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## Welcome to ESOPs: A Different Way of Selling to a Third Party

Tuesday, June 10, 2025 | 8:00am - 9:30am PT

Available Via Video Conference

NASBA CPE Credit: 1 hour for CPAs

CFP Credit: 1 hour

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- Today's program will run approximately 90 minutes and will be worth one credit hour
- Please be sure to look for and answer all NASBA required polling questions during the presentation to ensure your eligibility for credit
- You will not be graded on right or wrong answers, but please make sure to submit a response if you wish to receive credit

### Q&A

- Please raise your hand or interrupt our presenter at any time with any questions you might have on the presentation materials
- For any additional questions including technical items, please message “WealthPoint Team” in the chat or reach out to [Kristin@wealthpoint.net](mailto:Kristin@wealthpoint.net)

### Survey

- If you are interested in receiving CE and/or CPE credit for attending this webinar, please look for and complete the survey that will be sent to you
- Certificates will be emailed to you within 30 days of the webinar



## Learning Objectives

- Understand how ESOPs work and reasons for implementation
  - Reasons for an ESOP vs. an alternative exit strategy
  - Identify the impact on the company and its employees
  
- Identify crucial tax benefits for an ESOP and how they can help to repay company debt
  
- Understand key specifics of ESOPs and how they differ from 3<sup>rd</sup> party transactions
  - Bank debt vs. seller debt
  - Warrants
  - Share allocation
  
- Learn about the ESOP Trustee process
  - How they view an ESOP Transaction
  - What “control” do they have post-transaction



# ESOP Overview

# *EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)*

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ESOP

- ④ ESOP creates a method to monetize a company's owners' interests while maintaining control and provide a benefit to the employees
  - Stock in ESOP is allocated to employees over time (based on compensation – subject to certain limits)
    - Employees will monetize their interests upon retirement or other triggering events
      - Payments are typically paid over 5-years
  - All full-time employees must participate – ESOPs are non-discriminatory plans
    - However, you can provide key executives with additional ownership/value via stock appreciation rights plans (SAR)
  - ESOPs operate very similarly to a 401(k) or profit-sharing plan
    - Growth on value while in the ESOP is tax-deferred – employees pay ordinary income tax when they monetize their shares
    - Difference between 401(k) plan – the only asset is the company's shares



