

Morgan Stanley

The ESOP Group at Morgan Stanley

Helping Business Owners Reach
Their Financial Destination Via ESOPs





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An increasing number of privately held companies are turning to Employee Stock Ownership Plans (ESOPs) to address investment liquidity and diversification, while resolving matters of wealth transfer and business succession.

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Our Mission

Owners of privately held businesses have dedicated their lives to growing a business about which they are passionate. Frequently, though, they might not have taken the time to fully explore and consider all the choices they have available to them as they prepare for the next stage of their lives. Therefore, as Financial Advisors and Wealth Managers, we consult with business owners of all types to deliver in-depth advice that can help them gain liquidity, diversify wealth and reduce risk, while providing their employees with incentives through stock ownership. Often the best way to do this is with the use of Employee Stock Ownership Plans (ESOPs), which may enable business owners to remain as involved in their business as they desire, yet retire with confidence.

Our Commitment

Business owners of privately held companies are increasingly looking to ESOPs as an attractive alternative to help ensure that wealth transfer and business succession are addressed comprehensively.

We work hand in hand with their primary Financial Advisor(s) at Morgan Stanley by providing sound advice, tailored services and personalized attention to help clients simplify complex decisions and remain focused on their long-term vision. This is an ongoing consultative process that helps us to meet, and even anticipate, their wealth management needs with flexibility and preparedness. Our clients deserve financial advisors who continually earn their trust and work diligently to discover, present and implement the best solutions to meet their own unique objectives.



- SOUND ADVICE
- TAILORED SERVICES
- PERSONALIZED ATTENTION

ESOPs: An Introduction

An Employee Stock Ownership Plan is a qualified defined contribution employee benefit plan, much like a traditional profit-sharing plan. However, an ESOP is unique among qualified benefit plans in its ability to borrow money. In that way, an ESOP can be used as a corporate finance technique that provides liquidity to business owners.

Through an ESOP, business owners can achieve partial or total liquidity and diversification, usually in a tax-advantaged manner. At the same time, the ESOP benefits employees by making them stockholders in their company. In fact, an ESOP is one of the mechanisms that offers a meaningful benefit to employees, while providing private business owners with a market for their stock and companies with a means of borrowing money in a tax-advantaged fashion.

Business owners look to ESOPs as an attractive liquidity alternative, one they can use to take some or all of their “chips” off the table, providing liquidity to the owner in a tax-advantaged manner. The strategy permits them to diversify their wealth, yet allows them to remain

involved in their business if they so desire. As baby boomer business owners age, they are redefining retirement, often with an interest in remaining at least partially involved in their business. For this new generation of “semiretirees,” ESOPs may be one solution.

While a large percentage of ESOPs are initiated to effect a change in control, another motivation for ESOPs is to provide a benefit to employees. In many cases, employees do not pay outright for the stock, nor do they have the option to buy stock. Rather, the stock is allocated to them as an employee benefit according to a non-discriminatory formula that can take into account an employee’s compensation, seniority and other criteria.





The ESOP Candidate

ESOPs have existed for a long time. The concept was developed in the 1950s, and the legislation that first implemented tax advantages for ESOPs was passed in 1974. From only a handful in the 1970s, their numbers have grown to nearly 6,400 plans in existence today.¹

The National Center for Employee Ownership (NCEO) estimates that ESOPs have 14 million plan participants and control more than \$1.67 Trillion in plan assets.² ESOP legislation continues to provide incentives and advantages to both sponsoring companies and employees, adding to the attractiveness of this liquidity option.

Because of the broad appeal of these plans, ESOP candidates vary considerably. Most ESOPs (approximately 90%) are established for privately held companies. Any company — whether a manufacturing, distribution or service business — that can borrow enough money to fund the ESOP is a viable candidate. However,

high-end service businesses with educated workforces — such as architecture, engineering or consulting firms — tend to be better represented in the current universe of ESOPs.

While each situation needs to be assessed individually, the following characteristics can be used to identify a potential ESOP candidate:

- In order to maximize an ESOP (i.e., effectuate a tax-advantaged sale of stock for the ESOP) the company must currently be, or be willing to convert to, a C corporation. S corporations do not give sellers to ESOPs owning at least 30% of the stock the ability to defer taxation on the gain.
- The company must have sufficient capacity (collateral or cash flow) to support funded debt.
- A successor management team should be in place.
- Owners must be open to the concept of broad-based ownership.
- The company should have been in business for several years and have enough employees (i.e., at least 25) to make the plan worthwhile.
- The company should be able to reasonably predict future revenue and cash flows (this is probably more important than having hard assets to support the loan).

