

## ABOUT THE ESOP GROUP AT TUCKER ELLIS LLP

Our attorneys provide practical and effective solutions to closely held businesses considering wealth diversification and succession planning. We recognize that each business has unique characteristics that require individual attention and consideration. We take the time to fully understand our clients' business situations, including the short- and long-term goals of business owners and the fiscal and leadership needs of the business itself, as well as the corporate culture and family dynamics that may play into decision making. We advise our clients regarding the many options available to successfully transition ownership and/or leadership of small businesses. By listening to and educating our clients we can provide advice and counsel that make sense to the business owner and other affected parties.

One transition option for business owners is to transfer full or partial ownership of the company to its employees through an employee stock ownership plan (ESOP).

## Wealth Diversification and Succession Planning with an ESOP

### OVERVIEW

It's your business. You have dedicated much of your time, energy, passion and fiscal resources to making it successful. Your business has loyally served its customers and employed many dedicated employees over the years. You wish only the best for your company's future, but it's time to start thinking about your own future. Maybe you have been advised to diversify your wealth. Perhaps you are ready to step back from day-to-day operations. But the reality of transferring all or part of the business is overwhelming. Where do you start?

Even the most successful and savvy business owners may have difficulty navigating the transition of ownership, particularly when there is no heir apparent to whom the company can be simply turned over. In this situation, business owners often "choose" to do nothing, which ultimately leads to working themselves to death, so to speak, and leaving the responsibility of the business to unprepared loved ones upon their death. With no one to take the helm, most businesses end up shutting down or being sold. Would you be more comfortable with a transition if you could help ensure the business remain a going concern, while retaining control for as long as you wish? And, what if you would be rewarded for your efforts with the time and capital you need to buy and enjoy a vacation home?

You may have already thought about transitioning ownership and have legitimate concerns about your successor. Maybe you have received an offer, but the buyer is not interested in the company as an ongoing business or the deal never closed. Maybe someone has expressed interest, but you are concerned the individual lacks the experience in your industry needed to be successful. Maybe you have an employee you consider the perfect candidate, but the individual doesn't have the means to purchase the business outright. In any of these situations, an ESOP can help you transition ownership while maintaining operational control, training your successor and/or providing a means for your perfect candidate to ultimately own and run the business.



### WHAT IS AN ESOP?

An ESOP is an employee stock ownership plan, a type of tax-qualified retirement plan that enables a business owner to transfer ownership of all or part of a company to its employees.

There are nearly 7,000 ESOPs in the United States, covering about 13.5 million employees. An ESOP may be formed by an S Corp or a C Corp, or a limited liability company in certain circumstances. Corporate restructuring may be required to establish an ESOP and take advantage of certain tax benefits.

## WHO SHOULD CONSIDER AN ESOP?

Owners of financially strong, privately owned companies, who are interested in succession and/or liquidity, should consider establishing an ESOP. An owner interested in transferring ownership, but lacking an heir apparent, may be interested in establishing a 100% ESOP. An owner who wishes to remain involved in the company's operations, but is interested in liquidating a portion of his holdings in the company, may be interested in establishing a minority interest (e.g., 30%) ESOP.

Prime candidates for ESOPs are companies with EBITDA (earnings before interest, taxes, depreciation and amortization) of at least \$1.5 million and a stable cash flow. The ideal company also has a stable and committed workforce of at least 20 to 50 employees and a strong organizational culture. ESOPs are particularly popular among white collar businesses with professional or skilled employees, banks, small-town employers, contractors (and construction companies), local privately owned utilities, food and other manufacturers and distributors.

## WHAT ARE THE BENEFITS OF AN ESOP?

Creating an ESOP allows a business owner to transfer ownership of a company and/or enjoy one or more liquidity events without selling to a third party, such as a private equity group. Instead, the employees become owners of the company, in whole or in part. Having a vested interest in the success of the company, employee-owners are often more productive and have lower rates of absenteeism and turnover than non-owner employees.

Employees also benefit from participating in an ESOP because the stock held in their ESOP accounts is often contributed by the company at no cost to the employee. This can provide a valuable retirement benefit, especially if the value of the stock increases over time.

Finally, if structured properly, an ESOP can provide significant tax savings for the company as well as the business owner. For the owner, the gain derived from selling the shares is taxable at the long-term capital gains rate which, even at the highest rate of 20%, is significantly lower than the highest ordinary income tax rate of 39.6% that would apply to profits distributed to the owner. The company may even become tax exempt if it is 100% ESOP owned and is structured (or restructured after the transaction) as an S Corp.



If the company is a C Corp at the time of the transaction, the business owner may defer payment of the capital gains tax if the owner has owned the shares for more than three years and reinvests in qualified replacement property (QRP) (certain types of U.S.-based stocks and bonds) and the ESOP will own at least 30% of the shares. In this case, the capital gains tax is deferred until the QRP is sold or can be avoided completely if the QRP is passed to the business owner's heirs.

