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WEALTH MANAGEMENT

Employee Stock Ownership Plans

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Employee Stock Ownership Plans ("ESOPs") are a company-funded employee retirement benefit plan, formally recognized by Congress in 1974[1] and regulated under federal law, that provide workers with an indirect ownership interest in their company.

To incentivize employee ownership of companies, business owners who sell all or part of their interest in a company to an ESOP enjoy the potential for significant personal financial benefits. A full or partial sale to an ESOP can often allow the seller to indefinitely defer payment of capital gains tax on the sale, and potentially avoid capital gains tax altogether.

Moreover, an ESOP can create a market for inside or outside shareholders of closely-held companies where there had previously been none. At the same time, a sale to an ESOP can align the interests of employees and company shareholders by giving employees an ownership stake in the company's success, which can enhance motivation, productivity and loyalty, and frequently lead to superior business efficiency relative to peer companies.

There are approximately 6,500 businesses fully or partially owned by ESOPs in the United States, covering approximately 14 million employees.[2] ESOPs are implemented by companies of all sizes, from small to very large, and are found across a wide range of industries, including manufacturing, retail, professional services, and technology. Well-respected companies owned by ESOPs include BOD USA, Ocean Spray, Publix Super Markets, W.L. Gore, WinCo Foods, King Arthur Baking, Parsons, HealthPartners, REI, and the Associated Press.

Notwithstanding these statistics and success stories, in light of the substantial benefits an ESOP can create for multiple stakeholders, they remain relatively underappreciated and underutilized compared to other strategies commonly used to sell a business. This is most likely due to a lack of clear information for business owners on the ESOP model and its substantial benefits. When business owners understand ESOPs, they overwhelmingly express strong interest in exploring an ESOP strategy as part of an understanding of different types of exit planning strategies. In a recent survey from the ESOP Association, 68% of business owners indicated that they would consider selling to an ESOP.[3]

[1] The Employee Retirement Income Security Act of 1974 ("ERISA") created the statutory authority for ESOPs and their associated tax benefits. Congress has modified the laws governing ESOPs on numerous occasions since 1974.

[2] For a comprehensive list of ESOPs in the United States, see, e.g., the National Center for Employee Ownership's "ESOP Map of the U.S. 2024 Update." https://www.esop.org/maps/esop-map-us-industry.php

[3] "The ESOP Value Proposition: Communicating About ESOPs for Maximum Impact Across Stakeholder Groups," The ESOP Association, 2024, page 4

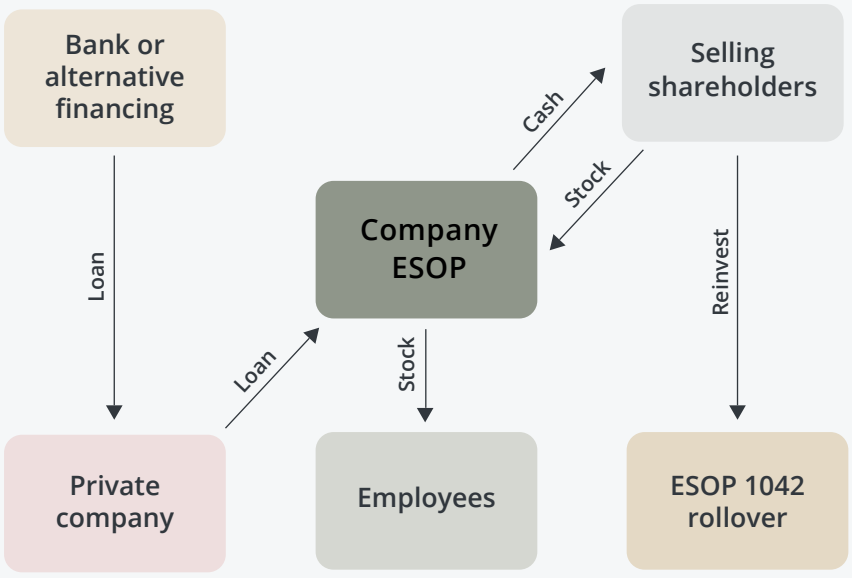
How does an ESOP work?

