UBS

ESOPs

Employee Stock Ownership Plans

Private Wealth Management

"We've learned over the last 30 years that to our clients, business is personal. The decision to sell is never easy. It's life-changing—for owners, their families and the future they're shaping. That's why we believe so strongly in what we do and how we can help you successfully take that next step—in business, but also in life."

– Keith A. Mericka

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Employee Stock Ownership Plans (ESOPs)

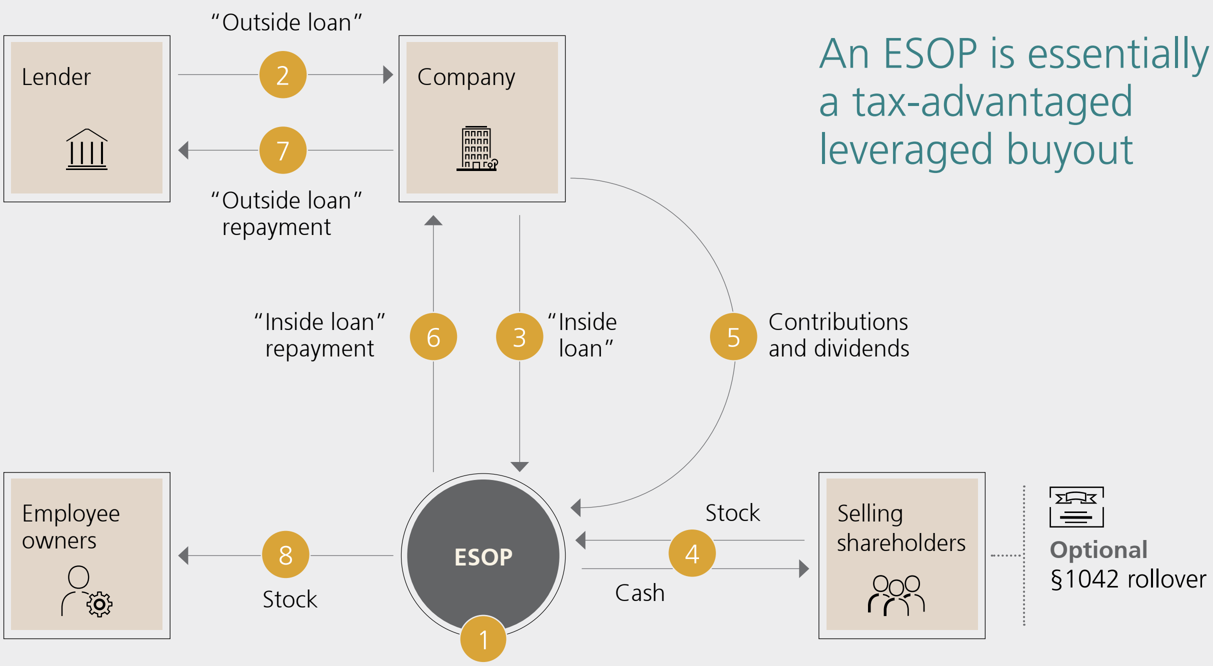
What is an ESOP?

An Employee Stock Ownership Plan, or ESOP, is both a qualified retirement plan for employees as well as a tax-efficient exit strategy for business owners. Owners of successful closely held businesses often use ESOPs to create a market in order to sell some or all of their shares to their employees and, if structured properly, the owner can defer or potentially eliminate the capital gain tax associated with the sale. To do this, the company establishes and contributes cash to an ESOP which is then used to purchase company stock from the selling shareholder(s). Over time that stock is allocated to employees in the form of a retirement benefit. In addition, the ESOP-owned portion of the company may be eligible to operate federal and state income tax free.

ESOPs, formalized under federal law with the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, are now widespread representing the most common form of employee ownership in the US. As of the most recent data, 6,669 plans exist, covering 14.4 million people.[1]

[1] Source: National Center for Employee Ownership, www.nceo.org/articles/esop-employee-stock-ownership-plan.

How do ESOPs work?



An ESOP is essentially a tax-advantaged leveraged buyout

Initial Structuring

1. Company creates ESOP trust

2. Company borrows funds from lender ("outside loan")

3. Company re-lends the funds to the ESOP ("inside loan")

4. ESOP uses funds from "inside loan" to purchase shares from selling shareholders (cash in exchange for stock)

***Optional:** If a C-Corp at the time of sale, selling shareholders can elect IRC section 1042 in order to defer capital gains tax associated with the sale

Ongoing

5. Company makes tax-deductible contributions to ESOP

6. ESOP repays the "inside loan" to company

7. Company repays "outside loan" to the lender

8. As the "inside loan" is repaid, shares held as collateral for the "inside loan" are released and allocated to retirement accounts for the employees

Why do business owners choose ESOPs?

