ESOP

Why 2026 Is a Breakout Year for ESOPs

Strong companies are using ESOPs to play offense. With rates stabilizing and talent still tight, employee ownership is delivering a durable edge:
Founder Liquidity—On Your Terms. Create a market for your shares without selling to private equity or competitors.
Major Tax Efficiency. Enable capital-gains deferral for selling shareholders (Section 1042 eligibility) and reduce or even eliminate ongoing corporate income tax for S-Corporation ESOPs—freeing cash for growth.
Talent Magnet. Meaningful employee ownership boosts engagement, retention, and performance—without relying solely on wage increases.
Resilient Margins. ESOP tax advantages help counter wage pressure, input costs, and tariffs—so more operating cash flows to strategy.
Control & Culture Intact. Transition ownership while keeping leadership and values in place.. Transition ownership while keeping leadership and values in place.
Bottom line: ESOPs create a rare win-win-win—for owners, the business, and employees.
Business Owners planning an exit, partial sale, or recapitalization
CFOs evaluating capital structure and tax strategy
Advisors & Succession Planners guiding owner-led companies

https://www.menke.com/landing/?utm_term=employee%20share%20scheme&utm_campaign=Menke+Group&utm_source=adwords&utm_medium=ppc&hsa_acc=8575270721&hsa_cam=95385582&hsa_grp=4725850542&hsa_ad=344623125320&hsa_src=g&hsa_tgt=kwd-300687196962&hsa_kw=employee%20share%20scheme&hsa_mt=b&hsa_net=adwords&hsa_ver=3&gad_source=1&gad_campaignid=95385582&gbraid=0AAAADyLyYpoxIAYivlF9FQXbi4s-W6Ig&gclid=CjwKCAiAuIDJBhBoEiwAxhgyFmLzkqOKc-qcAszQRU29GdjIf-p83qZGb4hf_ixMfPcAwH6ih17g3RoCb40QAvD_BwE

Employee Stock Ownership Plan (ESOP). Is it a Retirement Plan?

In the simplest terms, an Employee Stock Ownership Plan (ESOP) is a retirement plan. But, in reality, it is much more than that: ESOPs motivate employees, increase productivity, improve worker retention, keep jobs local, contribute to business longevity, and so much more.

ESOPs are governed by some of the same laws and regulations as 401(k) plans. ESOPs, though, are fundamentally different from 401(k)s, offering far more advantages to businesses, owners, employees, and communities.

ESOP Fast Facts

ESOPs boost employee engagement. When ESOPs are formed, shares of company stock are allocated to all employees, making them employee *owners* who share in the rewards if the stock rises and the risks if the stock falls. As a result, they are more invested in helping the business succeed and more likely to tackle problems, such as helping co-workers who are underperforming.

Most ESOPs require no out-of-pocket contribution from employees. For plenty of people, funding a contribution to a 401(k) each paycheck is a struggle. For employees like these, an ESOP might be the only retirement plan in which they can afford to participate.

ESOPs help narrow the wealth inequality gap. Employees at ESOP companies tend to earn higher wages and have greater savings than their peers in non-ESOP companies. In 2018, ESOPs distributed $126.7 Billion nationally.

Most business owners know that there are three options when planning for retirement.
One, they can sell their business.
Two they can, pass the business to a member of their family.
Or three, they can close up shop.

But, there's a fourth option. One that allows a business owner to sell the business to the people who care most about its success, the employees. It's called an Employee Stock Ownership Plan. This type of succession plan happens on the business owner's timeline and ensure the business stays open, local, and in the hands of people who are passionate about the legacy of the company.

In the vast majority of ESOPs, the company buys shares on behalf of the employees and places those shares in a trust; employees incur no out-of-pocket expense to participate.

ESOPs provide a retirement option for those employees who cannot afford to make a regular payroll deduction to a retirement plan.

Employees who can afford a payroll deduction still can make that contribution at many ESOP companies. The latest survey of ESOP Associatio members shows 93.6 percent of responding companies offer both an ESOP and a 401(k). Employees at these companies have two retirement plans. According to Pew, more than half of all employees don't participate in any retirement plan at work.

ESOPs are designed by law to purchase the employer's stock primarily. Employees earn shares based on certain criteria (such as salary, tenure, etc.) The share value may rise or fall, based on how the company performs.

Employees have a vested interest in ensuring the company performs well, since they share in the rewards via the ESOP. It takes time to dispose of stock. When employees leave an ESOP company, the plan may require that payouts be spread out over several years
https://www.esopassociation.org/what-is-an-esop

Advantages to Using an ESOP as a Succession Strategy

Taxes
ESOPs provide significant tax advantages. First, if certain conditions are met, owners who sell their shares to an ESOP have access to unique succession planning strategies. According to I.R.C. 1042, if the owners of a C-corporation sell at least 30 percent of their company to an ESOP, the owners will defer tax on any amount from the sale that they reinvest in "qualified replacement property." Qualified replacement property is defined as certain securities issued by domestically operating companies.

Essentially, family business owners who have held their shares for a long time and realized massive gains on those shares can delay paying taxes on those gains if they sell to an ESOP rather than a third party. (Taxation will eventually occur when the individuals ultimately sell the qualified replacement property.)

Cash or stock contributions made by the company to the ESOP are tax deductible, just like other contributions to a qualified retirement plan. This means that when a company puts money in the trust to purchase shares from the owners, it is reducing its tax burden.

Selling to an ESOP rather than a third party comes with at least two distinct cultural advantages for the company. **First,** the friction that inevitably comes when combining two businesses is avoided—the company is able to run the same way it always has.

Employees with an ownership stake in the company are more invested in its success as they will directly receive benefits from an improved bottom line. This can invigorate a workplace and encourage employees to reach new heights.

https://www.dwt.com/blogs/family-business-resource-center/2021/10/esop-family-business-succession-plan

ESOP Benefits to Shareholders

An Employee Stock Ownership Plan (ESOP) can provide significant benefits to shareholders, management and employees of a privately owned business.

