

ESOPs

Employee Stock Ownership Plans
Private Wealth Management



Employee Stock Ownership Plans (ESOPs)

What is an ESOP?

An Employee Stock Ownership Plan, or ESOP, is both a qualified retirement plan for employees as well as a tax-efficient exit strategy for business owners. Owners of successful closely held businesses often use ESOPs to create a market in order to sell some or all of their shares to their employees and, if structured properly, the owner can defer or potentially eliminate the capital gain tax associated with the sale. To do this, the company establishes and contributes cash to an ESOP which is then used to purchase company stock from the selling shareholder(s). Over time that stock is allocated to employees in the form of a retirement benefit. In addition, the ESOP-owned portion of the company may be eligible to operate federal and state income tax free.

ESOPs, formalized under federal law with the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, are now widespread representing the most common form of employee ownership in the US. As of the most recent data, 6,669 plans exist, covering 14.4 million people.¹

There are expenses associated with an ESOP. This type of transaction may not be the best option in all cases.

Why do business owners choose ESOPs?

ESOPs can provide significant tax advantages while representing a mutual alignment of interests

What's in it for the owners?

- **Can yield more in total after-tax proceeds to the owner compared to a sale to an outside buyer, mainly from the ability to:**
 1. Defer, or potentially eliminate, capital gains taxes on the sale of the company by electing Section 1042 of the Internal Revenue Code and reinvesting the sale proceeds in "Qualified Replacement Property (QRP)"—stocks, bonds and/or other securities of US operating companies that meet certain tests
 - If the business owner holds the QRP until death, the gain is eliminated since the basis in the QRP assets is "stepped up" to fair market value.
 2. Hold a high-yield seller note with an attractive interest payment
 3. Participate in the future upside of the business through warrants, which are taxed at favorable capital gains rather than ordinary income rates
 4. Continue receiving a salary
- **Can allow the owner to start the next chapter of their life while preserving their legacy and providing meaningful benefits to their employees**
- **Can provide the owner the ability to continue leading and controlling the company even after a sale**
- **Can preserve confidentiality unlike other liquidity alternatives that require the release of confidential information to prospective buyers**
- **Can provide an exit alternative to a third-party sale or when there are a lack of interested buyers**
- **Can be structured as a series of transactions**
 - If the owner does not want to sell all of their business or the business cannot afford to carry the amount of debt needed for a 100% buyout, the business owner can structure the first transaction to qualify for the deferral of capital gains tax (at least 30% sale to the ESOP). Subsequent sales can be structured to transfer the remaining 70% in one or more tranches as the leverage for the first transaction is paid down and the business is able to re-leverage itself.
- **Can facilitate sales between shareholders**
 - ESOPs can be used to buy out shareholder(s) wishing to exit. Often, this ESOP transaction works in the interest of both parties due to the tax benefits. The selling shareholder(s) may qualify for the deferral of capital gains under IRC Section 1042 and the shareholder(s) who remain in the business will benefit from the business' ability to repay the debt incurred to buy out the selling shareholder on a pre-tax basis.
- **Can accomplish many objectives of an estate and succession plan**
 - The estate becomes liquid allowing for the transfer of different types of assets to family members with different levels of involvement (i.e., cash to family members not involved in the business and stock to family members active in the business). In addition, since the cost basis of the QRP gets stepped up at the shareholder's death, the QRP could be sold to provide liquidity to pay estate tax. A leveraged ESOP can also create an ideal opportunity to gift shares to the next generation because the gifted shares will be valued on a non-marketable, minority interest, thus decreasing their value for purposes of gift and estate tax exclusions.

Is your company a good ESOP candidate?

Is your company a corporation (S-corp, C-corp or LLC), rather than a partnership or a professional corporation?

Does your company have an annual payroll of \$5 million or more?

Does your company have available capacity for additional debt?

Do you believe your company is worth \$10 million or more?

Is your company's EBITDA \$5 million or greater?

Does your company have strong earnings and/or cash flow over the previous five years?

Is your company experiencing steady and controlled growth?

Is there strong management in place if the principal executive departs in connection with the sale?

Do you expect your company to pay federal income taxes over the next several years?

Does your company customarily make payments to a profit-sharing or other employee benefit plan that might, in the future, be diverted to an ESOP?

Are the owners willing to share ownership with their employees, assuming a beneficial offer can be arranged?

Information contained herein is of a general nature and is provided for informational purposes only. Laws governing ESOP transactions and the rules under Section 1042 of the Internal Revenue Code of 1986, as amended ("Code"), are complex and persons considering an ESOP or Section 1042 transaction should seek professional guidance from their tax and legal advisors. Specific structures and decisions can only be developed based on a thorough review of the facts and circumstances relative to a particular company and its shareholders. Neither UBS Financial Services Inc. nor its employees provide tax or legal advice. In addition, shareholders who sell to an ESOP should understand the applicable rules of the Internal Revenue Code of 1986, as amended ("Code"), including requirements for qualified replacement property ("QRP") as defined by Code Section 1042. Shareholders should consult their tax and legal advisors regarding their personal circumstances. IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, any US federal tax information in this article is not intended, or written to be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code, or (2) promoting, marketing or recommending to another party any transaction or matter contained in this presentation. It is important that you understand the ways in which we conduct business and the applicable laws and regulations that govern us.



What's in it for the company?

