

ESOPs: An opportunity

Valuation is key to avoiding problems when creating an ESOP **Interviewed by Meredith McKenzie**

With the baby boomer generation nearing retirement age, many business owners are researching different options of what to do when they do step down.

One option that has become more popular recently is the employee stock ownership plan (ESOP). Especially in today's market, where sellers are pickier and mergers and acquisitions are tougher, ESOPs have become unique alternatives.

Not all companies are suitable for ESOPs, so you need to do some assessment and planning ahead of time to determine if this is the best option for you. You also need to make sure you receive an appropriate valuation.

"An ESOP is not allowed to pay more than fair market value for the shares it buys," says Brian Bornino, CPA/ABV, CFA, CBA, the director of valuation services at GBQ Consulting LLC. "Overvaluation is the biggest risk. If the ESOP pays too much, it is considered a 'prohibited transaction' under ERISA and the ESOP could get unwound and incur penalties and fines."

Smart Business spoke with Bornino about how to make sure an ESOP is valued properly and the business and tax advantages of forming an ESOP.

What are some major problems or risks that companies can run into when creating ESOPs?

You need to do planning ahead of time to determine if an ESOP meets your business objectives and is a good fit. You don't want to put an ESOP in a company where it's not a good fit. The planning upfront will help you determine if it makes sense or not. Oftentimes hiring an ESOP advisor to perform a 'feasibility analysis' is the first step.

You also need to avoid overvaluation of the company, which can be hard since you want to maximize the value. The important thing is to have the company valued at fair market value, because the ESOP can't overpay. The ESOP won't work if you're not willing to accept that number or lower.

How can you make sure you are getting a correct ESOP valuation?

It's important to work with a valuation firm that specializes in ESOPs. There are a number of factors that valuation people will look at, including forward-looking financial analyses that model out what the company will look like with an ESOP.

The buyer is the trustee, who typically hires



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the valuation firm. The trustee is appointed as a fiduciary to represent the ESOP in the transaction, although it will rely upon the valuation firm's opinion and expertise. The trustee will feel comfortable if the valuation firm has significant valuation and ESOP experience and a strong reputation in the ESOP community. The trustee and the valuation firm must gain a good handle on fair market value since it is the maximum that an ESOP will pay. If that price doesn't jive with what the seller is looking for, you move onto another option.

On the other hand, there are a lot of tax advantages that an ESOP transaction can offer that increases the business owner's net proceeds and often bridges the gap between seller expectations and fair market value.

What are some of the tax and financial advantages that you have by forming an ESOP?

First is capital gains treatment on the sale. Since an ESOP transaction is a stock sale, the seller's going to pay capital gains tax instead of ordinary income tax on the gain. Better yet, the seller may be eligible to defer that tax indefinitely if the requirements of a 'Section 1042 rollover' are met. Either way can be a big advantage relative to an asset sale.

If the seller is willing to finance the transaction itself instead of going to the bank and borrowing money, the seller has the oppor-

tunity to earn a fair interest rate on the loan it gives to the ESOP to buy shares. In these tough times, earning some fair interest rate, such as 8 or 10 percent, may be attractive. You can 'lock in' that rate rather than gambling in the stock market.

Depending on the transaction structure, it may be possible for the selling shareholder to stay and participate in the ESOP, and have some shares allocated to him or her. Even though they're selling the business, they can actually accumulate shares in the plan, and cash those shares in for fair market value down the road.

A key advantage of ESOPs is that a business owner can sell virtually any percentage of his or her ownership — they don't have to sell it in one big piece, but in chunks. Many business owners prefer to sell 30 to 49 percent, thus maintaining voting control of the company. Perhaps the most compelling benefit of an ESOP is that once a company is an ESOP, assuming it is an S corporation, the portion of company that the ESOP owns is exempt from income tax. The shareholder is the ESOP, which is a tax-exempt trust. If you can achieve 100 percent ownership by the ESOP in an S corporation, you can effectively create an income tax-free entity. That's one of the reasons ESOPs typically outperform non-ESOP companies, because they're keeping every dollar they make, instead of sending it off to the government or making distributions to shareholders to cover the personal tax associated with S corporation income. There's no personal tax to cover in ESOPs.

Why do ESOPs make sense?

You can preserve your company, your legacy, and not have to worry about employees or jobs going elsewhere if the company is sold. An ESOP is a good fit if you want to sell to your employees. You need to have a positive, participative type of culture and a strong management team to get the benefits of an ESOP.

An ESOP can be a great succession planning option, because you can sell the company in pieces, instead of 100 percent at once. This allows you to have more control than if you sold it to a third party.

Since employees in ESOPs are owners, they often act like owners and do things to improve the company and its value. Companies with a positive employee-oriented culture are often good candidates for an ESOP. <<

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