An ESOP can be an excellent financial alternative for business owners rather than selling their business to a third-party, such as a private equity group or strategic buyer. It can offer certain tax benefits while providing business owners liquidity, diversification and enhanced retirement benefits.

Facilitate the financing of corporate transactions and provide employees with an ownership interest in their employer and a valuable retirement benefit and maximize the economic and estate planning benefits compared to alternative options.

ESOP Sale Scenarios

An ESOP can be utilized as a creative solution for business owners who are wanting to retire from direct involvement of their company but also wish that the company continue in the hands of family members or employees who have a similar personal and emotional investment in the company. An owner who has spent years building a successful company may not be interested in selling his/her company to an unrelated third party.

In many cases, third party sales can be difficult due to the business owner's relationships being the main source of new business. Potential buyers may want significant earnouts, claw backs or other egregious purchase covenants.

As an alternative to selling to an outsider, such as private equity or a strategic buyer, an owner may consider selling to an ESOP. This strategy enhances their own personal security with the proceeds from the sale while concurrently maintaining significant ownership of the business. Additionally, through the ESOP strategy, an owner will share his/her ownership interest with others who have been managing or working in the company over the years and who, therefore, share a similar emotional investment in the business.

If a succession management team is not in place, the ESOP can be used as a tool to trigger a tax-advantageous monetization event while simultaneously preparing family members or a new management team to succeed the owner over a given time horizon such as three-, five- or ten-year period. If this next generation proves they can handle the management of the business, the owner can retire and get paid again from the payment of his/her ESOP interest, which can often be significant. If not, the company can then be sold to a third party. Both scenarios offer the owner, family members, management and employees incremental value due to the ESOP ownership interest and if structured properly, can result in a tax-free sale.

The government provides significant tax incentives for ESOP-owned companies. Many studies show that these plans outpace 401(k) plans as a source of retirement income for participants and can outperform the S&P 500 in year-over-year investment returns.

Combining an ESOP with a 401(k) plan can offer significant benefits to the owner and employees. Surprisingly, the total number of ESOPs – and the employees they cover – has not grown substantially in recent years.

There are a number of reasons for the slow growth of ESOPs, but most industry pundits point to a reputation hangover from the misuse of the plans by bad companies and a lack of understanding of the complex workings of ESOPs as the most likely barriers to adoption. Some have argued that there has been significant growth in ESOPs, but point out that many successful ESOPs are sold to third parties by successor management teams to monetize the business and de-risk the ESOP participants, thereby keeping the number of ESOPs at a level number in the United States at around 6,500.

Tax Benefits of an ESOP

An ESOP is a tax-qualified retirement plan that invests primarily in stock of the sponsoring employer and meets several other conditions.

An ESOP can potentially eliminate U.S. taxation on a business going forward. The trade-off for this tax planning approach is that the employer must share ownership with some or all non-shareholder employees. The ability to eliminate federal tax is the result of changes made in 1998 to the Internal Revenue Code (IRC) that exclude from federal tax the earnings of a Subchapter S corporation (S corporation) allocable to an ESOP. These provisions were added by Congress to incentivize employee ownership. Under current law, an S corporation that is owned 100% by an ESOP will not incur any federal taxes (or unrelated business income tax). Since an S corporation can have retained earnings, the ability to have such retained earnings grow tax-free represents a powerful vehicle.

Most states follow the federal statue and don't tax ESOP S corporation earnings. In many instances, such significant tax benefits allow for a quicker monetization of the business with better economics than a third party sale to either a private equity or a strategic buyer.

Many ESOPs are structured to defer the gain on a sale of a company to an ESOP. This is called an IRC §1042 exchange transaction. A shareholder who sells employer stock to an ESOP may defer recognition of capital gain if the ESOP owns at least 30 percent of the corporation after the transaction and the sales proceeds are reinvested in securities or bonds of domestic operating companies. The seller must have held the stock being sold to the ESOP for at least three years prior to the sale.

The mechanism for deferring gain on the sale is a reduction in the seller's basis in the replacement property purchased with the proceeds of sale of stock to the ESOP. If all the proceeds are reinvested, the basis reduction equals the gain on the sale and is allocated among the items of replacement property in proportion to their cost. If some proceeds are not reinvested, gain is recognized only to the extent that the proceeds exceed the reinvested amount and the deferred gain reduces basis. The seller will then recognize the deferred gain when he/she disposes of the replacement property in any transaction other than a tax-free reorganization (with some exceptions), a transfer by reason of death, a gift, or the sale of the property in another §1042 transaction.

In a §1042 transaction, the business owner and family members cannot participate in an ESOP. This strategy generally makes sense for a very old or sick business owner. However, given the low capital gains rate environment, some argue that paying capital gains today makes more sense if tax rates increase in the future thereby allowing more flexibility of the owner to re-invest sales proceeds without the restrictions of §1042. Of course, each situation should be reviewed carefully.

Another design approach for an ESOP company would be to add the ESOP to an existing 401(k) plan or create a new 401(k) plan with an ESOP component. This approach allows the owner to monetize their business interest while also permitting the owner to participate in the ESOP which can allow for a material tax deferral or tax-eliminated retirement benefit of the ESOP ownership interest.

401(k) plans integrated with ESOPs have been around for many years and are commonly used by publicly registered companies, but there has been an increased trend in such use for private companies. 401(k) plans can be structured utilizing a pre-tax approach or a Roth account approach whereby the investment in ESOP equity is taxable today but the retirement benefit that is paid out after the later of five years or age 59-1/2 is totally tax free. If the ESOP equity interest is included in a 401(k) plan such an approach may produce superior economic benefits as compared with a §1042 transaction, offer more investment flexibility and better align all stakeholders (the owner, family members, management team and workers).

ESOP for Estate Planning – Creating Liquidity and Diversifying

It is likely that a business owner's biggest asset is their company, which is not generally a relatively liquid asset. When the time comes for estate taxes to be paid on the owner's estate, unless other provisions have been made, the business may have to be sold to pay estate taxes. Rather than waiting for the eventuality of a possible forced sale in such a situation, a business owner can create current liquidity while at the same time retaining management control of their company by selling their interest in the company to an ESOP.

