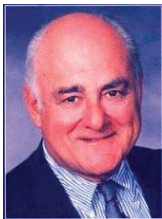




ESOP: A Four-Letter Word?

Liquidity and Perpetuation: Pros and Cons

By Dickson C. Buxton, CLU, ChFC
Ronald J. Gilbert, CLU, ChFC

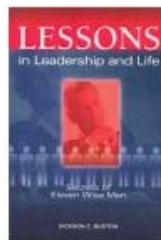


Editor's Note: *Dickson Buxton, the newest Board Member of the World Business Academy, has been perfecting the art of the Employee Stock Ownership Plan (ESOP) since the early 1970's. To him, ESOPs are not a science but an art. One may argue that he, more than anyone else, has influenced the propagation of successful ESOPs in the US.*

Perpetuation of independent businesses and tax-avoidance are the sole motivators of ESOP scientists and tacticians. Such people are responsible for this dismal statistic: 4 out of 5 ESOPs have failed.

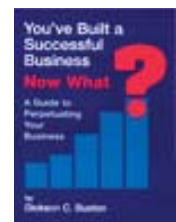
Something much deeper inspires Dick Buxton. It has to do with the intra-generational benefits that can flow from a "culture of ownership." Adherence to this value has built a track record of success without parallel.

This Viewpoint illumines Dick as the artist and also as the scientist and tactician. The latter perspective comes from an article he co-authored that is reprinted here through the kind permission of the [Society of Financial Service Professionals](#).



Dick Buxton has written two books: *Lessons in Leadership and Life: Secrets of Eleven Wise Men*; and *You've Built a Successful Business, Now What?: A Guide to Perpetuating Your Business*.

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The Culture of Ownership

by David Zweig, Sr. Editor

*'Mr. CEO,
how would
you like to go
public inter-
nally?'*

Dick Buxton guesses that 40,000 American firms have started Employee Stock Ownership firms. Here is how he accounts for them:

- "30,000 have tried to impose without having the right culture in place, and 30,000 have said 'to hell with it!'"
- "Of the 10,000 remaining, 5,000 are just using it as a tax deduction."
- "4,000 are groping for a way to do it right, and meanwhile the employees are sore and asking, 'Why didn't you just put our money in a 401-K retirement plan?'"
- "1,000 are doing it right."

Although he may be too modest to take credit, the record shows that a high percentage of those thousand successes bear his imprimatur.

After 30-plus years of architecting ESOPs, Dick has learned, "You cannot buy your own jet and let the employees eat cake or they will do to you what the French did to Marie Antoinette."

Years ago he coined a highly successful marketing tagline: 'Mr. CEO, how would you like to go public internally?' Repeated slowly, this question strikes many CEO's like a harpoon through the breastbone. Dick asserts, "You have to be just as careful with an ESOP as with a public offering. Perhaps more so. If you play funny with the employees they will visit the Department of Labor and an 800-pound gorilla will smack you hard."

"So, in the final analysis, an ESOP is corporate governance to the nth degree."

"There are a thousand ways to do an ESOP wrong, and a few ways to do them right."



The ESOP is one of the most forgiving provisions of the tax code, at once both byzantine and cobbled together with nails made of pure paradox. The United States fought the Cold War for 50 years, expending trillions of dollars of national treasure and sending 100,000 young men to their deaths in the armed services to break Communism -- a system nominally predicated on employee ownership of production.

Where does that leave us today? The American tax code rewards virtually nothing as much as it does the transfer of wealth from capitalists to workers. Company owners who sell a portion of their equity into an ESOP enjoy tremendous tax advantages. Corporate contributions to the care and feeding of the ESOP are fully tax-deductible. (The following article explains these details more deeply.)

Unsurprisingly most ESOPs are set up by lawyers and accountants to per-

petuate continuation of the enterprise in private hands, ensure the wealth of the founders, and maintain control of the company in the hands of management. They can accomplish these financial goals without referencing the aspirations of the new minority owners. Like slapdash carpentry, these jobs inevitably fall apart in short order.

Dick counters, "Among the annual list of 100 Best Companies for which to work, almost everyone has broadened ownership one way or the other: ESOPs or other similar programs. ESOPs are looked at by most lawyers, accountants, and owners as a tax shelter. We go through a three to four months of process of feasibility studies to make sure that the owners know that they are running for something like an elective office. If you don't share decision-making and keep everything close to the vest employees will feel had and say 'We have nothing.'"

