ESOPs:
A tax-efficient exit strategy

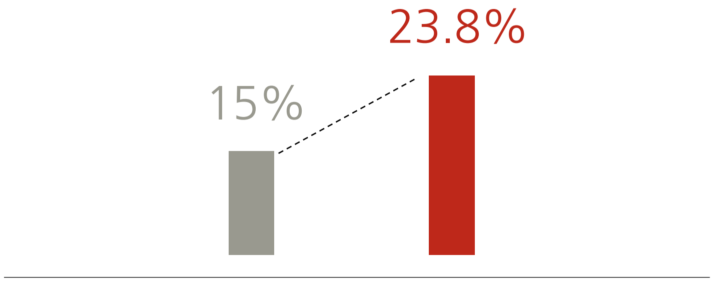
The Capital ESOP Group

UBS Financial Services Inc.

It is estimated that as many as

75%

of privately held business owners would like to exit their business within in the next 10 years.*

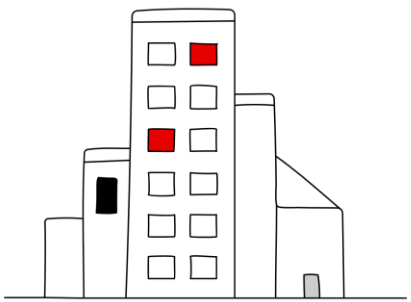


The maximum federal long-term capital gains tax rate increased from 15% to 23.8% at the end of 2012 and faces an uncertain future.**

* Exit Planning Institute. 2023, 2023 National State of Owner Readiness Report.

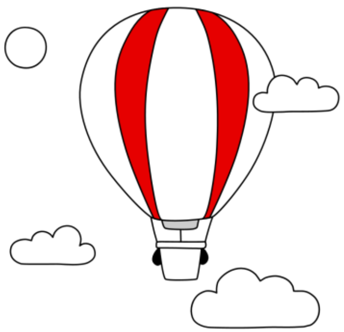
** Tax Foundation; An Overview of Capital Gains Taxes, April 16, 2019. For federal income tax, the top rate is 20%, and 3.8% Net Investment Income Tax (NIIT) may apply depending on income. State income taxes may also apply.

Internal and external liquidity options



Internal

- Management buyout
- Share redemption
- Employee Stock Ownership Plan (ESOP)
- Dividend recapitalization
- Intergenerational transfer



External

- Initial Public Offering (IPO)
- Sale to private equity
- Sale to strategic buyer

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Internal and external liquidity options

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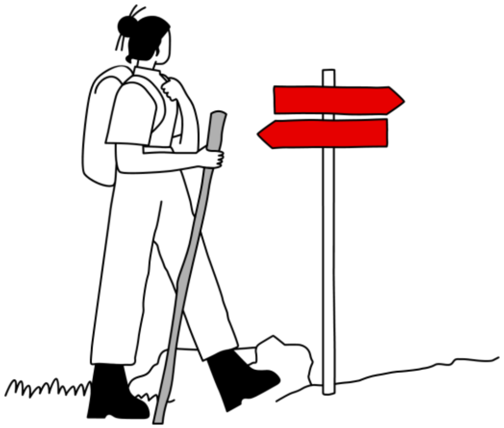
What is an ESOP?

- An ESOP is a flexible, tax-efficient exit strategy
- ESOPs allow owners of privately held businesses to sell a portion or all of their shares and defer or, with the proper planning, permanently avoid paying capital gains taxes on the sale while simultaneously rewarding employees

Flexibility



- A shareholder can sell any portion of their stock to the ESOP, from 1% to 100%
  - The shareholder can always sell retained stock to the ESOP in the future
- An ESOP transaction can be structured in different ways to meet a seller's unique objectives, such as:
  - Liquidity
  - Tax efficiency
  - Succession planning
  - Remaining active in the business
- If there are multiple shareholders, one can choose to sell their shares while the others choose to retain their shares and stay on with the company

Why consider an ESOP?

You may be able to defer capital gains taxes and potentially eliminate them entirely

You can control the process and avoid releasing confidential information to prospective buyers that may have an adverse impact on the business

You can continue to lead and participate in the management of the company even after a sale

An ESOP provides significant tax advantages: A 100% ESOP-owned S corporation is exempt from federal and most state income taxes

ESOPs can help reward employees and management, which may, in turn, increase productivity*

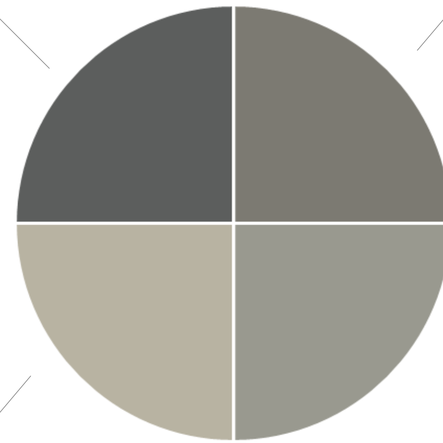
You can preserve your legacy within the company while gaining the independence to start the next chapter of your life

* Blasi, J & Kruse, Douglas & Weltmann, Dan. (2013). Firm survival and performance in privately held ESOP companies. Advances in the Economic Analysis of Participatory and Labor-Managed Firms. 14. 109-124. 10.1108/S0885-3339(2013)0000014006.

ESOPs enable an alignment of interests

Owner

- The potential for more in total after-tax proceeds, compared to a sale of the company to an outside buyer, mainly from the abilities to:
  - Sell stock and defer or potentially eliminate the capital gains taxes associated with the sale
  - Hold a high-yield seller note with an attractive total return
  - Retain upside potential in the company through warrants, which are typically taxed at long-term capital gains rates instead of ordinary income rates
  - Continue drawing a salary
- The ability to preserve your legacy and provide a potentially meaningful benefit to employees
- The ability to remain active in the business
- The time to create and implement succession and estate plans through a gradual ESOP transition over time



Company

- May reduce tax liability of corporate earnings
- The ability to repay debt with pre-tax dollars
- Potentially increased productivity from employees who are now "owners"/participants*
- The possibility for future, tax-efficient acquisitions

Employees

- No-cost retirement benefits for those participating in the ESOP
- Participation can be combined with other benefit and retirement plans
- The ESOP can create opportunities within the company, rather than reasons to leave the company

Management

- Gradual transition to fully running the company
- Participation in ESOP and Stock Appreciation Rights (Non-Qualified Plan) can provide meaningful wealth building opportunities
- Recognition opportunities that can help motivate, retain and recruit key talent

* "Research on Employee Ownership." Articles. July 01, 2019. https://www.nceo.org/article/research-employee-ownership.

