ESOP STRATEGY

Consider ESOPs in Legacy Planning for Business Owners

Selling a closely held business to an ESOP can provide business continuity, along with liquidity and tax savings for the shareholder.

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An Employee Stock Ownership Plan (ESOP) is a dynamic planning strategy that can serve many purposes. Most commonly, an ESOP is used by a business owner as a liquidity and ownership succession planning strategy whereby a company creates an ESOP and trust to which the owner sells all or a portion of his or her stock in a leveraged transaction. In this type of transaction, the ESOP also serves a tool of corporate finance, allowing a company to finance a leveraged buyout on a pre-tax basis.[1] An ESOP also can create numerous estate, gift, and charitable planning opportunities, although in the authors' experience, these opportunities are underused. This article presents a case study that illustrates the benefits of integrating estate, gift, and charitable planning into an ESOP transaction.

Background

An ESOP is a qualified retirement plan and must comply with the requirements of Section 401(a). An ESOP is distinctive, however, in that it:

- Must invest primarily in the stock of the sponsoring employer.[2]
- Is permitted to borrow money (i.e., a "leveraged ESOP").[3]
- Can engage in transactions with a party-in-interest (i.e., the ESOP can purchase stock from the sponsoring company's shareholders).[4]

ESOPs used in ownership succession planning typically are leveraged. An exemption to the prohibited transaction rule, which prevents qualified retirement plans from borrowing money from their sponsoring employers, allows loans to ESOPs provided the loans satisfy certain statutory requirements.[5]

An ESOP can provide multiple tax benefits for the company and the selling shareholder, the precise nature of which may vary depending on whether the corporation is taxed as a C or S corporation:

- The company may deduct its annual contributions to the ESOP.
- A C corporation may deduct dividends it pays on ESOP shares.
- Under Section 1042, a shareholder who sells C corporation stock to an ESOP may reinvest the proceeds received from the ESOP sale in "qualified replacement property" without immediately paying income tax on those proceeds.
- A 100% ESOP-owned S corporation can essentially operate as a tax-exempt entity.

Case study scenario

Jim and Joyce Smith, each age 70, have been married for 47 years. Jim is the founder, CEO, and sole shareholder of ABC Inc., a successful distribution company taxed as an S corporation. The Smiths have two children: Bob, age 45, who is active in the management of the company and Mary, age 42, who is a physician and not involved in the company. Jim has received a salary and bonus from the company of $1 million and S corporation distributions of $4 million for the past 15 years. Based on input from his advisor team, Jim believes that the company's equity value is $40 million. Jim and Joyce own assets outside the company worth $20 million.

Over the past five years, Jim has been considering ownership succession and liquidity strategies. Like most successful business owners, Jim receives many calls from investment bankers who tell him they would like to represent him in a sale of the company to a private equity group (PEG).

A few years ago, Jim hired an investment banker to prepare and distribute a confidential information memorandum and arrange meetings

1 For additional information, see Finnell and Holmes, "Consider ESOPs as an Estate Plan Component for Business Owners," 41 ETPL 3 (September 2014).

2 Section 4975(e)(7)(A).

3 Section 4975(d)(3).

4 Section 4975(c)(1).

5 Section 4975(a); Reg. 54.4975-7(b)(2).

with potential PEG purchasers. As Jim learned about the risks that are inherent in sales to a third-party such as a PEG, this strategy became less attractive. Jim realized that many of the key provisions of a purchase agreement such as representations, warranties, indemnifications, and escrows can result in a substantial amount of the supposed proceeds never being paid or being clawed back. More importantly, he realized that he began this process without first considering goals for himself, his employees, the company, and his family.

While the PEG could promise a big payday, Jim had spent the last 40 years creating and nurturing a certain company culture that he did not want to hand over to a PEG whose mission is to maximize returns for its investors. It is possible that the best interests of the PEG and its investors may be at odds with the best interests of the company's employees and its customers. Therefore, Jim terminated the third-party sale process and spent time with Joyce considering their goals and other liquidity options.

