



MENKE & ASSOCIATES, INC.  
ESOP ADVISORS AND INVESTMENT BANKERS

# **ESOP FUNDAMENTALS TAX & FINANCIAL BENEFITS (THE ABC'S OF ESOPS)**

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# Introduction

# What is an ESOP?

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- ▶ Similar benefits of other company funded retirement plans (e.g., 401k, PSP).
  - Tax deductible contributions for employer.
  - Tax deferred growth investments for employees.
- ▶ **But, it is also** an M&A transaction.
  - ESOP invests primarily in your company's stock.
  - Investments are directed by the Board of Directors.
  - ESOP then participates in earnings of the company.

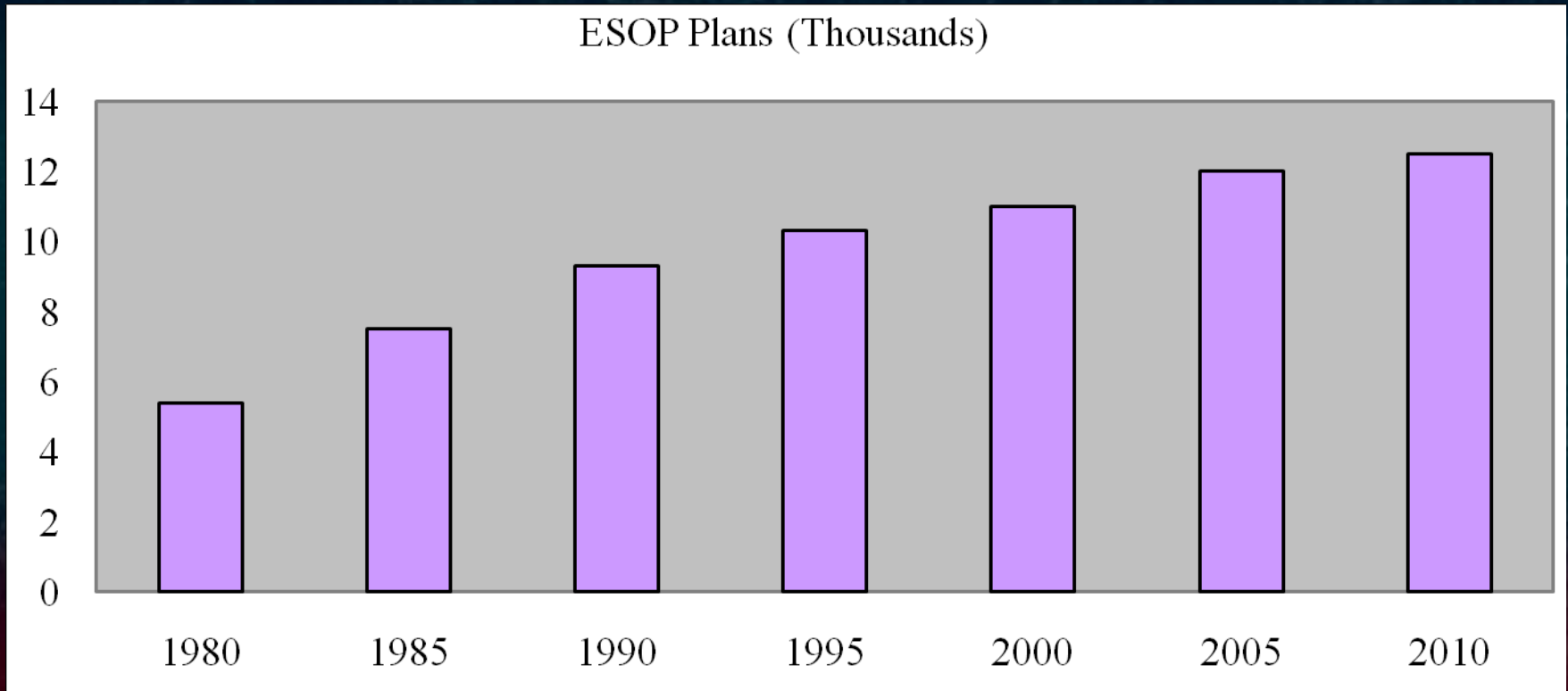
# ESOPs in a snapshot

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- ▶ ESOPs have been around since **1974**.
- ▶ Over **22,000** U.S. corporations have adopted ESOPs in that time!
- ▶ Today, there are over **10.3 million participants** (10% of U.S. workforce) with \$923 billion in assets (25% of 401k). Average retirement distributions are **\$370,000!!!** (ESOP Association 2008)

