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EMPLOYEE STOCK OWNERSHIP PLANS (ESOP): THE ROLE ESOPS PLAY IN BANK SUCCESSION PLANNING

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Prepared by:

Executive Benefits Network
833 East Michigan Street | Suite 1480
Milwaukee, WI 53202
Phone 414.431.3999
Fax 414.431.9689
ebn-design.com

PART 3:
THE ROLE ESOPS PLAY IN BANK SUCCESSION PLANNING

As Business Owners and Senior Leadership teams in the banking industry approach retirement, creating and developing the bank's succession plan is critical. Equally as important are the issues of retirement planning, estate planning and key employee retention. Stay with the Executive Benefits Network (EBN) as we take you through a three part series covering important topics including:

Part 1: Bank Succession Planning
Part 2: Retirement Planning for Bank Owners and Key Executives
Part 3: Employee Stock Ownership Plans (ESOPs)

There are multiple ways to recruit, retain and reward your key executives that can also be tied to the succession plan of your bank. One example is the implementation of an Employee Stock Ownership Plan (ESOP). An ESOP is an employee benefit plan that many banks and corporations use to retain their leadership team and provide them with a benefit, while effectively addressing their succession planning needs and providing liquidity for the bank ownership.

In this Whitepaper, we will further explore how an ESOP works, the tangible and intangible benefits it provides a bank, and how to determine if a bank is a good candidate for an ESOP.

"ESOP companies are more productive, faster growing, more profitable, have less turn over and generate more wealth."

- National Center for Employee Ownership

FUNDAMENTALS OF ESOPS

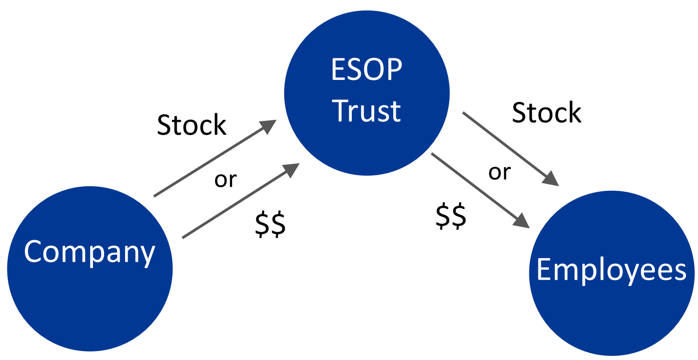
An ESOP is similar to a profit-sharing plan, in that it qualifies for certain tax advantages under the Internal Revenue Code. It allows an employee to obtain ownership interest in the bank, which aligns the employee's interest with that of the owner. Many bank owners choose to leave their bank with their family or key management, but the question in hand remains, how will those individuals be able to purchase the bank? An ESOP is a well thought-out business plan that allows for the purchase process to happen gradually, while the owner still maintains majority ownership.

In an ESOP, the bank sets up a trust fund and uses one of two structures to fund the shares: a non-leveraged ESOP or a leveraged ESOP. In both structures, the bank provides the entire benefit to the employee so that the employee does not need to make any personal contributions to acquire the stock. Over time, their account balances will grow as the value of the bank increases in value. When the trust is set up, it is owned by a ESOP Trustee, who serves as the plan fiduciary. The ESOP trustee has many responsibilities including: voting the ESOP shares to select the Board of Directors, managing assets of the ESOP trust and establishing the annual ESOP stock price.

FUNDAMENTALS OF ESOPS (CONTINUED)

As mentioned previously, there are two structures of ESOPs, a non-leveraged and a leveraged ESOP. A non-leveraged ESOP does not borrow funds to buy the shares to acquire the sponsoring employer's stock. Instead, it is funded by the employer with either cash or newly-issued stock. With the company providing the cash and stock, it will receive a tax deduction which helps improve cash flow and reduces taxable income. A non-leveraged ESOP is a flexible model as it allows the company to make contributions into the ESOP at the owner's discretion. Once an employee retires or leaves the company, they receive the stock or cash according to their vesting schedule.