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Tax advantages of ESOPs*

S Corporation (company level)

- Company operates as a tax-exempt entity for federal tax purposes to the extent of ESOP ownership
- Often income tax-exempt at the state level as well
- Example:
  - An ESOP owns 49% of the S corporation's stock
  - 49% of the company's profits will not be taxed

C Corporation (individual level)

- Selling shareholders can defer or potentially eliminate capital gains taxes on their proceeds from a stock sale to an ESOP
- Under Section 1042 of the Internal Revenue Code, the seller can defer taxes if they meet certain requirements, including:
  - The ESOP owns at least 30% of the company's outstanding stock after the sale
  - The seller invests 100% of their proceeds into securities designated as qualified replacement property ("QRP")

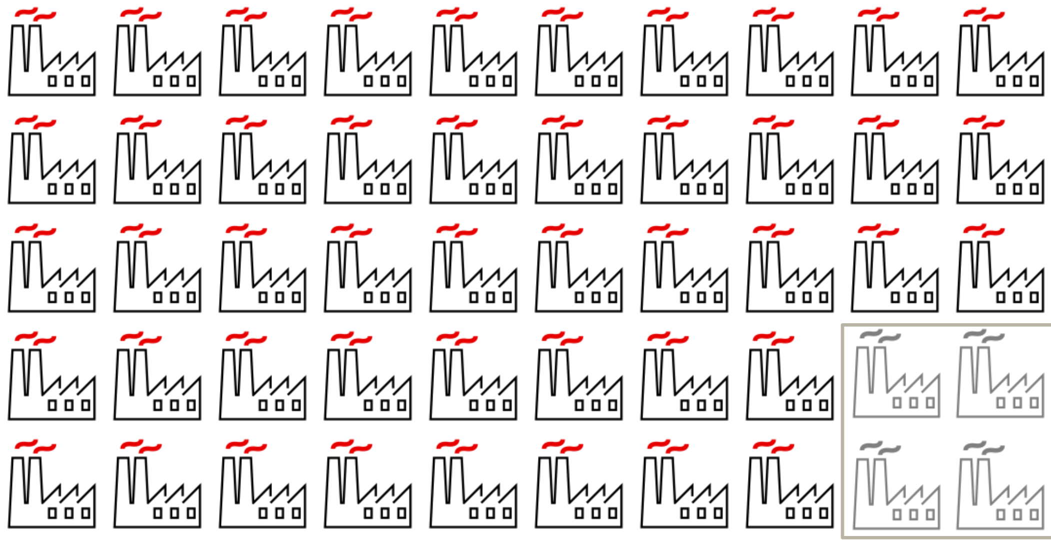
* www.nceo.org/articles/esop-employee-stock-ownership-plan.

Using an ESOP as an exit strategy

- In a 100% sale, the shareholder typically receives a portion of proceeds in cash and a portion in seller notes, usually to be paid out over 5 – 7 years
- In a partial sale, due to the use of multiple tranches to sell shares over time, the timeline can extend up to 10 years or more depending on the seller's timing

ESOPs by the numbers: 2022

6,548
ESOPs



92%
Private companies

8%
Public companies

14,956,315
total participants

$1,818,656,000,000
total plan assets

Data courtesy of National Center for Employee Ownership (NCEO); *ESOPs by the Numbers*. Updated March 2022.

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Is your company a good ESOP candidate?

These initial questions can help determine whether your company may be a good ESOP candidate.

- Is the company profitable?
- Does your company have a minimum of 30 employees?
- Does your company have moderate to significant debt capacity?
- Did your company have strong earnings and/or cash flow over the previous two years?
- Is your company experiencing steady and controlled growth?
- Does your company have a strong executive team that would remain in place after the active shareholders left?
- Would your company benefit from significant corporate income tax savings?
- Does your company currently make contributions to an employee benefit plan (i.e., profit sharing or 401(k) plan)?
- Would the current executive team be incentivized by equity-based compensation?
- Would the selling shareholders like to participate in the future growth of the company after the sale?

Common shortcomings of different options

Sale to strategic buyer

- Potential breaches of confidentiality
- Payment of substantial taxes
- Lengthy transaction process
- Uncertain conditions for management and employees
- Portion of sale proceeds may be at risk, subject to earnout, escrow or seller financing
- Risk of buyer re-trading terms and closing transaction
- Loss of legacy, ownership and operational control

100% ESOP buyout

- Complex structure
- Some seller financing is required
- Use of leverage may increase business risk
- Company is required to repurchase shares at some future date as vested employees retire or terminate
- Must comply with ERISA regulations
- Takes 5 – 7 years on average to be fully cashed out; owner continues to carry some level of business risk during that wait period

Leveraged recapitalization

- Likely results in loss of ownership or operational control
- Likely must roll significant equity into company going forward
- Taxable gain on portion of company sold
- Leverage decreases cash flow and financial flexibility
- Business will be sold again in the future

Minority ESOP

- Use of leverage may increase business risk
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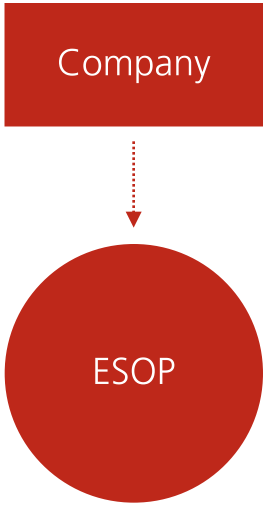
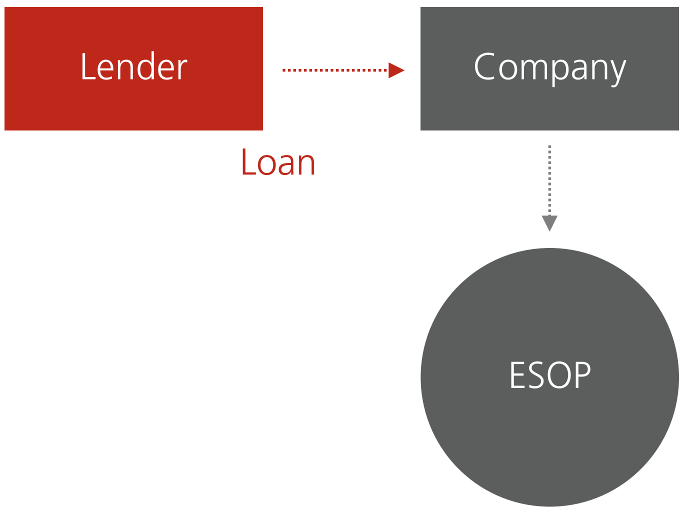
The process: Creating an ESOP

