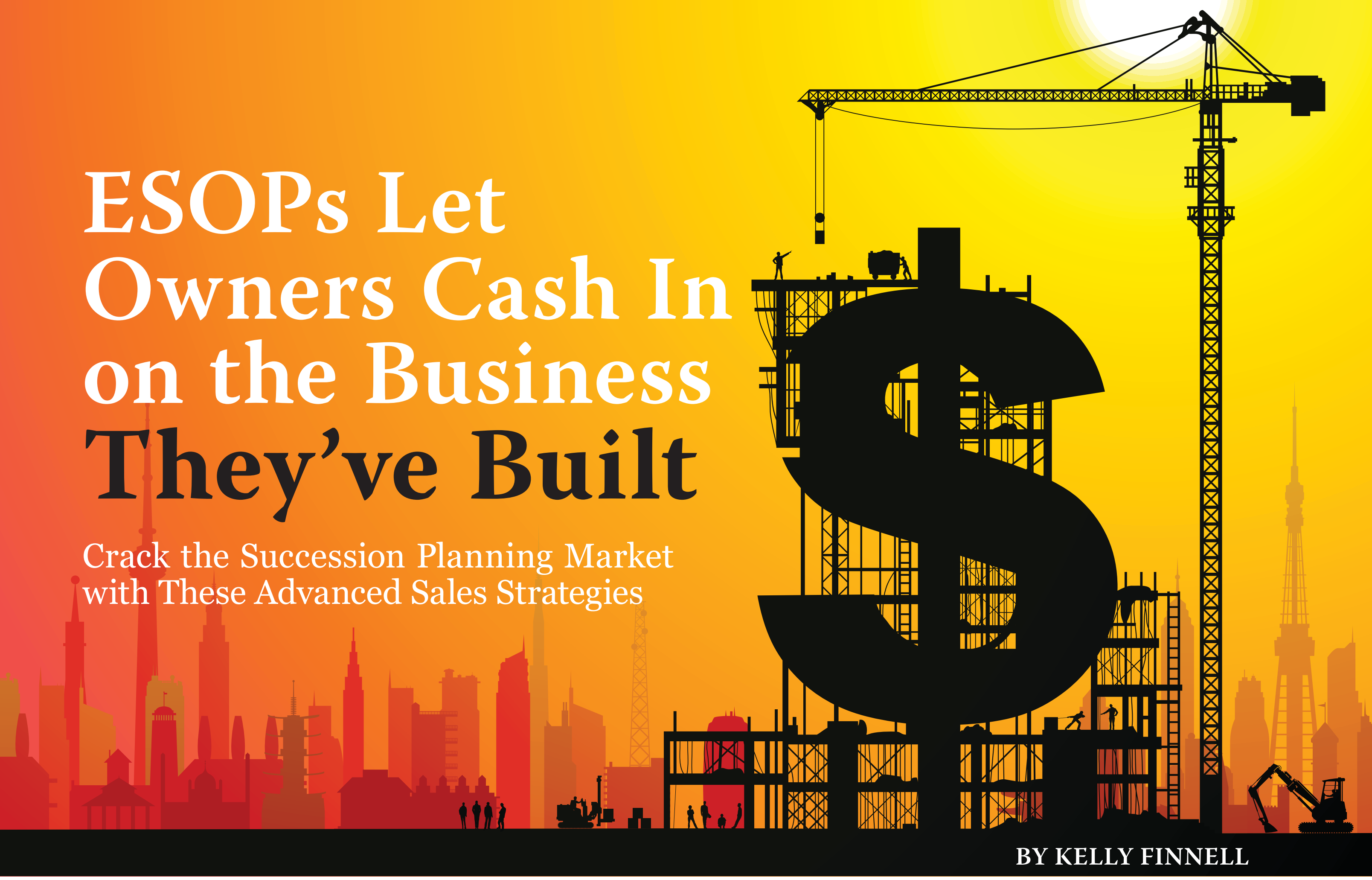

ESOPs Let Owners Cash In on the Business They've Built

Crack the Succession Planning Market with These Advanced Sales Strategies

BY KELLY FINNELL

Ownership succession planning represents a growing opportunity for insurance advisors, primarily because of the increasing number of retiring baby boomers. With the first cohort of boomers reaching age 65 in 2011, there will be many business owners asking their advisors for help with the most important financial question they've ever asked: "How can I cash in on the business I've spent my career building?"