By selling the company stock to an ESOP, a business owner can create immediate liquidity and retain management control of the company through participation in the ESOP. When the owner is ready to retire, he/she can get paid from the ESOP or initiate a sale of the company to a third party. Thus, a sale to an ESOP is an ideal planning mechanism for an owner's gradual secession from a company in a way that allows him or her to diversify their own portfolio and prepare for retirement in a tax-favorable manner while at the same time providing a benefit to employees which may, in turn, positively affect the health of the company.

The ability of a business owner to sell company stock to an ESOP and use the proceeds to diversify his or her portfolio enables the owner to treat their heirs equally even if they will not all inherit company stock equally. For example, if an owner believes that an heir is not interested in being involved with the business, is not well-suited for the business, or would disagree with another, more competent heir as to how the business should be run, he/she may wish to leave such heir assets that are equal in value to the company stock left to another heir. Thus, in order to avoid family feuds between heirs over a family business, an owner who has diversified his/her assets by selling to an ESOP can treat heirs fairly by leaving them property of equal value, whether it is shares in the family business, the ESOP, or shares in another investment.

If an heir works in the business, an ESOP could provide one of the best estate planning tools in the country to eliminate gift and estate taxes to parents who are running the business.

Characteristics of a Good Company for an ESOP

The characteristics of a good company for an ESOP include:
A desire for ownership diversification and wealth creation
A growing, profitable business with strong cash flow
A financially healthy business is best-suited to implement an ESOP and
An ownership group that is not reluctant to allow additional shareholders – their employees – to share in the company's equity.

An ESOP cannot save a highly indebted business or one with a poor business model, but it can be a powerful succession planning tool for a well-managed company.

An ESOP may be just the right tax/legal vehicle for those who own a business, want financial security and want to leave behind a legacy. So, plan now and explore an ESOP that can achieve both goals.

https://www.pkfod.com/insights/effective-succession-strategy-employee-stock-ownership-plan-esop/

How do ESOP Sales Differ from Other Transactions?

ESOPs offer privately-held companies continued independence, unique tax advantages, and employee benefits. Post-transaction oversight of an employee-owned business rests with the firm's board of directors, and selling shareholders often maintain meaningful roles.

Leveraged ESOPs are industry-agnostic, but private companies with taxable income and at least 10 employees are generally better candidates. Common use cases include family business ownership transitions, management buyouts, partner exits, and partial liquidity events for owners who want to stay with their companies.

Many third-party lenders, including major banks and funds, help finance leveraged ESOPs. These loans are secured by plan sponsors on behalf of their employee trusts. Senior debt, without personal guarantees, is commonly used to provide up-front cash to sellers. Seller notes are also a standard ESOP financing component.

An ESOP-exclusive benefit, this tax-deferral strategy enables selling shareholders to defer and potentially eliminate capital gains burdens on their sale proceeds. To earn the benefit, a seller must reinvest their proceeds in Qualified Replacement Property within 12 months of their ESOP transaction date.

When shares are transferred to an employee stock ownership trust, sponsor companies may earn state and federal income tax deductions equal to the fair market value of that stock. In addition, 100% ESOP-owned S corporations can become income tax-free in perpetuity.

https://info.csgpartners.com/esop-introduction?utm_medium=ppc&utm_term=employee%20stock%20ownership%20plan&utm_source=adwords&utm_campaign=Keyword+(Oct25)&hsa_src=g&hsa_grp=188735003489&hsa_kw=employee%20stock%20ownership%20plan&hsa_net=adwords&hsa_ver=3&hsa_tgt=kwd-39230982&hsa_acc=8259469429&hsa_cam=23062632130&hsa_ad=775968929890&hsa_mt=b&gad_source=1&gad_campaignid=23062632130&gbraid=0AAAAAD_XkqEEfwO7uXBwK6KpFF5-Lm4YN&gclid=CjwKCAiAuIDJBhBoEiwAxhgyFvAwipiib2E6jjLRMvWNl_XlB7IqHpJJwI2y-1PeRCgVOeb6cAjFnhoCUUEQAvD_BwE

How Are S corporation ESOP Companies Not Subject to Income Taxes?

When company leadership evaluates whether an ESOP is a good fit, they must carefully consider how transitioning to an ESOP may impact a company's tax obligations — and how ESOP taxation rules may provide a competitive advantage to the company.

The portion of a company owned by an S corporation ESOP is not subject to federal or state income taxation. This means that an S corporation that is 100% ESOP-owned is not subject to any federal or state income taxes. Practically speaking, in terms of running the business, this primary ESOP tax benefit can result in increased cash flow and a clear competitive advantage for the company.

S corporations are pass-through entities. This means that they pass through their corporate income to their shareholders for federal and state income tax reporting purposes. Each year, the shareholders receive an IRS Form K-1 and report the income flow-through on their personal tax returns based on their individual federal and state income tax rates.

As a result of the Small Business Job Protection Act of 1996, ESOP trusts are IRC Section 401(a) exempt organizations permitted as S corporation shareholders.

What does that mean?

The ESOP trust is an S corporation shareholder that is a tax-exempt entity and therefore not subject to income taxes.

https://www.esoppartners.com/blog/esop-taxation-rules

https://docs.google.com/document/d/11agWtweXjR_KHbAtRHc-h7mpM_5_fOelDWs3eH3_W2Q/edit?tab=t.0#heading=h.yj9fchogw209

Are ESOP Tax Advantages an Unintended Loophole in the Internal Revenue Code?

No. In short, ESOP tax advantages are intentional — not an oversight error.

ESOP tax benefits are specifically cited in legislation. Congress considers selling to an ESOP to be good public policy and has specifically created these tax advantages to further incentivize ESOPs and employee ownership.

Studies show that ESOP companies achieve stronger performance, provide higher compensation, and deliver a range of positive outcomes. These benefits often result in greater wealth being shared across more individuals, which can lead to increased overall tax revenues and reduced dependence on government-funded entitlement programs.

https://docs.google.com/document/d/11agWtweXjR_KHbAtRHc-h7mpM_5_fOelDWs3eH3_W2Q/edit?tab=t.0#heading=h.nvwtcoa96dlu

Common ESOP Merger and Acquisition Options

The difference between a positive liquidity event and seller’s remorse often comes down to strategic alignment. Deal terms and pricing are important, but the right structure often matters more. The "right" transaction generally reflects a business owner's distinct goals and needs.

