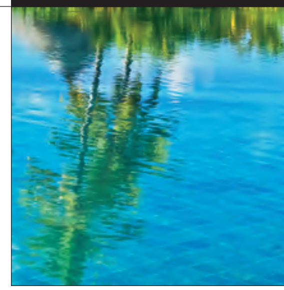

Ownership Transitions: ESOPs Compared to Other Strategies

When choosing how to structure the sale of a closely held business, a variety of considerations should be weighed, including tax ramifications.

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Much has been written about the baby boom generation (those born in 1946 through 1964) and its influence on the culture and economy of the U.S.[1] The impact of the 78 million children born in America during this generation cannot be overstated. Boomers tripled the number of college-educated individuals in the workforce. Many of those boomers who could not find traditional jobs with large companies or who had an entrepreneurial vision started their own companies. In the pre-boomer decades, new business formations grew from 250,000 per year to approximately 300,000. Then the 30-something boomers stepped up, and between 1975 and 1986, the formation of new businesses increased from the pre-boomer rate of 300,000 per year to over 500,000 annually. Many of those baby boomer business owners are now looking to cash-in on their life's work.

Four liquidity strategies are generally available to business owners:

1. Sell to an insider.
2. Sell to an outsider.
3. "Die with one's boots on."
4. Sell to an employee stock ownership plan (ESOP).

Each of these strategies has its advantages and disadvantages; often none of them is a perfect solution. This article examines the pros and cons of each strategy.

Sell to an insider

"Insiders" refer to a company's current employees and to the current owner's family members. In many closely held companies, family members (sons, daughters, brothers, sisters, etc.) and employees who are most important to the company's success are the insiders who will take over the business when the owner leaves. Insiders almost never have the cash or credit that is needed to purchase the company. Therefore, if they are to purchase the company, the acquisition must be "boot strapped." This is where the company pays the insiders cash bonuses that they use for the purchase. Unfortunately, the tax-bite involved in this process makes it very financially inefficient.

The figures below assume that an insider wants to purchase stock valued at $10 million from a current owner. The insider will either borrow $10 million from a bank with the company as a guarantor, or the current owner will sell to the insider for a $10 million promissory note guaranteed by the company. In either case, the company will pay a bonus to the insider equal to the cash he or she needs each year to service the debt. The company cash flow required to provide the insider with $10 million net after-tax to pay the selling shareholder is as follows:

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- Total bonuses paid: $15,873,016.
- Taxes paid on bonuses: $5,873,016 (at 37%).
- Net remaining: $10 million.

Because the insider needs $10 million to service the debt and the bonuses he or she receives are taxable to the insider, the company must pay bonuses of $15,873,016 in order for the insider to net $10 million. Therefore, this structure requires 59% more company cash flow due to the tax bite. The computation is as follows: $10,000,000 ÷ .63 = $15,873,016, with .63 being the after-tax amount kept by someone in the 37% tax bracket.

Using an ESOP as the purchaser "on behalf of" the insider saves $5,873,016. This is the result of two things:

1. The company receives a tax deduction for the ESOP contribution used to service the acquisition debt.
2. The insider is not taxed on the $10 million the company contributes to the ESOP.

This 37% tax savings (which represents a 59% cash flow for the company when it "grosses up" the tax on the bonus) makes an ESOP a much more financially efficient strategy than a traditional sale to an insider.

The calculations in the example above and throughout this article assume the top marginal individual rate under the 2017 Tax Cuts and Jobs Act (TCJA). A taxpayer's "effective" tax rate will be less than the 37% used here. Also note that these examples consider the impact of federal taxes only. The impact of state taxes, which can be substantial, are not considered. Business owners should apply their state and federal "effective" tax rate to the calculations used in each of the examples illustrated in this article.

Sell to an outsider

"Outsider" refers to several types of potential buyers, including: competitors, private equity groups (PEGs), suppliers, individual investors, etc. There are many advantages to selling to an outsider but these advantages are not as attractive as they may first appear. In fact, according to one source, 75% of people who sold their company to an outsider later regretted their decision.[2] Listed below are the major benefits of selling to an outsider with some of the caveats business owners should consider.