To implement a sale of some or all of a company to an ESOP, the company adopts the ESOP plan and establishes a trust as the legal entity that will own the company's shares on behalf of the employees, who are the trust's beneficiaries. The trust can acquire company shares in a variety of ways, the most common of which are: a direct contribution of shares by the company to the plan; a contribution of cash by the company to the plan, which then uses the cash to buy the shares (both of which are "non-leveraged ESOPs"); or, most commonly, the plan borrows money to buy shares (a "leveraged ESOP"). Company contributions—not the employees themselves—fund the plan. For leveraged ESOPs, money to fund the purchase of shares will typically be bank-financed, seller-financed, or some combination of both; frequently the company will be the primary borrower and then will lend the borrowed funds to the plan, since the plan has limited creditworthiness. The shares acquired by the ESOP trust can come from multiple sources: newly-issued shares, treasury shares, or shares of existing shareholders.

This diagram depicts a typical leveraged ESOP transaction, although many variations are commonly used.

Sample leveraged ESOP transaction

In a leveraged ESOP transaction, the company borrows from a bank or alternative financing source and lends proceeds to ESOP, taking back a note from ESOP. The ESOP then pays selling shareholder cash in exchange for stock. Here's how the transaction may work:



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The trust is controlled by a third-party trustee (a person or an entity initially selected by the company) who holds beneficial ownership of the shares on behalf of the employees and manages the trust's ongoing administration. Employees do not directly buy or hold shares through the plan. Typically, the shares are voted by the trustee–but some plans permit participants to exercise voting rights in certain circumstances. The trust can own any percentage of the company, but most ESOPs currently own or will own 100 percent of the company.[4] Typically, all employees 21 years of age or older are participants in the ESOP. Over time, the plan's shares are allocated to accounts of the individual participants, subject to vesting requirements. When participant employees leave the company, cash is distributed to them in an amount equal to the value of the shares in their ESOP account. Employees are not taxed on the stock allocated to their account until they receive distributions,[5] and they may continue to defer income tax after departing the company by rolling over their distributions to an individual retirement account.

There are additional significant tax incentives created by Congress for ESOPs.[6]

- Owners of closely-held C-corporations can defer all taxation on any capital gains realized by the sale of their shares to an ESOP if they reinvest the proceeds from the sale in what's called "Qualified Replacement Property"—the securities of United States operating companies—within 12 months of the sale of their shares to the ESOP. To qualify, the ESOP must own at least 30 percent of the company after the initial sale. Owners of S-corporations are not entitled to this tax deferral, but an S-corporation can convert to a C-corporation to permit this important benefit.[7] This is discussed more fully in the section below titled "How Does Capital Gain Deferral Under Section 1042 Work".
- The company can deduct its cash contributions to the ESOP, including cash used to pay principal and interest owed by the ESOP on money borrowed to buy shares from the business owner(s).[8] A company can also take a deduction for company shares it contributes to the plan.
- If the company is a C-corporation, cash dividends paid on shares owned by the ESOP are tax deductible. This benefit is only available to C corporations that are owned by ESOPs.[9]
- ESOPs are not taxed on their share of corporate income. Therefore, an S corporation that is wholly-owned by an ESOP effectively becomes tax-exempt, since its sole shareholder is a tax-exempt entity and reports no taxable income.[10] This tax benefit can create significant operational advantages for the company, which can use the tax savings to accelerate debt repayment, pay for ESOP benefits, or provide additional working capital to the company.

[4] Scott Rodrick, "An Introduction to ESOPs,"20th ed, National Center for Employee Ownership, 2023, page 4.

[5] Distributions are typically made when an employee retires, dies, becomes disabled, or terminates employment.

[6] Id. At 5-6.

[7] Such a conversion would, however, eliminate the ability of an S-corporation that was wholly-owned by an ESOP to operate exempt from federal income tax, as discussed below. Additionally, the SECURE Act 2.0 added a modified tax-deferral benefit for S Corps beginning in 2028.

[8] There are certain limitations on the deductibility of company contributions to an ESOP. Consult with your professional advisors for further information.

[9] Scott Rodrick, "An Introduction to ESOPs,"20th ed, at page 5.

[10] Unlike 501(c)(3) entities, however, S-corporations wholly-owned by ESOPs are not required to operate for charitable purposes.

What companies are well-suited candidates for ESOPs?

