Bloomberg Tax

Tax Management
Compensation Planning Journal™

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Selling Your Business? Consider an ESOP

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Approximately 2.9 million businesses in the United States are owned by individuals who are age 55 and older.[1] Those owners will exit those businesses in one way or another. As business owners start to consider their options for exiting their businesses, they should be considering an alternative that's not always known or properly understood: the employee stock ownership plan, or ESOP.

Several well-known companies are owned in a significant degree by an ESOP. Publix, the grocery store chain based in Lakeland, Florida, is more than 90% owned by its employees. Wawa, the convenience store chain, is owned about 40% by an ESOP. Robert W. Baird, the financial services company, is also employee owned. New Belgium Brewing, which makes Fat Tire beer, was an ESOP company until it was sold in a strategic sale a few years ago, resulting in significant payouts to its employee-owners. Currently there are about 6,900 ESOPs in the United States.

In this article, we'll talk about what makes a good ESOP candidate, the advantages of ESOP transactions (which include some significant tax benefits), and the process of how a typical ESOP is established.

WHAT IS AN ESOP?

Fundamentally, an ESOP is a tax-qualified retirement plan — just like a 401(k) plan — that is intended to primarily invest in the stock of the company that sponsors it.[2] Although they're qualified retirement plans, ESOPs are primarily implemented as an exit strategy for an owner who is looking to sell all or a portion of the business. ESOPs can be used as an incentive plan without the need to buy out an existing shareholder — so the company just makes contributions of a small percentage of the company's stock to the ESOP and allocates it to eligible employees — but those are relatively rare.

Although ESOPs are qualified plans like 401(k) plans are, they have some very important differences. First, ESOPs are rarely funded with employee contributions — instead, the plan is funded by contributions from the employer (more on how that works later). Second, an ESOP is the only type of qualified plan

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This article may be cited as John Burgess and Phillip Hayes, *Selling Your Business? Consider an ESOP,* 50 Tax Mgmt. Comp. Plan. J. No. 12 (Dec. 2, 2022).

[1] www.project-equity.org/communities/small-business-closure-crisis/.

[2] §409(a). All section references herein are to the Internal Revenue Code, as amended (''the Code'').

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ISSN 0747-8607

that can borrow money, which is an important factor in how the plan is set up.

A common misconception about ESOPs is that employees become legal owners of the company's shares, giving them shareholder rights such as the ability to see certain information and the right to vote the stock. That isn't the case. All of the stock in the ESOP is legally owned by the ESOP trustee, not individual employees. The employees have a financial interest in the stock, but they aren't the legal owners and therefore don't have the rights that a company shareholder has. For cultural reasons, many ESOP companies will provide more information on the company's performance to their employees than most companies do, but that's purely optional. In privately held companies, ESOP participants don't have the right to vote the shares that are allocated to their accounts except in limited circumstances, such as where the company is contemplating a major transaction such as a merger or a sale of substantially all of its assets.[3]

The shares in the ESOP are legally owned by the trustee, who is like a passive investor. The trustee will of course track the company's performance and make sure that it has strong governance and leadership, but the trustee is not interested in running the company's day-to-day operations. Most independent ESOP trustees act in that role for dozens of companies (if not more), so they do not have the time or the expertise in the industry to take an active role in operations. In fact, in nearly all ESOP transactions, the company's existing management (including any selling shareholders) stays in place. The trustee is also responsible for hiring an independent appraiser who values the stock of the company at least once per year.[4] The selling shareholder is frequently the company's President and CEO, and he or she will stay on for several years after the transaction — even after selling 100% of the company — to train other executives to take over once he or she decides to retire.

WHAT MAKES A GOOD ESOP COMPANY?

An ESOP simply isn't practical or feasible for every company. In general, a good ESOP candidate will have the following characteristics:

- A history of consistent income and cash flow;
- Enterprise value of at least $2 million;
- Little or no corporate debt;
- At least 20 full-time employees who can participate in the ESOP; and
- The next generation of leadership in place or being trained to take over in a few years

The motivations of the selling shareholder(s) is also an important factor in determining if an ESOP is a good alternative. Business owners who are motivated to sell to an ESOP are frequently the first- or second-generation owner of the company and are interested in preserving the company's legacy. It is also important to them that the employees who helped them build the company are rewarded and be given an additional opportunity to benefit from its success. While an ESOP can pay fair market value for the stock that it acquires, it cannot pay a premium to account for things like strategic alliances like other types of buyers, such as private equity or a competitor, can provide. Therefore, an ESOP is not going to be a good solution for a business owner who is simply looking to get the most cash possible out of the transaction.

