

ESOP 101

WHAT/WHY/HOW

A JOINT PRESENTATION BY
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Mark R. Kossow

Mark Kossow focuses his practice on employee stock ownership plans (ESOPs) and is a partner at **Archer & Greiner P.C.**

His practice is focused on implementing ESOP transactions and their compliance with IRS and Department of Labor requirements. Mark's strong tax background helps corporations, fiduciaries, and selling shareholders to maximize the tax advantages of their ESOP transactions.

He frequently speaks on topics relating to ESOPs, ERISA, and tax matters at meetings of The ESOP Association and other organizations concerned with exit planning and succession planning.

Mark is listed in Best Lawyers in America (Tax Law), and is an active member of The ESOP Association and the National Center for Employee Ownership (NCEO).

Mark is a graduate of the University of Michigan (with distinction) and Albany Law School (*cum laude*). He also holds an advanced legal degree (LL.M.) in taxation from New York University Law School.



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Robert C. Hilton, Jr., ASA

Rob Hilton, ASA is Director of Valuation and ESOP Services at Katz Sapper & Miller. He is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and is based in Rochester, NY. As one of the top 60 CPA firms in the nation, KSM has earned a reputation as a leader in the areas of accounting, tax and consulting services. KSM is regularly named one of the “Best of the Best” accounting firms in the nation by INSIDE Public Accounting magazine. KSM is a 100% employee owned S-corporation ESOP.

EXPERIENCE: Rob has about 20 years of experience and has provided hundreds of valuations in a wide variety of equity classes. Rob has extensive experience with the implementation and administration of employee stock ownership plans (ESOPs), the valuation of gift and estate planning, buy-sell agreements, recapitalization, mergers and acquisitions, purchase price allocations, financial reporting, and general corporate planning with experience in a broad range of industries. In addition, he focuses on the valuation of covenant-not-to-compete and non-solicitation agreements.

CERTIFICATIONS/EDUCATION: He is a member of the National Center of Employee Ownership and The ESOP Association and is a regular speaker at regional and national conferences. He is currently the Executive Vice President of the New York/New Jersey ESOP Association Chapter.

Rob has testified as an expert witness in the Superior Court of New Jersey.

Rob holds a B.A. in Chemistry and Psychology from Emory University and an M.B.A. from the University of Rochester, William E. Simon Graduate School of Business Administration.



Richard A. Heeter

Richard A. Heeter is a founder and Managing Director of Capital Trustees, LLC. **Capital Trustees** provides Independent Trustee and Fiduciary services for ESOP transactions and ongoing engagements, serving clients of all sizes and all types of industries.

Capital Trustees has been engaged as Transaction Trustee by companies ranging in size and value from \$4.0 million and 15 employees, to \$400 million and 3,000 employees. Additionally, Capital Trustees serves as ongoing Trustee to approximately twenty ESOP owned companies and has performed engagements in 15 states, primarily in the Mid –Atlantic, Midwest, Northeast, and New England regions.

Rich has been in the financial services and retirement planning field for 30 years, and an ESOP Trustee since 2008. During that time, he has worked with owners of closely held and family businesses, providing solutions in the areas of qualified retirement plans, executive benefits; and business transition planning.

Rich is involved with numerous industry and civic organizations, and has served on several of their respective boards, including:

The ESOP Association - *Current member*

National Center for Employee Ownership - *Current member*

Society of Financial Services Professionals, Harrisburg Chapter - *Past President*

Estate Planning Council of Central Pennsylvania – *Immediate Past President*

Harrisburg Association of Insurance and Financial Advisors – *Past Board Director*

Mechanicsburg Area School District Educational Foundation- *Current President*

A Penn State graduate, Rich has also earned both the Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU) designations from the American College. He is a licensed insurance broker and investment advisor representative.

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WHAT IS AN ESOP?

What is an ESOP?

“Employee Stock Ownership Plan”

- Retirement Plan - Qualified Defined Contribution Plan
 - Internal Revenue Code/ERISA
 - Tax-deductible contributions for employer
 - Tax-deferred growth for employees
 - Designed to invest primarily in employer stock
 - Permitted to borrow
 - Trustee
- Corporate Finance Tool
 - Tax-advantaged financing for the company
 - Deductible dividends (in some cases)
 - S Corporation ESOPs (1998) – generally income tax exempt

What is an ESOP?