1. Company creates ESOP



The process: Creating an ESOP

1. Company creates ESOP
2. Company borrows funds from Lender



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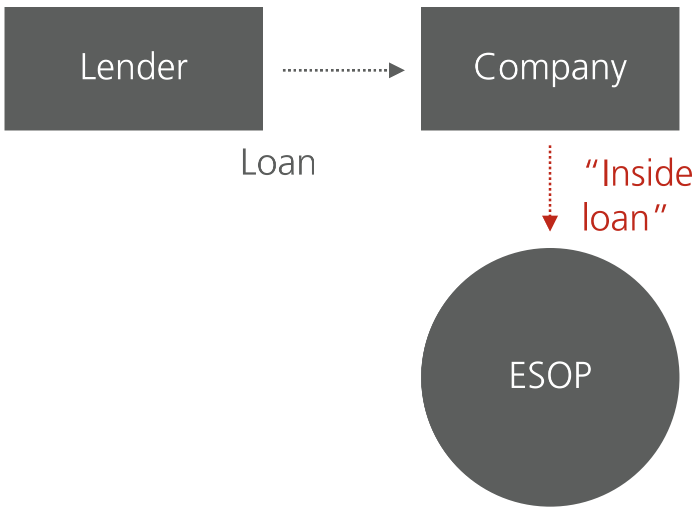
The process: Creating an ESOP

1. Company creates ESOP
2. Company borrows funds from Lender
3. Company lends the proceeds to the ESOP through an "inside loan"



The process: Creating an ESOP

1. Company creates ESOP
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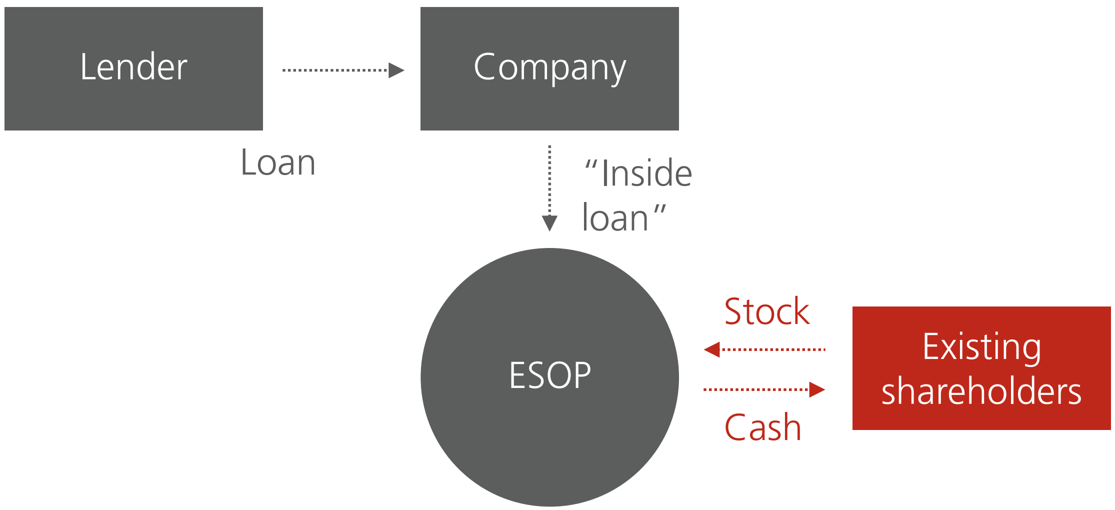
4. ESOP uses proceeds to purchase shares from existing shareholders



The process: Creating an ESOP

1. Company creates ESOP
2. Company borrows funds from Lender
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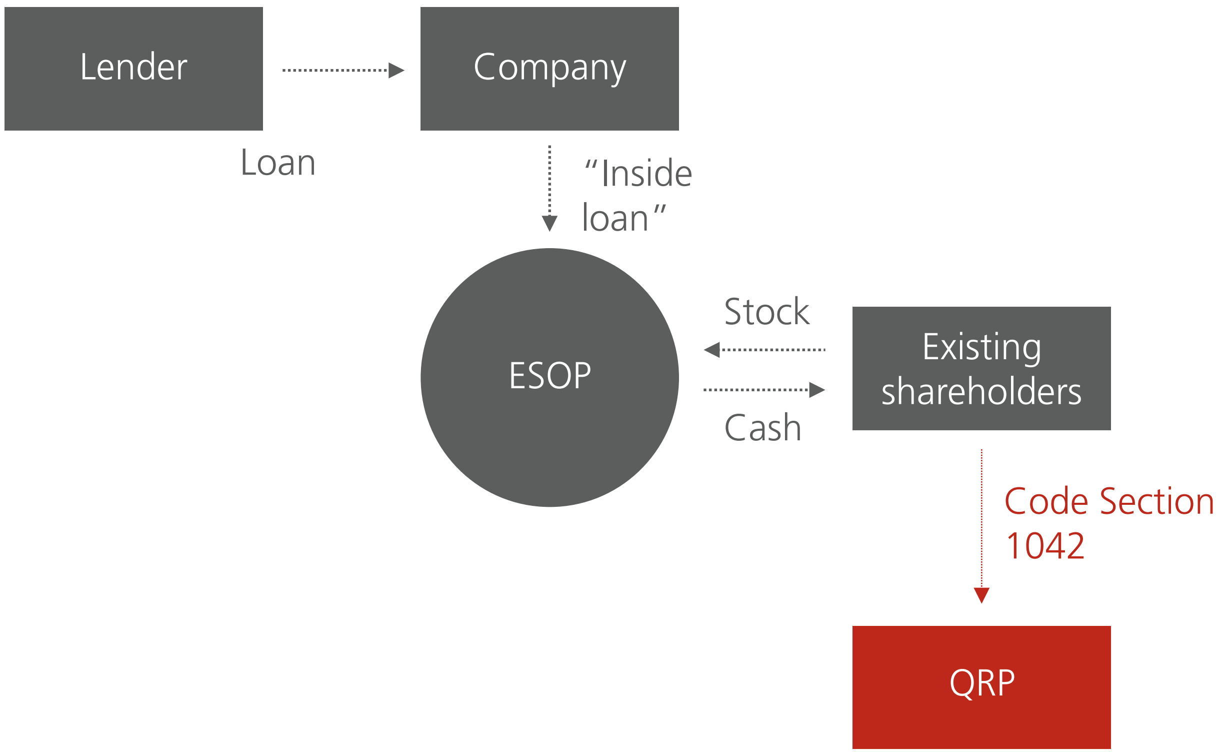
5. Existing shareholders have the option to elect Code Section 1042 and purchase QRP