Traditionally there have been three ownership succession planning options: sell to an insider, sell to an outsider and keep till death do us part. However, statistics indicate that there has been a significant increase in the number of business owners considering the use of an employee stock ownership plan (ESOP). According to PricewaterhouseCoopers' Trendsetter Barometer, the number of business owners considering an ESOP has increased more than 250 percent.

Interest in ESOPs is largely driven by their tax benefits, which include:

- Sellers may be able to receive their sales proceeds income-tax-free.
- An ESOP allows a company to get a tax deduction for principal payments on the ESOP loan.
- To the extent an ESOP owns stock in an S corporation, that portion of the company's income is free from taxation. In an S corporation totally owned by an ESOP, the company's income is not subject to federal taxation at the corporate or shareholder level.

ESOPs create numerous insurance planning opportunities.

The vast majority of ESOPs used in ownership succession planning are leveraged with a combination of bank debt and seller financing. The company that sponsors the ESOP is the debtor, and it should purchase life insurance to ensure its ability to pay off the debt in the event of the premature death of one of the company's key employees. The company would be the owner and beneficiary of the policy, which it may be required to assign to the lender as collateral for the loan. If there is a $5 million bank loan and $5 million of seller financing, the company should purchase $10 million of insurance and assign half of it to each of the creditors.

When business owners implement ESOPs, they often do so as part of a comprehensive planning process that includes changes to their estate plan. Many times, owners have delayed purchasing adequate amounts of life insurance because they didn't have the cash to pay premiums, since much of their net worth was tied up in their illiquid, closely held company. ESOPs create liquidity. In the example above, the business owner would have $5 million of cash plus annual cash flow from payments on the seller financing that could be used to purchase life insurance to pay estate taxes.

Long-term care insurance is a product with value that many business owners recognize, but they delay purchasing it due to a lack of cash to pay premiums.

An ESOP creates new liquidity that can be used to purchase LTCi, perhaps on a "quick pay" or single-pay basis. LTCi can help "bulletproof" a portfolio against a financial risk that many boomers will face — the medical care costs associated with longevity.

An ESOP sponsored by a closely held company requires the company to repurchase stock from ESOP participants (the company's employees) when participants become entitled to a benefit distribution. "Distributable events" include:

- Death
- Disability
- Retirement
- The participant's termination of employment (with distribution based on the extent to which his or her account is vested)

Life insurance can be used to help fund this ESOP repurchase obligation. If the ESOP is sponsored by a C corporation, life insurance could be used to accumulate cash on a tax-favored basis to fund this benefit obligation. If the company is an S corporation, life insurance typically would be used as a "cost recovery" vehicle. In this scenario the company might accumulate cash in a "side fund" and use corporate-owned life insurance to recover the cost of the side fund.

Charitably inclined business owners may want to use an ESOP in conjunction with a charitable remainder trust (CRT). The business owner could donate all or a portion of his or her stock to a CRT. The CRT would sell the stock to an ESOP, which will provide the CRT with the cash it needs to make payments to the donor. The donor and spouse would receive income from the CRT for their lifetimes. The donor also would receive a tax deduction for the value of the "remainder interest" in the CRT, which would pass to the charity's beneficiaries under a second-to-die policy. Life insurance could be purchased for an irrevocable life insurance trust (ILIT) so that the family would receive the value of the stock donated to the CRT. This technique, known as a "charitable replacement trust," could result in the family receiving the insurance proceeds on an estate-tax-free basis.

ESOPs are not the best ownership succession planning strategy for every business. However, in the right situation, an ESOP's tax benefits can make it a powerful planning vehicle. Insurance advisors can serve their clients and create opportunities for their products and services by discussing ESOPs.

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