Cash out and move on. Many business owners assume that when they sell their company they will receive cash at closing and will be able to retire the next day. That is almost never the case. Buyers want to make sure that the company they are purchasing will continue to grow and prosper after closing. In order to protect themselves from a negative surprise, purchasers often structure sales agreements containing some or all of the following provisions:

- Earn-outs.
- Escrows/holdbacks.
- Consulting/employment agreements.
- Covenants not to compete.

Earn-outs are designed to protect a purchaser from overpaying for the company it is buying. Purchasers are almost always buying a company's future cash flow. If a purchaser expects a company's future cash flow to be $2 million per year, the purchaser might agree to pay $10 million for the company. If the company's cash flow drops to $1 million per year immediately after the sale is consummated, the purchaser will have paid two times the cash flow multiple it anticipated ($10 million purchase price divided by the $1 million cash flow results in a valuation multiple of ten times cash flow instead of the five times cash flow multiple the purchaser intended to pay).

A purchaser could have protected against overpaying in the above example by including an earn-out provision in the purchase agreement. Instead of agreeing to pay five times cash flow at closing, the purchase agreement could have structured payments as follows:

1. The purchaser agrees to pay 2.5 times the three previous years' average annual cash flow at closing. Assuming annual cash flow of $2 million over the previous three years, the purchaser will pay $5 million at closing.
2. The purchase agreement in this example may state that the purchaser will make payments on the first two anniversaries of the closing of the sale ("earn-out payments"). The purchase agreement may further provide that on each anniversary, if the previous year's cash flow is in the range of $1 million to $2 million, the earn-out payment will be 2.5 times the amount in excess of $1 million.

The earn-out formula under step two would then be: (cash flow – $1 million) × 2.5. The purchase agreement may further state that if cash flows exceed $2 million, the earn-out payment will be calculated as follows: $2,500,000 + (cash flow – $2 million) × 1.5. The $2 million would be the earn-out payment on the first $2 million of cash flow. This second payment at (1.5x) would generally be referred to as a "bonus" earn-out payment. If cash

[1] See, e.g., Dini, *Your Exit Map: Navigating the Boomer Bust* (Gardendale Press, 2017).

[2] According to the Exit Planning Institute's "Readiness Survey" (2013), 75% of business owners "profoundly regretted" selling their business 12 months after the transaction closed.

flow is less than $1 million, no earn-out payments would be made. Several examples are shown below.

If the company continues to have $2 million of cash flow following the sale, the sellers would receive the following payments:

- Closing payment: 2.5 × $2,000,000 = $5,000,000.
- 1st anniversary: ($2,000,000 – $1,000,000) × 2.5 = $2,500,000.
- 2nd anniversary: ($2,000,000 – $1,000,000) × 2.5 = $2,500,000.
- Total purchase price = $10,000,000.
- Purchase price/Average annual cash flow = 5.

If the company has cash flow of $1.5 million the first year following the closing of the sale and $1.2 million the second year following closing, the sellers would receive the following payments:

- Closing payment: 2.5 × $2,000,000 = $5,000,000.
- 1st anniversary: ($1,500,000 – $1,000,000) × 2.5 = $1,250,000.
- 2nd anniversary: ($1,200,000 – $1,000,000) × 2.5 = $500,000.
- Total purchase price = $6,750,000.
- Purchase price/Average annual cash flow = 5.

In this case, the purchaser would have successfully protected itself using an earn-out provision. Cash flow over the two years following the sale averaged $1.35 million. The purchaser paid $6.75 million for the company, resulting in it paying a multiple of five times post-sale average annual cash flow ($6,750,000 ÷ $1,350,000 = 5).

If the company's cash flow decreased to $1 million or less after the sale, the purchaser would not make any payments following the closing payment of $5 million. If the company's cash flow increased to $3 million per year for the two years following closing, the seller would receive the following payments:

- Closing payment: 2.5 × $2,000,000 = $5,000,000.
- 1st anniversary: $2,500,000 + ($3,000,000 – $2,000,000) × 1.5 = $4,000,000.
- 2nd anniversary: (same as 1st above) = $4,000,000.
- Total purchase price = $13,000,000.
- Purchase price/Average annual cash flow = 4.33.