A Brief History

- The Employee Retirement Income Security Act (ERISA) of 1974 created a formal legal status for ESOPs
- There are about 7,000 ESOPs in the U.S., covering about 11 million employees (10% of private sector workforce)
- 5,000 ESOP companies are majority-owned by the ESOP and approximately 4,000 are 100% owned
- About 330 ESOPs, or 3%, are in publicly-traded companies
- At least 75% of ESOP companies are, or were, leveraged

Source: ESOP Association, www.ESOPAssociation.org, January 2018

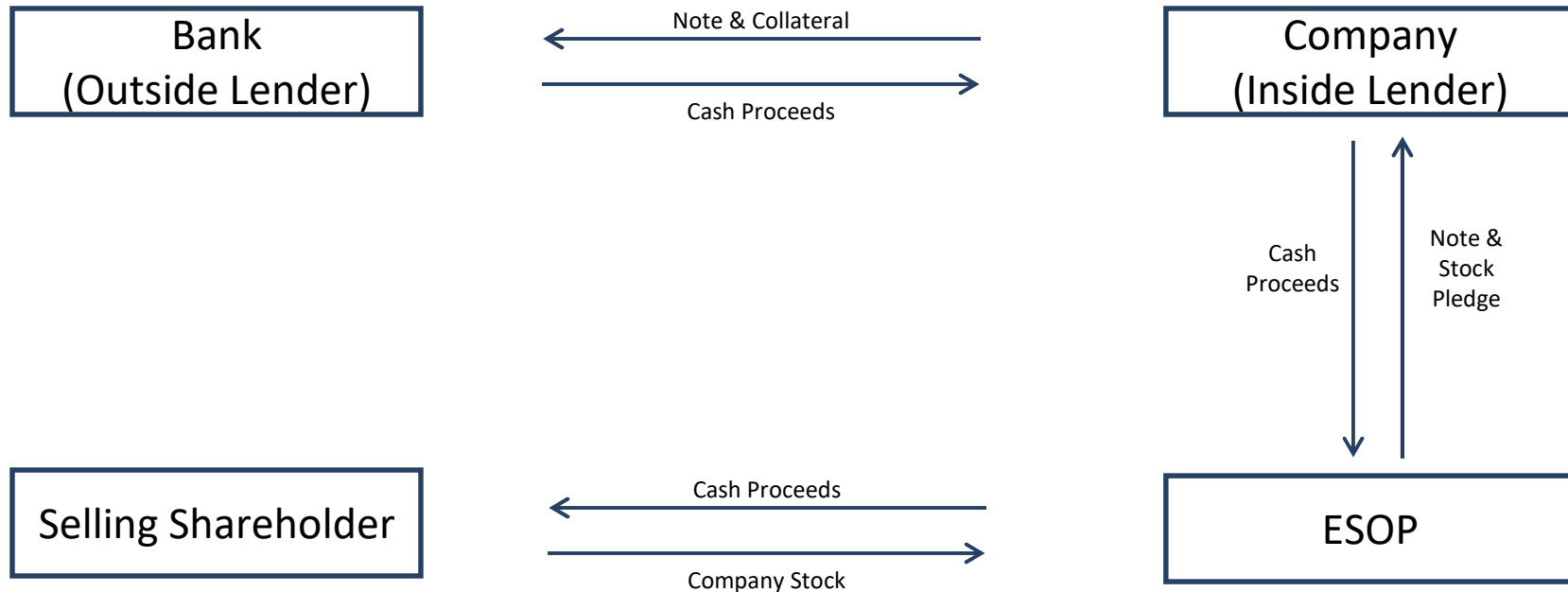
What is an ESOP?