To illustrate, let's explore three typical private company transactions: strategic sales, private equity (PE) deals, and leveraged ESOPs. Each carries its own unique pros, cons, financial benefits, and tax implications. While "perfect fit" is an elusive M&A concept, certain options may offer greater situational utility. With that in mind, we'll also examine each strategy through the lens of common priorities among a company's shareholders.

Strategic Sale
When business owners envision a mergers and acquisitions exit, this option is usually top of mind. Generally speaking, a larger player or deep-pocketed upstart is the acquiring company. They will purchase a target company to gain assets, product lines, intellectual property, customers, and/or sales territory.

Pros
An acquisition deal is a widely understood process
Transaction valuations may exceed fair market value (FMV)
Strategic buyers often have a greater appreciation of market dynamics and nuances
That familiarity may facilitate a smoother integration process for the newly combined company

Cons
Confidential company information is shared with potential competitors throughout the process

Selling shareholders pay taxes on their proceeds (capital gains)
Employees, including tenured staff and top talent, may not be retained by acquiring companies
Staff at target companies are often left with hard feelings and little to show for their efforts

Private Equity
Generally, these deals are leveraged buyouts. To complete an acquisition, a financial buyer will lever up a company’s balance sheet with private debt. Once in charge, the acquirer may seek to professionalize operations and drive future efficiencies.

Pros

Selling shareholders will often receive a substantial portion of the purchase price upfront
Private equity firms generally have the means and expertise to grow and/or scale a business
Sellers may also financially benefit from future add-on acquisitions and M&A activities

Cons
Sale proceeds are fully taxable
Sellers usually reinvest a portion of their proceeds in the post-transaction structure
PE firms often have the final say in future operational, strategic, and M&A decisions
Risk of putting excessive leverage on the target company

Leveraged ESOP
Similar to a management buyout, a company finances the purchase of an owner’s stock. But in this instance, the buyer is an employee trust, rather than a management team.
Pros
Sellers can eliminate capital gains taxes on sale proceeds and maintain potential upside
The company receives tax deductions equivalent to the sale value and can become an income tax-exempt entity
The business's board of directors continues to oversee operations
Employee stock allocations are generally periodic and subject to a vesting schedule

Cons
Employee trust cannot pay more than FMV
Highly structured deal process
Regulatory oversight by the Department of Labor and IRS
Outside lenders often provide non-recourse financing, but this may only cover a portion of the transaction (seller notes fund the remainder)

Owners who are ready to leave their businesses and want an up-front cash payout should give serious consideration to a strategic sale. This option likely represents the cleanest of breaks – free of continuing management duties and most other ongoing entanglements. Post-sale, the acquiring company is clearly in charge.

Of course, a third-party sale is subject to capital gains taxes, so a premium valuation can take on outsized importance.

When a company's shareholders seek to reduce their day-to-day involvement and diversify their personal portfolios, a PE or ESOP sale may be the ideal option. Both can provide a partial liquidity event with potential upside. Ongoing “skin in the game” takes the form of rolled equity in a PE sale and retained stock and/or stock warrants in an employee stock ownership plan transaction.

Businesses seeking an infusion of outside talent could be well served by a PE buyer. These firms often specialize in industry-specific transactions, providing operational expertise and human capital to scale their portfolio companies. The common trade-off is a loss of independence for the acquired company. While selling shareholders may play a role in the restructured entity, day-to-day control is generally assumed by the PE firm.

If a company already has the bench strength to facilitate a gradual leadership transition, an ESOP may be an attractive alternative. Sellers and their companies can reap the associated tax benefits with only a

30% sale to an employee trust. Even in the event of a majority or 100% ESOP sale, the company's board of directors will continue to operate the business, and sellers can continue to earn a salary and maintain meaningful roles without being obligated to stay.

While certain owners may be fully invested in their business, it could be the right time to take chips off the table. The case for an ESOP is compelling under these circumstances. The selling company can complete a partial, fair market value sale to an employee stock ownership trust and still maintain a majority stake.

Under a minority ESOP, operations and leadership remain largely unchanged, while the company benefits from increased cash flow, thanks to the ESOP's tax incentives. Employee-owned companies, on average, are also more stable and productive than their non-ESOP equivalents. The company's stock incentive can help foster increased employee engagement and provide a unique incentive for attracting and retaining top talent.

An employee-owned company also has significant flexibility to accommodate evolving stakeholder goals and future growth. Partial ESOP sales can be followed by a range of transactions, including secondary sales, M&A deals, PE investments, and ESOP plan terminations. As a result, owners have the latitude to actively shape their business legacies even after an employee stock ownership plan formation.
https://www.csgpartners.com/esop-resources-news/choosing-the-right-ma-option?hsCtaAttrib=196856424778

How does an Employee Stock Ownership Trust Acquire Shares?

A sponsor company's stock isn't directly transferred to employees. Instead, an employee trust (or ESOT) acquires equity, holds the shares on behalf of plan participants, and manages all allocations.

In general, the trust represents the employee owners' interests vis-à-vis the company sponsoring the plan. A trustee – often selected by an ESOP committee designated by the company's board of directors – acts as the shareholder of record and has a fiduciary obligation to all plan participants.

An ESOT commonly acquires company stock in one of two ways:
Company Issues Stock – Shares are transferred to the trust either in a single tranche or in multiple, periodic transactions.
Owners Sell Stock – Known as a leveraged ESOP, the trust purchases equity. Selling shareholders are paid fair market value following a negotiation with the ESOP trustee.
Employees do not pay out of pocket for shares. Instead, the sponsor helps arrange financing on the trust's behalf. This can take the form of seller notes, third-party debt (commercial loans, private credit, etc.), or a combination of the two. The sponsor repays the financing using pre-tax cash flow. Stock is released to the trust from the suspense account as the debt is paid down.