^{1,2} NCEO analysis of the Private Pension Plan (PPP) Research File made available by the Department of Labor from data reported on the Form 5500 for filing year 2019. To count literal ESOPs, we include all sponsors with plan type codes 20 (ESOPs other than leveraged ESOPs), 2P (leveraged ESOPs) and 2Q (S corporation ESOPs).



How an ESOP Works

To establish an ESOP, the company first borrows money to finance the purchase of stock from the current shareholder or shareholders, and the company lends these funds to the ESOP. A trust is created to purchase the stock of the company on behalf of the ESOP plan.

From its operating profits, the company then makes annual cash contributions to the trust. These contributions are potentially fully tax-deductible. As the trust uses this cash to pay down the ESOP loan, shares of stock are released and allocated to individual employee accounts based on compensation, and then vested on the basis of years of service.

Employees are typically vested in the stock within three to six years of receipt, but they may not actually sell the stock until they leave the company. At that time, the plan may provide that the company can buy back their shares at fair market value, as determined by an independent business valuation firm appointed by the ESOP trustee. The chart on the following page shows the structure and flow of an ESOP.

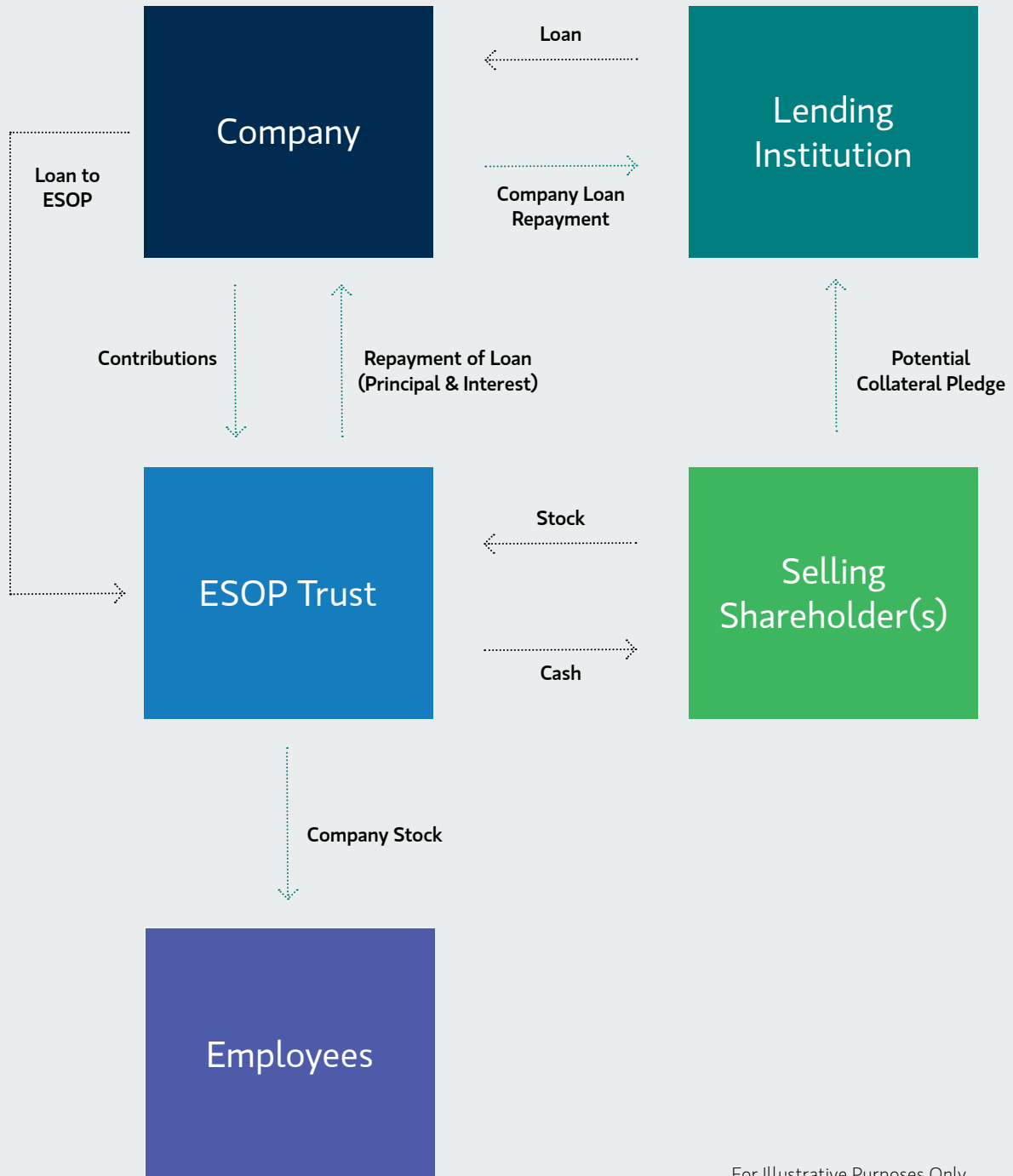
For More Clarification

Imagine that the tax basis in the business owner's company is \$5 million and resides in a zero tax state. The owner is considering either an outright sale or an ESOP, both of which have been valued at \$30 million, meaning the business appreciated \$25 million.

- Under the sale scenario, the business owner will pay the 20% long-term capital gains tax and 3.8% Net Investment Income Tax on the appreciated value, or \$5.95 million, reducing the net proceeds to \$24.05 million.
- Under the ESOP, the business owner can defer the capital gains tax and receive the full net proceeds of \$30 million, provided the following requirements are met:

- He owned the stock for at least three years and did not receive it as part of a compensatory transaction.
- Post-transaction, the ESOP must own at least 30% of the company.
- The company must be organized as a C corporation at the time the ESOP purchases the stock.
- The seller must reinvest the proceeds from the sale within 12 months after the sale in "qualified replacement property."
- Other requirements apply, including the filing of certain documentation with the IRS; interested parties should consult their tax and legal advisors.

Initial Transaction Annual Flows



For Illustrative Purposes Only.

Tax Advantages of an ESOP

Owners are often attracted to ESOPs as an exit strategy because of the tax-advantages available with the use of ESOPs. The sale of company stock to an ESOP can be exempt from capital gains taxes if the applicable criteria under Section 1042 of the Internal Revenue Code are met. An ESOP sale is one of the few opportunities for a business owner to transfer his or her wealth without triggering capital gains taxes.