The process: Post-ESOP creation

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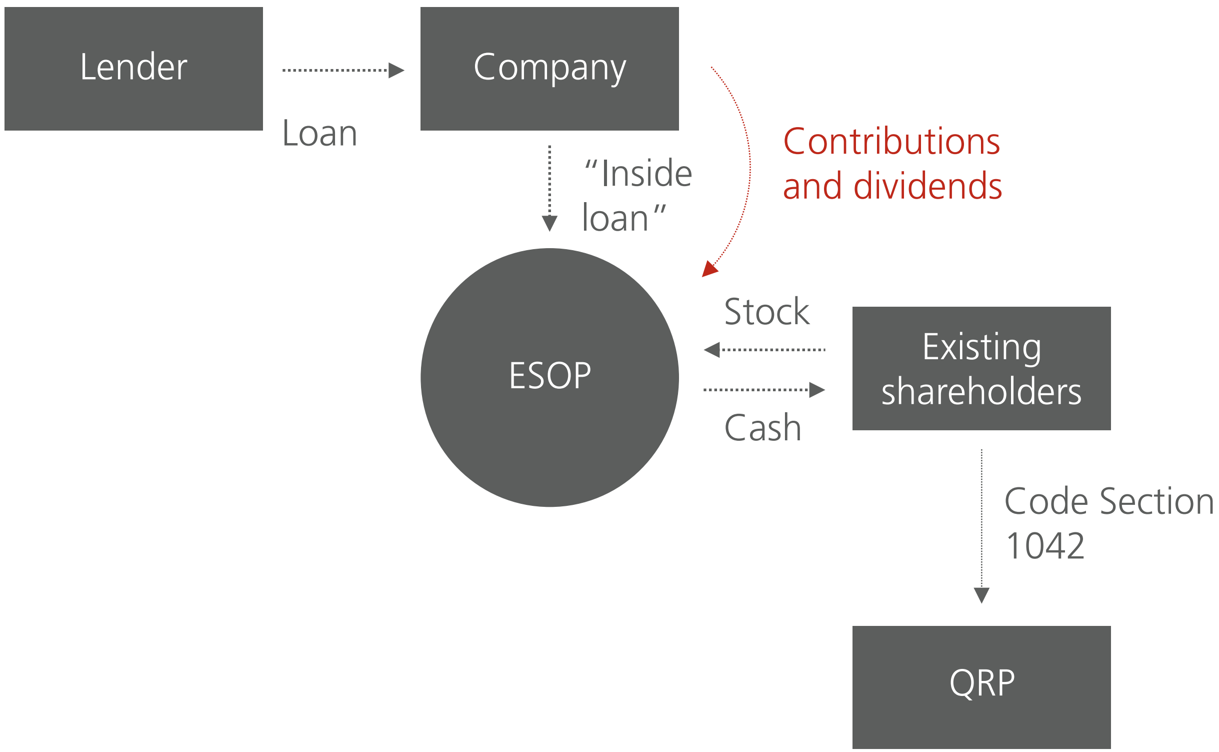
6. Company makes tax-deductible contributions to the ESOP



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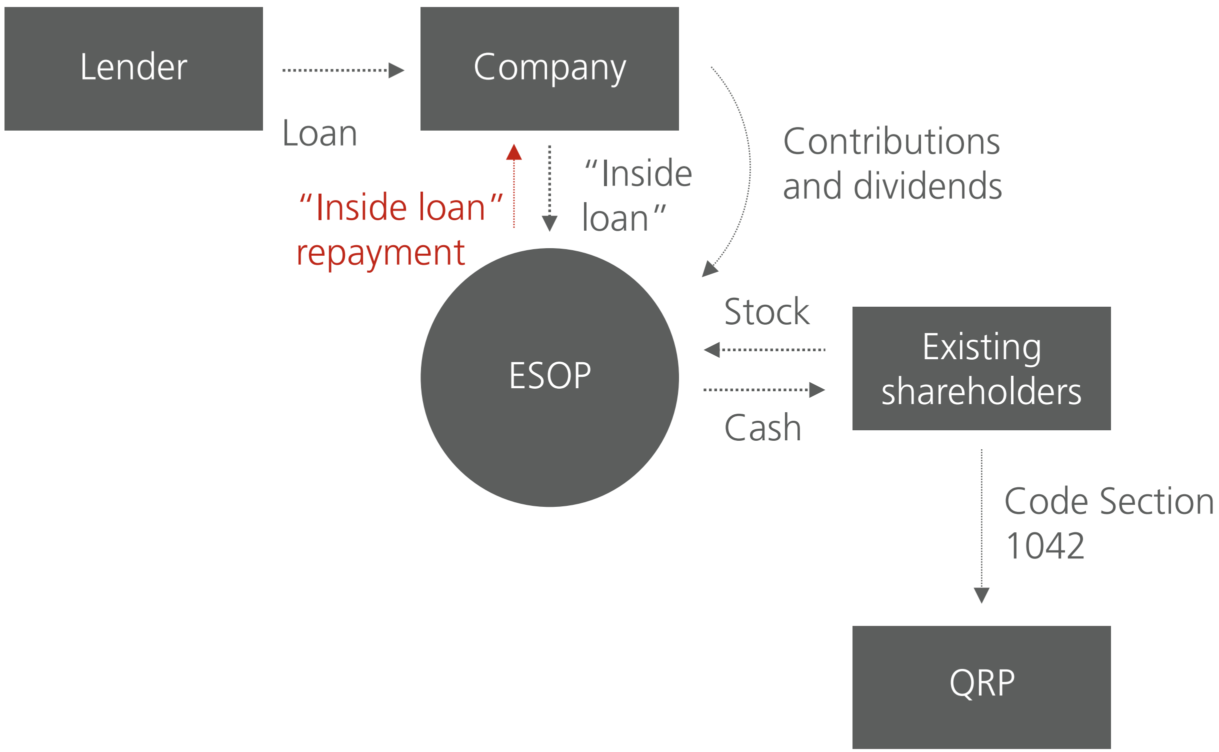
7. ESOP repays the "inside loan" to the Company using the contributions and dividends



