

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP): MODERN PLAN DESIGN TRENDS IN A RISING TAX ENVIRONMENT



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WHAT IS AN ESOP?

- Employee Stock Ownership Plan
- A tax qualified defined contribution employee retirement plan under IRC Sections 401(a) and 4975(e)(7)
- Must invest primarily in stock of the sponsoring company
- Designed to ease the strain on government safety nets
- Designed to curb the consequences of other sale options: (layoffs, corporate relocation, pay-cuts, community support/legacy)

POWER OF EMPLOYEE OWNERSHIP

- ESOP companies are **25%** more likely to stay in business
- Employee-owners were **4x** less likely to be laid off during the pre-COVID recession
- Employees at ESOP companies have **2.5x** greater retirement accounts
- ESOP employees receive **5-12%** more in wages

BI-PARTISAN SUPPORT

“Study after study shows that when workers have an ownership stake in the businesses they work for, productivity goes up, absenteeism goes down and employees are much more satisfied with their jobs.” - Bernie Sanders

“I can't help but believe that in the future we will see in the United States and throughout the Western world an increasing trend toward the next logical step, employee ownership. It is a path that benefits a free people.” - Ronald Reagan

ESOP CANDIDATE PROFILE

- Owner(s) wishing to cash out all or portion of business
- Payroll of \$1,000,000 or greater
- \$10,000,000 or more business value
- 25 + Employees
- Family or Non-family-owned businesses

TYPICAL SELLER CONCERNS

- “Can I get fair market value and leave my company financially sound?”
- “Will my management or my children be able and/or willing to obtain financing to buy me out?”
- “Will I have to be their bank?”
- “What will happen to my employees and family if I sell to an outside buyer?”
- Will private equity destroy my family and corporate legacies?”

MAJOR TAX INCENTIVES

1. Indefinite Deferral/Elimination of capital gains taxes normally due on a sale of a business: (C-Corp)
2. **Profits of a 100% ESOP owned S Corporation are NOT subject to federal or state income taxes (S Corp) ***
3. Significant estate & Charitable planning opportunities

* Some states may have a gross revenue tax that may not be exempt



CAPITAL GAINS TAX DEFERRAL

- Selling shareholder may elect to indefinitely defer/eliminate federal capital gains on sale proceeds regardless of basis
- **IRC § 1042** is similar to real estate provision IRC § 1031 and life insurance IRC § 1035
- Must reinvest sale proceeds into qualifying U.S. stocks and bonds
- Special ESOP financial vehicles are available to facilitate deferral and access to cash



S CORP TAX-FREE PROFITS

- Taxation is “passed through” to shareholders in proportion to ownership
- An ESOP is a tax-exempt trust, therefore no tax is paid on percentage owned by the ESOP
- Therefore, **profits of a 100% ESOP owned S Corp are NOT subject to federal or state income taxes**
- The tax savings is used to pay off the debt incurred to buy stock from selling shareholders



ESOP BASIC STRUCTURE

- ESOP borrows money from a bank and/or seller installment notes
- The ESOP uses the borrowed funds to purchase stock from sellers
- Company contributes tax savings to the ESOP
- ESOP uses contributions to repay debt

EMPLOYEE BENEFIT

- Shares owned by the ESOP are allocated into employee's accounts over a 20-40 year period
- Employees cash out stock balance when employment ends
- Company must make a market for exiting employee's stock
- This is called the "Repurchase Liability"
- Best practice is that the company should use some of the tax savings to financially prepare for the repurchase liability

CONTROL/VALUATION

- Employees only have a beneficial interest in the ESOP trust
- Employees have no right to confidential info, payroll etc.
- The board (selling shareholder, family, key management) continues to control the company
- Current board passes the reins to desired successor when ready
- Sellers and Buyers negotiate with trustee for sales price



FINANCING THE SALE

- Bank financing
- Seller financing
- Combination of bank and seller financing
 - Significant incentives for seller



RECOMMENDED STRUCTURE

- Seller receives installment note payments for the shortfall between the sale price and what the bank will lend
- Seller deserves to be rewarded for their subordinate position
- Once 100% of the purchase price has been received, seller receives an **ADDITIONAL** payment of up to 20-25% of the future value of the tax-free company

TOTAL OUTCOME EXAMPLE

Company Value \$20,000,000

Bank Down Payment	8,000,000
Seller Note - Principal	12,000,000
Seller Note – 4.5% Interest	4,524,000
Reward (20%) *	6,050,000
Approx. Total Proceeds	\$30,574,000

*Assumes company value grows at 3% annually over 15 years

ESOP OBJECTIONS

- **ESOPs are complicated:** Yes, but so are many worthwhile techniques
- **ESOPs are expensive:** It's relative. Consider costs of business broker/private equity fees as well as the potential elimination of capital gains tax on proceeds and income taxes on profits
- **Employees will run the business:** Not true
- **Difficult to finance:** ESOPs are financed like any other corporate loan or could be 100% seller financed. Banks like the cash flow enhancement of tax-free profits

PROCESS STEPS

1. Complimentary “ESOP 101”/Personal ESOP Informational Session (Compliments of Private Wealth Management)
2. Written ESOP financial review of corporate financial information (Compliments of Private Wealth Management)
3. Preliminary Valuation/Preliminary Analysis
4. Feasibility Study
5. Implementation

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