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Small Businesses on the Block Should Explore ESOPs

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by Matt Swartz

It has always been easier to sell a large business than a small one. Large businesses attract buyers because their size allows buyers to get more of whatever they are looking for in terms of revenue, contractors or employees than small businesses can offer. Large businesses also usually have less customer concentration and more administrative support than small ones.

Smaller companies do have strengths, though. They typically are more nimble and, until recently, had some advantages in obtaining certain government contracts.

But the Small Business Administration's new recertification rules have changed the government contracting advantage and made it even harder than before to sell a small business. Small businesses doing business with the federal government are now required to recertify their small-business status immediately after an acquisition. One large class of potential buyers of small businesses is composed of larger companies that themselves do not qualify for small-business status.

Accordingly, SBA's new rule will depress sales prices for small-business acquisitions that do happen and prevent some of them from occurring altogether.

Fortunately, there is a long-standing, often-overlooked alternative buyer for these small businesses: their employees. Through an employee stock ownership plan (ESOP), an owner can sell his or her business to the employees and get special tax benefits for doing so.

ESOPs are trusts that hold shares of company stock. If a business owner wants to use an ESOP to buy out his or her shares, the company would take out a loan to buy the shares, which would be placed into the ESOP to be held for the employees.

An owner selling a company through an ESOP enjoys a tax benefit and also leaves a tax benefit for the company. A shareholder selling shares to an ESOP is permitted to take the gain from the ESOP sale and, as long as he or she reinvests it in an "operating business" within one year, defer tax on the gain. The company's tax benefit comes from its right to deduct from taxable income both principal and interest on the debt incurred in funding the purchase of

ESOP shares, which can be repaid in pretax dollars. This is a significant advantage because most corporate debt is not deductible and must be repaid with post-tax dollars.

There may also be a psychological benefit. The exit of a significant stockholder can be disruptive, especially if the person is also a key operating executive. Employee ownership may provide a sense of continuity in which continuing employees find not only potential financial reward but also comfort that the reins of the company are in the hands of fellow employees they already know.

The most negative aspect of ESOPs is that from the management and employee perspective, owning a company through an ESOP is not the same as owning it directly. The shares are held by the ESOP for employees until they leave the company, at which time the shares are bought back. While the employee works for the company, the trustee of the ESOP holds most of the ownership rights over the stock. Also, because ESOPs are benefit plans under federal law, they are governed by detailed rules intended to make sure that ESOP participation is offered and administered fairly.

ESOPs may be a great option for sellers in any case. Now that SBA rules diminish the appeal of small businesses to large company buyers, they may be even more appealing.

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