In order for the business owner to avoid the capital gains tax, he or she must invest the proceeds from a sale to an ESOP in “qualified replacement property.” And if the selling shareholder holds the qualified replacement property for the rest of his or her life, the estate may receive a step-up in cost basis on the qualified replacement securities at death, thus eliminating the capital gains tax liability entirely. Certain dispositions of the qualified replacement property will trigger the taxation of the deferred capital gains.

ESOPs are also attractive from a corporate tax perspective. Each year, the company

will contribute cash to enable the ESOP to repay its loan. Since these annual ESOP contributions should be deductible from the company’s taxable income as contributions to a tax-qualified plan, the corporation repays both the principal as well as interest on an ESOP loan from (in effect) pretax income.

For a C corporation, principal payments are deductible up to 25% of covered eligible payroll. Interest payments are deductible in full and may exceed the 25% of the covered eligible payroll limit. For an S corporation, the maximum deductible amount is 25% of covered eligible payroll

and, unlike a C corporation, both principal and interest are included in the 25% limit.

In addition, dividends paid on ESOP stock in a C corporation are tax-deductible to the corporation if they are distributed in cash to plan participants, used to repay the ESOP loan or reinvested in additional shares of company stock in the ESOP. This deduction helps to increase the amount of cash available to the company compared to conventional financing. Dividends are not deductible for S corporation ESOPs.

More Advantages of an ESOP

ESOPs have a number of other significant advantages including liquidity with control flexibility, facilitating sales between shareholders, help with succession planning, protecting confidential information and improved employee motivation.

Liquidity With Control

An ESOP is an efficient mechanism by which a business owner can sell a partial interest at full fair-market value and still maintain total operating control of his or her company. Only 30% of the business needs to be sold to the ESOP to obtain the tax benefits for the selling shareholders. This allows the owner to ease out of the business while maintaining its culture. It also protects the owner from “outside” money and its corresponding influences, which can sometimes conflict with the owner’s philosophy of how to operate the business.

Flexibility

An ESOP can be structured as a series of transactions, which can facilitate the transfer of a larger percentage of the business over time. In addition, an ESOP does not preclude a business from undergoing a later sale to an outside buyer or an initial public offering, should those exit alternatives become attractive. The stock sale effectuated through an ESOP is also reversible; the company may repurchase the ESOP stock as employees retire, eventually regaining 100% ownership.

