Employee Stock Ownership Plans

Presented by
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ESOPs in the US
In November 1973, two men had dinner.

Louis Kelso

Russell Long
1974 Employee Retirement Income Security Act

- 1976 Tax Reform Act
- 1981 Economic Recovery Tax Act
- 1986 Tax Reform Act
- 1989 Omnibus Budget Reconciliation Act
- 1994 Small Business Job Protection Act
- 1996 Tax Reform Act
- 1996 Small Business Job Protection Act
- 2001 Economic Growth and Tax Relief Reconciliation Act
- 2004 American Jobs Creation Act
- 2006 Pension Protection Act

1977 Taxpayer Relief Act
My enthusiasm for ESOPs is prompted by two strongly held convictions.

First... the wealth of our nation should be more widely held...

Second... our capitalistic system should have a great many more capitalists.

# Employee Stock Ownership Plans

- 10,900 ESOPs today in US
- About 10.3 million employees
- Almost $900 billion in assets
- Average age: 10 years
- Typical size: 40 to 150 employees
Examples of ESOP Companies

- New Belgium Brewing
  - Fort Collins, CO
- Cal-Tex Coatings
  - Scherz, TX
- CALIBRE Systems
  - Alexandria, VA
- Stylmark
  - Minneapolis, MN
- ITAGroup
  - West Des Moines, IA
- King Arthur Flour
  - Norwich, VT
- Glatfelder Insurance
  - York, PA
- Publix Supermarkets
  - Lakeland, FL
- Gardeners' Guild
  - San Rafael, CA
- SAIC
  - La Jolla, CA
- Quik Trip
  - Tulsa, OK
- Glatfelder Insurance
  - York, PA

www.nationsonline.org/maps/USA_blank_map.jpg
<table>
<thead>
<tr>
<th>Industry</th>
<th>Distribution</th>
<th>Penetration</th>
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<tbody>
<tr>
<td>Manufacturing</td>
<td>22%</td>
<td>High</td>
</tr>
<tr>
<td>Finance and Insurance</td>
<td>20%</td>
<td>High</td>
</tr>
<tr>
<td>Professional, Scientific, Technical Services</td>
<td>17%</td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>10%</td>
<td>High</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>6%</td>
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<tr>
<td>Management of Companies and Enterprises</td>
<td>3%</td>
<td>High</td>
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<tr>
<td>Transportation and Warehousing</td>
<td>2%</td>
<td>Low</td>
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<tr>
<td>Information</td>
<td>2%</td>
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<tr>
<td>Administrative and Support and Waste Management and Remediation Services</td>
<td>2%</td>
<td>Low</td>
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<tr>
<td>Health Care and Social Assistance</td>
<td>2%</td>
<td>Low</td>
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<tr>
<td>Other Services (except Public Administration)</td>
<td>2%</td>
<td>Low</td>
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<tr>
<td>Real Estate and Rental and Leasing</td>
<td>1%</td>
<td>Low</td>
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<tr>
<td>Accommodation and Food Services</td>
<td>1%</td>
<td>Low</td>
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<tr>
<td>Agriculture, Forestry, Fishing and Hunting</td>
<td>1%</td>
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<tr>
<td>Mining, Quarrying, and Oil and Gas Extraction</td>
<td>&lt;1%</td>
<td>Low</td>
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<td>Utilities</td>
<td>&lt;1%</td>
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Do ESOPs Strengthen Companies?
“By facilitating employee ownership of firms, ESOPs have been shown to lead to higher wages, wage growth, job stability, and higher retirement plan contributions, among other positive outcomes.”

-Alex Brill, Fellow, American Enterprise Institute
On average, ESOP companies have...

- **Faster Growth**  
  *Companies with ESOPs grow 2.3% to 2.4% faster measured in sales, employment, and productivity growth.*

- **Higher compensation**  
  *5-12% higher wages than in comparable non-ESOP companies.*

- **More assets**  
  *ESOP employees have 2.5 times the retirement assets in company-sponsored plans.*

- **Improved company stability**  
  *Less likely to face bankruptcy or acquisition; 20% better “survival” rate.*
What Makes ESOPs Work?

Ownership can be...

...an Incentive

...an Organizational “Culture”
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<td>High</td>
<td>High (5 to 13%)</td>
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Creating an ESOP
Setting Up an ESOP

The ESOP buys all or some of the shares. The company pays for the stock purchase…

– …by repaying an acquisition loan
– …by making contributions

The ESOP pays no more than fair market value.
# Key Steps

1. Assess all current owners
2. Conduct a feasibility study
3. Value the stock
4. Hire an attorney or “quarterback”
5. Determine funding and plan design
6. Establish operating process
The ESOP Trust

Each ESOP is run by a trust.

