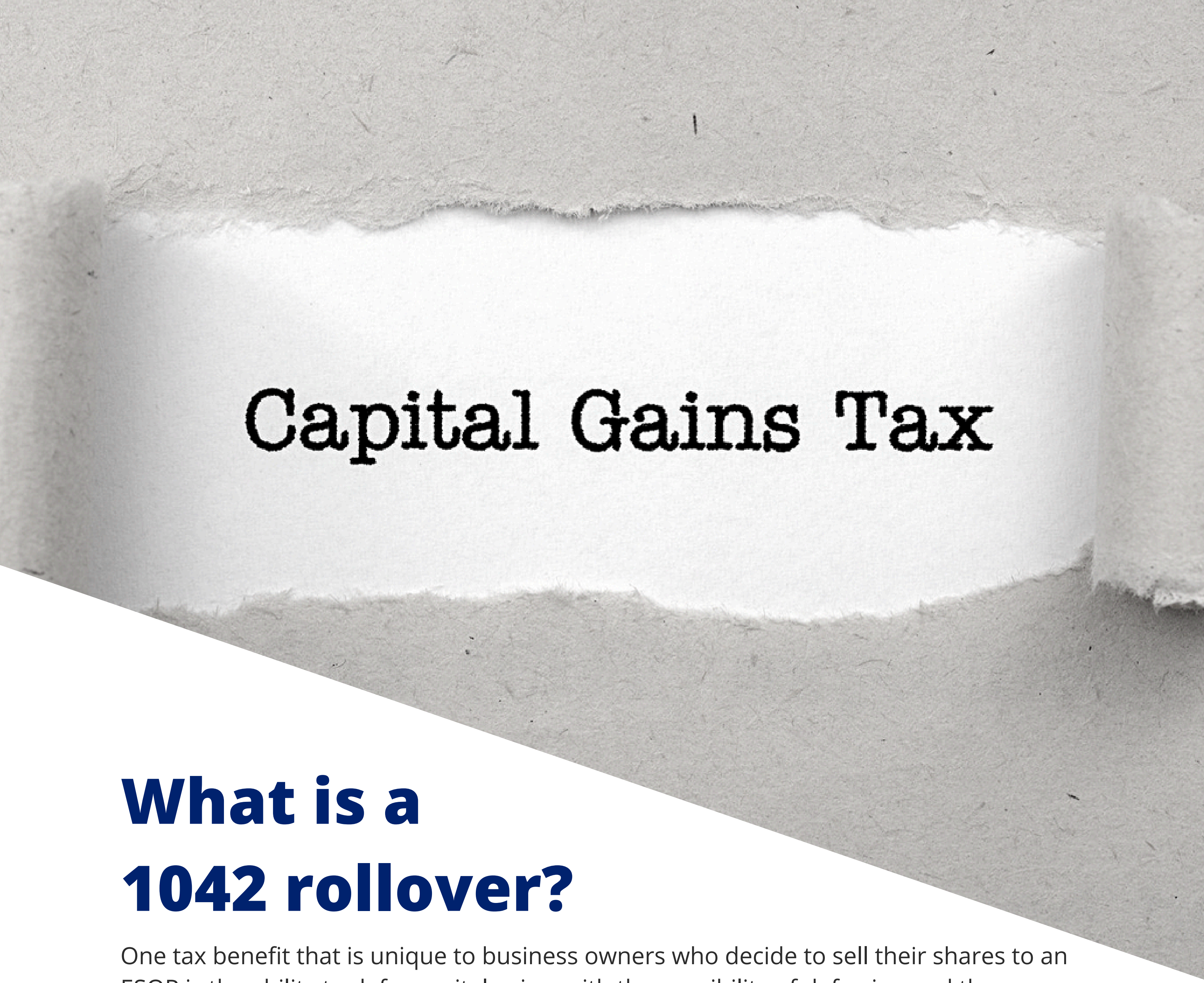
An ESOP pays fair market value for the stock of the company, like any financial buyer (for example, as in private equity transactions). A seller could receive less compensation by selling to the ESOP than by selling to a strategic buyer, but the seller should also consider the additional value that the tax savings of an ESOP sale generate. For instance, a sale to an ESOP can increase the after-tax proceeds to the selling shareholder. The company can also take a tax deduction of up to 25% of payroll by making an ESOP contribution each year. Further, selling to an ESOP can eliminate the ongoing tax or S corporation distribution obligations of the company, providing significant tax savings. This is because an ESOP is a qualified benefit plan, which is a non-tax paying entity. Since an S corporation passes through its profits to the shareholders, the percentage of the company that is owned by an ESOP is exempt from income tax.

What are the tax benefits of an ESOP?

