Leveraged ESOP or Contributory ESOP

Chances are you've heard of an ESOP. The business planning strategy has been around since 1954 and was formalized in the original ERISA code in 1974. ESOP's are normally used for business owners looking to exit their business NOW. There is an alternate version that allows business owners plan for:

- Their Retirement
- Eventual exit from the business
- Reduce taxes due on current profits

Do you know how you are going to exit your business? You may have a dream of going public, selling to the highest bidder, or retiring and handing over your business legacy to your family.

Big dreams aside, the truth is that many small business owners have no exit strategy for their businesses in the event of their disability, retirement, or death. Given the current economy, it isn't surprising small business owners focus their energies on business survival, future growth, and even remaining active in business after retirement. A business exit strategy not only means having a plan for the succession and transfer of ownership of your business when it comes time to hang up your hat and retire. It also means having a plan for the unexpected – including financial hardship, injury, disability and even death.

What will your business be worth? How will you sell it? To whom will you sell it? Will they keep the company intact? Will you still have to work? What will the taxes owed be on the sale?

An **ESOP** can help answer these questions and provide some possible solutions as well!

But Which Type of ESOP ?

The Leveraged ESOP

- **Liquidity Event -** 18 to 24 Months
  The leveraged EOSP is typically a business exit strategy for an owner looking to exit the business "NOW".

- **Requires borrowing/leverage** – In the most common scenario, a 100% sale to ESOP, the business generally must borrow from a bank in order to purchase up to 50% of the owners stock. ESOPs have preferential treatment for borrowing-the business can deduct the interest and principal payment for debt-servicing. However the repayment creates an additional cash flow obligation.

- **Owner will carry a note -** In a complete sale/exit 100% of the stock will be sold to the ESOP. In a partial sale, some portion of the owners stock will be traded to the ESOP in exchange for note.

- **Owner may lose control –** In cases where the ESOP owns 51% or more of the company, control of the company will be in the hands of the ESOPs Trustee/ Fiduciary & Board of Directors.

- **For business owners exiting their business**– As mentioned above this strategy works well for business owners who have managed to survive or grow their business but have decided they no longer wish to be in the business.

- **Expensive –**The cost of establishing a Leveraged ESOP typically runs between $50,000 to $250,000. These costs can be prohibitive to smaller companies.

- **Requires a successor to be in place** –If an individual or team doesn't already exist within the company to succeed the owner, outside talent will be required in a short period of time to ensure the continued success of the business.

The Contributory ESOP

- **Pre-planning –(min 5+ years)** Contributory (aka Pre-Leveraged ESOP) is best for owners who know that one day they will exit but aren't ready to step away or surrender control.

- **Funded with Tax Savings** - The company receives a current tax deduction for the value of shares of stock contributed to the ESOP. The Tax-Offset can minimize or eliminate profit but creates TERC(tm) (see below).

- **Tax Exempt Retained Capital** (TERC(tm)) is created as a by-product of the stock transfer to the ESOP. Since the TERC has already been exposed to taxes it is now and forever more Tax Exempt. This TERC is used to grow the company, the owners balance sheet or both!

- **Owner Maintains Control** –The owner controls the dilution rate and they determine when/if they ever want to surrender control of the company to the ESOP.

- **Internally Funded** -The company/ESOP generally does not need to borrow money from a third-party/bank in order to create the stock transfer.

- **Employees are rewarded now**-The employee's receive a current vested interest in helping grow the company now instead of waiting for the owner to decide to exit the business at some point the future.

- **Less Expensive –** Typical first year costs are $20,000-$50,000. On going annual maintenance costs are typically half of the initial start up costs.

- **Allows the owner to develop a succession team**–The typically longer transition period allows the owner to determine and train the successor or recruit another person to fill that role.

Features of BOTH

- **Creates a buyer** –According to the Exit Planning Institute (EPI), 70-80% of business won't transition successfully[1]. This is often due to the lack of a suitable buyer.

- **Insures a sale at FMV**–Professional valuation experts that specialize in determining the fair market value of business are utilized before, during and after the sale.

- **Improves employee retention–** Studies from EPI, National Center for Employee Onwerhip (NCEO), Harvard, and others show that employee retention increased 30% on average for companies that were owned in part or whole by an ESOP.

- **Improves profitability–** The same studies also indicated that productivity and profitability are 20% greater than their peers that were non-ESOP owned.

- **Bipartisan Support**–Since the inception of ERISA Code in 1974, ESOPs have enjoyed support from both Republicans and Democrats. The recent 2018 Main Street Employee Ownership Act[2] introduced by Senator Gillibrand (D-NY) had additional sponsors–three Democrats and three Republicans further expands support of ESOPs.

- **Defer/Eliminate Capital Gains tax from sale** -Taxes from the sale of ownership interest sold to an ESOP can be, at worst, deferred. With proper estate planning, taxes can eliminated.

[1] 2018 Exit Planning Institute, "State of Owner Readiness", 2013

[2] Main Street Employee Ownership Act of 2018 H.R5236 -115th Congress (2017-2018)