THE ESOP ALTERNATIVE$_{TM}$

THE ULTIMATE EXIT STRATEGY$_{TM}$ FOR PRIVATE SELLERS

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If we can show you how an Employee Stock Ownership Plan ("ESOP") structure can bring over 100% of the transaction value in *additional* financial benefits to the buyer and seller(s), would you be interested? This article explains how these benefits are achieved and demonstrates that an ESOP should be seriously considered when selling a privately owned company.

Why would a seller of a highly successful and growing manufacturing company turn down a premium, full cash offer from a private equity group to back a management-led buyout in favor of selling his stock to an ESOP? Why would the owner of a rapidly growing publishing company choose an ESOP over a very attractive offer from a well-capitalized buyout group? The answers are different in each case.

In the first case, the seller did not want his company to be consolidated into a larger group or to be sold to the highest bidder in five to seven years. In the second case, the seller was interested in the continued rapid growth of the company. In both cases, the sellers wanted to keep their companies locally owned and to maximize the after-tax proceeds of the sale transaction.

Overview

The Ultimate Exit Strategy$_{TM}$ for private sellers of a closely held business is an ESOP. Generally, only shareholders of closely held corporations ("Private Sellers") are eligible for the full array of tax benefits of the Ultimate Exit Strategy$_{TM}$. The shareholders can be individuals, partnerships, trusts, or estates. Shareholders of "C" corporations are eligible for all the tax advantages, while "S" corporations and "LLCs" are eligible for the majority of these benefits.

As their businesses mature and the private sellers begin the planning process for their exit, several choices are available to most business owners:

a) An initial public offering,
b) Sale to a strategic buyer, financial buyer, outside third party, or supplier,
c) Redemption of stock,
d) Sale to management,
e) Sale to employees (the ESOP), or
f) A combination of b, c, d and e.

Instead of undergoing the expense and uncertainty of a public offering or attempting to sell their equity portion of the company to an outside buyer, private sellers can create their own buyer--the employees of their company. In so doing, they can enjoy tax benefits unrivalled by *any* other exit strategy.

Why Use an ESOP?

Perhaps the following facts best demonstrate why an ESOP may be better than a sale, merger, or public offering:

> If the owners sell their closely held company to another company or third-party buyer, as Private Sellers they will pay an immediate capital gains tax, lose control of their company, and probably not be able to retain any residual equity.
>
> If they sell their stock to the public, they will incur an immediate capital gains tax, become subject to the jurisdiction of the SEC, and risk the possible loss of control.
>
> If they enter into a tax-free merger, the capital gains tax will be deferred; however, they will still have all the risk associated with a concentrated investment position, but likely without the control.
>
> If they sell to an ESOP, they can defer the federal capital gains tax, maintain local control and/or management of the company, retain residual equity, and invest the proceeds in a diversified, low-risk portfolio of stocks and bonds, all while rewarding the loyal people who helped them build their business.

What are the Disadvantages of ESOPs?

There are three aspects of ESOPs that might be considered disadvantages. The first is that the ESOP structure will require debt. The second is the mandatory obligation of the corporation to repurchase stock from participants who die, retire, become disabled, or otherwise terminate service, and to provide liquidity to participants at certain ages. The third is that ESOPs are perceived as complex. Each of the first two disadvantages can be turned into advantages if the ESOP is properly structured. (Specifically how this is done is beyond the scope of this article). The third, unfortunately, is accurate, since in fact ESOPs are complex. The government has made the hurdles to a successful transaction more burdensome over the years by adding rule upon rule. On the other hand, the government allows the additional financial benefits in exchange for following the rules, something thousands of companies do every year.

ESOP Financial Benefits Compared to a Non-ESOP Transaction

Following is an overview of the potential benefits an ESOP transaction could provide to sellers. For purposes of this example, we have assumed a 100% ESOP buyout from Private Sellers with a transaction value of $10 million (and a negligible or zero tax basis in the securities sold). The proportionate benefits of using the ESOP technique of corporate finance would inure to the parties to the transaction regardless of size. Transaction costs are generally less for an ESOP buyout—in contrast to a sale to an outside buyer.