The trust must operate “for the exclusive benefit of plan participants.”

The trust is a separate legal entity from the company.
Tax Issues

C Corporations

- The seller can defer capital gains tax.

S Corporations

- Possible shield for corporate income tax.
<table>
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<th>ESOP Team</th>
</tr>
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<tr>
<td>Legal</td>
</tr>
<tr>
<td>Administration firm</td>
</tr>
<tr>
<td>Financing</td>
</tr>
<tr>
<td>Valuation firm</td>
</tr>
<tr>
<td>Outside trustee (possible)</td>
</tr>
<tr>
<td>Communications consultant (possible)</td>
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# When Are ESOPs a Good Fit?

<table>
<thead>
<tr>
<th><strong>Good Fit</strong></th>
<th><strong>Bad Fit</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Company is profitable</td>
<td>Unprofitable or unpredictable</td>
</tr>
<tr>
<td>Valued work force</td>
<td>Fewer than 20 employees</td>
</tr>
<tr>
<td>Partial sale desired</td>
<td>Crisis-mode</td>
</tr>
<tr>
<td>Phased sale desired</td>
<td>Strategic price necessary</td>
</tr>
<tr>
<td>Preserve legacy</td>
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Introduction to ESOPs

John Stone, CPC, QPA
Agenda

• **Overview**
• Lending to an ESOP
• How an ESOP works
• Repurchase Liability
• IRC Section 1042
• ESOP Advantages and Disadvantages
• Wrap-up
What Is an ESOP?

- Tax-qualified defined contribution retirement plan with two unique attributes:
  - Required to invest primarily in employer stock
  - May borrow money (leveraged ESOP)

- A versatile tool used to accomplish a wide range of financial and employee relations objectives
What Is Tax-qualified?

- Contributions are immediately tax-deductible to employer and no tax to employees until benefit is received

- Must meet IRC requirements regarding:
  - Coverage and non-discrimination
  - Limits placed on benefit to participants
  - Limit placed on deduction for contributions

- Assets held in trust
  - Employer and trustees take on fiduciary responsibilities
  - Trust is tax-exempt
Why Do Companies Choose An ESOP?

• Employee recruitment and retention
• Aligns employee and employer interests
• Create a market for closely held shares
  • Provided liquidity for shareholders
  • Fund a buy-out with pre-tax dollars
• Provide a business succession plan with little disruption of control
• Create a tax-exempt entity with an S-corporation
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- Overview
- **Lending to an ESOP**
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Lending to an ESOP

• **HOW AN ESOP LOAN DIFFERS FROM OTHER LOANS**

• **ESOP IS A QUALIFIED RETIREMENT PLAN** - A plan disqualification could have a negative impact on cash flows (i.e.: no more pre-tax contributions.)

• Lender will want to see that the borrower is working with an EXPERIENCED attorney, administrator, valuation firm and financial advisor.

• **Adequate PAYROLL ?**
How an ESOP Loan Differs From Other Types of Bank Loans (cont.)

- ESOP loans are typically “NON-PRODUCTIVE DEBT”
  (compared to a loan to finance the purchase of a building or piece of equipment - company adds an ASSET corresponding to DEBT)

- ESOP accounting treatment can create NEGATIVE EQUITY which can be a problem for many lenders

- Lender may require a pledge of ADDITIONAL COLLATERAL to ESOP loan (e.g. 1042 qualified replacement securities) or other collateral

- Seller Financing-Seller financing is common in 100% sales
How an ESOP Loan Differs From Other Types of Bank Loans (cont.)

• **ENHANCED CASH FLOW** in S or C Corp as a result of ESOP contribution – pre-tax expense that is used to repay ESOP loan

• **ENHANCED CASH FLOW** due to reduction or elimination of federal income tax in S Corp

• **THE OWNER MAYBE LEAVING.** Who will run the company?
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The Basic Non-Leveraged ESOP

Basic ESOP Funding Structure (an Example)

- Company
- ESOP Trust
- Purchase Shares At Current FMV
- Build Employee Equity Over Time
- Or New Issue Shares to Improve Cash Flow
- Shareholders
How Does a Leveraged ESOP Work?