Facilitates Sales Between Shareholders

Remaining shareholders can use an ESOP to buy out partners wishing to exit the business. Often, the transaction works in the interest of both parties. The selling shareholders may qualify for the tax-advantaged treatment of the sale of their stock, while the remaining shareholders will benefit from the special tax treatment for ESOP financing that allows for the deductibility of payments on ESOP loans.

Facilitates Succession Planning

ESOPs can help with estate and succession planning on several levels. For example, a leveraged ESOP temporarily reduces the value of company stock, providing an opportunity to make gifts of shares to the next generation at a reduced valuation. In addition, after a partial sale to an ESOP, owners will hold both company stock and liquid assets in their estates. Then they can transfer different types of assets to family members depending on their involvement in the business. Family members involved in the business can receive stock, while those not involved can be allocated cash. If the ESOP involves a majority of the business, the remaining (minority) interest held by

the estate can be discounted for non-marketability for estate-tax purposes.

Alternative to a Dormant M&A Market

Some industries and certain businesses fail to attract sufficient buyer interest to complete an outright sale. In such instances, an ESOP can provide a good alternative exit option for the business owner.

Protection of Confidential Information

Under an ESOP, business owners can generally maintain confidentiality with regard to revenue and profit figures, owner’s compensation, employee compensation plans, proprietary advantages and other business secrets.

Improved Employee Motivation

ESOPs can help a company attract, retain and motivate talented employees. National Center for Employee Ownership (NCEO) research shows that giving workers a significant stake in their companies can increase their dedication, improve their work effort, and reduce absenteeism and turnover.



Qualified Replacement Property (IRC § 1042)

Qualified replacement properties are simply securities — stocks and bonds — of U.S. corporations that meet the following requirements:

The corporation must use more than 50% of its assets in the active conduct of a trade or business; and

Passive income earned by the corporation may not exceed 25% of its gross income.

As long as the replacement properties meet these criteria, business owners have a wide range of investment choices and diversification options. They may invest their proceeds in stocks, bonds, preferred stocks, convertible bonds, floating-rate notes and a variety of other securities.

Note: If the securities mature or are called by their issuer or otherwise sold, the sale will trigger the originally deferred tax liability — not only on any gains the business owner achieved after purchasing the securities, but also on the gain he deferred when he sold his company stock to the ESOP. In other words, the cost basis of the qualified replacement property is the basis in the company stock that the business owner sold to the ESOP.

Creating the ESOP

There are many parts to an ESOP, including the selling shareholders, employees, lending institutions and ESOP trust. As a result, creating an ESOP truly requires experienced consulting, legal, tax and financial advice. An ESOP transaction includes the following steps:

Business owners who are interested in establishing an ESOP have a wide range of options in tailoring a plan best suited to their particular needs and goals. This includes variations in ESOP structure, differences in percentage of stock held by the ESOP and other considerations.



1 CONDUCTING

a feasibility study to determine the company's ability to repay the loan, as well as how the ESOP can be structured to meet ownership objectives.

2 VALUATION

of the company's stock by an independent outside valuation expert. (The ESOP specialist can help present the company to the independent valuation team in a way that is designed to promote maximum value.)

3 SECURING

funding for the plan, including performing lender and investor due diligence.

4 NEGOTIATING

the shareholder and loan agreements, and structuring the ESOP.

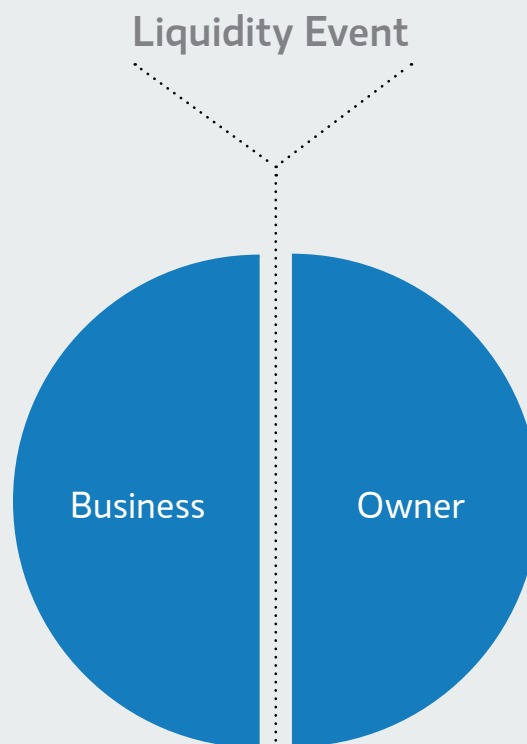
5 ESTABLISHING

a process to operate the plan, including appointing a trustee and setting up an ESOP committee.