Creates Market to Sell Shares by:

- Selling all or part of shares
- Combining with management buyout
- Spreading sale of shares over many years
- Allowing diversification for seller
- Retaining many control elements for seller/management
- Deferring income tax potentially forever
- Continuation of company as a going concern

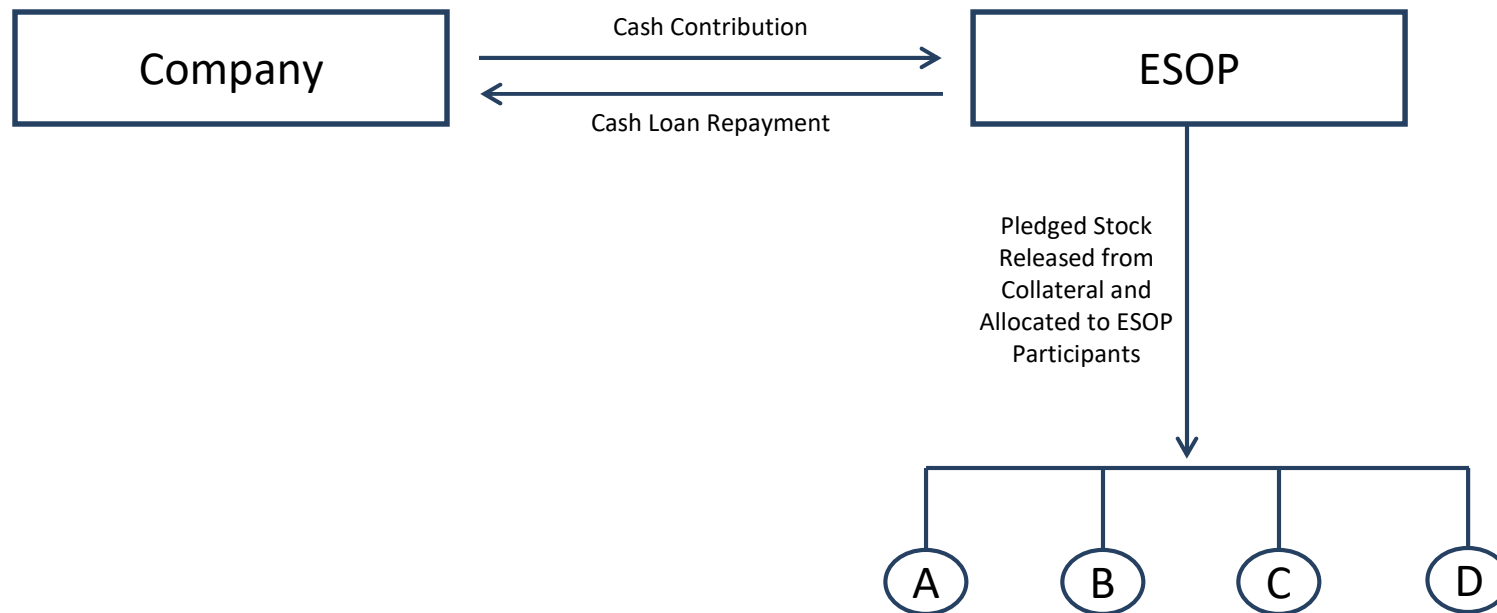
What is a Leveraged ESOP Transaction?

Stage One: Loan and Stock Acquisition



What is a Leveraged ESOP Transaction?

Stage Two: Repaying the Loan



TAX BENEFITS & SAVINGS: C CORPORATIONS

Tax Benefits & Savings: C Corporations

Tax Benefit to Selling Shareholders

- Tax deferral; Section 1042
 - C Corporation
 - Qualified employer securities
 - 30% sale/ownership by ESOP
 - 3-year holding period (tacking)
 - Stock owned is not a result of stock options or other employee benefit plan
 - Restrictions on allocations to seller, children, brother/sister, spouse or parents; or >25% shareholder
 - Purchase Qualified Replacement Property (QRP) within 15 month period
 - Stocks, bonds, debentures, or notes issued by domestic operating corporation

Tax Benefits & Savings: C Corporations

Tax Savings Comparison

ESOP Tax Savings of Sale to an ESOP

	Taxable Sale	ESOP Sale
Sale Price	\$30,000,000	\$30,000,000
Basis	5,000,000	5,000,000
Appreciation	\$25,000,000	\$25,000,000
TAX @25% ¹	\$6,250,000	\$0
Net Proceeds	\$23,750,000	\$30,000,000