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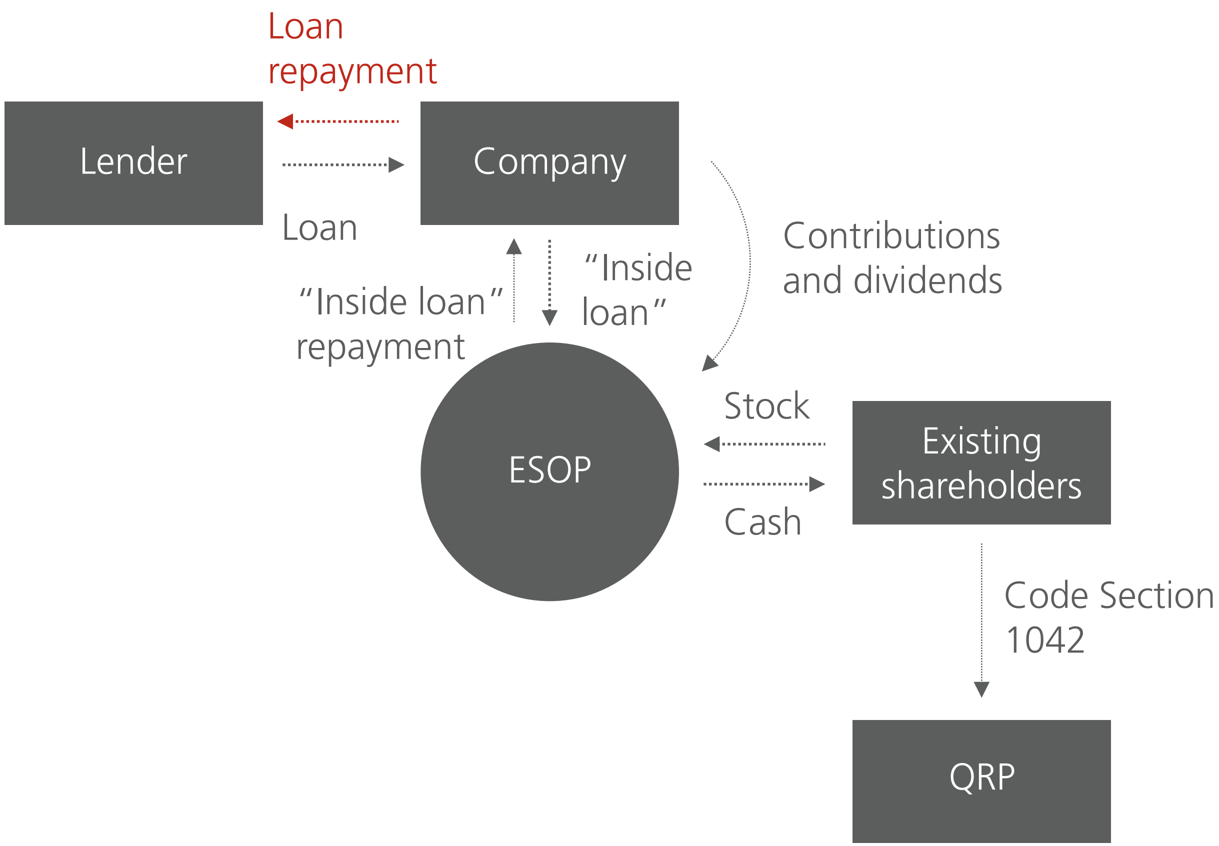
8. Company repays the Lender



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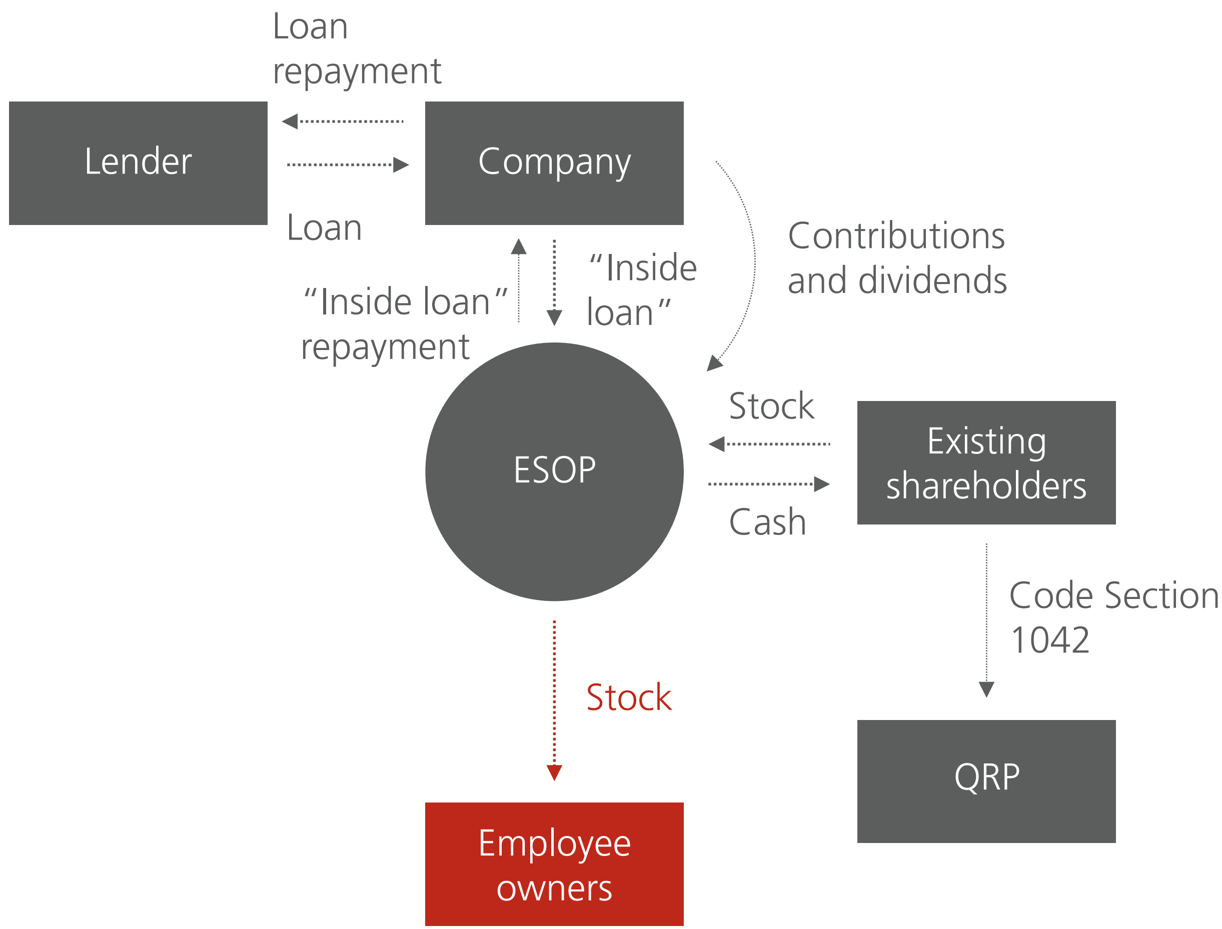
8. Company repays the Lender
9. Shares held by the ESOP are released to employee accounts as the "inside loan" is repaid



