Part II: Using ESOPs to Grow Your Business and Build a Dedicated Workforce

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How an employee stock ownership plan can be used to meet the twin goals of corporate growth and development of a stronger and more committed workforce.

Part One of this article provided basic information about the uses and general operation of an employee stock ownership plan (ESOP), including an explanation of the special tax and prohibited transaction rules that favor the use of ESOPs for certain types of transactions.

Unlike other methods of raising capital, because an ESOP is also an employee retirement plan, the ESOP can also serve as a powerful engine for attracting and maintaining a competent and committed workforce. These goals are wholly complementary and achievement of the latter may well serve to insure the success of the former. Here are some of the key issues to consider before deciding if use of an ESOP is appropriate for the company or for a particular transaction.

Using an ESOP in a Capital Transaction

Normal Asset Purchase. A corporation has several options to raise capital to implement a company growth strategy, which can be used individually or in combination, including: (a) borrowing from shareholders or a third-party lender; (b) capital contributions by existing shareholders; and/or (c) selling equity to a third party. Consider a typical asset acquisition:

- Buyer enters into an asset purchase agreement with Seller for $5,000,000. Buyer gets a commitment from Bank to lend 75 percent of the purchase price ($3,750,000) and funds the remaining 25 percent ($1,250,000) with additional equity investments.
- Bank's loan is a fully amortizing, 10-year term loan at a fixed rate of 6.0 percent, payable in equal annual installments of $509,504.84 each.
- Assuming an effective combined state and federal corporate tax rate of 25 percent, Buyer will need approximately $603,000 of pre-tax earnings to pay the loan in the first year, since the principal portion (over $281,000) is not deductible for federal or state tax purposes. By the tenth year, Buyer will need approximately $706,000 of pre-tax earnings to make the final loan payment. Over the entire term, the amortization of principal with after-tax dollars effectively adds $1,250,000 to the total cost of the transaction.

Adding an ESOP. Buyer adopts an ESOP when it buys Seller's assets and sells common stock having an appraised fair market value (after giving effect to the acquisition) of $3,750,000 to the ESOP on terms identical to the loan from Bank. Each year, Buyer makes a tax deductible contribution to the ESOP of $509,504.84. The ESOP uses that contribution to pay annual debt service on the purchase of employer stock back to Buyer, which Buyer then pays to Bank.

Using this structure, (a) the interest income received by Buyer is offset by a deduction for the interest Buyer pays Bank, (b) there is no income to Buyer on the principal portion of the stock purchase payment by the ESOP, so (c) Buyer can fully deduct the total amount paid to Bank because the loan payment equals the deductible contribution to the ESOP. Assuming the same combined 25 percent federal and state corporate tax rate, this should generate tax savings of $937,500 over the full term of the Bank's loan. Ideally, the extra cash flow generated by the tax savings should be sufficient to pay most or all of the required return on investment owed to the equity investors.

Planning is Essential. These tax benefits are dramatic, but before proceeding with the ESOP (and well before closing), Buyer must address several questions, including:

- Are the annual principal payments required on the "mirror loan" to the ESOP less than the 25 percent of compensation deduction limit (as discussed in Part One)? Note that interest payments are not a concern because of the special rule for interest on exempt loans.
- Is the employer's value high enough to sell company stock to the ESOP for $3,750,000? Even so, will the other shareholders (including any new equity investors) consent to the dilution of their interests?

If these questions are answered in the negative, the ESOP may not be feasible. But even if the analysis shows that the ESOP cannot cover the entire transaction, it might be worthwhile to sell less stock to the ESOP so the tax benefits can still be obtained for part of the deal.

Building a Dedicated Workforce

In recent years the retirement plan of choice for many employers has been a 401(k) plan, which permits employees to save for retirement on a pre-tax basis and may also include an employer matching contribution on part of the employees' elective deferrals. As the number of 401(k) plans has increased, so have concerns about employees not fully using the 401(k) plan and failing to appreciate its value as an employee benefit. An employer looking for ways to attract and retain qualified employees should consider an ESOP as an alternative to (or in combination with) a 401(k) plan for several reasons:

- Employees understand that while most (if not all) of the contributions to a 401(k) plan are funded from the employee's compensation, contributions to an ESOP are more valuable because they are being funded by the employer.
- The stock in the ESOP is valued every year, so the employees learn that their contributions to the success of the business directly translate to increased value in their retirement accounts.
- The ESOP provides a way to make employees feel like owners, without actually issuing stock to them, which avoids the practical problems of giving former employees the rights of minority stockholders under corporate law.

- When properly communicated and continually reinforced, this culture of employee ownership tends to promote loyalty, create a strong work ethic and encourage cost-consciousness, all of which can have a significant effect on profits. If this education program is pursued diligently, it will lead to substantial employee "buy-in" that will be self-perpetuating.

