Every year, hundreds of small businesses bestow the title “owner” upon their workers by establishing an employee stock ownership plan (ESOP) to purchase the company’s shares. An ESOP is a retirement plan that is not only permitted to hold unlimited amounts of employer stock, but can also borrow money or issue a promissory note to purchase the stock. Why, in every economic climate, do business owners turn to ESOPs?

Adaptability: ESOPs can be adapted to any exit strategy. They are sometimes structured to purchase 100 percent of a company’s stock at one time if the owner is ready to retire from the business. But they can buy a smaller interest if the owner is just looking for some liquidity or a chance to diversify, but is not ready to disengage from the business.

Flexible Financing: Many ESOP stock purchases are financed with bank loans. But when credit is tight, ESOPs commonly use deductible employer contributions or seller financing to fill the void.

Tax Benefit for Sellers: Owners of C corporations can sell stock to an ESOP without recognizing a capital gain for tax purposes, if certain conditions are satisfied. The gain is not taxed until the shareholder sells the replacement investments purchased with the proceeds (or not at all if the replacement securities are held until death).

Tax Benefits for Company: Every business owner wants to leave their company in the best possible condition, to flourish for years after they have retired—even more so where the owner has financed the ESOP purchase and is counting on the company’s continuing profitability to receive full payment. Owners take comfort in knowing that, by choosing an ESOP buyout, they have given their companies a few unique advantages. Using an ESOP allows the company to deduct every dollar used to repay the debt, not just the interest payments. The company can also earn a deduction without expending cash by contributing stock to the ESOP. The story gets even better for S corporations with ESOPs. Generally, taxes are not owed by the company or the ESOP on the company’s income attributable to the ESOP-owned shares. Income taxes may be completely eliminated when an ESOP acquires 100 percent of an S corporation’s stock.

ESOP as Performance-Enhancer: Objective research has shown that the vast majority of ESOP companies are high-performing businesses that have better sales, are more sustainable, pay better, and provide more retirement savings compared to similar companies that are not employee-owned. Just as owners of homes and cars are predictably better caretakers of their property than renters, employees who adopt the mindset of an owner are more likely to go the extra mile for the business and its customers.

The slow economy may have temporarily closed off some of the more traditional avenues for exiting small business ownership. However, owners might find that, with a carefully planned ESOP sale, they can still proceed with their exit strategy on the original schedule.