"Too many people are in the field of advising owners to put an ESOP. They don't understand that the ESOP is merely a trust. You don't have any culture change because you put one in. You must change culture for it to be effective."

He says in his book *You've Built A Successful Business: Now What?*:

The most vital step in the perpetuation process is to carefully consider the value of the human resources. These are the employees who serve the customers, provide the services or produce the product and the gifted managers who motivate and leader the people.

He observes, "If employees see that someone else is pocketing all the money, the ESOP won't last. I did motivational and inspirational speaking and it never lasted long. Suppose I want you to 'rent' *and* feel good about it. You know you will never own anything. Employees have to be full citizens with the right to own. They do not necessarily have to run the company, but they do have the ability to put you out of business."

A large part of his involvement actually falls under the heading of Organization Development. This implies intensive work creating the three legs of the tripod that supports the successful ESOP: owners, managers, and employees. Dick often changes the mindsets of each party: owners cede some real authority to managers and employees who heretofore had not been so empowered. *Managers and employees start to think of themselves as owners when they come to understand the potential impact of ESOP success on their retirement and the livelihoods of their spouses and children.* The ESOP structure must provide meaningful benefits. It must be architected so it can be funded in the years to come, and it can accommodate future employees, to name only two common concerns.



The Academy's Global MindChange Forum in March 2004 profoundly changed the way Dick applied his mind (and spirit) to his business. Academy Fellow Lance Secretan shared one of the central tenets of his approach to connecting organizations with the souls of their employees, by inviting people to

...the ESOP is merely a trust. You don't have any culture change because you put one in. You must change culture for it to be effective."

define their Destiny, Cause, and Calling.

Destiny: Why I am on Earth

Cause: How I will be while I am here

Calling: What I will do

When an individual is clear about his motivations, and can articulate his destiny, cause, and calling, the ESOP stands a great chance to succeed.

The experience caused Dick to define his firm's destiny, cause, and calling, and also to use the process to screen prospective customers. Through the decades, he has developed a particular catechism that bares the souls of the would-be ESOP creator. Recently he has refined this to a 2-hour video tape for the use of affiliates of his firm. The tape dramatizes a particular issue concerning the appropriate motivations for creating an ESOP that are necessary preconditions for success.

"An applicant-owner goes through a two-hour interview program. Diagnosis necessary for prescription. Prescription without diagnosis is malpractice. In order to do prescribe we have to get into the person's gut. After the two hours the client knows how they feel about everything that is important to perpetuate their company. If they feel they cannot perpetuate it, we sell the company: This ship will not make it to the other shore. It doesn't have the crew. Or it has the crew but not the fuel. Perhaps they realize they do not want to wait for their kids to take over they sell the company. There are many reasons *not* to do an ESOP, or why we as a firm would elect not to work with a particularly individual. If they are in it for the wrong reasons, it will never work."

The attitude of the owners appears to be the single greatest influencer on the culture of ownership among employees.

When an individual is clear about his motivations, and can articulate his destiny, cause, and calling, the ESOP stands a great chance to succeed. To facilitate this exploration, Dick shares his own firm's Covenant:

Destiny

Not unlike the inbred instinct that drives the Australian working sheep dog to shepherd its flock, Private Capital's fate is also sealed by its very nature; to protect and guide clients toward the freedom and security of high ground; to help them avoid the pitfalls, dead-ends and perils that invariably appear without warning.

Cause

By helping clients build a sound strategic foundation, we leave them in better shape than we found them, prepared and poised for unprecedented success. In this climate of aspiration, we must encourage them to balance and enrich their working lives through inspirational relationships. In doing so, we never fail to awaken the best that lies in all of us.

Calling

We have a responsibility, if not an obligation, to put our clients at the center of our competency. If we can not rightly give them our best, or do our best on their behalf, we must respect them and ourselves enough to pass them by. As staunch client advocates, therefore, we fully expect to pledge and exercise our personal and professional integrity.

ESOP: A Four-Letter Word? Liquidity and Perpetuation: Pros and Cons

By Dickson C. Buxton, CLU, ChFC
and Ronald J. Gilbert, CLU, ChFC

Abstract: While the employee stock ownership plan (ESOP) offers tremendous tax advantages to both selling shareholders and the sponsoring corporation, as well as allowing employees to build significant wealth, it is also very important to understand the potential disadvantages of the ESOP. After outlining the tax benefits and potential advantages, the authors then discuss potential disadvantages and misconceptions, and cite extensive ESOP research. Their goal is to create more ESOPs that are used in the right situations for the right reasons and reduce the number of situations where the ESOP is a "four-letter word" by cautioning against using the ESOP in the wrong circumstance and/or for the wrong reasons.