# Polling Question #1

## WHO ARE THE PLAYERS?

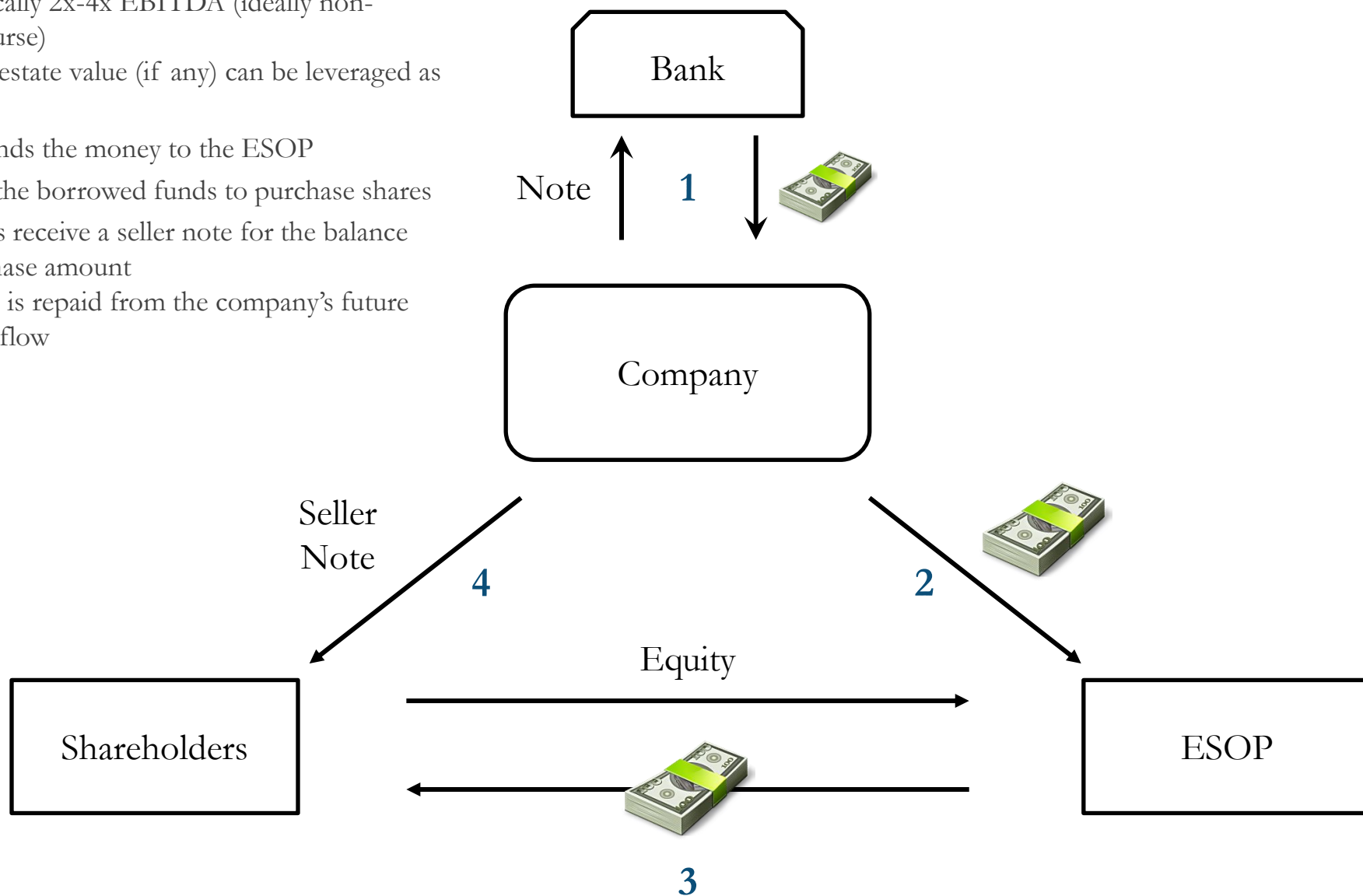
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- ④ Company and its Shareholders
  - Note that not all Shareholders have to participate in the sale to an ESOP
- ④ Trustee
  - Hired by the ESOP plan sponsor to represent the best interest of the employees
  - Highly encouraged to have an independent Trustee (at a minimum for the transaction)
- ④ Legal counsel x2
  - Both the Trustee and Company will have legal counsel to represent the arms-length transaction
- ④ Valuation firm
  - Hired by the Trustee to perform an independent valuation of the business
    - Used by the Trustee to support the negotiations with the Seller
- ④ TPA
  - Outsourced firm to help manage the compliance aspects of an ESOP
    - Participant statements, compliance testing, etc.
- ④ Commercial Banker
  - Provides bank financing (if applicable)
- ④ WealthPoint
  - Helps to structure the transaction, stress-test financial models and push the process forward
  - Facilitates plan integration and conducts feasibility analysis for the ESOP



