Next Steps: Would an ESOP Work for Your Company?

Like hemlines and hairdos, employee stock ownership plans (or ESOPs) have had their ups and downs in terms of popularity. For owners of manufacturing and distribution companies seeking an exit strategy, it's worthwhile to consider whether an ESOP might work for your company.

An ESOP is a tax-qualified defined contribution retirement plan, which by design invests primarily in the stock of the employer. Employees have individual ESOP accounts invested in the employer's stock, which makes employees owners of the company.

The Upside

ESOPs have several advantages not available to other types of retirement plans. For example:

- ***Control:*** The owner can sell just a portion of the company to the employees and thus retain control of the business.
- ***Financing:*** Unlike other tax-qualified plans, an ESOP can borrow money and engage in other transactions to acquire company stock. Thus, an ESOP can be used to refinance corporate debt and repay it with pre-tax dollars, which means lower borrowing costs.
- ***Tax benefits to owners:*** If the business is a C corp and the owner sells at least 30 percent of the company to the ESOP, gains on the sale of the owner's interest can be deferred if the owner purchases other qualified investments with the proceeds.
- ***Tax benefits to the company:*** If the business is an S corp, the percentage owned by the ESOP is not subject to federal income tax (or state income tax, in many cases). This can represent a significant tax savings.

  Also, contributions of stock and cash to the ESOP are tax-deductible. For example, employer stock can be contributed to the ESOP as a matching or profit-sharing contribution and the company can take a deduction for the full value of the stock contributed.
- ***Succession planning:*** An ESOP can be an excellent exit strategy. The ESOP provides the owner the opportunity to sell the company's stock to a ready market, diversify his or her holdings outside the business, and gradually step out of the company with wealth preserved.

The Downside

However, there are some disadvantages to ESOPs as well:

- ***Cost:*** ESOPs can be expensive to set up and administer. Plus, like other tax-qualified plans, they require a fair amount of reporting and compliance work. Federal regulations also require a valuation of ESOP shares on a regular basis.

- ***Liquidity:*** Cash flow may be impacted as the company re-purchases the stock of exiting employees. This can be especially burdensome if the stock's value has increased substantially, there are a large number of employees leaving or retiring, or a large number of shares are vested.
- ***Performance:*** If company performance falters, employees may be less interested in owning its stock. If the company fails, employees will lose their funds invested in company stock.
- ***Balance sheet implications:*** If the company borrows money to fund an ESOP, the loan becomes a liability on the company's balance sheet and the company's debt-to-equity ratio takes a hit.

Despite all of their pros and cons, ESOPs are viable tools for exit planning. It's important to carefully consider the advantages and disadvantages of an ESOP to see if it is right for your company

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We are committed to your success and we hope you find this information valuable. Interested in learning more about an ESOP? Contact us today to discuss the pros and cons for your business.

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