ESOPs can provide significant tax advantages while representing a mutual alignment of interests

What's in it for the owners?

- **Can yield more in total after-tax proceeds to the owner compared to a sale to an outside buyer, mainly from the ability to:**
  1. Defer, or potentially eliminate, capital gains taxes on the sale of the company by electing Section 1042 of the Internal Revenue Code and reinvesting the sale proceeds in "Qualified Replacement Property (QRP)"– stocks, bonds and/or other securities of US operating companies that meet certain tests
     - If the business owner holds the QRP until death, the gain is eliminated since the basis in the QRP assets is "stepped up" to fair market value.
  2. Hold a high-yield seller note with an attractive interest payment
  3. Participate in the future upside of the business through warrants, which and are taxed at favorable capital gains rather than ordinary income rates
  4. Continue receiving a salary
- **Can allow the owner to start the next chapter of their life while preserving their legacy and providing meaningful benefits to their employees**
- **Can provide the owner the ability to continue leading and controlling the company even after a sale**
- **Can preserve confidentiality unlike other liquidity alternatives that require the release of confidential information to prospective buyers**
- **Can provide an exit alternative to a third-party sale or when there are a lack of interested buyers**
- **Can be structured as a series of transactions**

– If the owner does not want to sell all of their business or the business cannot afford to carry the amount of debt needed for a 100% buyout, the business owner can structure the first transaction to qualify for the deferral of capital gains tax (at least 30% sale to the ESOP). Subsequent sales can be structured to transfer the remaining 70% in one or more tranches as the leverage for the first transaction is paid down and the business is able to re-leverage itself.

- **Can facilitate sales between shareholders**

– ESOPs can be used to buy out shareholder(s) wishing to exit. Often, this ESOP transaction works in the interest of both parties due to the tax benefits. The selling shareholder(s) may qualify for the deferral of capital gains under IRC Section 1042 and the shareholder(s) who remain in the business will benefit from the business' ability to repay the debt incurred to buy out the selling shareholder on a pre-tax basis.

- **Can accomplish many objectives of an estate and succession plan**

– The estate becomes liquid allowing for the transfer of different types of assets to family members with different levels of involvement (i.e., cash to family members not involved in the business and stock to family members active in the business). In addition, since the cost basis of the QRP gets stepped up at the shareholder's death, the QRP could be sold to provide liquidity to pay estate tax. A leveraged ESOP can also create an ideal opportunity to gift shares to the next generation because the gifted shares will be valued on a non-marketable, minority interest, thus decreasing their value for purposes of gift and estate tax exclusions.

* If a C-corp at the time of the transaction

What’s in it for the company?

- Stock and/or cash contributions to the ESOP are tax-deductible, therefore providing the ability to repay debt with pre-tax dollars
- S-corp ESOP companies may be eligible to operate federal, and in many cases, state income-tax free
- Ability to acquire other companies in the future using pre-tax dollars
- Potentially increased productivity and retention due to employees’ “owner” mentality
- ESOP repurchase obligations are postponed until transaction debt is repaid

What’s in it for the employees?

- Rewards employees with tax-deferred retirement benefits. Employees do not pay tax on the stock contributed to their accounts until distributions are taken similar to an IRA or other qualified plan.
- Employees receive equity in the company without having to invest any of their own cash
- Participation can be combined with other benefit plans

What’s in it for management?

