



Not Your Old-School Employee Stock Ownership Plan:

Modern Design and Creative Trends

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WHAT IS AN ESOP?

- **Employee Stock Ownership Plan**
- A tax qualified defined contribution employee retirement plan
- Overseen by the IRS and the Department of Labor like 401(k) plans
- Qualified Plan under IRC Sections 401(a) and 4975(e)(7)
- Unlike other qualified plans, an ESOP must invest primarily in stock of the sponsoring company

Pennsylvania's ESOP Community



259

ESOPs in privately held companies

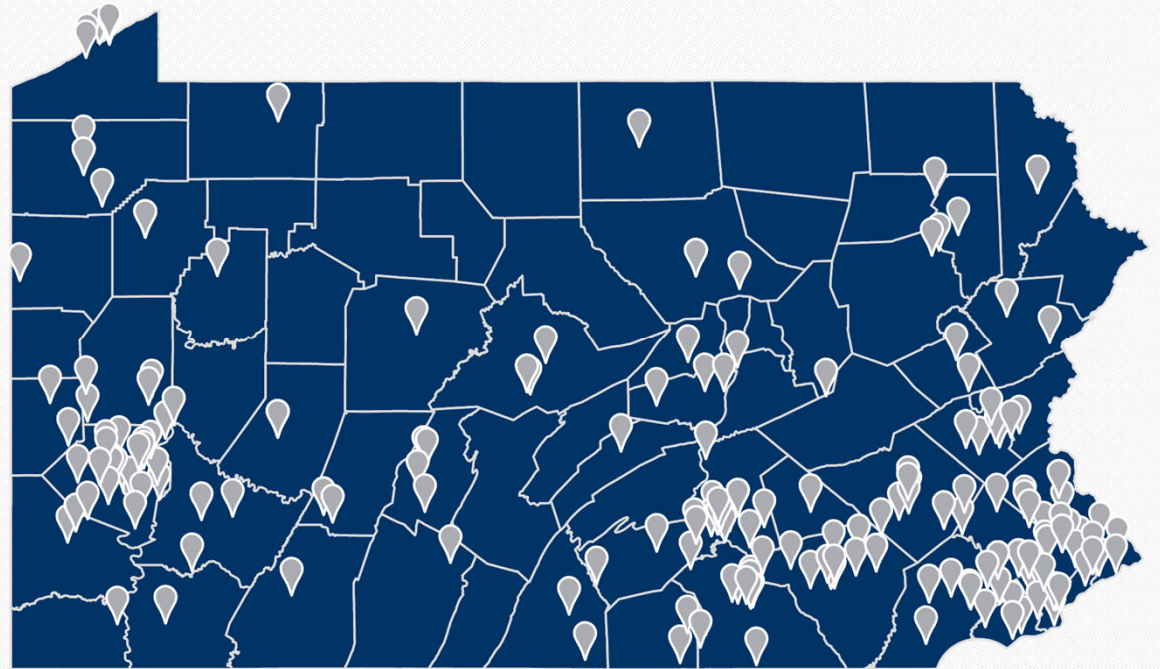


Headquartered

across **212+** local communities



Covering over **104,171**
participants, with 76,496
current employees



Pennsylvania's ESOP Community



Holding more than
\$8.3
billion
in total plan assets



Mostly in smaller
businesses: more
than half have under
 **100**
employees



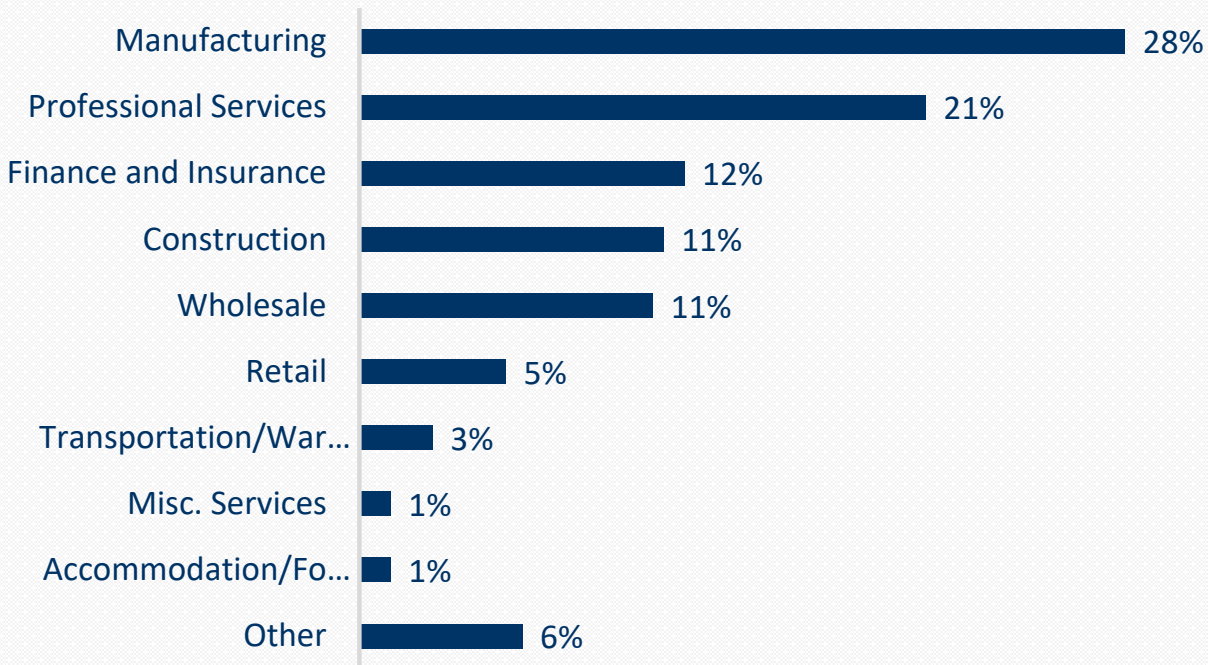
Pennsylvania ESOPs
paid out over
\$1.1
billion
in benefits in the
most recent year