Section 1042 of the Internal Revenue Code enables qualifying shareholders of privately held "C" corporations who have a three-year holding period to reinvest the proceeds of a sale of that stock to employees into the securities of domestic, active corporations (debt or equity, public or private) on a tax-deferred basis that can become a permanent tax savings.

1042 Tax Deferral Benefit Comparison

	Non-ESOP	ESOP
Gain on Sale	$ 10,000,000	$ 10,000,000
Tax (Combined Federal and State)[1] (20%)	2,000,000	-0-
Net Proceeds	$ 8,000,000	$ 10,000,000

[1] Assumes state of residence sale where this benefit is recognized for both state and federal tax purposes (rounded).

Reinvestment Benefit (assume a let-it-ride and compound approach)

Additional After-Tax Proceeds from an ESOP Sale	$ 2,000,000
After-Tax Reinvestment Return (Assumed Rate)	.05
Life Expectancy - Years (Assumed)	21
Total Future Value of Reinvestment Benefit	$ 5,572,000

Computation of Additional Total Financial Benefits to the Sellers

1042 Rollover Benefit	$ 2,000,000
Sellers' Reinvestment Benefit	3,572,000
Sub-Total Additional Financial Benefit to Sellers	$ 5,572,000

As evidenced above, the total *additional* benefits to the sellers attributed to the ESOP are approximately 50% of the transaction value. It is the overall magnitude of the enhancements an ESOP can provide that appeals to potential sellers and makes an ESOP worthy of further evaluation.

Corporation ESOP Principal Payments Tax Deductible

If the corporation is a "C" corporation and has an ESOP, or an "S" corporation has an ESOP, then principal payments on the ESOP financing are tax deductible for the ESOP buyer. This gives rise to another financial benefit of up to $4,000,000 on a $10,000,000 transaction (or 40% of the transaction value). Another way to look at this is to recognize that the "C" corporation has to earn $16,666,667, pay $6,666,667 in taxes at a 40% combined federal and state rate, to be able to pay $10,000,000 of principal. That's approximately 67% of the transaction value.

100% ESOP-Owned "S" Corporations Pay No Federal IncomeTaxes

Once a company has been acquired by an ESOP, by electing the "S" corporation tax structure the company becomes a virtually tax-free operating entity. This comes about as a result of the "S" corporation passing its tax obligations through to its shareholders, which in this case is a tax-exempt, qualified trust, and not liable for the payment of income taxes. This is an enormous benefit for the company and its new shareholder (the ESOP), in that the pretax cash flow enables the ESOP to rapidly repay any transaction debt, and fund future growth and benefits to the employee/owners.

For the buyers (the ESOP), the additional financial benefits of electing "S" corporation status can exceed 50% of the transaction value. For more information, please call the authors at 800-922-3767.

Employees as Equity Holders

An ESOP increases share ownership among employees, who often favor long-term growth over short-term profit, and who can be motivated to regard the company through the eyes of an owner. Upon receipt of distributions (usually upon retirement) the employees generally pay a combination of capital gains and ordinary income taxes. This usually results in a much lower overall tax rate than for other qualified plans that do not distribute employer securities.

Conclusion

An ESOP structure can bring over 100% of the transaction value in additional financial benefits to the buyer and sellers. The ESOP Alternative$_{TM}$ provides many benefits for sellers, both for the initial transaction and for years afterwards. The ESOP Alternative$_{TM}$ provides a versatile transaction format that can be applied to a wide range of transactions, and a format that produces substantial tax savings and financial benefits to both buyer and seller. Is The ESOP Alternative$_{TM}$ worthy of further exploration? Knowledgeable private sellers consider The ESOP Alternative$_{TM}$ to be The Ultimate Exit Strategy$_{TM}$. Sellers (and their advisers) not totally familiar with the full value an ESOP can provide have much to gain by learning more about The ESOP Alternative$_{TM}$.

