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Business EXPERTise

Recognized and respected issue experts from PA Chamber member companies answer businesses' most frequently asked questions about HR, Tax, Communications and Environmental concerns, compliance and best practices.

Finance/Tax

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What are the various ways for a business owner to transfer their privately-owned business?

The most common method of selling a privately held business is a sale to an unrelated third party, which is typically a strategic buyer — such as a competitor in the industry or a private equity firm. When selling to an unrelated third party, it is generally recommended to run a competitive process by utilizing a FINRA-licensed investment bank to minimize risks and maximize returns.

In cases where the owner desires to keep the business in the family, the owner can transition the business to the owner's children, either by sale or by gifting all or a portion of the business to the children. In cases where management wants to purchase the business, a transaction — called a management buy-out - may be possible. However, children often do not have the desire or ability to take over the business, and management often do not have the means to purchase the business.

In other situations, an alternative to these approaches can be utilized — an Employee Stock Ownership Plan. An ESOP involves a sale of the business to a retirement trust that ultimately benefits the company's employees.

Why Might an Owner Sell to an ESOP Rather than Sell to an Unrelated Third Party?

A sale to an ESOP has the ability to provide economic value to the owner, as well as significant potential other value much different than would ordinarily be available in selling to a third party:

- Legacy — A sale to an ESOP is much more likely to keep the family name than a sale to a third party
- Community — A sale to an ESOP is much more likely to keep the business locally owned and benefit the community than a sale to a third-party
- Reward Employees — A sale to an ESOP provides very large benefits to employees
- Retain Jobs — ESOP-owned companies are much less likely to result in layoffs, even during recessions, than their peers
- Flexibility — ESOP transactions permit the owner to sell all or part of the business and, if desired, remain involved in the business following the sale to an ESOP
- Tax Efficiency — There are a variety of tax benefits that can make an ESOP transaction economically valuable to the prior owner, the company and the employees

For owners who find value in the foregoing, an ESOP transaction might be an attractive alternative that allows the owner to achieve liquidity from the sale of their business and also achieve some of the other goals that often are not available when selling to third parties.

What exactly is an ESOP?

An ESOP is a type of a retirement plan that is required to invest primarily in employer securities. Like a 401(k) plan or a profit sharing plan, an ESOP is a defined contribution plan. As such, each employee will have an account in their ESOP that is invested in employer stock. The value of the employee's ESOP account, therefore, is tied to the value of the company, thereby incentivizing employees to make decisions on a day-to-day basis that grow the value of the company.

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What Tax Benefits are Involved in an ESOP Transaction?

There are three primary types of tax benefits in ESOP transactions: for the selling shareholder, for the company and for the employees.

Selling Shareholder — If structured properly, a selling shareholder can avoid paying capital gain tax on the sale of shares to an ESOP. This requires the company to be a C Corporation at the time of the sale (which can be structured even if the company was not historically a C Corporation). This also requires the selling shareholder to purchase "qualified replacement property" following the closing of the transaction, which is generally debt or equity of an operating company. If the selling shareholder holds the qualified replacement property until death, then capital gains have been avoided completely upon the sale of shares to an ESOP because the shareholder's descendants will inherit the qualified replacement property with a basis that was stepped up at death. This ability to avoid paying capital gain tax is limited to federal capital gains. In Pennsylvania, unlike other states, shareholders are still required to pay state capital gains tax on the sale of shares to an ESOP.

Company — When using an ESOP to buy shares, the company is effectively using pre tax money to fund the purchase of stock since the purchase is funded utilizing deductible contributions to a tax-qualified retirement plan. There is an additional tax benefit for S Corporations that are partially or entirely owned by an ESOP. In those situations, there are no federal or Pennsylvania income taxes paid on the profits of the company for the ESOPs proportionate ownership percentage. For a company that is 100 percent owned by an ESOP, the company no longer needs to make any tax distributions since the ESOP itself does not need to pay federal or state income tax related to the company's profits. To the extent that the company is only partially owned by an ESOP, this partial ownership, if structured properly, can create a tax shield for the ESOP's proportionate ownership, thereby greatly reducing the cost of the debt borrowed for the ESOP transaction.

Employees — The ESOP itself does not need to pay any tax on an annual basis so the value of the stock in the employee's ESOP accounts grows tax deferred while in the ESOP. When the employee ultimately retires or takes a distribution from the ESOP, the value of the distribution is taxed as ordinary income, although the employee has the ability to roll over the distribution to an IRA to continue deferring income tax until required to take a distribution in accordance with IRA rules.

How are ESOP Transactions Financed?

In most ESOP transactions, the company will borrow from a bank as much money as can be borrowed without impairing the company's ability to make debt payments or capital expenditures. Depending upon the current debt of the company, this could be as much as 3 (or even 4) times the company's earnings before interest, taxes, depreciation and amortization. This typically provides enough senior debt capacity to sell 30-50 percent of the company to an ESOP and permit the owner to put that cash in his or her pocket when the transaction closes. Some owners desire to sell 100 percent of the company in one transaction. In that case, the value beyond what is available from third party financing sources is typically financed by a seller note. The seller note typically provides for a higher rate of return than banks will typically charge and, if structured properly, also gives the selling shareholder the ability to get equity-like returns on a portion of the seller financing (i.e., a second bite at the apple on a later exit).

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