Tax Advantages of an ESOP

by Mark Klopfenstein

We may be at the beginning of a new era of popularity for a sometimes misunderstood concept: indirect employee equity participation through Employee Stock Ownership Plans (ESOPs). Several emerging factors, including higher tax rates, the "graying" of America, an unyielding tax planning environment, and a suboptimal market for traditional sales, are prompting more business owners to use ESOP-based structures to extract value from companies. CFA has powerful capabilities around this concept to assist business owners interested in (i) a complete or partial exit, or (ii) an internal restructuring to allow the business to grow faster and the owner to make more money.

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Under the basic structure, a company forms an Employee Trust (ET) and adopts a qualified employee retirement plan (the ESOP). The ET acts as a buyer of outstanding or newly-issued shares for fair market value, and it can own a partial or total interest in the company. The purchase price is fair market value, negotiated with the institution that serves as the trustee of the ET and supported by independent valuation advisors. The ET can fund its purchase with external financing based on the company's credit capacity and/or seller financing. The financing arrangement can also include continuing participation in the enhanced equity upside of the company.

Federal and state statutory tax incentives apply for owners/sellers and corporations exclusively under various forms of this structure. Owners can often qualify to defer capital gain taxes (sometimes permanently), and in many cases the tax liability from business operations can be entirely eliminated. The enhanced cash flow from tax savings can be used to repay the deal financing, then to facilitate significantly faster growth. In many situations, this structure can be customized to help companies and their owners achieve their financial and other objectives much more efficiently.

In addition to the objectively quantifiable tax benefits, abundant empirical evidence shows that employee equity participation can enhance productivity and profitability. This is true even though the employee participation is indirect, as the employees are beneficiaries of a trust, not direct owners. The beneficial interests in the shares owned by the ET are allocated and vested to employee accounts based on customized plan formulae. Employees ultimately realize the value of their account balances in cash over time after they leave the company. This "repurchase obligation" should be actuarially managed.

Of the several common misunderstandings about ESOPs, control and corporate governance issues tend to be the most prevalent. Companies with an ESOP shareholder are governed in the same manner as before the introduction of the ESOP. The ESOP trustee is appointed by the board and is responsible for overseeing the ESOP. The trustee votes the stock held on behalf of the employees on either a "directed" or "discretionary" basis. As beneficiaries of a trust, the employees neither own shares directly nor exercise any control over operations. The law entitles employees to vote, however, on certain major corporate capital events (excluding a sale of stock).

The initial step usually involves financial modeling to show how this concept could work. We can efficiently compare the ET/ESOP alternative to all other alternatives, including maintaining the status

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quo. We can help clients properly understand the pros and cons of various ESOP strategies and navigate the common misunderstandings. Whether an ESOP strategy involves a partial or complete exit, or an internal re-structuring, these powerful and flexible concepts can help owners and companies become more successful. ■

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