The process: From start to finish

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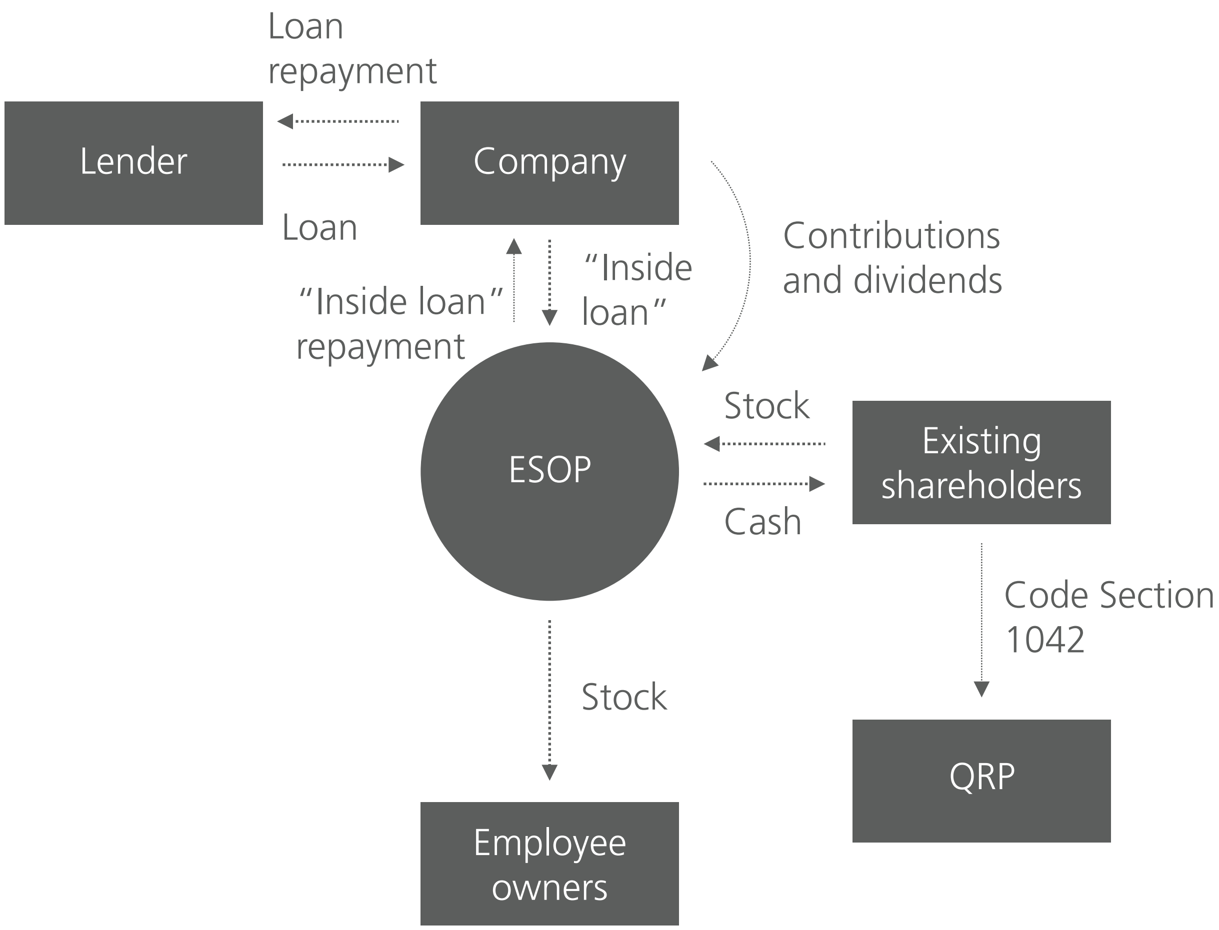


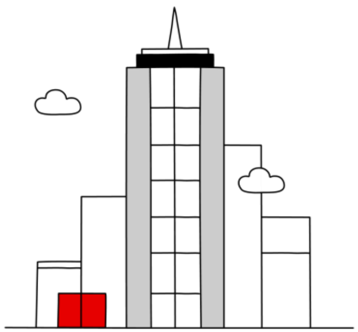
The Code Section 1042 election*

Selling shareholders in an ESOP can choose to:

1. Pay capital gains tax. ESOP sales are typically structured as stock sales, rather than as asset sales; OR
2. Defer and potentially avoid capital gains tax by electing Code Section 1042 of the Internal Revenue Code and reinvesting the sale proceeds in Qualified Replacement Property ("QRP"). The following conditions must be met:
   - ESOP must own at least 30% of the company after the transaction
   - Selling shareholder must not have received the stock sold to the ESOP from:
     – A retirement plan
     – Pursuant to a stock option
     – As restricted stock
     – As a form of compensation
   - Selling shareholder must have owned the stock for a minimum of three years prior to the transaction
   - Must be a non-publicly traded C corporation
   - Must be common stock, having the highest voting and dividend rights, or preferred stock convertible into such common stock
   - Be reinvested into QRP during the window starting three months prior to the sale and ending 12 months after the sale
   - Statements of Election, Consent and Purchase must be filed with the shareholder's tax return for the year in which the sale occurs

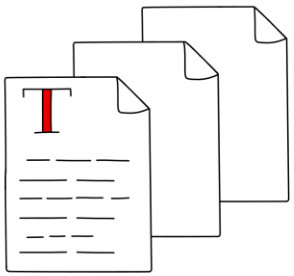
* As outlined in the Internal Revenue Code § 1042(a) and § 1042(b).

What is Qualified Replacement Property (QRP)?*



Eligible investments

- Common stock
- Preferred stock
- Convertible bonds
- Corporate fixed rate bonds
- Corporate Floating Rate Notes (FRNs)

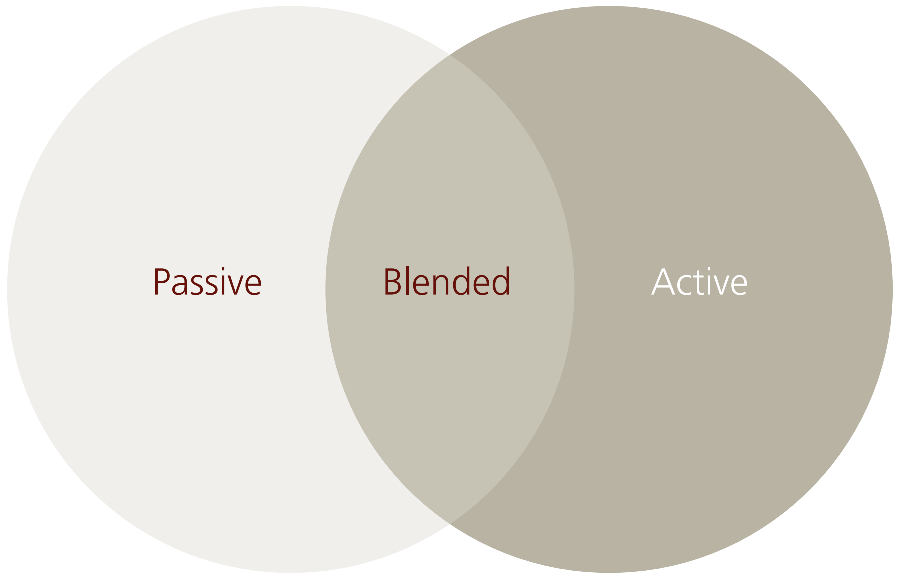


Ineligible investments

- Bank Certificates of Deposit ("CDs")
- US government bonds
- Municipal bonds
- Foreign securities
- Exchange Traded Funds ("ETFs")
- Mutual funds
- Real Estate Investment Trusts ("REITs")
- Master Limited Partnerships ("MLPs")

* As outlined in the Internal Revenue Code § 1042(c)(4).

