Can't Find A Buyer? Create an ESOP

By Robert W. Wood • Wood & Porter • San Francisco

Though notoriously difficult to get closed, offer extraordinary tax and business benefits for those able to run the gauntlet of technical rules. An Employee Stock Ownership Plan (ESOP) is a special type of employee benefit plan designed to hold stock of the employer. You may think of an ESOP holding stock in a large public employer with thousands of employees.

However, ESOPs can work wonders in a closely held corporation. Suppose that you, your brother and sister each own one third of your family company. You are each getting on in years and want cash. Your brother is particularly anxious to get out. He says he'll even sell to your arch rival if necessary.

Neither you nor your sister has the cash to buy your brother's stock, nor does the company. In fact, you and your sister would each like cash too, although you are not as desperate as your brother. There is no public market, and most people wouldn't buy only a portion of your business. The competitor your brother mentioned might be interested in buying only a portion of the business, but he probably just wants to loot your business.

Regardless of the reason for a shareholder wanting to sell (death, retirement, illness, regulatory changes, shareholder disputes, *etc*.), this situation may be ripe for an ESOP. If the business doesn't have sufficient cash to purchase the stock, the business can form an employee plan to do so. Of course, the plan would need cash to allow the ESOP to buy the stock.

This is where leverage comes in. Usually, the bank will make a loan to the company, which in turn will loan the money to the ESOP. The company makes annual contributions to the ESOP in an amount necessary for the ESOP to make the annual payments on the loan.

The ESOP then makes the payment to the company, which in turn makes the payment to the lending bank. Often, the terms of the two loans are the same. The amount a lender is willing to lend is often a multiple of the company's earnings before interest, taxes, depreciation and amortization (EBITDA).

Shareholder Tax Savings

Shareholders of closely held C corporations may have a rude awakening when discussing a sale. They often find they will pay two taxes, paying tax at both the corporate and shareholder levels. However, an ESOP transaction is always a stock sale, which incurs only one level of tax.

Even more remarkably, an ESOP can provide a shareholder with deferral on the sale of his stock. If the ESOP owns 30 percent or more of the outstanding stock after the sale, and if the seller reinvests the proceeds into qualifying stocks, bonds or other securities of operating companies incorporated in the U.S. (qualified replacement property) within a specified 15-month period, the gain on the stock sale to the ESOP is deferred. [*See* Code Sec. 1042(c)(4)(D).]

The gain is rolled over into the replacement securities and will not be taxed until they are sold. Furthermore, if the shareholder still holds the replacement securities on his death, there's no income tax at all. The securities receive a stepped-up basis for income tax purposes on the holder's death.

Corporate Tax Savings

ESOPS also provide tax savings to the corporation. The corporation can claim a deduction for its contributions to an ESOP. If the corporation's income is taxed at 40 percent, the corporation has tax savings equal to 40 percent of the cost of acquiring the selling shareholder's stock. If the company is an S corporation, the tax benefit is greater, for its income is passed through to shareholders.

If the S corporation is partly or wholly owned by an ESOP, the ESOP pays no income tax on the income allocated to the ESOP. In some cases, a selling shareholder sells his stock to the ESOP in two or three stages. Because of the tax savings, ESOP ownership may conceivably even enable the company to increase its cash flow.

Deductible Dividends

Axiomatically, corporations generally pay dividends from after-tax earnings: Dividends are nondeductible by the paying corporation. Yet for a corporation wholly or partially owned by an ESOP, if the corporation pays dividends, it may be able to claim a deduction for dividends that are:

- paid in cash to employees within 90 days after the close of the plan year;
- used to pay the debt incurred to acquire the stock for the ESOP; or
- voluntarily reinvested by the plan participant back to the ESOP for more stock. [Code Sec. 404(k).]

Conclusion

ESOPs are incredible tools, providing a company with a market for its stock and facilitating the liquidity needs of shareholders. There are many tax and nontax advantages of an ESOP. They have the flexibility to structure transactions to fit the needs of the company and the selling shareholders.

There are, of course, downsides. One of them is transaction costs. ESOP transactions tend to be expensive, especially so given fiduciary concerns and appraisal requirements. Nevertheless, in the right situation an ESOP transaction can accomplish much that a more traditional purchase cannot hope to achieve.