



## ESOPs: Continuing A Legacy

Cara Benningfield & Angela Fisher, 2024

# Agenda



1. Introductions
2. Definition of an ESOP
3. Benefits of an ESOP
4. ESOP Plan Design
5. Considerations
6. Closing

# Introductions

## Meet the Team



**Cara Benningfield, CPA**  
Partner



**Angela Fisher, CPA**  
Director

# ESOP Consulting Practice

- Successfully facilitated over 150 ESOPs (the majority of which were 100%) nationwide involving wide ranges of industries
- Transactions range in size from several million to several hundred million
- Not just a “deal team,” work with clients on a post-transaction basis, which gives us unique insight during implementation
- As part of Forvis Mazars, allows us to integrate financial & tax planning & evaluate other succession alternatives
- Provide ongoing ESOP consulting services to some of the largest 100% ESOPs in the U.S.
- Active in the ESOP community & closely monitor & evaluate ESOP regulatory environment & industry best practices



# Continue A Legacy

- Implement an ownership transition plan
- Preserve culture, jobs, & community
- Continue to manage the business & operations
- Provide stockholder liquidity (generally over time) in a tax-efficient sale while possibly retaining some upside
- Reduce or even eliminate corporate income tax
- Reward long-term employees
- Reward key management
- Uniquely position company for growth via acquisitions



# What Is an ESOP?

- Qualified retirement plan
- Similar to profit-sharing plan, except
  - Designed to invest primarily in company stock
  - ESOP can borrow money (leveraged ESOP) to purchase company stock
- Stock is held by ESOP trust
  - ESOP trust is legal shareholder
  - Employees are beneficial (not actual) owners in value of stock allocated to their account
  - Employees do not receive stock
- Governed by IRC & ERISA, with oversight by IRS & DOL



# ESOP Statistics

- Over 6,500 ESOPs covering over 14 million employees
- Majority are privately owned companies
- Approximately 2,500 are 100% ESOP owned
  - Less than 100 in 1998
- Numerous studies have shown ESOP companies, on average, outperform non-ESOP companies & are more sustainable

Source: [www.nceo.org](http://www.nceo.org)



# Benefits to Owner

- Can continue to manage company
  - Receive reasonable compensation
  - Participate in ESOP (unless 1042 is elected)
  - Select & mentor next generation management
- Favorable tax treatment
  - Treated as stock sale (vs. asset sale)
  - IRC Section 1042 gain deferral
  - Installment treatment available to extend seller financed
- Depending on financing structure, possibly retain some upside in company (via warrants)



# Can the ESOP Pay Fair Market Value for My Stock?

- Absolutely – requirement is that ESOP not pay MORE THAN fair market value
  - ESOP is viewed as a financial buyer
- ESOP trustee has own valuation performed by an independent appraiser to determine fair market value
  - That valuation is NOT shared by ESOP trustee with seller or any other parties
- Seller & ESOP trustee, through good faith negotiations, agree early in process on purchase price & other economic terms, pending due diligence and final negotiations
  - Seller will often engage Forvis Mazars to perform valuation on seller's behalf for purposes of negotiating with ESOP trustee



# IRC Section 1042 Gain Deferral

- Not heavily used in today's environment
  - Relatively low capital gain tax environment
  - Less attractive for existing S corporations
  - Used more frequently in states with high income tax rates
- Requirements include
  - Stock must have been held for three years
  - Company must be a C corporation on date of sale
  - ESOP must own 30% or more of company after sale
  - Must reinvest proceeds in qualified replacement property (QRP) within 12 months of sale
    - Proceeds includes cash & seller notes
- Do not have to elect 1042 on total proceeds
- SECURE 2.0 will allow S corporation shareholders to defer tax on 10% of gain – effective for sales after December 31, 2027

