

The Why (and How) of Setting up an ESOP for Your Business

If you're like many of our clients, you're looking ahead to the next decade or so and thinking hard about what comes next. This process is much more complex for business owners: you *could* just close up shop and go to the beach, but after years or even decades building your business you probably want to monetize your hard work as much as possible.

In some cases, an outright sale makes the most sense. In others, it might not—for any number of reasons. In any situation, we believe it makes sense to consider all of your options, and one option that doesn't get a lot of attention is the ESOP, or Employee Stock Ownership Plan.

These plans are relatively complex and can necessitate a bit of legwork to set up. However, they can help owners achieve multiple objectives with one strategy—not just succession, but also tax planning and employee motivation.

We urge our clients to look into an ESOP, even if it's just to get another look at the business and the possible roads available. In doing so, we've developed this quick guide, which lays out the basics of ESOP plans, the initial steps in setting one up, and a few of the key considerations that we recommend reviewing before making any final decisions.

If you need help or some further information, please don't hesitate to reach out to us for a consultation—we're always happy to share some of our knowledge, experience, and the experiences of clients who have grappled with similar decisions.

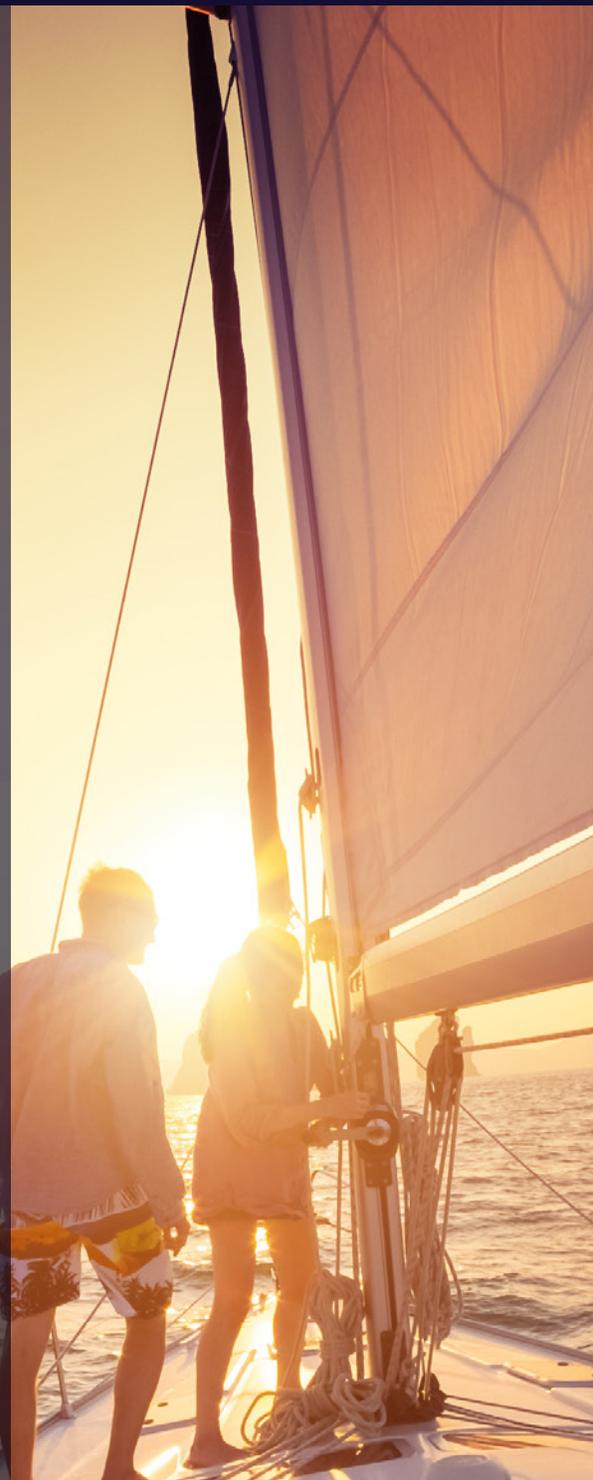
Regards,

Peter D'Agati and Tom Kosinski



**Why Would
You Want an
ESOP?**

- You want your succession planning to include employee ownership
- You want to attract and retain entrepreneurial employees
- You want to enjoy the tax benefits of ESOP contributions and rollovers



How Does it Work?

An ESOP is a benefit plan that gives employees a chance to have partial ownership in their company. Like a 401(k), it's a type of define (d) contribution plan, meaning that employees do not pay income tax on the amount contributed, only on any distributions. However, unlike a 401(k), contributions to the plan are made by the employer, rather than employees.

Every year, company shares are allocated to individual employee accounts, and at the time of termination, disability, retirement, or death, the employer buys back the shares at fair market value.

In other words, employees get the chance to participate in the growing value of a company. However, just because they own shares it doesn't mean they get control: the ESOP accounts are held by a trustee for the *benefit* of employees, meaning that they cannot vote their shares, elect the board, or exert influence over managerial decisions.

What Makes ESOPs Attractive?

An ESOP gives your employees a hand in the future of their company and provides a clear path for owners to transition out of ownership—without the expense, headache, and risks of finding a third-party buyer. In some cases, this can be a great way to “pass the baton” from a founder to the employees who helped grow and develop a business.

There are also some great tax breaks:

- Discretionary annual corporate contributions are tax-deductible—on up to 25% of participant salaries!
- If the ESOP borrows money to buy shares, the money you put back into the plan to repay the loan is also tax-deductible (with some limitations).
- Earnings within an ESOP are tax-free, and employees only pay income tax on distributions.

Critically, for some business owners, if you sell your stock into the ESOP and reinvest the proceeds according to certain rules, you'll be able to defer capital gains. But with the right planning, *you may be able to avoid capital gains entirely.*



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Do I need an ESOP?

There is often more than one way to achieve your goals as a business owner. For example, you might want to consider alternatives like stock options or profit sharing as a way to motivate employees. Similarly, you can consider many other routes for eventually selling your business to employees or a third party.

That last point is important if you consider monetizing your business to be a top priority. As part of setting up an ESOP, your company stock's value will be assessed by a third party—but for some companies, seeking out a motivated buyer would generate a lot more value per share. It's one factor of many that we recommend you carefully and methodically consider.

What Steps Do I Need to Take?

If you're interested in setting up an ESOP for your company, the first step is to do a feasibility analysis: you'll want to know if your company's equity value justifies the establishment of an ESOP and scope out the cost of setting up the plan and making required contributions.

From there, you'll need a plan to submit to the IRS—we strongly recommend working with a qualified attorney or advisor on this—and establish an ESOP trust. Then it's a matter of funding your contributions and implementing procedures for administering the plan.

Basic Requirements for an ESOP



Your company is a C- or S-corporation



You should have a plan in place for repurchasing departing employees' shares



You should be prepared for the initial setup costs



You need to be prepared to allow all full-time employees over age 21 to participate (with some exceptions)

Don't Tackle This Alone

Making decisions about succession planning and employee benefits is a long game, one that balances both the unique aspects of your business and the practical considerations of your life—everything from trust in your employees to managing your tax bill.

That's why it's so important to map out the possibilities of various options. With clear projections and an understanding of your key priorities, it's easier to develop an apples-to-apples comparison and find a path that meets your needs.

Contact us today to learn more about how we can help you take the next steps in your life.



We've worked with numerous business owners looking for a way to plan for succession and beyond. **Contact us today** to learn more about how we can apply that experience to helping you take the next steps in your life.

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