FAMILY WEALTHREPORT

Originally posted on www.familywealthreport.com

Business Transition Challenges - The Employee-Owned Route

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14 March 2019

There is not much doubt that one of the largest challenges for business owners is reaching the most effective way to transfer what they have built. They want to avoid a nasty tax bill or cause damage to the company's future.

Business transitions - aka liquidity events - come in many forms: private equity purchases, trade sales, initial public offerings and management buyouts. In some cases different elements are blended to make a transition work. Much varies on how old the entrepreneur is , how wealthy they are, their state of health, and so forth. And ,of course, one reason family offices exist is to help the founders retire while bequeathing a business to successive generations.

A form of transfer that does not appear to be a headline-grabber is the employee-owned approach through which staff get to own the majority or even all of a company when a transition comes around. In these cases, worrying about handing over the reins to a son, daughter or grandchild does not apply. And there are substantial tax and related advantages to this route, according to Daniel Goldstein, chief executive of Folience, a 100 per cent-owned diversified holding company that buys privately-held firms and transitions them for ownership by their staff.

A model that he specifically cites - because of its favorable tax status - is the Employee Stock Ownership Plan, or ESOP.

"It gives a very strong, coherent way forward with a proven form of ownership," Goldstein told *Family Wealth Report*. "ESOP companies have a demonstrated advantage over other forms of companies."

"A switch from family ownership to employee ownership continues the patient capital model that builds value," Goldstein, who has worked in public and private sector roles in North America and Europe, said.

The pathway for a firm is therefore different to that of say, a private equity buyout, or a management buyout. The employee-ownership model, which has been around since 1975, also tends to be more positive in the broadest sense for employees, their families, and the local communities, he said.

One of his jobs involved handling a succession plan project for a family office, an experience that gave him an insight into business transition issues more broadly.

Folience, a 100 per cent employee-owned diversified holding company, acquires privately held businesses and transitions them to be employee owned. Folience, based in Cedar Rapids, Iowa, traces its roots back to 1884. The company transitioned from partial fourth and fifth family generation ownership to 100 per cent-employee ownership in 2012. Goldstein joined the business in 2016, when it was primarily focused on media businesses, and helped build a new company strategy. Folience has diversified to hold a number of employee-owned manufacturing businesses in recent years.

The transition decision
The oft-touted figure of $30 trillion is thrown around, relating to the value of assets due to be shifted from Baby Boomers to successors in the next few years. A large chunk of this sum will be in illiquid business assets rather than hard cash.

A number of wealth management firms now make a point of advising families about the transition process, often a difficult one as owners who have invested emotionally as well as financially into a firm find it hard to let go. Organizations such as Abbot Downing, US Trust and Key Private Bank , Citi Private Bank, UBS and Family Wealth Advisors are among a number of others who target wealthy families for advice, including issues thrown up by business succession. It is an important fee earner for firms. Related to this is that many HNW and UHNW clients' wealth remains linked to operating businesses – there is often only a very fuzzy dividing line.

With most US businesses falling outside the Fortune 500 rankings, their smaller size means that they can also fall off advisors' radar, leaving owners sometimes struggling to figure out the best way forward.

“There are cases where there's a business that can continue but needs to have a transfer of ownership,” Goldstein told *FWR.* In many cases, businesses fall in the small- and mid-cap categories, and are unlisted and not traded on the public markets, he said.

And the ESOP model can help deal with some transitions, although Goldstein was at pains to stress that it is not ideal for all cases.

An ESOP is a type of stock bonus plan; a defined contribution retirement plan that is designed to be funded with employer stock. Employer contributions into an ESOP are deductible in the year that they are actually made to the plan. The contribution can consist of cash or the employer corporation's stock. If a contribution is made in stock, the employer won't recognize any gain or loss on its taxes . There is no 10 per cent early distribution tax on distributions that are dividends from an ESOP, even if a person receives them before 59½ years of age.

An employer's tax-deductible contribution to an ESOP is capped at 25 per cent of the compensation paid or owed during the tax year to all of the plan's beneficiaries. In calculating this limit, the maximum compensation of an employee taken into account is $270,000 . If the contribution is more than the limit for a given year, the excess amount can be carried forward to future tax years. .

ESOP companies have an advantage over other forms of companies, Goldstein said. “There is a stronger commitment to a stable and sustainable future, and avoids the resale cycle caused by private equity transactions that seek to return immediate returns to investors. These are the benefits. The challenges are finding good companies that meet the profile and are in need of transition. The risks are the same as for any business: tariffs, workforce, economic factors, disruption, etc.”

However, Goldstein cautioned that the legal and transaction costs required to set up an ESOP are not insignificant and there has been increased action taken by regulatory agencies investigating new ESOPs.

So, what of the future for Folience and the employee-owned approach?

“The future business strategy is to continue acquiring successful businesses with strong management teams to further diversify the revenue base. The scalability of the model is in the diminishing cost of shared services that support the transition of ownership and integration of the companies to the Folience platform,” Goldstein said.

Some sectors of the economy are better suited to the ESOP approach than others, he said.

“With ESOPs, employees do not pay for ownership - they invest their labor to earn equity in the business,” Goldstein added.

(Editor's note: We are keen to hear from other wealth management practitioners about what they think of the employee-owned approach to transition, either positively or negatively. Email the editor at tom.burroughes@wealthbriefing.com