How are ESOP Shares Allocated to Employees?

An ESOP is a non-discriminatory employee benefit plan. As a result, all full-time employees are generally eligible to participate. Certain distinct classes of workers may be excluded, though, such as union members. The sponsor formalizes these details before plan formation.

Share allocations typically take place once a year.

Even when equity is issued to an employee trust (rather than sold to it), that stock is usually parcelled out to participants over multiple years. An employee stock ownership plan is meant to be a rolling employee benefit program, rather than a one-off distribution of stock.

Each year, eligible employees receive share allocations proportional to their annual salaries. For example, an employee earning $100,000 a year would receive twice as many ESOP shares as an employee earning $50,000. Plan participants may also receive cash distributions in addition to their annual stock allocations.

As mentioned earlier, all stock is held by the trust, even post-allocation. Share distributions are not made directly to ESOP participants. ESOP shares follow a vesting schedule.

Similar to 401(k) plans, there's generally a three-to-six-year vesting period for allocated stock. The details are determined before the plan is formed and outlined in the ESOP plan document.

Cliff Vesting – Employees fully vest after working at a company for a set period (no more than 3 years). It's an all-or-nothing proposition. Employees who depart before attaining this service goal forfeit any shares previously allocated to their accounts.

Graded Vesting – Employees vest gradually, over time, until they are fully vested. A typical structure has employees earning 20% of their shares after two years of service and receiving an additional 20% each year until they are fully vested (after six years).
Forfeited, unvested shares are usually reallocated to plan participants.

How do Employee Owners Redeem Shares?

Employee owners realize the financial benefits of their ESOP accounts when they depart or retire from their plan's sponsor. At that time, all of their vested stock is sold back to the company.

Shares are priced at a current fair market value, and the transaction is orchestrated by the trust on the employee's behalf. Once ESOP shares have been repurchased, the sponsor may grant the shares back to the trust for future allocation or retire the shares to treasury.

ESOP distribution schedules vary.

If a participant retires (at or after the plan's set retirement age), becomes disabled, or passes away, the sponsor must begin payment of the vested benefit no later than the next plan year.

If a participant leaves for another reason (quitting, dismissal, etc.), distributions must begin no later than six years after the plan year in which their employment was terminated.

Full payment is either made periodically (equal payments over a maximum of 5 years) or in a single lump sum. Plan participants can roll their proceeds into another qualified retirement plan. Otherwise, they will generally be subject to ordinary income taxes.

There are a few notable exceptions to these payment schedules. With that in mind, it's important to work with an experienced third-party administrator to keep track of all the odds and ends.

What Happens if an Employee-Owned Company is Sold?

Trustees sign off on any transaction involving company shares, including share buybacks and sales to strategic buyers or private equity firms. In general, they're not looking to block deals. But ESOP trustees do have a fiduciary responsibility to secure fair market value for all plan participants.

Upon sale to a third party, plan participants receive payment for their vested shares, based on the sale price. Additional considerations are made for unallocated shares where the original ESOP loan remains outstanding.

If an acquirer is also employee-owned, shares may roll over to the merged entity's employee stock ownership plan.

https://www.csgpartners.com/esop-resources-news/how-an-esop-works

An M&A Alternative with Broad-Based Benefits

What is an employee stock ownership plan? At its core, an ESOP is an ERISA-authorized retirement plan that invests in employer securities. Company stock is either issued or sold to an employee trust.

As a result, ESOPs enable closely-held companies to sell equity, at an independent valuation, to an employee trust. For middle-market firms seeking alternatives to third-party and private equity sales, employee stock ownership plans offer powerful business transition strategies.

These defined contribution plans also offer meaningful wealth-building opportunities for participants, tax advantages for all stakeholders, and continued autonomy for family-owned and private businesses.

https://www.csgpartners.com/whats-an-esop?hsCtaAttrib=196857608978#ESOP-FAQ

Section 1042 Tax Deferral

Capital gains taxes can squeeze even the most generous liquidity event. A business owner can expect a 20–38% post-tax reduction in sale proceeds following a typical M&A transaction. That is, unless the buyer is an employee stock ownership plan (ESOP).

Section 1042 of the US Internal Revenue Code provides shareholders with the opportunity to defer (and potentially eliminate) capital gains taxes on the sale of stock to ESOPs and eligible worker-owned cooperatives. To take advantage of this unique benefit, a seller must reinvest their sale proceeds in a qualified replacement property (QRP). Commonly known as either a 1042 rollover or a 1042 exchange, the strategy is similar to a 1031 exchange of real estate.

QRPs are securities issued by US operating corporations (with some exceptions). These may include:

Common stock, Convertible bonds, Corporate fixed-rate bonds, Corporate floating-rate notes and Certain real estate investments

US Treasury Bonds and mutual funds are not eligible for QRP reinvestment. Selling shareholders have 12 months after closing to reinvest their proceeds into a QRP.

To qualify, sellers must have owned their company shares for at least three years before completing an ESOP sale. Following the transaction, an employee trust must hold at least 30% of the company's stock. Additionally, sellers and their immediate family members cannot participate in the employee stock ownership plan.

For a seller to take full advantage of a 1042 rollover, their company must close its ESOP transaction as a C corporation. While S corporation shareholders are also entitled to a tax deferral, QRP reinvestment is limited to 10% of their sale proceeds. The remainder is subject to standard capital gains taxes.

If an investor sells their qualified replacement property, capital gains taxes on the initial ESOP transaction can be triggered and owed. However, if an investor holds a QRP until death, the investment receives a step-up in basis and can then be sold without triggering taxes.

Gifts of QRPs and transfers tied to divorces also do not qualify as taxable dispositions. As a result, 1042 exchanges offer clear estate planning benefits.

https://www.csgpartners.com/esop-resources-news/1042-rollovers-capital-gains-taxes-esop

ESOP Sale Value Deductions

When stock is sold to an ESOT, the plan's sponsor receives tax breaks equivalent to the transferred equity's fair market value. So, when a company sells $15 million of stock to a trust, it earns $15 million in deductions to offset future state and federal income tax burdens. Both C and S corporations are eligible for this incentive.