In this case, the purchaser paid $3 million more than it would have paid without the earn-out but its purchase price multiple would be less than the five times cash flow it was willing to pay for the company's future cash flow. The sellers also would have benefited by receiving the additional $3 million. This earn-out formula with a bonus payment for "excess cash flow" was a good deal for both parties.

There are many ways to structure earn-outs, and this is just one example. The point is not that every earn-out will be structured as illustrated above. Rather the point is that purchasers are very careful not to overpay for a company and, as a result, sales agreements often contain an earn-out, particularly when a purchase price cannot be agreed on. Therefore, in a sale to an outsider, the seller probably will not be able to cash-out and move on immediately following the sale.

Sales agreements almost always include "representation and warranties" in which the seller states certain facts about the condition of the business. If these facts later turn out not to be accurate, the purchaser may have a financial claim against the seller. To streamline collecting on this financial claim and avoid having to bring suit against the seller for the amount claimed, a portion of the sales proceeds may be placed in escrow at closing. A typical escrow amount is 10%. A typical escrow period is two years.

In the scenario described above, an escrow arrangement might affect the timing of payments as follows:

- The seller would receive $1.5 million at closing instead of $2.5 million.
- $1 million would be placed in escrow by the purchaser.
- The seller would be paid the $1 million escrow amount in two years when the escrow period expires (if the purchaser does not make a claim against the escrow).

Escrows present an additional hurdle to sellers being able to cash out and move on immediately following a sale.

Sales agreements generally include provisions preventing the seller from competing against the purchaser or pirating the company's customers. In addition, sales agreements often contain provisions requiring the seller to work for the company for one to three years following the sale. This prevents the seller from retiring immediately after the sale is closed.

Sometimes people say that they do not want to do an ESOP because it will not allow them to exit their company immediately following the sale. While this is true, the same can be said about a sale to an outsider. Owners of closely held companies are almost never able to sell their company and walk away regardless of whether they sell to an insider, an outsider, or an ESOP.

Taxes. Most business owners know that if they sell stock that they have owned for at least one year, they will pay tax at long-term capital gains tax rates rather than at ordinary income tax rates. Currently, the maximum federal long-term capital gains tax rate is 20% (plus a 3.8% Medicare surtax), and the maximum ordinary income tax rate is 37%. Therefore, being able to pay tax at the capital gains tax rate results in a savings of 35.7% ((.37 – (.20 + .038)) / .37).

According to one source, 75% of people who sold their company to an outsider later regretted their decision.

Many business owners assume that when they sell their company, they will pay long-term capital gains tax on the sales proceeds and will enjoy the tax savings described above. However, this often is not the case. The taxation of proceeds from the sale of a company depends on several factors. The principal factors are whether the sale is structured as a stock sale or an asset sale and whether the company is a C corporation or a "pass-through" entity such as an S corporation or limited liability company (LLC).

If the sale is structured as a sale of stock, the tax consequences will be the same regardless of whether the company is a C corporation or an S corporation: The sellers will pay long-term capital gains tax on the sales proceeds they receive in excess of their tax basis. Obviously, this is the best possible result for the sellers. However, purchasers almost always prefer purchasing a company's assets rather than its stock.

The first reason acquirers prefer purchasing assets, is because when doing so they assume only liabilities directly associated with those assets—such as mortgages. If an acquirer purchases a company's stock, the acquirer assumes all of the company's liabilities—known and unknown. This includes errors and omissions, product liability, environmental, etc. In a transaction of less than $100 million, the cost of due diligence to assure that there are no such liabilities is not justified by the size of the deal. Therefore, most potential acquirers will insist on purchasing assets.

The second reason acquirers prefer purchasing assets is that doing so increases the acquirer's tax benefits. This tax advantage is best illustrated by an example. Assume that an acquirer pays the seller $10 million for company stock. The assets of the purchased company will retain the same tax basis they had prior to the acquisition. Also assume that the total tax basis of all the assets was $3 million. The acquirer has paid $10 million, but has a tax basis in the company's assets for depreciation purposes of only $3 million. If the purchaser had purchased the company's assets, the tax basis of those assets would have been "stepped-up" (i.e., increased to the amount paid for each asset). This could increase the acquirer's future tax benefits on the depreciation of these assets dramatically. (A stock sale coupled with a Section 338 election may achieve virtually the same result, depending on the circumstances).