Introduction

Owners of privately held companies face difficult choices when they seek to liquidate some or all of their ownership interest. If they also desire to perpetuate the company, the choices become fewer. For certain companies at certain times in certain industries, selling to an outside buyer for a good price may be a viable option. Even when the price is right, contingencies, holdbacks, or earnouts may make the transaction less than attractive. Enter the employee stock ownership plan (ESOP). The vast majority of ESOPs (there are over 10,000) were implemented to address the issues cited above. Specifically, ESOPs can provide partial or full liquidity for selling stockholders, while simultaneously perpetuating the business and providing the employees of the company with a "piece of the action." Even if the sellers desire to

[The] goal is to create more ESOPs that are used in the right situations for the right reasons and reduce the number of situations where the ESOP is a "four-letter word"

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maximize the sale price, and perpetuation is not an issue, the ESOP is frequently the best option due to the very substantial tax benefits offered to both selling shareholders and the sponsoring corporation.

In many respects the decision to implement an ESOP may be the most important decision ever made by a business owner next to founding the business itself. ESOPs can be, and often are, implemented on a limited basis where a minority block of stock is sold to the ESOP, and the selling shareholders remain active and continue to run the business. However, many other ESOP transactions involve the sale of a large block of stock and the immediate or eventual retirement of one or more major shareholders from active involvement in the business. It is in this latter set of circumstances that the ESOP is most frequently used in privately held companies as a liquidity and perpetuation planning vehicle. In selling to an ESOP, owners can maintain partial or complete control of the company, retain equity, and invest the sale proceeds in a diversified portfolio of stocks and bonds without incurring a capital gains tax, all the while rewarding the loyal people who helped build the business. In making the decision whether or not to use the ESOP as a principal (but not necessarily the only) perpetuation vehicle, the impact on (1) the selling shareholders, (2) the company, (3) other existing shareholders, and (4) the employees (especially key management) must all be considered.

In many respects the decision to implement an ESOP may be the most important decision ever made by a business owner next to founding the business itself.

Summary of ESOP Uses

An ESOP is a very flexible financial and equity incentive instrument that uses corporate tax-deductible or taxfree dollars to achieve a variety of individual and corporate objectives. These objectives include raising working capital, facilitating charitable giving and providing for the acquisition or divestiture of a division or subsidiary. These ESOP applications are beyond the scope of this article, which focuses on providing shareholder liquidity and perpetuation planning. In this context, the ESOP can provide a market (at fair market value) for the partial or complete sale of stock by existing shareholders, while simultaneously providing a strong equity incentive for employees.

Individual Tax Benefits

Individuals (or partnerships) who own stock in a privately held C corporation may be eligible for tax-free rollover treatment provided that the initial ESOP ownership is 30% or greater, and the shareholders otherwise qualify. These requirements include ownership of the C corporation stock for at least three years and reinvestment of the proceeds from the sale of the stock to the ESOP in stocks or bonds of U.S. operating companies within 12 months after the sale of stock to the ESOP.¹ If the sponsoring company is an S corporation, then it may be able to convert to C corporation status to provide selling shareholders with the tax-free benefit. This benefit is the equivalent of a tax-free stock swap with a publicly traded company. The capital gains tax (generally 15% federal plus state capital gains tax) is deferred. Upon death the estate receives a stepped-up basis, and the capital gains tax is extinguished. (Note that the current estate tax law substantially changes in 2010.)

Selling shareholders may not qualify to elect the tax-free rollover for a variety of reasons. The sponsoring company may be an S corporation and not wish to convert to C corporation status; the shareholders may have received their stock through some form of stock option plan or other method that makes it ineligible; the stock may be owned by a corporation; the company may be publicly held, etc. In these instances, the stock sold to the ESOP would be subject to long-term capital gains tax treatment, provided the normal one-year holding period had been satisfied.

Example: A publicly traded company wishes to use the ESOP to go private. Selling shareholders do not qualify for the tax-free rollover treatment because the company is not privately held. The selling shareholders would pay capital gains tax on the difference between their basis in the stock and the sale price. Shareholders of privately held companies are frequently eligible for tax-free rollover treatment when they sell stock to the ESOP. Even when they are not, the tremendous tax benefits available to the corporation can make the ESOP an ideal liquidity and perpetuation planning vehicle.

