

Help Boomer  
Business Owners  
Minimize  
Their  
Tax Bill

# ESOP Answers

By Kelly Finnell

**T**he baby boomers are entering their retirement years, and the statistics are staggering. In this first decade of the 21st century, business owner retirements are expected to mushroom from 50,000 in 2001 to 750,000 in 2009 – an increase of 1,500 percent.

The looming retirement of baby boomer business owners (BBBOs) presents insurance and investment professionals with an enormous opportunity in the coming years.

It is a well-known fact that most BBBOs will need to use some of the wealth they have created in their businesses in order to get the funds they need for secure retirements at ages when they can enjoy the fruits of their successes. Historically, this has meant selling their businesses to others.

As advisors engage business owners in the process of succession planning, they should ask their clients two important questions:

1. Why should you (the business owner) have to walk away from your life's work and pay a huge tax bill for the privilege?
2. Is there an alternative that avoids the enormous financial and personal disadvantages of simply selling the business and walking away?

There is a solution that will empower BBBOs to retire comfortably without surrendering control of their businesses or throwing away their wealth in the form of huge taxes. I call that solution the ESOP Innovation.

When business owners think about succession planning and retirement, they traditionally consider three options: selling to outsiders, selling to insiders or, if the right deals don't come along, maintaining ownership until their deaths. Each one of these carries significant tax consequences for all those involved.

## The ESOP Innovation

The ESOP, or the Employee Stock Ownership Program, method allows business owners and their successors to achieve their business-planning goals while minimizing the "tax bites" on the business transfers. This is what this planning strategy looks like:

- It would allow business owners to control the transactions and sell on their terms. They would be able to sell all or a portion of their companies and negotiate terms with "friendly" buyers.
- The sellers would be able to retain some key company-provided perquisites, including country club memberships, company cars and, most important, medical insurance.
- Owners would be able to:
  - Ensure financial security for themselves, their families and employees;
  - Provide successors with clear succession plans containing determinable endpoints; and...
  - Transition gradually into retirement, growing from business operators to mentors.
- This ideal succession plan would be substantially less expensive (generally 50 percent less) than sales to outsiders would be.
- Finally, this ideal succession plan would minimize the tax bites, reducing them by more than 50 percent.

The great news for business owners and investment advisors is that the ideal succession-planning strategy I am describing is available right now in the form of an ESOP.

## ESOP Tax Benefits

In order to sponsor an ESOP, a company must be incorporated, and the tax benefits of an ESOP will differ depending upon whether the business is a "C" or an "S" corporation.

There are three major tax benefits available for a "C" corporation that sells its shares to an ESOP.

### 1. Company contributions to the ESOP are a tax-deductible expense.

The buyout of the owner's stock is financed through what we refer to as the ESOP Loan. Because company contributions to the ESOP are used to pay off the ESOP Loan, the net result is that the company gets a tax deduction for both the principal and the interest on the loan.

### 2. Taxes on reinvested proceeds are deferred indefinitely.

If the selling shareholder reinvests his or her ESOP sales proceeds in accordance with the like-kind exchange provisions in Internal Revenue Code section 1042, taxation on the sales proceeds can be deferred indefinitely.

### 3. Companies can get tax deductions for dividends paid on ESOP shares if certain conditions are met.

The tax benefits of this ESOP structure are best appreciated by comparing an ESOP to other succession-planning strategies such as corporate stock redemption or leveraged management buyout. As you will see in chart 2, using an ESOP as opposed to one of these traditional succession-planning strategies reduces the tax bite by almost 50 percent.

"S" corporations that sponsor ESOPs receive even greater tax benefits than do those available to "C" corporations. Although the tax-deferred sales provisions of section 1042 are not available to owners of "S" corporation stock, other benefits more than make up the difference.



## ESOPs and Life Insurance Checklist

- Key Person Insurance for ESOP Debt
- Insurance of Fund Equity Based Incentive Plan
- Life Insurance for Repurchase Liability
- Insurance for Buy-Sell Agreement
- Insurance for Wealth Replacement with Charitable Planning

## ESOP Candidate Profile Checklist

1. Corporation has unused debt capacity (not heavily in debt).
2. Corporation is profitable and can easily cash-flow additional ESOP acquisition debt.
3. Corporation and/or its shareholders pay taxes at or near the top marginal bracket.
4. Corporation has been doing business successfully for at least five years.
5. Corporation has a payroll of at least \$1,000,000, excluding seller.
6. Corporation is producing sales of at least \$7,000,000 annually.
7. Corporation is doing business in a solid industry.
8. Majority shareholder is interested in sharing equity ownership with employees in order to attract, retain and reward productive employees.
9. A corporation with strong secondary management is capable of taking over and desires to do so.
10. The ESOP will purchase at least \$3 million of the corporation's stock from existing shareholders.

One of the unique features of "S" corporations is that they do NOT pay corporate income taxes. Instead, taxable income is "passed through" to their owners. Since an ESOP is a tax-exempt entity under section 401 of the Internal Revenue Code, income that "passes through" the "S" corporation to its ESOP is not subject to taxation.

The results of this unique "S" corporation tax benefit are illustrated in the chart, where we've assumed that the ESOP owns 100 percent of an "S" corporation and that it is generating \$2 million per year in what otherwise would have been taxable income.

## ESOP Prospects

As BBBOs are reaching retirement age, there has been a significant increase in ESOP activity, which we refer to as the ESOP Boom. According to PricewaterhouseCoopers' "Trendsetter Barometer" newsletter, the interest in ESOPs as a succession-planning strategy increased more than 250 percent between January 2005 and January 2007. We believe that this increase is attributable to the fact that as more financial and investment advisors become aware of the many advantages of the ESOP Innovation, they are recommending this strategy to their clients.

An ESOP is not the best planning strategy in every situation. Generally, ESOPs work best when the answers to at least seven of the 10 questions in chart 3 are yes. If you have clients who fit this description, I strongly recommend that you introduce them to the ESOP Innovation. [INN](#)

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