# How QRP Works

- QRP is generally stocks or bonds of domestic operating companies
- QRP receives “carryover basis” from stock sold to ESOP
- Sale of QRP during lifetime triggers income tax
- If hold QRP until death, receive “step up” in tax basis of QRP & income tax is never paid
- ESOP Floating Rate Notes
  - Can margin up to 90% with carrying cost



# Company Benefits

- Company repays acquisition debt with pre-tax dollars
  - Interest & principal on acquisition debt is tax deductible
- If 100% ESOP owned S corporation, the company is exempt from federal & generally most state income tax
  - Maximum federal income tax rate of 37%
- Can result in a more productive workforce
  - More communication = better results



# Leveraged ESOPs in General

- ESOP borrows money to purchase stock from selling stockholder(s)
- Similar to traditional leveraged buy-outs, except
  - Allows owner to continue to manage business
  - Tax benefits to seller & company
  - Over time, wealth is transferred to broad-based employees



# Two Types of Leveraged ESOPs

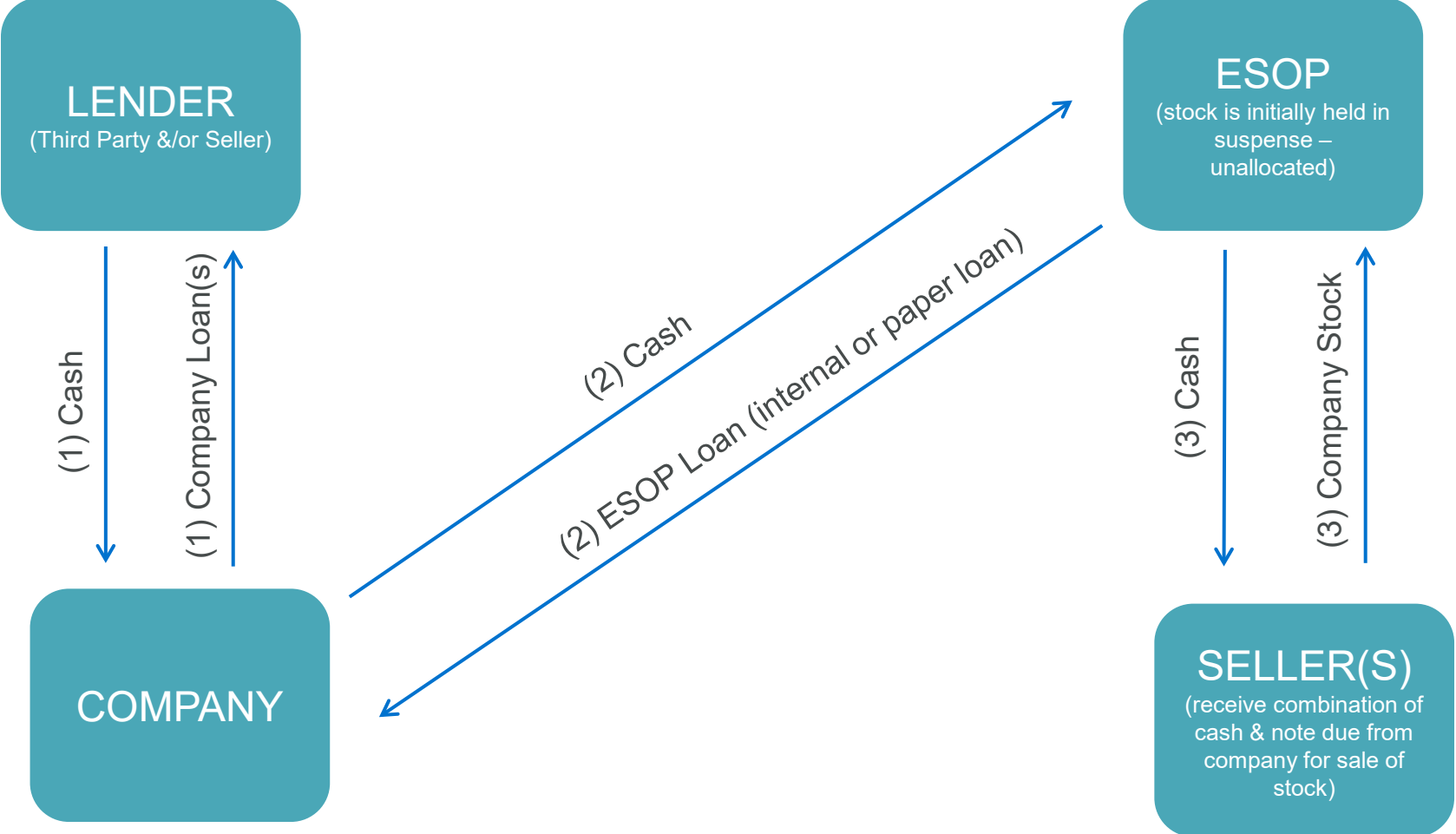
## 100% Sale

- Company's earnings completely exempt from income tax
- Seller can possibly retain some upside via synthetic equity
- No need for future stock transfers (complete & permanent liquidation)

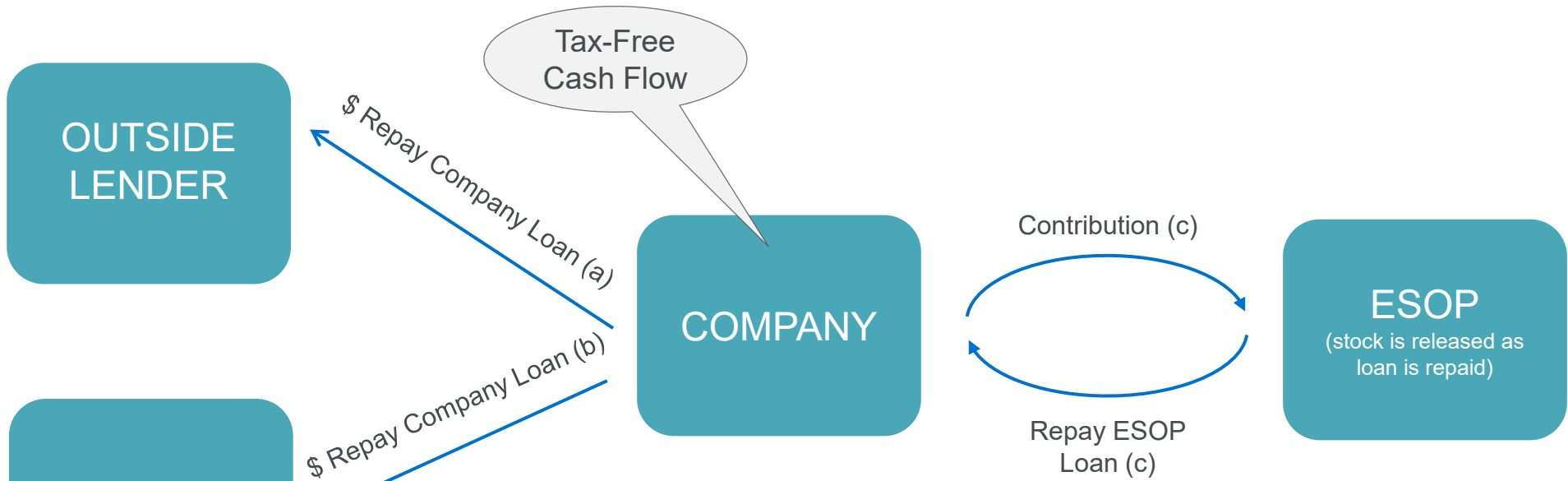
## Partial Sale, e.g., 30% to 49%

- Company has partial tax benefit via deduction of principal on ESOP loan
- Seller retains upside in remaining stock ownership
- Future transaction necessary to liquidate seller's remaining stock ownership

