The ESOP Insurance OPP

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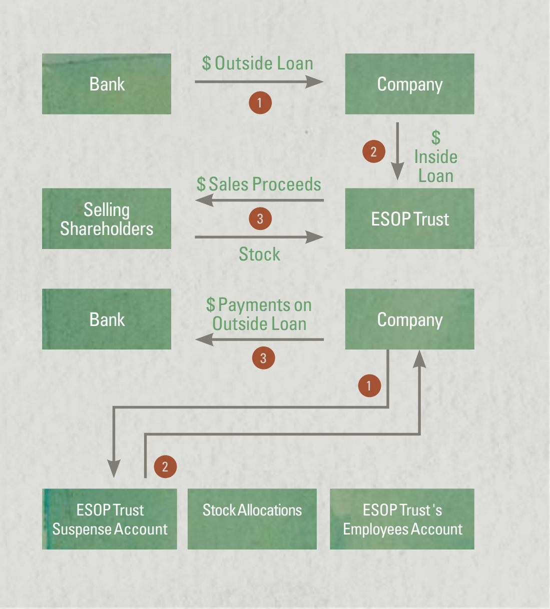
Since employee stock ownership plans (ESOPs) were introduced as part of the Employee Retirement Income Security Act (ERISA) in 1974, they have captured the attention of insurance producers who recognize the plans' appeal to their business-owner clients. They also recognize the many insurance sales opportunities that result when an ESOP is created.

Now, as the first baby boomers reach 65 this year, the ESOP market is on the verge of an unprecedented expansion as boomer business owners seek out tax-efficient ownership succession strategies.

What is an ESOP?

An ESOP is a qualified retirement plan, like a 401(k). In many respects, an ESOP works like any other type of qualified retirement plan. However, there are three distinct differences between an ESOP and every other type of qualified retirement plan. These differences make an ESOP work effectively as an ownership succession strategy.

- An ESOP can borrow money.
- It can engage in transactions with parties in interest. In this case, "parties in interest" refers to the owner or owners of the business.
- An ESOP is required to invest primarily in the stock of the company that sponsors the plan.



The chart below illustrates how stock is sold to an ESOP in a typical ownership succession planning scenario.

What are the ESOP Tax Incentives?

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

Employees participating in an ESOP are not taxed on the stock allocated to their accounts or on its earnings until distributed, generally at death, disability, retirement or termination of service (subject to vesting).

Companies that sponsor ESOPs are able to deduct ESOP contributions (subject to certain limitations). This results in a company converting 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 both 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 an avenue for a company to get money into its ESOP in excess of the

ESOP/Insurance Sale Opportunities

- Key person coverage for ESOP debt
- ESOP repurchase liability funding
- Chartiable gift/wealth replacement
- Nonqualified retirement plan funding
- Estate planning/ILIT funding
- Long-term care insurance
- Annuities

ESOP Candidate Profile Checklist

Is an ESOP for you? If most of the following describes your company, the answer may be "yes."

Yes	No	
❑	❑	Company has unused debt capacity (not heavily leveraged).
❑	❑	Company is profitable and can easily cash-flow additional ESOP acquisition debt.
❑	❑	Company and/or its owners pay taxes at or near the top marginal bracket.
❑	❑	Company has been doing business successfully for at least five years.
❑	❑	Company has a payroll of at least $1,000,000, excluding seller.
❑	❑	Company is producing sales of at least $10,000,000 annually.
❑	❑	Company is doing business in a solid industry.
❑	❑	Company has strong secondary management capable of taking over and desiring to do so.
❑	❑	Company or majority shareholders desire(s) buying out minority shareholders on a tax-deductible basis.
❑	❑	Management is interested in making acquisitions or purchasing capital goods on a tax-deductible basis.
❑	❑	Company wants to refinance existing debt, resulting in the tax-deductibility of both principal and interest on the new debt.

contribution limits referenced above.

S corporations are "flow through" entities for tax purposes, meaning they do not pay tax. Instead, their income "flows through" to their owners, who include their share of the company's taxable income on their tax return. Let's follow a corporation through the process:

- Assume an S corporation has $5 million of taxable income and two equal shareholders; each of them would receive an IRS form K-1 for $2.5 million.
- Assuming that they pay tax at the 35 percent federal tax rate, each of the shareholders would pay $875,000 in federal income tax on the S corporation earnings.
- However, since an Employee Stock Ownership Trust (ESOT) is tax exempt, like all qualified retirement plan trusts, its portion of the company's income is free from taxation.
- Therefore, in the prior example, if an ESOP were one of the two owners, the tax liability on the company's income would be reduced 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 free from federal income tax, saving $1.75 million in income taxes.

As can be seen from this example the Congress has created powerful tax incentives for business owners to use an ESOP as an ownership succession planning vehicle.

What Insurance Opportunities do ESOPs Present?

There are numerous opportunities for insurance producers whose clients implement an ESOP. ESOPs create liquidity to pay life insurance premiums and they also create corporate liabilities to be funded with corporate-owned life insurance (COLI).

The immediate insurance need when an ESOP is established is key-person coverage to insure the ESOP debt. In a typical ESOP, a company borrows 100 percent of its value from a combination of bank debt and seller financing. Thus, in a company with a fair market value of $10M, the company will take on new debt of $10M to finance the ESOP. Prudent business practice would dictate that the company purchase $10M of insurance to mitigate the risk of the company's key employee(s) dying or becoming disabled and the company not being able to repay the loan. If a premature death or disability causes a loan default, not only would the default hurt the selling shareholders' families but it also could result in a catastrophic loss of value in employees' ESOP accounts. Therefore, not only do best practices suggest life and disability insurance but there may be a fiduciary obligation to purchase coverages to protect employees' retirement benefits.

Companies that sponsor ESOPs are required to convert the stock in employees' accounts to cash upon the occurrence of one of the following distributable events: death, disability, retirement and termination of service. In addition, when employees reach age 55 and have participated in the ESOP for 10 years, the participants become entitled to diversify a portion of their ESOP account. The requirement to convert this liquid, closely held company stock to cash is known as the "ESOP repurchase liability." This company liability should be quantified by an ESOP consulting firm in an ESOP repurchase liability study and it can be funded using COLI.

Often, when a company purchases life insurance to cover a debt, it uses term insurance. However, when a company implements an ESOP, it should strongly consider using permanent life insurance. The permanent policy will serve the dual purpose of mitigating the risk of a premature death prior to repayment of the ESOP loan and funding the repurchase liability after the loan has been retired.

ESOPs create a number of other insurance planning opportunities, including funding wealth replacement trusts in conjunction with charitable ESOPs and creating liquidity to pay premiums for long-term care insurance.

The aging of baby boomer business owners will result in an unprecedented opportunity for the creation of new ESOPs and the insurance products that are integral to their success. I believe this represents one of the best emerging markets for insurance producers to consider adding to their practice, either by developing ESOP expertise in-house or by partnering with an experienced ESOP consulting firm. INN

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