- Stock and/or cash contributions to the ESOP are tax-deductible, therefore providing the ability to repay debt with pre-tax dollars
- S-corp ESOP companies may be eligible to operate federal, and in many cases, state income-tax free
- Ability to acquire other companies in the future using pre-tax dollars
- Potentially increased productivity and retention due to employees' "owner" mentality
- ESOP repurchase obligations are postponed until transaction debt is repaid

ESOP participants have

2.2x as much
in retirement plans
compared to those at
non-ESOP company²

What's in it for the employees?

- Rewards employees with tax-deferred retirement benefits. Employees do not pay tax on the stock contributed to their accounts until distributions are taken similar to an IRA or other qualified plan.
- Employees receive equity in the company without having to invest any of their own cash
- Participation can be combined with other benefit plans

What's in it for management?

- Gradual transition to "run" the company
- Participation in the ESOP and possibly an executive non-qualified plan provides meaningful wealth building opportunities
- Creates opportunities to motivate, retain and recruit key talent

The ESOP Group—ESOP advisory services

For business owners

We understand the unique challenges of business owners and are committed to working with you to help you pursue your goals at every stage of your business life cycle.

Pre-sale wealth planning

How will a sale affect your retirement, taxes and legacy? Together, we will design a transition plan and long-term strategy to inform your short-term decisions.



Creating value

Customized cash flow and tax modeling to help you answer the question, “Am I going to be OK?” by comparing the economic outcomes of a taxable installment sale and a tax-deferred sale to an ESOP

Introductions to qualified transaction advisors, including experienced investment bankers to facilitate capital raises for acquisitions and growth, enable sell-side mergers and acquisitions, or provide advisory services to companies considering an ESOP

Estate and trust assessment to help you identify potential gaps and efficiently transfer wealth

Philanthropic planning strategies to help you optimize your charitable gifts and determine whether gifting pre-sale stock or post-sale cash is most beneficial

Insurance solutions to protect you, your family and your business from unexpected events

Post-sale wealth and financial planning

Comprehensive post-sale wealth management is as critical to our clients’ success as the transaction itself. We work with you to create a well-integrated plan that reflects your evolving life and your long-term priorities for growing and preserving your wealth, managing tax liabilities and ensuring that your assets are appropriately managed, allocated and titled.



Life after business

Internal Revenue Code Section 1042 rollovers to help you defer, or potentially eliminate, capital gains tax on the sale of your closely held business to an ESOP—including:

- Constructing and implementing diversified Qualified Replacement Property (QRP) reinvestment portfolios
- Providing lending solutions that may be required to accomplish your IRC Section 1042 rollover
- Supplying necessary tax documents required to obtain IRC Section 1042 capital gains deferral

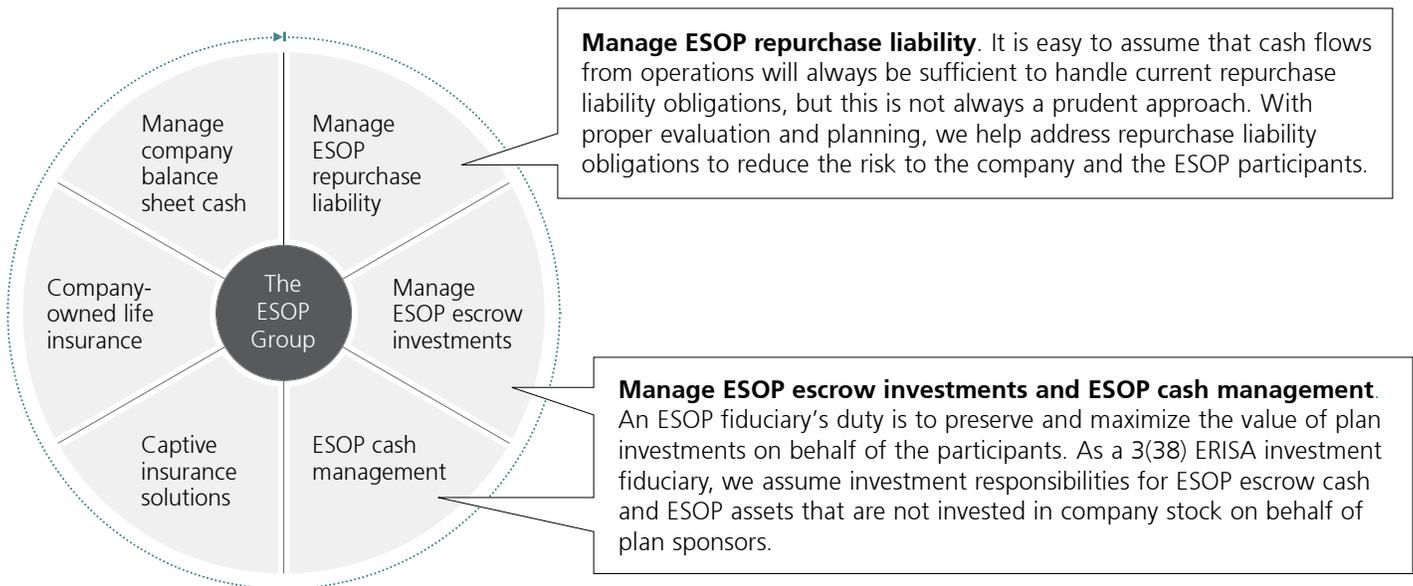
Post-liquidity lifestyle and financial planning to understand your personal goals and develop a plan to pursue them

Family education and governance to help manage the transition of wealth and/or business interest between generations

Personalized investment management to integrate your proceeds with your life’s vision

For ESOP companies

The ESOP Group's decades of experience working with hundreds of privately held businesses positions us as industry leaders. From mature ESOPs to those just getting started, we are well-versed in the unique issues ESOP companies face.



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