Approximately
9 Pennsylvania
companies
set up an ESOP
each year

Pennsylvania's ESOP Community

Spanning a wide range of industries:



Some ESOP companies you might know:





BI-PARTISON 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



POWER OF EMPLOYEE OWNERSHIP

- Over a 10 years, ESOP companies have **25% higher job growth**
- ESOP companies **increased sales** by about 2.3%-2.4% per year
- ESOP companies are **25% more likely to stay in business**
- Participants were **4x less likely to be laid off** during the recession
- Employees average **2.5x greater retirement accounts**
- ESOP companies see average yearly post-ESOP **improvement in Return on Assets** of +2.7%.
- Employees at ESOP companies receive **5%-12% more in wages**

*Statistics from National Center for Employee Ownership



ESOP CANDIDATE PROFILE

- Owner wishing to cash out all or portion of business
- Payroll of \$1,500,000 or greater
- Strong succession management
- \$10,000,000 or more business value
- 25 + Employees

MAJOR TAX INCENTIVES

1. Indefinite Deferral/Elimination of capital gains taxes normally due on a sale of a business (C Corp)
2. Dollar for dollar corporate deduction on every dollars' worth of stock sold to the ESOP (S & C Corp)
3. **Profits of an ESOP company may become 100% federal and state income tax exempt (S Corp)**
4. Significant estate and charitable planning opportunities and transfer discounts (S & C Corp)

NOTE: There are several design methods that may allow the best of both C and S Corp tax advantages



IRC § 1042

- Selling shareholder may elect to indefinitely defer federal capital gains on sale proceeds regardless of basis
- Similar to real estate provision IRC § 1031 and life insurance IRC § 1035
- Must reinvest proceeds into “Qualified Replacement Property” (U.S. stocks and bonds)
- Special ESOP financial vehicles are available to facilitate deferral and access to cash



100% S CORP ESOP

- **Profits are NOT subject to Federal or State corporate income tax** to the extent ESOP ownership
- Taxation is “passed through” to shareholders in proportion to ownership
- An ESOP is tax exempt, therefore no tax is paid on percentage owned by the ESOP
- Corporation does not have to distribute income

ESOP BASIC STRUCTURE

1. ESOP borrows money from bank and/or seller note
2. The ESOP uses the borrowed funds to purchase stock from sellers
3. Company makes annual tax-deductible contributions to the ESOP
4. ESOP uses contributions to repay debt



ESOP BASIC STRUCTURE

5. Employees are allocated shares over a 20-40 year period
6. Employees cash out stock balance when employment ends
7. Company must make a market for exiting employees' stock



CONTROL

- Employees/Participants never actually own stock
- Employees/participants only have a beneficial interest in the ESOP trust
- EE's have no minority shareholder rights
- EE's have no right to confidential info, payroll etc.
- EE's cannot call shareholder meeting
- Trustee votes shares on behalf of EE's



VALUATION

- BTA serves as the sellers' valuation consultants
- Trustee will hire independent valuator
- BTA/Sellers negotiate with Trustee
- ESOP is a financial buyer
- Valuation is forward looking via forecasts
- Rev. Rul. 59-60 fair market value, willing seller and willing buyer standards apply
- ESOP has specific discounts (positive)



FINANCING THE SALE

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



POSSIBLE STRUCTURE

Need to finance 100%





RECOMMENDED STRUCTURE

- BTA often recommends the seller take a note for everything above senior debt
- Seller is entitled to a Market Rate of Interest
- Market Rate of Interest is NOT what the senior lender (bank) is charging
- Market Rate IS what a secondary lender (mezzanine) would have charged to lend money in the same subordinated position



CONSIDERATIONS

- Generally, senior lender does not allow the seller to have a higher rate of interest than the bank
- Corporate cash flow may suffer if required to pay actual market rate of 10%-12%
- Seller pays hefty ordinary income tax on interest
- In lieu of current “market rate of interest”, seller may take a lower rate (5%-7%) plus a substantial future equity stake of the Company (18%-22%)