# HOW AN ESOP TRANSACTION WORKS – CROSS-PURCHASE

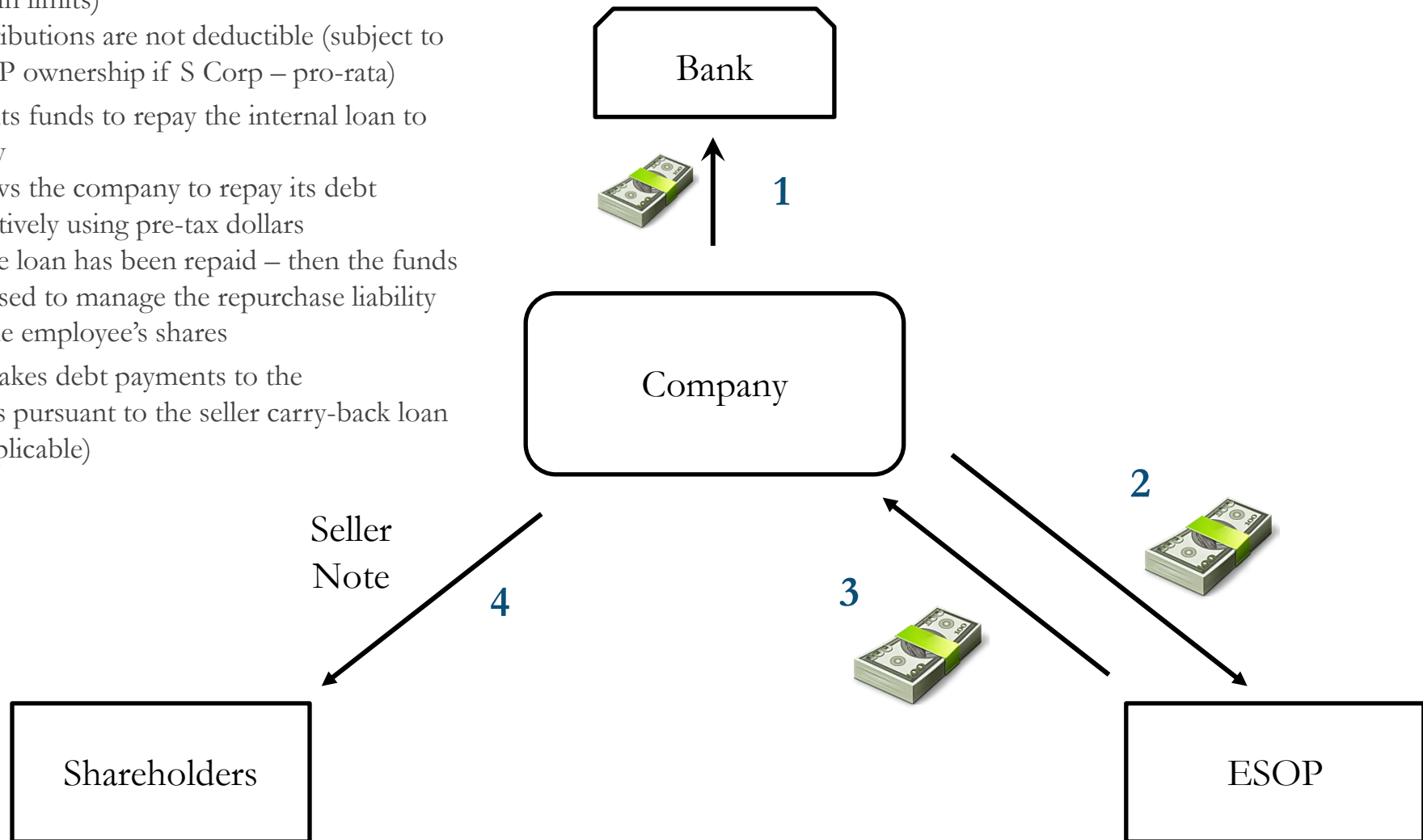
1. Company borrows money from a bank to finance the purchase amount
  - a. Typically 2x-4x EBITDA (ideally non-recourse)
  - b. Real estate value (if any) can be leveraged as well
2. Company lends the money to the ESOP
3. ESOP uses the borrowed funds to purchase shares
4. Shareholders receive a seller note for the balance of the purchase amount
  - a. Note is repaid from the company's future cash flow





# HOW AN ESOP WORKS – POST-TRANSACTION

1. Company makes debt payments to the Bank
2. Company makes contributions and/or distributions to the ESOP
  1. Contributions are tax deductible (subject to certain limits)
  2. Distributions are not deductible (subject to ESOP ownership if S Corp – pro-rata)
3. ESOP uses its funds to repay the internal loan to the company
  1. Allows the company to repay its debt effectively using pre-tax dollars
  2. If the loan has been repaid – then the funds are used to manage the repurchase liability of the employee's shares
4. Company makes debt payments to the Shareholders pursuant to the seller carry-back loan terms (if applicable)



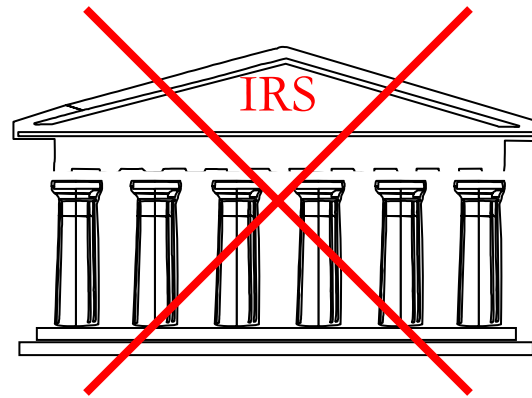
## *TRUE OR FALSE – COMMON ESOP INACCURACIES*