# How Does a 100% Leveraged ESOP Work?



# How Does Repayment of a 100% Leveraged ESOP Work?



- (a) Generally, seven- to eight-year amortization
- (b) Interest only while outside lender is repaid
- (c) ESOP Loan generally repaid over 30 years or longer (no cash outlay)



# Company Loan Options

- Traditional bank financing
  - Collateral, cash flow, & strength of management
- Seller financing
  - Transaction can be 100% seller financed, if desired
  - Subordinated to bank, if bank financing is obtained
  - Increased repayment flexibility
  - Interest rate generally between 7% to 10%
    - Straight interest
    - PIK
    - Warrants



# ESOP Loan Considerations

- Has no cash flow impact!
- Contributions & dividends can be used to repay ESOP loan
  - Contributions generally limited to 25% of compensation
- Contributions to repay loan are tax deductible
  - Possible tax planning opportunity in initial year of 100% ESOP
- Shares are released & allocated to employees annually as loan is repaid
- ESOP loan in 100% ESOP is generally minimum of 30 years



# How Employees Benefit

- Retirement benefit invested in company stock
- Employees incentivized to improve stock value and, as a result, their retirement benefits
  - Communication!
- Longer an employee stays, the more stock they should receive
- Once receive retirement benefit, generally can continue to defer taxes by using IRA



# ESOP Plan Design

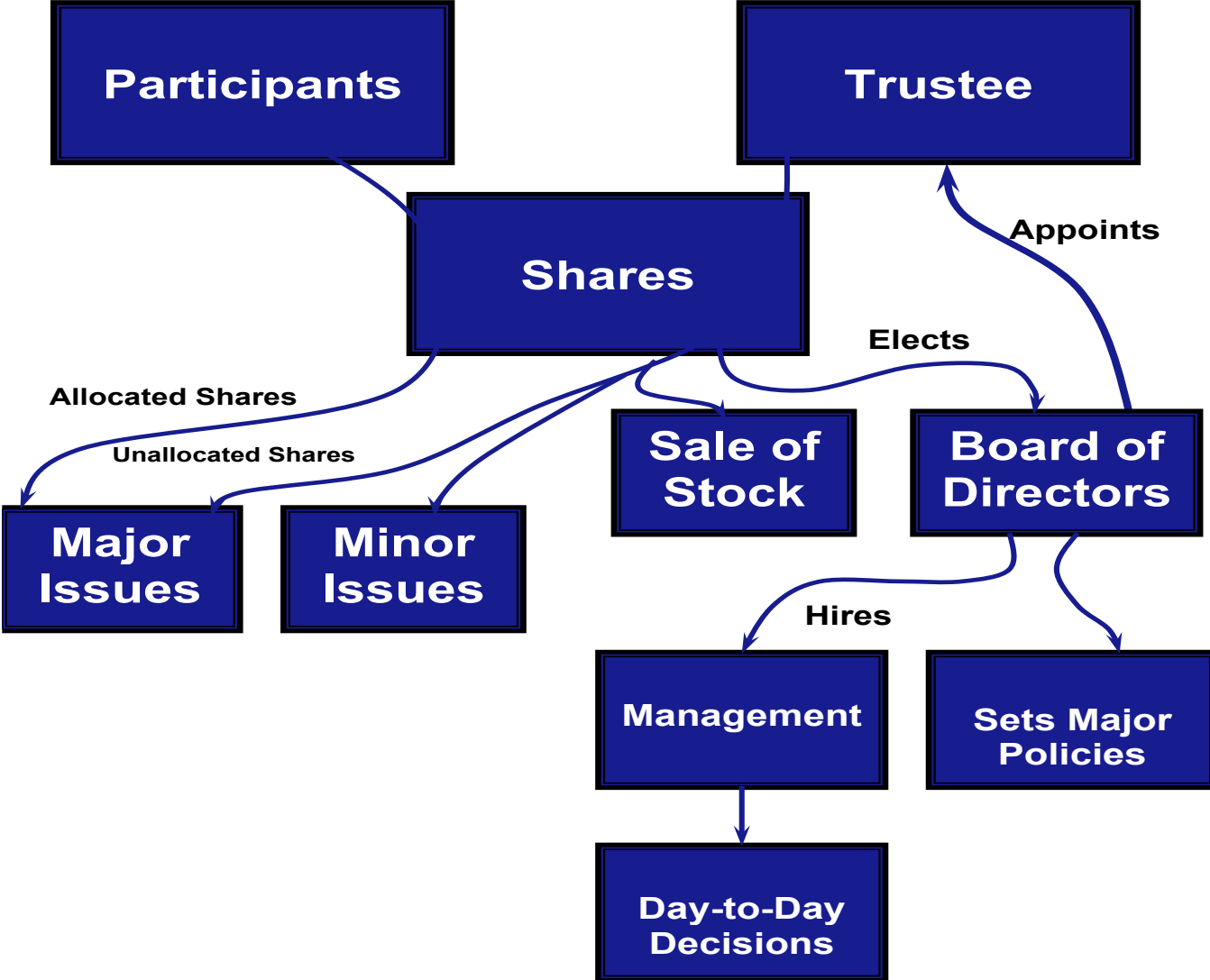
- Eligible employees participate
  - Subject to age & service requirements
- Shares allocated annually based on compensation (subject to limits)
- Annual statement of ESOP account balance
  - Do not have to share company financial information
- Six-year graded or three-year cliff vesting
- Repurchase liability
  - Receive benefit in cash at retirement, disability, or death
  - Delay in receiving cash benefit if leave for normal termination
    - Wait longer of five years or repayment of ESOP loan
    - Paid in installments over five years

