ESOPs in 2021: Update on Employee Ownership

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November 4, 2021
ESOPs in 2021: Update on Employee Ownership

INTRODUCTION

ESOPS IN 2021: UPDATE ON EMPLOYEE OWNERSHIP

Introduction – Why Now?

- President Biden’s Tax Plan
  - Appointment and confirmation of ESOP proponents

- Viable exit planning option
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Introduction – What Is an Employee Stock Ownership Plan?

- Qualified retirement plan
- Invests primarily in the stock of the companies adopting and sponsoring them
- Governed by ERISA and IRC
  - Regulated by DOL and IRS
- Employees share in capital appreciation of the company

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Introduction – ESOP Facts

- There are roughly 6,600 ESOPs covering more than 14 million participants
- Two-thirds of ESOPs are used to provide a market for the shares of a departing owner
- Less than 10% of plans are in public companies
- 55% of ESOPs are in S corporations
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Introduction – ESOP Facts

- Industries of ESOP Sponsors
  - Manufacturing – 22%
  - Professional/Sci./Tech. – 19%
  - Finance/Insurance/Real Estate – 15%
  - Construction – 13%

Topics to Be Covered in this Presentation

- ESOP Roots
- Misconceptions, Benefits and Alternatives
- Vetting an ESOP – Feasibility
- Repurchase Obligation Liability
- Basic Leveraged ESOP Transaction
- Tax Considerations
- Valuation Considerations
ESOP Roots

- Economist Louis O. Kelso created the first ESOP in 1956 as a means to transition ownership of Peninsula Newspapers, Inc. from its two founders to their chosen successors.

- Kelso’s unique idea:
  - Instead of having the Company borrow the funds and repay with after-tax dollars, the Company’s profit sharing plan would borrow the funds and repay both principal and interest out of the annual contributions the Company was already making to the plan.
ESOP Roots

- Nothing in the Internal Revenue Code authorized leveraging of an IRS tax-qualified retirement plan – exception was that the transaction had to be arms-length and in the best interest of the plan participants
- Originated the strategy of using an IRS tax-qualified plan as a tool for succession
- In 1984, Senator Russell Long (D-LA) was the catalyst for four provisions of the Tax Reform Act of 1984 relating to ESOPs

ESOP Roots

- The concept of an ESOP was formally signed into law in 1974 when the Senate passed its version of the Employee Retirement and Security Act of 1974 (ERISA)
- Starting in 1979, ESOPs were used to save failing companies – employees were given stock in exchange for negotiated salary reductions
  - Weirton Steel, Chrysler Corporation and United Airlines
- From the 1970s to 1990s, ESOPs were used to facilitate divestitures, defend against hostile takeovers and going-private transactions
- Since 1980s ESOPs are used as a business succession tool
Common Misconceptions

- ESOP is primarily an employee benefit plan
- Selling shareholder must sell 100% of his/her stock
- Shareholder can get a higher price selling to a third party
- Sensitive information must be shared
- Selling stock to an ESOP results in loss of control by owner
- Can only be established for a C corporation
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Common Misconceptions

- Must be 100% invested in shares of the Company
- ESOP participants are able to exercise voting rights
- ESOPs make sales difficult to a third party in the future
- Creates a repurchase liability that may harm the future of the Company
- Too costly to implement and administer

ESOP Benefits

- Selling Owners
  - Provides ready market to sell shares at fair market value
  - Effective means for exiting the Company for controlling shareholders
  - Significant tax benefits to selling owners; potentially tax-free sale
  - Allows selling shareholders to retain voting control
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**ESOP Benefits**

- **Company**
  - Effective means for succession – continuity of management team
  - Incentive for recruiting/retaining employees and a way to increase employee morale and productivity
  - Reduction of corporate taxes and increase in cash flow
  - Pre-tax dollars to finance repayment of debt
  - Finance corporate acquisitions