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Statement	True or False	Comments
When you sell to an ESOP, you must sell for less than fair market value	FALSE	An independent 3 <sup>rd</sup> party valuation is performed to substantiate the purchase price
The Trustee takes over control of the business	FALSE	The Trustee's only role is to represent the employees in their best interest. Most quality Trustee's want nothing to do with running the business.
All employees must weigh in on every decision	FALSE	The employees now have beneficial ownership in the business – that doesn't mean they now have control
I must sell 100% of my ownership to the ESOP	FALSE	An owner can sell any amount of shares to the ESOP
Employees will never have enough cash to buy me out	FALSE	Most ESOPs are funded out of the company's future cash flows
The annual compliance fees make an ESOP unaffordable	FALSE	Compared to the tax savings and employee impact, the compliance fees are a small price to pay
ESOPs are a viable succession planning strategy for the right business	TRUE	Depending on the company and shareholders' objectives, ESOPs can be a viable strategy for an exiting businessowner



## Polling Question #2



- ④ Beat the IRS out of their money with their own rules
  - An ESOP is a tax-exempt entity
    - Income flows through from the company to the ESOP and zero taxes are paid (if an S Corp.)
  - Use the government's money to be reinvested into future growth or accelerated repayments of company's debt
  - ESOP Contributions are tax deductible (up to 25% of eligible payroll)
    - Funds are repaid to the company to pay off the internal note between the ESOP and the company
- ④ §1042 Rollover for shareholders
  - Selling shareholders can defer and eliminate capital gains due upon sale
  - Shareholders have 12 months to reinvest proceeds into “qualified replacement property” (QRP)
    - Example: stocks and bonds of US operating companies
  - No capital gains due on reinvestment
    - QRP investments receive carryover cost basis of stock sold to ESOP
  - Constraints: Company must be a C Corp at the time of sale

## *IRS COMPLIANCE – KEY ITEMS*

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### Overview of IRS compliance items to be aware of when implementing on an ESOP

#### — 404(a)

- Limits the maximum contribution permissible and provides that contributions paid by an employer to a qualified plan are deductible
  - The IRC Sections 404(a) and 404(a) limits are determined separately first
  - Amounts allowed as deductions are subject to limitation of **25%** of the compensation otherwise paid or accrued during the taxable year to the beneficiaries defined under the plans (total wages/payroll)
  - Allowable deduction can differ between S-Corps and C-Corps implementing on ESOPs

#### — 415

- Limits contributions made to a plan participant's account in the current tax-year
  - Annual additions consist of all employer contributions, and any elective deferrals the plan participant designated to contribute
  - Annual additions cannot exceed the lesser of 100% of the participants compensation or the statutory limit in effect for the calendar year in which the plan year ends
  - (As of 2023, limit is currently \$66,000)

#### — 408(k) & 414(q)

- Sets highly compensated employee limitation of \$150,000 in 2023
- Sets maximum compensation limit of \$330,000 in 2023

# IRS COMPLIANCE – KEY ITEMS (CONT'D)

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## 🌀 Overview of IRS compliance items to be aware of when implementing on an ESOP (*Cont'd*)

### — 409(p)

- Prohibits any accrual or allocation to a disqualified person in a non-allocation year
  - Disqualified person(s) are not allowed to participate in the ESOP
  - A disqualified person is an individual that owns at least 10% of the number of deemed-owned ESOP shares
  - Any synthetic equity owned by an individual or their family must also be included in the testing
  - If an ESOP participant and his or her family members own 20% or more of the shares or synthetic equity, such participant is also a disqualified person
  - While the Section 409(p) test is a daily test, most ESOPs typically only update participant balances on an annual basis. Changes in stock allocation or family ownership, etc. can trigger non-allocation years