Post-sale reinvestment strategies



Passive

- Portfolio of qualifying stocks and/or bonds designed to remain constant over the selling shareholder's lifetime
- Provides flexibility to use margin
- Capital gains realized on the ESOP transaction only if/when QRP is sold. QRP can be passed on to heirs—with a step up in cost basis—upon death of the selling shareholder
- Often generates income/yield for the selling shareholder

Blended

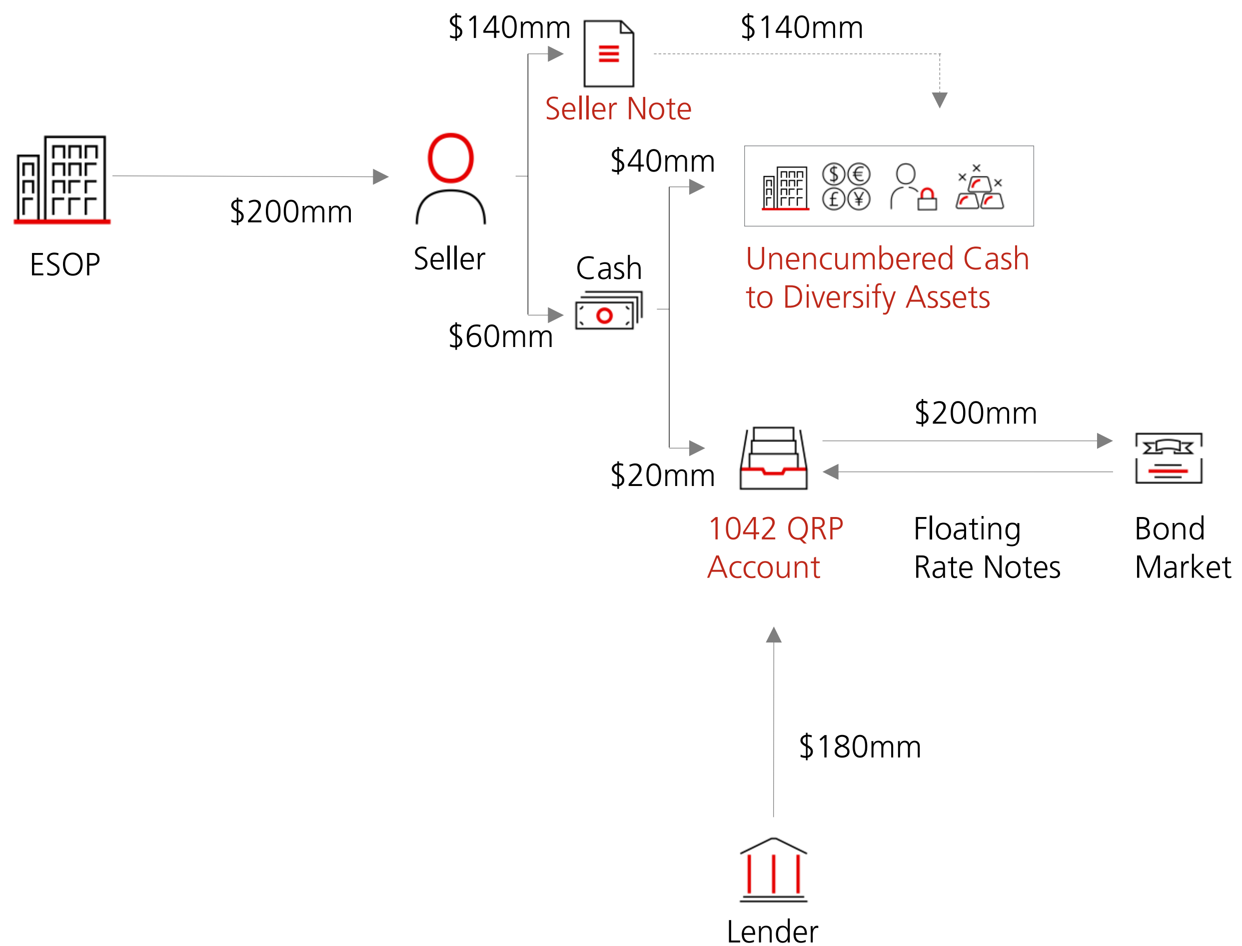
- Combines both the passive and active strategies to further accommodate the selling shareholder's investment goals and objectives

Active

- Leveraged Floating Rate Notes (FRNs) enables selling shareholder to diversify into a flexible portfolio
- Capital gains realized on the ESOP transaction only if/when QRP is sold. QRP can be passed on to heirs—with a step up in cost basis—upon death of the selling shareholder
- Provides the selling shareholder with greater liquidity and flexibility
- Use of leverage increases complexity and incurs higher expenses

How active reinvestment works ($200mm example)

1. Seller receives total proceeds from ESOP sale in cash and seller note
2. 10% of the total proceeds are deposited into a brokerage account with margin. The remainder of the cash proceeds are fully unencumbered
3. A lender provides a monetization loan for 90% of the total proceeds*
4. Seller uses the deposit and loan proceeds to purchase Floating Rate Notes (ESOP Bonds) as QRP
5. Seller Note principal payments that are paid over time are also unencumbered**



* Subject to credit approval.
** Interest from the Seller Note is subject to applicable taxes.
This illustration is for demonstration purposes only. No representation is made that the shareholder will achieve results similar to those shown.

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Past successes

Case studies

The case studies presented, based on actual client experiences as told by the Financial Advisors, are provided as an illustration and may not be representative of the experience of other clients.

There is no guarantee of the future success of any of the strategies discussed.

Increasing the thread count

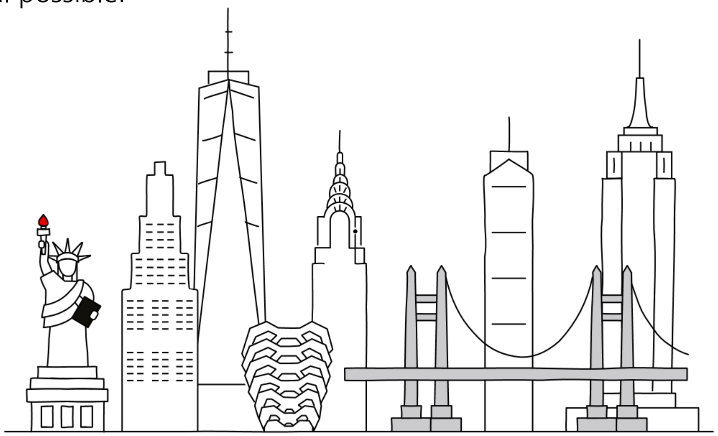
The clients
The owner and operator of a textile manufacturing company in New York City.

