IDAHO BUSINESS REVIEW EXPERTS FORUM


## Employee Stock Ownership Plans Explained

Presented by KeyBank

# Is an ESOP Right for Your Company?

***By Scott Schlange – KeyBank Idaho Commercial Banking Sales Leader***

The global pandemic has had both a swift and inequitable impact on privately held businesses. Many business owners were unprepared to handle its consequences. The unforeseen events of 2020 have only amplified the need for business owners take a closer look at their succession and retirement plans. While there are many exit options to consider - a sale to a third-party buyer, a management buyout, transfer to the next generation, or even an IPO - there is another option that business owners tend to be less familiar with which is an Employee Stock Ownership Plan, or an ESOP.

Using an ESOP as an exit strategy can be an effective way to meet many of your transition goals and provide for the long-term success of the organization you worked so hard to build.

As you think about the future of your business, you may find yourself asking what is the value of autonomy within the context of an unpredictable economy? How does the change in ownership impact the value of my business in the future? What is my best option for creating a legacy for and maximizing the return on investment for my business? Employee Stock Ownership Plans may offer potential answers to these important questions.

**What Is ESOP**

An Employee Stock Ownership Plan or ESOP is a qualified, defined benefit contribution employee benefit plan that invests primarily in the stock of the employer company. This investment is a unique benefit that grants employees' ownership in the company over time.

ESOPs are most commonly used to provide a market for the shares of departing owners of successful closely held companies, to motivate and reward employees, or to take advantage of incentives to borrow money for acquiring new assets in pretax dollars. In almost every case, ESOPs are a contribution to the employee, not an employee purchase.

**ESOP Rules**

An ESOP is similar in some ways to a profit-sharing plan. In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Additionally, the ESOP company can borrow against the value of their business to buy shares of the business, which in turn build equity for those employee owners. Whether a leveraged ESOP (whereby they seek bank debt or seller carry for their purchase in part) or a non-leveraged sale (where existing cashflows can downstream the ESOP Trust), this ownership realization is a critical outcome.

ESOP companies are also endowed with unique tax benefits that provide cash flow benefits, as well as tax advantages for the exiting ownership. Originally ratified in 1974 as a response in many ways to the failures of pension plans, congress has continued to bestow increased flexibility and expansion to ESOP provisions as they find it provides wealth realization to employees to better direct their financial outcomes. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits.

**Employee Empowerment Matters**

Studies continue to support the benefits associated with empowerment that include increased job satisfaction, organization commitment, increased performance, decreased employee strain, and decreased turnover. ESOPs provide just that. Each employee, while earning ownership, is given a stake in the outcome of the ESOPs future. ESOP companies consistently rank empowerment of their employees as a top attribute of their success.

Peter Drucker, renowned management consultant once stated, "culture eats strategy for breakfast." This wasn't intended to demean the value of strategy, but to reinforce that an empowered employee base would exceed all expectations that strategy alone could not. An ESOP not only maintains the legacy of the departing owner, but it also creates a culture that rewards the employees who helped build the business.

Who can forget the story about Richard Montañez, a former janitor at Frito-Lay. Montanez is credited for providing a revitalization of the Frito-Lay's brand when he helped to create a spicy, Mexican street corn inspired take on a stalwart product, forever immortalized as Flamin' Hot Cheetos. The omission of an ever expanding, underserved demographic may never have come into the board room, save Richard Montañez who was inspired by a companywide video of then CEO Roger Enrico saying, "We want every worker in this company to act like an owner. Make a difference. You belong to this company, so make a difference."

"Here's my invitation. Here's the CEO telling me, the janitor, that I can act like an owner," Montanez later recalled at the 2014 League of Latin American Citizens' National Convention. "I didn't know what I was going to do. Didn't need to. But I knew I was going to act like an owner." What if the entire business thought this way? Not in platitudes, not in strategy, but in DNA? ESOPs embody this culture.

**Ownership**

Stock ownership is a great differentiator in wealth building.

As the National Center of Employee Ownership points out, all who participate in an ESOP become shareholders in the businesses where they work. And because the vast majority of ESOPs require no out of pocket contribution from employees, there is no barrier to entry for those earning lower wages.

ESOPs can help low wage earners, who are likely to have the greatest need for stock ownership while being the least able to afford it. COVID-19 has put enormous strains on low wage earners in particular, driving many of them ever closer to financial ruin—and making ESOPs more important than ever.