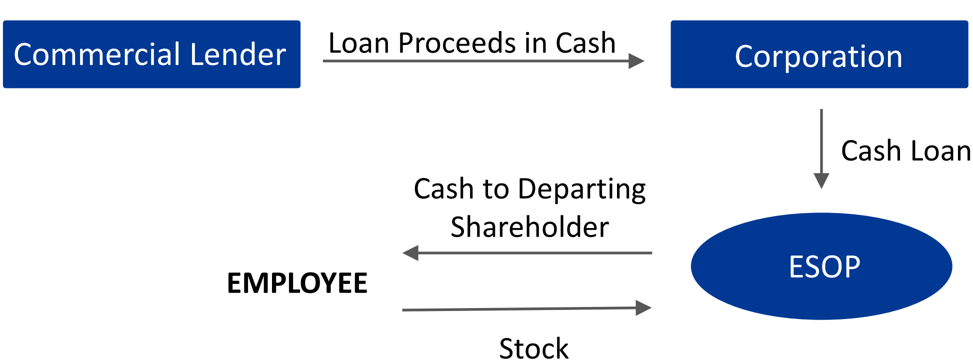
NON-LEVERAGED ESOP GRAPH



Source: The ESOP Association, October 26, 2017, http://www.esopassociation.org/explore/how-esops-work/learn-about-esops/leveraged

In a leveraged ESOP structure, the company borrows the funds used to buy the shares from a lender. The company makes annual tax-deductible contributions to the ESOP (which it then uses to repay the loan). Similar to non-leveraged ESOPs, the employee receives the funds once they leave or retire from the bank.

LEVERAGED ESOP GRAPH



Source: Northwestern Mutual, October 26, 2017, Employee Stock Ownership Plans In Brief

> **"Today, there are roughly 14.1 million ESOP participants and 6,717 ESOPS in 2017."**
>
> **- National Center for Employee Ownership**

EMPLOYEE BENEFITS

Employees are attracted to banks where they know their work will be appreciated and their efforts will be seen and rewarded. The greater the incentives, the more likely an employee will remain loyal to the bank and strive to do the best at their job. According to the National Center of Employee Ownership, "56% of the ESOP companies have at least one additional employee benefit plan." In addition to having a benefit of ownership in the bank, it also gives employees a sense of job security.

An ESOP provides an employee with a significant retirement benefit. The longer the employee has been at the bank, the greater their contribution is to the bank's success. In return, their stock has a greater accumulation of earnings, which provides increased funds at their retirement. Up until the distribution of cash, the employee is not taxed on any employer contributions or earnings. The participant is informed on a yearly basis of the number of shares owned in their account and the current stock value. Providing this information to the employee allows them to see the growing affect, which increases their confidence in the plan and motivates them to be more productive.

"The greater the incentives, the more likely an employee will remain loyal to the bank and strive to do their best job."

BANK ADVANTAGES

Not only are ESOPs beneficial for the employees, but the bank sees many advantages to providing an ESOP. Below are some of the benefits banks may experience:

- Extra cash flow from tax savings is generated from contributing to the stock;
- By making deductible cash contributions to an ESOP, the cash can be recovered by the company tax-free when selling stock to the ESOP;
- The owner has flexibility, turning over the bank to employees while still maintaining control of the bank;
- The bank receives a dollar-for-dollar income tax deduction on the entire stock sale price;
- Working with third party lenders, an ESOP can be used as a finance technique to raise new equity by refinancing outstanding debt or acquiring assets or stock;
- Greater productivity, less turnover and higher profits than non-ESOP banks.

"Extra cash flow from tax savings is generated from contributing to the stock."

SUCCESSION PLANNING

Peter Wilder, attorney with Godfrey & Kahn, S.C., has seen these benefits firsthand: "In the right situation, ESOPs can solve for at least one of the most critical challenges facing community banks today: succession planning at both the employee and ownership levels. I've seen family owned banks, in particular, realize a benefit in continuing to own a majority stake for the family's next generation, yet allow themselves a tool to attract and retain employees with an ESOP benefit." An ESOP is a valuable tool for succession planning at a bank. One of the biggest struggles an owner may have with succession planning is determining how to successfully transition the bank to the next prospective owner. An ESOP could be the answer the bank owner is looking for, all without giving up their control in the process. Below are a few thoughts owners have that may lead to them to consider an ESOP for their bank:

- A desire for ownership transition to the next generation;
- A need for liquidity in an estate plan for tax payments;
- Lifestyle changes;
- A desire to sell the bank due to retirement age.