### — 410(b)

- Protects fairness and tax-benefit status
  - Sets qualifications such as: Age 21 or completion of one-year of service or certain number of hours worked to be eligible to participate in the plan
  - Sets rules for vesting, breaks in service and other items
  - Sets minimum coverage and nondiscriminatory requirements
  - Tests sufficient participation of non-highly compensated employees to highly paid employees
  - The plan benefits at least 70% of employees who are not highly compensated

## *BOARD CONTROL/GOVERNANCE*

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- ④ The business operations and governance will remain the same pre- and post-ESOP
  - Company will continue to be run by a Board of Directors
    - ESOP Trustee is a shareholder and not involved in day-to-day management
- ④ Board of Directors is determined prior to sale to ESOP
  - Current owners determine who will comprise the Board prior to closing
  - ESOP Trustee typically requests that within a certain period of time post-closing, the Board must include 1 independent board member
    - Not appointed by the Trustee but approved by the Trustee
  - State law will dictate how the Board remain in place
    - Until resignation; specific period of time; etc.
  - The Board will have the ability to replace the ESOP Trustee (if deemed prudent)



## Polling Question #3



## *INCENTIVES FOR KEY PEOPLE*

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- ④ Transaction could include an Equity Plan for key employees and management
  - Could represent X% of Company's equity value (for example)
  - Typical structure includes synthetic equity (i.e. Stock Appreciation Rights, etc.)
  
- ④ Employee will share in economic value of the business without receiving actual equity
  - Vesting and exercise rights can be customized based on the company's objectives
  - When exercised, the key employee is paid the increase in value of a specific percentage of the company's fair market value
  - SARs package must be negotiated with ESOP Trustee and valuation firm prior to ESOP transaction
    - Dilutes ESOP ownership/value
  
- ④ Alternatively, employees could receive real equity via a buy-in or equity grant



## ESOP WARRANTS OVERVIEW

- ④ Additional upside potential for sellers – Warrants
  - Warrants allow for the selling shareholders to receive a future economic benefit based on the financial performance of the business
  - 100% ESOP are normally when warrants are used
  - Seller note financing arrangements are attractive for the use of warrants
  - Best utilized if current shareholders remain in management for longer periods post-sale
  - Larger transactions are normally better suited to the use of warrants

Warrant Example					
Current Period		(5 Years Later)		(10 Years Later)	
Company Value Before Transaction	\$ 35,000,000	Future Company Value	\$ 40,000,000	Future Company Value	\$ 45,000,000
Bank Debt	\$ (34,000,000)	Bank Debt	\$ (17,500,000)	Bank Debt	\$ -
Equity Value Post Transaction	\$ 1,000,000	Equity Value	\$ 22,500,000	Equity Value	\$ 45,000,000
ESOP Shares	150,000	ESOP Shares	150,000	ESOP Shares	150,000
Warrants:	25,000	Warrants:	25,000	Warrants:	25,000
Fully-Diluted Shares	175,000	Fully-Diluted Shares	175,000	Fully-Diluted Shares	175,000
Price Per Share	5.71	Price Per Share	128.57	Price Per Share	257.14
Less: Assumed Strike Price	10.00	Less: Assumed Strike Price	10.00	Less: Assumed Strike Price	10.00
Warrant Value	-	Warrant Value at Exercise	118.57	Warrant Value at Exercise	247.14
Warrant Pay-Out	\$ -	Warrant Pay-Out	2,964,286	Warrant Pay-Out	6,178,571