The Smiths' goals focused on creating a legacy of financial security for their children and grandchildren, as well as a sense of significance resulting from the establishment of a charitable trust to support their community, church, alma mater, and other worthy causes. Jim and Joyce also sought an equitable way to divide their assets between their children, a process that can be challenging for business owners. Like many business owners, two-thirds of the Smiths' net worth was tied up in the company. Therefore, if they left the company to Bob (the active child), Mary would be disadvantaged. On the other hand, leaving Mary a 50% interest in the company that Bob managed would present a host of challenges.

Based on discussions with their team of professional advisors, Jim and Joyce decided the answer to their planning challenges was for the company to establish an ESOP that would purchase 100% of Jim's stock.

Planned transaction. Section 1042 provides a tax deferral to shareholders who sell C corporation stock to an ESOP. Therefore, the company revoked its Subchapter S election prior to the ESOP transaction in order to give Jim the option to elect the tax-favored treatment under that Code section.

The company financed the ESOP transaction with a $20 million senior bank loan, fully amortized over five years, and a $20 million subordinated seller note. Jim will receive $20 million in cash at closing (from the senior bank loan) and he will receive payments of interest at the rate of 6% on the seller note until the senior bank loan is fully paid, at which time the seller note will be fully amortized over three years (or refinanced with a new bank loan). The seller note also has detachable warrants equal to 25% of the company's fully-diluted equity. The combination of a 6% interest rate and detachable warrants for 25% of the company's fully-diluted equity provides an all-in return on the seller note consistent with returns for commercial subordinated debt.

Post-transaction position. Immediately after the transaction, Jim and Joyce's assets include the $20 million of investable assets they had prior to the transaction, plus $20 million of cash they received at closing and a $20 million seller note with detachable warrants. The planning process often ends when the ESOP transaction closes; however, Jim and Joyce's advisors recognized this was just the first step in the process.

Jim elected Section 1042 tax treatment on his cash proceeds, and his financial advisor helped him select a diversified portfolio of income-producing stocks and bonds that satisfied the "qualified replacement property" (QRP) requirements of that Code section. Jim purchased those assets solely in his name so that at his death, the beneficiaries of his estate would receive a stepped-up basis in those assets, converting a tax deferral into a tax forgiveness that saves $4.76 million of federal long-term capital gains tax ($20 million × 23.8%).

Charitable giving. Jim and Joyce also had charitable planning goals in addition to tax, liquidity, and ownership succession planning goals. Ultimately, the Smiths sought to make a charitable gift equal to 50% of the value of Jim's stock. The Smiths considered the following three planning alternatives to achieve their charitable planning goals.

Jim first considered making a gift of half of his ABC stock to a charity or charitable trust prior to the ESOP transaction and then have the charity sell that stock to the ESOP. This approach would result in Jim avoiding paying long-term capital gains tax when the stock is sold because it will be sold by the charity rather than by Jim. He also would receive an income tax deduction for the value of the gift, subject to Internal Revenue Code limitations. This planning option had to account for the impact of a discount for lack of control (i.e., a minority interest discount) that is applied when determining the value of the charitable income tax deduction. Because Jim considered making a gift of a noncontrolling interest (i.e., not more than 50%) in the company's stock, the value of the gift would be sub-

ject to the minority interest discount. Assuming a 20% discount, the value of the gift would be $16 million rather than $20 million.

The second alternative Jim considered was making a charitable gift of the $20 million cash proceeds he received at closing. Because Jim preferred to avoid paying tax on his capital gain, he would invest his $20 million cash in QRP and then make a charitable gift of the QRP. This gift would not be subject to the minority interest discount, which results in the value of the gift being $20 million rather than $16 million (as the option above).

