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SELLING TO AN ESOP

Tax Rates, Strategic Premiums, and the Cost Benefit

Is an ESOP is a beneficial strategy for someone who wants to sell a business? The only way to find the answer involves introspection and a comparative financial analysis. The inputs to that analysis changed dramatically on January 1, 2013, when capital gains rates shifted. In the following article, Chris Best of Acclaro Valuation Advisors examines the shifts in the financial terrain for C corporation ESOP transactions.

Since the reduction of capital gains tax rates in the late 1990s, most business owners would realize more after-tax cash proceeds by selling their shares to a strategic buyer than by selling to an ESOP. However, with the recent increase in the long-term capital gains tax rate and the additional Medicare surcharge, the situation has changed dramatically.

The decision regarding which one is more financially beneficial depends on a number of factors including the following:

- Tax basis in the shares of the common stock, which in turn will determine the amount of capital gains.
- The average acquisition premium paid by strategic buyers in the industry in which the company operates.

The Model

To analyze the question, a model was constructed using the following data:

- The average acquisition premium offered for the years 2007 to 2011, broken down by the industry of the company being sold. These data come from the 2012 FactSet Mergerstat/BVR Control Premium Study ("Mergerstat").
- The effective long-term individual capital gains tax rates (excludes state and local taxes) for 2012 and 2013.

Owners who sell their shares to an ESOP sponsored by a C corporation can defer the capital gains tax on the sale using section 1042 of the Internal Revenue Code, provided that they meet specific conditions. Since all owners have different basis in the stock they are potentially selling and the value of the deferral depends directly on the amount of that basis, the model calculates the equilibrium point by determining the level of tax basis that the stockholder would need to have in the business's stock so that the after-tax proceeds from the sale to a strategic buyer would equal the after-tax proceeds from the sale to the ESOP.

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OWNERSHIP NEWS

President's Budget Includes Repeal of ESOP Dividend Deduction

President Obama's proposed budget for the 2014 fiscal year would "eliminate section 404(k) ESOP dividend deduction for large C corporations" and calculates that the move would increase federal tax revenue by $407 million that fiscal year, rising to $722 million in 2023. The explanation of this proposal specifies that "large" C corporations would be those with $5 million or more in annual revenue. Companies smaller than that would still be allowed to deduct applicable

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