If the sale is structured as an asset sale, the tax consequences to the seller will depend on whether the company is a C corporation or a pass-through entity.

If it is a C corporation, the tax consequences of an asset sale can be confiscatory. In an asset purchase, the sales agreement is between the purchaser and the company—not the purchaser and the shareholders. If the purchaser pays

EXHIBIT 1
Tax Impact of an Asset Sale

	Basis	FMV	Gain	Tax
Accounts receivable	$ 0	$ 1,000,000	$1,000,000[1]	$ 370,000
Inventory	1,000,000	2,000,000	1,000,000[1]	370,000
Warehouse	1,500,000	4,500,000	3,000,000[2]	714,000
Land	500,000	500,000	0	$0
Good will	0	2,000,000	2,000,000[1]	740,000
Total	$3,000,000	$10,000,000	$7,000,000	$2,194,000

[1] Indicates an asset whose gain is taxed as ordinary income.
[2] Indicates an asset whose gain is taxed as a capital gain.

$10 million for the company's assets, the payment is made to the company, not the shareholders.

C corporations (unlike their shareholders) pay tax on the sale of assets at ordinary income tax rates (potentially 21%) rather than capital gains rates. After a C corporation has received the sales proceeds and paid the tax associated with the sale, it then distributes the net amount to its shareholders who pay the 20% (plus a Medicare surtax of 3.8%) rate on "qualified dividends." This results in a double layer of tax. The total tax liability on a C corporation asset sale followed by a shareholder distribution is shown below:

1. Asset sales proceeds: $10,000,000.
2. Assets' tax basis: $3,000,000.
3. Taxable gain: $7,000,000.
4. C corporation tax (21%): $1,470,000.
5. Net distribution to shareholders: $8,530,000.
6. Shareholder tax (20% + 3.8%): $2,030,140.
7. Net sales proceeds: $6,499,860.

If the company is a pass-through entity (i.e., S corporation, partnership, or LLC), an asset sale results in far less tax. Because pass-through entities do not pay federal tax, there is only one, rather than two, levels of taxation. Whether the tax will be at ordinary income tax rates or at capital gains tax rates will depend on the asset being sold.

Returning to the earlier example of a $10 million company and here assuming it owns assets listed below, the tax impact of an asset sale is as shown in Exhibit 1. The effective tax rate on the sales proceeds is 21.94% ($2,194,000 tax liability divided by the $10,000,000 sales proceeds). The effective tax rate on the "taxable gain" is 31.3% ($2,194,000 tax liability divided by the $7,000,000 taxable gain).

A business owner who receives an offer from an outsider to purchase his or her company should ask an accountant to calculate the taxes that will be due on the sales proceeds and the after-tax amount the owner will be able to "bank" after the sale. The business owner may want to compare the net after-tax proceeds he or she would receive from a sale to an outsider versus the amount that would be received from a sale to an ESOP.

When an owner sells to an ESOP, he or she almost always sells stock (more than 99% of the time). If the company is an S corporation at the time of the sale, the owner will pay tax at capital gains tax rates. If the company is a C corporation, the owner may be able to defer tax, perhaps even permanently. In either event, a sale to an ESOP will, in most situations, result in substantial tax savings for the selling shareholders.

Maximize price. Many business owners assume that they will be paid more if they sell to an outsider than if they sell to an ESOP. In most cases, this is not true.

In general, there are two types of buyers:

1. *Financial buyers.* A financial buyer purchases a company for its future cash flow and pays the seller a multiple of cash flow based on prevailing market conditions. For example, a financial buyer, such as a private equity group (PEG) or a private investor may pay five times the company's expected future cash flow, generally defined as earnings before interest, taxes, depreciation, and amortization (EBITDA). An ESOP is not allowed to pay more than the maximum amount a financial buyer would pay—but an ESOP can pay as much as any other financial buyer.
2. *Strategic buyers.* A strategic buyer, such as a competitor or supplier, may pay more than a financial buyer because of

potential cost savings, new revenue opportunities, and other synergies. Business owners may receive a higher price from a strategic buyer than they could receive from an ESOP or other financial buyer.