ESOPs ARE FLEXIBLE

One of the primary attractions for a business owner is that ESOPs offer tremendous flexibility in transaction structure. While plenty of ESOP transactions involve the acquisition of 100% of the company at once, that doesn't have to be the case. In fact, a significant number of ESOPs start with the acquisition of a minority interest in the company, usually 30% or 40%. This allows a selling shareholder, who may have nearly all of his or her wealth tied up in the business, the opportunity to diversify some wealth while continuing to own a majority of the company. In many cases, several years after the initial transaction, a minority ESOP will do a second-stage transaction to acquire more (and perhaps all) of the company.

There is also significant flexibility in how an ESOP acquisition is financed. In some transactions, a bank will provide a loan to the company to finance a portion of the purchase price so that the selling shareholder will be able to receive an immediate payment for his or her stock. The remaining purchase price, especially in a 100% ESOP transaction, will be funded through seller notes taken by the selling shareholder, in many cases with a detachable warrant that allows for a lower interest rate on the seller notes while preserving an adequate internal rate of return. In a few cases, especially where the seller does not need the cash proceeds from the sale right away, the transaction will not involve a bank and 100% of the purchase price will be funded by seller notes, and possibly warrants.

ESOP TAX ADVANTAGES

Congress has a favorable view toward employee ownership, so ESOPs have been highly incentivized under the Code.

[3] §409(e).

[4] §401(a)(28)(C).

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First, under §1042, if the company is a C corporation when the ESOP buys stock from the selling shareholder, the shareholder can defer capital gains on the sale if, after the transaction, the ESOP owns at least 30% of the company. In order to defer the gain, the selling shareholder must, within one year of the transaction, reinvest the proceeds in ‘‘qualified replacement property,’’ which includes stocks and bonds issued by domestic companies.[5] Section 1042 treatment currently isn't available to ESOP sales involving S corporations, but legislation is introduced on a regular basis to do this.

Second, an S corporation ESOP carries significant tax advantages. An S corporation, as most tax practitioners know, is a ‘‘pass-through'' entity that doesn't (with a few exceptions) pay taxes on its income. Instead, it passes that income up to its shareholders, who report the income and pay taxes on it. An ESOP trust is a tax-exempt entity under §501(a), so any income that is passed up to it is not subject to tax. This means that an S corporation that is 100% owned by an ESOP is not subject to any federal income tax! This gives the corporation a significant cash flow advantage that it can use to invest in its business or use to make strategic acquisitions. Anti-abuse rules under §409(p) prevent a corporation with just a few employees from having an S corporation ESOP, as that defeats the purpose of encouraging broad-based employee ownership. The §409(p) rules are complex and so any S corporation ESOP must, with the help of its ESOP professionals, continuously monitor compliance with §409(p) because the consequences of failure are significant, as we will discuss in more detail below.

There are occasions when the shareholder of an S corporation will require that the corporation revoke its S election prior to the transaction in order to take advantage of §1042. Once it does that, the corporation cannot revert to S corporation status for five tax years, but the tax bill that comes from C corporation status during that time can be managed, especially because the company is deducting interest payments on the outside loans and/or seller notes, and the contributions to the ESOP are deductible as compensation expenses.

FIDUCIARY DUTIES

As a qualified retirement plan, an ESOP is subject to the jurisdiction of the IRS and the Department of Labor. Therefore, it is important that an ESOP company pay attention to the fiduciary duties that are required under ERISA. This is especially the case when an ESOP is established, since it is critical to avoid a situation where the ESOP pays more than fair market value for the stock of the company. This is why we always recommend that an independent trustee be retained to act on behalf of the ESOP (and indirectly, the company's employees) in negotiating and entering into an ESOP transaction. The potential for an ESOP overpaying when it buys stock from the selling shareholder is a significant hot button issue for Labor, so it is vitally important to use independent professionals who are experienced in ESOP transactions.