Leveraged ESOP Transaction Structure (an Example)
How an ESOP Works

Release of Shares from Encumbrance

Encumbered

Allocated to Participants

ABC CO.
COMMON
STOCK
How an ESOP Works
Release of Shares from Encumbrance

Encumbered

Allocated to Participants
How an ESOP Works
Release of Shares from Encumbrance

Encumbered

Allocated to Participants
How an ESOP Works

Release of Shares from Encumbrance

- Lender
- Company
- ESOP Trust
  - $ Term Loan Repayment
  - $ ESOP Loan Repayment
  - $ Fully Tax Deductible Contribution

Participant Accounts

Year: 2 4 6 8 10 12 14 16 18 20

- Stock
ESOP Benefits for C-Corporations

Tax advantages for the corporation

• If leveraged, contributions up to 25% of pay can be deducted if used to pay down principal

• If leveraged, the deduction for contributions used to pay interest is unlimited

• Deduction limit is not shared with other plans
  • ESOP contributions can generate deductions up to 25% of pay (plus interest) and contributions to other plans (DC and DB) can be deducted up to 25% of pay
ESOP Benefits for C-Corporations

Tax advantages for the corporation (continued)
• Dividends paid to the ESOP may be deducted, if…
  • Paid in cash to participant or beneficiary
  • Reinvested (per participant’s election) in employer stock in the ESOP
  • Applied to the ESOP loan
  • Dividends must be reasonable
ESOP Benefits for S-Corporations

- Effective in 1998, ESOPs were authorized to become shareholders in Sub-chapter “S” corporations

- S-Corporations are pass-through entities

- Income tax is paid at the shareholder level

- An ESOP trust is a tax exempt entity

- Therefore, an S-Corporation ESOP is a tax exempt entity
Anti-Abuse Rules

• S Corporation ESOPs enjoy significant tax benefits

• Unscrupulous individuals promoted the so-called “ShamSOPs”

• Congress enacted IRC §409(p) to deal with abusive ESOP practices
Anti-Abuse Rules

• S Corporation ESOP “Anti-Abuse” rule
  • To avoid anti-abuse problems, ownership needs to be widespread
  
  • Cannot have “disqualified persons” owning 50% or more of the S Corporation stock

• Who is a “Disqualified Person”
  • Persons who own at least 10% of deemed-owned shares, or
  
  • Persons and their family members who own at least 20% of deemed-owned shares (note – the definition of family member for this purpose is very broad)
Anti-Abuse Rules

• Failure results in:
  • *Offending allocation taxed to disqualified person*
  • *50% excise tax on employer on the prohibited allocation*
  • *If a prohibited allocation occurs, the plan loses its ESOP status*
  • *Any exempt loan being repaid by the ESOP becomes a prohibited transaction*
  • *The plan becomes subject to the tax on Unrelated Business Taxable Income (UBTI)*
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IRC Section 1042

• Tax options for the selling shareholders
  • Pay tax on the gain at capital gains rate (currently 15%)
  • Defer tax on gain under IRC §1042
IRC Section 1042

- Owner of C Corporation wants to transition a majority or all of the company
- Establish an ESOP with a loan and sell stock to the ESOP
- Owner would normally pay tax on proceeds of sale (albeit at Capital Gains rate)
- But owner makes election under Code §1042
IRC Section 1042

- Seller invests proceeds in “Qualified Replacement Property”
  - Generally domestic stocks and bonds

- No tax paid on appreciation until QRP is sold

- If QRP held until death of seller, heirs receive step-up in basis
  - Strategy – use long-term debt instruments
ESOP Tax Deferred Rollover

- **Loan Company (C corporation)**
- **Lender**
- **ESOP Trust Shareholders**
- **Replacement Securities**
- **IRC SEC. 1042**

Diagram showing a flow of money from the lender to the loan company to the ESOP trust shareholders, with IRC SEC. 1042 related to the tax deferred rollover.
IRC Section 1042

• Seller must have owned stock for 3 years

• ESOP must own 30% of company after the sale

• 15 month window to buy QRP

• Downside – seller and family (and 25% owners) generally cannot participate in ESOP

• The seller has made millions on the sale of the company, and if she has the good sense to die before selling the QRP – she (and heirs) pay no tax on sale of company
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- **ESOP Advantages and Disadvantages**
- Wrap-up
ESOP Advantages

- Financing advantages
  - Principle and interest payments are tax-deductible
- Tax free rollover for seller
- Deferral of taxation for participants
- Larger contribution limits
- S Corp ESOP tax advantages
- Employee motivation
- Takeover protection
- Deductible dividends
ESOP Disadvantages

- Fiduciary LIABILITY
- Valuation issues
- Dilution of ownership
- Operating costs
- Cash flow issues
- Loss of control for owner
- Deduction limit on S Corps
- Employee impact if stock goes bad
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Who Should Consider an ESOP?