# WARRANTS AS AN ESTATE PLANNING VEHICLE

ESOP Value Post-Debt	\$	6,875,000								
Warrant Strike Price	\$	50								
Warrants		20,000								
Forecast Growth Rate		5%	<i>Beyond projections from client in 2030</i>							
Date	TTMEBITDA	Multiple	Enterprise Value	ESOP Debt	Equity Value	Equity Value Per Share	Warrant Strike Price	Warrant Value		
1/1/2024	\$ 22,675,000	5.5x	\$ 125,000,000	\$ (125,000,000)	\$ -	\$ -	\$ 50	\$ -		
1/1/2025	\$ 23,750,000	5.5x	\$ 130,625,000	\$ (113,280,011)	\$ 17,344,989	\$ 126	\$ 50	\$ 1,522,907		
1/1/2026	\$ 27,000,000	5.5x	\$ 148,500,000	\$ (101,068,955)	\$ 47,431,045	\$ 345	\$ 50	\$ 5,899,061		
1/1/2027	\$ 29,400,000	5.5x	\$ 161,700,000	\$ (88,346,255)	\$ 73,353,745	\$ 533	\$ 50	\$ 9,669,636		
1/1/2028	\$ 31,650,000	5.5x	\$ 174,075,000	\$ (75,090,475)	\$ 98,984,525	\$ 720	\$ 50	\$ 13,397,749		
1/1/2029	\$ 34,100,000	5.5x	\$ 187,550,000	\$ (61,279,277)	\$ 126,270,723	\$ 918	\$ 50	\$ 17,366,651		
1/1/2030	\$ 35,805,000	5.5x	\$ 196,927,500	\$ (46,889,390)	\$ 150,038,110	\$ 1,091	\$ 50	\$ 20,823,725		
1/1/2031	\$ 37,595,250	5.5x	\$ 206,773,875	\$ (31,896,566)	\$ 174,877,309	\$ 1,272	\$ 50	\$ 24,436,699		
1/1/2032	\$ 39,475,013	5.5x	\$ 217,112,569	\$ (16,275,544)	\$ 200,837,025	\$ 1,461	\$ 50	\$ 28,212,658		
1/1/2033	\$ 41,448,763	5.5x	\$ 227,968,197	\$ -	\$ 227,968,197	\$ 1,658	\$ 50	\$ 32,159,011		

- ⊗ Warrants can be a significant estate planning vehicle
  - Warrants are issued immediately post-transaction
    - ESOP debt reduces the equity value of the business
- ⊗ Warrants can then be transferred to a Trust at a very low value
  - Over time, the value of the warrants may appreciate resulting in significant wealth transfer



# SHARE ALLOCATION FOR EMPLOYEES

## ESOP Share Allocation - Points

### Inputs

Compensation 



 for every 



 of compensation  
Years of Service 



 for every year of service

Employee	Years of Service	Years of Service Points	Compensation	Compensation Points	Total Points	Percentage of Share Allocation
EMPLOYEE #1	2	20	\$ 48,000	9	29	0.2%
EMPLOYEE #2	14	140	\$ 125,000	25	165	1.3%
EMPLOYEE #3	5	50	\$ 110,000	22	72	0.6%
EMPLOYEE #4	11	110	\$ 250,000	50	160	1.2%
EMPLOYEE #5	2	20	\$ 65,000	13	33	0.3%
EMPLOYEE #6	18	180	\$ 80,000	16	196	1.5%
EMPLOYEE #7	2	20	\$ 175,000	35	55	0.4%

- Ⓢ Shares held in the suspense account within an ESOP are allocated to eligible employees based on the plan document
  - Most ESOPs are allocated based on compensation
- Ⓢ “Points”-based plans are becoming more popular
  - Allocate points for compensation and years of service to create a customized benefit



## *ACCOUNT BALANCE PROJECTION – SAMPLE*

Employee Stock Ownership Plan Account Balance Projections						
Pay Level	12/31/2027		12/31/2032		12/31/2042	
	Shares	Value	Shares	Value	Shares	Value
\$ 290,000	316.398	\$ 201,386	872.953	\$ 760,710	1,933.781	\$2,054,175
\$ 150,000	163.654	\$ 104,165	451.527	\$ 393,471	1,000.232	\$1,062,504
\$ 100,000	109.103	\$ 69,443	301.018	\$ 262,314	666.821	\$ 708,336
\$ 50,000	54.551	\$ 34,722	150.509	\$ 131,157	333.411	\$ 354,168
Per Share Value		\$ 636.50		\$ 871.42		\$ 1,062.26
<b><u>Assumptions:</u></b>						
2% annual growth in company value through FYE 2042						
ESOP Ownership remains at 50%						