Corporate Tax Benefits

A corporation receives tax deductions for making contributions to the ESOP (within the limits discussed below) regardless of whether the ESOP is leveraged or unleveraged. However, in the context of perpetuation planning, most ESOPs are leveraged, either initially or several years after adoption.

In a leveraged ESOP, the ESOP receives a loan and uses the proceeds to purchase a block of stock from current shareholders. The loan is frequently made to the corporation by a bank, and the corporation re-lends the money to the ESOP. The corporation that sponsors the ESOP is responsible for repaying the bank loan, and selling shareholders are sometimes required to guarantee a portion or all of the debt if the company has inadequate collateral. The company or selling shareholder can also provide some or all of the financing. The stock purchased by the ESOP is held in a trust. As the company makes tax deductible contributions to the ESOP to repay the ESOP's debt, shares held in an ESOP suspense account are allocated to employee accounts at a rate corresponding to the debt amortization. Plan participants vest in the shares allocated to their account under normal ERISA vesting schedules (see Figure 1). Tax-deductible contributions are made by the corporation to the ESOP in amounts equal to the principal and interest payments on the ESOP's loan from the corporation;² in turn, the ESOP uses the funds to repay the loan. The combined federal and state tax rate is approximately 40%. For every \$1,000,000 of debt repaid through the ESOP, there is approximately \$400,000 of corporate tax savings.

Contribution Limits

The company may generally contribute up to 25% of covered payroll annually to repay ESOP debt. Interest is normally excluded from this limit in C corporations. Reasonable dividends on ESOP-owned C corporation stock when used to repay ESOP debt (or passed through in cash to ESOP participants) are excluded from the 25% limit and are tax deductible to the corporation.³

As a result, tax deductible contributions to the ESOP can frequently be substantially above 25% of covered payroll.

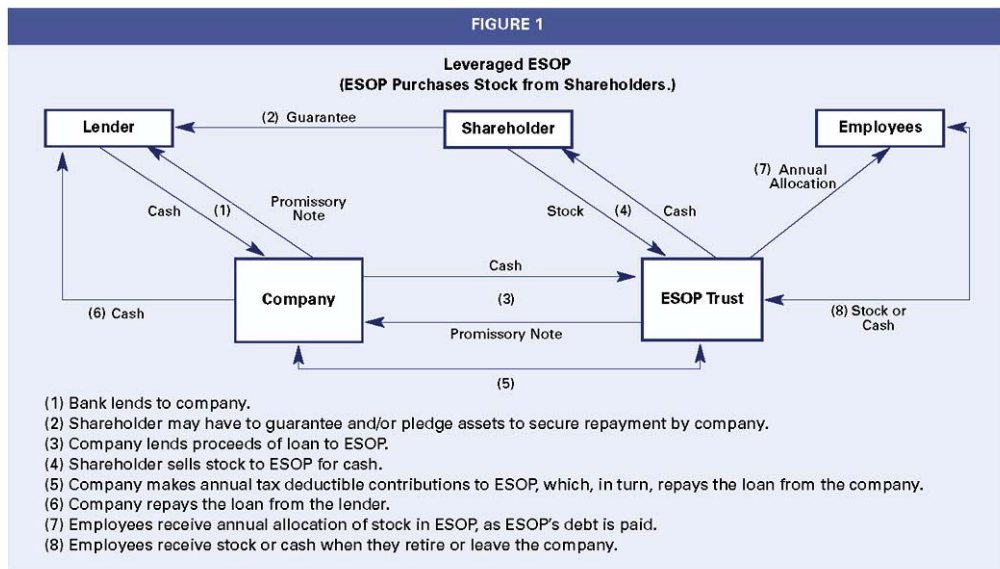
Tax-Free Corporate Income

As advantageous as the above corporate tax benefits are, there are even more substantial tax advantages for an S corporation.

The income attributable to S corporation stock owned by an ESOP is not subject to federal income tax.⁴ Most states mirror this provision. Example: If an S corporation were 40% owned by an ESOP, then 40% of the company's income would be tax free. If the company were 100% ESOP owned, then the company would pay no income tax. This is not a deferral; the tax liability no longer exists. In most instances, ESOP companies with at least 20 employees can benefit from tax-free S corporation income.

An ideal ESOP candidate is a C corporation with more than 20 employees, with pretax, discretionary bonus income of \$1,000,000 or more, whose owners seek liquidity and wish to perpetuate the company.