# The number of ESOPs is growing!

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Source: NCEO 2011

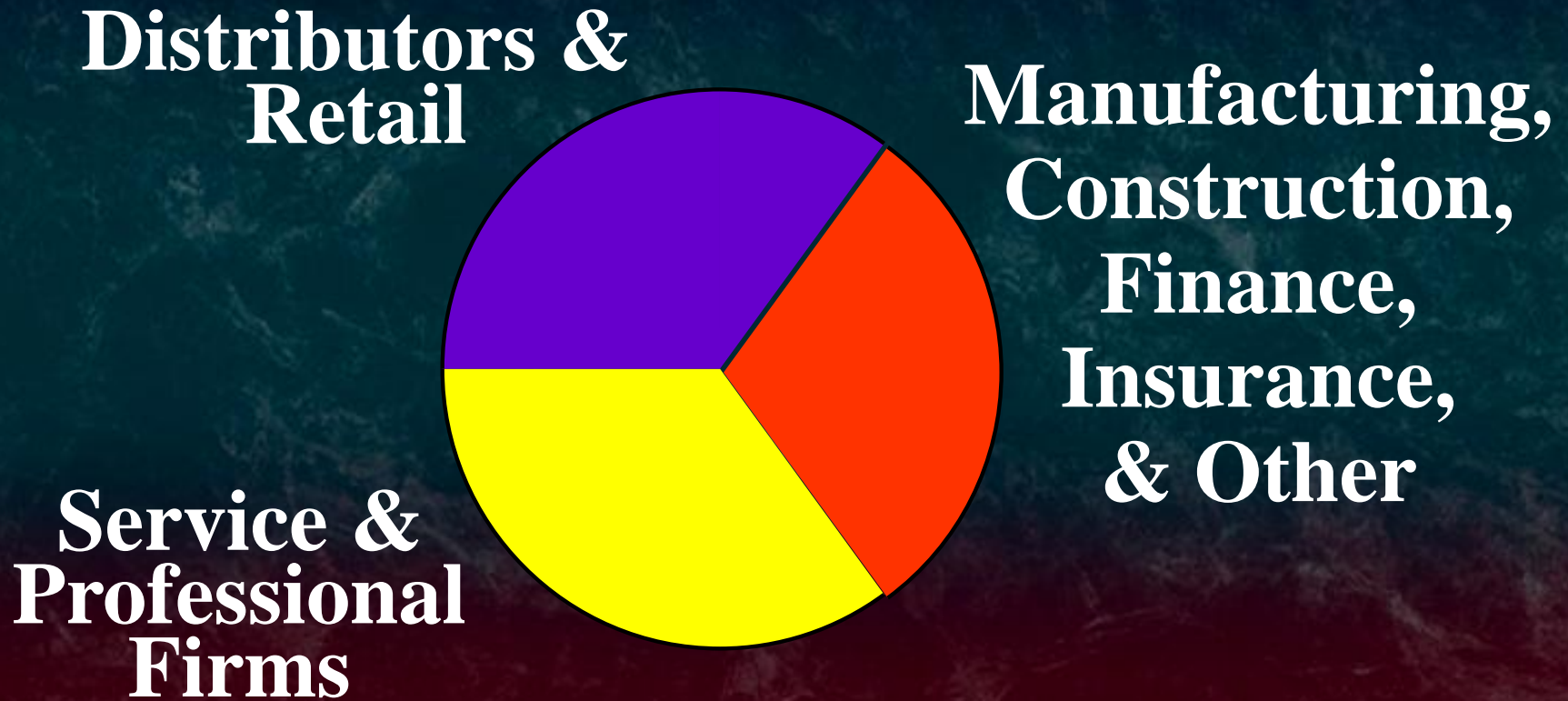
# Why are ESOPs popular?

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- ▶ **Win** - Business owners find a buyer of stock and/or a means of succession planning.
- ▶ **Win** - Company has an alternative to a sale and a means to increase productivity.
- ▶ **Win** – Employees receive a company-funded retirement plan and an incentive to affect their own personal wealth.
- ▶ **Win** - Vendors & customers receive better service and product.
- ▶ **Win** – Federal Government collects more taxes.

# ESOPs follow industries

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# Stock ownership of ESOPs

No requirement to sell a certain amount

Percent of each company owned  
by its ESOP

0-10%

11-  
30%

31-  
50%

51-  
100%

Percent of total *private*  
ESOP Companies

20%

20%

25%

35%

Source: NCEO



# Stock owned by ESOPs

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Over 2,500 U.S.  
businesses are owned  
100% by their ESOP!



# ESOP Benefits to Business Owners

# ESOP benefits to business owners

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1. Liquidity for shareholders
2. Diversify owner's asset allocation
3. Defer or avoid capital gains tax
4. Real business succession strategy
5. Increase company cash flow
6. Maintain control
7. Limited disclosure to employees
8. Enhance employee productivity

# **1. Liquidity for shareholders (while still running their business!)**

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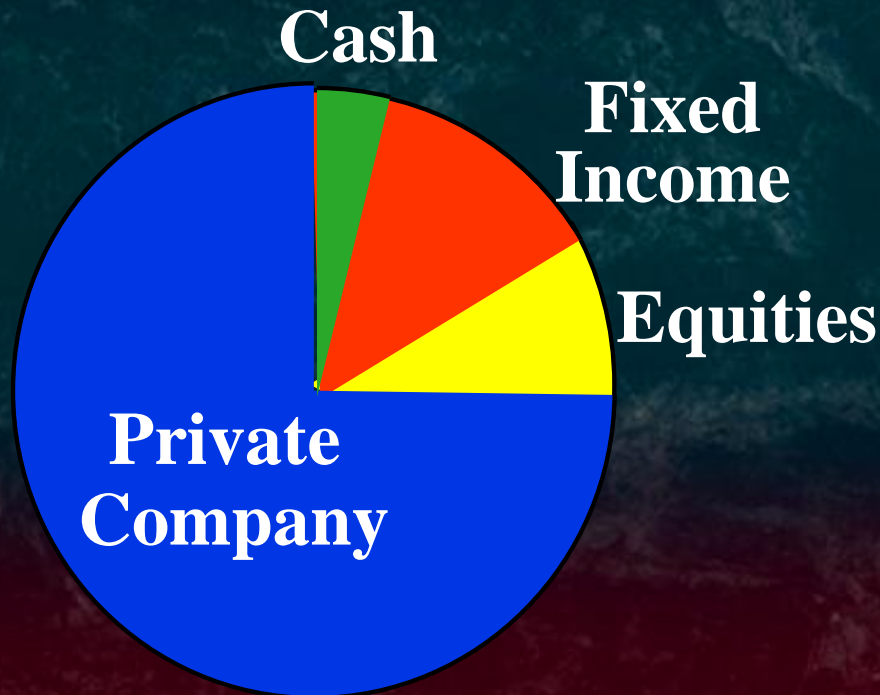
**Significant portion of owner's wealth tied up in  
company stock?**

- ▶ Owners can sell all or part of their shares.
- ▶ Can spread sale of shares over years.
- ▶ Can keep some shares, even after retirement.
- ▶ Many times selling the entire company to a third party is not possible, but this option does not come off the table after the ESOP is started.