## *CURRENT NEWS IN THE ESOP WORLD*

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- Ⓢ IRS Letter August 8, 2023
  - IRS warned against the tax avoidance strategies pertaining to ESOPs
    - Unclear as to what cases they are referring to or what prompted the notice
- Ⓢ Some practitioners promote abusive structures
  - Unreasonable internal loan terms between the company and the ESOP
    - Loan terms should be commercially reasonable and promote an arms length transaction
    - Duration and interest rate
  - Excessive use of warrants
    - Negotiating a transaction leveraging substantial warrants to either buy-back ownership or monetize for excessive value
  - Structuring the transaction to benefit the seller more than the benefit to the employees
    - Over-leveraging the business
      - Unfair valuation or terms
  - Use of 401(k)/IRA funds to roll into an ESOP for the initial purchase
- Ⓢ Tax avoidance will always be corrected by the IRS
- Ⓢ Draft guidance for ESOP Transactions – 2024


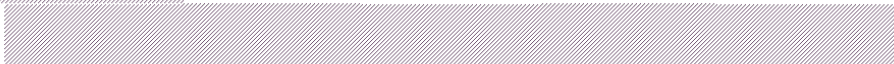





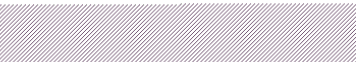

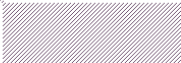


# ESOP Transaction Process

# ESOP TIMING – SAMPLE WORK SCHEDULE

## ESOP Implementation Timeline

 Projected Activity Duration

ACTIVITY	Responsible Party	January	February	March	April	May	June	July
Phase I - Discovery & Planning	Facilitator							
Bank Financing	Company/Facilitator							
Trustee Services	Trustee							
Legal Documents	Attorney							
Valuation	Trustee/Valuation							
TPA Services	Trustee/TPA							
Review/Finalize documents	All Parties							
ESOP Education for Participants	Company/Facilitator							
Deal Closing	All Parties							
IRS Letters Post-Closing	Company							

- ⌚ There is a defined sales process with an ESOP transaction
  - Most ESOPs can close in approximately 6-7 months
    - Depends on the complexity of the transaction





- ④ Phase 1 – Discovery, Education and Feasibility
  - Discovery interviews with key stakeholders
  - Preliminary valuation and analysis/feasibility study
  - Define proposed structure for ESOP
    - Bank financing
    - Seller carry-back notes
  - Preliminary ESOP testing
  - Corporate structure/analysis
- ④ Phase 2 – Evaluate Debt Structure
  - Develop analysis comparing debt structures
  - Evaluate financing ratios and covenants
    - Fixed charge coverage; cash flow recapture; debt – EBITDA, etc.
- ④ Phase 3 – Evaluate & Engage Service Professionals
  - Trustee, 3<sup>rd</sup> Party Administration, Valuation, Legal
  - Facilitate due diligence process
- ④ Phase 4 – Legal
  - Draft, review and finalize all legal documents
    - ESOP Plan Document
    - Redemption or cross-purchase/refinance
    - Transaction documents (LOI, Stock Purchase Agreement, Loan Agreements, etc.)



## *IDEAL ESOP PROCESS (CONT'D)*

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- ④ Phase 5 – Closing
  - Execute deal documents
  - Transfer funds
  - Employee Announcement
  - IRS Determination Letter
- ④ Phase 6 – Annual Plan Compliance (post-closing)
  - Facilitate annual compliance for the ESOP
    - Compliance testing
    - Valuation
    - Share allocation/participant statements
  - Analyze ESOP funding/contribution amounts
  - Board governance/meetings



- Ⓢ EBITDA/Profit: \$2,000,000+
  - Consistent profitability is desired

- Ⓢ Revenue: \$20,000,000+

- Ⓢ Number of employees: 25+

- Ⓢ Industries:
  - Manufacturing
  - Distribution
  - Services
  - Construction



# Independent ESOP Trustee Q&A

## TRUSTEE QUESTIONS

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- Ⓢ Are Independent Trustee's necessary in an ESOP?
- Ⓢ What role should an ESOP Trustee play post-transaction?
  - How involved are you in the company's Operations? Board? Leadership?
- Ⓢ What does the transaction process look like for the Trustee/Trustee team?
- Ⓢ What makes a company a quality ESOP candidate?
- Ⓢ How do you view valuation and negotiations as the “buyer” in an ESOP transaction?
- Ⓢ What steps does an ESOP Trustee take to represent the employees/ESOP in the transaction?



