

“ Who is going to take over this business when I want to retire? ”



TRANSITIONS: THE ESOP SOLUTION FOR SUCCESSION CHALLENGES

If you are a successful construction business owner in your early fifties or older, you have probably asked the following two questions:

- (1) Who is going to take over this business when I want to retire?
- (2) What can I do to reward the folks who helped make this business what it is?

This article will explore the ways an employee stock ownership plan (ESOP) will help you arrive at answers that satisfy the seemingly opposing needs represented by these two questions. In the process, an ESOP can also enable you to be a “home-town hero”—keeping jobs rooted in the community, providing a benefit for employees who want to work hard and creating a way for your business legacy to live beyond your lifetime.

What is an ESOP?

An ESOP is an employee stock ownership plan that is a so-called “qualified” retirement plan under federal law. ESOPs are governed by special rules contained in the Internal Revenue Code (Code) and Employee Retirement Income Security Act of 1974 (ERISA).

The use of the phrase “ownership,” however, is somewhat misleading. The ownership comes by virtue of the employee stock ownership trust (ESOT), established under the ESOP. The trustee of the ESOT holds and votes the shares in most situations, and in many situations, the trustee can be a company “insider.” The employees benefit indirectly from the stock in the trust by being able to convert their relative interest in the trust to cash when they leave the company, retire, die or become

disabled.

An ESOP is a “defined contribution” retirement plan. This means that the benefits received by retirees are derived from the value of the retiree’s retirement plan account rather than from a promise to pay the retiree a certain amount over a period of time. In an ESOP, the market value of an account is determined primarily on the basis of the value of the employer stock. The value of the participant’s account in the ESOP is not dependent on what Wall Street is up to, but rather it is directly dependent on how the participant’s employer is performing and indirectly on if and how that participant is contributing to the success of the company. The employee’s retirement aspirations are, like the owner’s, tied in part to the toil he/she will put into the business.

Solving the Questions of Management and Employee Succession with an ESOP

The story of the successful construction business owner often tracks the following familiar course:

The owner begins by working for a short time in his/her twenties or thirties in the construction business until he/she finagles a way to buy or lease a couple of trucks. He/she then starts bidding on jobs, often at a loss. After a year or two, he/she gets the bidding down to something approaching a science and incrementally starts to:

1. Increase the number of active contracts
2. Add employees
3. Buy more trucks
4. Buy a piece of land on which to build the shop

Before you know it, the construction company's name adorns a fleet of trucks, a handsome, well-kept building in the industrial area of town and the backs of local Little League t-shirts.

Something else has also happened here. The value of the business is growing and not just commensurate with the profit earned each year. Now, the owner must start thinking about succession planning. So what are the traditional ways an owner can transition ownership to managers, and how might an ESOP provide an alternative that can reward not only managers but also employees as a whole? Let's first look at two methods for delivering stock to managers:

- (a) A direct transfer of stock

“ ESOP purchase transactions can be structured so that you do not recognize taxable gain on the sale of your stock to the ESOP. ”

- (b) Granting options to buy stock

Direct Transfer of Stock

In a direct transfer of stock, the company issues the manager shares of stock. Let's say the business is worth \$5 million and the company issues the manager \$500,000 worth of stock. This is a taxable event to the manager that must be reported as wages on his/her W-2. At 40 percent combined federal and state income tax rates, this costs the manager \$200,000 in taxes. The manager would have to come up with that money, and the company would actually get a deduction for the value of the stock.

Let's say the manager borrows \$200,000 from a bank in order to pay those taxes. What would he/she need to earn to pay that off? He/She would have to earn enough to pay both the taxes on the earnings and the principal on the debt. This adds up to about \$330,000. So, for \$500,000 in stock value, that manager has to earn about \$330,000 to pay the tax debt. If the owner were to transfer stock directly, the result would be the same under federal tax law.

Options to Buy Stock

If an option is a nonqualified option, that manager must pay ordinary income tax on the difference between the exercise price and the value of the shares. Let's say the manager is granted an option to buy \$500,000 worth of stock for \$250,000. The \$250,000 difference would be taxed as ordinary income and subject to

wage withholding. Further, if the initial price of the option is cheap (i.e., less than the fair market value of the stock), then the option will be subject to the Byzantine rules of Code Section 409A governing deferred compensation.