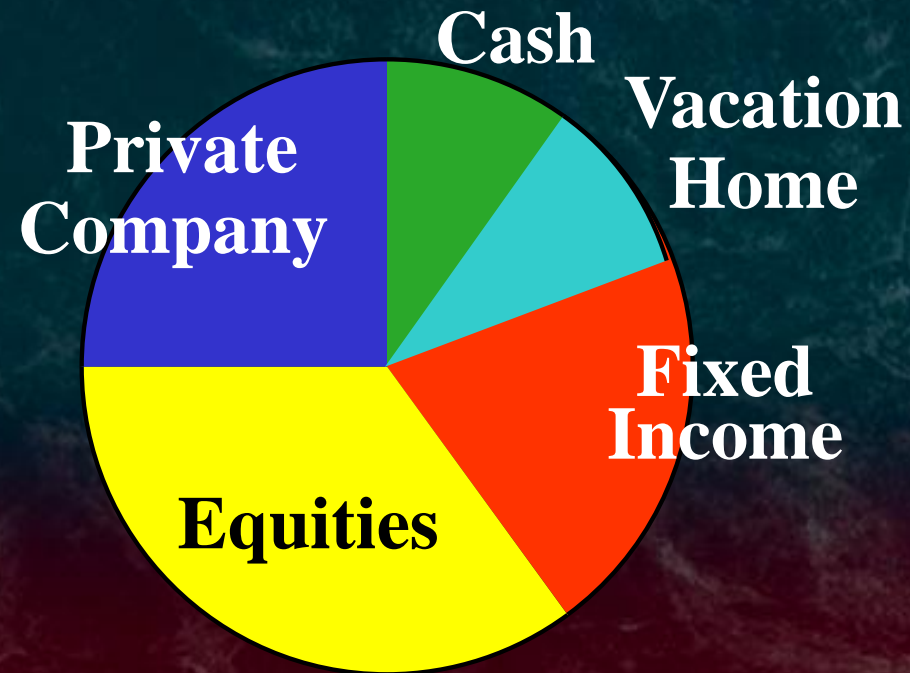
## 2. ESOPs diversify owner's asset allocation (while still running their business!)

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**Pre-ESOP**



**Post-ESOP**





# Basic ESOP Structures

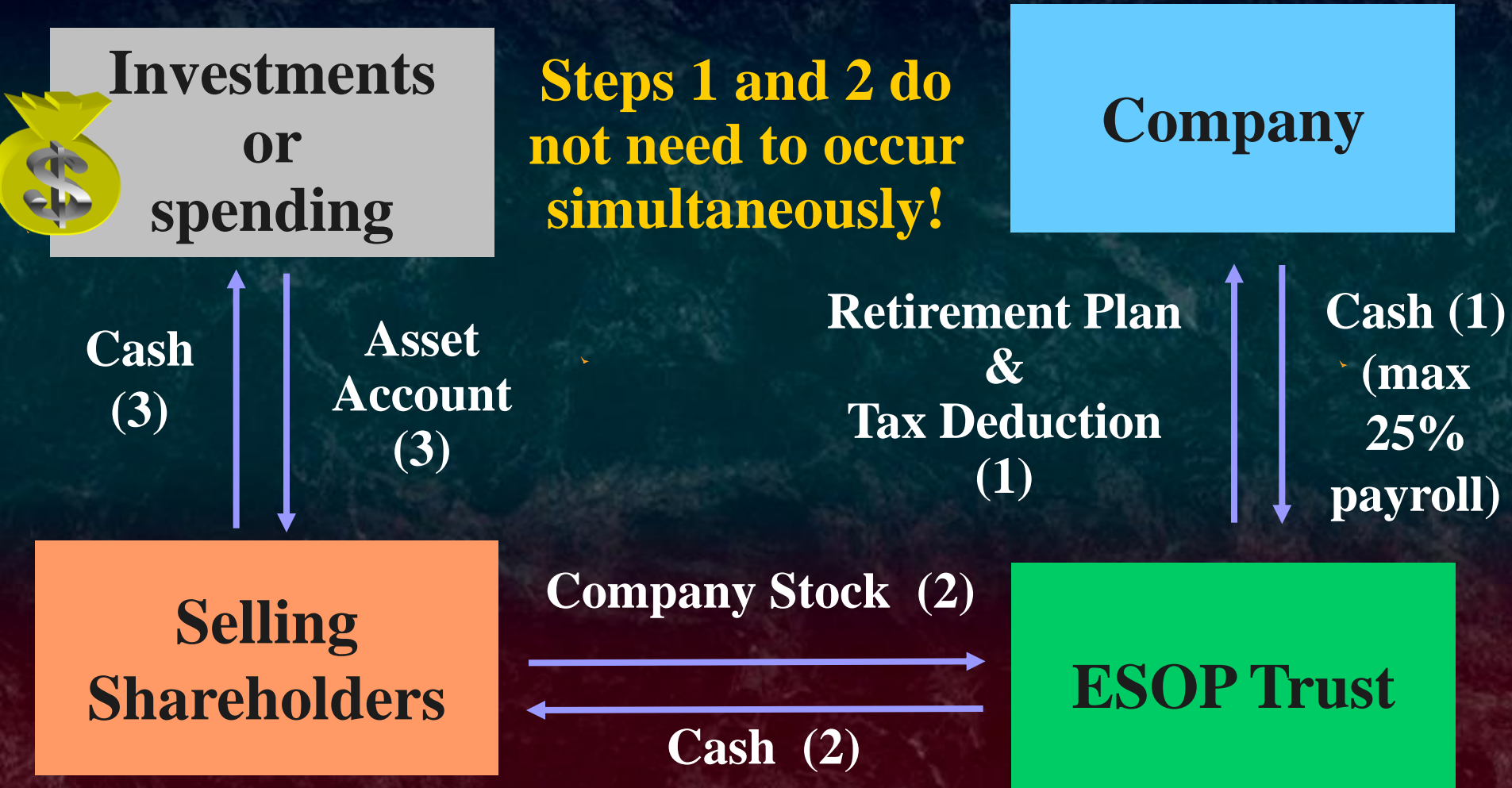
# How is an ESOP structured?

