Selling Ownership to an ESOP: An Attractive Route to Cashing Out

By Martin Staubus

There comes a point in the tenure of every company owner when he or she begins to think about how much longer they should keep going with the business. Is it time to sell – or not? Any business owner who evaluates their options without investigating the concept of an employee stock ownership plan (ESOP) will be making a mistake.

What Is an ESOP?

Technically, an ESOP is simply an employee retirement plan – one in the family of "tax-qualified" retirement plans that include 401(k) plans, profit-sharing plans, etc. But in actual use, an ESOP is so much more. The function of an ESOP is to buy company stock, and then hold it as a retirement investment for the company's employees. To facilitate this, ESOPs are authorized to borrow money to finance the purchase of stock. This means that if you own stock in a private corporation, you have a way to sell that stock – whether just a few shares, a major portion or the whole interest.

How Does it Work

To establish an ESOP, a business must be a corporation – either S corp or C corp. So if your company (we'll refer to it with a capital C – Company) is organized as, say, an LLC, the first step will be to convert it to a corporation. As a corporation, the process is straightforward:

• **Step 1.** The Company establishes an ESOP (that is, a lawyer draws up an official "plan document" which is formally adopted by action of the Company's board of directors).

• **Step 2**. The Company retains an independent business appraiser of their choice, who will determine the "fair market value" of the stock you want to sell. That sets the sale price.

• **Step 3**. Financing is arranged for the ESOP so it will be able to pay you for your stock. This may be a bank loan to the ESOP (guaranteed by the Company). Or it may be "seller financing," in which you get some cash up front plus an IOU to be paid off over the next few years.

• **Step 4**. With the financing lined up, the deal closes. The ESOP hands you a check (and possibly an IOU) and you give the ESOP a stock certificate.

• **Step 5**. As the ESOP's debt payments come due, the Company will give the ESOP the money it needs to meet its obligations. These company contributions are tax-deductible. Thus, at current tax rates, the government is effectively covering 40 percent of the cost of paying for your stock.

• The employees of the Company then become owners, through their retirement accounts, of a good amount of their Company's stock, turning them into highly motivated performers.

Advantages of Selling Stock to an ESOP

Selling stock to an ESOP offers some remarkable advantages. These include:

- **Big tax advantages.** As a rough rule of thumb, a stock sale to an ESOP can produce tax savings that equal the entire price paid by the ESOP for the stock. If an ESOP purchases, say, $1 million of stock from you, that transaction will generate about $1 million in tax deductions/deferrals. These tax savings are spread among three parties:

  • **The company.** For a company, the cost of redeeming stock from a shareholder is not tax-deductible. By using the ESOP to redeem your stock, however, the expense is treated as a deductible contribution to the Company's qualified retirement plan, making the expenditure deductible. This deductibility saves about 40 percent of the transaction cost.

  • **The seller (you)**. A unique ESOP tax law (code section 1042) allows you to get paid for the stock you sell without paying the capital gains tax that would ordinarily be due. At California tax rates, this saves you taxes worth about 25 percent of the transaction cost.

• The employees. Employees who are shareholders become highly interested in improving their company's performance. If you simply gave stock to the employees directly in order to generate this performance-boosting effect, the value of that stock would be immediately taxable to them as compensation. By using the ESOP, it is not. Employee tax brackets vary, but on average they may save about 35 percent.

Totaled up, these tax savings will be in the range of 100 percent of the value of the stock you sold.

- **• The ability to sell a portion of a company.** With other buyers, a sale will be an all-or-nothing proposition – sell them the business or don't sell it. With an ESOP, you can sell any portion of the company you want – the ESOP stands ready to pay full market value for whatever stake you may want to sell. This is a great option in a number of common situations:

    - • The Company has more than one owner; and one wants out while the other(s) wants to keep everything going. Answer: buy out that person with an ESOP.
    - • You aren't yet ready to walk away, but with so much of your net worth tied up in an illiquid, at-risk investment, you are concerned about some worrisome "what ifs." Take some value off the table and diversify your wealth by cashing out a portion.
    - • You're getting burned out from the daily grind, but don't really want to quit entirely. Answer: sell part of your ownership to the ESOP, where it will go to your employees. They will then be motivated to drive the performance of the business, so you can trust them to "mind the store," allowing you to reduce the time you put into the operations.

  • No adversarial buyer across the table. You get sole control over the terms of deal. Set up a sale when you want, in the amount you want – however you want to proceed, limited only by the law, not what an adversarial buyer is demanding.

- **• The Company is assured of a strong future.** An ESOP can be used in many different ways, for many different purposes. The most common path, no doubt, is for an owner to sell a portion of the company – 25 percent, 30 percent, 50 percent or whatever – to the ESOP, with the idea that he, the company and the management team will then embark on a five-year transition plan. Over those five years, the original ESOP financing will be paid off. Just as importantly, the management team will be trained over that time so that, when the five-year transition period is concluded, the owner can sell the balance of the company to the ESOP, with the management team ready to step up and continue operating the business while the owner fully retires. To many owners, who have worked long and hard to build their business into a successful company, it means something to know that the business will not be merged out of existence, liquidated, or otherwise killed off. And it means something that the employees who have helped the owner for many years will have the opportunity to seize this chance, keep their jobs and work to make a go of it on their own.