

# Residential DESIGN & BUILD

**Design Trends and New Products for CUSTOM HOME BUILDERS**

## Planning your exit

*ESOPs can be both an attractive exit strategy for business owners and a meaningful benefit for their employees*

By Robert Massengill

Facing business succession and transition plans is inevitable for every successful company. Because there are numerous alternatives with complicated financial implications, many owners simply opt not to plan. This strategy generally limits their options when the time comes, for one reason or another, to leave the business.

Succession planning is the process of identifying the primary goals, timing and method for leaving a business to someone else. Company size is an important criterion in determining the appropriate method of transitioning a business and generally speaking, larger companies have more options than smaller companies. For the average-sized custom home builder and architect, this means fewer choices to consider. Options available usually include selling to the key managers, a competitor, or the least-known buyer — an Employee Stock Ownership Plan.

Many owners dream of selling their business to either their key employees or a competitor as a means of realizing some value for their company. Key managers are the natural choice in many instances, though they typically lack the funds. Selling to an outsider often is impractical as the typical custom home builder cannot offer something that its competitors don't already have. In many cases, that means either shutting the business down or transitioning via an ESOP.

An ESOP is a special buyer of company stock that also serves as a tax-qualified retirement plan for its employees. The government allows business owners whose companies sponsor ESOPs to indefinitely defer the payment of their capital gains taxes and companies to deduct all buyout costs — including debt payments. Unlike other pension

plans, ESOPs are designed to purchase private company stock and are allowed to borrow for this purpose. For these reasons, ESOPs frequently are used by business owners to create an “inside” buyer for their shares.

Custom home builders, architects and those in affiliated fields are increasingly using ESOPs to transfer ownership of their companies, create liquidity and to reward dedicated employees. To paint a better picture of how it works, here's a short description of how the ESOP operates:

First the company establishes the Employee Stock Ownership Trust, which is governed by trustees appointed by the board of directors. The plan is funded using company profits, before taxes. The ESOP trust uses that money to buy shares from the owner(s). This can be done on a year-to-year basis or in lump sum using seller-financing or bank debt. Structured properly, the seller can indefinitely defer paying capital gains taxes by investing sale proceeds in like-kind securities known as Qualified Replacement Property. Each year after the sale, the company makes a tax-deductible payment to the ESOP which the ESOP uses to pay off its loan. As the ESOP's loan payments are made, a portion of the shares owned by the trust are credited to employee accounts based on salary.

The shares put in employees' accounts are a company-funded retirement benefit and act in many ways like a 401(k). Their shares, which are subject to a vesting schedule, are redeemed by the business when they leave the company or retire. Typically, these shares are bought back over time.

Unlike sales to third parties, ESOPs allow for a staged exit by selling to shareholders at fair value today. Rather than having to find and negotiate with an interested buyer (or just a shopper), business owners can sell all of their stock, or just a minority interest to an ESOP. They also

can control the timing and amount of the sale. The ESOP offers unlimited transaction design flexibility, including the ability to remain actively involved in the business while gradually selling to employees. In addition to their flexibility, ESOPs are an attractive succession planning alternative because of their tax benefits: the ability for the seller to defer capital gains taxes; the sale is financed on a tax-advantaged basis; and the employees' retirement benefit is tax-deferred.

### *Typical ESOP Situation*

The sole owner/founder's company builds 7 to 10 new homes each year and has 15 employees. The business makes \$300,000 per year, but profits typically are distributed as bonuses so the company shows little profit. The company has a good reputation in the market, and the owner has done a good job of developing his successor management team. He would like to exit the business and leave it to his employees, but they don't have any capital to purchase his shares. The ESOP can be used to help facilitate this transition.

First, the company is valued by an independent appraiser for \$1.5 million. The company creates the ESOP for the purpose of buying the owner's shares. The owner will sell his shares to the ESOP for \$1.5 million in return for either a seller note or bank debt, if available. Each year the company puts pretax profits in the ESOP so the ESOP can pay for the shares or repay the bank. Assuming the company continues to make profits of \$300,000 per year, the owner (or bank) would be paid back in about six years assuming a 6 percent interest rate on the seller or bank note.

The result is a company that is 100 percent owned by the ESOP. This is not only good for the seller, but perhaps better for the company. The federal government (and most states as well) will cancel its taxation on a company's earnings that is a 100 percent ESOP-owned company, so long as it is taxed as an S-corporation. Relieving the company from federal taxation leaves money for paying back the seller/bank, and after that, financing growth, funding the ESOP and paying bonuses.

Shares that are purchased by the ESOP are held in trust and divided among the employees based on their pay, as the ESOP pays for the stock. For example, if the ESOP buys 6,000 shares of stock from the owner and pays for them over six years, then all eligible employees will share in 1,000 shares that are allocated to their accounts each year. The longer employees stay with the business, the more allocations they receive. Also, if the stock price rises, the more they benefit from the stock price appreciation.

When an employee leaves the company, that person's shares are redeemed by the company or the ESOP at the fair market price. There are many rules for buying back these shares, but for employees that quit or are terminated, there usually is a waiting period (as long as five years) with a payout period (as long as five years). In addition, if the ESOP still owes the bank or the owner for the stock purchase, those employees have to wait until that debt is paid off. These rules protect the company's cash flow from unforeseen layoffs or mass defections. Employees that reach retirement age are not subject to a waiting period, though they, too, can be paid out over time.

In the right situation, an ESOP can be an excellent succession planning tool for creating a tax-efficient, controlled sale for part or all of an owner's privately held stock. Companies best suited for ESOPs are established, profitable, nonleveraged businesses that have a good second-generation management team in place. Although it is possible for a small company to sponsor an ESOP, there are initial and ongoing expenses associated with these plans, including annual valuation reports and yearly plan administration.

A company considering an ESOP must evaluate these costs as well as the impact of the transaction on the company's financial statements. ESOPs also tend to be complex. When deciding on this strategy, it is important to consult with an experienced professional who should be willing to spend some time up-front at no cost to provide some preliminary guidance. ▶

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