- ▶ The assets are **held in trust** for the benefit of plan participants.
- ▶ Trust is tax exempt.
- ▶ Assets invested primarily in Company Stock.
  - Highest class of stock
  - Voting



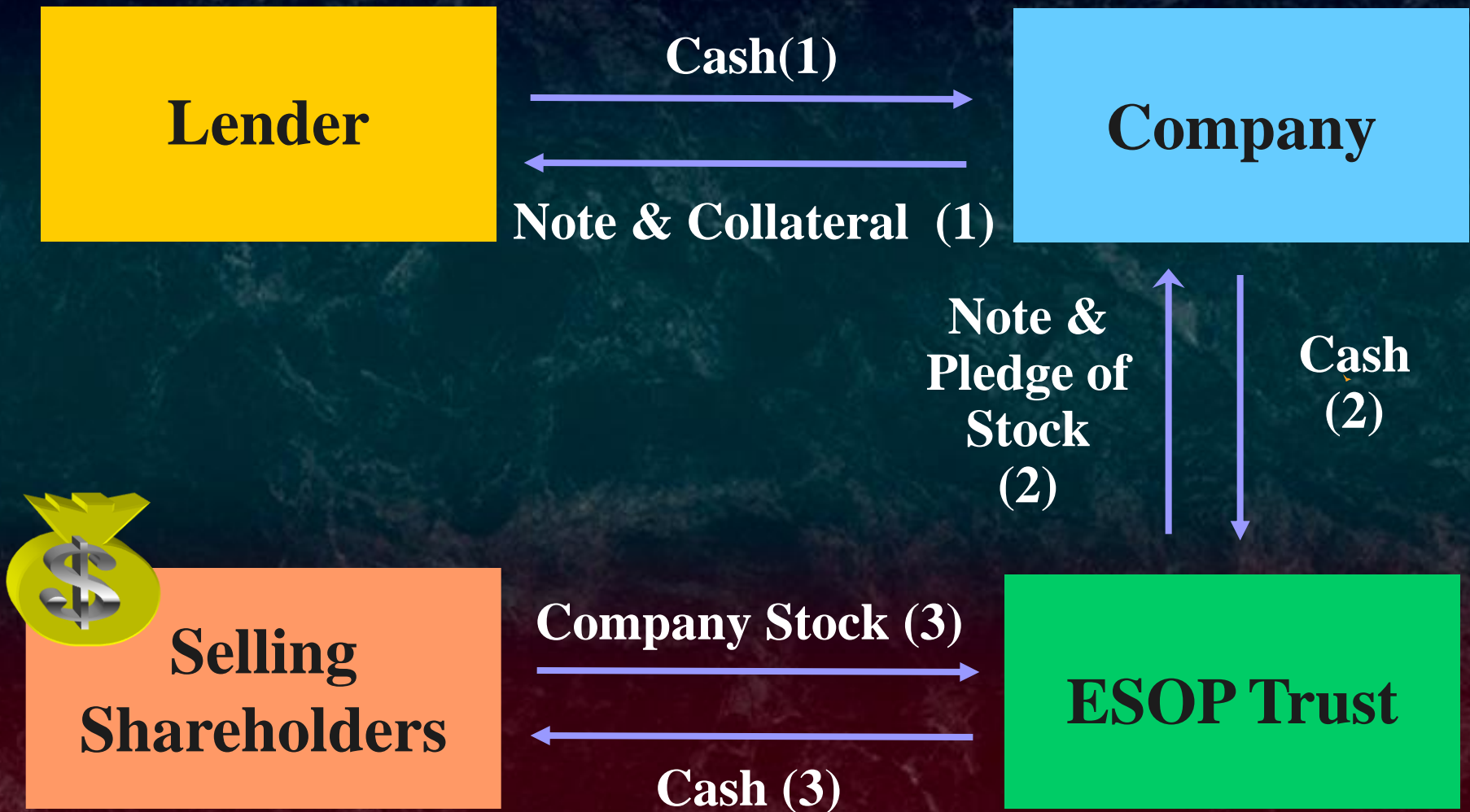
# ESOP Transaction #1

## Unleveraged Cash Contribution



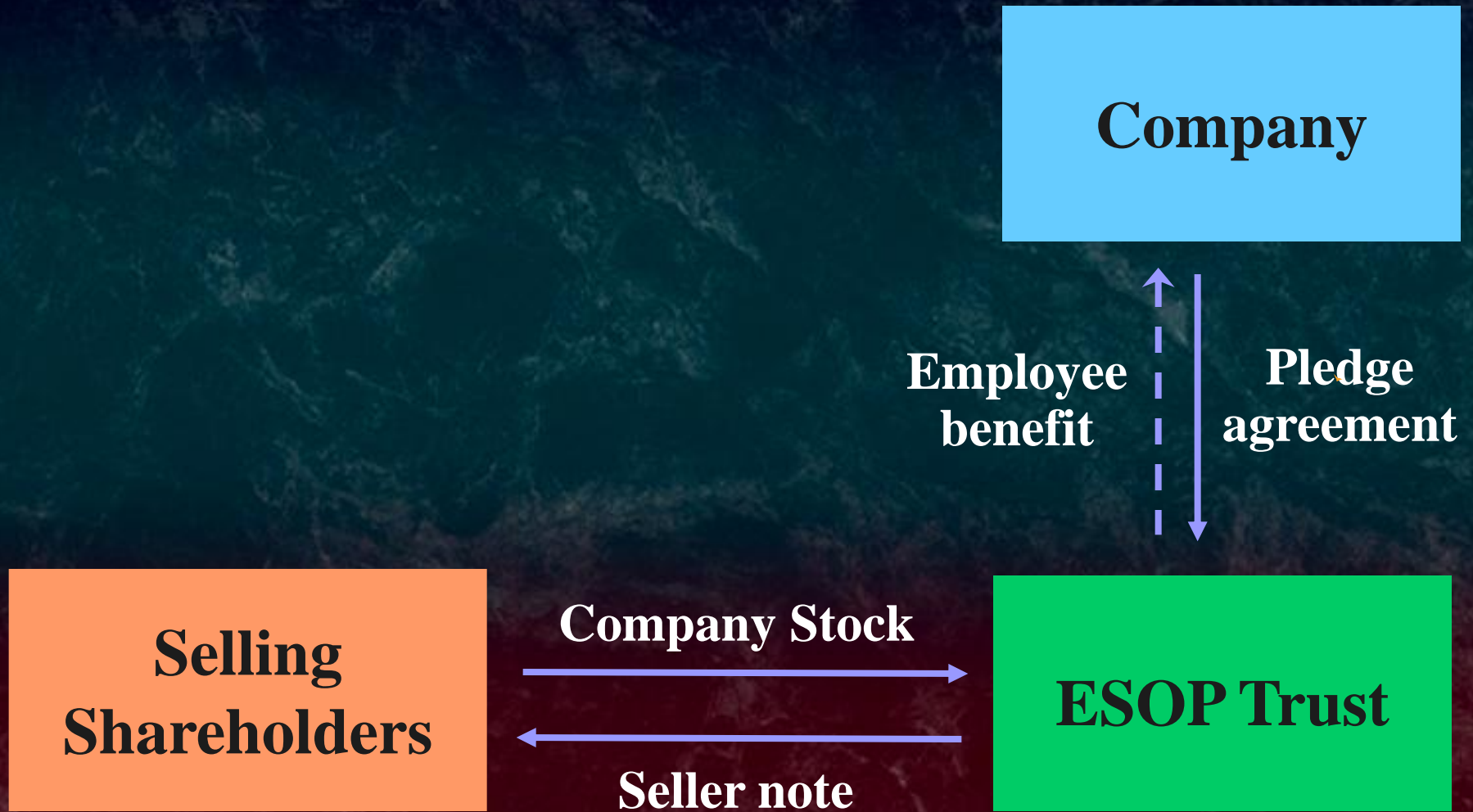


# ESOP Transaction #2a Leveraged (with bank)



# ESOP Transaction #2b Leveraged (with seller financing)

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# Typical ESOP Scenarios

