FEATURE

POST-COVID-19:

PARTIAL ESOPS FOR LIQUIDITY, DIVERSIFICATION AND RETIREMENT

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As an 11-year economic expansion comes to an abrupt end1, business owners across the United States who had been looking to sell their companies may find themselves in a position they could not have fathomed months or even weeks prior. Owners who were looking to sell to take advantage of economic prosperity and high multiples will likely face lower valuations and a more limited pool of potential buyers when returning to market after COVID-19 quarantine restrictions are lifted. Amid the new recessionary conditions, many of these business owners may be seeking liquidity after being mandated to close their doors to the public – and thus their sources of income – for weeks on end. Those searching for a solution to their liquidity needs may find their answer in a partial sale to an Employee Stock Ownership Plan (ESOP).

March 2020 marked one of the worst months in nearly 90 years for both Main Street, which is comprised of small businesses, and Wall Street alike.[2] Global economies shut down as the health of consumers and families took precedence over supply chains and economic expansion.

In the midst of a global panic surrounding the COVID-19 pandemic, the Dow Jones Industrial Average (DJIA) suffered its largest single-day point loss in history, dropping 2,353 points, and the largest percentage drop – 10 percent – since Black Monday in 1987.[3] Despite the efforts of the United States government to rapidly pass stimulus packages, small businesses across the nation have borne much of the burden of a rapidly shrinking economy. With no end in sight to the impact of quarantines and shelter-in-place orders brought forth by COVID-19, millions of local stores have been forced to

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close their doors, halting virtually all of their potential cash inflows.[4] This dark cloud over the small business economy looms even larger considering that 33 percent of small businesses have no emergency funds saved for unexpected expenses.[5]

These factors, in combination with the uncertainty regarding the coming months and years, may seem to spell disappointment for business owners who had been expecting to sell their companies at valuations that they worked hard to create to support their planned retirements. Private equity firms, equipped with $1.5 trillion in cash, are poised to take advantage of valuation drops and close cheap deals with struggling businesses.[6] Other third-party buyers will be looking to limit their downside risk exposure by negotiating closing conditions or seeking special indemnity against COVID-19-related liabilities.[7] Some business owners may believe that their options are limited to either selling at a significantly lower price or walking away from a sale completely. However, those who believe in the strength and future solvency of their business can find middle ground in a partial sale to an ESOP.

Selling a minority stake of a privately held business to an ESOP offers business owners the unique ability to solve multiple problems with one solution. It can act as a tool for selling shareholders to extract liquidity from an enterprise in the present while still allowing the owners to retain a controlling interest. This injection of liquidity provides both funding and time for business owners to regain their footing and rebuild the company's valuation to pre-pandemic levels before monetizing their remaining shares of the business in the years to follow.

Along with creating liquidity, selling shares to an ESOP can provide tax advantages for both the company and the selling shareholder if the transaction is structured properly. If the company is structured as an S corporation at the time of the sale, it will operate federal income tax-exempt to the extent of ESOP ownership, and will often be tax-exempt at the state income level as well. For example, if an ESOP owns 49 percent of company stock, then 49 percent of the company's profits will not be taxed.[8]

Conversely, if the company is structured as a C corporation at the time of the sale, the selling shareholder can defer or potentially eliminate capital gains taxes on their proceeds from the stock sale. Under Section 1042 of the Internal Revenue Code, the seller can defer these taxes provided that the ESOP owns at least 30 percent of the company's outstanding stock after the sale and that the seller invests 100 percent of their proceeds into securities designated as Qualified Replacement Property ("QRP").[9]

Some business owners will elect C corporation status prior to selling stock in order to be eligible for capital gains tax deferral under Section 1042. Upon making this election, there is a mandatory five-year waiting period before the company can revert back to S corporation status, at which time it can enjoy the tax advantages offered by an ESOP at the corporate level.[10] One potential sale timeline could be structured as follows:

1. The company elects C corporation status prior to the shareholder selling stock.
2. The shareholder sells 30 percent of the company's outstanding stock to the ESOP.
3. The shareholder reinvests 100 percent of their proceeds into QRP within 12 months of the sale so that they are eligible to defer capital gains taxes from the 30 percent stock sale.
4. The shareholder then focuses on capitalizing the business, ramping up revenue, and increasing margins in an effort to raise the company's valuation back to pre-COVID-19 levels.
5. Moving forward, the shareholder evaluates whether they want to sell their remaining ownership stake to the ESOP or consider other ways to monetize. One option would be to sell through a dual-track M&A process, using the ESOP as a "stalking horse" to drive a competitive offer from private equity or a strategic buyer.

A partial sale to an ESOP may be useful in addressing multiple issues faced by business owners who are looking to sell. In the short term, it can help satisfy the need or desire for liquidity and diversify a shareholder's wealth away from the business. It can also provide long-term flexibility for the owners. An ESOP may not be the best option for all businesses, and there are expenses and other requirements associated with them. Business owners should seek the advice of people experienced in these types of transactions before participating in one. ■

Based in Washington, DC, Keith Apton and Nick Francia of The Capital ESOP Group have spoken nationally on the topic of ESOPs. The Capital ESOP Group is a financial advisory team within UBS, one of the world's largest global wealth managers. The Capital ESOP Group has helped create over $2.5 billion of liquidity through successful transactions and is positioned to help business owners and their trusted advisors understand if an ESOP is the right fit for the company.

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[8] *"How an Employee Stock Ownership Plan (ESOP) Works." NCEO, 10 Apr. 2018, www.nceo.org/articles/esop-employee-stock-ownership-plan.*

[9] *Ibid.*

[10] *"26 CFR § 1.1362-5 - Election after Termination." Legal Information Institute, Cornell Law School, www.law.cornell.edu/cfr/text/26/1.1362-5.*