Once the ESOP is in place, although it's not required, it's always a good idea for the company to appoint an ESOP Committee that will act as the ‘‘plan administrator'' under ERISA and oversee the administration of the ESOP. The members of the ESOP committee are normally employees of the company who will be fiduciaries of the plan, so the company should provide indemnification for actions taken in good faith. This committee is responsible for making sure that the ESOP's third-party administrator (which helps with a number of tasks such as the allocation of ESOP shares to individual accounts, preparing and distributing annual participant statements, and processing distributions) is doing an adequate job and addressing any issues that may come up in the operations of the plan. The committee should also receive fiduciary training so that it understands its roles and responsibilities under ERISA.

HOW THE TRANSACTION WORKS

Although ESOP transactions can be structured in any number of ways, there are a few fundamentals that are a part of every typical ESOP transaction:

- The company lends money to the ESOP — in some cases the company takes cash that it obtained from an outside lender and immediately loans it to the ESOP — this is referred to as the ‘‘inside note.''
- The ESOP buys stock from the selling shareholder(s), using any cash it was received from the company, with the remaining price (if any) payable via a promissory note to the selling shareholder(s).
- If part of the purchase price paid to the selling shareholder(s) was a promissory note, the company assumes the promissory note from the ESOP, making the company responsible for paying it.

This is a simplification of a series of complex transactions but in the end, the company is owed the amount of the inside note from the ESOP, and then the company owes whatever combination of the loan that it received from the outside lender plus the note to the selling shareholder(s). Of course, any loan to an out-

[5] §1042.

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side lender will have priority over the note that is owed to the shareholder(s).

When the ESOP is first established, the stock is initially held in a ''suspense'' account that is not allocated to individual employees. Instead, that stock acts as security for the inside note that the ESOP owes to the company. Each year, the company will contribute to the ESOP an amount equal to the payment that the ESOP needs make on the inside note for that year. The ESOP then makes the payment on the inside note back to the company — in other words, the cash contribution that the company made to the ESOP is returned to it — and a portion of the stock in the suspense account is released to the accounts of eligible employees. In most cases, the stock that is released from suspense is allocated to eligible employees relative to the compensation that they receive from the company for that year (but limited by §401(a)(17)), although some companies will base the allocation formula on a combination of age and years of service in order to reward longer-term employees. It is possible for the company to make contributions to the ESOP above and beyond what is required to the inside note, and those contributions are typically used to prepay the balance on the inside note, allowing for more shares to be released from the suspense account to the accounts of eligible employees.

Once shares are allocated to an employee's account in the ESOP, they are normally subject to vesting, just like 401(k) employer contributions may be. Vesting can occur with continued service over no more than six years, and an employee's service before the effective date of the ESOP doesn't have to count.[6]

Employees then see the benefits from their ESOP accounts after they terminate employment. While 401(k) benefits can almost always be taken out in a single payment, an employer needs to manage its ESOP repayment obligation because the stock of the company isn't liquid. ESOP companies rarely distribute the actual stock of the company, so either the company or the ESOP needs cash to buy the shares that are subject to the distribution. To help ESOP companies manage this, the Code allows an employer to require an employee who terminates for any reason other than retirement, death or disability to wait for up to six years after termination to begin receiving distributions, and require distributions to be made over up to five years.[7] However, employers will frequently pay out employees more quickly if there is cash available to do it because that eliminates the possibility of those shares gaining value in the future, increasing the repurchase price. An ESOP company needs to monitor the repurchase obligation for future benefit distributions because failing to do so can result in liquidity issues for the company — in extreme cases, it can force the sale of the company to an outside buyer.

The ESOP Transaction Process

An ESOP transaction is much like other business sale transactions, involving multiple advisors with differing areas of expertise. The following chart illustrates each of the major steps and where they fall in the process:

[6] §411(a)(2).

[7] §409(o).

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An Example ESOP Transaction

The following example is a completely hypothetical scenario that illustrates the steps of the ESOP transaction process.