Therefore, it is not entirely true that an ESOP cannot pay as much as other buyers. An ESOP can pay as much as other financial buyers, which may be less than what a strategic buyer would pay.

Die with one's boots on

Some business owners say they want to "die with their boots on." Often these individuals have their work and much of their identity and self-worth tied to their involvement with their company. It is not unusual to see these business owners work well into their 70s. Several risks are inherent in a "die with one's boots on" strategy.

During the economic turmoil that engulfed the world beginning in the later part of 2007, many business owners who had been highly successful for decades saw their companies suffer a dramatic downturn or even fail. Companies involved in manufacturing and construction were particularly hard hit.

Consider a 70-year-old business owner who in July 2007 had a construction or manufacturing company worth $10 million, 401(k) and personal investments worth $2 million, and a home and personal property worth $1 million. Eighteen months later, his home and 401(k) could have dropped in value 20%-40%, and his construction or manufacturing company could have been liquidated, with the proceeds used to pay off its debts.

Most people know someone who experienced this type of financial meltdown. The lesson to be learned is that diversification and asset allocation are critical to protecting financial security. What would have happened to this business owner if he had sold 50% of his company to an ESOP for $5 million prior to the economic downturn and invested that money very conservatively? He would have lost some of his net worth as a result of the recession, but he would have been much more financially secure. Selling to an ESOP would have enabled him to have enhanced his financial security while allowing him to continue to work for and to control his company for as long as he chose to do so.

Another risk inherent in a "die with one's boots on" strategy is the risk of disability or pre-mature death. In many small to midsize companies, if the owner becomes disabled or dies, the company may have to be sold for a fraction of its value. Owners can protect themselves from this risk with buy-sell agreements and with disability and life insurance, but ESOPs also can play a valuable role.

The final risk inherent in a "die with one's boots on" strategy is the potential loss of key employees. Here is a common situation: A company with a single owner who is age 55 has a 30-year-old key employee who the owner thinks will be able to run the company after he is gone. This presents a dilemma: If the owner plans to work his entire life, how can he keep the key employee "engaged" for the next 20-plus years?

Entrepreneurs generally are inpatient by nature. Therefore, a young key employee who truly will be able to run the company someday likely will not be satisfied with the owner telling him or her that the employee can purchase the company from the owner's estate after the owner dies. Any successor who is worth having is going to be too impatient to accept this type of amorphous planning. Instead, the successor is going to want to see a more concrete planning structure in place, and he or she is going to want to have some significant role and decision-making authority before the time he or she is 55 (as in the example, the key employee is 30 and the owner's life expectancy is 25 years).

Sell to an ESOP

A sale to an ESOP offers many advantages compared to traditional strategies.[3] An ESOP is nearly always structured as a stock sale which means that the federal tax rate on the sale proceeds will not exceed 23.8%. If the stock being sold is C corporation stock, the sellers could make an election under Section 1042 that will result in taxation of sales proceeds being deferred and potentially eliminated entirely.

If the subject company is an S corporation whose sole shareholder after the sale is the ESOP, the company could be totally exempt from paying federal and state income taxes.

A sale to an ESOP also offers a company the opportunity to remain independent and perpetuate its current culture.

Conclusion

No single ownership and liquidity strategy works best in every situation, and often no strategy is perfect for meeting all of an owner's goals. In elaborating on some of the problems inherent in the three traditional strategies—sell to an insider, sell to an outsider, and "die with one's boots on"—the purpose of this article is not to discredit any of the strategies. Rather, the intent is to provide a balanced comparison of the advantages and disadvantages of these strategies compared to selling to an ESOP. ■

[3] For a detailed discussion of ESOPs and their many benefits see, Finnell and Holmes, "Consider ESOPs as an Estate Plan Component for Business Owners," 41 ETPL 3 (September 2014).