What is an ESOP?

An Employee Stock Ownership Plan or ESOP is a tax-qualified retirement plan. It is similar to a profit-sharing plan, but is designed to be invested primarily in stock of the sponsoring employer and allows for higher contributions and deduction limits than are normally available to other qualified plans. Employees share in the growth of the company stock while the company and its shareholders enjoy substantial tax benefits and increased employee productivity.

An ESOP is a powerful exit strategy, business succession, and tax planning tool for shareholders of closely held companies because of the ability for them to indefinitely defer taxation on any gain resulting from the sale of their stock.

Unlike a typical profit-sharing plan, an ESOP is invested primarily in employer securities. Distributions to terminated participants can be made in the form of shares of appreciated employer stock which can be sold to the company or cash in an amount equal to the fair market value of the stock. This enables an employee to incur only a long term capital gain, rather than ordinary income, tax on appreciation in the stock value. The closely-held common stock of the employer held by the ESOP is typically voted by the ESOP trustee.

An ESOP company makes discretionary contributions on an annual basis of up to 25% of covered payroll. The contributions can be made in either stock or cash. Cash contributions are normally used by the ESOP to pay indebtedness incurred to buy company stock, or to fund distributions to departing participants. With a leveraged ESOP, the company obtains a loan from a commercial lender and then lends this money to the ESOP which uses it to buy stock from either existing shareholders, or the company itself. Thereafter, the company makes deductible contributions to the ESOP to service the loan. As a result, even principal payments on the loan are tax deductible to the company. Moreover, the company can pay tax deductible dividends to the ESOP to amortize the loan. As the loan is repaid, the stock held in a suspense account as collateral on the loan is released and allocated to the participants' accounts within the ESOP.

How can an ESOP unlock the potential of my company?

An ESOP is an incredibly versatile tool that can benefit a corporation, its shareholders and its employees in the following ways:

ESOP Benefits to Corporations

- **ESOPs Can Reduce Corporate Income Tax Liabilities.** ESOPs provide directors and corporate officers with an opportunity to reduce and even eliminate future corporate income tax liabilities for those companies that become 100% ESOP-owned S corporations.

- **ESOPs are Effective Retention Tools.** The retirement benefits created by an ESOP provide corporations with a powerful method of attracting and retaining key employees.

- **ESOPs Offer Strategies for Succession Planning.** ESOPs permit directors and corporate officers to remain in place for so long as desired and to provide the opportunity to develop and implement a successful succession planning strategy.

ESOP Benefits to Shareholders

- **ESOPs Create a Market for Otherwise Unmarketable Stock.** ESOPs create a market in which shareholders of an otherwise unmarketable corporation may sell all or a portion of their stock. In addition, ESOPs are permitted to pay up to full fair market value for the stock purchased from shareholders.

- **ESOPs Can Create Diversification of Wealth.** ESOPs offer shareholders the flexibility to determine what percentage of their wealth to diversify and thus what percentage of their stockholdings to sell to the ESOP.

- **ESOPs Offer Income Tax Deferral Opportunities.** ESOPs may present shareholders with the opportunity to defer and even eliminate long-term capital gains tax liabilities incurred in connection with the sale of stock.

- **ESOPs Offer Shareholders Continuing Upside Participation.** ESOPs allow shareholders to continue to benefit from appreciation in the equity value of the corporation through the use of seller financing and warrants.

ESOP Benefits to Employees

- **ESOPs Offer Meaningful Retirement Benefits.** ESOPs provide employees with a meaningful retirement benefit and allow employees to share in the success of their employer.

- **ESOPs Offer Significant Tax Benefits.** Unlike other qualified retirement plans, benefits distributed from an ESOP to employees may be taxed at lower long-term capital gains rates as opposed to higher ordinary income rates. The benefits afforded by an ESOP may be coupled with the benefits afforded by a non-qualified deferred compensation plan, which permits directors and corporate officers to provide equity-like value to key employees on a selective basis.

- **ESOPs Can Boost Employee Morale.** By providing employees with an ownership stake in their employer corporation, an ESOP can be a powerful motivational tool for employees.

What are the characteristics of a good ESOP Candidate?