Bob Smith owns a profitable construction company (Smith Construction) that was founded 30 years ago and is taxed as an S corporation. The company currently employs more than 100 full-time people who are non-union employees. Bob is the only shareholder, owning 100% of common stock. There are five key employees in upper management. Bob does still work in the business, but has been able to work less hours over the last few years since his key employees are stepping up to their respective roles. The company has built business processes that are definable and effective in all elements of the business, including business development, workflow operations, finance, talent retention and recruitment, customer service and marketing. The company has a strong bonding relationship but only bonds about 20% of its total contracts. The company has had a stable history of reasonable revenue growth and consistent profitability. The balance sheet has appropriate debt structure with access to a line of credit that is unused since the company has been heavily capitalized by the owner leaving excess working capital in the business.

Bob heard about ESOPs from his friend and has an interest in moving forward. He likes the ESOP as he would like to begin transitioning the ownership to his employees, but also likes the flexibility and is not ready to turn over his whole operation at this time. He engages a sell-side advisor to begin the steps to determine if his company is a good candidate for an ESOP and whether it would be feasible.

Valuation Model

The sell-side advisor has answered a lot of conceptual questions for Bob and will need to provide an estimate of value on the business. A valuation model is built that utilizes the Capitalization of Earnings method, which primarily focuses on the income approach and averages five years of a subject company's historical cash flows that are normalized to determine an estimated average free cash flow or economic benefit stream:

Free Cash Flow
"Normalized" Earnings before Interest and Taxes
(Minus) Taxes
(Plus)Depriciation and other non-cash expenses
(Plus/Minus) Working Capital Requiirements
(Equals) = Debt-free Cash Flow to Invested Capital/Enterprise

"Normalized" cash flow means the subject company's cash flow that is functionally available to a hypothetical buyer where expenses that are nonrecurring (e.g., one-time consulting expenses) and/or discretionary (e.g., owner excess compensation) will adjust either upward or downward the cash flow available to a hypothetical buyer.

The Capital Asset Pricing Model (CAPM) quantifies the relationship between the risk of an investment and the expected return for assets. primarily stocks. This is a finance model that incorporates the current market rates and considers a relationship between the Beta (volatility of stock within a specific industry) and market premiums along with the risk-free rate of returns. This is representative of the cost of equity and is utilized in the analysis to estimate the weighted average cost of capital (WACC) model to determine a capitalization rate under the capital asset pricing model, using this formula:

Weighted Cost of Capital

Cost of Equity (K_e) — Capital Structure (E=Equity, D=Debt)

$$WACC = K_e \times \frac{E}{E+D} + K_d \times (1-T)\frac{D}{E+D}$$

Cost of Debt (K_d) — Tax Rate (T)

Capital Asset Pricing Model (CAPM) and Assumptions Explained, By Will Kenton

Updated October 24, 2022

As part of analyzing the normalized cash flow, the valuation model will utilize a company-prepared financial forecast, typically for five years into the future. This forecast supports the Discounted Cash Flow

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ISSN 0747-8607

model that estimates the value of future cash flows factored back to present values using the WACC.[8]

The valuation model will then analyze the company's balance sheet to determine the overall required working capital, based upon averages related to total revenue. Actual working capital when compared to target working capital can result in either a positive or a negative adjustment to the purchase price.

In our example for Smith Construction, we have a range of estimated ESOP valuation to consider for planning purposes. The table below illustrates the Capitalization of Earnings model alongside the Discounted Cash Flow model. Once the adjustments are made for net working capital and deductions for company debt, the estimated equity value is reduced for a discount for lack of marketability at 5%. After this adjustment, the estimated valuation ranges from a low of $13,569,781 to a high of $17,984,435. The range is a good estimate of value, but there are multiple variables that can change until the ESOP deal is closed. This includes the balance sheet variables with actual net working capital and debt which will be calculated prior to closing.