RECOMMENDED STRUCTURE

BLENDED
MARKET RATE

10-12%

SELLER TO
ACCEPT

5-7%

Plus
Warrants

SELLER
NOTE

70 – 50%
TOTAL EQUITY

LEND 2-3X
EBITDA

5-7%

SENIOR
BANK DEBT

30 – 50%
TOTAL EQUITY



TOTAL OUTCOME EXAMPLE

Company Value \$40,000,000

Bank Down Payment	16,000,000
Seller Note - Principal	24,000,000
Seller Note – 4.5% Interest	9,048,000
Warrants (20%) *	12,100,000
Approx. Total Proceeds	\$61,148,000

*Assumes company value grows at 3% annually over 10 years



POSSIBLE OUTCOME SUMMARY

- Retain control indefinitely
- Salary/Healthcare/Phone/Clubs/Car/Board Fees
- ESOP Participation
- Estate planning/Charitable gift/transfer benefits
- Company's profits become income tax-free

ESOP OBJECTIONS/MYTHS

- **ESOPs are complicated:** Yes, but so are many worthwhile techniques
- **I won't get as much for my company:** Not true, maybe more.
- **ESOPs are expensive:** It's relative. Consider costs of a broker/private equity and 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 client “Introduction to ESOPs”
2. Complimentary ESOP financial review
3. Preliminary Valuation/Preliminary Analysis
4. Feasibility Study
5. Implementation

B T A | ESTATE PLANNING IDEAS

- Gift financing vehicles at significantly discounts to family
 - Warrants
 - Seller Installment Notes
- Use of GRATs and GRUTs for income stream may reduce gift value to near zero
- Combine Family Limited Partnerships & ESOPs to transfer significant wealth to future generations

ESTATE TRANSFER DISCOUNTS

Company Value	100,000,000
Warrant Percent	25%
Future Realized Value (No Growth)	20,000,000
Future Realized Value (3.5% Growth)	28,211,975
Post Leverage Company Value (5%)	5,000,000
Warrant Percent	25%
Gift Value at Transfer	1,250,000
Transfer Discount (No Growth)	93.8%
Transfer Discount (3.5% Growth)	95.6%

Transfer 28.2M of future value for 1.25M of Lifetime Exemption

B T A | CHARITABLE PLANNING IDEAS

- Sell stock to an ESOP, elect 1042, donate what would have been paid in cap gain taxes, take deduction. Net more than NOT giving
- Sell stock to an ESOP, elect 1042, donate some or all of the proceeds, get higher annual AGI deductions (CHESOP)
- Integrate CRATs and CRUTs for an income stream

Deductibility Comparison

		Business Interest Donation Type		
		<u>Stock</u>	<u>Cash Sale Proceeds</u> <u>No ESOP</u>	<u>Sale Proceeds of</u> <u>ESOP/IRC 1042</u>
Capital Gains Tax		Eliminated	Owed	Eliminated
Donation Deductibility		Up to 30% of AGI w/ 5 year carry forward	Up to 60% of AGI w/ 5 year carry forward	Up to 60% of AGI w/ 5 year carry forward

Note: The combination of no capital gains tax and higher deductibility limits allow for more tax-free dollars available to be donated



SELLER SATISFACTION

- According to a study by PwC, more than **75 percent** of business owners who have sold their business experience “profound regret” within a year after the sale.
- In contrast, a 2015 study by the National Center for Employee Ownership found that **93 percent** of sellers to an ESOP are either “Very Satisfied” or “Satisfied” with the sale, with only 7 percent expressing “Neutral” or “Dissatisfied” sentiments.

Case Study

BACKGROUND

- Engineering Company
- S Corporation
- \$34,500,000 business value
- 25 employees w/ 1.5M payroll
- 64-year-old owner in fair health
- Key manager willing to run business but cannot afford to buy it outright

GOAL

- Begin transition of ownership to key executive immediately (chips off the table)
- Transition control to key executive within 5 years
- Gain estate liquidity
- Reward long-term employees
- Secure business continuation
- Reduce taxes when possible

SOLUTION

- Implement ESOP for 100% of the company shares
- \$16,000,000 from bank as senior 5 yr. debt at 4.0%
- Seller finance \$18,500,000 (balance) as subordinate 10 yr. debt payable at 4.5% but effective mezzanine rate of 11.2%
- Additional payment is made for difference when loan is paid off in the form of warrants

BENEFIT TO CLIENT/COMPANY

- Tax savings of over \$37,000,000 over first 10 years
- Seller received immediate cash of \$16,000,000
- Seller received a total of \$42,900,000 in seller note principal and interest
- Seller gets an estimated additional \$11,000,000 in 10 years when warrants are exercised
- **Total Estimated Payments to Seller: \$69,900,000**

PLANNING NEEDS



BUSINESS
SUCCESSION
PLANNING



CHARITABLE
PLANNING



CORPORATE
REPURCHASE
LIABILITY



ESTATE
PLANNING



EXECUTIVE
BENEFITS NQDC



FINANCIAL
PLANNING



FINANCING



QUALIFIED PLANS



WEALTH
MANAGEMENT

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