There are numerous tax benefits associated with ESOPs. For instance, if the selling company is structured as an S corporation, the percentage owned by the ESOP does not owe income taxes. Thus, a 100% ESOP-owned S corporation does not pay federal income taxes, and in most states, it would not pay state income taxes. For S corporations of which the ESOP owns a minority interest, the company can deduct contributions to the ESOP of up to 25% of covered payroll, which includes all qualified retirement plans.

In the case of C corporations owned by an ESOP, a company may deduct contributions of up to 25% of covered payroll if used to make principal payments on an ESOP loan. Unlike an ESOP that is owned by an S corporation, any contributions used to pay interest on an ESOP loan are not included in the 25% limit. However, interest expenses could be limited under Internal Revenue Code (IRC) Section 163(j). Under Section 163(j), deductibility of interest expense is limited to 30% of adjusted taxable income (per the CARES act, the limit is increased to 50% for tax years 2019 and 2020). A C corporation is allowed an additional deduction of up to 25% of covered payroll for contributions made to any qualified plan, as long as it is not used to repay an ESOP loan. Furthermore, a C corporation may deduct dividends to an ESOP plan outside of contribution limits (subject to certain limitations).

Selling shareholders may also defer capital gains taxes through a 1042 tax deferral, which is the biggest advantage in selling to an ESOP as a C corporation.



What is a 1042 rollover?

One tax benefit that is unique to business owners who decide to sell their shares to an ESOP is the ability to defer capital gains, with the possibility of deferring and then eliminating capital gains taxes. IRC Section 1042 states that if after the sale of an ESOP, (1) the ESOP owns at least 30% of the stock in the company, (2) the company is a C corporation and (3) you have owned the stock for at least three years, there is a mechanism in which you can potentially defer your capital gains tax obligation indefinitely.

If the proceeds from the sale to the ESOP are reinvested into what is referred to as qualified replacement property and the property is held until the investor's death, then the heirs receive a step-up in basis and pay no capital gains taxes on both the original principal and the market appreciation. Qualified replacement property consists of domestic stocks, bonds and corporate floating rate notes (subject to certain rules).

ESOP vs 401(k): What is the difference?

An ESOP and a 401(k) plan are both ERISA-covered retirement plans. The biggest difference between the two plans is the out-of-pocket cost to the employee. In a 401(k), a portion of the funds that are invested typically come out of employees' paycheck, pre- or post-tax. Many, if not most, ESOP-owned companies will retain the prior 401(k) plan and may or may not continue to make matching 401(k) contributions after the sale to an ESOP. In an ESOP, the shares are allocated based on an employees' salary and/or tenure with the company. For most ESOPs, there is no cost to the employee. The proceeds will be taxed at ordinary income tax rates when those shares are bought back at retirement, death or separation from the company.

Another significant difference relates to how the funds are invested. In an ESOP, the shares are primarily invested in company shares, whereas in a 401(k), funds are generally allocated across asset classes. To offset this concentration of investment in the company stock, an employee age 55 or older of an ESOP can diversify up to 50% of the holdings into other asset classes.