			ESOP Sale 100%	ESOP Sale 100%
			COE	DCF
Indicated Enterprise Value on a Controlling, non-Marketable Basis			16,508,021	$21,155,044
Cash			$3,508,177	$3,508,177
Misc. Receivables				
Excess or Defict W r ki rg Capi tal				
Current Assets	(A/R - no cash)	20,400,701	$(5,190,397)	$(5,190,397)
Current Liabilities	(A/P - no debt)	21,341,098		
Working capital		-$940,397		
	$4,250,000.00	Working Capital Requirement		
Interest-bearing debt			$(541,820)	$(541,820)
Estimated AAA Distribution				
Indicated Fair Value of Equity on a Controlling, Marketable Basis			$14,283981	$18,931,004
Adjustment for Lack of Marketability at 5 percent			$(714,199)	$(946,550)
Indicated Fair Market Value of Equity on a Controlling, Non-marketable Basis		Amort.	$13,569,781	$17,984,435
Total Proceeds to Sellers (AAA Distribution plus indicated FMV of Equity)			$13,569,781	$17,984,435

ESOP Feasibility

From a negotiation standpoint, the sell-side advisor targets an $18 million transaction as an expected target for the ESOP transaction. This amount may differ depending upon the timing of the transaction and changes in the company. However, early in the ESOP planning process it is important to have a target transaction value.

ESOP feasibility is necessary to answer some questions, such as:

- How will the company support the future cash flow burden of the buyout debt?
- Will the company's payroll and employee population be adequate to support the IRS testing limits for 404 and 409(p)?

Based upon some early conversations with ESOP lenders, the sell-side advisor determines that the incumbent bank, given the long history with the client, would be able to provide up to $9 million of bank financing with a five-year amortization at 5.5% with no personal guarantees, but would require an excess cash flow requirement for additional principal payments annually as well as a fixed-charge coverage ratio of 1.5 times. The bank will allow the seller note of $9 million to be paid interest only while the bank loan is outstanding, but reserve the right under a subordination agreement to suspend interest payments on the seller note if the fixed-charge coverage ratio falls below 1.5 times. It should be noted that typical ESOP financing is much less than 50% of the transaction, but this was a favorable situation given the banking relationship.

Bob Smith will be taking a seller note of $9 million for the remaining purchase price, with a negotiated internal rate of return (IRR) of 10% made up of a 3% interest rate on the seller note, and the remaining 7% consisting of warrants to purchase 250,000 shares, exercisable once the seller note is paid in full.

The analysis for feasibility incorporates amortization schedules to test the five-year cash flow model based upon the forecast. At 100% of the forecasted cash flow, the company has the ability to service the debt and other ESOP compliance costs with an average of approximately $3 million in excess cash — one major reason this is relatively high is that the company will become a 100% S corporation ESOP that pays no federal or state income taxes.

Feasibility Model: 100% of Forecast

	2021	2022	2023	2024	2025
COMBINED COMPANY NET CASH FLOW	$4,757,754	5,709,332	$4,749,640	$4,768,308	$4,470,286
Forecasted Net Income Before Tax	4,757,754	5,709,332	4,749,640	4,768,308	4,470,286
Taxable Income	-	-	-	-	-
Total Taxes	-	-	-	-	-
Total Debt Service	(1,244,047)	(2,488,093)	(2,488,093)	(2,488,093)	(2,488,093)
Total Net Cash Flow After Tax and Transaction	$3,513,708	$3,221,238	$2,261,547	$2,280,215	$1,982,193

Feasibility Model: 56% of Forecast

The cash flow model can then be stress tested to determine how much the company could be short in

[8] McKayla Girardin, *Discounted Cash Flow (DCF) Valuation: The Basics* (Sept. 8, 2022), https://www.theforage.com/blog/skills/dcf-valuation.

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ISSN 0747-8607

forecasted cash flow and still be able to service the debt and ESOP expenses. The table below shows that the company could be down by 44% and still have positive cash flow. Stress testing the cash flow is a vital step in the ESOP planning process to determine the strength of the cash flow and to test the company's structure of debt. In this example, the company would still have an average positive cash flow of approximately $500,000 after this much of a drop. In the event that it is too tight, then multiple decisions can be made to adjust the transaction structure that could include longer amortizations, suspension of seller interest payments and reconsidering valuation expectations.