FIGURE 1



The Perfect ESOP

An ideal ESOP candidate is a C corporation with more than 20 employees, with pretax, discretionary bonus income of \$1,000,000 or more, whose owners seek liquidity and wish to perpetuate the company. Assuming the sellers qualify, they sell their stock to the ESOP and pay no capital gains tax (tax savings = approximately 20%). Corporate contributions to repay ESOP debt, both principal and interest, are tax deductible to the corporation (tax savings = approximately 40%). If the company converts to S corporation status, then it is income tax-free to the extent of the corporate income attributable to its ESOP-owned stock. If the ESOP owns 100% of the stock, the federal income tax is completely eliminated. In many instances, it is impossible to achieve the liquidity objectives of shareholders in a privately held company, and perpetuate the company, without the use of an ESOP.

Summary of Potential ESOP Advantages

There are tremendous potential ESOP advantages in many liquidity and perpetuation planning situations for stockholders, for the corporation, and for the employees of the corporation.

Stockholders

For stockholders, an ESOP:

1. Creates liquidity, possibly tax free, at fair market value;
2. Allows control to be maintained (under certain circumstances);
3. Provides for tax-free rollover treatment available to sellers of privately held C corporation stock;⁵
4. Establishes value and provides liquidity for estate planning purposes;
5. Allows additional corporate equity incentives (stock option, bonus, purchase, phantom stock, etc.)

Company

ESOP advantages for the company include the following:

1. There is a substantial corporate tax savings (40% to 100%).
 - Pretax dollars repay debt;
 - There are tax-deductible C corporation dividends;⁶
 - S Corporation stock owned by ESOP is not subject to federal income tax.⁷
2. Cash flow is increased.
3. There is corporate perpetuation.
4. Accumulated retained earnings are justified.

Employees

Advantages to the employees include:

1. Employees share directly in equity growth of the company;
2. Company contributions to the ESOP tend to be larger than 401(k) matching or profit-sharing contributions;
3. Studies conducted over the past 25 years demonstrate that the ESOP is a proven motivator, which builds unity and team spirit and retains key employees;
4. ESOP accounts accumulate tax-free, and are tax-favored at distribution;⁸
5. Employees can realize dividend income;
6. Buy/sell agreements can ensure future employee ownership in coordination with the ESOP.

There are tremendous potential ESOP advantages in many liquidity and perpetuation planning situations for stockholders, for the corporation, and for the employees of the corporation.

The Potential Disadvantages of an ESOP

In privately held companies, the corporation has the obligation to repurchase shares from participants who terminate due to death, disability, retirement or "other" reasons.⁹ Funding for this so-called repurchase liability or repurchase obligation requires careful planning. Also, if selling individuals elect the tax-free rollover, they, as well as certain family members and 25% shareholders, are excluded from participation in the ESOP.

Furthermore, it may be necessary, or at least strongly recommended, to change the corporate governance structure, especially if the ESOP is a majority owner. More and more ESOP companies have outside board members, and the current stockholders may receive a higher price for the sale of the business to an outside strategic buyer who might be willing to pay more than the appraised fair market value of the company. In this instance a number of loyal long-term employees may lose their jobs, but if the highest price is the only consideration to current shareholders, the ESOP may not be able to compete with an outside buyer. Also, the ESOP by itself may not provide enough equity incentive for key management, and ESOPs can be complicated. It should be emphasized that these are potential disadvantages. However, through proper planning, and corporate and transaction structuring, these disadvantages can frequently be addressed to the satisfaction of all parties involved.

