ESOP — a succession solution for both business owners and employees

The American small business environment has reached a critical juncture. More than half of privately held firms in the U.S., or 2.9 million businesses, are owned by baby boomers.[1] As this cohort gets deeper into retirement age, their plans to transition their businesses will have repercussions beyond themselves and their families. At the same time, the COVID-19 pandemic — and its severe impact on older populations — has accelerated many business owners' timeline to retirement.

Small and middle-market businesses help communities thrive, providing necessary services and goods, as well as employment of local residents and essential tax revenue to their towns. Private ownership comes with significant responsibilities and challenges, and one of the most important is succession planning. Business owners who are ready to exit their business should consider an Employee Stock Ownership Plan (ESOP), which can be tax advantageous[2] to them and support a stable and enduring business environment in their communities.

What is an ESOP?

An ESOP is a tax-qualified retirement plan regulated under the Employee Retirement Income Security Act of 1974 (ERISA) that provides a company's workforce with ownership interest in the company. Owners sell company stock to a trust account for benefit of the employees over time. The sale is financed through tax-advantaged[2] bank loans and seller debt.

When an ESOP makes sense

For many business owners, expecting to pass down their business to another generation of family may not be realistic. According to a Harvard Business Review report, about 70% of family-owned businesses fail or are sold before the second generation takes over, and only 10% remain active, privately held companies for the third generation to lead.[3]

But, selling their businesses outright may not be feasible either. Even if a small or middle-market business is profitable with stable and moderate growth projections, it may not have the steep growth trajectory sought by private equity (PE) or strategic buyers in acquisition mode. It may be in a niche industry or in a rural location, which also limits the prospective interest. Finally, for owners with close ties to their communities, selling may risk their business being relocated or closed, which could jeopardize their legacy and impact the greater population.

Benefits to an ESOP for owners, employees, and the company

Put simply, an ESOP offers business owners a path toward succession, while giving employees an opportunity to participate in the company's profitability and success. It gives closely held companies a sustainable and tax-advantaged path forward.

Benefits for Owners

Owners who sell in an ESOP transaction can benefit from:

- Selling minority positions, allowing them to diversify holdings while maintaining company control.
- Rewarding the employees who made them successful with a beneficial ownership and a retirement plan.
- Maintaining their community legacy by keeping their business open and in the same location.
- Sellers of C-Corp stock to an ESOP can elect to defer, and ultimately avoid, capital gains taxes if they reinvest in Qualified Replacement Property.
- Participating in upside growth after sale through warrants attached to seller debt, or by selling in stages.

Benefits for Employees

Employees can also win in an ESOP transaction because:

- They are not taxed on annual contributions or appreciation until they take a distribution, when they can roll over to an Individual Retirement Account (IRA) to defer taxes.
- Vested stock held by the trust for the employee is repurchased by the company (or by the ESOP) at retirement, death, disability, or termination of employment.
- At age 55 and 10 years of employment, participants are allowed to diversify a portion of their company stock holdings into traditional marketable investments such as mutual funds.

Benefits for Companies

At the company level, the benefits of an ESOP transaction are numerous:

- Can generally repay ESOP acquisition debt principal with pretax dollars, subject to limitations, increasing the ability to service debt.
- If an S-Corp is 100% owned by an ESOP, no distributions are required to pay the owners' tax bill — ESOP trusts do not pay taxes.
- Acquisitions by an ESOP-owned company can be structured to allow target company sellers to defer capital gains, potentially lowering the acquisition price.
- Aids in employee retention and recruitment, which is especially important in a tight and very mobile labor market like the one we're experiencing today.
- Motivates high performance from employees and aligns their interests with other stakeholders because they now share in the success or growth of the company.

Research from the National Center for Employee Ownership (NCEO) explores how the ESOP structure can make a positive impact on business fundamentals. In fact, a multiyear study conducted with Rutgers University found that sales per employee increased by 2.3% to 2.4% per year over what would have been expected absent an ESOP.[4] Last year, the NCEO found that ESOP companies laid off employees at one-quarter the rate of non-ESOP companies during the pandemic.[5] Their findings suggest that ESOP-structured companies incentivize strong performance and loyalty throughout an organization.

By the numbers

>50%

of privately held U.S. firms are owned by baby boomers.

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KeyBank supports thoughtful business transitions

The steps to establish an ESOP can seem complicated. Business owners must navigate the complex regulatory environment, as well as weigh the benefits and drawbacks of receiving proceeds in an ESOP transaction versus as a straight sale to a PE or strategic buyer. Yet, the upside of an ESOP can be very attractive for sellers who are ready to exit their business, but want to see it continue with the employees who made it successful. Business owners who are contemplating an ESOP should work with skilled ESOP practitioners to advise on the financial, tax, and legal implications.

KeyBank brings together expertise from across the bank, including underwriting and financing, wealth management, and employer solutions to make the ESOP transition seamless. KeyBank supports both the sellers and buyers of the shares, beginning with structuring a loan for the business to finance the initial sale of shares, and wealth management and tax strategies for the selling shareholders. After the initial sale of shares, our cross-departmental team of bankers can advise on managing the company's share repurchase obligation, ongoing corporate finance needs, and tax strategies and wealth planning for employee participants. Throughout the process, KeyBank recognizes the goals of every participant – for an end result that is a success for all.

To learn how an ESOP can be the right path forward for your business, contact:

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[1] "The Small Business Closure Crisis: Baby boomers own over half of all privately held firms in the United States" Project Equity Organization, March 2021, project-equity.org

[2] KeyBank does not provide tax or legal advice. Consult your tax advisor regarding your specific situation.

[3] "Avoid the Traps That Can Destroy Family Businesses" Harvard Business Review, January-February 2012, hbr.org

[4] "Research on Employee Ownership, Corporate Performance, and Employee Compensation," National Center for Employee Ownership, October 2018, nceo.org

[5] "New Research on Employee Ownership and the Pandemic," National Center for Employee Ownership, October 2020, nceo.org