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Should Family Businesses Have Employee Ownership Plans?

Corey Rosen (National Center for Employee Ownership)

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Like almost all family businesses, Commercial Casework in Hayward, California had to plan for when family owners would want to sell. The company, with about 100 employees, is one of the San Francisco Bay Area's premier casework companies. Formed in 1976 by the four Palmer brothers, the company set up a pioneering open-book management system that helped it prosper.

By the 1990s, CEO Bill Palmer started looking at ways to ensure business continuity. They could have sold to another company or maybe even a private equity firm, but Bill's son Nick, now the CEO, said Bill opted for an Employee Stock Ownership Plan (ESOP), a tax-favored way to transition ownership to the company's employees. Nick said the choice was the only viable option.

"Selling the business to private equity would strip Commercial Casework of what it was known for," Nick said. "Selling to the employees who had no cash wasn't viable, and closing up shop didn't sound good." An ESOP just made sense.

The company was sold gradually to the ESOP, and now is 100% ESOP owned. Nick says that being an ESOP allows the company to keep its culture and gives all employees a true stake in the game. "Everyone wants employees to 'think like owners,' he said. "With an ESOP, you *are* an owner, no pretending needed." Nick knows that in many family businesses, he could have become the sole owner, but he's happy that the choice was an ESOP. The company has prospered—most employee accounts in the ESOP are well into six figures (and often high six figures)—and Nick has shared in this prosperity.

Nick biggest piece of advice to any family-owned business is: "If you are thinking of forming an ESOP, start as early as possible. You need to plan early so that you can start the ownership transition well before retirement."

Nick understands that many people worry about installation costs, but "I always push back and ask them why would you rather send hundreds of thousands of dollars to the government when instead you can fund a retirement plan for your employees that may ultimately cost you less and be a far larger benefit to the employees." And indeed it has been a great benefit—those who have stuck around with the company (quite a few, given its low turnover) have hundreds of thousands of dollars in their retirement accounts.

While most ESOPs end up owning 100% of the company, many family-owned businesses keep some of the ownership in the family and some in the ESOP. That is the case for New York-based Stewart's Shops, a chain of more than 350 convenience stores with more than 2,850 employee partners. Stewarts makes its own ice cream from its own dairies (named the best ice cream in the country by the World Dairy Expo). The Drake family, now in its third generation, owns 60% of the company, but found an ESOP to be the ideal way to share the rewards of growth with its partner employees and provide liquidity for family owners. The ESOP owns 40% of the company, and has provided employees with a substantial benefit. In 2020, for instance, employee accounts grew by 20%, and employees got contributions to the plan worth 19% of pay. In fact, Stewart's has over 100 millionaire ESOP participants. Perhaps that is part of why Stewart's is consistently named one of the best places to work in the region.

There are about 6,500 ESOPs in the U.S., with over 90% of them in closely held companies. ESOPs are in place at companies with as few as 20 or so employees and at some of the nation's largest companies. There are 100 majority-ESOP owned companies with over 1,500 employees, including Publix (225,000 employees) and seven of the largest 15 engineering companies.

An Attractive Option for Family Firms

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ESOPs can be an attractive option for family-owned businesses, especially those looking for a complete business transition, like Commercial Casework, or as a partial liquidity option, like Stewart's. Family members can still run the company, even if the company becomes 100% employee owned. The reason for this is that ESOP law makes the trustee. The board appoints the trustee. In practice, trustees do not want to get involved in company operations but focus instead on making sure the valuation is done properly. Because of the special tax advantages of an ESOP, family heirs to the sale may end up with substantially more of the proceeds, and, if there are charitable interests, they can get more too.

Congress likes ESOPs, and has provided substantial incentives for companies and their owners to sell to them. The track record of ESOPs backs up that support. ESOP companies grow about 2.5% per year faster than would have been expected absent an ESOP; lay people off at one-third or less the rate of other companies; have much lower voluntary turnover; and provide employees with a retirement benefit that is about 2.2 times that of typical 401(k) plans (although most ESOP companies have those in addition to the ESOP as well.)

The secret sauce of ESOPs is that the plans are funded by the future tax-deductible profits the employees themselves help generate. Employees do not buy the shares. It is not unlike any leveraged buyout, except that in an ESOP, the employees, not some distant investor or company, become the owners.

But ESOPs are not right for every company. They generally only work for companies of at least 20 or so employees that are profitable enough to pay the costs of setting up the plan ($100,000 to $500,000 usually) and have enough money left over to buy back shares and still run the business in a sustainable way. While there is some flexibility in the rules for how stock is allocated, there are rules, and some owners might not be comfortable with them. The rules (discussed below) do not allow companies to pick and choose who is in the plan, for instance, But many business owners are told that ESOPs just won't work for them when, in fact, they may be a very good choice. This article can help you make the decision.

ESOP Tax Incentives

ESOPs have been given a lot of tax benefits. Owners of C corporations (or companies who convert to C) can defer taxation on proceeds on the gain from the sale to the ESOP by reinvesting in the stocks and bonds of other domestic companies. If the company stays S, the owner does pay capital gains tax on the sale, but reaps all the other benefits of selling to an ESOP. The most important of these is that for C or S corporations, the owner's shares are bought in tax-deductible dollars, either from company contributions or plan borrowings. Say that instead of an ESOP, you do a standard stock redemption to buy a $5 million company. The company will have to earn about $7.5 million (depending on its tax rate) to have $5 million left over because the redemption is not deductible as in an ESOP. Or say instead you want to sell to a group of managers—they would have to pay taxes first too. But an ESOP is all pre-tax.