ESOPs help build financial knowledge, they expand workforce capabilities through investments in training and mentoring, they enable asset preservation and investment, they increase access and inclusion by race, ethnicity, and gender, while lastly improving health and well-being.

Importantly, the study noted that family budgets and resources are protected while raising children when ESOP values build without requiring income-based contributions. ESOP accounts are not taxed, and do not count against any asset limits for social services for low income employees who may be eligible. They offer the opportunity for making intergenerational investments, creating opportunities for parents to help their children while still living, as well as potentially through inheritance of ESOP share proceeds if some resources remain after death. They are also a form of life insurance, as a few noted. If they should die before they retire, the ESOP value is transferred to their families.

Idaho houses a great deal of successful ESOP companies, both small and large. Over 55 companies, from Winco to Lighthouse Foods, Cliff Bar to Gary's Produce, Brown and Caldwell to Norco, CHSQA to the recently announced Tate's Rents. Further, ESOPs per capita outweigh many in the United States. ESOPs prove a great resource to benefit the business, benefit the employees, benefit the sellers, and to benefit the continued growth of Idaho.

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*Scott Schlange had a decision to make three years ago, stay in Beverly Hills or take a job in Idaho. He made the right choice and brought his 15 years of banking experience to KeyBank as Idaho's Commercial Banking Sales Leader. As a hobbyist boxer, he brings the same skills he learned in the ring to his clients and employees on a daily basis- determination, dedication, and heart. Scott is a dad of three with his wife, who makes it all happen. A graduate of California State University of Northridge and active volunteer in the community, he has proudly put down his roots in Idaho.*

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# Millionaire Grocery Clerks: The Amazing WinCo Foods Story

***By: Mary Josephs, Verit Advisors***

In Corvallis, Oregon, a couple miles north of the Oregon State University campus, sits a WinCo Foods discount supermarket and, unless you're in need of groceries, you might drive by without noticing it. I assure you, however, it's an extraordinary building, a laboratory of capitalism worthy of pilgrimages by the world's great business schools.

It is not the fact that the building itself is not well presented. With an enticing glass storefront similar to the designs you might see completed by the INDUSTRIAL DOOR COMPANY, and familiar signage adorning the walls, the building is immaculately well kept. However, it is the astonishing wealth hidden away in the bank accounts of the occupiers of this building that is something of a well-kept secret.

Inside the store labor 130 employees of WinCo – grocery clerks, shelf stockers, display builders, bakery workers – and their combined retirement savings roughly comes to an astounding $100 million. And that figure is growing rapidly, such that in a few years the average wealth of these employees could easily exceed $1 million. Quite a few individual workers already have account balances above that level.

Outside of Wall Street and Silicon Valley, the WinCo store represents an unusually concentrated – and unlikely — grouping of millionaires. The secret to their wealth is employee ownership. Since 1985, WinCo, which operates 98 stores across eight states from its headquarters in Boise, Idaho, has been employee owned, with an Employee Stock Ownership Plan, or ESOP, as the vehicle for its workers' main retirement savings. (WinCo also has a 401k and about 70% of workers participate.)

The company is by all indications well managed, grows steadily and provides its clientele of families on a budget a combination of low prices, wide selection and efficient and friendly service. Sales for fiscal 2015 are expected at about $6 billion. Same store sales growth and expansion into new markets have propelled WinCo's profits and thus its ESOP stock past competitors and, indeed, past most growth stocks. The shares have risen at a compounded annual rate of about 20% since 1986. Purchased for $10 million from its former owners in 1985, company workers today hold shares valued at close to $3 billion.

The Corvallis store, with a long-tenured staff, leads all other WinCo stores in accumulated wealth. But it's hardly an outlier: workers at a Lancaster, Calif., store have piled up more than $75 million; Redding, Calif., more than $65 million; Twin Falls, Idaho, more than $54 million; and those who work at the company's distribution centers have combined ESOP accounts valued at more than $165 million.

In Corvallis, the story of Cathy Burch and of her twin sister, Deborah Cook, explains not only the WinCo miracle but also much about the retirement savings crisis in the U.S. On the same day 23 years ago, Cathy and Deborah, then aged 19, walked into the WinCo store and applied for jobs. Each of the women was already a young mother and they were looking for steady work to provide for their families. Retirement savings weren't on their radar screens.

