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ESOPs in 2021: Update on Employee Ownership

GYF VIRTUAL CPE DAY 2021

Presented by:

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INTRODUCTION

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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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ESOPS IN 2021: UPDATE ON EMPLOYEE OWNERSHIP

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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ESOPS IN 2021: UPDATE ON EMPLOYEE OWNERSHIP

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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ESOPS IN 2021: UPDATE ON EMPLOYEE OWNERSHIP

Introduction – ESOP Facts

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

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ESOPS IN 2021: UPDATE ON EMPLOYEE OWNERSHIP

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

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ESOP ROOTS

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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*

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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

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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

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BENEFITS AND MISCONCEPTIONS

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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

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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*

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ESOP Benefits

- 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*

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VETTING AN ESOP – FEASIBILITY

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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

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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*

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Vetting an ESOP – Feasibility

- 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

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REPURCHASE OBLIGATION LIABILITY

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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

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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

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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*

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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*

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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"*

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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

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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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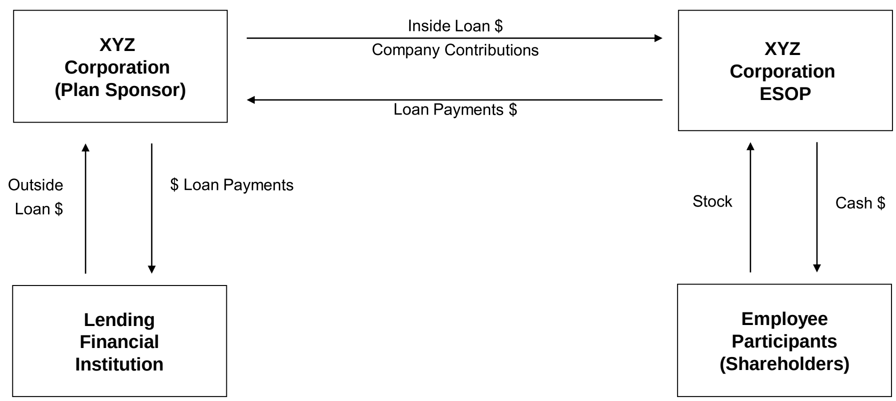
Basic Leveraged ESOP Transaction



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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*

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Tax Considerations

- Tax Benefits to Company
  - *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)

	C Corporation	*S Corporation*
Pretax income before ESOP payment	$ 1,200,000	$ 1,200,000
Less: ESOP contribution	200,000	200,000
Pre-tax income	$ 1,000,000	$ 1,000,000
Federal income taxes (at 21%)	210,000	0
Net income to Retained Earnings	$ 790,000	$ 1,000,000
Distribution to all shareholders – None	0	0
Retained by Company	$ 790,000	$ 1,000,000

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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*

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ESOP Valuation Considerations

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

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ESOP Valuation Considerations

- ESOP Valuation Fundamentals
  - *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?

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ESOP Valuation Considerations

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

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ESOP Valuation Considerations

- ESOP Valuation Fundamentals
  - *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

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ESOP Valuation Considerations

- 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*

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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

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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

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Questions?

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