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Pros & Cons of ESOPs – Is this Succession Planning Tool for You?

Many business owners who are at or nearing retirement age are facing the difficult task of developing a business succession plan in order to reap the benefits of years spent developing a successful business. Often times, there is no "next generation" to inherit or carry on the family business or no team of key management with the financial wherewithal to buy out the owner, and the thought of selling the business to an outsider is worrisome. Founders often worry that a potential buyer will make substantial changes in the culture of their business and possibly terminate loyal employees and managers who have helped the founder build that successful business. In other instances, despite a lot of effort, a suitable buyer just cannot be found.

If these concerns exist, one strategy that should be considered and analyzed is the use of an Employee Stock Ownership Plan (ESOP) as the business owner's succession plan. The creation and use of an ESOP may allow the owner to sell the company all at once or in several tranches over several years. The owner may continue to serve on the Board and in a key officer position while grooming the next generation of management.

How Does an ESOP Work?

In order to purchase company stock from the selling shareholder, an ESOP typically borrows the money from the company and repays the acquisition loan with tax deductible contributions by the company, thus making a sale by the business owner to the ESOP a tax efficient mechanism. In certain circumstances, it is possible for the business owner to sell his/her company stock to the ESOP and never pay any federal taxes on the sale. This is known as a Section 1042 transaction.

The financing of an ESOP purchase can take many forms. In some cases where the company has sufficient assets for collateral, a senior lender may be involved. In many cases, the selling founder provides financing in the form of a promissory note taken from the company or ESOP. Thus, ESOP purchases can take many forms depending on the facts and circumstances of the planned transaction.

ESOP Pros and Cons

Despite many tax and financing benefits, the use of an ESOP as a business succession tool is not for everyone. Three factors should be present if this technique is to be successful. First, there either needs to be a solid, next generation of senior management in place to run the company or the selling shareholder must be committed to stay long enough to develop the team. Second, the future of the business should project positively. Running an ESOP owned business is a

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bit more complicated than normal, so if the business is on a downward trajectory, things could become even more difficult to manage with the presence of an ESOP. Finally, there needs to be a motivated seller. Typically, the owner/founder desires to retire or to diversify his/her wealth and would like to do that in a way that both fairly rewards the owner/founder, and also recognizes the efforts of the employees who were there to make the business successful.

ESOP transactions are more complex and regulated as compared to typical stock purchases and sales, because they not only involve traditional corporate and tax law issues, but they also involve employee benefit concepts regulated by the IRS and Department of Labor. Thus, it is important to identify professionals who are experienced and skilled in planning and closing such transactions, and who can explain the pros and cons of ESOPs.

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