"An ESOP is a good way for an owner to transition the bank without giving up their control."

TAX BENEFITS

ESOPs have many significant tax benefits, but the most notable are:

- **Contributions and Dividends are Tax-Deductible:** An employer is able to deduct contributions up to 25% of the plan participant's compensation. With these deductions, a bank will have additional cash flow that can be used towards other parts of the bank's overall plan. Dividends that are used to repay an ESOP loan, given to employees, or reinvested by employees in stock are tax-deductible.
- **Employees Receive Tax Deferral***:* Employees are able to defer tax when rolling the ESOP distributions into an IRA or another retirement plan. If the stock is distributed in one taxable year, special rules exist to have the income tax portion of the distributions. If this does occur, the employee would be taxed 10% if the distribution is made before 'normal' retirement age. Once the employee withdraws money, they are taxed on the distributions.
- **Sellers in a C-Corporation able to Defer Taxes:** In C-corporations, once the ESOP owns 30% of all the shares in the company, the sellers are able to defer paying the taxes on their sale proceeds for a certain amount of time. If a seller purchases a qualified replacement property of a different company within a year of the sale, taxes are not charged according to Section 1042 of the Internal Revenue Code.

- **Tax Free Ownership in S-Corporations:** In S-corporations if the ESOP is the only owner of the bank, there is no income tax. If the ESOP does not own the entire bank, it still receives a tax savings based on its ownership percentage. The higher the ownership stake, the less the taxes.
- **In a Leveraged ESOP, Repaying the Loan is Tax-Deductible:** Whether the ESOP borrowed the money to buy existing shares or new shares, financing the ESOP is done without tax consequences.

WOULD AN ESOP WORK FOR YOUR BANK?

ESOPs provide many benefits to banks, their owners and its employees, but before adopting an ESOP, the bank must determine if they are good candidate to include it in their overall strategy. In order to incorporate an ESOP, the bank must be a corporate entity. There are ways for partnerships and limited liability companies to be structured to benefit from an ESOP, but they are not technically permitted to sponsor an ESOP.

There are certain elements that make banks good ESOP candidates, which include:

- **Employee Ownership:** Maybe the most important factor is the desire that employees obtain a level of ownership in the bank. The Owner and Shareholders need to want the ESOP, as well as the support that the employees would appreciate this benefit.
- **Financial Strength:** Banks should have a stable, strong and consistent financial performance. The ability to repay a loan from cash flow and predict future profits are necessary components to providing the employees with their funds at retirement.
- **Strong Senior Management Team:** If an ESOP is adopted, the management team would own shares of the bank. Make sure that they are committed to the future of the bank. Their goals need to align with those of the bank.
- **Substantial Payroll:** As a standard guideline, the employer's payroll should be at least $700,000. The higher the payroll, the more meaningful the contributions made. If leveraged, a sufficient payroll will ensure the bank has the funds to repay the loan.

Many individuals are involved when implementing an ESOP, including the bank's management, accountants, attorneys and financial advisors. Most importantly, according to Peter Wilder, the Board of Directors plays a critical role: "Boards owe it to their shareholders, customers, and employees to explore a range of strategic options, and an ESOP is one such option. By no means is a Board required to seriously pursue an ESOP, but given how common they are for community banks, Boards should at least understand how an ESOP might fit into its bank's strategic plan, if at all." In order to determine if your bank is a good candidate for an ESOP, an outside consultant should assess all aspects of the bank and run a study.

"Bank management, accountants, attorneys, financial advisors and consultants are involved in implementing an ESOP."

According to Lexology, “Generally, the components of the study should include:

- A preliminary valuation of the bank to determine the approximate price the ESOP would need to pay to acquire the bank's stock;
- An analysis of the effects of the proposed ESOP on all shareholders and the financials of the bank;
- An analysis of various ESOP plan designs and financing strategies; and
- An analysis of the bank's liquidity to determine the bank's ability to repurchase the stock allocated to the accounts of ESOP participants upon the participants' retirement, death or other termination of employment.”

Source: Holland & Knight LLP, Lexology, March 13, 2017. “*ESOPs: A Powerful Tool for Closely Held Banks*, ”https://www.lexology.com/library/detail.aspx?g=1d4e0c2e-6653-4187-bba5-9f037d1a1356

“The Midwestern U.S. is home to the greatest number of ESOPs.”

