

# Ownership Transition – ESOP Option

Employee Stock Ownership Plans (ESOPs) are beneficial for all parties to the transaction. The business owner may be able to defer capital gains tax on the sale, and the employees participate in the ownership of the company. The company can realize tax benefits to assist with financing the purchase by the ESOP trust.

## What is an ESOP?

An ESOP is a qualified retirement plan, like a 401(k), but is designed to invest primarily in the stock of the employer. Like other tax qualified plans:

- Company contributions are tax deductible
- Employees are not subject to tax currently on contributions
- Earnings on investments in the plan are not subject to a current tax

An ESOP has two additional benefits:

- An ESOP is allowed to borrow in order to purchase employer stock
- An ESOP can remain primarily invested in employer stock without the diversification requirements of other qualified plans

These two extra attributes make an ESOP an Ownership Transition Option for owners who wish to sell the business to employees.

## The Leveraged ESOP

Most ESOPs use leverage to borrow the funds to purchase stock, although some ESOPs are non-leveraged. In addition, ESOP ownership is sometimes increased through corporate redemptions of non-ESOP stock.

ESOPs can be structured to meet the needs and objectives of the business owner, and the choice of structure is generally based upon an analysis of the tax benefits.

If the company is an LLC or a partnership, a re-organization to a corporate form may be necessary to implement an ESOP.

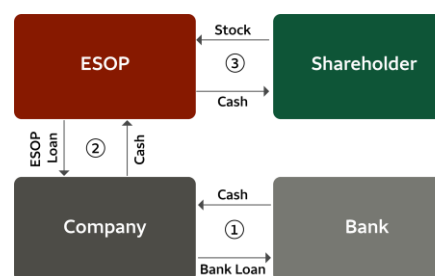
### S Corporation ESOPs

- Most common structure
- The ESOP as a shareholder is not subject to federal income tax
  - Partial S ESOPs use tax savings to aid in transaction financing and can deduct the transaction price over time
  - 100% S ESOPs pay little to no income tax
- Seller capital gains deferral may not be available depending on the structure

### C Corporation ESOPs

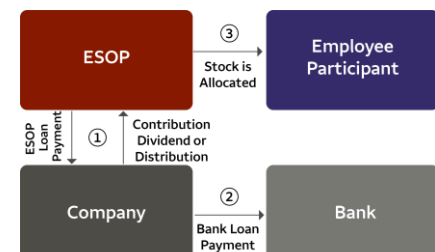
- Seller may be able to defer capital gains tax on the sale to the ESOP
- Company can deduct transaction price over time

## Transaction Cash Flows



1. The company borrows from the bank (the “Bank Loan” or “External Loan”)
2. The ESOP borrows from the company (the “ESOP Loan” or “Internal Loan”)
3. The ESOP uses the borrowed funds to purchase stock from the sellers

## Annual cash transactions



1. The company contributes cash, pays a dividend on ESOP stock or makes an S corporation distribution to the ESOP trust; the ESOP uses cash to make ESOP Loan payments (back to the company)
2. The company uses cash to make payments on the bank loan
3. Stock is allocated to employee participants as the ESOP Loan is paid

## Investment and Insurance Products are:

- **Not Insured by the FDIC or Any Federal Government Agency**
- **Not a Deposit or Other Obligation of, or Guaranteed by, the Bank or Any Bank Affiliate**
- **Subject to Investment Risks, Including Possible Loss of the Principal Amount Invested**

### Advantages of ESOPs

- Provides liquidity for an owner of a privately held business
- Represents an alternative to other ownership transition options
- Allows the company to continue its strategic direction with current management
- Aligns employees' interests with other stakeholders which could lead to increased performance
- Creates income tax savings for the company
- Allows the selling shareholder to defer (and possibly eliminate) capital gains tax in some ESOP structures

### Disadvantages of ESOPs

- Execution of a complete sale may take more than one transaction or result in a highly leveraged capital structure
- Creates a corporate obligation to repurchase shares as participants leave the Company
- Regulation by the Department of Labor (DOL) and Internal Revenue Service (IRS) creates compliance requirements
- The tax laws that create the benefits afforded ESOP companies could change

### Wells Fargo Advisors understands ESOPs

Our team has been providing education and resources to both internal and external partners regarding ESOP transactions for over 20 years. We collaborate with other lines of business within Wells Fargo & Company, including Wells Fargo Commercial Bank and Wells Fargo Private Bank\*, to provide comprehensive support throughout the transaction as much as possible. This ESOP expertise includes initial ESOP stock purchases, second-stage transaction financing, deferral of capital gains through Section 1042 election, refinancing of seller notes and more. It is our goal to help simplify the process and provide guidance and resources whenever we can.

### For more information, contact:



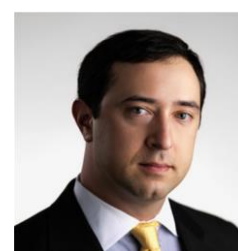
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