CAPITAL INSIGHTS

Employee Stock Ownership Plans: The Basics and the Benefits

What is an ESOP?

Employee stock ownership plans (ESOPs) constitute an alternative option for selling a company by allowing employees to become beneficial owners of the stock in their company. Regulated by the Employee Retirement Income Security Act (ERISA) of 1974 – and encouraged by laws subsequently enacted by Congress – ESOPs were initially designed as a tool that could increase broad-based equity ownership for rank and file employees that would help them achieve financial security throughout their lives.

The legislation that created ESOPs also provided substantial tax benefits for selling shareholders to encourage owners of privately held companies to consider transitioning ownership to their employees.

"An ESOP is an interesting solution for a company that enables a selling shareholder to transition ownership of the business to a broad base of the employees, which, in turn, creates a very entrepreneurial culture among ESOP companies."

Gregory Hogan
Managing Director, SC&H Capital

A business owner typically has competing objectives when considering transition and liquidity options. Therefore, in addition to clarifying each objective in practical terms, the owner's advisors must understand the relative levels of importance of those objectives to properly guide a client towards a successful transaction.

Why Do Businesses Consider ESOPs?

As of 2020, the National Center for Employee Ownership estimates there are roughly 6,600 ESOPs covering more than 14 million employees — evidence that, for some private business owners, ESOPs are a rewarding exit strategy. In addition to assuring the continuation of their business, owners leverage ESOPs for reasons ranging from their unique tax benefits to their ability to manage the business for years following the sale of the company.

Top 3 Reasons Businesses Evaluate ESOP's:

1 2 3

Business owners usually evaluate ESOP's for one of three reasons:

First and foremost, the tax advantages that go along with implementing an ESOP can be substantial, both for the selling shareholders and the plan sponsor companies.

Secondly, ESOPs provide business owners who feel strongly about their existing corporate culture the ability to maintain that culture long-term.

Finally, ESOPs are an alternative to a third party sale. For example, if a business pursued a third party sale and could not attract the right buyer, or an owner would rather not go through a third party sale process altogether, an ESOP is an interesting alternative.

What are the Benefits of an ESOP?

TAX ADVANTAGES FOR BOTH THE SELLER AND THE COMPANY

If an ESOP is purchasing the shares of a C-Corp, selling shareholders can potentially defer, or even eliminate, the payment of capital gains tax on the sale of shares through investment in qualified replacement property. In addition, the company's contributions to the ESOP, including those required to repay the acquisition debt incurred in the transaction, are tax-deductible. Therefore, in many ESOP transactions, both principal and interest payments on transaction debt are tax-deductible to the company post-transaction.

CONTROL

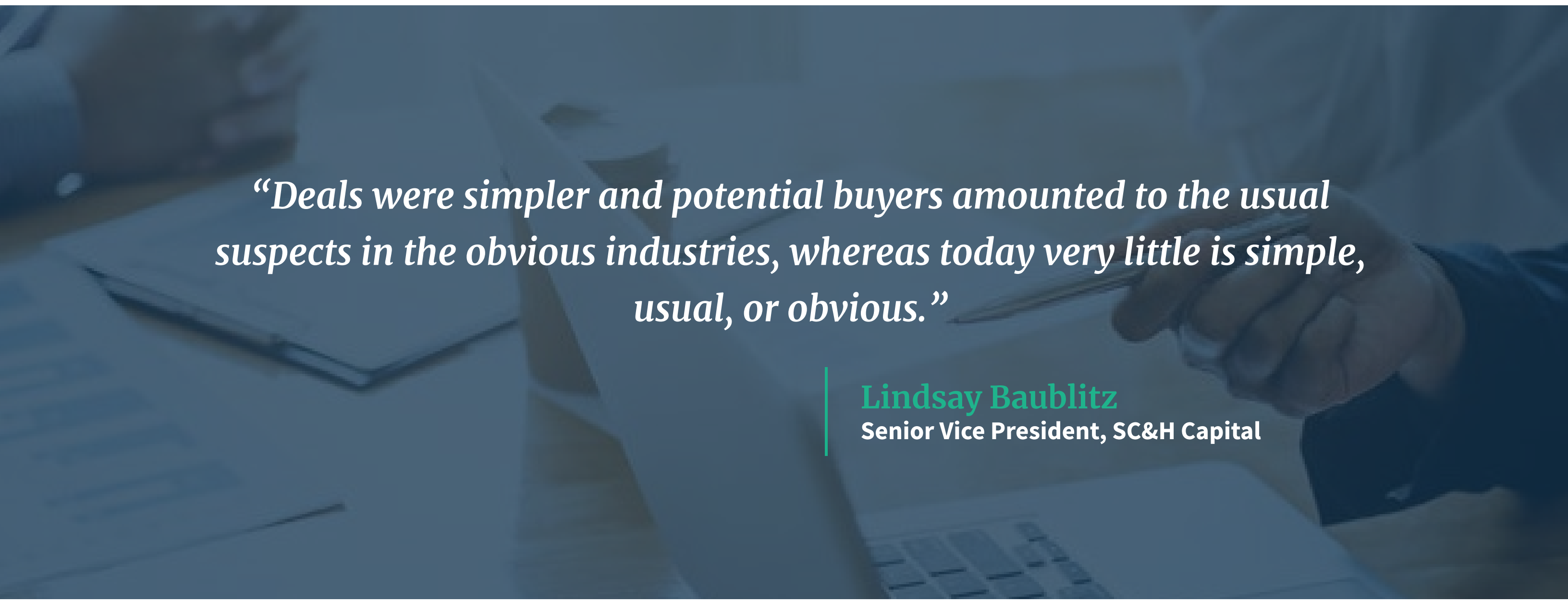
Whereas third party sales result in an immediate transfer of ownership and control, ESOP transactions allow shareholders to sell stock and transfer operational control over time. Because owners can withdraw gradually, they can remain active in the business years after selling all or most of the company, helping to preserve its culture and mentor the management team.