Based on his planning goals and with the advice of his advisors, Jim made a gift of the $20 million seller note (but retained the detachable warrants) to a charitable remainder trust (CRT), naming a donor-advised fund (DAF) established at his local community foundation as the remainder beneficiary. Jim's family was given the ability to direct grants from the DAF to qualifying charities each year. Jim and Joyce created a separate document that described their family values and instructed their children and grandchildren to meet semiannually to discuss and direct the disbursement of the grants to charities that supported those values. Jim and Joyce felt that this was a key component in helping perpetuate their values and legacy over succeeding generations. The value of the CRT gift (the remainder interest) was $12.26 million, resulting in income tax savings of $4.9 million (40%).

The calculation of the value of the CRT gift is based on Jim retaining a 6% income interest ($1.2 million annually) for eight years. Jim and Joyce gifted this $1.2 million CRT payment each of the eight years to a dynasty trust, which purchased $20 million of survivorship life insurance. Because the total premium of $9.6 million was less than their combined lifetime gift tax exclusion of $10.9 million, no gift tax was due on the gift, and the $20 million life insurance proceeds would pass outside their estate, saving an additional $8 million in estate taxes (40%).

The gift of the seller note is a "disposition of an installment obligation," resulting in a taxable gain equal to the difference between Jim's basis in the seller note and the fair market value of the installment obligation. Therefore, the result will be the same as if Jim had elected not to report the seller note under the installment method. He will report a long-term capital gain on the disposition of the note in the year of the gift to the CRT. For some taxpayers, this mismatch of tax being due in year one but cash being received in subsequent years could create a financial hardship. Fortunately for Jim, he and Joyce have an investment account with $20 million of liquid assets and Jim received $20 million in cash at closing from the ESOP. (When calculating Jim and Joyce's assets after the transaction, the $4.9 million long-term capital gains tax Jim paid on the gift of the note to the CRT has been subtracted.[6])

Company's future. Jim made a gift of the retained warrants to his son, Bob, who became the president and chairman of the board of the company. The warrants will provide a powerful equity incentive for Bob to continue to grow the company. The strike price of the warrants is based on the company's post-transaction drop in value. A 5% organic company growth rate, coupled with the deleveraging of the ESOP debt, will produce a value of $15.8 million of the warrants in eight years. The gift tax value of the warrants, which is based on the Black Scholes option pricing model, is $2.22 per share for 333,333 shares, or $739,999.

The amount of this gift plus the total amount of the annual gifts to the dynasty trust ($10.34 million) is less than the $10.98 million gift tax exclusion for 2017.

Overall impact. The charts in Exhibit 1 illustrates Jim and Joyce's assets before and after implementing the ESOP transaction and planning strategy.

In the process of achieving their financial and legacy goals, Jim, Joyce, and the company together have saved $48.6 million in federal taxes, consisting of the following:

- Section 1042 income tax savings (23.8% of $20 million)—$4.76 million.
- Income tax deduction for $20 million gift of seller note to CRT (40% of $12.26 million remainder interest—$4.90 million.
- Estate tax savings on $20 million dynasty trust (40%)—$8.00 million.
- Gift tax savings on warrants (40% of [$15.8 million future value less $740,000 value of gift])—$6.02 million.
- Present value of company tax savings over first ten years after ESOP transaction—$24.92 million.

Using an ESOP transaction as part of an overall estate and gift tax planning strategy can allow business owners to maximize their legacy while minimizing taxes. Through the skilled advice of their advisor team, Jim and Joyce have used an ESOP transaction as more than a liquidity and ownership succession

6 See Section 453(e)(1)(B) regarding dispositions of installment obligations.

planning strategy; they have achieved their comprehensive planning goals.

Jim and Joyce will be financially secure for life. Jim will continue to receive an annual salary of $1 million from the company after the ESOP transaction, but since he is no longer a shareholder of ABC, he will no longer receive annual distributions of $4 million; however, assuming their $35.1 million investment account produces an annual return of 5%, Jim and Joyce will have an annual income of $2.75 million per year. This income will be sheltered from tax for 4.45 years by the income tax deductions of $12.26 million generated by the CRT gift. The $20 million life insurance-funded CRT will provide a financial legacy for their community, church, alma mater, and other worthy causes and will serve as a platform to perpetuate Jim and Joyce's values.