- **Employees**
  - Employees acquire beneficial ownership in the Company without having to invest their own money
  - Employees are able to acquire ESOP stock without paying current income tax on the stock
  - Growth of employees’ interest not subject to tax until distribution
  - Employees share in current and future economic rewards of Company ownership
  - Builds loyalty and motivates performance
Vetting an ESOP – Feasibility

- Critical first step in the determination to move forward
- Conducted to determine whether ESOP will achieve goals of owners, management team and employees
  - **Ultimate goal is to prevent expensive errors and ensure long-term success**
- Provides analysis of impact to sponsor Company
- Facilitating debt service requirements is critical
Vetting an ESOP – Feasibility

- Primary aspects of a full feasibility study:
  - Preliminary valuation of the Company
  - Analysis of impact on existing shareholders and the Company’s financial performance
  - Plan design study
  - Repurchase obligation liability impact

Formality of a feasibility study will vary as some companies may need approval from board of directors

Evaluation of feasibility is ongoing as circumstances change, updates are required, and other opportunities are considered
Repurchase Obligation Liability

- IRC and DOL Regulations
  - Require sponsor Company to repurchase shares of stock from participants receiving distributions – through a “put” option
    - Participants can put shares back to sponsor Company in exchange for cash consideration
    - Right to sell is guaranteed to participant, but not required
    - Also provide opportunity for participants to diversify
Repurchase Obligation Liability

- These put and diversity rules (referred to together as “repurchase obligation liability”) reduce Company cash flow.
- Considered “off balance sheet” liability that changes over time.
- Must consider future cash flow requirements and their impact on future Company performance.

Repurchase Obligation Liability

- Magnitude of the liability is impacted by:
  - Sponsor Company’s employee census
  - Size and timing of repurchases/distributions
  - Fair market value of stock (must be valued annually)
  - Speed with which sponsor Company turns stock over
  - Manner in which the “put” is handled by sponsor Company
BASIC LEVERAGED ESOP TRANSACTION

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Basic Leveraged ESOP Transaction

- Transaction advisors
  - Company legal counsel
  - Third-party administration firm
  - Shareholder financial advisor
  - Communications firm
  - Trustee
  - ESOP law firm
  - ESOP financial advisor
Basic Leveraged ESOP Transaction

- Company (ESOP sponsor) sets up a trust to purchase the stock of the Company from the owners
  - *ESOP trustee can be an individual or institution*
- Can purchase all or a portion of outstanding stock
- Purchase price of the stock must not exceed its fair market value
  - *No less favorable to the ESOP than “adequate consideration”*

Basic Leveraged ESOP Transaction

- Financing comes from external loan
- Internal loan is designed to be repaid through annual deductible contributions to ESOP and dividends paid on stock purchased by ESOP
  - *Results in a tax deduction for funds used by ESOP to repay internal loan*
- Amortization on internal and external loans do not have to match
Basic Leveraged ESOP Transaction

- Participants are allocated shares annually as the internal loan is repaid
- Allocations are subject to vesting requirements
- Employees are given options to diversify at specified times
- Various options for distributions
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**TAX CONSIDERATIONS**

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**Tax Considerations**

- **Benefits to Shareholder**
  - *Can sell any % of the Company to the ESOP for “adequate consideration”*
  - *Will defer tax as long the ESOP owns at least 30% of the Company after the sale (IRC Section 1042)*
    - Must invest the proceeds in qualified domestic replacement securities (can choose amount to be taxed)
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Tax Considerations

- Benefits to Shareholder
  - Can maintain control of the Company and continued equity in the Company
  - Can continue to receive salary
  - Will receive greater investment income since no tax will be paid, and more will be invested
  - Immediately achieves a more diversified portfolio

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Tax Considerations

- ESOP with ESOT
  - Company establishes Employer Stock Ownership Trust (ESOT) with the ESOP, which is a qualified, defined contribution, employee benefit plan
  - ESOT holds shares as beneficial owner for the employees’ retirement account, to be allocated to the employees over time
  - Contributions are allocated to individual employee accounts
  - Diversification for employees can be achieved at a certain age
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**Tax Considerations**