The UBS Team
The client's UBS Financial Advisor and The Capital ESOP Group.

The background
The business owner met with Keith Apton to learn about his options to transition his business. While he was intrigued by the option of selling to an ESOP, the client and his advisors decided the timing wasn't right.

A few months later, the owner was presented with an unsolicited offer from a strategic buyer.

The owner's financial advisor encouraged him to re-engage The Capital ESOP Group to analyze and create cash flow analyses for the different scenarios, helping to ensure he received the best deal possible.



The approach
We encouraged our client to speak to their investment banker about exploring a "dual-track" process, in which they reviewed and compared an ESOP to a third-party sale. This process helped the client feel comfortable that they had explored all of their options and understood the pros and cons of each strategy to the family, the company and the employees.

The Capital ESOP Group worked with a boutique investment bank who leveraged the tax-advantaged price of selling to an ESOP in their negotiations, ultimately leading the strategic buyer to submit a higher offer.

The solution and its benefits
Thanks to The Capital ESOP Group's dedication and creativity, and the investment bank's ability to negotiate, the strategic buyer felt the pressure and made an offer that was over 30% higher than his original unsolicited offer—and higher than the tax-advantaged price of selling to an ESOP.

The owner accepted and closed the deal with significantly more liquidity than he would have received from the original offer.

Family matters

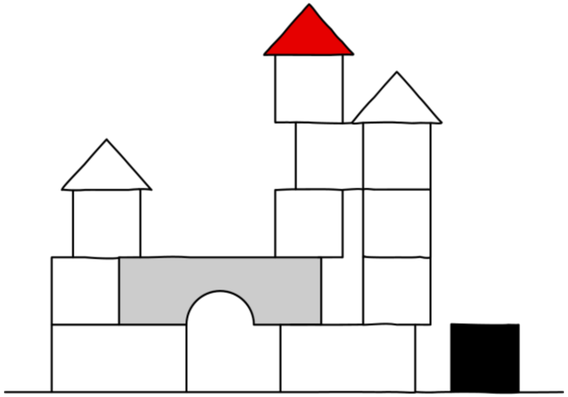
The clients
A husband and wife in their mid-50s and their two children.

The UBS Team
The clients' CPA and The Capital ESOP Group.

The background
The couple had owned and operated a successful general contracting company in California for over 20 years. They had very different goals and could not agree on a succession plan.

The wife wanted liquidity to preserve the family's lifestyle and legacy; the husband did not want to give up control of the business.

At the request of the family's CPA, Keith Apton and Nick Francia flew to California to educate the business owners and their CFO on ESOPs.



The approach
The Capital ESOP Group created cash flow analyses illustrating what a partial ESOP transaction would look like. This allowed the business owners to decide what was best for their family, their company and their employees.

The couple realized that this solution addressed both of their concerns: it would provide significant liquidity while still enabling them to retain control of the company and their legacy.

The solution and its benefits
The couple decided to sell 30% of their stock to an ESOP. This helped them diversify their net worth and preserve their lifestyle. The ESOP structure allowed them to avoid capital gains tax on the sale proceeds, remain active in the business and hold equity/upside in the business.

The family now has the flexibility to decide how to transition the remaining 70% ownership. They have the choice between an outright sale or gifting the equity to their children.

Communications breakdown, solved

The clients
Five siblings who owned a cable, Internet and telecom services provider in the Northeast.

The UBS Team
The clients' UBS Advisor and The Capital ESOP Group.

The background
The siblings could not agree on how to manage or transition their business.

They had tried to sell the company with the help of an investment bank over the previous five years but had not found a deal that all of the siblings would agree to.

Anticipating the challenge of getting all the siblings to agree, the family's trusted investment banking advisor thought the flexibility of an ESOP may be worth exploring.

The approach
Keith Apton and Nick Francia were brought in to discuss business succession planning, specifically ESOPs.

The owners were intrigued and wanted to learn more about how an ESOP could work for their specific circumstances. The Capital ESOP Group provided models comparing various transaction assumptions to help them understand the flexibility of an ESOP.

The solution and its benefits
The Capital ESOP Group helped the business owners sell 100% of their company to an ESOP.

Five years prior, there was no indication that the five siblings would ever be able to sell their company without disagreement from at least one of them. The flexibility of an ESOP allowed the family to create a structure that accomplished each of the siblings' independent goals through a single transaction.

Let us know how we can help you

The Capital ESOP Group

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Important information

Information contained herein is of a general nature and is provided for informational purposes only. Any information presented is general in nature and not intended to provide individually tailored investment advice. The strategies and/or investments referenced may not be suitable for all investors as the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Investing involves risks and there is always the potential of losing money when you invest. 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.

UBS Financial Services Inc., its affiliates and its employees are not in the business of providing tax or legal advice. Clients should seek advice based on their particular circumstances from an independent tax or legal advisor.

Active Reinvestment Strategy Considerations
Legal and tax considerations: 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. In addition, shareholders who sell into an ESOP should understand the applicable rules of the Code, including requirements for qualified replacement property as defined by Code section 1042 ("QRP").

QRP Considerations: Shareholders should understand the potential risks that may be associated with obtaining securities as QRP, sufficiency of available QRP in the market that satisfy the shareholder's investment objectives, limitations on UBS's ability to offer margin or financing for the purchase of a new-issue QRP where UBS has participated in the underwriting of such new issue, availability of QRP with put features and whether available QRP offers appropriate diversification. Further, for QRP that is a FRN, any payment on a FRN, including any repayment of principal, is subject to the creditworthiness of the issuer. Investors could lose their entire investment in the FRN if the issuer becomes insolvent. Shareholders who invest in QRP should consult with their tax and legal advisors regarding their personal circumstances.

Margin Loan Considerations: Margin loans are demand loans and are subject to credit approval and collateral maintenance requirements. The lender can demand repayment at any time without notice. If the required collateral value is not maintained, the lender can require you to post additional collateral, repay part or all of your loan and/or sell your securities. Failure to promptly meet a request for additional collateral or repayment or other circumstances (e.g., a rapidly declining market) could cause the lender to liquidate some or all of the collateral supporting the margin loan. Any required liquidations may result in adverse tax consequences. Margin loans are subject to credit approval.

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