That's because deductions only become available when the employee trust formally receives equity. Leveraged ESOPs are financed transactions, and stock is only released to the trust when the loan between the sponsor and ESOT is paid down. The company earns a portion of its total anticipated tax deduction with each loan payment.

It's important to note that employees do not directly make payments on this internal loan. Instead, an employee-owned company makes annual contributions to the trust. The ESOP immediately sends that money back to the sponsor as a loan payment. Technically, it's this contribution that's tax-deductible.

Each year, an employee-owned company can contribute an amount equivalent to 25% of its ESOP-eligible payroll (total W-2 wages paid to plan participants). For example, a company with an eligible payroll of $10 million can make a maximum annual contribution of $2.5 million and receive an equivalent income tax deduction. Interest payments on the internal loan and optional dividend payments to the ESOP are also tax-deductible.

https://www.csgpartners.com/esop-resources-news/tax-benefits-for-esop-owned-companies?hsCtaAttrib=196859777421

Tax Exemptions for Employee-Owned S Corporations

S corporations are pass-through entities. As a result, earnings are passed through to shareholders by a company. Applicable taxes are then assessed on those individuals. Meanwhile, ESOTs are tax-exempt entities. The combination of these two concepts yields a potent tax advantage.

100% ESOP-owned S corps can operate income tax-free in perpetuity.

Say an S corp is fully ESOP-owned. The company's earnings and associated tax burdens pass through to the sole shareholder — an employee trust. Because the trust is tax-exempt, its potential income tax liability is nullified.

A limited number of states and localities still levy a nominal stand-alone tax on pass-through entities. An employee-owned S corp is not shielded from these burdens. However, even in the most stringent tax jurisdictions, S-ESOPs can still expect substantial income tax savings. That can have a significant impact on a company's free cash flow.

https://www.csgpartners.com/esop-resources-news/tax-benefits-for-esop-owned-companies?hsCtaAttrib=196859777421

ESOP Transaction Financing

Many commercial lenders are attracted to ESOPs. The associated tax incentives drive increased cash flow, while companies with strong employee ownership cultures statistically outperform their peers.

Senior debt, offered without personal guarantees and at reasonable terms, can often finance a sizable portion of a leveraged ESOP transaction. Higher-interest-rate mezzanine debt is also available when additional upfront cash is needed. Employee-owned companies repay these loans with pre-tax corporate cash.

Although ESOP lending options are plentiful, most transactions include a seller note component. The extent of seller financing often depends on a company's fundamentals and industry. For some businesses, this detail is irrelevant. Debt-averse firms can structure transactions exclusively as seller-financed.

Selling shareholders with the sole goal of maximizing their cash at closing may be better served in a private equity sale. Nonetheless, their capital gains will be taxable, and sellers may be required to roll equity into the deal.

https://www.csgpartners.com/esop-resources-news/the-pros-and-cons-of-esops#transaction-financing

Capital Sourcing for Companies Considering an ESOP

One of the most critical elements to implement an employee stock ownership plan (ESOP) is the ability to obtain debt financing. BDO works with businesses to structure and finance the ESOP transaction. We first undertake an initial study that includes a modeling assignment to evaluate whether an ESOP is feasible. Once feasibility is determined and the decision is made to move forward, we can assist with facilitating a capital raise for the transaction, entity restructuring, plan design and the negotiation with the trustee team and sources of capital.

There are several potential sources of debt financing including asset-based senior lenders, cash flow-based senior lenders, mezzanine funds and seller financing. Commercial banks familiar with ESOP transaction are usually willing to lend to creditworthy companies to help facilitate the sale to an ESOP. Any remaining balance on the sale could be made up using alternative lenders or deeply subordinated seller financing.

https://insights.bdo.com/ESOP-Financing-Services.html?utm_medium=cpc&utm_source=google&utm_campaign=PaidSearch_TAXESOP_C0098&utm_content=ESOPFinancing&utm_term=esop%20financing&utm_id=17003297258&adgroupid=134599999610&keyword=esop%20financing&gad_source=1&gad_campaignid=17003297258&gbraid=0AAAAAD

kzsvCE4CTbIa1Lu3Edm2rSLTjb5&gclid=CjwKCAiAuIDJBhBoEiwAxhgyFirfm3KdCY0Yg70JQkDO1DJVHTv6seRzlOv0WRMz6kOQiirJlsNBmBoChQkQAvD_BwE

The Straightforward Guide to ESOP Financing and Key Takeaways

Creating an employee stock ownership plan (ESOP) is a complex financial transaction that not all lenders have experience with. However, an ESOP is a common ownership transition tool and employee retirement plan used in many industries.

Financing an ESOP usually fits two general categories: leveraged or non-leveraged ESOP. A leveraged ESOP is more common and occurs where the company creating the plan finances the initial stock purchase with money borrowed from a bank and/or selling shareholder(s). The company self finances a non-leveraged ESOP through cash or shares.

If these terms – or the entire concept of ESOP financing – feel overwhelming, a lender with ESOP experience can help you consider your options and navigate the process.

Key takeaways

An employee stock ownership plan (ESOP) can facilitate an owner's controlled exit at retirement. The smoother the process of creating and formalizing the ESOP, the likelier it is your business will thrive. ESOPs can also be used to provide diversification to owners or to buy out minority owners.

An ESOP can be either leveraged or non-leveraged. In the more typical leveraged ESOP financing scheme, the (1) company creates the ESOP trust and, (2) obtains lender financing, (3) the ESOP purchases stocks to be held in trust for the plan.