- Private business owners that want to sell their stock for full fair market value while continuing to control the company

- Businesses that want to deduct the cost (both principal and interest) of buying out some of its stockholders

- Management groups that want to buy the subsidiary or division that employs them using pre-tax dollars
- Companies that want to outbid their competitors and deduct the cost of acquisitions
- Business owners who want to deduct principal payments on existing or new loans to finance growth

Representative Transactions of the Dickinson Wright ESOP Team in 2012

1. The Dickinson Wright ESOP Team advised and assisted in a second stage ESOP transaction resulting in the successful sale of 58.5% of the issued and outstanding capital stock of a producer of nationally distributed specialty craft beer to the company's existing ESOP such that the ESOP became the owner of 100% of the company's stock. The Dickinson Wright ESOP Team served as legal counsel to the company.

   The company had one principal shareholder and a group of minority shareholders seeking a liquidity event and succession plan that would facilitate the long-term growth of the business as an independent company, as well as the company's goal of becoming a 100% ESOP-owned S-corporation. The shareholders believed that pursuing a second-stage sale to its existing ESOP, over the other strategic options available to them, would not only achieve these goals, but would also incentivize top management and other key employees to remain at the company and to assist the company in pursuing its long-term, strategic goals. Moreover, company management and its shareholders believed that 100% employee ownership would align well with the company's broader goals of social consciousness, environmental friendliness and sustainability. The Dickinson Wright ESOP Team structured the transaction, assisted in the placement of capital, and advised its client throughout the negotiation process, which resulted in a successful outcome for the company, its selling shareholders and its employee owners.

2. The Dickinson Wright ESOP Team advised and assisted in a successful partial sale of an intermodal marketing firm to an ESOP. Dickinson Wright served as legal advisor to the institutional trustee of the employee stock ownership trust. The two shareholders of the company wanted to diversify a portion of their wealth. They wanted to sell only a minority block of their equity in the company, which made a third party sale practically impossible. The shareholders concluded that an ESOP presented the most attractive solution to achieve their objectives. The Dickinson Wright ESOP Team structured the transaction, counseled the institutional trustee throughout every phase of the ESOP transaction and consummated a successful sale of a minority equity interest in the company to the ESOP.

3. The Dickinson Wright ESOP Team counseled its client-corporation in the successful sale of 100% of the issued and outstanding capital stock of the client, a manufacturer of equipment used in the production of semiconductor and display technologies, to a newly created ESOP from its two founding shareholders.

   The company had two principal shareholders and a group of minority shareholders seeking a liquidity event and succession plan that would facilitate the long-term growth of the business. These shareholders believed that a sale to an ESOP would incentivize top management and other key employees to remain at the company and pursue long-term, strategic goals. The deal was financed with senior debt and junior subordinated promissory notes with warrants taken back by the selling shareholders. A nonqualified deferred compensation plan was also adopted by the company in connection with this ESOP transaction to permit the company to grant stock appreciation rights to certain management employees. The Dickinson Wright ESOP Team structured the transaction, raised capital, and advised its client throughout the negotiation process. The end result: a successful outcome for the company, its shareholders, and its employees with the creation of a 100% ESOP owned S Corporation.

4. The Dickinson Wright ESOP Team advised and assisted in a second stage ESOP transaction resulting in the successful sale of 70% of the issued and outstanding capital stock of a company providing IT government contracting services to the company's existing ESOP such that the ESOP became the owner of 100% of the company's stock. The Dickinson Wright ESOP Team served as legal advisor to the company.

   The founder and sole shareholder of the company sought to create a liquidity event while establishing a long-term employee retention and incentive program. Ultimately, a second-stage sale to the Company's existing ESOP was chosen as the strategic option best capable of achieving all of these goals for the selling shareholder, the company and its employee owners. In addition, the sale would permit the company to reap the many benefits of becoming an 100% ESOP-owned S Corporation. The Dickinson Wright ESOP Team structured the transaction, raised capital, and advised their client through every step of the ESOP transaction process. Today, the company is enjoying the benefits of 100% employee-ownership, and the founder is still able to play a key role in the management of his business.