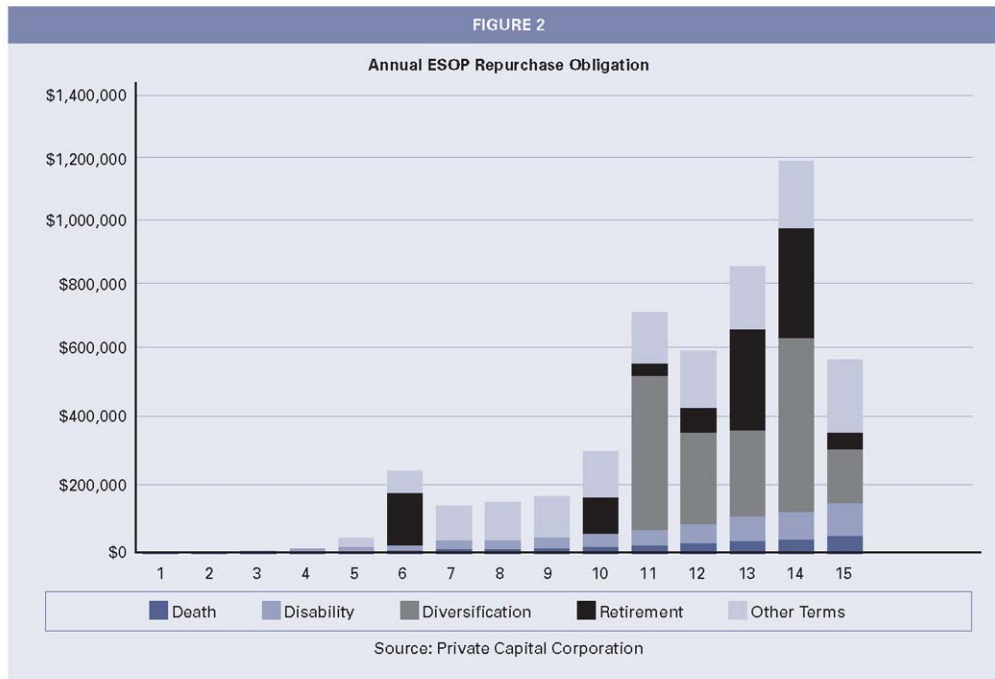
Repurchase Obligation

The repurchase obligation normally begins to emerge approximately six or seven years after the ESOP has been established, about the time that the first ESOP loan is typically repaid. Figures 2 and 3 demonstrate a typical trend. While retirements and turnover are somewhat predictable, death and disability are virtually impossible to estimate due to the relatively small number of employees in the ESOP.

Funding for the repurchase obligation frequently is done through the corporation. This is particularly true when key person life insurance is used to fund the repurchase obligation. A "split-funded" approach is usually best, with the corporation, not the ESOP, being the owner, premium payer, and beneficiary. Typically the individuals with the largest ESOP account balances, representing approximately 20% of all ESOP participants, would be insured for death and disability. Failure to properly plan for the repurchase obligation can create a ticking bomb that can emerge suddenly and threaten to sink the company.

More and more ESOP companies have outside board members, and the current stockholders may receive a higher price for the sale of the business to an outside strategic buyer who might be willing to pay more than the appraised fair market value of the company.

FIGURE 2



The stock allocated to their individual ESOP accounts may offset a substantial portion of capital gains tax paid on the sale to the ESOP.

Annual ESOP Repurchase Obligation

Note that while Generally Accepted Accounting Principles (GAAP) do not currently require that the repurchase obligation be listed as a liability on the company's balance sheet, it is possible that this could change in the future.

Exclusion from ESOP Participation

When selling shareholders elect the tax-free rollover, no portion of those shares may be allocated to the seller, certain family members (including parents, children, brother and sisters), or any person who holds directly or by attribution more than 25% of any class of outstanding stock.¹⁰ The company must be a C corporation at the time of the sale for the sellers to be eligible to elect the tax-free rollover. In many situations the excluded individuals can be made whole outside of the ESOP through a nonqualified deferred-compensation plan. The larger the payroll of excluded participants as a proportion of the total payroll, the more difficult it is to accomplish the "make whole" objective. If the company is operating, or will operate, as an S corporation, recent IRS regulations limit the amount of deferred compensation.¹¹ A frequent solution to this problem is for selling shareholders to pay capital gains tax on their sale of stock to the ESOP. Selling shareholders, as well as individuals referred to above, would all be included in the ESOP, provided they are employees of the sponsoring corporation. The stock allocated to their individual ESOP accounts may offset a substantial portion of capital gains tax paid on the sale to the ESOP.

Corporate Governance

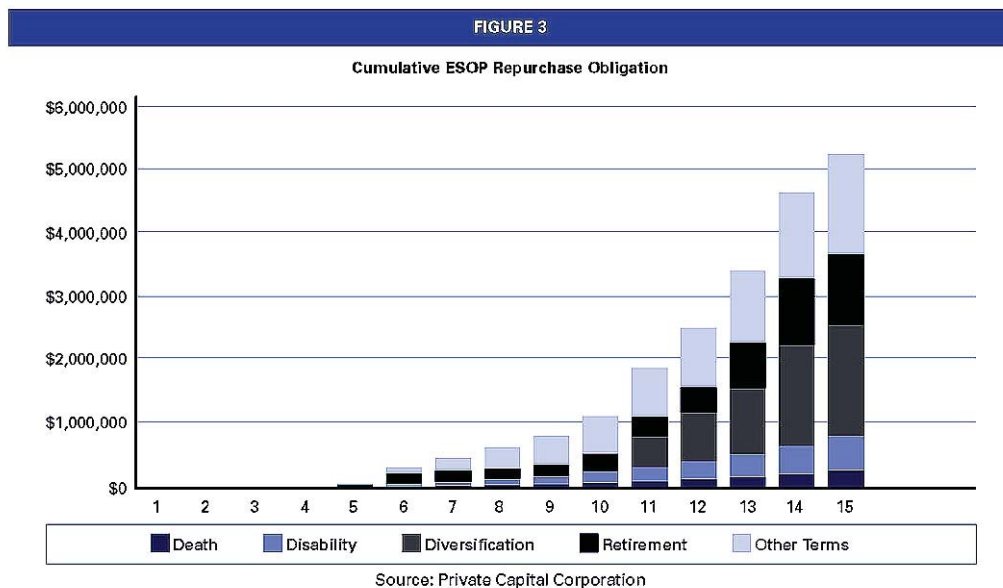
In this post-Enron/WorldCom era, there is more focus on proper corporate governance in all corporations, including ESOP companies.

