

The ESOP boom in SUCCESSION PLANNING

Congress has created powerful tax incentives for business owners to use ESOPs as an ownership succession strategy. There's never been a better time to help your clients take advantage of them. BY KELLY FINNELL

Historically, employee stock ownership plans have been one of the least understood and least utilized types of employee benefit plans. However, the baby boomer age wave will result in an ESOP boom — and employee benefit advisers will do well to prepare themselves by increasing their knowledge of this powerful planning strategy now.

ESOPS

The first cohort of baby boomers reaches age 65 this year, with the final cohort reaching age 65 in 2029. This means there is an unprecedented opportunity for employment benefit advisers to offer services and products to aging baby boomer business owners looking for assistance with ownership succession planning.

According to a recent report from the PriceWaterhouseCoopers consulting firm:

- 72% of privately held U.S. companies plan to monetize their value eventually
- 62% of those companies are planning to do so within the next five to six years
- the desire to monetize is being driven by the need to realize and diversify wealth (66%) and owners desiring to retire (34%)
- owners anticipate that the "value realizing event" will be sale of the business to an insider/ESOP (46%) or to an outsider (41%)

According to a 2008 exit planning study, 90% of business owners recognize the importance of ownership succession planning, but only 10% have a written plan. According to the study, 90% of business owners want to learn more about ownership succession planning, with 50% stating that it is a "top" or "high" priority.

And according to Hoovers, Inc., the target market is significant. There are 195,533 privately held U.S. companies with revenues between \$5 million and \$500 million.

The ESOP as an ownership succession planning strategy

Traditionally, business owners have had three options for their succession planning: sell to an outsider, sell to an insider, or a "till death do us part" strategy. One of these succession planning strategies can be the right fit based upon a business owner's situation and goals.

But despite the fact that ESOPs have been available as an ownership succession strategy for more than 35 years, very few business owners are aware of this option and the many benefits that it provides. Let's take a closer look at using ESOPs as an ownership succession strategy — starting with some basics.

What is an ESOP?

There are three different parties or constituencies involved in ESOPs. Thus, the answer to the question, "What is an ESOP?" depends upon which constituency's perspective you are considering:

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- To an owner of a closely held company, an ESOP is a way to get money out of the company on a tax-advantaged basis and transfer control of the company to key employees or family (that is, insiders).
- To the company's employees, an ESOP is a retirement plan (like a 401(k) plan) that allows employees to share in the value of their company.
- To the company, an ESOP is a vehicle of corporate finance that offers tax benefits not available anywhere else in the Internal Revenue Code.

Advisers need to focus on income, not assets

A new report from MetLife suggests that financial advisers need to do a better job of educating their clients about the importance of managing their emotions as well as their spending and investing behavior during and close to retirement, just as they did — presumably — when they were younger and saving up for their golden years.

The report, "Engaging Clients in a New Way: Putting the Find-

ings of Behavioral Strategies to Work," encourages financial advisers to gradually shift the conversation and clients' investment strategies from accumulation of assets to the distribution of those assets into income as they near retirement.

The advice comes at a time when more and more Americans admit they're panicked about whether or not they'll have enough savings and — more important — income

when the time comes to retire.

In March, a sobering survey of 1,260 pre-retirees by the Employee Benefit Research Institute found that more than half of all respondents acknowledged that they're "not at all confident" or "not too confident" that they have the nest egg and income sources they need to afford a decent retirement — the highest level of investor uncertainty in the survey's 21-year history.

However, according to the most recent data collected by the Investment Company Institute, Americans by the end of the fourth quarter of 2010 collectively socked away more than \$17.5 trillion for their retirement years — up 9.1% year over year. Retirement savings now account for 37% of all U.S. households' financial assets, according to the Institute's data. —Larry Barrett, *Financial Planning* magazine

ESOPS

How does an ESOP work?

In many respects an ESOP works like any other type of qualified retirement plan. There are three distinct differences between an ESOP and every other type of qualified retirement plan, however, and these differences make an ESOP work effectively as an ownership succession strategy:

- 1) an ESOP can borrow money
- 2) an ESOP can engage in transactions with parties in interest (which, in this case, are the owner(s) of the business)
- 3) an ESOP is required to invest primarily in the stock of the company that sponsors the plan.