ESOPs can be a powerful tool for business succession planning, employee motivation, and future growth for the company. However, ESOPs are not suitable for every business. Here are some characteristics of businesses that are typically the best candidates for ESOPs:

- **Stable and profitable:** Companies that have a history of stable earnings and profitability are suitable candidates for ESOPs. This is because the ESOP will need to service the debt incurred to buy the shares, and stable cash flow is essential for this purpose.

- **Medium to large size:** While ESOPs can be implemented in companies of various sizes, they are often more feasible for medium to large-sized businesses (for example, rules of thumb frequently indicate 30 or more employees and/or annual payroll of $1 million or more). This is because the administrative costs and complexities of setting up and maintaining an ESOP can be significant, and the smallest companies are not well-suited to absorb these costs.
- **Strong management team:** A company with a strong and capable management team is more likely to succeed with an ESOP. The transition to employee ownership can be complex, and strong leadership is essential to navigate this process effectively, especially if the selling owner is departing the business completely.
- **Employee-centric culture:** Companies that already have a culture of employee involvement and empowerment are more likely to benefit from an ESOP. Employee ownership can enhance motivation and productivity, but it works best in environments where employees are already engaged and invested in the company's success.
- **Healthy balance sheet:** Companies with a strong balance sheet and low levels of existing debt are better positioned to take on the additional debt that may be used to finance the ESOP transaction.
- **Growth potential:** Companies with strong growth potential can benefit from an ESOP as it aligns the interests of employees with the long-term success of the company. As the company grows, the value of the employee-owned shares can increase, providing significant financial benefits to the employees.

Is an ESOP right for me as the seller?

Deciding whether an ESOP is right for you as a seller depends on various factors, including the nature of the business, your personal financial needs and objectives, and your vision for the company's future and its employees. Here are some key considerations to help you determine if an ESOP might be a good fit.

Benefits of an ESOP for sellers:

- **Tax Advantages:** Selling to an ESOP can offer significant tax benefits. For example, as discussed more fully below, under Section 1042 of the Internal Revenue Code, sellers of C-corporation stock can defer capital gains taxes if the proceeds are reinvested in the debt or equity of United States corporations ("qualified replacement property" or "QRP"). Capital gains for heirs can be avoided entirely if QRP is held until death and cost basis is adjusted to fair market value as of the date of death.
- **Legacy and employee welfare:** An ESOP can help ensure that the business continues to operate in a way that aligns with the seller's values and vision. By selling to an ESOP, owners are better able to preserve the culture and legacy of the company they've built, and an ESOP can be a way to reward and motivate employees by giving them a stake in the company.
- **Gradual exit:** An ESOP can facilitate a gradual transition of ownership, allowing the seller to "take some chips off the table," but remain involved in the operation of the business if desired or necessary (for example, if the next generation of leadership isn't quite ready to take over entirely).
- **Market for shares:** An ESOP creates a market for closely-held company shares, which can be particularly valuable if, for a variety of reasons, there are no available external buyers.

Potential Drawbacks:

- **Complexity and costs:** Setting up and maintaining an ESOP can be complex and relatively costly, not unlike other merger and acquisition transactions. It involves legal, financial, and administrative expenses.
- **Regulatory requirements:** ESOPs are subject to strict regulatory requirements and ongoing compliance obligations under ERISA, which some can find burdensome and may be costly.
- **Valuation issues:** Under ERISA regulations, the company must be valued at fair market value by an independent appraiser, and the valuation process can be intricate and time-consuming. Selling to a third party, such as a strategic buyer, may enable the owner to attract a higher price compared to an ESOP, and the purchase price will not be subject to scrutiny by independent appraisers.
- **Impact on company finances:** The company may need to take on debt to finance the purchase of shares by the ESOP, which could ultimately impact its financial health.

Key questions to consider:

- What are your personal financial needs and objectives? Are you looking for immediate liquidity, or are you willing to accept a longer-term payout?
- What is your vision for the company's future?Do you want to ensure that the company remains independent and employee-owned?
- How is the company's financial health? Is the company in a strong financial position to support an ESOP? Does the company have a strong management team to continue running the business in the future?
- Are you prepared for the complexity and costs involved? Do you have the bandwidth and resources to manage the setup and ongoing administration of an ESOP?