# Company assumptions

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**Sales** \$ 10,000,000

**Eligible Payroll** \$ 1,000,000

(max contribution 25% is \$250,000 in this example)

**Pre-tax Profit** \$ 500,000

**Fair Market Value** \$ 3,000,000

**Owners:**      **Majority**      **75%**

**Minority**      **25%**

# Objective #1

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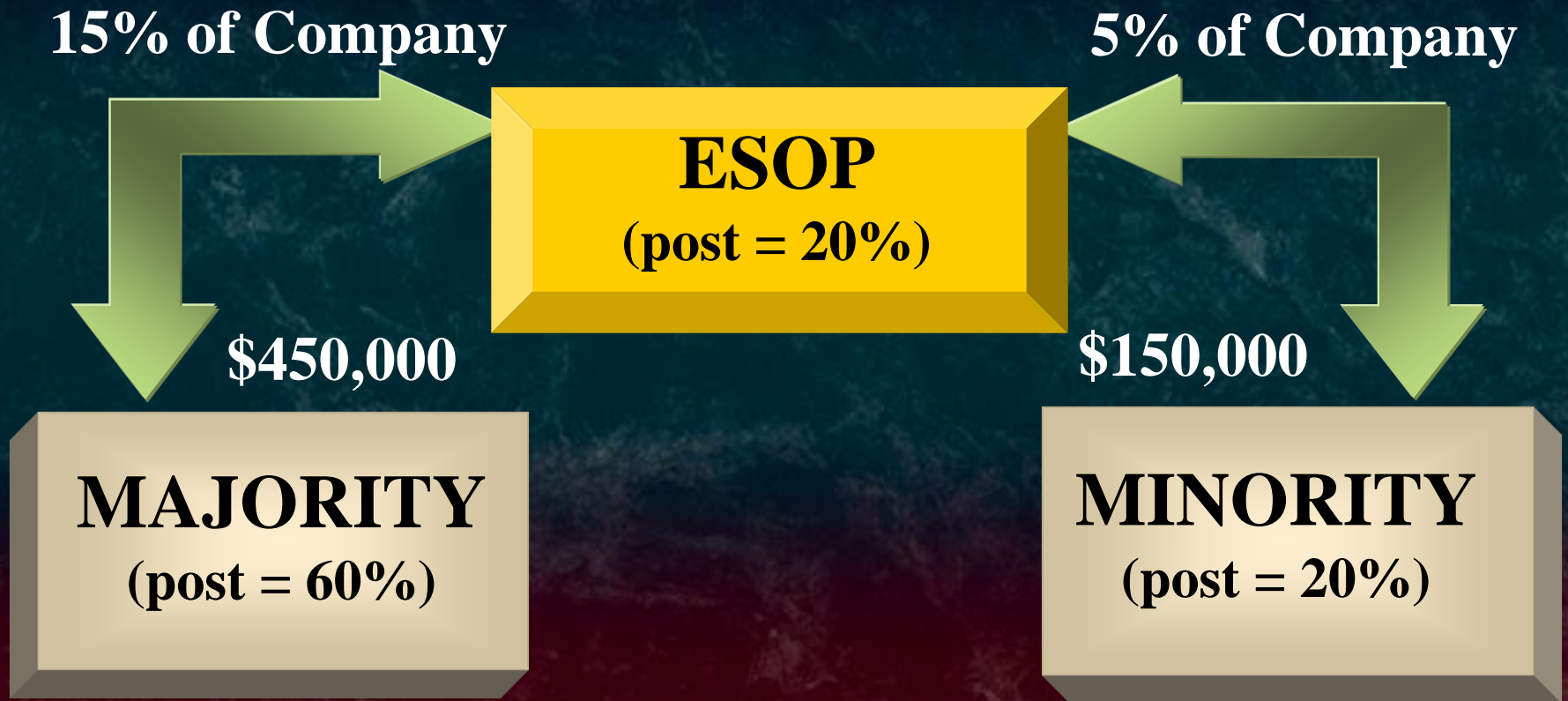
Shareholders want to cash out pro rata.  
(state law default)