ESOP participants in privately held companies generally must be given voting rights on only seven major issues, which do not include voting for the board of directors, or for the sale of stock of the company. The seven "vote passthrough" issues are merger, consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of the assets of a trade or business. Where a shareholder vote is required with respect to one of these vote passthrough issues, then under state law, participants must be given full disclosure and afforded an opportunity to confidentially vote the shares allocated to their accounts. In many ESOP companies, a vote pass-through is never triggered because one of the seven issues cited above never arises. However, in this post-Enron/WorldCom era, there is more focus on proper corporate governance in all corporations, including ESOP companies. More and more experts recommend that there be at least one outside independent member of the board of directors, especially when the ESOP has a majority ownership stake.

A Higher Price

An ESOP can pay no more than fair market value for the stock it acquires, as determined by an independent appraisal.¹² Once the ESOP is established, the stock must be appraised at least annually. Outside buyers may offer to pay a higher price for the company due to strategic fits, or downsizing that will occur after the acquisition, or a combination of the two.

FIGURE 3



If the outside offer is higher, the ESOP frequently can be a competitive buyer for several reasons. If the sellers are eligible for the tax-free rollover, then the

outside price will normally need to be more than 20% higher to net the selling shareholders the same amount after they have paid their capital gains tax on the sale.

If the buyer is purchasing assets in a C corporation, then selling shareholders may have to pay substantially more than 20% in tax. In addition, outside offers frequently contain some type of contingency, hold back, earnout, etc. In many instances, the ESOP can be a very competitive buyer.

Insufficient Management Equity

A stand-alone ESOP may not provide sufficient equity incentives for key management. The solution is to provide either real (i.e., stock options, stock purchase, or stock bonus plan) or synthetic (phantom stock or stock appreciation rights) equity. Many planners feel it is essential that key management have "skin in the game" in order to focus them intently on the success of the company going forward.

Ownership Culture

Focusing only on the tax benefits of the ESOP and then expecting employees to jump with joy when told that the company is now "employee owned" may lead to major disappointments. How does the ESOP benefit compare with retirement benefits provided under the old profitsharing, 401(k) or defined-benefit plan? How will an ownership culture that motivates employees to "think like owners" be developed? Research has demonstrated that the full benefit of the ESOP is realized only when an ownership culture incorporating employee involvement is developed.

Tax Loophole ESOPs

From time to time some misguided planners have attempted to use the ESOP in ways never intended by Congress or the regulatory agencies that oversee ESOPs (the IRS and the Department of Labor). After the passage of the Taxpayer Relief Act of 1997, S corporations were allowed to sponsor ESOPs, generating tax-free income as explained earlier in this article. Some planners decided they would create "one-person" ESOPs that provided benefits to only one or to a very small group of highly compensated individuals. This resulted in a provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that contained an antiabuse amendment to stop arrangements that did not create significant employee ownership.¹³ The industry's leading trade organization, The [ESOP Association](#), acted in concert with key members of Congress to shut down the abuses. The passage of this law spawned the so-called "management company" abuse scheme. The ESOP was established in an S corporation with more than 10 employees, thus creating tax-free corporate income. Much of the income of the operating company was "up streamed" to the management company that provided benefits, frequently including nonqualified deferred compensation, for a

Focusing only on the tax benefits of the ESOP and then expecting employees to jump with joy when told that the company is now "employee owned" may lead to major disappointments.