	2021	2022	2023	2024	2025
COMBINED COMPANY NET CASH FLOW	$2,664,342	$3,197,226	$2,659,798	$2,670,252	$2,503,360
Forecasted Net Income Before Tax	4,757,754	5,709,332	4,749,640	4,768,308	4,470,286
Taxable Income	-	-	-	-	-
Total Taxes	-	-	-	-	-
Total Debt Service	(1,244,047)	(2,488,093)	(2,488,093)	(2,488,093)	(2,488,093)
Total Net Cash Flow After Tax and Transaction	$1,420,296	$709,132	$171,705	$182,159	$15,267

Section 404(a): 25% Limit Test

Once the cash flow has been tested, we move on to evaluate the structure of the ESOP contributions. The allowable company contribution to a qualified retirement plan, including the 401(k) contribution, is 25% of annual payroll,[9] which here would total $1,322,454.13. From a planning perspective, the sell-side advisor would discuss the possibility of suspending or discontinuing the 401(k) contribution in lieu of the ESOP contribution. This happens in some circumstances to free up a larger ESOP contribution. The analysis is also helpful in planning the structure of the "inside" note which determines the amount of shares released annually to the employees.

[9] §404(a)(3).

Section 404(a)(3) Compensation	$5,289,816.53
Maximum Deductible Contribution	$1,322,454.13
Employer Contributions	-
Total Allowable ESOP Contribution	$1,322,454.13

Section 409(p) Test: Anti-Abuse Rules for S Corporation ESOPs

When the ESOP is sponsored by an S corporation, a violation of §409(p) would create significant issues. Section 409(p) provides that no assets of an ESOP may be allocated to "disqualified persons" if they own more than 50% of the equity of an S corporation.[10] Section 409(p) was designed to prevent indirect concentrated ownership in an S corporation through an ESOP.

A "disqualified person" is defined as either an individual that owns individually at least 10% of the "deemed" ESOP shares, or a family group owns more than 20% of the "deemed" ESOP shares.[11] The "deemed" ESOP shares include those that have been either purchased by or contributed to the ESOP plan. Deemed-owned shares includes both allocated and unallocated shares, assuming that the same proportion of unallocated shares held in the suspense account is allocated fully to the participant. Any "synthetic equity" — such as stock appreciation rights, phantom stock, and warrants — would also be treated as being held by the participant as part of the total percentage.[12] In our example below, there is a mock allocation that would include synthetic equity, but we will assume there is none. There are no disqualified persons in Smith Construction. The table below provides percentages for both the individual and family grouping.

[10] §409(p)(3).
[11] §409(p)(4).
[12] §409(p)(5).

If there are any disqualified persons, the next step is to determine if they in the aggregate own more than 50% of the total equity of the company. This includes any deemed-owned shares plus any equity held outside of the ESOP — so if the selling shareholder retained any direct ownership of the company, those shares would count toward the 50% calculation. If this were to happen at any point during an ESOP plan year, such year would be treated as a non-allocation plan year and the ESOP treated as having distributed to disqualified persons, the disqualified persons would be taxed on the amount, the S election would be re-

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ISSN 0747-8607

Allocated ESOP Shares	Mock Allocation	Synthetic Equity	Total Deemed Owned Shares	Individual Percentage W/SynEquity	Family Percentage W/SynEquity
670.3091	16,087.4184	0.0000	16,757.7275	1.68%	
573.1902	13,756.5648	0.0000	14,329.7550	1.43%	
1,536.6221	36,878.9304	0.0000	38,415.5525	3.84%	
1,060.4828	25,451.5872	0.0000	26,512.0700	2.65%	
2,449.9603	58,799.0472	0.0000	61,249.0075	6.12%	11.36%
1,496.0157	35,904.3768	0.0000	37,400.3925	3.74%	
598.7967	14,371.1208	0.0000	14,969.9175	1.50%	
480.0656	11,521.5744	0.0000	12,001.6400	1.20%	
505.0641	12,121.5384	0.0000	12,626.6025	1.26%	6.80%
1,436.9367	34,486.4808	0.0000	35,923.4175	3.59%	
778.2466	18,677.9184	0.0000	19,456.1650	1.95%	
657.9095	15,789.8280	0.0000	16,447.7375	1.64%	
259.5486	6,229.1664	0.0000	6,488.7150	0.65%	
575.0378	13,800.9072	0.0000	14,375.9450	1.44%	
1,241.8721	29,804.9304	0.0000	31,046.8025	3.10%	
1,029.5433	24,709.0392	0.0000	25,738.5825	2.57%	2.61%