# Solution #1

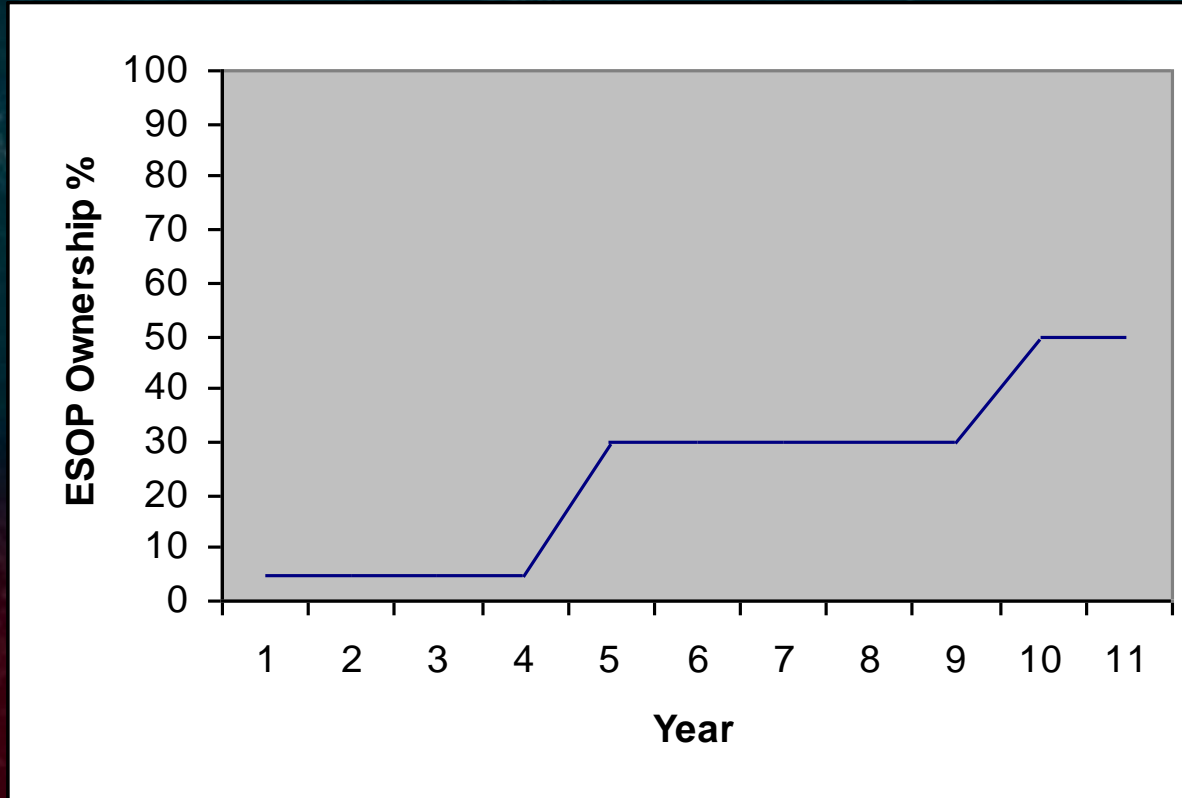
## Pro Rata Sale of 20%

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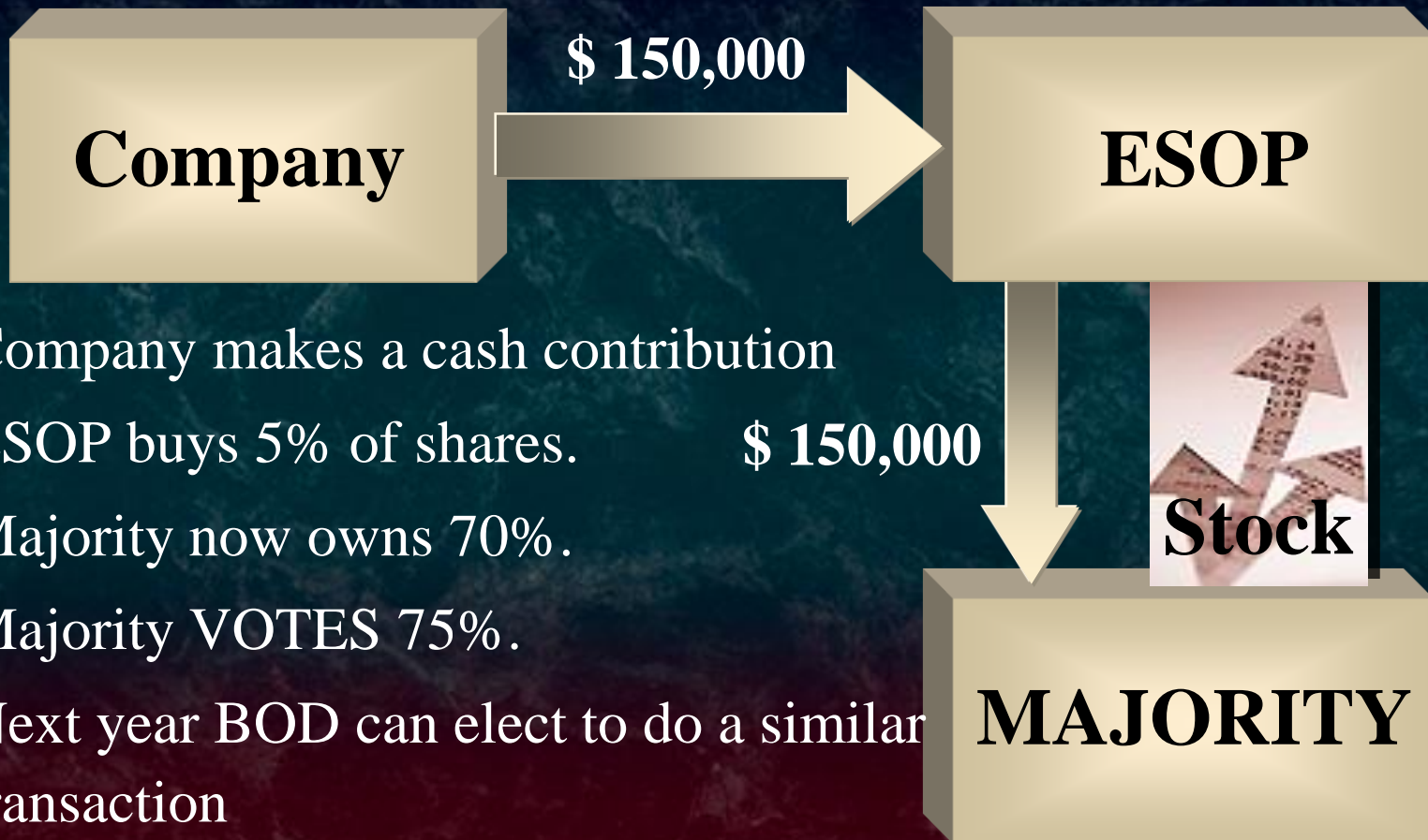
## Objective #2

Majority wants to cash out on a gradual basis (e.g. start with 5%).



