# What You Need to Know About ESOPs

By Toddi Gutner | Business on Main



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***An employee stock ownership plan can be a great way to attract top talent — but be sure you aren't giving up too much of your business in an effort to be competitive.***

Management at Padilla Speer Beardsley had the right idea when they decided to create an employee stock ownership plan (ESOP) 20 years ago. “We put the ESOP in place to help prep for the next generation of leadership,” says Matt Kucharski, executive vice president of agency services for the marketing and public relations firm based in New York City and Minneapolis. “Rather than finding people who could buy out the company, we created an ESOP,” he says.

Initially, the firm kept ownership at 70 percent for senior leaders and 30 percent for employees, before switching to an S corporation in 2000. This move allowed the firm to become entirely employee-owned. “It's been an excellent way to instill an ownership culture with the employees,” says Kucharski.

**What is an ESOP, exactly?**

By definition, an ESOP is a qualified defined-contribution employee benefit plan that invests primarily in the stock of the employer company and allows employees to become partial owners of the business. In the U.S., there are nearly 11,000 ESOPs, stock-bonus plans and profit-sharing plans invested primarily in employer stock, with an estimated 10.3 million participants and a total value of $869 billion, according to the National Center for Employee Ownership (NCEO).



While an ESOP is certainly an effective motivational and engagement tool for employees, that benefit isn't the primary reason for many business owners to adopt one. A significant reason is the tax advantages. An ESOP is a tax-advantaged method of creating liquidity and a ready market for company shares so that the owner can take some cash out of the business. That represents about two-thirds of all ESOPs. Most of the remaining ESOPs are used either as a supplemental employee benefit plan or as a means of borrowing tax-advantaged money, according to NCEO.

There are two types of ESOPs: leveraged and nonleveraged. “The structure a company does depends on what's affordable at the time the ESOP is created,” says Jerry Ripperger, director of consulting for the Principal Financial Group. Companies can make tax-deductible cash contributions to the ESOP to purchase stock or have the ESOP borrow money to buy the shares.

Under a leveraged ESOP, an ESOP obtains a loan from a bank, usually with a company guarantee. The ESOP then uses the loan proceeds to buy stock from the company and/or existing shareholders. The company makes annual tax-deductible contributions of cash to the ESOP, which in turn repays the bank. With a nonleveraged ESOP, the company makes annual contributions to the trust either in the form of stock or in cash that is then used to buy shareholder stock.

**Is an ESOP right for your company?**

There's been a great deal of interest in ESOPs lately. “Business evaluations are down and it isn't a good time for business owners to sell their companies, even though they may want to cash out and retire,” says Ripperger. With most of their net worth tied up in their businesses, an ESOP gives them a tax-efficient way to transfer their business.

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But ESOPs aren't for every company. The company must be either an S or C corporation. LLCs, partnerships and sole proprietorships aren't eligible to use them. And expert opinion varies on the minimum size a company needs to be, both in terms of employees and valuation, to consider ESOPs. Estimates range from $5 million to $10 million for a minimum valuation, while at least 30 employees are recommended as a minimum workforce.



It turns out that only 3 percent of publically traded companies take advantage of ESOPs. "Using an ESOP in smaller companies is similar to the way larger companies do IPOs [in terms of popularity]," says Robert Mittelstaedt, dean of the W.P. Carey School of Business at Arizona State University. Due to the regular and ongoing contributions that must be made to the plans, ESOPs are also best for companies that have steady income.

Still, there's a great deal of flexibility when designing ESOPs, says Ripperger. Some of the considerations include the following: How much of the company does the owner want to sell? How many transactions should there be? Over what time frame will the ESOP be carried out? How will ownership be allocated to the ESOP?

Finally, businesses need to think in terms of startup and ongoing costs. The ESOP process isn't cheap. Initial costs can run between $60,000 and $100,000, and there will be ongoing legal and consulting fees, annual stock appraisal fees and recordkeeping costs.

No doubt, the advantages of ESOPs are many. But be sure to do your due diligence when deciding whether they're right for your company.



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