For many sellers, the decision to exit their companies through an ESOP can be viewed as a more altruistic choice and a "best of all worlds" strategy because it enables the seller the opportunity to personally benefit in a tax efficient manner (if the company is a C corp) while protecting the legacy of the company they built and enhancing the lives of valued employees.

Is an ESOP right for my business?

Determining whether an ESOP is right for your business involves evaluating several factors related to your company's operational and financial efficiency, company culture, and long-term objectives. Here are some examples of considerations to help you assess if an ESOP is a suitable option for your business.

- **Operational advantages:** An ESOP can be a powerful tool for increasing employee engagement and motivation, as employees become partial owners of the company and have "skin in the game." Consider whether your workforce is likely to embrace this ownership culture—and capable of being owners of your business.
- **Tax efficiency:** ESOPs can make the business more tax efficient because ESOP contributions, including loan repayments, can be tax deductible to the company.
  - **Employer contributions:** Contributions made by the company to the ESOP are typically tax deductible. This includes both contributions of stock and cash contributions used to buy stock. This can reduce the company's taxable income.
  - **Loan repayments:** If the ESOP borrows money to buy company stock in a leveraged transaction, the company can make tax-deductible contributions to the ESOP to repay the loan. Both the principal and interest payments are tax deductible, subject to certain limitations.
- **Tax-exempt earnings for S-corporations**
  - The ESOP itself is a tax-exempt entity. When the ESOP buys some or all of an S corporation, the portion of the company's earnings attributable to the ESOP's ownership is not subject to federal income tax. Thus, if an ESOP owns 100% of an S corporation, the company would pay no income tax on its earnings.
- **C-corporation dividends**
  - With C-corporations, dividends paid on ESOP-owned stock can be tax deductible if they are used to repay an ESOP loan, passed through to employees, or reinvested in company stock by employees.
- **State tax incentives:** Some states offer additional tax incentives for companies that establish ESOPs, such as tax credits or deductions. These benefits vary by state and can provide further financial advantages.
- **Enhanced cash flow from tax savings:** The tax deductions and deferrals associated with ESOPs can enhance the company's cash flow, providing additional funds for reinvestment, debt repayment, or other corporate purposes.

Is an ESOP right for my employees?

One of the fundamental motivations for the creation of an ESOP is to provide enhanced financial benefits to loyal employees. Studies have shown a range of many other positive impacts for your team.

Employee financial benefits

- **Retirement savings:** ESOPs can significantly enhance employees' retirement savings. Employees accumulate shares in the company over time, which can grow in value and provide a substantial retirement benefit.
- **Wealth building:** As partial owners, employees can benefit from the company's financial success. If the company performs well, the value of their allocated shares increases, contributing to their personal wealth, which can sometimes be life-transforming.
- **Tax advantages:** ESOPs offer tax advantages for employees, such as tax-deferred growth of their ESOP accounts, which can continue after departure from the company if distributions are rolled over into an individual retirement account (IRA).

Employee engagement and motivation[11]

- **Ownership culture:** ESOPs can foster a sense of ownership and responsibility among employees. When employees have a stake in the company, they may be more motivated to work harder, innovate, and contribute to the company's success.
- **Job satisfaction:** Employee ownership can lead to higher job satisfaction. Employees may feel more valued and invested in the company's future.
- **Retention and longevity benefits:** An ESOP tends to help keep companies intact, preserving jobs relative to other types of business exits and encouraging employees to stay with the company longer than employees of peer companies.

Organizational culture and readiness

- **Communication and education:** For an ESOP to be successful, employees need to understand how the plan works and what it means for them. If employees don't understand their ownership interest in the company, they won't act like owners. This typically requires ongoing transparency, open lines of communication, and educational efforts by management.
- **Employee involvement:** ESOPs work especially well when employees are engaged in the direction of the company. Consider whether your company culture supports employee involvement in decision-making. For an ESOP to be optimally effective, employees should be encouraged to participate and contribute ideas for the company's overall success.

[11] Scott Rodrick, "An Introduction to ESOPs,"20th ed, at page 31-32; Corey Rosen & Scott Rodrick, "Understanding ESOPs," 2nd ed., National Center for Employee Ownership, 2024, at pages 147-154.

When is an ESOP better than selling to a third-party?