The ESOP plan also facilitates employee retention and retirement. Employees earn distributions from the ESOP based on compensation and years of service. Because an employee may not vest in earned shares until years into the future, awarding shares also encourages employees to remain with the company.

https://www.bankatfirst.com/business/resources/commercial/straightforward-guide-esop-financing.html

Capital for ESOP Creation

When an ESOP is first created, the ESOP buys shares from a business owner, and the cash for the transaction is “loaned” by the Company to the ESOP. Those funds typically come from three sources: the company’s cash on hand, debt from a bank or another outside lender, and debt from the selling stockholder. Senior lenders (such as a bank) typically only finance a portion of the debt needed, especially when forming a new majority ESOP. Even with smaller tranches, in multi-phased conversions to ESOP, senior lenders may not finance 100% of the debt needed to complete the transaction. This means that buyers either need to access higher cost debt (such as mezzanine debt) or sellers need to self-finance the gap. Particularly for sellers looking to retire and wanting to be fully cashed out at the transaction close, this can often eliminate the option of converting to ESOP.

To foster more ESOPs, access to capital is critical. Mezzanine lenders are typically much more expensive, causing the burden of debt to become too risky for the transaction. To close the gap, when sellers will accept less than 100% cash on close, sellers often provide financing, either with or without warrants, earn outs or other mechanisms that go beyond straight amortization with interest. However, these elements are now under increased scrutiny by the Department of Labor.

To remove access to capital as a barrier to ESOP conversion, either sellers need to be better motivated to accept less than 100% cash on close, or better structured funding sources need to be identified or created that allow sellers to receive 100% cash on close. ESOPs must be protected from lenders and equity investors who seek to abuse the system, taking advantage of ESOP tax treatment to capture more than their fair share in the process.

Capital to fund ESOP conversions comes in two forms, debt and equity. Incentives to create more debt capital might include tax credits, sinking loan funds, or subsidized debt and these might be with or without government backed guarantees. Incentives to create more equity capital might be directed to family office, institutional, and PE investors but should include protections for ESOPs to prevent equity investors from flipping companies, wresting control, or selling off assets. Protections for any debt or equity incentives scenarios should also include limits on cost of capital, returns on investment, and might be structured similarly to enterprise or opportunity funds.

Selling stockholders are also important sources of capital because they can elect to receive debt instead of cash in return for a portion of the sale of their ownership. If a senior lender is already providing debt and has first call on the Company's assets, the selling stockholder typically will need added incentives to take on the risk associated with providing subordinated financing. This usually takes two forms: a higher interest rate or warrants that provide added returns based on the performance of the stock after it is sold to the ESOP. While these practices are common for mezzanine lenders in the broader marketplace, the Department of Labor has begun scrutinizing interest rates and warrants in their investigations, further impeding the motivation of sellers to provide financing.

Another motivation to incentivize sellers is "1042 Treatment" (under IRC Section 1042), which allows sellers to defer capital gains taxes by rolling over the proceeds from a sale of stock to the ESOP into certain domestic securities. While this has been helpful to close the gap between a 100% cash up-front sale to a third party, until 2022, section 1042 only applied to the sale of stock of C Corporations, while many small to medium sized businesses are S Corporations. The SECURE 2.0 Act of 2022 allowed, for the first time, S corporations access to section 1042 benefits starting in 2028 and only at a limited (10%) level.

https://www.esopassociation.org/articles/access-capital-barrier-esop-creation

ESOP Financing Options

If your company cannot fully fund an ESOP on its own, you will need to collaborate with a lender. The most typical source of financing will come through an institutional foundation like a bank, but if you're structuring a 100 percent ESOP transaction — or have some leverage on your balance sheet already — you'll likely need other sources of financing to cover the full value.

Seller notes may be necessary if traditional financing can't cover the full value of the buy-out. It often comes from the seller in the form of a seller note or alternative sources of capital such as mezzanine financing. These alternative sources are more expensive than traditional bank loans but could provide more flexibility and offer the liquidity the seller is seeking.

The extent of seller notes will vary based on the liquidity goals of the selling shareholder(s) but can also include an added layer of flexibility in the form of warrants. Warrants can provide the company with improved cash flow in the years following the transaction, while also giving the seller the ability to benefit from the future growth of the company.

Although not a necessity, working with a lender with experience in ESOPs will likely help the process move more smoothly. This is especially true in the underwriting process, as having a thorough understanding of how ESOPs work allows the lender to maximize lending capacity.

Debt service ratios typically involve Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) as the benchmark, but often in ESOP financing, ESOP compensation is also an add-back (EBITDAE). This is due to ESOP compensation being largely a non-cash item during the de-leveraging phase.

https://www.kmco.com/insights/considerations-when-leveraging-esops-for-financing-a-business-buy-out/

Key Objectives in ESOP Financing: Liquidity & Capital Planning

There are three main goals when financing your sale to an ESOP.

Create liquidity. The financing provided allows the shareholders to sell their stock or equity investment and, in turn, receive cash, enabling them to diversify their personal holdings.

Match the goals of the sellers, the company, and the capital provider. Several questions should be considered:

How much cash do the shareholders want to receive?

Can the company comfortably repay the debt while still considering what is required to continue to run and grow the business?

Who are the right capital providers who understand the business, its needs, and the transaction?

Exploring ESOP Financing Sources: Bank vs. Seller Financing

There are two primary financing sources: bank financing and seller financing.

Bank financing, commonly called senior financing, has its pros and cons. The financing provided by banks satisfies the selling shareholder's desire for diversification and cash in hand at closing and is generally secured at advantageous terms. A five-to-seven-year repayment term coupled with advantageous interest rates make senior financing very attractive in nearly all ESOP transactions.

However, with a bank now your partner, other considerations of oversight come into play. The bank will analyze various items such as collateral, earnings history, and your financial projections to determine what covenants will be required to ensure the company's ability to repay debt. Additionally, understanding the role of an ESOP trustee can help ensure compliance with fiduciary responsibilities. Financial covenants are standard with ESOP transactions and usually focus on the amount of leverage (debt versus cash flow) and debt service (cash flow over debt repayment obligations). Furthermore, because banks have regulators, they are subject to market risk just as companies are. The regulations can dictate terms and conditions the bank is willing to extend.

Leverage Levels. Leverage is a key term in banking as it reflects the amount of debt capacity a company has versus its cash flow to repay that debt. Following the Great Recession, banks have been made subject to strict guidelines on how much leverage they can provide a company. This is not only true in operations financing, but also in an ESOP transaction. An ESOP transaction is likely going to be unsecured – creating potentially more perceived risk for the bank. Therefore, banks focus on the amount of leverage based on the size of the company's recurring cash flow.