HOW STOCK IS HANDLED. The following step-by-step description illustrates how stock is sold to an ESOP in a typical ownership succession planning scenario. Also see the diagram, "How stock is sold to an ESOP," for an illustration of the relevant process.

In Step 1, the company obtains a loan, often from its current bank. This is referred to as the "outside loan." Due to technicalities in the lending laws, banks almost never lend money directly to an ESOP. Instead, they lend money to the company, which then lends it to the ESOP.

In Step 2, the company lends money to the ESOP. Generally, the company lends the same amount it borrowed from the bank in Step 1, although it could lend the ESOP more or less. This is referred to as the "inside loan." The terms (repayment period, interest rate, etc.) of the inside loan often mirror the terms of the outside loan, but in certain

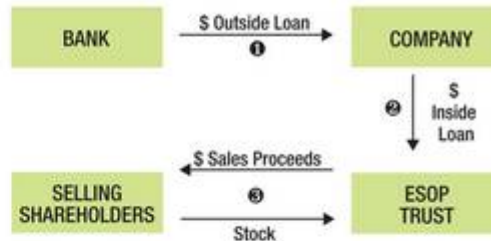
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situations there may be reasons for the terms of the inside loan to differ from those of the outside loan.

In Step 3, the employee stock ownership trust, or ESOT, uses the cash it received from the inside loan to purchase company stock from the selling shareholder(s). The stock that is purchased will be held initially in the ESOT's suspense account.

ANNUAL ACTIVITIES. See the diagram, "Annual activity in an ESOP," for an illustration of these activities and how they relate to each other.

How stock is sold to an ESOP



Annual activity in an ESOP



What are the tax incentives?

In the worst-case scenario, owners who sell stock to an ESOP will pay tax at the 15% long-term capital gains tax rate. If the company is a C Corporation, however, the seller(s) may be able to defer tax, perhaps even permanently.

Employees who participate in an ESOP are not taxed on the stock allocated to their accounts or on the earnings until they receive distributions from the ESOP — which generally occurs at death — or upon disability, retirement or termination of service (subject to vesting).

Companies that sponsor ESOPs are able to deduct ESOP contributions (subject to certain limitations). This allows the company to convert what would have been a non-tax-deductible principal payment on a loan into a tax-deductible retirement plan contribution. This tax benefit is available for C and S Corporations.

C Corporations also are able to deduct dividends paid on ESOP-held stock under certain conditions. This is the only way a company can get a tax deduction for dividend payments, and it may allow a company an avenue to get money into its ESOP in excess of the contribution limits referenced above.

S Corporations are "flow-through" entities for tax purposes, which means that they do not pay tax. Instead, their income "flows through" to their owners, who include their



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share of the company's taxable income on their tax returns. Let's follow a corporation through the process.

- Assume an S Corporation has \$5 million of taxable income and two equal shareholders. Each shareholder would receive an IRS form K-1 for \$2.5 million.
- Assume that the shareholders pay tax at the 35% federal tax rate. Each of them would pay \$875,000 in federal income tax on the S Corporation's earnings.
- However, since an ESOT (like all qualified retirement plan trusts) is tax exempt, its portion of the company's income is free from taxation.
- Therefore, in the example above, if an ESOP were one of the two owners, the tax liability on the company's income would be cut in half, saving \$875,000.
- If an ESOP owned all of the company in this example, the company's \$5 million of taxable income would be completely free from federal income tax, saving \$1.75 million in income taxes.

As you can see, these are powerful tax incentives for business owners to use ESOPs in a succession strategy.

The aging of baby boomer business owners will result in an unprecedented opportunity for the creation of new ESOPs. This represents one of the best emerging markets for employee benefit advisers to consider adding to their practice, either by developing ESOP expertise in-house, or by partnering with an experienced ESOP consulting firm. **EBA**

Finnell, J.D., CLU, AIF, is the president of Executive Financial Services, Inc., an ESOP consulting firm based in Memphis, Tenn. Reach him at (901) 259-7979 or kfin@execfin.com.