An ESOP can be a better option that other types of business sales to third parties in certain circumstances. Here are certain scenarios where an ESOP may be more advantageous.

Seller desires a tax-advantaged sale

- **Tax deferral for sellers:** Under Section 1042 of the Internal Revenue Code, sellers of C corporations can defer capital gains taxes if the proceeds are reinvested in QRP. Selling to third-party other than an ESOP will constitute a taxable event, potentially triggering capital gains.
- **Tax benefits for the company:** Contributions to the ESOP are tax deductible, and in some cases, the company can become partially or fully tax-exempt if it is structured as an S corporation owned by an ESOP.

Gradual exit strategy

- Unlike the typical sale to a third party like a strategic or financial buyer, an ESOP can be designed to allow for a gradual transition of ownership in stages (i.e., "taking some chips off the table"), enabling the seller to remain involved in the business for a period of time if desired or necessary. This can be advantageous if more time is needed to ensure a smooth transition and mentor the next generation of leaders.

Lack of external buyers

- **Internal market for shares:** If there are no apparent external buyers for your business, an ESOP can create a ready internal market for your shares, ensuring that you can achieve partial or full liquidity when that might not otherwise be possible.

Confidentiality

- Selling to an ESOP allows the company to avoid the disclosure to competitors or other potential buyers of confidential financial performance information or trade secrets.

Desire to preserve company culture and independence

- Selling to an ESOP can help maintain the company's culture, values, and legacy by keeping the company independent. An ESOP can help avoid potential changes in direction or culture that might come with a sale to a competitor or private equity firm.

Conversely, an ESOP may not be the best option for sellers who need immediate liquidity or a quick exit, which other types of sales may be better suited to provide. ESOPs would not be a good choice for companies in financial distress or with inconsistent cash flow. Finally, ESOPs would not be an optimal choice for companies where the employees would not be interested in or understand the concept of—or be ready to take on the responsibilities of–employee ownership.

Even in situations where it is determined that a sale to third parties would likely be a superior option, it can be advantageous to simultaneously explore an ESOP as another bid to analyze on a post-tax basis and compare against outside offers received during the process of marketing the company externally. In such circumstances, sellers have the ESOP in their pocket as a type of "insurance policy" if third-party buyers never materialize or offer relatively unfavorable terms.

How does capital gain deferral under Section 1042 work?

For a seller to enjoy the benefit of indefinite deferral of capital gains realized by selling their company to an ESOP, certain requirements must be met under Section 1042 of the Internal Revenue Code.

- The company must be a C corporation at the time of the sale.
- The seller must have held the stock for at least three years before the sale.[12]
- The ESOP must own at least 30 percent of the company after the transaction (or 30 percent of each class of outstanding stock).
- The shares sold to the ESOP must include the most senior stock.
- The seller must reinvest the sales proceeds (or cash in an amount equivalent to the sales proceeds) into QRP during the period from 3 months prior to 12 months after the sale.
- The seller looking for indefinite tax-deferral can be an individual, a non-grantor trust, an estate, a partnership or a limited liability company, but not another corporation.[13]

[12] If the stock was acquired by gift the three-year holding period includes the prior holding period of the donor. If the stock was acquired as part of a tax-free exchange, for example, as a result of a conversion from a partnership, S-corporation or LLC to a C-corporation, the three-year holding period includes the time prior to the conversion. Scott Rodrick, "An Introduction to ESOPs,"20th ed, at page 26. In addition, the ESOP must hold the acquired stock for three years after the purchase or pay a 10 percent excise tax on its disposition.

[13] Scott Rodrick, "An Introduction to ESOPs,"20th ed, at page 24.

*Employee Retirement Income Security Act of 1974

To incentivize reinvestment in the corporate economy of the United States, IRC Section 1042 requires that QRP must consist of stocks, bonds, or other securities (such as floating rate notes) of operating companies incorporated in the United States. Indefinite tax deferral is not available for other types of financial assets such as government bonds, real estate, real estate investment trusts, master limited partnerships (MLP), mutual funds, or ETFs. The seller can reinvest all of the sale proceeds into QRP, or can elect to pay capital gains on any portion of the sales proceeds that the seller does not wish to reinvest in QRP. Once QRP is purchased, any sale or exchange will trigger the gain that was deferred on the portion sold (that is, if a portion of the QRP is later sold, only an equivalent proportion of the deferred gain would be realized).

