Business Succession Planning & ESOPs

An employee stock ownership plan (ESOP) may make sense for some dealers and other aftermarket retailers looking to build a succession plan they can control while protecting wealth, diversifying assets and deferring taxes.

Steven Greenapple

Steven Greenapple is a partner in the law firm of Steiker, Fischer, Edwards & Greenapple, P.C., a boutique law firm specializing in creating and administering Employee Stock Ownership Plans. He has worked with clients in a wide array of industries, including RV dealerships, to meet their succession planning, financial planning, and corporate finance goals. Greenapple can be reached at (973) 540-9292 or at sgreenapple@sfeglaw.com

You've built a successful business and watched it grow, but who will run it when you're ready to retire? How will you get all the value that you've created out of the business and into your retirement savings?

Perhaps you are considering selling to a national company, but you don't want to risk the loss of identity and the potential loss of your loyal employees' jobs. Or maybe you'd like to sell a portion of the business to a group of managers, but they don't have the financing to purchase it.

Despite the importance of succession planning, many business owners do not plan adequately for this major event in their business lives. Earl and Ginny Stoltzfus of Stoltzfus RV and Marine in West Chester, Pa., recently used an Employee Stock Ownership Plan to address these issues. Employee Stock Ownership Plans – more commonly referred to as "ESOPs," allow you to build a succession plan that you control, to help you meet your business and financial goals.

For the business owner, an ESOP is a way to protect wealth, diversify assets and defer taxes. For employees, an ESOP is a company-funded retirement plan that offers an ownership stake in the company. For the company, an ESOP is a way to finance ownership transition in a tax-favored transaction. But what exactly is an ESOP?

What is an ESOP?

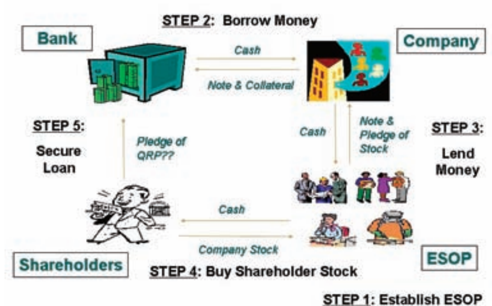
An ESOP is a tax-qualified retirement plan that was initially created as part of the Employee Retirement Income Security Act (ERISA) in 1974. The ESOP concept dates back as early as the 1950s when investment banker Louis Kelso first conceived that businesses nationwide would be stronger and more profitable if employees of a company were offered a stake in the company's success. According to the nonprofit National Center for Employee Ownership, today there are more than 11,000 ESOP companies nationwide, covering more than 8.5 million employees.

ESOPs are similar to 401(k) and profit sharing plans in many ways, but they have several distinguishing characteristics. First, they are the only qualified retirement plan able to borrow money to acquire stock. Second, they are the only qualified retirement plan that is permitted to enter into a transaction with the sponsoring company, or an owner of the sponsoring company. Third, they are the only type of qualified plan permitted to invest primarily in the stock of the company that sponsors the plan. In combination, these features allow business owners to use an ESOP to create a market for their otherwise illiquid privately held stock.

Common Misconceptions

There are many persistent misconceptions regarding ESOPs. Before we focus on the details of what an ESOP *is*, let's take a moment to talk about what it *is not.*

- An ESOP is a stock option plan. **False!**
- Employees own the stock of the company. **False!**
- Employees are entitled to the company's financial information. **False!**
- The company has to be a C corporation. **False!**
- An ESOP must own more than 30 percent of the company. **False!**



How an ESOP Works

The first step in establishing an ESOP is to analyze your company's financial information, revisit your business plan and determine what you want to accomplish with the ESOP. The result of this feasibility analysis is an approximate valuation of the company, and an ESOP transaction design, that will meet your goals.