- Tax Benefits to Company
  - *XYZ Corp can take federal and PA corporate tax deductions for both the interest and principal payments on loans borrowed to fund the purchase of A’s shares*
  - *Annual contributions to the plan are tax-deductible*
  - *Cash contributions are deductible*
  - *Dividends paid in cash on shares held by an ESOP can be tax deductible by sponsoring corporation*

- *Cash dividends passed through to ESOP employees are tax deductible for the Company*
- *ESOPs can qualify as shareholders in an S corporation*
- *In an S corporation, percentage of ownership held by ESOP is not subject to income tax at the federal level*
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Tax Considerations

- Tax Benefits to Employees
  - Employees acquire beneficial ownership in the Company without having to invest their own money
  - Employees are able to acquire ESOP stock without paying current income tax on the stock
  - Growth of employees’ interest not subject to tax until distribution
  - Employees share in current and future economic rewards of Company ownership

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Tax Considerations

- C Corporations vs. S Corporations
  - Attributes of C corporations
  - Attributes of S corporations
  - Tax incentives differ for each
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**Tax Considerations**

- **Tax Incentives Related to ESOPs**
  - *Non-taxable income related to ESOP stock for S corporations*
    - S corporation is a “pass-through” entity
    - ESOP, as a qualified retirement plan, has no Federal income tax liability – participants pay income tax on distributions
    - S corporation that is 100%-owned by ESOP pays no Federal income tax
    - Assets in ESOP increase free of income taxes until withdrawal

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**Tax Considerations**

- **Comparing a C Corp and S Corp (100% ESOP)**

<table>
<thead>
<tr>
<th></th>
<th>C Corporation</th>
<th>S Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income before ESOP payment</td>
<td>$1,200,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Less: ESOP contribution</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Pre-tax income</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Federal income taxes (at 21%)</td>
<td>210,000</td>
<td>0</td>
</tr>
<tr>
<td>Net income to Retained Earnings</td>
<td>$790,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Distribution to all shareholders – None</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Retained by Company</td>
<td>$790,000</td>
<td>$1,000,000</td>
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VALUATION CONSIDERATIONS

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ESOP Valuation Considerations

- ESOP trustees/fiduciaries should appoint valuators that:
  - Are qualified,
  - Are independent, and
  - Meet requirements of both IRS and ERISA
ESOP Valuation Considerations

- ESOP Valuation Fundamentals
  - DOL requires “adequate consideration”
  - Valuator must consider factors that are specifically applicable to ESOPs

- Identification of valuation subject
  - Total of all stock to be purchased or held by ESOP

- Level of value
  - Liquidity – how quickly and easily the appraisal subject can be converted to cash?
  - Ownership control – can the owner of the subject influence employer corporation’s policies and operations?
ESOP Valuation Considerations

- ESOP Valuation Fundamentals
  - Standard of value
    - Under DOL rules and ERISA, standard of value is “adequate consideration”
    - Fair market value

- Premise of value
  - Value in continued use, as a going concern
  - Value in place, but not in current use, in the production of income
  - Value in exchange – orderly disposition, voluntary and involuntary liquidation
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ESOP Valuation Considerations

- ESOP Valuation Fundamentals
  - Valuation date
    - "As of" date
      - Transaction date
    - Value can change materially over time due to internal and external influences

- ESOP Valuation Fundamentals
  - Analyze forecasts provided by management of sponsor Company
  - Valuator should consider all approaches
  - Perform an analysis of transaction to determine sponsor Company’s ability to service debt associated with transaction
ESOP Valuation Considerations

- ESOP Valuation Fundamentals
  - *Issue fairness opinion relative to:*
    - Transaction price not greater than fair market value
    - Reasonableness of interest rates
    - Terms of transaction are fair and reasonable to ESOP from a financial point of view
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Closing Comments

- ESOPs provide many tax and economic benefits to companies, owners and employees
- Use of an ESOP should not be dismissed without proper education and examination of feasibility
- The value provided can justify the cost to implement and administer an ESOP

Questions?

For More Information About ESOP-Related Issues Contact:

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