# Executive Compensation

- Attract & retain quality management team & align ESOP & management interests
- Employment contracts
  - Salary & bonus structure
  - Non-compete
- Synthetic equity
  - Incentive stock options
  - Stock appreciation rights
- Approval by independent ESOP trustee during the initial transaction & by independent board members post-transaction
  - Reasonable compensation
  - Dilution & overall fairness



# Corporate Governance – 100% ESOP?

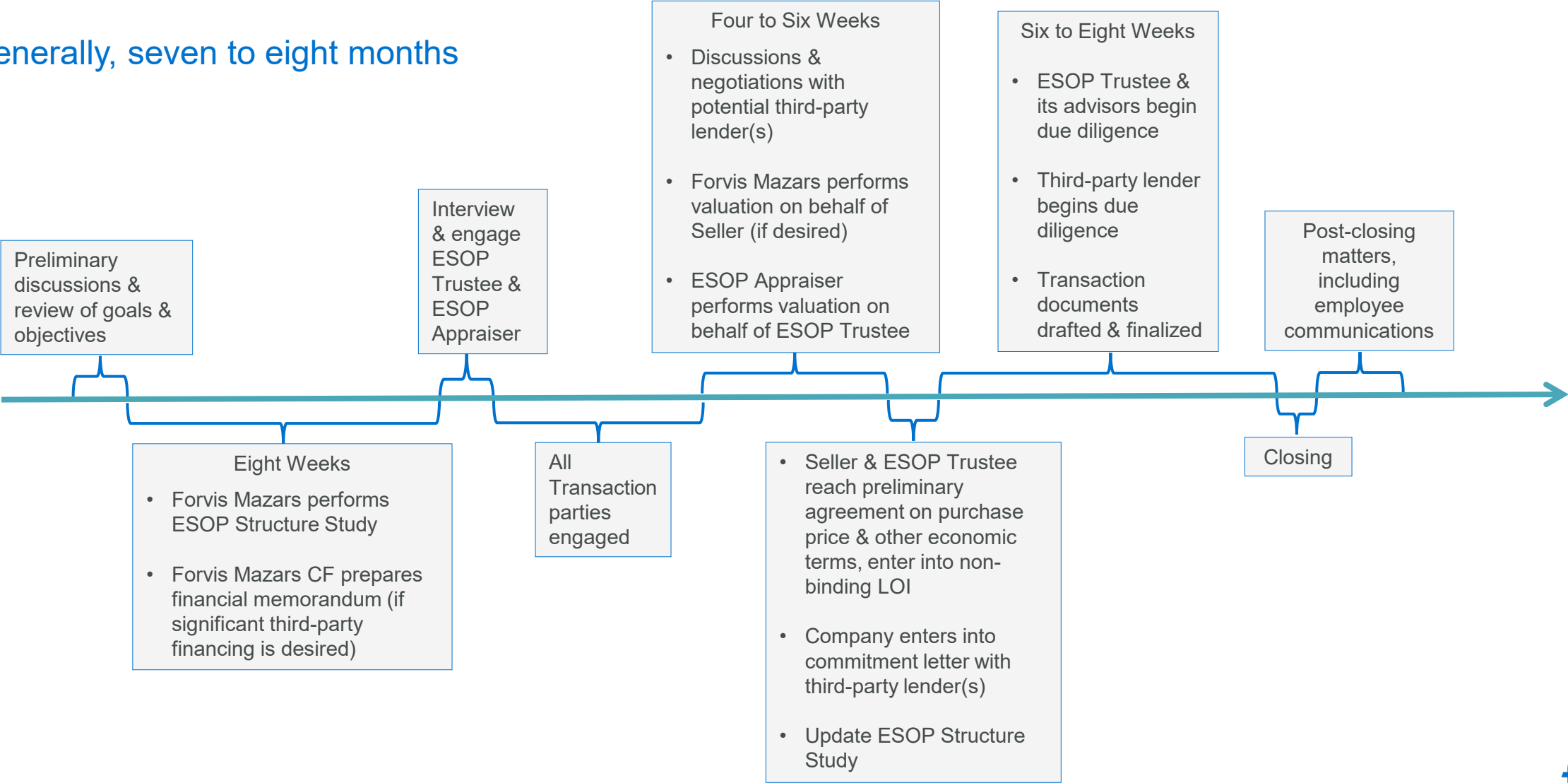


# Transaction Consulting

- Forvis Mazars
  - Design & facilitate transaction
  - Assist with obtaining financing
  - Perform separate valuation on behalf of seller(s)
  - Assist with negotiations
- Corporate/ERISA counsel
- Independent professional ESOP trustee
  - Negotiates purchase price & transaction terms
  - Hires own counsel
  - Hires independent appraisal firm
- Bank & bank counsel

# Typical Transaction Timeline

Generally, seven to eight months





# Current ESOP Transaction Environment

- Interest rate environment & financing impacts
- Continuing impacts of inflation
- Overall political & economic considerations



# Potential Cons of ESOP Transaction

- While ESOP can pay fair market value, there may be “strategic buyers” that can pay a higher price
  - Opportunity to run parallel paths which involve exploring ESOP transaction while simultaneously testing the market (Forvis Mazars CF)
- Generally, does not involve seller(s) completely cashing out at time of transaction, as seller financing is typically involved
- ESOPs are regulated by DOL & IRS
  - DOL &/or IRS have right to investigate the transaction after it has occurred
  - DOL or IRS could claim ESOP paid more than fair market value, which could result in a prohibited transaction

# A Few Other Considerations

- Should be coordinated with individual estate tax, charitable, & wealth planning
- Abuse of S corporation ESOPs
  - Must provide broad-based employee ownership
- Key man life insurance
  - Seller note
- Fiduciary risk
  - Insurance
  - Independent institutional trustee

# When an ESOP May Be Right!

- Owner wants to preserve company legacy, but is thinking about retirement
- ESOP culture is a good fit
- Owner is willing to carry some of financial risk, *i.e.*, seller notes, for a period of time
- Generally fair value of equity of \$5 million or more
- Generally, 30 employees or more
- Stable cash flow
- Potential for significant corporate income tax savings
- Looking for long-term growth platform



# Contact

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