

## **An ESOP Fable**

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Once upon a time there was an oilheat company owner who wanted to retire. Alas, he had no children willing to take over the business, nor did any of his competitors wish to buy him out. The company owner despaired of ever fulfilling his dream of retiring to a sandy beach to sip tropical drinks in the sunshine.

Fortunately for the oilheat company owner, a mischievous leprechaun told him a wondrous tale about ESOPs. The owner created his own ESOP and was soon basking in the warmth of a comfortable retirement.

An ESOP is not a mythical beast, nor a fairy godmother, but it can be an almost “magical” solution to the challenge of profitably exiting your oilheat business. “ESOP” stands for Employee Stock Ownership Plan. Essentially, it is a way to sell your business to your employees and to enjoy considerable tax benefits while doing so.

According to the National Center for Employee Ownership, ESOPs are by far the most common form of employee ownership in the U.S. Almost unknown until 1974, more than 11,000 companies now have these plans, covering over 8 million employees.

An ESOP is a tax and business succession planning tool in which shares of a closely held company are sold to a Defined Contribution Retirement Plan for the benefit of employees. The selling shareholder, has the ability to remain in control and, most beneficially, can defer taxes on the sale indefinitely.

The owner of a privately held company can use an ESOP to create a ready market to purchase his or her shares by selling to the most obvious buyer, his or her employees. Under this approach, the ESOP borrows the money to buy the shares. The company makes its deductible retirement plan contributions annually, which the ESOP now uses to make the loan payments.

Let’s look at an example of the tax advantages available to the selling shareholders and the company when a sale to an ESOP trust takes place. A shareholder who owns stock worth \$4,000,000 in a closely held company (for which stock he or she originally paid \$300,000) will pay \$740,000 in federal and state income taxes on the sale (assuming a

combined federal and state tax rate of approximately 20%). This means that he or she will net a maximum of \$3,260,000 from the sale.

But if the owner sold his or her stock to an ESOP, he or she will defer federal and state income taxes indefinitely. Why indefinitely? If the proceeds from the sale are invested in qualified domestic securities (like utility stocks) the gain will not be recognized until such time as that investment is liquidated. The selling shareholder will net \$4,000,000 on the sale, a tax savings of \$740,000. The selling shareholders will have an additional \$740,000 invested in their portfolio.

There are many requirements that must be met before you can sell your company to an ESOP and enjoy the full tax benefits:

- The selling shareholder must be an individual, a trust, an estate, a partnership, or a limited liability company, and must have owned the company stock sold to the ESOP trust for at least three years.
- The selling shareholder must not have received the stock from a qualified retirement plan (e.g., an ESOP or stock bonus plan), by exercising a stock option, or through an employee stock purchase program.
- The sale must otherwise qualify for capital gains treatment but for the sale to the ESOP trust.
- The stock sold to the ESOP trust must (in general) be voting common stock with the greatest voting and dividend rights of any class of common stock or preferred stock that is convertible into such voting common stock.
- For the 12 months preceding the sale to the ESOP trust, the company that establishes the ESOP must have had no class of stock that was readily tradable on an established securities market.
- After the sale, the ESOP trust must own at least 30% of the company that establishes the ESOP (on a fully diluted basis).
- ESOPs often are required to have annual audited financial statements.
- ESOPs require an annual valuation as part of its filing with the Department of Labor.
- ESOPs are required to file an annual tax return in addition to any returns required to be filed by the company.
- ESOP's are available to both C and S corporations, but each has their own set of special rules.

Employee participation: Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an

increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or gradual.

There are several features of an ESOP that make it particularly appealing.

- The sale of the business generates immediate income for the original owner.
- If properly structured, taxes are deferred on any gain resulting from the sale.
- Employees remain employed and retain accrued benefits.
- The company has a tax deduction for the repayment of funds borrowed to purchase the shares.
- Employees gain the tangible and intangible benefits of owning their own business.

ESOPs are not something that can be set up overnight. It is best to start your ESOP at least several years prior to retirement to gain full advantage of the benefits. Be sure to have your professionals in place – CPA, banker, valuation analyst, attorney – with a solid plan before starting an ESOP.

Properly structured and nurtured, an Employee Stock Ownership Plan can be a tremendous benefit for your employees, and a “golden ticket” to retirement for you.

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