¹ Approximate State and Federal Capital Gains Tax and Net Investment Income Tax

TAX BENEFITS & SAVINGS: S CORPORATIONS

Tax Benefits & Savings: S Corporations

- Corporate Income Tax Exclusion
- A 100% ESOP-owned S Corporation has significant tax saving opportunities
 - If the corporation makes an S election, there will be no federal tax on its annual income (most states mirror this provision)
 - Although income will be passed through to the shareholder (the ESOP), no shareholder level tax will be imposed because the ESOP is a tax-exempt entity
 - The income tax liability will effectively be deferred until the participants in the ESOP receive their benefits

Tax Benefits & Savings: S Corporations

- ESOP owns less than 100%
 - Tax exclusion in proportion to ESOP ownership
 - ESOP entitled to its share of S distributions paid if corporation makes distributions to non-ESOP shareholders to cover payment of taxes on the passed-through corporate income
 - Example
 - ESOP owns 30% of company
 - Annual taxable income was \$1 million
 - Non-ESOP shareholder income allocation = \$700,000; corporation distributes \$245,000 (35%) to cover federal tax liability
 - Corporation also required to distribute \$105,000 to the ESOP (\$350,000 total)
 - Cash in ESOP can be used for ESOP debt service, repurchase obligations, or to purchase additional shares
 - If cash from S distributions builds up in ESOP, it may not be available to company for investment or expansion

S Corporation ESOPs

ESOP C Corporation vs. ESOP S Corporation

	C Corporation	S Corporation
Pre-Tax Earnings	\$1,000,000	\$1,000,000
Income Tax (21%)	\$210,000	\$0
Net Income	\$790,000	\$1,000,000
Dividend to cover S/H Tax	\$0	\$350,000
Net to Equity	\$790,000	\$650,000

BENEFITS TO COMPANIES

Benefits To Companies

Benefits to Companies

- Contributions are deductible
 - Net effect is that the bank debt is paid with pre-tax dollars (subject to 25% of covered compensation limitation)
- Increased productivity/participation by participants
 - Studies show ESOP companies have superior sales, employment, and sales/employee relationships vs. non-ESOP companies with similar size/industries¹
- Potentially avoid taxes 100% – S Corporation ESOP

¹ Source: ESOP Association, January 2018

BENEFITS TO PARTICIPANTS

Benefits to ESOP Participants

- Retirement Benefit
 - Allocation of ESOP assets, usually in proportion of salary/wages to covered payroll
 - Usually 100% employer-funded
 - Retirement benefit grows on a tax-deferred basis
- Advantages of equity ownership
 - Tangible benefits (dividends and appreciation)
 - Intangible benefits (pride of ownership)

STOCK VALUATION & FINANCING

Stock Valuation & Financing

- ESOP can't pay more than "Adequate Consideration" for the shares = fair market value based on independent appraisal
 - May be lower than value received in external transfer
- BUT
 - Owner can retain some elements of control
 - Owner keeps job, salary, and reasonable perks (part of negotiation)
 - Owner can participate in future value of business
 - Properly installed, the ESOP can increase productivity of company and thus value retained shares (if any)

Stock Valuation & Financing

ESOP Financing Alternatives

- Bank financing
 - Asset based lenders
 - Cash flow lenders
- Seller note
- Mezzanine lenders
- ESOP cash pre-funded
- Other plan assets rollover

Additional Considerations for ESOP Transactions

- ESOP transaction is a highly leveraged transaction
- Unlike debt financing for operations, the proceeds of the loan “leave the company”
- Enhanced cash flow available for debt service from ESOP tax benefits

OTHER ITEMS

Other Items

Common ESOP Fables

- Employees will run the company - False
- Employees will access financial/confidential information - False
- Seller can not receive fair market value - False
- Seller must guarantee the ESOP loan considerations - False
- Because the business owner controls the transaction, timing is not important – False
- An ESOP requires the sale of 100% of the company - False

Other Items

Current Macro Factors Supporting ESOPs

- Demographics
 - Baby boomer business owners are approaching retirement age and need an exit strategy
- Valuation
 - Stock market multiples are at or near multi-year highs
- Interest rates
 - Borrowing rates on loans are at or near all time lows
- Liquidity
 - Banks' lending parameters have generally loosened in the last couple of years
- Taxes
 - Taxes are favorable at the current time

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THANK YOU
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