When ESOPs are formed in an attempt to exploit real or perceived loopholes in the law, the loopholes are ultimately closed, and ... employees may have a lot of questions to ask, and they may not be easily answered.

small number of key employees. The IRS became aware of this abuse, and under the antiabuse provisions of EGTRRA, issued temporary and proposed regulations that, in effect, limit the amount of nonqualified deferred compensation that S corporation ESOPs can have.¹⁴ As evidenced above, when ESOPs are formed in an attempt to exploit real or perceived loopholes in the law, the loopholes are ultimately closed, and the ESOPs that were formed to exploit the loopholes will usually be terminated. When that occurs, employees may have a lot of questions to ask, and they may not be easily answered.

Lack of Planning

ESOPs should be formed only after a comprehensive feasibility study has been performed to show the impact of the transaction on the selling shareholders, the corporation, and the employees. Individual and corporate cash flow, stockholder equity, projected repurchase obligation, etc., is all studied under different ESOP scenarios. CEOs or CFOs of a company attempting to implement an ESOP without such a study are "flying blind without radar." In addition to projecting the repurchase obligation, the rate at which the ESOP debt is repaid, the impact of different distribution policies, whether to operate as a C corporation or an S corporation in the future, using ESOP stock as a match to a 401(k) plan, and even using a convertible preferred stock in the ESOP instead of common stock, are among the issues addressed in a comprehensive feasibility study. The feasibility study is designed to be a decision package in which current shareholders, management, and the board of directors (which may or may not overlap) determine to what extent an ESOP can meet individual and corporate objectives.

Misconception

Sadly, sometimes the ESOP as an option for liquidity and perpetuation planning is never seriously addressed, due to misconceptions held by major shareholders and/or their key advisers. Once business owners and their advisers carve out several hours to communicate with an experienced ESOP practitioner, they frequently find that an ESOP is not only a viable option, but may be the best option.

ESOP Research

Numerous studies have been done over the past 25 years demonstrating the productivity and performance of ESOP companies. Several examples are listed in Tables 1, 2 and 3.

ESOP Success Stories

Our greatest pleasure comes from visiting client companies and hearing the employee owners talk glowingly about the size of the average employee account.

When we talk with employees, management and nonmanagement, they express their appreciation for those who share this ownership. Incidentally, these companies grow much faster and therefore the family that shares own-

TABLE 1		
Productivity after ESOP		
Productivity	Number of companies	Percent
Strongly improved	39	17
Somewhat improved	142	61
No impact	33	14
Negative impact	1	-
Not sure	19	8
Totals	234	100

Source: The ESOP Association, 2002 (www.esopassociation.org).

TABLE 2	
Difference in Corporate Performance Post-ESOP vs. Pre-ESOP	
Annual sales growth	+2.4%
Annual employment growth	+2.3%
Annual growth in sales/employee	+2.3%
Annual growth in sales/employee +	+2.3%
Average increase in productivity	+4.5%

Projected over 10 years, an ESOP company with these differentials would be a third larger than a comparable non-ESOP company.

Source: Rutgers University, Kruse and Blasi, 1998 (www.nceo.org).

TABLE 3	
Average Value of All Retirement Accounts	
ESOP accounts	\$32,213
Non-ESOP companies	\$12,735

Source: Kardas & Keogh, Washington Department of Community Trade & Economic Development, 1998, and Adria Scharf, University of Washington (www.nceo.org).

ership might end up with a much smaller percentage of the company, but the company is many times larger than it otherwise would have been.

Summary

ESOPs, when used in the wrong situation or in an effort to exploit some real or

imagined tax loophole, will result in the ESOP becoming a four-letter word in the true meaning of that phrase. However, when used for liquidity and perpetuation planning purposes, ESOPs provide substantial tax benefits to selling shareholders and the corporation while simultaneously providing employees with the opportunity to create significant tax-deferred wealth.

About the authors:

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Footnotes

1. IRC § 1042.
2. IRC § 404(a)(9).
3. IRC § 404(k).
4. IRC § 512(e).
5. IRC § 1042.
6. IRC § 404(k).
7. IRC § 512(e).
8. IRC § 402.
9. IRC § 401(a)(23) and 409(n).

10. IRC § 409(n).
11. Temp. and Prop. Treas. Regs. Dec. 1. 409(p)-1T.
12. IRC § 401(a)(28)(C).
13. IRC § 409(p) and 4979(A).
14. Temp. and Prop. Treas. Regs. Dec. 1. 409(p)-1T. Another potential abuse, where individuals were given options to buy stock in subsidiaries of parent corporations, was addressed in Revenue Ruling 2004-4, 2004-6IRB 414.