A typical leveraged ESOP transaction design works like this:

1. The company establishes an employee stock ownership trust.
2. The company borrows money from a bank, usually secured by a security interest in the company's assets.
3. The trust borrows this money from the company, secured by a pledge of the stock that it purchases with the money.

4. The trust uses the borrowed money to purchase all, or a portion of the company stock from the stockholder.
5. The bank may require the shareholder to pledge some of the money it receives as security for the bank's loan to the company.

As a result of these steps, the employee stock ownership trust is a shareholder of the company. Initially, all of the stock that the trust purchased is held in a "suspense account." This suspense account stock is not initially allocated to employees' ESOP accounts. Over succeeding years, the debt gets paid off and the shares get allocated to employees' accounts like this:

6. Each year, the company makes a contribution to the ESOP, similar to a contribution to a profit sharing plan. This contribution is fully tax-deductible. This process allows the company to cash out the selling shareholder with tax deductible dollars.
7. The ESOP uses this contribution to repay the money that it borrowed from the company. As the ESOP repays the loan from the company, the ESOP "allocates" a portion of the shares of company stock held in the suspense account, to the ESOP accounts of the company's employees.

The company uses the money it receives from the ESOP to repay its debt to the bank. If the bank received collateral from the shareholder, the collateral is released as the loan is paid off.

Employees who remain with the company over time will accumulate an ESOP account measured in shares of company stock. Employees, who remain long enough to "vest" in their ESOP account will have the right to be paid out – over a period of years – when they die, become disabled, or retire. While they remain with the company, they come to work each day knowing that the value of their retirement account depends on the company's success.

Tax Advantages of ESOPs

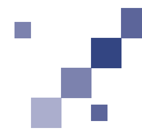
In addition to the fact that the selling shareholder is able to turn his illiquid wealth (the company) into cash without giving up control of the company, there are also substantial tax benefits available:

- The company is able to use its pre-tax earnings to finance the leveraged acquisition of shareholders' stock in the company.
- The selling shareholder may qualify to *indefinitely* defer capital gains on the sale, under Internal Revenue Code Section 1042, if he reinvests the proceeds into qualified replacement property ("QRP") within 12 months following the sale of company stock to the ESOP. QRP is any stocks or bonds issued by a U.S. domestic operating company. The holder of the QRP is not taxed until he cashes in these investments.
- In a subchapter S corporation, the shareholders – rather than the corporation itself – are taxed on the corporation's income. Because it is a tax-qualified retirement plan, an ESOP does not pay taxes. Therefore, the ESOP's portion of a subchapter S corporation's income is not subject to taxation *at all*. If a subchapter S corporation is owned 100 percent by an ESOP, the corporation operates tax free!

Conclusion

In conclusion, an ESOP is more than an employee benefit plan. It's more than just an exit strategy. An ESOP is a multifaceted financial planning tool that can help solve challenging succession planning dilemmas by allowing owners of privately held companies to sell some or all of their stock, at the same time that they create a meaningful benefit plan for their employees.

The choices available in structuring an ESOP transaction are broad and varied. Unlike many other succession strategies, the business owner controls many of the key points of transaction size, design, and timing. Businesses in the RV industry, such as Stoltzfus RV and Marine, have already embraced this concept. As record numbers of business owners in the baby boomer generation retire, look for more companies to "go ESOP." PRO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Steiker, Fischer, Edwards & Greenapple, P.C.

Steiker, Fischer, Edwards & Greenapple, P.C. is a law firm specializing in Employee Stock Ownership Plans (ESOPs) and other employee-centered succession and compensation strategies.

10 Shurs Lane, Suite 102
Philadelphia, PA 19127
(215) 508 – 1500

6 South Street, Suite 201
Morristown, NJ 07960
(973) 540-9292

235 Promenade Street, Suite 497
Providence, RI 02908
(401) 632-0480

www.sfeglaw.com

Contact Steven Greenapple at (973) 540 – 9292 for a complimentary ESOP feasibility assessment today!