> *"Business owners spend a lifetime building equity in their businesses. When it is time to convert some or all of this equity into cash, The ESOP Alternative$_{TM}$ may be their ultimate exit strategy."*

About ESOPs: What To Do <u>Next</u>:

As a creature of the Internal Revenue Code and ERISA, ESOPs are highly complex, and, should you wish more information on using the ESOP as an exit strategy, Bob Smiley or Ed Bixler would be pleased to discuss with you the various ways and means of properly structuring this exit vehicle. Benefit Capital has been involved in over $5 billion in ESOP transactions.

The Benefit Capital Companies Inc., in conjunction with BCC Capital Partners LLC, has assembled an "ESOP Assessment Package" to help you more rapidly determine whether the ESOP technique of corporate finance is the proper engine to drive a Private Seller's exit. The materials include:

- **<u>Why Use an ESOP?</u>**
  Outlines the major advantages of an ESOP transaction.

- **<u>ESOP Financial Benefits</u>**
  Graphically illustrates the financial benefits available to the parties to an ESOP transaction.

- **<u>ESOP Candidate Checklist</u>**
  Permits business owners and their advisers to do a succinct self-evaluation of whether the ESOP technique of corporate finance is applicable.

- **<u>ESOP Objectives & Benefits Checklist</u>**
  Outlines the primary objectives an ESOP can be structured to accomplish; its reverse side lists the 20 major benefits available with each primary objective.

There are many additional materials available to help answer the questions that are usually asked about ESOPs.

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Edward M. Bixler is the founder and Managing Partner of BCC Capital Partners LLC. Mr. Bixler's career includes extensive experience in investment banking and corporate finance. He holds both a B.S./B.A. from Bowling Green State University and an M.B.A. from Ohio University at Akron. He is a CMA (Certified Management Accountant) in California, has successfully completed the CPA (Certified Public Accountant) examination, and is a past member of The ESOP Association's Valuation Advisory Committee.

Mr. Bixler is active in a number of professional and business organizations and is the author or contributing author of a number of published articles and authoritative works.

Robert W. Smiley, Jr.

Robert W. Smiley, Jr. is Chairman of the Board and a Managing Director of The Benefit Capital Companies Inc., a national group of merchant banking and financial advisory firms headquartered in Southeastern Nevada, with offices in Irvine, CA; Los Angeles, CA; Katonah, NY; Dallas, TX; and Honolulu, HI. His principal functions include the implementation of management and employee buyouts using employee stock ownership plan (ESOP) and other tax advantaged financing techniques.

Mr. Smiley has been involved as a principal, consultant or adviser to over $5 billion in successful transactions in diverse industries over the past 25 years. He is a member of the management team of Benefit Capital Partners, which provides equity financing for management, employee, and other buyouts.

Mr. Smiley is a founder, past president and lifetime member of the Board of Governors of The ESOP Association, a nonprofit trade association for ESOP companies with over 2,200 current members and a full-time Washington, D.C. staff. He is a member of the Association's Advisory Committee on Legislation and Regulatory Issues. Mr. Smiley is also a director of The National Center for Employee Ownership and a founding editor of and contributing author to its flagship publication, *The Journal of Employee Ownership Law and Finance*. He is also a trustee of The Employee Ownership Foundation.

Mr. Smiley has testified before the Committee on Finance of the United States Senate in regard to pension legislation. In recognition of his contribution to pension policy in the United States, he received the President's Special Achievement Award from the President's Commission on Pension Policy. He is the senior editor and a co-author of *Employee Stock Ownership Plans: Business Planning · Implementation · Law and Taxation,* first published in 1989 with current annual yearbooks published through 1998 by Warren Gorham Lamont, and currently undergoing a major revision for publication in 2004.

Mr. Smiley has served on the faculty of the University of California, Los Angeles (UCLA) Extension. He served as a trustee of the Reason Foundation, a free-market think tank, for nine years. Mr. Smiley received his A.B. in Economics from Stanford University and an LL.B. from LaSalle University, Chicago. Prior to entering Stanford he served a tour of duty in the United States Navy. He is a current member of the State Bar of California and the American Bar Association. He has served as a director for a number of companies, both public and private.