## *LEARNING OBJECTIVES ACHIEVED*

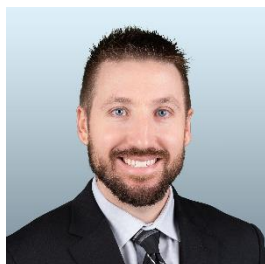
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### Learning objectives achieved:

- ✓ Understand how ESOPs work and reasons for implementation
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## Methods of Analysis and Projection

Information collected is intended to project future financial scenarios to meet your future goals or liquidity requirements. Financial Projections and other information prepared by WP are based on assumptions provided by and/or reviewed with the client in their final report, are hypothetical in nature, do not reflect actual investment or business results and are not guarantees of future performance. Actual results will vary, perhaps to a significant degree.

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- Business Income Statement, Cash Flow Statement and Balance Sheet – Current company financial statement information is provided by the client, as well as revenue and expense growth assumptions for future years. These assumptions are used to project future Net Income, and business valuation based upon an appropriate multiplier disclosed to the client.
- Personal Cash Flow – Cash flows are projected based on information obtained from the client (tax returns, personal financial statements, bank statements, W-2s, 1099s, K-1s, etc.). Future cash inflows and outflows are based on input from the client and the client's advisors.



## *IMPORTANT DISCLOSURES (CONT'D)*

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- Estate/Trust Cash Flow – Cash flows due to and from Trusts will be based on trust documents and financial information (tax returns, financial statements, etc.) obtained from the client.
- Personal Assets – In some situations, WP may project the value of an asset (i.e. real estate, other assets, etc.) based on input from the client and the client's advisors.
- Taxes – Taxes are being calculated in the analysis. However, WP does not provide tax advice and the tax calculations are for illustrative and hypothetical purposes only. The client should consult with their tax advisor to evaluate their tax situation.

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In addition to WP's business consulting services, and the fees charged to clients as outlined in the Relationship and Engagement Agreement, WP Partners are licensed agents to sell insurance. WP may receive fees from life insurance companies, if insurance is purchased through WP relationships. Any commissions or fees will be disclosed to you in any life insurance proposal and agreement. WP is a member firm of Partners Financial and has access to all insurance providers on their network. The needs and circumstances of the client will drive the choice of the insurance provider.

### Insurance Product

An investment in variable life insurance is subject to fluctuating values of the underlying investment options and entails risk, including the possible loss of principal. The performance of your account will vary and you may receive more or less than the amount invested. Product guarantees, including the death benefit, are subject to the claims-paying ability of the issuing insurance company. Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

An insurer's financial strength rating represents an opinion by the issuing agency regarding the ability of an insurance company to meet its financial obligations to its policyholders and contract holders. A rating is an opinion of the rating agency only, and not a statement of fact or recommendation to purchase, sell or hold any security, policy or contract. These ratings do not apply to the safety or performance of any separate account.

### Sub Account Performance Disclosures (for Variable Universal Life policies)

The fund performance data shown in this report that relates to variable life insurance policies was obtained through Morningstar and represents the individual net returns of the underlying funds shown in the report. Morningstar is a non-affiliated third party investment research and management firm that provides mutual fund information, news, commentary, portfolio analysis, comparison reporting and other services. Past performance does not guarantee future results. The fund performance data is being provided for informational purposes only and does not reflect the actual returns of the sub accounts in the variable component of the insurance policies that are invested in those funds, which may be lower or higher than the performance quoted due to the timing of cash flows, holding periods, sub account allocation changes, policy fees and other expenses. Policy fees or expenses include premium loads, cost of insurance, administration fees, mortality and expense risk charges, or any other charges that may be incurred under the policy. Policy returns would be significantly lower after all policy fees and expenses are deducted.

Securities offered through Kestra Investment Services LLC (Kestra IS), member FINRA/SIPC. Investment advisory services offered through Kestra Advisory Services, LLC (Kestra AS), an affiliate of Kestra IS. WealthPoint is a member firm of PartnersFinancial. Kestra IS and Kestra AS are not affiliated with WealthPoint, LLC or PartnersFinancial. WealthPoint, LLC is independently owned and operated.