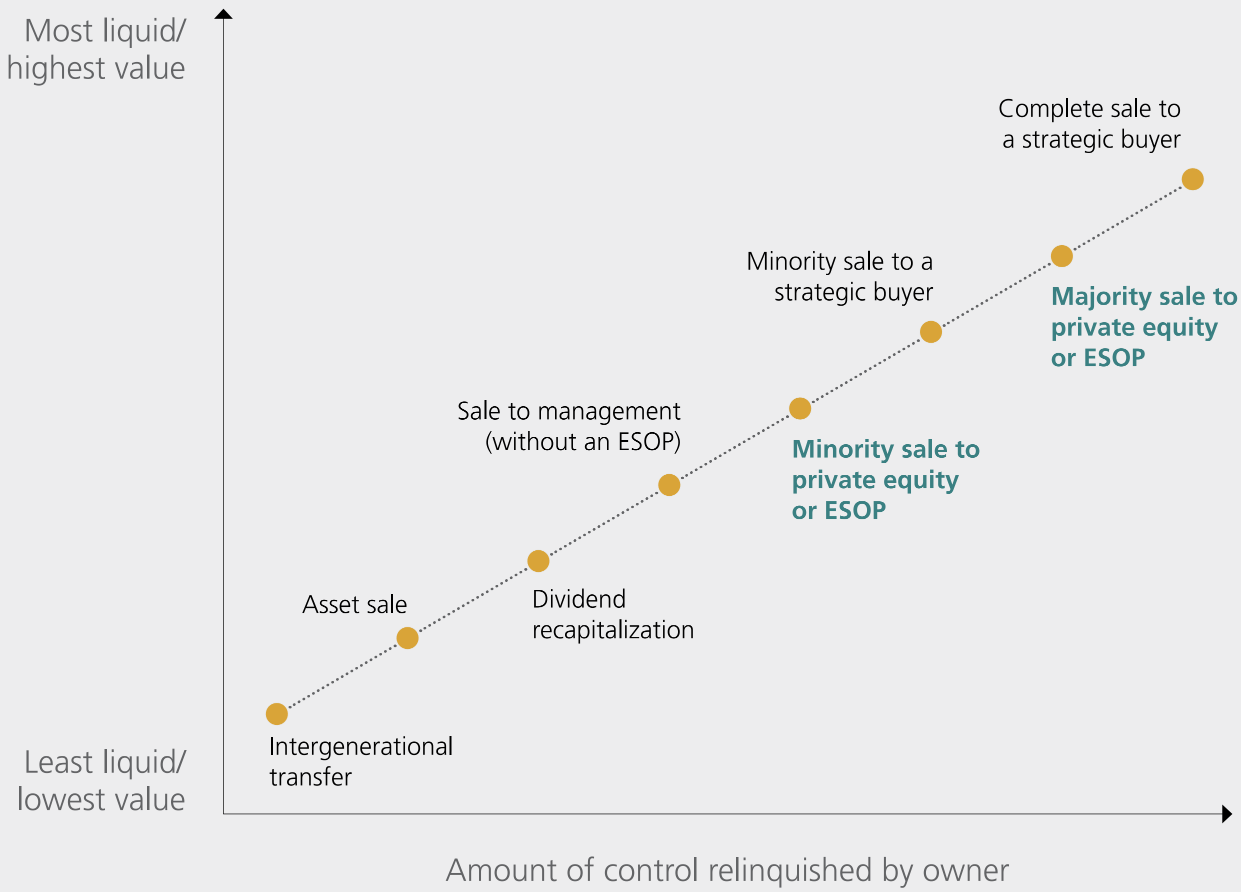
- Gradual transition to “run” the company
- Participation in the ESOP and possibly an executive non-qualified plan provides meaningful wealth building opportunities
- Creates opportunities to motivate, retain and recruit key talent

ESOP participants have 2.2x as much **in retirement plans** compared to those at non-ESOP company[2]

[2] Source: National Center for Employee Ownership (NCEO), The Economic Power of Employee Ownership. www.nceo.org

ESOPs compared to other liquidity alternatives

	Sale to third party	IPO	Dividend recap	ESOP
Shareholder liquidity	100% (unless stock transaction)	Typically minimal to partial	Partial	Between partial and 100%
Valuation	Potential for premium over market value	Stock is issued at discount to market value	N/A	Fair market value (FMV)
Certainty of close	Low	Medium/High	Medium	High
Financing risk/ dependence on favorable market conditions	Low	Medium/High	Medium/High	High
Tax-advantaged	Yes	No	No	Yes
Ownership dilution	Typically 100% transferred to buyer	Typically 20% – 40% dilution	Typically zero dilution	Typically 30% – 100% transferred to employees through ESOP trust
Business disruption	High	High	Moderate	Low
Employee retention	Significant flight risk	Excellent retention incentive	Leverage increases operational risk	Excellent retention incentive and increased productivity
Confidentiality	Sale process may be leaked Competitors/ strategic buyers may access confidential information	Business strategy/ key contracts publicly disclosed	Confidential information limited to potential lenders	Confidential information limited to potential lenders, trustees and valuation firm



Productivity improves by 4% – 5% on average in the year an ESOP is adopted[3]

