January 2010
Issue 82

The ESOP Quarterly

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Pending Tax Increases and Succession Planning: A Coordinated Approach *by: Kelly O. Finnell*

We've all heard the old saw: "The only two things you can count on are death and taxes." For business owners, the 2010 edition of this familiar quip should be: "The only two things you can count on are that none of us are getting any younger and taxes are sure to increase in 2011."

What does this mean for business owners?

- Start making business succession plans *NOW*; and
- Make plans to address increasing income and capital gains tax rates *PRIOR TO 2011*.

We're Not Getting Younger

Baby Boomers (those of us born between 1946 and 1964) are nearing retirement age and the statistics are staggering. Business owner retirements have mushroomed from 50,000 in 2001 to an expected 750,000 in 2009 - an increase of 1,500%! However, studies indicate that most business owners (90%) have not implemented a business succession plan.

Business succession planning is a responsibility of every business owner. A Business Succession Plan (Plan) addresses critical issues about a company's future:

- How much is my company worth?
- When I am ready to retire, to whom will I transfer my ownership interest?
- If I sell all or a portion of my interest in my company, how much annual income will the sales proceeds generate?
- How can I minimize death taxes?
- How can I retain and reward my company's key employees?

Without a carefully designed and implemented Plan, business owners may find themselves without adequate retirement income, their key employees may desert them, they may have to sell their company at a distressed price or their company could even fail.

Taxes Increasing in 2011

Income and capital gains tax rates are almost certain to increase in 2011. With the massive government bailout of the banking and auto industries and funding shortfalls in social security and medicare, many pundits agree that this may be just the first of many tax increases.

Those businesses that plan now for these tax increases may be in a better position to compete in the future!

Tax and Succession Planning – A Coordinated Approach

For business owners facing the dual challenge of tax and succession planning, an Employee Stock Ownership Plan (ESOP) is a planning strategy they should consider. An ESOP offers the following benefits as a Tax and Succession Planning Strategy.

- Business owners can create an ESOP and have it purchase their stock for its full fair market value. They will be taxed at capital gains tax rates (not ordinary income tax rates) on the sales proceeds and in certain situations, may even be able to receive the sales proceeds income tax-free.
- The company's employees (and especially its key employees) will receive the value of the stock purchased by the ESOP upon their death, disability or retirement.
- To the extent of the ESOP's ownership interest, the company could operate on a tax-free basis. For example, if the ESOP owns 100% of the company's stock, the company's income could be completely free of federal income tax.

Conclusion

Some of the most successful privately held companies in the U.S. are taking advantage of the many benefits offered by ESOPs.
Here is what Wally McAlexander, CFO of BPI, says about how an ESOP has helped their Company.

"BPI has always practiced a "win-win" philosophy and the biggest "win-win" transaction in the history of our Company was the decision by the BPI shareholders to sell 100% of their stock to the BPI ESOP.

Going ESOP was a "win" for the individual shareholders because they were able to sell their closely held business interest at a fair value and either retire or continue to participate in the business at their election. The ESOP was a "win" for the outstanding senior and middle management team along with all of the other hard-working BPI associates that contributed to the success of the company because they became the beneficial owners of the Company over time as the debt incurred to purchase the BPI common stock is retired.

The "win" for the Company was that as a 100% ESOP-owned S corporation, BPI's corporate cash flow is free from federal taxation and free from state taxation by those states that recognize the federal subchapter S election or allow for a state Subchapter S election. The Company's tax advantaged cash flow will first be used to retire the stock acquisition indebtedness and then be used ultimately to retire all interest-bearing debt of the company. The final "win" is that our ESOP has created a culture of managers and associates who think like equity owners."

Executive Financial Services, Inc. is the preeminent Exit Planning and ESOP consulting firm in the MidSouth. We provide innovative solutions for closely held companies through a multi-disciplinary team of experienced, highly qualified professionals. Since 1981, EFS has established over 90 ESOPs throughout the U.S. ESOPs as exit strategies are quickly growing in popularity due to the significant tax advantages they offer for businesses and business owners who are seeking creative means to transition their companies. Over the next five years, approximately 50% of U.S. companies will transition. Therefore, if you have clients who are considering exiting their business or need to be considering exiting, we would appreciate the opportunity to work together. Don't lose a client by failing to introduce the concept of proactive Exit Planning. Many business owners sell out because they have not been exposed to strategies that can allow them to continue to run their business yet provide liquidity and diversification.

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