A common strategy designed to generate the maximum tax advantage for the seller's heirs is to choose QRP with the intention to hold until death, at which time all embedded capital gains would typically be eliminated due to cost basis adjustment (also known as "stepped up basis"). Thus, for owners who sell their C corporation shares to an ESOP, reinvest all sale proceeds in QRP and hold that QRP until their subsequent death, no capital gains tax would have been paid for the sale of the business.

In order to free up liquidity to use for other purposes, many sellers will obtain a line of credit secured by the QRP, thus permitting the purchase of other investments or to enjoy for personal use. Combining the indefinite tax deferral (or tax elimination if QRP is held until death) with a secured line of credit that can be used for other purposes can create an extremely attractive way for sellers to enjoy the fruits of their labor, while benefitting the company and employees, a true "win-win-win." Note, however, that of course there is an interest cost associated with the loan; if the interest cost is higher than the interest received from the floating rate notes the value of the QRP to the seller's heirs could decline if unpaid interest needs to be paid at the seller's death.

What are some potential pitfalls of selling to an ESOP?

As with all exit strategies, there are certain risks associated with ESOPs that should be carefully considered.

- **Administration costs—**Because ESOPs are qualified retirement plans under ERISA, administration, compliance, and record-keeping for the plan comes with an additional layer of expense as the company must engage independent experts like trustees, administrators, attorneys, and independent appraisers.
- **Employee education and engagement—**creating a thriving culture of employee ownership often requires extensive employee education and activities to promote the myriad of benefits among the employee base. Neglecting this aspect of an ESOP means that the substantial benefits of an "ownership culture" may not be optimized.
- **Declining business valuations—**Each year, the ESOP must obtain an independent valuation of the company, which can have an impact on sellers and employees. For sellers of C corporation stock who elected to employ a 1042 exchange to defer capital gains, a devaluation can affect the seller's tax obligations if there are "clawback" provisions involved in the structure of the sale. For employees, a declining company valuation can create morale issues and can negatively impact choices for those seeking to retire or leave the company.

- **Negative business results or insolvency—**For sellers who self-financed a portion of the sale to the ESOP in lieu of a full upfront cash payment, the solvency of the company is essential to realizing the full value of the ESOP monetization. If the business has negative financial results or edges toward insolvency, the ESOP may not be able to satisfy its obligations to the seller. Moreover, this may have a highly negative personal financial impact on employee participants in the ESOP.

What are some common misconceptions about ESOPs?

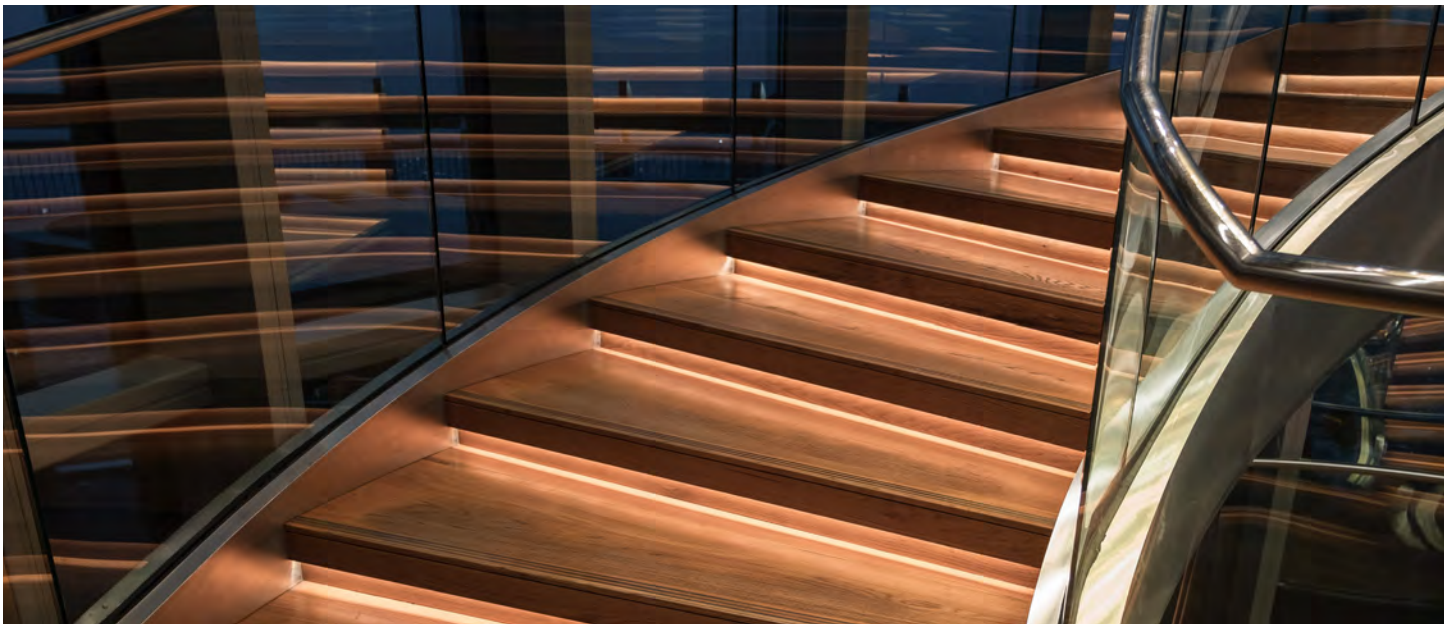
Because ESOPs are relatively complex retirement plans regulated by ERISA, many misconceptions about them exist. Here are some of the most common misconceptions business owners have about ESOPs and the reality.