- National Center for Employee Ownership

CAVEATS

While there are many benefits to implementing an ESOP at a bank, there are drawbacks to consider as well.

- It is very costly to set up an ESOP. According to the National Center For Employee Ownership, “perhaps $40,000 for the simplest of plans.”
- ESOPs cannot be used in partnerships or LLCs, and S-corporations with ESOPs are treated differently than C-corporations.
- If an employee leaves the bank, the individual has the right to sell the stock back to the bank at the fair market value, which could lead to a big expense.
- When new shares are issued, the existing stock for owners is diluted.

The bank must consider the affect of the new shares against the potential tax and employee benefits.

CONCLUSION

Over this three part series of bank succession planning, we have explored different ways to plan for short term, long term, management, shareholder and board succession planning, as well as looked further into the needs of management retirement planning and learned how an ESOP can play an important role in the planning of a bank’s future. The Partners of Executive Benefits Network can serve as a valuable part of the bank’s team to determine if an ESOP is the right decision for your bank and how to help plan for the future of the bank.

About the Authors:

R. David Fritz Jr., CLU®
Managing Partner
dfritz@ebn-design.com
Office: (414) 431-9688

David is the Co-Founder of Executive Benefits Network and a 32-year veteran of the financial services industry. David is a frequent speaker across the banking industry as an expert in the area of Nonqualified executive benefit plans and Bank Owned Life Insurance programs. David is the Chairman of The American College Foundation, member of the AALU Nonqualified Plan Committee, Trustee of the Village of River Hills, board member of the Milwaukee Country Club and Past-President of the Milwaukee Winter Club Youth Hockey Organization. He is a member of the Indiana Bankers Association, Wisconsin Bankers Association, Bank Holding Company Association, the Society of Financial Service Professionals and the MDRT Association's Court of the Table.

Patrick J. Marget, JD, CPA, CFP®, CLU®
Managing Director
pmarget@ebn-design.com
Office: (414) 431-9681

Pat is a Co-Owner and Managing Director of Executive Benefits Network and a 17-year veteran of the financial services industry. Prior to entering the financial services industry, Pat worked as a senior accountant in audit for KPMG in the bank service area and as an attorney for Michael Best & Friedrich LLP where he concentrated on general corporate and securities law. Pat's career focus is in the BOLI/COLI marketplace, as well designing creative strategies for executive compensation planning, business succession planning and estate planning. Pat is a shareholder and Director of a bank in Iowa and is an active member in the State Bar of Wisconsin. He is a frequent speaker in industry meetings and seminars. He is a member of the Community Bankers of Iowa, Iowa Bankers Association and Wisconsin Bankers Association.

Peter Wilder, J.D.
Godfrey & Kahn S.C.
Shareholder
pwilder@gklaw.com
Office: (414) 287-9609

Peter Wilder is a shareholder with the Banking and Financial Institutions Practice Group at Godfrey & Kahn S.C.. His clients include banks, mortgage companies, finance companies, financial services company vendors, and business executives. Peter provides a wide range of corporate and regulatory advice on topics including mergers and acquisitions, strategic revenue enhancement strategies, branch sales, capital raises, vendor contracts, and consumer finance laws. He has also provided legislative support to the Wisconsin community banking and mortgage banking industries. Peter is a graduate of the Graduate School of Banking at the University of Wisconsin-Madison.

ABOUT EXECUTIVE BENEFITS NETWORK (EBN):

As the leading industry advisor, EBN specializes in the customized design, administration, and informal financing of Nonqualified Executive Compensation and Benefit Plans (Deferred Compensation Plans), as well as the procurement of Bank Owned Life Insurance (BOLI) programs to attract, retain, and reward key executive talent. We emphasize the importance of education and build long-lasting relationships with clients in all 50 states, and we have access to the highest rated insurance companies in the nation. Lastly, we believe that no two companies are alike in their needs; therefore, customization of executive benefit and compensation plans is paramount to a successful program.

Executive Benefits Network
833 E. Michigan St. | Suite 1480
Milwaukee, WI 53202
Phone 414.431.3999
Fax 414.431.9689
www.ebn-design.com