In a S corporation ESOP, the portion of income attributable to an ESOP is not taxable. So a 30% ESOP pays no tax on 30% of the profits; 100% ESOPs pay no tax at all. That is not a loophole—it is the law. S corporations do have to make pro-rata allocations of any distributions to all shareholders relative to their ownership share, so if a company makes distributions, as would normally be done to allow owners to pay their taxes on their share of income, the ESOP gets a distribution too. But that money, which would have otherwise just been paid to the IRS by the owner, can now be used to buy more shares from other owners (because the ESOP pays no tax).

The sale can be all at once or gradual, for as little or as much of the stock as desired. For the employees, no contributions are required to purchase the owner's shares. The owner can stay with the business in whatever capacity is desired. The plan is governed by a trustee who votes the shares, but the board appoints the trustee, so changes in corporate control are usually nominal unless the plan is set up by the company to give employees more input at this level.

The simplest way to use an ESOP to transfer ownership is to have the company make tax-deductible cash contributions to the ESOP trust, which the trust then uses to gradually purchase the owner's shares. Alternatively, the owner can have the ESOP borrow the funds needed to buy the shares. In this way, larger amounts of stock can be purchased all at once, up to 100% of the equity. The loan can be from a bank and/or seller notes. The seller note interest rate is usually priced a few points above what a bank loan would charge.

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If the company is a C corporation and the owner has held the shares for at least three years, once the ESOP owns 30% of the company's shares, the owner can reinvest the gains in the securities of other U.S. companies (other than real estate trusts, mutual funds, and other passive investments) within 12 months after or three months before the sale. No taxes are due until the replacement securities are sold. If held to death, no capital gains tax is due. These special rules mean family members end up with more than if the company were sold to another buyer. If some of the securities are sold, tax is due only on a prorated basis. The replacement securities can also be donated at full pre-tax value to a charity, yielding more for the charity and a bigger deduction for the owner.

How the Price the Selling Owner Receives Is Determined

The price the ESOP will pay for the shares, as well as any other purchases by the plan, must be determined at least annually by an outside, independent appraiser. The appraiser is assessing what a financial buyer would pay, one who would operate the business as a stand-alone entity. A strategic buyer, such as a competitor, by contrast, might pay an additional premium because when the target company is acquired, there are perceived operational synergies that make the target more profitable to the buyer than it would be as a stand-alone entity. The ESOP cannot match this price because it cannot generate these synergies. Sales to synergistic buyers do trigger capital gains taxes, however, and often come with numerous contingencies. Note that selling to another buyer also comes with very high transaction costs, often including a success fee of 2.5% to 5% for a business broker or M&A advisor. ESOP fees, though high, tend to be lower than fees for other sales.

How Employees Get Stock

ESOPs are much like other tax-qualified retirement plans. All employees who have worked at least 1,000 hours in a plan year must be included. They receive allocations of shares in the ESOP based on relative pay or a more level formula. If there is an ESOP loan, the shares are allocated each year based on the percentage of the loan that is repaid that year. The allocations are subject to vesting for as long as six years. Employees do not receive a distribution of shares until they terminate, and then the distribution can be delayed for five years if for reasons other than death, retirement, or disability. The plan is governed by a trustee appointed by the board; employees have very limited required voting rights (they do not have to elect the board, for instance), although companies may provide additional rights.

Making the Decision

All of this may sound appealing, but it is not feasible for every company. Several factors must, at a minimum, be present:

1. *The company is making enough money to buy out an owner.* The company must be generating enough cash to buy the shares, conduct its normal business, and make necessary reinvestments.
2. *If the company is borrowing to buy the shares, its existing debt must not prevent it from taking out an adequate loan.* Similarly, the company must not have bonding covenants or other agreements that prohibit it from taking on additional debt.
3. *The seller(s) must be willing to sell their shares at fair market value, even if the ESOP pays less than an outside buyer would.* An ESOP will pay the appraised fair market value based on a variety of factors, but sometimes an outside buyer can pay more for a company if it has a particular fit that creates synergies that go beyond what the company is worth on its own.
4. *Management continuity must be provided.* Banks, suppliers, and customers will all want to be persuaded that the company can continue to operate successfully. It is essential that people be trained to take the place of departing owners to assure a smooth transition.

Conclusion

For many owners of closely held companies, an ESOP is an ideal solution. For others, it simply will not work. To make a decision, create an initial business plan, factoring in legal costs, the costs to buy the shares, and the company's cash flow. If that looks encouraging, talk to an accountant about your figures. If things still look promising, have a valuation done. Your valuation specialist will tell you how much your stock is worth and should also give you a more detailed idea about the practicality of selling these shares. If things still look good, hire a qualified ESOP attorney to draft your plan. As you consider an ESOP, find some other ESOP

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company executives to talk to, attend an ESOP meeting or two, and finalize your plans with all the key players.

Corey Rosen is the founder of the nonprofit National Center for Employee Ownership and the coauthor of the recently published Ownership: Reinventing Companies, Capitalism, and Who Owns What.

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