



ESOP Facts

Answers to the questions that business owners frequently ask.

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1 Is this some kind of weird or untested idea? Nope. After decades of skepticism, there are enough successful ESOP companies (and 10,000 ESOPs in total) that the idea has been refined. Many professional service firms specialize in working with ESOPs. There's ample proof of concept.

2 What's with the tax breaks and the capital gains deferral? The tax provisions of an ESOP can be a source of tremendous benefits to a retiring owner. The so-called Section 1042 rollover, for instance, allows C corps to defer all capital gains taxes so long as they sell at least 30% of the company's shares to an ESOP. To qualify for tax deferral, you must buy other U.S. operating companies' securities with the proceeds. But if you then leave those securities to your heirs, their cost basis for tax purposes will be "stepped up" as of the date of your death, and your capital gains liability simply evaporates.

3 How can employees afford to buy the business? Quick answer: Just as in a leveraged buyout, they borrow against future earnings. A new legal entity called an employee stock ownership trust usually borrows the money, and the company provides the trust with the funds to pay back the loan. As the loan is paid off, shares of stock are allocated (often in proportion to salary) to each employee's account.

4 Will I have to give up control--and will I have to disclose salaries? From a management point of view, an ESOP company runs just like any other: The CEO is in charge and can share or not share any financial information he or she chooses. Typically the board appoints the ESOP trustee, which means that directors effectively control the votes represented by ESOP shares. "An ESOP is great for the entrepreneur who finds it psychologically difficult to disinvest in the company," says Mary Josephs, a senior vice president with LaSalle Bank's ESOP Financial Services Group in Chicago.

5 How is the price set? An independent valuation expert sets the price at which the ESOP will buy out an owner. This is the moment of truth: Tom Schramski of CPES, for example, figured he was probably leaving \$1 million on the table by selling to an ESOP rather than a strategic buyer (see main story). But other companies find that the "going concern" valuation prepared for an ESOP buyout is more than any other buyer is willing to pay. Of course, the price can change over time with each block of stock the owner sells.