## HOW DOES AN ESOP WORK?

In its simplest form, the company makes tax-deductible cash contributions to the ESOP. The ESOP uses the cash to purchase shares and allocates the shares to participants' accounts. The shares in a participant's account are not taxable until the participant takes a distribution (not including a rollover to an IRA or other qualified retirement plan), which generally follows the employee's termination of employment. If the company is an S Corp or in certain other limited circumstances, the ESOP can force a cashout of shares at distribution so that the shares are never held by individuals who are no longer employed by the company. The company needs to be prepared to repurchase shares upon distribution, although certain distribution restrictions may be implemented to give the company time to plan ahead for these events. Repurchased shares may be held by the company and/or reallocated to participants.

Approximately half of ESOPs are "leveraged" by a bank loan, often so that an owner may sell 100% of his shares to the ESOP trust in a single transaction. In a leveraged ESOP, the company

# WEALTH DIVERSIFICATION AND SUCCESSION PLANNING WITH AN ESOP

typically takes an “outside loan” from a bank, then makes an “inside loan” to the ESOP trust. The ESOP trust uses the loan proceeds to purchase the shares from the owner. If the loan proceeds do not equal the full value of the shares, the ESOP may issue a “seller’s note” to the owner for the difference. If a seller’s note is issued, the company may guarantee or assume the note. Each year, the company makes a payment on the loan, which ultimately results in the allocation of a portion of the shares to participants’ accounts. If a seller’s note exists, the ESOP or company also makes payment on the note. The company must anticipate having enough cash to make the bank loan and seller’s note payments. The company is also responsible for the expenses associated with the various ESOP transactions.

Dividends of a C Corp (and distributions of an S Corp) may be used to repay the ESOP loans if certain requirements are met. C Corp dividends (but generally not S Corp distributions) also may be passed through to ESOP participants. C Corp dividends that are used to repay the ESOP loans or are passed through to ESOP participants are tax deductible by the company (tax deductibility generally is not an issue for an S Corp ESOP).



## HOW ARE SHARES ALLOCATED UNDER AN ESOP?

In general, shares are allocated among all active participants, based on a nondiscriminatory formula that may take into account compensation, age and/or service. Participation may be limited to certain groups of employees on a nondiscriminatory basis and the ESOP may require that employees have a year of service and/or have attained age 21 before participating in the ESOP. These restrictions help to avoid allocating shares to the accounts of employees who may not intend to work at the company for an

extended period. Allocated shares also may be subject to a vesting schedule so that short-term employees do not enjoy the full benefit of ownership.

## ARE THERE OTHER BENEFITS TO CREATING AN ESOP?

Yes. An ESOP can be very flexible as to how many shares it will hold, the extent and timing of the transfer of ownership to the ESOP, and the form of financing. With an ESOP, a business owner may direct the terms of the transition of ownership and responsibilities, establish the time period over which the transition is to take place and negotiate the form of financing. These options generally are not available to a business owner considering an outside investor. In that case, the owner may have little or no control over the terms or timing of the transition or the fate of the company after the transaction is completed.

An ESOP also may appeal to a business owner interested in a liquidity event, regardless of the owner’s immediate intention to transfer ownership. An owner of a privately held company typically has a substantial portion of his net worth invested in the company and often lacks investment diversity in his personal portfolio. An ESOP can offer a business owner liquidity to diversify investments, make major purchases without liquidating other assets or simply retain a certain amount of cash or other liquid investments, without requiring the owner to relinquish control or majority ownership of the business. An owner interested in partial liquidity now may, but is not required to, transfer the remaining ownership to the ESOP down the road.

In addition, if the owner owns both the company and the land on which it sits, the owner can continue to hold the property and lease it to the company or sell it as part of the initial or a later transaction. An ESOP also can be used in conjunction with a management buyout if the business owner has identified a key person or persons to purchase a portion of the company. Finally, an ESOP may be used to defend against a takeover by an unfriendly suitor.

**If you are interested in exploring an ESOP, please contact one of our ESOP Group Team members to learn more.**

## OUR VISION

Our desire is for all who encounter us to have a better experience than they would with any other law firm. We measure our success on the continuing demand for our services. We have and shall maintain a special culture of excellence, client service, teamwork, diversity, and loyalty to our clients, our communities and each other—and believe together we can vastly improve the manner in which legal services are provided.

## OUR TEAM

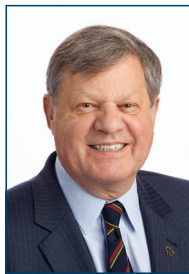
ESOPs can be complicated, often involving multiple areas of law. The ESOP Group at Tucker Ellis uses an efficient team approach, working closely across disciplines to ensure a seamless delivery of services to our clients, from conception to design to implementation and maintenance—making our practice the one-stop shop for our ESOP clients' legal needs.

Our ESOP Group includes significant depth in every aspect of a full-service ESOP practice. In addition to our estate planning and employee benefits groups, our team includes professionals with experience in corporate structure and governance, corporate finance and lending, fiduciary representation, securities regulation, employment and labor, mergers and acquisitions, and litigation. Our ESOP Group also has strong professional relationships with other service providers needed in the implementation and maintenance processes, including bankers, independent trustees, valuation experts, 1042 investment advisors and brokers, accountants, and employee education and communication consultants.

Below is a representative sampling of the members of our team.



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