ESOP Overview

Introduction to ESOPs

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What is an ESOP?

- Employee Stock Ownership Plan
- Retirement plan protected by ERISA
- Similar to profit sharing or 401(k) match
- Two differences:
  - Primarily invested in company stock
  - Can borrow money to buy stock
- Flexible tax-advantaged tool for many corporate finance transactions!

Contemplating the Exit

Third Party
Family
ESOP

Selling Shareholder(s)
# Third Party Sale

- Seller pays capital gain tax
- Buyer pays with after-tax earnings
- Seller loses control
- Corporate identity?
- Fate of employees?

# Family Sale

- Seller pays tax
- Buyer pays with after-tax earnings
- Family retains control
- Business retains identity
- Retain employees

# ESOP Sale

**ESOP ADVANTAGES**
- Liquidity may be tax free
- Retain control
- May eliminate corporate taxes
- Employees are beneficial owners of stock of business and do not pay taxes until they receive a distribution from the plan
- Buyer pays with tax deductible dollars
ESOP Leveraged Transaction

- Tax Deferred Reinvestment
- Selling Shareholder(s)

Repayment of ESOP Loan is Tax Deductible

- Company receives tax deduction for providing shareholder liquidity!
- In other words, tax savings pay 40 percent of debt!

Allocation of Stock

- ESOP Trust
- Participant Accounts
- Stock

Yr 2 4 6 8 10 12 14 16 18 20
It gets better……

S corporation advantage

**S Corporation – Before the ESOP**

- Shareholders pay tax
- $2,000,000
- S dividend distributions
- $2,000,000

Assume:
- $5 million taxable income
- 40% tax rate (fed & state)
- Requires $2,000,000 tax distribution

**S Corporation – After the ESOP**

- NO TAX!
- ESOP $1,000,000
- S Tax distribution
- $1,000,000

Assume:
- $5 million taxable income
- 40% tax rate (fed & state)
- ESOP owns 50%
## ESOP Advantages

**Employees**
- Ownership at no cost
- No tax until receive distribution from ESOP or IRA

**Company**
- Tax savings pay for all or part of the seller’s liquidity
- Retain, reward, attract and motivate employees

## Seller
- Friendly buyer for all or part of the stock
- Tax on capital gain may be deferred
- Tax on capital gain may be eliminated if reinvestment is held for lifetime
- Seller may retain control
- Control fate of company and employees

## Requirements for Tax Advantage
- The company is a closely-held C corporation at the time of the sale
- The seller owned the stock for at least 3 years
- The seller did not acquire the stock through an option or other compensation situation
- The ESOP owns at least 30 percent immediately after the sale
### ESOP Uses in Private Companies

- Heavy lifting in an exit succession strategy while providing continuity of management and control
- Partial or complete liquidity for inactive shareholders
- Create a market for closely held stock
- Acquisition strategy
- Reward, retain and attract employees
- Create tax efficient employee-owned company

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### Owen A. Schmidt

Owen Schmidt is a Director of Consulting in the Retirement and Investor Services of The Principal Financial Group® in the Fort Worth, Texas office. Owen’s areas of expertise include the feasibility, design, installation and administration of qualified and nonqualified plans, including ESOPs, 401(k) plans, defined benefit plans, and defined contribution plans.

Owen is a member of the National Center for Employee Ownership, The ESOP Association, and a Board Member of the Southwest Chapter of The ESOP Association. He is a graduate of the State University of New York with a Bachelor of Arts degree in Economics.

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### Questions?

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