- **"ESOPs are only for very large companies."**
  - **REALITY:** While ESOPs are often associated with larger companies, they can be implemented by small and medium-sized businesses as well. The feasibility depends more on the company's financial health and goals rather than its size. ESOPs are viable for smaller companies with at least 11 employees (a legal requirement) and with an annual payroll of $1 million or more, as rules of thumb. In fact, the U.S. Treasury created the $10 billion dollar State Small Business Credit Initiative in 2021 to provide financial programs to support small businesses and employee ownership at the state level.
- **"ESOPs are very expensive to set up and maintain."**
  - **REALITY:** While there are significant costs associated with setting up and maintaining an ESOP, such as legal, financial, and administrative expenses, these costs can be outweighed by the tax advantages and other benefits that ESOPs provide. Additionally, the long-term benefits to employee engagement and retention can further outweigh the initial and ongoing costs. For the smallest companies, initial costs average a few hundred thousand dollars, and can range up to 2.5% of sales proceeds on larger transactions.[14] Ongoing expenses are similar to most profit-sharing plans except for the annual valuation update, which is typically the most significant ongoing expense associated with an ESOP.
- **My employees don't have the funds to buy the company."**
  - **REALITY:** In the vast majority of ESOPs, employees do not pay for their shares out of pocket.[15] Instead, the company makes contributions to the ESOP, which are then used to buy shares on behalf of the employees. The employees are allocated these shares as part of their compensation and retirement benefits, subject to vesting requirements.
- **"ESOPs are just another employee benefit plan."**
  - **REALITY:** While ESOPs do provide retirement benefits, they are fundamentally different from other employee benefit plans like 401(k)s. ESOPs create an "ownership mentality," which can significantly improve company culture, employee engagement, and business performance.
- **"ESOPs guarantee job security."**
  - **REALITY:** While ESOPs can improve job security by fostering a sense of ownership and loyalty among employees, often leading to competitive business performance relative to peers, ESOPs do not guarantee superior financial results or job security for employees. Some ESOP companies do not succeed for any number of business reasons.

[14] Scott Rodrick, "An Introduction to ESOPs,"20th ed, at page 83-84.

[15] "ESOPs v. 401(k)s," The ESOP Association, 2024, https://www.esopassociation.org/esops-v-401ks#:~:text=In%20the%20vast%20majority%20of,any%20retirement%20plan%20at%20work.