WinCo at the time had an anti-nepotism policy and could only hire one sister; Cathy scored slightly higher on an employment test and joined part-time, working two days a week, which she fit in around a 40-hour schedule at a fast food outlet. After a year flipping burgers, Cathy received a 5-cent hourly raise and was offended by the smallness of the sum. She quit and went full-time at WinCo. In the years since, Cathy has worked a variety of front-line jobs at WinCo, including checker, shelf stocker, inventory orderer and, when I spoke to her one recent morning at about 4:30 a.m., she was headed off to do "go-backs" for the day, restocking items that customers put into their carts but later choose not to buy.

These aren't tasks we normally associate with robust retirement savings, and the Employee Benefit Research Institute would tell you that most Americans in Cathy's situation have either no savings at all or an account such as a 401k containing less than $50,000.

Cathy tells me, while getting ready for work, "I have almost $1 million in stock." She's 42. "If I wanted to, I could retire right now," she adds. Instead, she plans to work a good deal longer, perhaps another 15 years, to fund a comfortable retirement for herself and her husband, Kevin, and also to help their five children, ages 13 to 27, get a good start in life.

"This is the chance of a lifetime," Cathy tells me. "The work is hard. But it's consistent. I'm used to it. When people quit WinCo, I ask them, 'Are you crazy?' "

Now let's check back in with sister Deborah, who generously agreed to share her story with me. Deborah, too, has worked hard at jobs, moving north to Portland: three years at the regional telephone company; some time at a department store and at a pharmacy; finally at a doctor's office for 17 years. By 2008, Deborah, quite typical for someone in her position, had about $30,000 in a retirement account, and it was mostly in stocks. The market collapse roughly cut that total in half, and that was a wake-up call. "Since then, I've been looking for another career," Deborah tells me. "Even if I had to go to lower pay but better retirement, I'd do it."

After three years of applying, she recently landed a job with a federal agency and figures, after working 25 years until age 67 she'll have a decent pension: "I'm 42. I had to start over." For working Americans, of course, a secure and adequate retirement income is increasingly rare and difficult to obtain.

WinCo is one of thousands of ESOP-owned U.S. companies employing millions of workers. And its industry includes many employee-owned chains, including Publix, the largest employee-owned company and another great example of capitalism played as a team sport.

WinCo has more than 400 front line employees with more than $1 million in their ESOP accounts and hundreds of retirees similarly well set. Each year, it sets aside an amount equal to about 20% of each employee's pay, in the form of stock, and the value of the underlying shares has risen rapidly, too. Retirees can cash out their shares and in fiscal 2015, ending early next year, WinCo will have paid out approximately $200 million to retirees. Over the last seven years, it has paid out almost $1 billion to retirees. Retirees pay the usual federal and state income taxes on these payouts.

Operating as an S-Corporation for the past decade, WinCo doesn't pay federal or most state income taxes. As a pass-through vehicle, the owners pay the full complement of income taxes when they retire or otherwise withdraw their shares. The tax benefit has allowed the company to expand by investing heavily in new stores.

WinCo competes directly with Wal-Mart (WMT) and other discount grocers, keeping its costs low. It doesn't accept credit cards. Customers bag their own groceries. It scarcely advertises. And that efficient approach permeates the workplace, where, as at other ESOP-owned companies, there is a self-policing culture among workers that reduces waste and boosts productivity. "We work our tails off," says Lance Hart, another Corvallis store employee with 28 years at WinCo. "We're more of a team than just working for a typical company. There's a carrot out there you're working for, for the rest of your life."

WinCo management was nice enough to confirm historical and financial facts in this article, but preferred to let front-line workers such as Cathy Burch and Lance Hart speak for their colleagues.

WinCo is an unusual workplace. But the power of employee ownership – to transform a company's culture and to reward hard work with financial security – is available to most American companies. Together, the productivity advantage and the significant tax benefits make an ESOP an attractive exit strategy for most any owner, including private equity funds. One of the great bonuses of working around employee-owned companies, as I have for more than 25 years, is meeting people like Cathy Burch and Lance Hart, who're enjoying well-deserved success.

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*Mary is a director of Hisco, Manson Construction and Performance Contracting. Ms. Josephs was selected as one of the Most Influential Women in Mid-Market M&A by Mergers & Acquisition publication. Chicago Crain's recognized Ms. Josephs as a Notable Entrepreneur in 2019 and Private Board Directors magazine named Mary a Director to Watch in 2019.*

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# Taxation of ESOPs

*By: Randy Million – Principal, Ripley Doorn & Company, PLLC*

Employee Stock Ownership Plans ("ESOP") provide a powerful option for owners looking to sell closely held corporations to their employees. ESOPs are qualified retirement plans that fall under the authority of the IRS and ERISA. ESOPs are formed in conjunction with a sponsoring corporation to purchase corporate stock and thereby allowing eligible employees (participants) to own the stock through a trust. Sponsoring corporations can either be S Corporations or C Corporations with important distinctions in the tax treatment of both types of entities.