## Solution #2

# Gradual or “Pay-as-you-go” ESOP



1. Company makes a cash contribution
2. ESOP buys 5% of shares.
3. Majority now owns 70%.
4. Majority VOTES 75%.
5. Next year BOD can elect to do a similar transaction



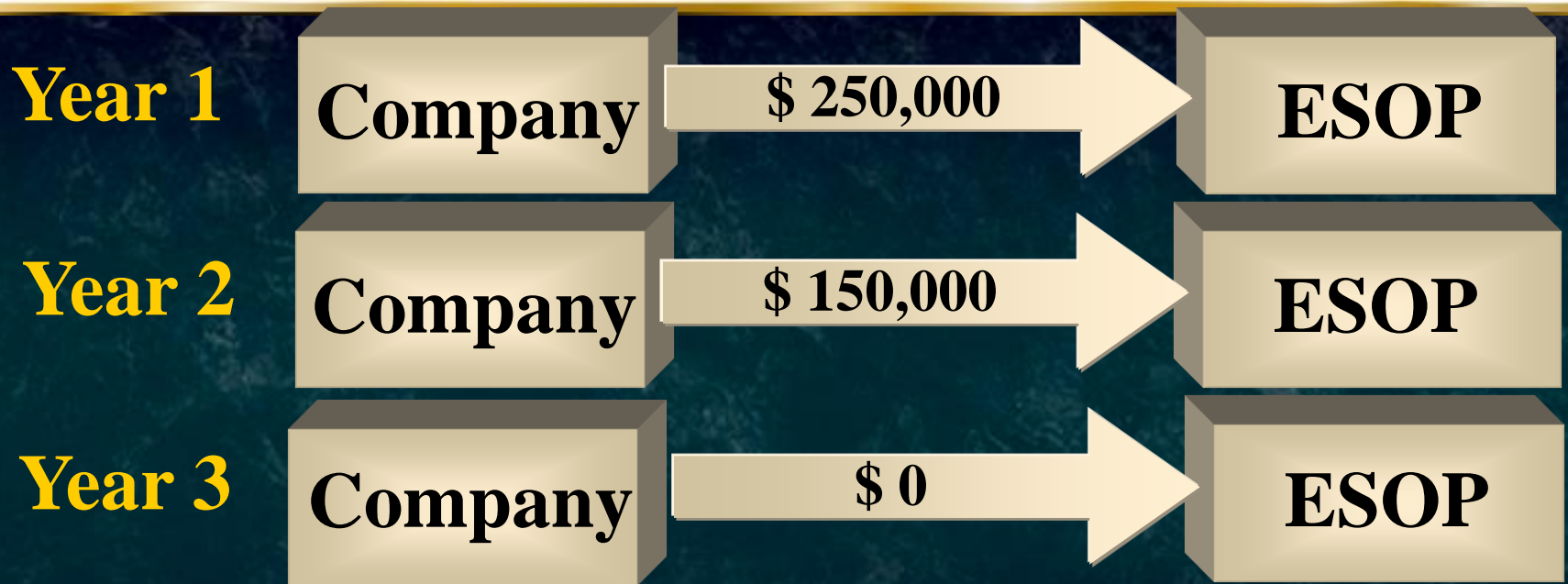
## Objective #3

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- ▶ Shareholder not ready to sell any stock but wants to create a tax deduction for this year and next year.
- ▶ Reasons for doing this include (1) not ready to diversify, (2) believe upside in stock price is great, or (3) want to accumulate enough funds to reach 30% threshold for §1042 rollover election.

# Solution #3

## The Prefunded ESOP



- ▶ Company may prefund up to 25% of payroll, or \$250,000 per year
- ▶ ESOP accumulates \$400,000 for future purchases of stock.
- ▶ Company receives tax deductions totaling \$250,000 and \$150,000 in years 1 and 2, respectively.
- ▶ Year 3 BOD can decide no contribution for various reasons.