- **"Employees will be running the company and will control business decisions."**
  - **REALITY:** While employees in an ESOP do become partial owners, they do not have direct control over day-to-day business decisions. The company's management and board of directors continue to make strategic decisions. However, employees may have a voice in certain governance matters, depending on the structure of the ESOP and preference of the business owner.
- **"ESOPs are a quick exit strategy for sellers."**
  - **REALITY:** Setting up an ESOP is a complex process that requires careful planning and time. It is not a quick exit strategy. Frequently, sellers to an ESOP will continue to be involved with company in some capacity, especially if they have only sold a partial interest or if they have carried back seller financing. Owners who want to sell their business quickly and in its entirety may find other options, such as selling to a strategic buyer or private equity firm, more suitable.
- **"ESOPs are for companies in financial trouble."**
  - **REALITY:** ESOPs are not a solution for companies in financial distress. In fact, a company needs to be financially healthy and stable to support an ESOP, as the plan requires ongoing contributions and the ability to service any debt incurred to finance the ESOP.
- **"ESOPs are too rigid because of government regulation."**
  - **REALITY:** Notwithstanding ERISA rules and regulations, ESOPs are highly customizable and can be tailored to fit the specific needs and goals of the company and its employees. The structure, funding, and governance of an ESOP can vary widely depending on the circumstances.
- **"ESOPs eliminate the need for other employee retirement plans."**
  - **REALITY:** While ESOPs provide significant retirement benefits, they are often used in addition to, not as a substitute, for other retirement plans like 401(k)s. Diversification is important for employees' retirement security, and relying solely on an ESOP can expose employees to excessive risks associated with the company's performance.



What steps should I take to explore an ESOP?

When a business owner determines to explore an ESOP as a potential exit strategy, certain steps should be undertaken.

- **Educate yourself.** There are numerous industry and professional organizations across the country that provide education on ESOPs, as well as communities of employee owned businesses, that can be invaluable resources to owners contemplating this path. Your J.P. Morgan advisor can assist you in finding these organizations and communities to further inform yourself.
- **Assemble an experienced professional team.** Owners should carefully assemble a team of experienced professionals in the various disciplines required to ensure proper vetting of a transaction and an orderly and efficient execution of their deal, including financial advisors, attorneys, accountants, and valuation firms. This process of team building should begin well in advance of a desired transaction to ensure the right team with relevant skills and expertise is available to execute a successful transaction in the desired time period. The team to execute an ESOP transaction will include all the team members we've discussed in our earlier white papers as well as legal, tax, and financial professionals who are experienced in the intricacies of ESOP transactions.[16]
- **Conduct an initial feasibility study.** A feasibility study will assess whether your company is a viable fit for an ESOP transaction, considering factors such as the company's financial health, employee base, and long-term goals.
- **Obtain an independent valuation.** An independent, qualified appraiser will conduct a valuation of the company to determine the fair market value of the shares to be sold to the ESOP. The appraiser will provide a detailed valuation analysis, which will be used to set the sale price of the shares.
- **Assess employee interest.** Employee engagement is one of the most critical elements of creating a successful ESOP. Well-educated employees tend to be more engaged, productive, and enthusiastic about an ESOP transaction than those who do not understand the benefits available to them through the plan. Create a framework to solicit feedback from employees ahead of deciding to use the ESOP as the exit strategy of choice.
- **Estimate plan costs.** Understanding what it will cost to set up the plan and to administer it on an ongoing basis is important before making a decision to utilize an ESOP. Your team of experienced professional advisors can provide education and help you assess potential expenses.
- **Assess the availability of financing.** The availability of bank financing and on what terms can be a critical component to assess the viability of an ESOP and how it would be structured. Different lenders can have varying appetites for the size of the deal, the industry in which the business operates, and respective requirements for borrowing. Understanding the availability of lending partners and the relative strengths and weaknesses of each before making the final decision to proceed with an ESOP is essential. This will also allow you to determine how much, if any, should be self-financed.

[16] For a more detailed discussion, see our recent white paper, "Introduction to Business Succession Planning" JP Morgan Wealth Management, 2024 and our recent publication "Business Succession Planning: Building an Effective Team," JP Morgan Wealth Management, 2024

In conclusion

Due to current IRS regulations and tax incentives afforded by the federal government, an ESOP can be a powerful tool to benefit business owners, the business itself, and its loyal employees. While relatively complex compared to other types of exit strategies, the significant tax and non-tax benefits to the stakeholders are so substantial that owners should consider an ESOP as part of a comprehensive process of exploring all exit strategies. J.P. Morgan and your other trusted advisors can help guide you through this important process.

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