Importance of Wealth Management

Because of the added tax considerations involved in an ESOP, post-ESOP wealth management takes on new importance. Some examples of investment strategies include the following:

As the saying goes, a business owner's liquidity event has two components: "What they get for the business, and what they get to keep."



Passive Growth

If the business owner does not need these assets to meet expenses, he or she can simply keep them invested in qualified replacement property, making certain they avoid securities with call provisions or near-term maturity dates. After the business owner's death, the securities will become part of their estate. Their heirs may not be liable for gains generated by the securities after they were purchased, or for the gain the business owner deferred when he or she sold the stock to the ESOP. Instead, the heirs may benefit from a date-of-death step-up in cost basis to the fair market value of the securities.

Passive Income

Business owners can generate income from their qualified replacement property by investing in high-dividend stocks or long-term fixed income securities. While this approach does not allow them to access the securities directly without triggering tax consequences, it does generate current income.

Active Portfolio

Business owners can invest in floating-rate notes, which are sometimes referred to as ESOP Notes because they were designed specifically for ESOP sales. These are securities issued by major corporations that 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 reset monthly or quarterly, depending on the security.

- Highly rated floating-rate notes are often the first choice for investors in qualified replacement property because they are typically marginable for up to 90% or more of their market value. As a result, business owners can monetize them by borrowing a substantial portion of their market value and then reinvesting the borrowed funds in a diversified portfolio of stocks, bonds and other assets.

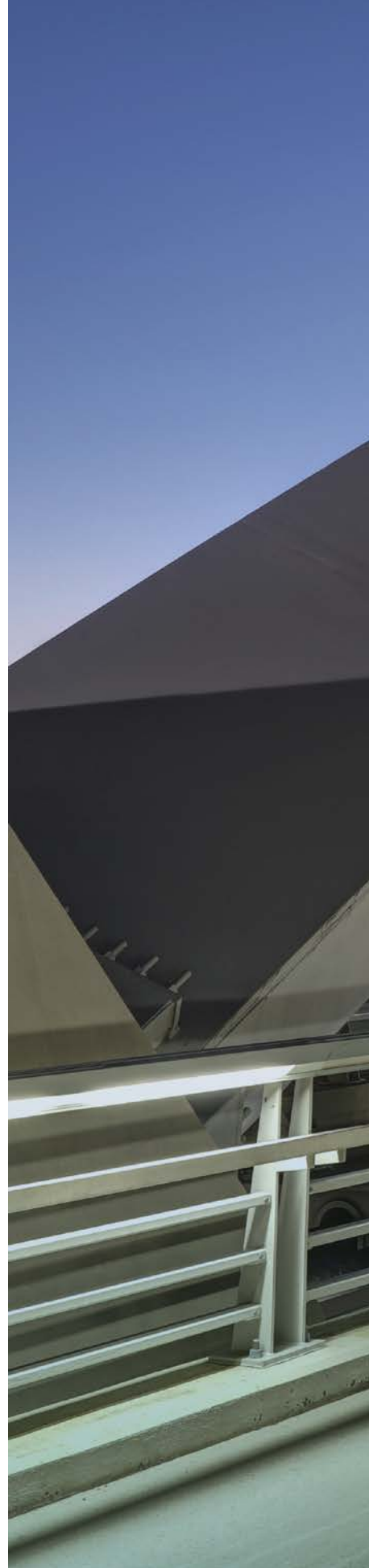
- The investment portfolio can then be actively managed without triggering tax on the deferred capital gains resulting from the ESOP sale. Business owners will have to pay interest on their margin loan, but the rate will be relatively low and the interest paid may be partially or fully offset by the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

ESOPs are not for Everyone

As appealing as the benefits of an ESOP can be, there are some important issues that business owners should take into consideration:

- ESOPs may not be used in partnership structures or in most professional corporations.
- Although ESOPs can be used in S corporations, there are certain restrictions and lower contribution limits for S corporations than for C corporations.
- The ESOP is both a corporate finance and retirement savings vehicle. If not handled properly, these dual roles might create a conflict of interest under ERISA. For smaller companies, where an ESOP's fiduciaries might also serve as officers or directors, these conflicts might be difficult to resolve without independent legal, investment and financial counsel.
- The company may be required to repurchase vested shares of departing employees. The funding of this repurchase must be managed carefully.
- 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. This must be considered against the tax and other benefits an ESOP can provide.
- ESOPs may not be appropriate for smaller companies because of their costs to establish and administer.

