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Tax Planning

ESOPS: POWERFUL TOOLS FOR TAX AND FINANCIAL PLANNING

By establishing an Employee Stock Ownership Plan, a business owner can receive fair market value for the stock of a company, on a tax-free basis, while at the same time reducing transfer tax liability and maintaining control of the company.

Business owners approaching retirement age are often faced with a complex estate planning dilemma. That dilemma is how to monetize the stock of a closely-held company, thereby achieving financial security, while at the same time providing tax-sheltered monies for heirs or a favorite charity.

Tap Cash Value of Company Stock

An Employee Stock Ownership Plan (ESOP) offers a very effective solution to this common dilemma. An ESOP enables the owner of a closely held business to:

1. Receive fair market value in cash for company stock on a tax-free basis;
2. Reduce transfer tax liability (estate and/or gift taxes); and at the same time
3. Maintain control of the company.

This article explains how an ESOP can be used to help business owners achieve each of these objectives.

Defer Capital Gain Taxes Permanently

Perhaps the most significant benefit of an ESOP is the one that accrues to the selling shareholder. By complying with the provisions of Internal Revenue Code (IRC) Section 1042, a selling shareholder may permanently defer any capital gains tax that would be due on the sale of stock. This is an extremely advantageous provision for a client who has little or no basis in the stock of a closely-held company.

The conditions for such deferral are that immediately after the sale, the ESOP must own at least 30 percent of the employer stock. In addition, the proceeds from the sale of shares must be reinvested in "qualified replacement property" (specifically defined as stocks and bonds of domestic operating corporations actively engaged in a trade or business), and such reinvestment must take place within three months prior to, or 12 months after the sale to the ESOP. It is then possible to borrow against the replacement property in order to get the cash out of it.

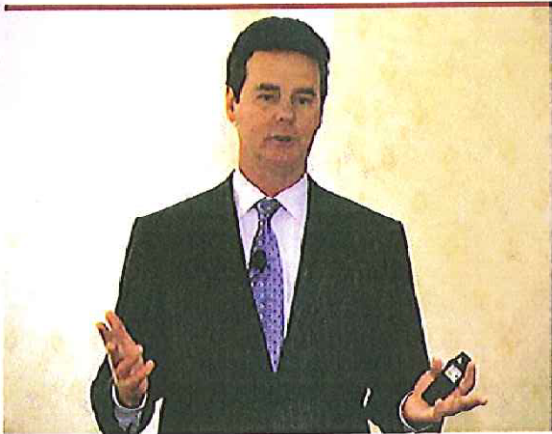
In addition to the tax-free monetization, an ESOP offers other important advantages. Being a qualified retirement plan that is permitted to borrow money, an ESOP can use loan proceeds to purchase all or a portion of a business owner's stock. In order to repay the loan, the company makes contributions to the ESOP, which the ESOP then uses to repay the lender. Through this process, a company is repaying both principal and interest through tax deductible contributions to the ESOP.

Maintain Total Control of the Company

The most obvious way for current owners to maintain control of a company after the ESOP transaction is to sell less than 50 percent of their stock to the ESOP. However, as explained below, they can still maintain control even if more than 50 percent of their stock is sold.

When shares are allocated to an employee's ESOP account, the employee receives shareholder equity but not voting control. Voting control is maintained by the ESOP trustee. Thus, employees are entitled to the value of the stock in their accounts, but the trustee votes the shares, except in specified situations.

The trustee of the ESOP votes the shares as directed by the sponsoring company's ESOP committee. That committee is >>



appointed by the company's board of directors. The board, of course, is appointed by the current shareholders. Through this process, the current owners always maintain control.

Participants (not the ESOP trustee) are allowed to vote allocated shares in the following situations: merger or consolidation, recapitalization, reclassification, liquidation or dissolution or sale of substantially all of the assets of the company. It should be noted that even in one of these situations, participants only vote shares allocated to their accounts.

Such shares are allocated each year as the ESOP loan is repaid. Therefore, assuming a 10-year loan, only 10 percent of the shares sold to the ESOP would be allocated each year to participants' accounts. Thus, even if 100 percent of the stock were sold to an ESOP and an unusual situation occurred where a vote had to be taken relative to one of the matters listed above, the participants would not control the outcome of the vote until six years after the ESOP had been established and more than 50 percent of the stock had been allocated to their accounts.

If current owners so desire, there is an additional step they can take in order to assure their control of the company.

Although it is akin to wearing a belt and suspenders simultaneously, some owners elect to recapitalize their company prior to implementing an ESOP. In the recapitalization, the owners receive nonvoting convertible preferred stock which they then sell to the ESOP. Thus, the ESOP would own nonvoting stock, thereby assuring that the original owners retain control of the company.

Significantly Reduce Transfer Taxes

A basic concept of business valuation is the minority interest discount/majority interest premium. For example, if we assume Mary Smith owns 100 percent of a company with a total value of \$20,000,000, then 51 percent of the stock (a majority interest) is worth more than \$10,200,000. Assuming a 30 percent control premium, she might be able to sell 51 percent of her stock to an ESOP for \$13,000,000. Initially, it might appear that her remaining 49 percent would be worth \$7,000,000. However, due to the discount for lack of marketability, and the fact that the ESOP has added \$13,000,000 of debt to the company's balance sheet, the fair market value of her remaining

49 percent interest could be worth approximately \$3,000,000. This is the ideal scenario under which Mary can gift stock to her children or a family limited partnership in that it could significantly reduce her transfer tax (gift and estate tax) liability. Mary could further reduce her estate tax liability by making a gift of a portion of her qualified replacement property to a charitable trust.

Realize Financial Security While Creating a Legacy

An ESOP can enable a business owner to receive the maximum value for the stock of a company, on a tax-free basis, while at the same time reducing transfer tax liability and maintaining control of the company. There are very few tax and financial planning techniques available to a closely held business owner as powerful as an ESOP. □



Did you miss Kelly Finnell's highly rated presentation at the 2008 Annual Meeting? Mr. Finnell's presentation, *Using ESOPs in Exit Planning*, was the highest rated Qualified Plans Workshop at the 2008 Annual Meeting! To access the full audio and PowerPoint presentation for this workshop or any other Annual Meeting workshop visit the AALU Knowledge Center today! See page 36 for details.

ABOUT THE AUTHOR

Kelly O. Finnell, JD, CLU, AIF® founded Memphis based, Executive Financial Services, Inc. 1981. Kelly specializes in employer sponsored retirement plans, including 401(k)s, ESOPs and Nonqualified Plans for executives. Executive Financial, a member of the M Financial Group, provides innovative and integrated employee benefit solutions through a multi-disciplinary team of experienced, highly qualified professionals.

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