• Public companies
  • *Looking to align employee interests with corporate goals*
  • *Make dividends on ESOP-held stock deductible*
  • *Get stock in friendly hands*

• Closely-held companies
  • *Desire to reward employees who build the business*
  • *Want to develop internal succession plan*
  • *Owner wants phased retirement*
  • *Employee motivation (align goals)*
Attributes of a Good ESOP Prospect?

- Owner who is loyal to employees
- Good employer-employee communication
- Strong middle management
- Solid financial outlook
- Family business where next generation not interested in ownership
Welcome to Hamill Manufacturing

“We are a Veteran Owned Business”

www.hamillmfg.com
And now we’re an ESOP company!
(49% employee owned as of July 31, 2012)

How did we get there?
Background

- Hamill was founded in 1952 by Bill Kelly in Monroeville, PA.
- Jeff Kelly became President in 1996 and purchased it from Bill in 2002.
- For a long time, it was obvious that the company was not going to get to a third generation of the Kelly family.
- Jeff consider his options: Either sell to a third party or sell it to the employees utilizing an Employee Stock Ownership Plan (ESOP).
- As early as 2001 Jeff started to think about an ESOP and attended a seminar conducted by the NCEO in Pittsburgh.
Factors Considered in Choosing the ESOP route

- Jeff felt that the employees had been the primary reason for Hamill’s success. He felt they deserved a chance to own the company some day.

- He was concerned that selling to a third party could lead to the ultimate demise of the company. Many so called strategic buyers turn out not to be so – they are hard to screen.

- Sub Chapter S ESOP’s have considerable tax advantages for the ESOP that can help make them successful – they pay no federal income tax!

- Owners care more about and are more deeply involved in their business than the average employee.
Factors – con’t

- Hamill had a reasonably strong management team, most of whom were under the age of 50.

- Hamill’s President, John Dalrymple, had demonstrated significant leadership ability and Jeff felt that John could lead the company after his own departure.

- Hamill had no debt and had come off 3 very profitable years; Jeff thought that the company’s value would be significant.

- Jeff felt everything was in place to have a successful transition to an ESOP. He just had to make sure that it wasn’t wishful thinking, but that a decision to pursue an ESOP could withstand serious, professional scrutiny.

- He was also determined to do a deal while the 15% capital gains tax rate was in effect.
In April 2009 Jeff and his wife, Sharon, attended the NCEO ESOP Conference in Portland, Oregon.

While there they met Martin Staubus of the Beyster Institute out of the U.of Cal. at San Diego. The Beyster Institute was a co-sponsor of the conference.

Eventually Hamill contracted with the Institute to do a feasibility study to determine if Hamill was a good candidate for an ESOP.

By September, the study was completed and it indicated that Hamill fit the profile of a company that could have a successful ESOP implementation. Jeff decided to go with a 25% ESOP.
Beyster appointed Steve Fischer, a retired ESOP attorney to “quarterback” the process.

Steve made recommendations for the evaluation firm to establish Hamill’s value, the law firm to put the deal together, the record keeping firm that would administer the ESOP once established, and a consulting firm to help educate the employees about ESOP’s.

He then worked closely with Hamill’s accounting firm and Hamill’s controller to clean up the balance sheet by spinning the real estate company (Numis Corporation) off as a separate company that would not be part of the ESOP. Jeff wanted to maintain control of the real estate independently.
Process – cont’d

- Steve worked with Hamill’s management and the valuation firm to develop a multi-year financial pro forma that formed the basis of the valuation of the company.

- He then helped Hamill to line up the financing to do the transaction.

- Hamill’s long standing bank was coming out of the 2008 banking crisis a little gun shy about doing a large transaction with which it had little experience.

- After considerable hand holding and getting a competitive quote from another bank, Hamill secured a commitment for the financing of the leveraged ESOP deal.

- Hamill closed on the ESOP deal in January 2010.
How’s it going

- So far, very well. The post transaction per share value increased 13% from January 2010 to December 2010.
- At the end of 2011 the year-over-year share value had increased by another 17% - a net 32% increase in 2 years.
- It’s going so well we decided to increase the ESOP’s ownership from 25% to 49%.
- The plan is to become a 100% ESOP when Jeff reaches age 70 in 2017.
- The ESOP has accumulated a significant amount of cash due to equitable tax distributions given to the owners to make estimated payments. The ESOP retains the money because it doesn’t pay taxes.
What we’ve learned

- Use ESOP specific professional help to manage all stages of ESOP implementation. It will be costly, but it will be worth the expense.
- To develop an ownership culture among the new owners (employees) is critical. It takes continuous work.
- There are abundant resources in the ESOP community to help make yours successful – use them!
- Engage your company’s natural leaders to lead in the development of the ownership culture. Send them to conferences, other ESOP companies – help them see what a successful ESOP should look like.
Questions?

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