

ESOPs

Employee Stock Ownership Plans

Give Owners Maximum Value, Tax Advantages and More Control

BY KELLY FINNELL, JD, CLU

BY ESTABLISHING AN EMPLOYEE STOCK OWNERSHIP PLAN, a business owner can receive the maximum value for the stock of a company, on a tax-free basis, while reducing transfer-tax liability and maintaining control of the company.

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

TAP CASH VALUE OF COMPANY STOCK

An employee stock ownership plan (ESOP) offers an effective solution to this common dilemma. An ESOP enables the owner of a closely held business to:

1. Receive maximum cash value for company stock on a tax-free basis
2. Reduce transfer-tax liability (estate and/or gift taxes)
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 GAINS 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% 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. It is then possible to borrow against the replacement property in order to get the cash out of it.

In addition to this tax-free monetization, an ESOP offers other important advantages. As 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 FACTS

- Approximately **11,500 ESOPs are in place in the U.S.**, covering 10 million employees (10% of the private-sector workforce)
- About 330 ESOPs — 3% — are in publicly traded companies. However, these companies employ just under 50% of the nation's 10 million employee owners
- An estimated 7,000 of the 11,500 companies have ESOPs that are large enough to be a major factor in the corporation's strategy and culture
- Approximately **4,000 ESOP companies are majority-owned by the ESOP**
- Approximately 2,500 are 100% owned by the ESOP
- While ESOPs are found in all industries, more than **25% of them are in the manufacturing sector**
- At least 75% of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the employer securities held by the ESOP trustee
- A majority of ESOP companies have other retirement plans, such as defined-benefit pension plans or 401(k) plans, to supplement their ESOP
- **Total assets owned** by U.S. ESOPs was estimated to be **\$800 billion at the end of 2006**

Source: The ESOP Association

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% of their stock to the ESOP. However, as explained below, they can maintain control even if more than 50% of their stock is sold.

Under an ESOP, stock can be characterized as "shareholder voting" and "shareholder equity." 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, dissolution or sale of substantially all of the assets of the company. It should be noted that even in 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% of the shares sold to the ESOP would be

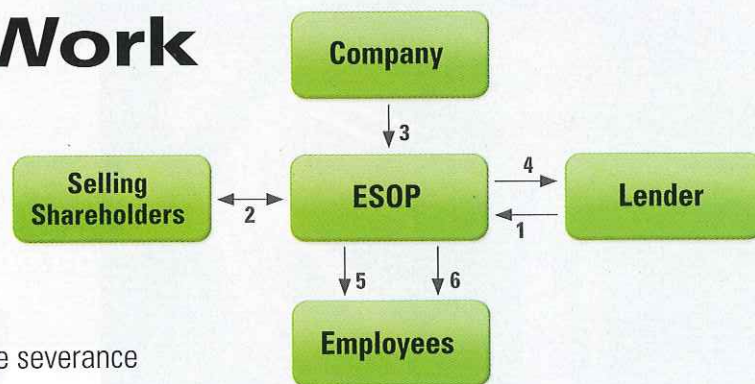
allocated each year to participants' accounts. Thus, even if 100% of the stock were sold to an ESOP and an unusual situation occurred where a vote had to be taken relative to one of the matters listed above, the participants would not control the outcome of the vote until six years after the ESOP had been established and more than 50% 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

How ESOPs Work

- 1 Lender provides funds to ESOP
- 2 ESOP purchases targeted stock
- 3 Company contributes cash to ESOP
- 4 ESOP repays loan
- 5 Shares allocated to employees' accounts
- 6 Shares redeemed by company at employee severance



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% of a company with a total value of \$20 million, 51% of the stock (a majority interest) is worth more than \$10.2 million. Assuming a 30% control premium, she might be able to sell 51% of her stock to an ESOP for \$13 million. Initially, it might appear that her remaining 49% would be worth

\$7 million. However, due to the discount for lack of marketability and the fact that the ESOP has added \$13 million of debt to the company's balance sheet, the fair-market value of her remaining 49% interest could be worth approximately \$3 million. In this ideal scenario, Mary can gift stock to her children or a family limited partnership and 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

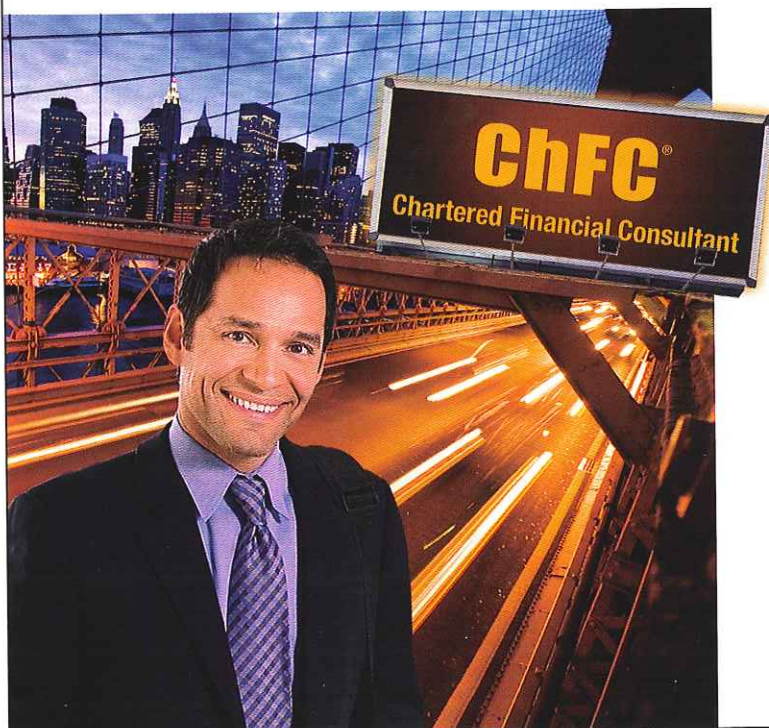
An ESOP can enable a business owner to receive the maximum value for the stock of a company, on a tax-free basis,

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. ■

Kelly O. Finnell, J.D., CLU, AIF®, founded Executive Financial Services Inc. in 1981. Finnell specializes in employer-sponsored retirement plans, including 401(k)s, ESOPs and nonqualified plans for executives. Finnell has been widely published and quoted on retirement planning topics and has spoken at seminars in more than 20 cities throughout the United States and internationally in London and Sydney. Finnell can be reached at kfin@execfin.com.



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