Is an ESOP the Right Choice for Everyone?

In light of the significant economic benefits of using an ESOP in the example above, as well as the potential benefits for building a dedicated workforce, why are ESOPs not used more often? The reasons include:

Pass-Through Voting Rights. Participants must be given the right to vote shares allocated to their accounts on certain corporate matters requiring shareholder approval, such as a merger, recapitalization, liquidation or dissolution and sale of substantially all of its assets. If the ESOP holds a significant percentage of the company's stock, participants might not vote their ESOP shares to support management's proposed action. When the ESOP trustee votes, he has a fiduciary duty to only vote the ESOP shares in the best interests of the participants and their beneficiaries, which may be contrary to management's intent.

Independent Trustee. Like all qualified retirement plans, the assets of an ESOP must be held in trust. Given the potential conflict of interest when the ESOP trustee is also a principal of the company (which is common for plans adopted by a closely held business), it is often advisable to either engage an independent trustee for the ESOP or as needed to decide significant matters affecting the ESOP. The trustee may not decide these issues in favor of management.

Stock Re-Purchase Obligation. Generally, ESOP participants may demand that their distributions be paid in stock, but if the stock is not publicly traded, participants have the right to demand that the company purchase any employer stock distributed to them. The ESOP is not required to distribute stock if (a) the company is an S corporation or (b) a provision in its corporate charter or bylaws limits the ownership of stock to the ESOP (or another qualified plan) and employees of the company. In that case, the ESOP will make cash distributions (funded by employer contributions) to terminated participants or the company will re-purchase the shares simultaneously with their distribution.

If the employer re-purchases the shares directly (instead of contributing to the ESOP), it will only have to re-purchase each ESOP share once, but the payments will not be tax deductible. When re-purchased stock remains in the plan, stock ownership inside the ESOP tends to concentrate in the accounts of shareholder and top management employees because they are typically long-term employees.

Complexity and Cost. Unfortunately, ESOPs and ESOP transactions can be complicated and there are additional costs to adopt and maintain an ESOP, including engaging an independent trustee or other fiduciary and getting an annual appraisal. Unless the company and the amount involved in the transaction are large enough, the benefits may not justify the costs.

Additional ESOP Considerations

S Corporation ESOP. An S Corporation may adopt an ESOP, but special rules prohibit contribution allocations to be made to any "disqualified person" (a participant who owns at least 10 percent of the ESOP shares) in any "non-allocation year," in which at least 50 percent of the stock in the S corporation is owned by disqualified persons. As a result, it may never be possible to allocate shares to any disqualified persons. If that is a concern, it is essential to do a feasibility study before an S corporation adopts an ESOP or a C corporation with an ESOP makes an S election.

On the positive side, there will be no tax on the corporation's income passed through to the ESOP in its capacity as a stockholder.

Non-Corporate Employer. Only corporate stock can be qualifying employer securities so limited liability company (LLC) or partnership interests would not qualify as employer securities for ESOP purposes. Nevertheless, an LLC can still establish an ESOP by forming a C corporation to which the LLC's members will contribute their LLC interests in exchange for stock of the corporation, so the corporation becomes the LLC's parent. The LLC, which would still be the employer and operate the business, could then adopt an ESOP, which would be funded with stock of the parent corporation, since the parent's stock is a qualifying employer security.

Final Observations

How to Decide. In the right circumstances, an ESOP can be a useful tool for company growth, attracting and maintaining good employees and developing a culture of employee ownership. But despite these benefits an ESOP is not right for every company. It is important to address a number of issues to determine if an ESOP is a viable option:

- Clearly define the objectives and/or key financial and other terms of the transaction for which the ESOP will be used.
- Get an initial estimate of company value to determine (a) if the value supports the underlying transaction and (b) the effect ownership of stock by the ESOP will have on the non-ESOP shareholders.
- Analyze the projected contribution and deduction limits for annual funding. Even with the economic benefits of the ESOP, management needs to be reasonably confident that the annual funding costs for the ESOP transaction are supportable from projected cash flow. The best ESOP candidates are usually companies that have little or no existing debt service obligations and increasing revenue.
- Obtain a feasibility study to determine both the initial and recurring costs of the ESOP.

It is important for fiduciary responsibility, corporate governance and tax purposes to carefully document the decision-making process (including all issues that were considered) before adopting the ESOP or engaging in any ESOP transaction.

Assembling the Team. Finally, it will be necessary to assemble a strong team to work with management to undertake the feasibility analysis for the ESOP. At a minimum, the team should include an accountant and attorney who both are familiar with ESOP transactions. An appraiser also may be necessary to provide a preliminary estimate of value. If the company decides to proceed with the ESOP the appraiser will make a final determination of the company's value and provide a fairness opinion on the underlying transaction.

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ATTORNEYS MENTIONED

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