An option can be structured to be a "qualified stock option" under the code if the initial option price equals the then fair market value of the stock and if certain other restrictions are met. However, if the option is exercised when the value of the stock is greater than the option price, this favorable spread is an item of "preference" subject to the alternative minimum tax. Therefore, while options may seem advantageous, they present significant and potentially problematic tax hurdles.

The ESOP Solution to the Management and Employee Succession Problem

Rather than take any of the foregoing paths, the successful business owner might consider adopting an ESOP for succession planning. How can an ESOP enhance your planning goals?

You Can Save Taxes Selling to an ESOP.

ESOP purchase transactions can be structured so that you do not recognize taxable gain on the sale of your stock to the ESOP. There are a number of technical hoops through which you have to jump. Primarily:

- (a) The ESOP must be the owner of at least 30 percent of the company's stock following the sale.

- (b) The company must be a “C” corporation when the sale takes place.
- (c) You must invest the proceeds of the sale into stocks and bonds of operating U.S. corporations.

The tax on the sale is only deferred as long as you hold the replacement property described in (c). However, if you continue to hold that property until death, you will completely avoid capital gains.

The ESOP Purchase Debt Costs Less.

The debt an ESOP incurs to purchase the owner’s stock is fully tax-deductible, in contrast to “regular” debt for which only interest is deductible. This is because the ESOP debt is retired through company contributions to the ESOP. Every penny of a company contribution to an ESOP is tax-deductible. How would this compare for a company borrowing \$5 million if it were taxed at a marginal rate of 40 percent? The table below outlines this example.

The Company and Its Shareholders Can Stop Paying Income Taxes on Its Profits.

For the past ten years, an ESOP has been a permitted shareholder of a subchapter “S” corporation. The ESOP does not pay taxes on its share of “S” corporation earnings. If the ESOP owns all the company’s stock, then none of the company’s profits

are subject to tax. The untaxed profits can be used to retire the debt the ESOP incurred in connection with the stock purchase from the owner, buy new equipment, pay bonuses or assist in any other business purpose. Plus, if your company engages in competitive bidding, this tax shield will allow you to bid lower than a comparable competitor who is subject to tax.

The Seller and Managers Can Control the Voting of ESOP Shares.

Even if an ESOP owns a controlling block of stock, the seller or the seller and managers can control the voting of the shares of stock in the company for all matters except, in general: the sale of the company, certain recapitalizations and a sale of all or substantially all of the company’s assets. Generally, a seller will want to retain control through the board of directors until his/her debt is paid off. Following that, the seller can transition so that other managers will take over the board of directors and trusteeship of the ESOP. The ESOP thus serves as a gradual management transition planning tool.

Employees Can Be Empowered by the ESOP.

Objective data indicates that ESOPs can be used to empower employees and make them more productive—adapting an “owner’s view” of how to succeed in business. ESOP companies that share information with

employees about profitability and how the company works and use the ESOP as an economic instructional tool do better, on average, than their peers. Therefore, an ESOP can be used as a tool to retain and attract quality employees.

Can an ESOP Work for You?

ESOPs are complex and not perfect for every business. The business should have a minimum of thirty employees and a company value of at least \$3 million or more for an ESOP to be a wise decision. Further, if you bond for projects, the ESOP leverage can cause problems with sureties, in which case you could only do an ESOP a little at a time. However, if you want your employees to be involved in the next generation of your business and if you feel a strong sense of community about your business, you may find that an ESOP is the right fit for you. ■

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“Regular” vs. ESOP Debt Savings

	“Regular” Bank Debt	ESOP Purchase Debt
Debt Amount	\$5,000,000	\$5,000,000
After-Tax Cost of Principal at Marginal Rate of 40 percent	\$8,333,333	\$5,000,000
Savings	N/A	\$3,333,333



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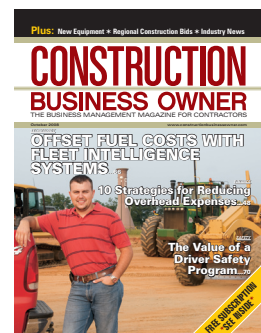
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