TLC tip

What is an ESOP?

An ESOP is the acronym for Employee Stock Ownership Plan. It essentially accomplishes what is says: allowing employees to come into ownership of a business. This can be done several ways, such as through direct purchases, bonuses, or profit-sharing plans.

The primary use of an ESOP is as an exit plan for the departing owner of a closely-held business. One reason for this is that the ESOP provides ready market for the the shares of the business. Closely-held businesses are typically quite difficult to value. As opposed to public companies, there is not an open forum to check the price of shares against. Even with a closely-held business, if we have determined a workable value - and that can be done several ways - it is only good to the extent of someone is willing to purchase the business. And there is not always someone willing to buy.

An ESOP addresses these issues. Through a very thorough appraisal of the business, a fair value for the company is determined. In turn, this price is paired with an interested audience, the employees. The owner secures funds for his retirement and the employees begin to share in the profitability of the business.

There are additional benefits to an ESOP as well. Owners are usually quite attached to their business. There is no surprise in that. Owners pour their lives into their businesses, working extreme hours to start it, keep it afloat, and see it prosper. As a natural instinct owners want to see the business continue after them. It is their legacy; the significant accomplishment of their lifetime. However, there is always a risk when selling to a third-party that one is selling to a predator. An entity that will pick up the company and gut it. Maybe the entity simply wants the name, or is looking to acquire the assets or patents within the business. Once it has those, there just isn't the commitment to continue the business as before. In the alternative, some prucahsers want to continue the business, but have no interest in doing so where the business has traditionally been located. A buyer may simply up and move the company to a different state, leaving the employees behind. None of this is likely what the owner imagined when transitioning out of the business.

By establishing an ESOP, an owner is taking measures to ensure the owner's legacy is preserved, the business continues, and that the employees are taken care of. For these reasons, if you are looking to do business succession planning - and you should be - an ESOP can be quite a useful element in your scheme.

There are no bright line rules for the size of the company apporpriate for and ESOP. General consensus is that there should be greater than 30 employees, if not significantly more, and the business itself should be worth several million. The business does, though, need to be either an S Corporation or C Corportation. It should be noted that enetering into an ESOP does not demand a complete sale of the business. Any percentage of the business may be sold to the ESOP, and the owner may pair an ESOP with other business succession planning strategies. By creating a hybrid plan, an owner can simultaneously provide for the business' employees while ensuring the owner's unique planning objectives are satisfied.

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