[3] Source: National Center for Employee Ownership (NCEO), The Economic Power of Employee Ownership. www.nceo.org

Illustration of ESOP vs. taxable sale*

Considerations	ESOP	Taxable sale
Deal structure		
Cash at close	35% – 50%	90% – 100%
Seller note	50% – 65%	0%
Deferred compensation/rollover	15% warrants	0% – 10%
Ongoing participation		
Time	5 years	1 to 2 years
Non-compete	Yes	Yes
Ability to transition	Yes	No
Personal guarantee	Depends	No
Influence	High	Low
Financial upside participation	Yes	No
Transaction process		
Type	Internal buyer/No auction	External buyer/Auction
Timing	4 to 6 months	6 to 9 months
Confidentiality risk	Low	Moderate
Buyer type	Trust/Employees	Strategic or financial
Probability of close	High	Low to moderate
Management participation		
Buy-in	Possibly	No
Option pool/SARs	Yes	Maybe
After-tax proceeds consideration[1]		
100% tax deferral	Yes	Maybe, depends on terms
Estimated after-tax proceeds[2]	100%	60% – 70%
Initial sale	$20,000,000	$12,589,000
Rollover equity/warrants[3]	$1,896,000	$0
Total after-tax proceeds[4]	**$21,896,000**	**$12,589,000**

[1] Assumes stock sale, zero basis and 1042 deferral under ESOP transaction.

[2] All transactions assume a $20 million equity value and a federal capital gains tax rate of 20% and 13.3% state income and capital gains tax rate. This also includes a 3.8% Medicare surtax (applies only to the extent of AGI in excess of $250,000).

[3] Estimated rollover equity and warrant amounts assume 15% of the company's equity value would be issued as warrants in an ESOP transaction. The value at the time of exercise was estimated at $3.0 million and was reduced by the estimated federal and state capital gains taxes.

[4] All future proceeds discounted at a 5% discount rate and assume a five-year holding period. Excludes all transaction costs.

*Source: Eureka, "Overview of ESOP Buyouts."

Is your company a good ESOP candidate?

- ☑ Is your company a corporation (S-corp, C-corp or LLC), rather than a partnership or a professional corporation?
- ☑ Does your company have an annual payroll of $5 million or more?
- ☑ Does your company have available capacity for additional debt?
- ☑ Do you believe your company is worth $10 million or more?
- ☑ Is your company's EBITDA $5 million or greater?
- ☑ Does your company have strong earnings and/or cash flow over the previous five years?
- ☑ Is your company experiencing steady and controlled growth?
- ☑ Is there strong management in place if the principal executive departs in connection with the sale?
- ☑ Do you expect your company to pay federal income taxes over the next several years?
- ☑ Does your company customarily make payments to a profit-sharing or other employee benefit plan that might, in the future, be diverted to an ESOP?
- ☑ Are the owners willing to share ownership with their employees, assuming a beneficial offer can be arranged?

Additional S-corporation ESOP opportunities

When an ESOP owns 100% of the outstanding stock of a S-corp, no federal income taxes are due. These transactions create a for-profit, tax-exempt entity allowed under the Internal Revenue Code—the 100% ESOP-owned S-corp. The tax savings generated can be used to fuel growth, acquire other businesses, service debt, etc. (annual consideration of IRC Section 409(p) is necessary to prevent a misuse of this tax structure).

The following represent examples of ESOP transactions that have been designed to take advantage of the S-corp tax benefits:

Public to private company

ESOP solution
The Sarbanes-Oxley Act has made the cost of being public prohibitive for some smaller companies. For companies interested in delisting, the 100% S-corp tax benefits can provide the needed equity to optimize the going private transaction.

Divestitures or spin-offs of public companies

ESOP solution
Many public companies have significant concern over the continued viability of a division that was sold. The financial risk is reduced in the 100% S-corp ESOP transaction. In addition, less seller financing and/or guarantees may be required.

Management-led leveraged buyout

ESOP solution
ESOPs can be combined with management funds to buy out other investors. The ESOP can raise capital from other qualified plans, provide tax-advantaged leverage or create the 100% S-corp ESOP tax benefit. Management's equity can be designed as a subordinated debt tranche with warrants providing commensurate non-cash returns. Many times the tax benefits of the ESOP transaction can provide the needed equity for these otherwise difficult transactions.

Companies with an existing ESOP

ESOP solution
The 100% S-corp ESOP structure can be used to create a “platform” company. The tax savings from the 100% S-corp ESOP structure provides the needed capital for acquisitions, thus allowing the company to participate in a consolidation trend in a fragmented industry.