Cash flow. If you have strong and recurring EBITDA, you are likely to receive more leverage, which equates to more liquidity at closing. Consequently, lower or large fluctuations in your EBITDA may lower your cash in hand. As you continue to repay your bank loan over time, the bank gains comfort and is likely to increase your liquidity if there is any secondary or seller debt to refinance.

Collateral. Collateral is important to lenders as a backstop to pay off their debt if cash flow is unavailable. In most ESOP transactions, debt provided by the lenders is not collateralized. For this reason, it is important to partner with the right bank to ensure they understand the overall structure, just as much as you do. If collateral is available, the terms of the loan can be more favorable.

Seller financing also has pros and cons. At inception, seller financing trades your current stock and equity investment risk into a note with debt risk, whereby the seller acts as the bank. This is a major consideration when evaluating financing and risk diversification. Seller financing comes with several benefits. It allows you to control the debt repayment and avoid regulatory oversight and covenants, and you will not have to contend with close monitoring of your company's performance. At the same time, seller financing allows you to earn a market yield on your seller note and creates potential upside or extra cash payout down the road through a warrant.

Your financing objectives in your ESOP transaction will guide you to financing sources. Before moving forward, it's crucial to understand the five factors to consider before selling to an ESOP. A combination of bank and seller financing is common in many ESOPs as it achieves the best of both options.

https://www.pcecompanies.com/resources/financing-a-sale-to-an-esop

Common ESOP Use Cases

Shareholders Taking "Chips off the Table"

Founders and owners often have most of their net worth locked up in their companies. At the same time, many have no intention of selling out and walking away. Whether they're too young for retirement, want their firms to remain independent, or enjoy their current work-life balance, a third-party sale is generally not an option.

Partial ESOP sales offer a meaningful compromise. When shareholders sell a minority stake to an employee trust, they can receive fair market value for their shares, maintain future upside potential, and continue with their day-to-day routine and responsibilities. Furthermore, when at least 30% of outstanding equity is sold to an ESOP, a selling shareholder can defer capital gains taxes on their proceeds.

Following the transaction, an employee-owned company is free to sell additional shares to the ESOP, repurchase stock, make acquisitions, or sell to outside buyers. That represents significant flexibility for owners with extended time horizons.

Family Business Succession Alternative

Intergenerational transfers have become a rarity. Many family businesses would prefer to remain independent, but younger family members increasingly forge their own career paths, and internal equity sales can carry significant tax burdens. Departing shareholders often need liquidity, so gifting isn't always a solution.

A leveraged ESOP buyout of individual owners or entire ownership groups can help perpetuate a family-owned company's legacy and set the stage for additional, targeted ownership transfers. How so? The seller note and/or third-party debt that helps facilitate these transactions will temporarily depress a company's value. Shareholders can use that opportunity to gift retained interest without triggering taxable limits or sell outstanding equity or warrants to family members at lower valuations.

The liquidity generated by an ESOP sale enables families to financially prepare for looming estate tax burdens without having to engage in the forced sale of a closely held business. As a result, this unique version of shared ownership enables businesses to stay in families, prepare for the future, and remain rooted in their communities.

Facilitate a Management Buyout

Willing and able management teams often don't have the financial wherewithal to orchestrate shareholder buyouts. Cash is usually tight, and it's challenging to raise transaction financing independently. Even in instances where a standard management buyout (MBO) is feasible, the unfavorable tax treatment on both sides of the deal can cloud a transaction.

When leveraged ESOP-MBOs are structured, the sponsoring company can negotiate the creation of warrants alongside the sale of stock to an employee stock ownership trust. Like stock options, warrants are a form of synthetic equity that grants holders the right to purchase company shares for a specified period at a predetermined price. This strike price is typically low, as it reflects the business's depressed valuation post-transaction.

Selling shareholders are permitted to gift or sell warrants to their management team. This enables a management team to take a meaningful stake in the company, beyond standard ESOP allocations. Warrants can appreciate as the company delivers and grows, driving real economic value to the company's new leaders.

High Payroll Companies

A leveraged ESOP sale creates corporate income tax deductions equivalent to the transaction price. For example, a $10 million stock sale can result in $10 million in write-offs for the sponsoring company. However, the pace at which those deductions are utilized is tied to a company's payroll. That puts staffing, professional services, and other labor-intensive firms in a unique position.

An employee-owned business earns a portion of its allotted deductions when the firm makes contributions to its ESOP plan. Contributions are limited to 25% of the company's annual ESOP-eligible payroll. So, if the firm in question has an $8 million annual W-2 payroll, it can make a $2 million non-cash contribution to the plan and earn $2 million in annual deductions. In other words, the higher the payroll, the faster a company can utilize its overall tax benefits.

Asset-Heavy Companies

Latent tax liabilities can significantly impact the sale of a trucking, real estate, or equipment-intensive company to a third party. Asset-heavy firms typically utilize accelerated depreciation to lower their annual income tax burdens. In a typical asset sale, the difference between the market value and the depreciated cost of these assets is taxed at ordinary income rates. This is known as depreciation recapture.

An ESOP deal is a stock sale, not an asset sale. As a result, a properly crafted transaction will not trigger depreciation recapture. That can meaningfully enhance a selling shareholder's post-tax sale proceeds.

Government Contractors and Other Designated Businesses

When GovCon and related minority, veteran, and woman-owned firms consider M&A options, two issues commonly arise: the buyer pool is often limited, and strategic sales may result in the loss of a valuable set-aside status. These constraints can negatively impact a company's sale value if a transaction can be consummated at all.

Minority ESOP sales and even some majority transactions can be structured to help contractors preserve their status and secure fair market shareholder liquidity events. Furthermore, employee-owned, cost-plus vendors can benefit from an added incentive. ESOP contributions and dividends represent "allowable" expenses and are reimbursed by the government on cost-plus contracts.

https://www.csgpartners.com/esop-resources-news/common-esop-use-cases