BENEFITS EMPLOYEES

True to the tax law's intent, selling shareholders can provide their employees with significant retirement benefits. In addition, there are several other qualified or nonqualified retirement plans and compensation plans that can be put into place alongside ESOPs to further incentivize management.

Why is Proper Guidance Key?

Middle-market M&A today is almost unrecognizable when compared to M&A 15 to 20 years ago. The deals have become significantly more complex due to numerous variables, especially the proliferation of technology in an array of industries, increased globalization, new tax implications, a global pandemic, and aging Baby Boomer owners looking to exit their businesses.



> *"Deals were simpler and potential buyers amounted to the usual suspects in the obvious industries, whereas today very little is simple, usual, or obvious."*
>
> Lindsay Baublitz
> **Senior Vice President, SC&H Capital**

For some, the best buyers now originate from abroad or industries that aren't easily identified, let alone discerned. For others, ensuring their employees' long-term well-being is as important as realizing a premium sale price for their business. Therefore, neither the conventional buyer nor even the highest bidder is necessarily the preferred buyer—a reality that requires today's seller to adopt a nuanced, tailored approach to succession planning.

ESOP transactions can be very complex. Each company and shareholder's goals are unique and require an in depth analysis to determine the most advantageous percentage of ESOP ownership (100%, majority, or minority), organizational structure (C-Corporation or S-Corporation), and financing options.

In a world where regulations are ever-changing, it is important to work with seasoned professionals who understand current regulations and guidance. SC&H Capital's ESOP professionals understand the tax impacts on employee-owned businesses and Department of Labor ESOP regulations and best practices. In addition, SC&H Capital works with its clients to navigate financing alternatives to maximize liquidity.

"All ESOP transactions are different. Every shareholder has unique personal and professional goals, and we work together with them to help design an ESOP structure that will help them meet those goals and maximize returns."

Lindsay Baublitz
Senior Vice President, SC&H Capital

ESOPs are a unique transaction type that requires partnering with knowledgeable and experienced advisors to guide the transaction to completion. While ESOPs are a viable option in the overall landscape of middle-market M&A, they are often overlooked and misunderstood and not the best fit for the majority of middle-market business owners, but, for some, it is ideal for their specific objectives.

Despite complexities referenced, DIY M&A—transactions executed without a lead sell-side financial advisor and with only limited assistance from legal and accounting counsel—still exist. As recently as a decade ago, you could go it alone and still have reasonable expectations of a successful transaction, but the odds today are prohibitively unfavorable. The middle market is far more global and fractured with ever-changing regulations for companies to walk the succession planning tightrope alone.

Why SC&H Capital?

Our dedicated ESOP experts assist plan sponsors with the formation, administration, and termination of their ESOPs. SC&H Capital professionals have a deep understanding of the unique challenges and opportunities that come with managing an ESOP because SC&H Capital itself is 100% employee-owned. We offer various professional services to ESOP plan sponsors, from advising on initial plan structuring to assisting with plan implementation to fulfilling compliance obligations. With the benefit of our seasoned experience, our clients meet goals and objectives and often realize gains beyond their expectations.

About SC&H Capital

SC&H Capital, an affiliate of SC&H Group, is a premier investment bank and advisory firm providing merger and acquisition (M&A), employee stock ownership plan (ESOP), and business valuation solutions globally leading middle market companies. SC&H Capital advises leading companies across numerous industries including technology, healthcare, manufacturing, and government contracting to help owners maximize their exit planning goals and liquidity objectives. **To learn more visit** **schcapital.com**

Contact Us

Gregory Hogan
Managing Director

410.988.1352

ghogan@schgroup.com

Lindsay Baublitz
Senior Vice President

410.785.8012

lbaublitz@schgroup.com

SC&H CAPITAL