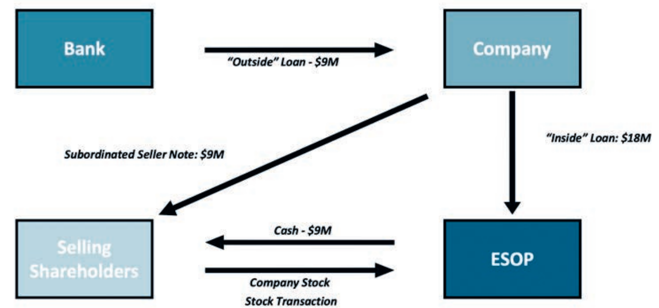
voked, and the company would be subject to a significant excise tax.[13]

ESOP Process to ESOP Closing

As illustrated in the ESOP process above, the remaining steps to move through an ESOP transaction are going to create an arm's-length negotiation similar to a normal merger and acquisition transaction. The main difference in an ESOP transaction is that the buyer is regulated by the Employee Retirement Income Security Act and cannot pay more than fair market value for the stock of the company — so there cannot be premiums for strategic or financial reasons. As such, there will need to be a buy-side team including a transaction trustee, valuation firm (financial advisor) and an attorney. On the sell-side, the client will also need to engage an ESOP attorney for the company, who will be responsible for helping with the negotiations and then writing up the transaction documents and the ESOP plan and trust agreement. Once due diligence is complete by the buy-side, all of the aspects of the deal are negotiated including but not limited to the purchase price, seller note interest and amortization, warrants, SARs, inside note, governance and indemnifications. Once the plan documents and other documents are created, the advisors will move through the closing process with all of the parties involved in documentation review, including the bank and its legal counsel. At closing, any net proceeds from the outside loan will be disbursed to the selling shareholders.

Leveraged ESOP Structure

The following graphic provides a schematic of how the leveraged ESOP transaction is structured utilizing senior debt and seller loans as the ''outside'' promissory notes to fund the ESOP. Seller notes are subordinated and typically interest only until loans to outside lenders are repaid.



The outside loan to the bank is repaid before the debt to the selling shareholders, then shareholder notes are repaid. The ''inside'' loan from the company to the ESOP is amortized over a sufficient time — usually 20–30 years, starting in year of transaction. Annual ESOP contribution expense is typically a ''cashless'' expense and should be taken into account when creating financial covenants. The company makes a tax-deductible contribution to the ESOP for the loan repayment amount for that year, and then the ESOP immediately sends it back to the company as a loan repayment.

As the inside loan is repaid, shares are moved from the unallocated ''suspense'' account to accounts of individual employees. Employees become vested in

[13] §409(p)(2).

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ISSN 0747-8607

their accounts over several years, and can take distributions after leaving the company.

CONCLUSION

As we move through the ESOP process, it can typically take six months from beginning to end. There are many decisions that have to be made throughout the process. Experienced ESOP advisors are critical to this process being successful. In addition to these considerations, there are many discussions in the ESOP community relative to the cost of a transaction and the ongoing costs of maintaining an ESOP. It would be advisable to talk to multiple sources to determine the appropriate deal team and structure of your ESOP. In contemplating an ESOP transaction, it is also advisable to think beyond the transaction at the post-ESOP company and planning for a sustainable ESOP that can provide long-term benefits to the selling shareholder(s), the employees, the customers, and the community.

In the right situation, an ESOP can be an excellent strategy for a business owner who is looking to find the next generation of ownership for his or her company. There is a significant body of research showing that ESOP companies generally outperform similar non-ESOP companies, retain more employees, and significantly improve the financial well-being of their people.[14] While ESOPs are complex, hundreds of new ones are successfully implemented every year with the help of professionals who can help to demystify the process and achieve the goals of both business owners and employees.

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[14] https://www.nceo.org/article/research-employee-ownership.

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ISSN 0747-8607