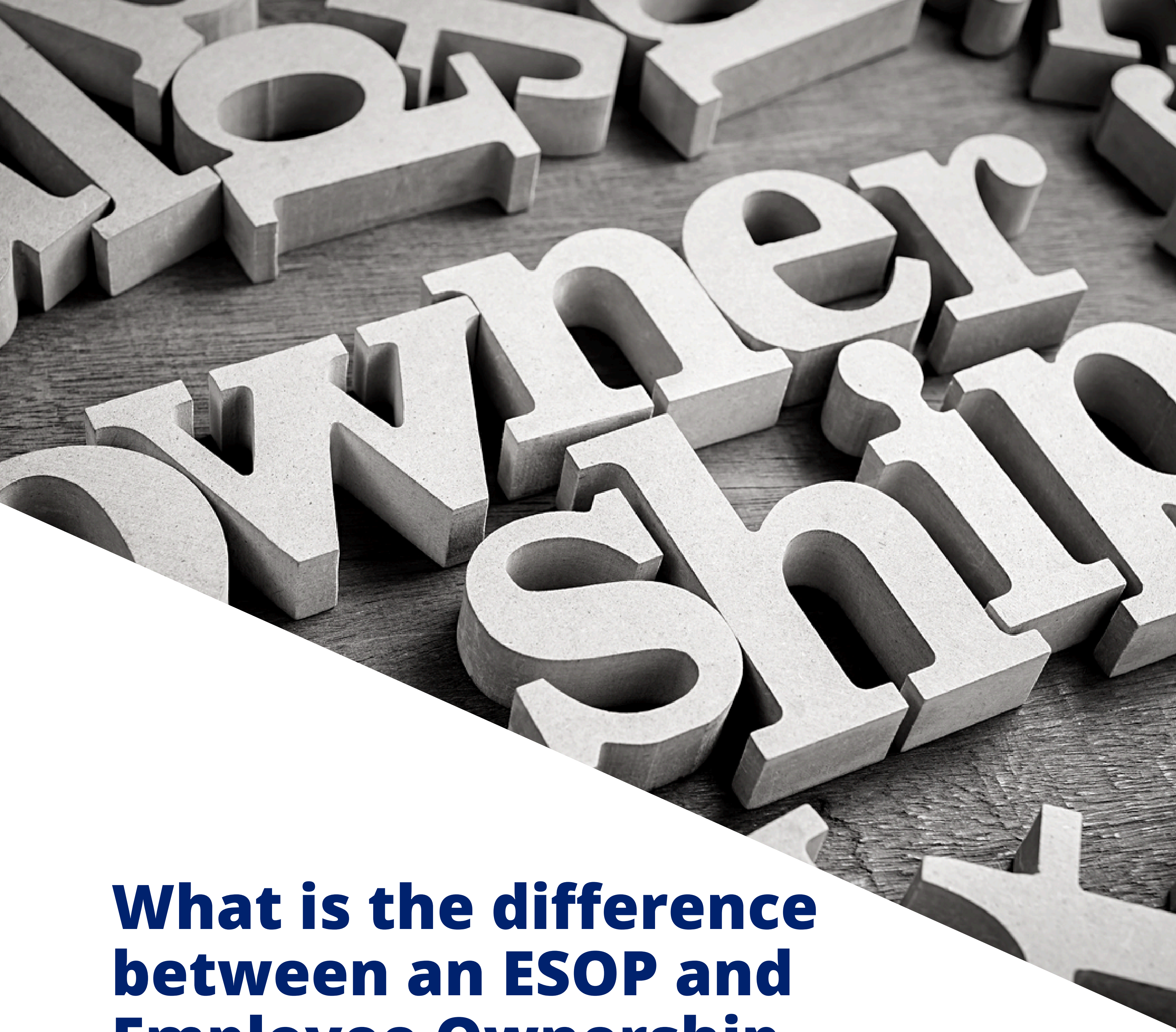
Finally, another difference between an ESOP and a 401(k) is that enrollment into an ESOP is automatic for all qualifying employees, whereas with a 401(k) plan, automatic enrollment is not a given and an employee must opt-in if automatic enrollment is not part of the plan. Enrollment into a 401(k) can require a lot of effort for an employee.

How is an ESOP financed?

One of the more pressing questions from business owners regarding ESOPs pertains to the consideration they will receive for selling their ownership in the company to the ESOP.

How do they get cash out of this transaction? First, commercial banks that are familiar with the structure and process of an ESOP transaction are usually willing to lend to creditworthy companies to help facilitate the sale to an ESOP. Any remaining balance on the sale could be made up using alternative lenders or deeply subordinated seller financing. Alternative lenders, such as mezzanine providers, require a higher return than a senior lender and can be expensive. If a company does not wish to use mezzanine financing to fund the ESOP purchase, then the sellers can replace that tranche of capital with seller notes that include cash pay interest, warrants or a combination of the two. Combined, they represent the market return for a subordinated debt provider.

As such, sellers have an option to receive high cash pay interest or reduce the cash pay interest rate and make up the overall rate of return with warrants. A warrant is a financial instrument that gives the holder the right to own future equity in the company. Interest payments to the seller note holder are taxed at ordinary income rates, whereas a warrant would be taxed at capital gains (the capital gains tax rates in the U.S. are lower than ordinary income rates as of the date of publication of this article). High interest payments are also a potential drain on company cash flows. A warrant allows the seller to reduce the cash pay interest rate and make up the overall rate of return. A warrant also provides the seller with upside in exchange for a lower annual cash return on his or her subordinated seller notes. This is a win-win for both parties, as the lower cash pay preserves cash flow at the company while the warrant(s) allow for the seller(s) to participate in the future upside of the company and receive capital gains treatment when exercised. Warrants can also help bridge the valuation gap between buyer and seller when the company is growing fast.



What is the difference between an ESOP and Employee Ownership Trust (EOT)?

An ESOP and an EOT are both true employee ownership models in that the company is sold to the employees through a trust for the benefit of the current and future employees of the firm. ESOPs are more common in the U.S., EOTs in the UK. The key difference between the EOT and the ESOP model is that in an ESOP, the employees receive beneficial shares in individual retirement accounts and when they leave the company or retire they receive payment from the company for the value of those shares. Under the EOT model, the employees do not receive actual shares; instead, the trustee of the EOT holds the shares for and on behalf of all employees in the company.