**S Corporations**

S Corporations are considered pass-through entities and generally don't pay income tax at the entity level. Instead, an S Corporation passes its income through to the owner/stockholder who pays the income tax. ESOPs, however, are tax-exempt retirement plans and do not pay income tax. Avoiding income tax is technically not permanent as the employee/owners eventually pay income tax when they take their retirement distributions from the plan. When an employee of an ESOP owned S Corporation retires or otherwise leaves the company, the company stock held in their ESOP account is exchanged for cash prior to being paid out to the employee. These provisions are in place in the S Corporation environment to avoid the risk of company stock being transferred to an ineligible shareholder resulting in the company losing its S-status. Once the employee's account is converted to cash, they can choose to have it paid out in a taxable distribution or "rolled over" into another qualified plan or to their IRA like any other retirement plan distribution.

**C Corporations**

Unlike S Corporations, C Corporations that are owned by an ESOP continue to pay corporate level income taxes. As a result, many C Corporations that become wholly owned by an ESOP will seek to make an S-election to take advantage of the income tax deferral available to S Corporations mentioned above. As with any conversion from C Corporation to S Corporation, there are potential limitations and conditions that can result in corporate level income taxes even after the company becomes an S Corporation. The unique aspect about selling C Corporation stock to an ESOP is the tax deferral option available to the seller under Internal Revenue Code ("IRC") Section 1042. Given certain conditions, capital gains tax can be deferred allowing the transaction proceeds to be invested in Qualified Replacement Property ("QRP"). Long-term capital gains are recognized upon the liquidation of QRP securities at a future date after a required holding period. If the QRP is not sold and becomes an asset of the seller's estate, under current estate tax law, it enjoys a stepped-up basis at date of death and, if sold, avoids capital gains tax on the step-up.

**Stock or Assets?**

As discussed above, regardless of the type of corporation involved, when the owner of a company chooses to sell their business to their employees through an ESOP, they sell the stock of the corporation. Most entrepreneurs selling their company to an outside buyer will be negotiating a transaction that will be treated, for tax purposes, as an asset sale versus a stock sale. There are numerous tax and liability reasons why an asset purchase is more favorable to an outside buyer. If the buyer of the stock, however, is an ESOP, these potential tax considerations are eliminated because the ESOP doesn't pay income tax. In contrast, in almost all situations, a stock purchase provides more favorable tax treatment to the seller.

**Leverage**

A leveraged ESOP is one in which the ESOP and/or the corporate sponsor borrows money to fund the purchase of stock from the selling shareholder(s). In a typical S Corporation transaction, the corporation will purchase a portion of the stock from the owners and also loan money to the ESOP to purchase the remainder. Note: in most ESOP transactions, the selling owners carry back a note for a portion of the proceeds as the corporation will not normally be able to borrow sufficient funds from a third-party lender to completely finance the buyout. If the Company is a C Corporation, and the seller is attempting to utilize IRC 1042 to defer income taxes on the transaction, all the stock will be purchased from the sellers by the ESOP. Transactions utilizing IRC 1042 are complex and many times require additional forms of financing at the seller's level to entirely reinvest the proceeds within the prescribed timeframes. The loan between the Company and the ESOP is a very important component of an ESOP transaction. Within the industry, these loans are referred to as "inside loans". As the Company makes annual profit-sharing contributions to the ESOP, the ESOP in turn uses the contribution to make the loan payment back to the Company. As the loan is repaid over time, shares of company stock are allocated to the accounts of the eligible employees. That is one of the powerful things about an ESOP. Each year, eligible employees are allocated shares in the company where they work. The employees are rewarded for their efforts by becoming owners in the Company through the ESOP.

**Who should consider an ESOP?**

There are pros and cons with ESOPs. While they are complex and costly to form and administer, they can also provide a once-in-a-lifetime opportunity for employees to essentially become owners of the companies where they work. ESOPs also provide owners of successful companies an avenue to sell their stock in a transaction that has potential tax advantages. A Company that would be a considered a good candidate for an ESOP should be profitable, maintain a strong balance sheet, has strong internal leadership capable of running the business, and is willing to hire qualified advisors to walk them through the process of evaluating whether an ESOP is a viable option.

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