EQUITY EXPANSION
INTERNATIONAL, INC.

JBM S-Corp ESOP v. External Investors

The most obvious advantage all S-Corp ESOPs enjoy is no liability for state or federal corporate income taxes. Assuming that the federal corporate tax rate is 34% and that of the Commonwealth of Kentucky is 6%, a company that is organized as a Subchapter S corporation and is 100% owned by the workers through an ESOP trust would save approximately 40% of its profits in taxes that do not have to be paid. This is an effective increase of profitability by a factor of 1.67 — 67% (1/.6). This significantly increases the cash available for debt service and, later, for distribution to the owners or expansion.

A corporation that is owned by outside investors must pay federal and state corporate income taxes on all reported profits. If a C-Corp has an ESOP, partial or 100%, it can only deduct the annual contribution and pass-through dividends from taxes. There is a statutory limit on the amount that can be contributed to an ESOP, whether C-Corp or S-Corp, and thus the amount that can be sheltered from taxation by a C-Corp ESOP. Dividends paid to the outside investor are taxed twice, first at the corporate level, and then at the personal level. This significantly decreases the cash available for debt service and distribution to the owners, both internal and external.

When a company combines share ownership with profit sharing and participatory management such as Justice-Based Management, studies reported by the National Center for Employee Ownership in Oakland, California show that such companies outperform otherwise similar companies by a factor of 1.5, or 50%. This also significantly increases the cash available for debt service and for distribution to the owners.

Combining the tax savings with the "ESOP Advantage" of a 100% JBM S-Corp ESOP gives a potential increase — assuming that the studies reported by the NCEO are accurate — by a factor of 2.5 (1.67 tax savings factor x 1.5 ESOP Advantage factor). *Potentially*, then, a 100% JBM S-Corp ESOP can be more than twice as profitable as an otherwise comparable company as a result of the corporate ownership structure and financing source.

Outside investors typically want a control block of shares, especially of a company without a track record, which (as far as an outside investor is concerned) puts the company into the realm of a speculation instead of investment, and therefore significantly greater risk. For assuming greater risk, the investor will want control, if only for protection.

If the plan is to buy out an outside investor after the company becomes profitable so that the company can become 100% owned by an ESOP, the Trust cannot pay more than the appraised fair market value of the shares — in any form. The IRS is beginning to scrutinize all payments or asset transfers to a selling shareholder to ensure that the prohibition against the ESOP paying more than fair market value is not violated. An outside investor could lose a substantial portion of his or her original investment if the fair market value is below the original investment.

Paying more than fair market value would disqualify a plan and possibly involve a breach of the trustees' fiduciary duty. Nor can an ESOP force a sale at the fair market value. The best that could be achieved would be a right of first refusal — which would be worthless if the price offered by another buyer is clearly more than the fair market value.