



The ESOP Group

Understanding Employee Stock Ownership Plans



Wealth
Management



Employee Stock Ownership Plans

A business succession strategy that can benefit the owner, employees, and preserve the legacy of the company.

At RBC Wealth Management, we believe that small and middle-market businesses are the lifeblood of the economy. To support these businesses and business owners we have built a platform to address their most pressing needs. Our goal is simple: to provide business owners with the education, perspective and tools needed to guide them through their most significant financial decisions.

When it comes to legacy and business succession, many owners have not begun to answer the question: “who is going to own and run the company after me?” When asked, most owners assume they will either sell to a third party, or to their management team. Few are aware that an Employee Stock Ownership Plan (ESOP) can be the most flexible and tax advantaged option to transition ownership at fair market value.

In the following pages we will outline how ESOPs can be a powerful tool for business owners to address succession, legacy and shareholder liquidity, all while providing a long-term benefit for the employees.

What is an ESOP?

ESOPs are defined contribution plans that invest primarily in employer stock and are governed by The Employer Retirement Income Security Act (ERISA) of 1974

- The intent was to create ownership and retirement assets for working-class Americans
- Subject to DOL and IRS regulation and compliance

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An ESOP is an ownership transition tool which is:

- A hybrid between a direct sale and an internal transfer
- A sale to a trust that is a single shareholder where employees are beneficiaries of the trust
- Flexible and available to own 1–100% of the shares of the company
- Typically, a 4–6-year process for the owner

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An ESOP is an employee retirement plan that:

- Is a non-discriminatory retirement plan, where all eligible participants can benefit
- Requires an independent trustee to act as a fiduciary
- Enables employee accounts to grow tax deferred and are eligible for a tax-free rollover into an IRA upon distribution
- Requires the company to buy out employees' vested shares when they terminate employment

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An ESOP is a tax-considerate leveraged buyout structure that can benefit the company, owner and employees where:

- ESOP/company will typically borrow money to acquire shares, but repay loan with tax-advantaged dollars
- A 100% ESOP-owned S-corporation typically pays no federal or state income taxes
- Owners can defer/eliminate capital gains taxes on the sale of eligible shares by electing 1042

What are the benefits?

ESOPs can provide a significant tax advantage while representing a mutual alignment of interests to all parties.

Benefits to owners

An ESOP is an ownership transition tool that is used to help:

- Defer/avoid capital gains tax on sale under IRC § 1042
- Sell up to 100% of shares at fair market value
- Compare favorably in price to a private equity sale in terms of total consideration received
- Structure a transaction with warrants that may allow seller to capture upside in the business for post-sale
- Retain operational and board control during transition
- Protect legacy in the community and reward employees
- Provide significant estate planning benefits
- Increase certainty of close and confidentiality

Benefits to employees

An ESOP is an employee retirement plan that:

- Is an added retirement benefit to employees at no cost
- Participants share in equity like ownership returns
- Motivates and rewards employees
- Is often accompanied by a senior management benefit through Stock Appreciation Rights (SARs) or other non-qualified plan for recognition of service
- Provides alignment of interests between employees and management
- Offers transparency through an annual update to the valuation that is reflected in participant account statements including vesting

Benefits to company

An ESOP is a tax-considerate leveraged buyout where:

- A C-corporation company will effectively receive a tax deduction for the total value of the company over time
- A 100% ESOP-owned S-corporation incurs no federal and, in some cases, state income tax liability at the corporate level
- The company can experience increased cash flow as a result of tax savings
- Future acquisitions can be structured to allow the seller to sell tax deferred under IRC § 1042
- Management and employees are motivated to act like “owners”
- The company can “stitch” employees into the company culture, which is particularly helpful in a tight labor market for retention and recruitment

IRC Section 1042 Exchange

IRC Section 1042 allows an owner of a closely held C-corporation to indefinitely defer capital gains tax on stock that is sold to an ESOP (Employee Stock Ownership Plan).

IRC Section 1042 and qualified replacement property

A 1042 ESOP exchange allows a shareholder to exchange his or her interest in a private company for a portfolio of qualified replacement property without paying any capital gains taxes on the transaction.

Capital gains tax is deferred as long as the qualified replacement property is held. Through the use of IRC Section 1042, the qualified replacement property (QRP) is assigned the basis of the original investment.

Investments that qualify for QRP:

- Common stock
- Preferred stock
- Convertible bonds
- Corporate fixed rate notes
- Corporate floating rate notes (FRNs)

If a U.S. corporation uses 50% or more of its assets in an active trade or business and does not receive greater than 25% of its gross receipts from passive income, the securities can be used as QRP.

These strategies let the business owner sell their business and defer the tax until the securities mature, are called by the issuer, or sold. Thus, a business owner might be able to defer or eliminate capital gains on the sale of their business.

Wealth management and ESOPs

Business owners can generate income from their qualified replacement property by investing in high-dividend stocks or long-term fixed income securities. This approach allows them to generate income without triggering tax consequences.

Another option is for business owners to invest in long-term floating rate notes, because they are designed specifically for ESOP sales. These securities are issued by major corporations, which have maturities of 30 to 40 years or more and offer a variable interest rate based on a short-term market index. The rate is typically monthly or quarterly, depending on the security.

The highly rated floating rate notes are marginable for up to 90%. As a result, business owners can monetize them by borrowing a substantial portion of their market value and then reinvesting borrowed funds in a diversified portfolio of stocks, bonds and other assets. In addition, the notes have a put feature for liquidity purposes.

The investment portfolio can then be actively managed without triggering tax on the deferred capital gains resulting from the ESOP sale. Business owners will have to pay interest on their margin loan, but the rate will be relatively low and the interest paid may be partially or fully offset by the interest earned on floating rate ESOP notes.

