

Special Report

ESOP: The right solution for you?

Employee stock plans offer tax-free exit to owner

Complex transaction can be right solution for some

Ever thought about taking some of the cash off the table but come up against a stiff tax bill because your business has grown so much in value? George Whitlow, who owns Chevrolet and Lexus dealerships in Richmond, Va., says he felt like he was painted into a corner after growing his business for more than 15 years.

He ended up choosing an Employee Stock Ownership Plan to sell off half his company and avoid paying any taxes on his gains (see accompanying story). An ESOP is a retirement plan that gives employees an equity stake in the company while providing owners of a closely held enterprise a chance to take out some of their equity in a tax-advantageous way.

The main tax advantage: No capital gains tax on the equity sold to the employee plan. Also, the total cost of funding the plan – interest and principal – is tax deductible

“It’s a great liquidity event for the owner,” says Todd Berko of Bel Air Partners, a Princeton, N.J.-based investment bank. “It’s an extra benefit for employees that enables them to build equity and net worth. They work better if they own a stake in the company.”

An ESOP is not for everybody. It is genuinely complicated and there are some real disadvantages. One extra hurdle for car dealers is the need to get the manufacturer’s approval. Only a handful of car dealerships have joined the group of closely held companies who have adopted this retirement plan.

“There are so many alternatives” for raising cash, says Marc Crumback, an attorney with Beers & Cutler in Washington, D.C. An owner can get a partner, sell stock to a Real Estate

Investment Trust (REIT), or get a working capital loan, he says.

Crumback says none of his dealership clients has opted for an ESOP. “Most of them seem to like the 100%-owned arrangement,” he says.

It can also create potential difficulties when it comes time to sell the dealership, says Nancy Phillips, a New Hampshire-based broker. “It’s like having multiple partners,” she says.

“They are popular in some industries,” says Karen Bonn, an accountant at BDO Seidman LLP, who works on ESOPs. “It is a liquidity alternative for closely held companies.”

Don’t confuse an ESOP with a stock option plan, like those used in public companies to give incentive compensation to managers, or those used by

Continued on page 4

ESOP Case Study:

Richmond dealer finds an exit strategy

George Whitlow felt he was painted into a corner. He had acquired a Chevrolet dealership in Richmond, Va. in 1985, and it had mushroomed in value from a few hundred thousands of dollars to now, after adding a Lexus franchise, being worth tens of millions of dollars. The company was holding cash reserves and the real estate was all paid for. Any exit from the business, structured as a C-Corp, faced a tax bill that ran into the millions. “It wasn’t pretty,” he says.

Whitlow, now 56, didn’t want to retire and didn’t want to sell, but he was worried about how he was going to get his money out of the business. At his accountant’s suggestion, he took a close look at an ESOP. “It looked like a win-win all the way,” Whitlow says.

Continued on page 5

Employee stock plans offer tax-free exit to owner (Continued from page 3)

cash-short dotcom startups to pay all employees, who then got a huge windfall during the tech boom. An ESOP is a retirement plan, like pensions or 401K, with distributions to employees that are vested over time. The stock (not options) is held in a trust, not directly by the employees.

Some dealers who have tried it really like it. "It's not for everyone," says Whitlow. "But for my situation, it was ideal."

Some industry trends might make ESOPs more attractive to car dealers in the near future:

An older generation of owners is nearing retirement. In family firms, the next generation may not

be entering the business, or the business may have outgrown family management. Owners might be looking for a way to start disengaging themselves from the business.

Multistore dealerships make it harder to find sufficiently well-heeled buyers. A buyer only needs to pay for the stake not owned by the employees if he keeps the ESOP in place.

It's increasingly necessary to add benefits to keep employees. While workforces may have been transient in the past, nowadays there's too much invested in training to let employees go. ■

How to set up an ESOP

- 1. Conduct an ESOP feasibility study.** Analyze the trade-offs, see if the numbers work for you.
- 2. For car dealers, the next step is to get the manufacturer's approval.** This can take some time, depending on how familiar the manufacturer is with ESOPs. Car makers are reluctant to see the sale exceed 49% of total equity.
- 3. Convert to a C-Corp.** This is not a requirement for an ESOP, but some of the main tax advantages are only available if it's a C-Corp because of the way the law is constructed.
- 4. Set up a trust to buy the shares.** Headed by a trustee, usually a third party, who votes the employee stock in most cases.
- 5. Get a loan to fund the purchase of the shares.** This can be a potential stumbling block if the dealership's debt service is already consuming a good portion of cash flow.
- 6. Sell at least 30% (the minimum prescribed by law) of the dealership to the trust.** There's no top limit, but you wouldn't sell more than 49% if you wanted to make sure of keeping control.
- 7. Invest the proceeds of the sale in approved securities (called Qualified Replacement Property).** These are special obligations issued by big U.S. companies like General Electric. Any capital gains tax due on the sale of equity is deferred as long as the proceeds are invested in these securities. The owner can borrow at any time against this asset. If the QRP is held to death, it would get a step up in basis and never be subject to capital gains tax.
- 8. Pay down the loan to the trust from the dealership's cash flow.** As the loan is paid down, employees are vested in the equity. Both interest and principal payments are tax deductible for the dealership. Employees pay tax when they withdraw at retirement (or it can be rolled over into an IRA).