# Objective #4

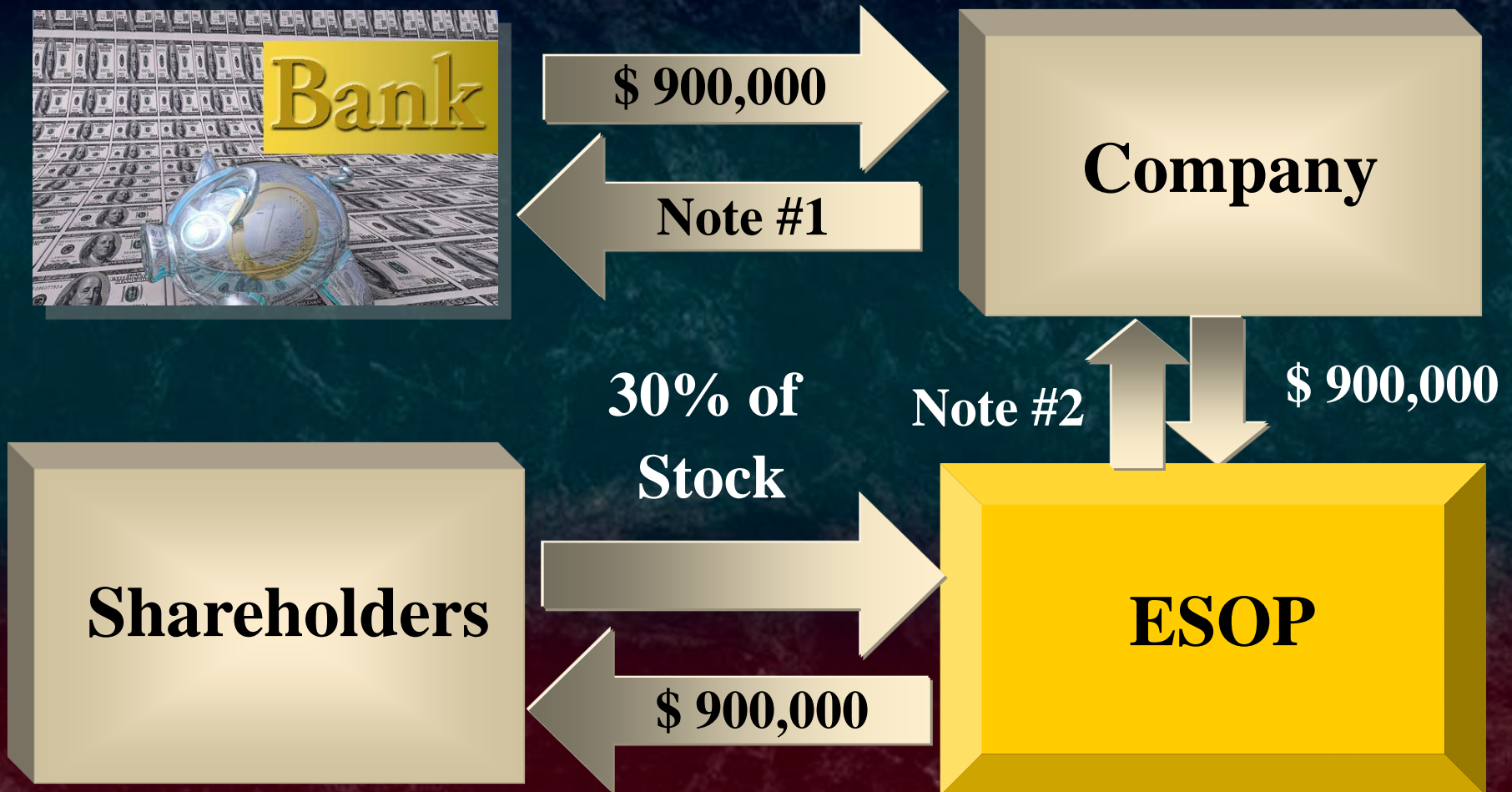
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Shareholders want to cash out a large amount of shares.



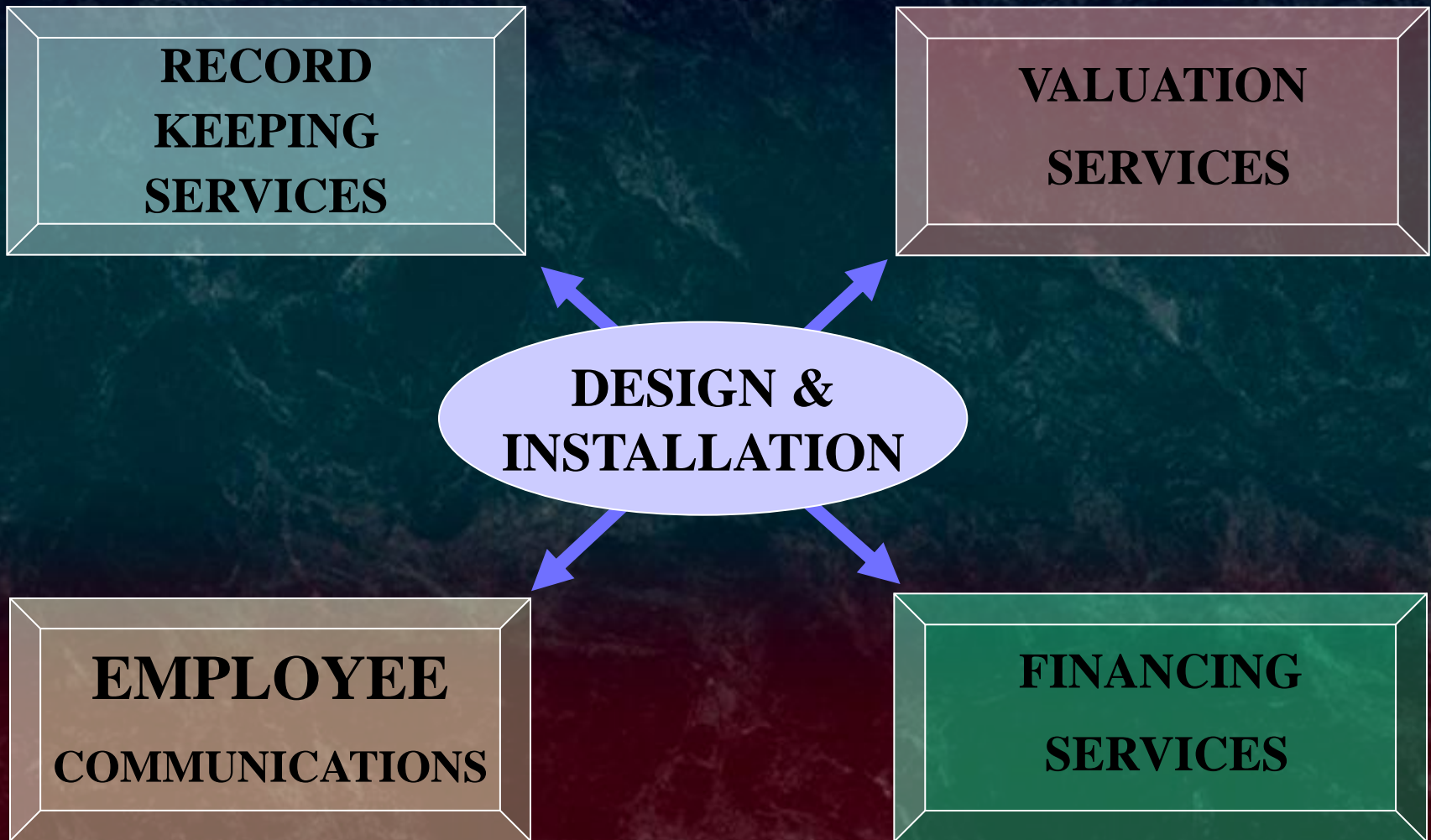
# Solution #4A

## Bank lends the money



# Menke & Associates Total ESOP Servicing

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# Questions and Answers

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# The End

*Thank You For Attending*



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