Reinvesting the proceeds from an ESOP is complex and requires the assistance of a professional who is well-versed in ESOPs and qualified replacement properties. Business owners do not want to find themselves liable for taxes they thought they had deferred or unable to withdraw assets for the fear of triggering tax consequences.

ESOP sale as compared to a taxable sale

Considerations	ESOP	Taxable sale
Deal structure		
Cash at close	35% - 50%	90% - 100%
Seller note	50% - 65%	0%
Deferred compensation/rollover	15 - 20% Warrants	0% - 10%
Ongoing participation		
Time	5 years	1 to 2 years
Non-compete	Yes	Yes
Ability to transition	Yes	No
Personal guarantee	No	No
Influence	High	Low
Financial upside participation	Yes	Sometimes
Transaction process		
Type	Internal buyer/No auction	External buyer/Auction
Timing	6 to 8 months	8 to 12 months
Confidentiality risk	Low	Moderate
Buyer type	Trust/employees	Strategic or financial
Probability of close	High	Moderate to high
Management participation		
Buy-in	No	No
Option pool/SARs	Yes	Maybe
After-tax consideration¹		
100% tax deferral	Yes	Maybe, depends on terms
Estimated after-tax proceeds ²	100%	62% - 80%
Initial sale	\$20,000,000	\$20,000,000
Rollover equity/warrants ³	\$2,106,000	\$0
Total after-tax proceeds ⁴	\$22,106,000	\$14,040,000

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

² All transactions assume a \$20MM equity value and a federal capital gains tax rate of 20% and 6% state income and 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 \$3.0MM and was reduced by the estimated federal and state gains taxes.

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

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

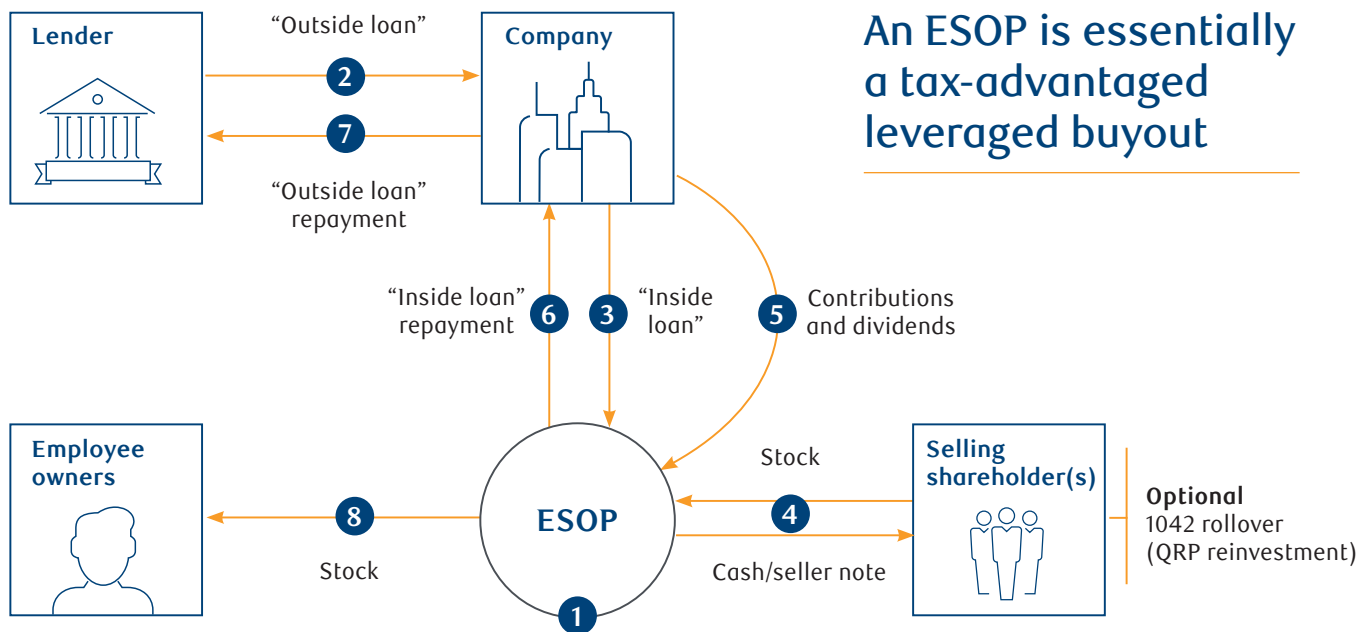
Is your company a good ESOP candidate?

- 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 additional debt capacity?
- 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 a strong management team 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?



How ESOPs work

The following steps illustrate the way most companies establish an ESOP.



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/seller note exchange for stock)
 - Optional: If a C-Corp, at the time of sale, selling shareholders can elect IRC § 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

ESOPs may not be for everyone

Although ESOPs can help business owners achieve liquidity and diversification, offer many tax advantages, and inspire employees through stock ownership, they can present some drawbacks as well.

First, ESOPs may not be used in partnership structures or in most professional corporations. Although ESOPs can be used in S-corporations as well as C-corporations, restrictions and lower contribution limits can apply.

Second, a conflict of interest under ERISA could result (if not handled properly). An ESOP is both a corporate finance and retirement savings strategy—especially in smaller companies where an ESOP's fiduciaries might also serve as officers or directors. Situations like this might require the help of independent legal, investment and financial professionals.

In addition, the company may be required to repurchase vested shares of departing employees. The funding of this repurchase must be managed carefully. Also, the equity value of existing owners is diluted any time a company assumes debt to finance a transaction without reducing the number of shares outstanding.

Careful consideration of some of these issues should be weighed against an ESOP's potential tax and other advantages.



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Strengthening your financial securitySM



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