Private equity and ESOP co-investment

ESOP solution
Private equity co-investment with an ESOP can improve the after-tax return on investment compared to traditional buyout structures, while providing selling shareholder(s) with a complete liquidity alternative rather than financing a portion of the transaction themselves through seller notes. Private equity sponsors typically invest by forming subordinated debt with warrants where the ESOP is the sole common shareholder of the company in order to take advantage of the favorable tax treatment afforded to 100% S-corp ESOPs.

The ESOP Group—Practice overview

The ESOP Group is an experienced team of professionals focused exclusively on the unique needs and challenges of business owners and their families. For more than 30 years we have provided advice to our clients, guiding them through major milestones in their businesses and lives. Our clients entrust us to coordinate the resources of our firm, professional network, and team to tailor solutions that fulfill their goals and preserve their legacy. Whether helping our clients build a succession plan for their company, a trust and estate plan for their family, or financial plan for their assets, our goal is to help make life's biggest financial decisions easier.

Industry recognition

Keith A. Mericka
Managing Director–
Wealth Management
Private Wealth Advisor
Senior Portfolio Manager
Family Office Consultant

- *Barron's* Top 1,200 Financial Advisors, 2014 – 2019
- *Barron's* Top 1,000 Financial Advisors, 2009 – 2013
- *Financial Times* 400 Top Financial Advisers, 2013 – 2016, 2018
- *Forbes* Best-In-State Wealth Advisors, 2020
- *REP*. and WealthManagement.com's Top 100 Wirehouse Advisors, 2011, 2013 – 2016

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Managing Director–
Wealth Management
Private Wealth Advisor
Family Office Consultant

- *Barron's* Top 1,200 Financial Advisors, 2018, 2019
- *Barron's* Top 100 Women Financial Advisors, 2016 – 2019
- *Financial Times* 400 Top Financial Advisers, 2017, 2018
- *Forbes* Best-In-State Wealth Advisors, Georgia, 2018 – 2020
- *Forbes* Top 200 Women Advisors, 2017 – 2019
- *REP.* and WealthManagement.com's Top 50 Wirehouse Women, 2015

The ESOP Group–At a glance

1989
The ESOP Group was formed 30+ years ago

$6+ billion
Total enterprise value created

$3.4+ billion
Assets under management

700+
ESOP transactions

150+
Years of combined team ESOP experience

10
Highly credentialed professionals to meet clients' diverse needs

The ESOP Group—ESOP advisory services

For business owners

We understand the unique challenges of business owners and are committed to working with you to help you pursue your goals at every stage of your business life cycle.

Pre-sale wealth planning
How will a sale affect your retirement, taxes and legacy? Together, we will design a transition plan and long-term strategy to inform your short-term decisions.

Post-sale wealth and financial planning
Comprehensive post-sale wealth management is as critical to our clients' success as the transaction itself. We work with you to create a well-integrated plan that reflects your evolving life and your long-term priorities for growing and preserving your wealth, managing tax liabilities and ensuring that your assets are appropriately managed, allocated and titled.

Creating value

Customized cash flow and tax modeling to help you answer the question, "Am I going to be OK?" by comparing the economic outcomes of a taxable installment sale and a tax-deferred sale to an ESOP

Introductions to qualified transaction advisors, including experienced investment bankers to facilitate capital raises for acquisitions and growth, enable sell-side mergers and acquisitions, or provide advisory services to companies considering an ESOP

Estate and trust assessment to help you identify potential gaps and efficiently transfer wealth

Philanthropic planning strategies to help you optimize your charitable gifts and determine whether gifting pre-sale stock or post-sale cash is most beneficial

Insurance solutions to protect you, your family and your business from unexpected events

Life after business

Internal Revenue Code Section 1042 rollovers to help you defer, or potentially eliminate, capital gains tax on the sale of your closely held business to an ESOP—including:

- Constructing and implementing diversified Qualified Replacement Property (QRP) reinvestment portfolios
- Providing lending solutions that may be required to accomplish your IRC Section 1042 rollover
- Supplying necessary tax documents required to obtain IRC Section 1042 capital gains deferral

