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ESOP FAQ's

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ESOP // FREQUENTLY ASKED QUESTIONS (FAQS)

General ESOP Questions

- **What is an ESOP?**
  - An ESOP (Employee Stock Ownership Plan) is a retirement plan that allows employees to own shares in the company they work for. It provides liquidity to business owners, tax incentives, and enhances company culture.

- **How does an ESOP transaction work?**
  - The company borrows money (or uses its own assets) to fund the ESOP trust.
  - The ESOP trust purchases company shares from the owner.
  - Employees receive shares as part of their compensation over time.

- **What are the main benefits of an ESOP?**
  - Provides a liquidity event for business owners.
  - Offers substantial tax incentives (including IRS 1042 tax election).
  - Creates a strong company culture by giving employees ownership.

- **What are the tax benefits of an ESOP?**
  - Business owners can defer capital gains tax under the 1042 election.
  - The business gets a large tax deduction, sometimes making it a tax-free entity.
  - Employees receive stock in a tax-advantaged retirement account.

- **What businesses are eligible for an ESOP?**
  To qualify for an ESOP:
  - The business must have at least 10 employees.
  - It should have at least $1 million EBITDA.
  - It must be structured as a C-Corp or S-Corp.

- **How long does it take to complete an ESOP transaction?**
  - The process takes about 5-6 months from start to finish.

<u>Funding an ESOP</u>

- **How is an ESOP typically financed?**
  - Through bank loans or internal company funds.
  - The company takes out a loan and repays it using future profits.
  - Sometimes, accounts receivable can be sold to finance the ESOP.

- **What if the company doesn't want to take on debt for an ESOP?**
    - A non-leveraged ESOP allows a business to fund the ESOP without a bank loan, often by using internal company assets (e.g., selling accounts receivableor if the company has significant cash on the BS).

- **What are the costs of setting up an ESOP?**
    - Legal, accounting, and valuation costs typically range from $300,000 to $350,000.
    - Colorado offers a $150,000 tax credit for setting up an ESOP.

- **Can an ESOP buy a company without the buyer using personal funds?**
    - Yes, an ESOP can acquire businesses with no out-of-pocket cost to the acquirer by structuring the transaction through financing.

<u>Employee Considerations</u>

- **What happens if an employee leaves the company?**
    - Employees receive only their vested shares.
    - They can sell shares back to the company, hold them, or (in rare cases) sell on the open market.
    - The company must buy back shares within one year (if voluntary departure) or five years (if fired for misconduct).

- **Is there a limit on how large an ESOP can be?**
    - No, but companies must have at least 10 employees to qualify.

- **How are shares distributed among employees?**
    - Shares are allocated based on payroll, meaning higher-paid employees receive more shares.
    - The company can set up phantom stock for non-payroll contributors like advisors or board members.

- **Can ESOP shares be given more favorably to long-time employees?**
    - Yes. The business owner has some discretion to allocate more shares to key employees or managers.

<u>Exit and Failure Considerations</u>

- **What happens if the business fails after setting up an ESOP?**
    - If the business cannot make loan payments, banks take the loss in most cases.
    - There is usually no personal guarantee required from the owner.
    - The ESOP trustee ensures the business is properly managed to prevent failure.

- **Can an ESOP be unwound or sold?**
  - Yes, ESOPs can be reversed at any time, allowing the business to be sold to a private buyer or another entity.
  - Employees with vested shares receive their proportional share in a sale.

- **Does an ESOP affect the control of the business?**
  - No. The original owner can still control the board.
  - The ESOP trustee ensures fairness for employees but does not interfere with management.

- **Can an ESOP be used to buy another business?**
  - Yes. An ESOP can acquire another company with no personal funds from the buyer, with financing handled by the ESOP structure.

Comparison: ESOP vs. Traditional Sale (M&A)

- **How does selling to an ESOP compare to selling to private equity (PE)?**
  - ESOPs provide tax-free sales and keep the company culture intact.
  - PE sales can result in higher upfront payments but often come with layoffs and business restructuring.

- **What is the cost difference between an ESOP and a brokered M&A sale?**
  - A brokered sale usually costs 5-10% of the total transaction (e.g., $5M on a $50M deal).
  - An ESOP setup fee is about $350,000, making it much cheaper.

- **Can you sell only part of your business to an ESOP?**
  - Yes, ESOPs can be structured to sell anywhere from 1% to 100% of a business.
  - Some owners choose to sell in tranches (e.g., 25% every few years), but multiple transactions increase costs.

Additional Financial Insights

- **What is the 1042 tax election?**
  - The 1042 election allows sellers to defer capital gains taxes if proceeds are reinvested in qualified replacement property (QRP) like stocks or bonds.

- **What is the typical interest rate for ESOP financing?**
  - Most ESOP loans have interest rates between 6-9%.

- **Can ESOPs be structured with seller financing?**
  - Yes, business owners can finance part of the transaction through a seller carry note at 5-8% interest.

- **Are there any government incentives for ESOPs?**
  - Yes. In Colorado, businesses receive a $150,000 state tax credit for setting up an ESOP.
  - The state of CO also gives 50K ongoing every year as long as ESOP is active.

- **What are the biggest risks in setting up an ESOP?**
  - The only major risk is if financials are inaccurate or the company cannot sustain loan payments.
  - This is mitigated by careful due diligence and financial audits before proceeding.

<u>**Other Considerations**</u>

- **Who should consider an ESOP?**
  - Business owners looking for an exit strategy while maintaining company culture.

- **Companies seeking tax advantages and a way to retain key employees.**
  - Entrepreneurs looking to acquire a business with no out-of-pocket cost.

- **How can I start the ESOP process?**
  - Work with an ESOP advisor to evaluate financials, structure the deal, and secure funding.
  - Prepare necessary documentation like financial statements, tax returns, and business valuations.
  - Identify the right trustee group to oversee the ESOP.

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