The company's employees will continue to work in a culture they have come to know and thrive under, and will not be subject to the whims of a PEG whose primary focus is maximizing returns for its investors. The liquidity created by the transaction will allow Jim and Joyce to treat each of their children fairly without having to deal with the challenges inherent in leaving company stock to an inactive child. Bob will serve as the company's CEO after the transaction, and the warrants will provide him a very generous financial incentive to continue to grow the company.

Conclusion

While cashing in on one's lifework is a worthy goal, doing so while building a legacy that will last for generations represents a higher calling for many business owners. Jim and Joyce have created enduring legacies for their family, company, and community. For their family, they have provided financial security for their children, grandchildren, and succeeding generations. They also have defined and created a system to reinforce their family's values through semi-annual family meetings.

For the company, they have created a liquidity event while protecting their employees from the risks inherent in a sale to a third party, such as downsizing and relocation. The ESOP also will provide their employees an equity-based incentive to increase employee productivity and enhance their employees' financial security. For their community, they have created a $20 million trust that will make grants to worthy causes.

Section 1042 provides a tax deferral to shareholders who sell C corporation stock to an ESOP.

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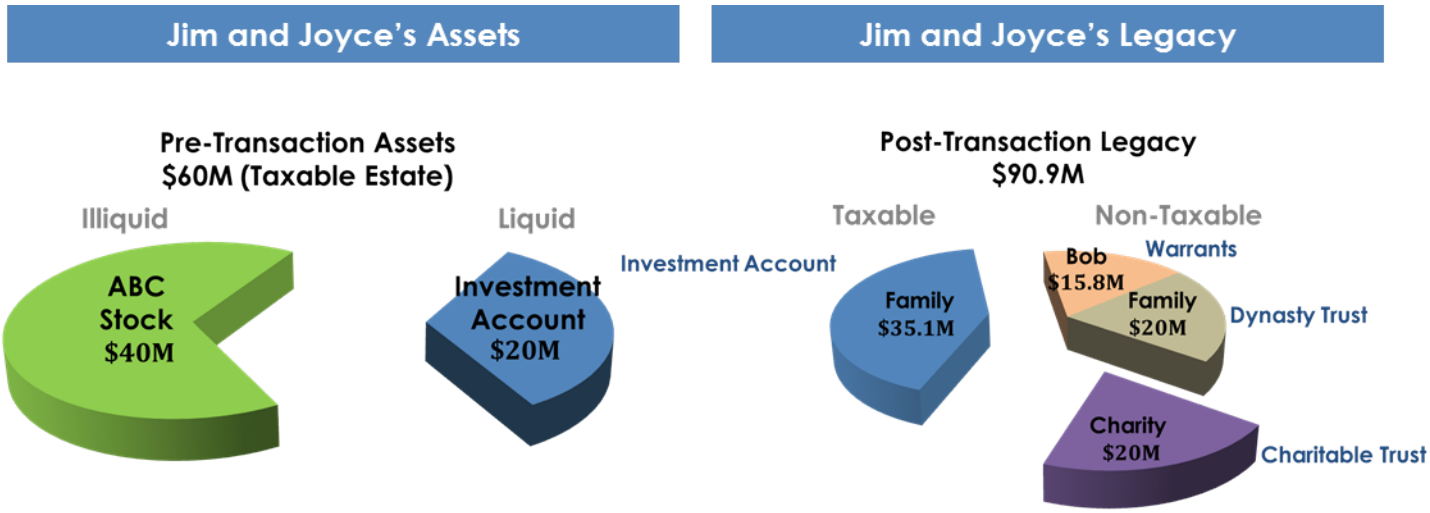
Exhibit 1



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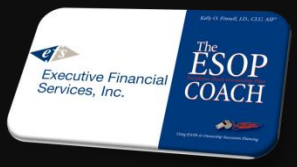

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