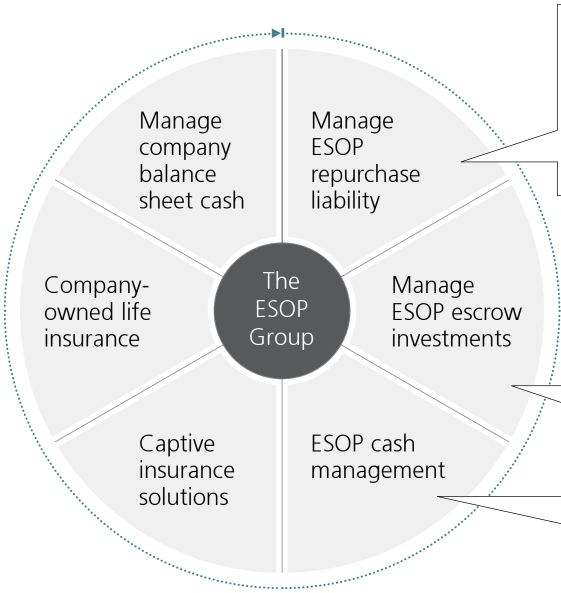
Post-liquidity lifestyle and financial planning to understand your personal goals and develop a plan to pursue them

Family education and governance to help manage the transition of wealth and/or business interest between generations

Personalized investment management to integrate your proceeds with your life's vision

For ESOP companies

The ESOP Group's decades of experience working with hundreds of privately held businesses positions us as industry leaders. From mature ESOPs to those just getting started, we are well-versed in the unique issues ESOP companies face.



Manage ESOP repurchase liability. It is easy to assume that cash flows from operations will always be sufficient to handle current repurchase liability obligations, but this is not always a prudent approach. With proper evaluation and planning, we help address repurchase liability obligations to reduce the risk to the company and the ESOP participants.

Manage ESOP escrow investments and ESOP cash management. An ESOP fiduciary's duty is to preserve and maximize the value of plan investments on behalf of the participants. As a 3(38) ERISA investment fiduciary, we assume investment responsibilities for ESOP escrow cash and ESOP assets that are not invested in company stock on behalf of plan sponsors.

Meet the team—The ESOP Group

The partners

Keith A. Mericka
Managing Director–
Wealth Management
Private Wealth Advisor
Senior Portfolio Manager
Family Office Consultant

Leslie A. Lauer, CFP®, ChFC®, CEPA®
Managing Director–
Wealth Management
Private Wealth Advisor
Senior Portfolio Manager
Family Office Consultant

Comprehensive planning, portfolio management and sell-side advisory

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Senior Wealth
Strategy Associate
Private Wealth Advisor

Rebecca T. Glasgow, CFP®, CEPA®
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Catherine A. Mericka, CFP®, CEPA®, CRPC®
Senior Wealth
Strategy Associate

Rudy L. Pedraza, CFA, CRPC®
Wealth Strategy Associate

Client service and reporting

Dana D. Breland
Team Administrator

Dianna M. Moore
Team Administrator

Christy H. Dryden
Client Service Associate

We've earned the confidence of these companies nationwide*

* Logos have been used with the permission of the client. Actual client experiences will vary based on individual suitability and needs.

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Important disclaimers
Information contained herein is of a general nature and is provided for informational purposes only. Laws governing ESOP transactions and the rules under Section 1042 of the Internal Revenue Code of 1986, as amended ("Code"), are complex and persons considering an ESOP or Section 1042 transaction should seek professional guidance from their tax and legal advisors. Specific structures and decisions can only be developed based on a thorough review of the facts and circumstances relative to a particular company and its shareholders. Neither UBS Financial Services Inc. nor its employees provide tax or legal advice. In addition, shareholders who sell to an ESOP should understand the applicable rules of the Internal Revenue Code of 1986, as amended ("Code"), including requirements for qualified replacement property ("QRP") as defined by Code Section 1042. Shareholders should consult their tax and legal advisors regarding their personal circumstances.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, any US federal tax information in this article is not intended, or written to be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code, or (2) promoting, marketing or recommending to another party any transaction or matter contained in this presentation. It is important that you understand the ways in which we conduct business and the applicable laws and regulations that govern us. As a firm providing wealth management services to clients in the US, we are registered with the US Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Though there are similarities among these services, the investment advisory programs and brokerage accounts we offer are separate and distinct, differ in material ways and are governed by different laws and separate contracts. As a firm providing wealth management services to clients, we offer both investment advisory and brokerage services. These services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. For more information on the distinctions between our brokerage and investment advisory services, please speak with your Financial Advisor or review the PDF document at **ubs.com/workingwithus.**

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