These possible ESOP drawbacks should be carefully considered against the plan's potential tax and other benefits.





The ESOP Group – Our Partners



First row (Left to Right): Mindy M Day Business Development Director, Adelyn Carmody Registered Client Service Associate, Ann M Kim Financial Advisor, Rhiana Johnson Registered Client Service Associate, Sheri Camp Director of Business Strategy

Back row (Left to Right): Joe Kern Registered Client Relationship Analyst, James L Massey Financial Advisor, William E O'Brien Managing Director, Financial Advisor, Bryan Boesen Managing Director, Financial Advisor, Devon McLochlin Wealth Management Associate, Dominic Salonya Wealth Management Analyst

Helping business owners access their wealth, maintain their legacy, and reward their employees through Employee Stock Ownership Plans (ESOP) and other exit strategies.



William E. O'Brien

Managing Director

Financial Advisor

Bill has been focusing on ESOPs and capital markets since 1989. He is Co-head of The ESOP Group at Morgan Stanley, assisting business owners and corporations, including several in the Fortune 100, in areas such as corporate liquidity transactions, business succession planning, retirement plan design, and employee financial education.

Of particular note is his experience in assisting business owners that have completed or are contemplating an ESOP, understanding the complexities of Internal Revenue Code Section 1042, leveraging equity risk management, and tax advantaged strategies. Bill has successfully completed over 450 ESOP transactions.

Over \$4 Billion Floating Rate Notes as of 06/28/2023 inclusive of 1,000+ individual clients



Bryan Boesen

*Managing Director
Financial Advisor*

Bryan has been a Financial Advisor with Morgan Stanley and predecessor firms since 1999, providing consulting services to institutional and private clients. Bryan has vast experience working with and understanding the needs of nonprofits, developing sound investment strategies and striving to create income streams by leveraging the resources available at Morgan Stanley. Additionally, he assists affluent individuals and families with wealth planning to help secure their legacy.

For many years Bryan has worked exclusively with privately owned, mid-sized companies, nonprofits and affluent individuals and families. Because of this experience, he brings a deep understanding of the dynamics of closely held and family-owned businesses. His retirement services resources provide counsel and objectivity to help implement a plan designed to be the most effective for the company. Specifically, his capabilities include helping businesses implement employee stock ownership plans (ESOPs), understanding the complexities of Internal Revenue Code Section 1042 and leveraging equity risk management and tax advantaged strategies.



Ann M. Kim

Financial Advisor

Ann is an accomplished ESOP executive with 20+ years of experience in a multitude of industries. Prior to joining The ESOP Group at Morgan Stanley, she was the General Counsel and Chief Administrative Officer at a \$500MM employee-owned company. Prior to her tenure in private industry, Ann was a Partner at Katten Muchin as Head of the ERISA practice.

Ann brings end-to-end knowledge in several matters involved within an ESOP, accompanied with exemplary legal and financial acumen as former attorney and accountant at well established firms. She will work with advisors and business owner clients to navigate the complexity of an ESOP and assist business owners in avoiding common pitfalls.



James L. Massey

Financial Advisor

Prior to joining Morgan Stanley, Jim held leadership positions with top middle-market Investment Banking firms as Founder, Director, and Head of the Houlihan, Lokey, Howard & Zukin Dallas office and led the Duff & Phelps Southwest regional office as Managing Director and City Leader.

Over the last 35 years, his historical engagement deliverables have facilitated business mergers and acquisitions, corporate recapitalizations and sell-side transactions involving ESOP structures.

The ESOP Decision

Business owners face a complex decision to determine whether an ESOP is right for their company. It requires careful analysis of the benefits and drawbacks of an ESOP, as well as a thorough calculation of the costs and potential benefits associated with a plan. There are also personal considerations to take into account, and business owners are advised to compare the ESOP features and benefits against those of other liquidity strategies to help insure that an ESOP is the best option for them.

The ESOP Group at Morgan Stanley works closely with attorneys and other financial advisors to guide business owners in making well-informed decisions about ESOPs and how they can best be implemented. For more information and sound advice, please feel free to contact us.



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Although Morgan Stanley offers both passive and active reinvestment strategies, its role is much more limited in the passive strategy. This is not a commitment to lend money.

All loans are subject to required credit approval.

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Tax-aware strategies seek to reduce capital gains. There is no guarantee that they will eliminate them.

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