Guardian

A tax-deductible business succession plan using an ESOP

An Employee Stock Ownership Plan (ESOP) is a qualified pension plan that permits the plan trustee to purchase shares of stock of the employer. Shares are allocated to each plan participant's account, but at retirement the stock is usually sold back to the employer for cash (a put option on the stock). This helps to motivate employees to help make the company profitable, since retirement benefits are directly based on the future value of the company. But perhaps more importantly for you, the business owner, the ESOP can be an exit strategy. You will have a ready buyer and can sell all or a portion of your stock in the company when you're ready to leave, at fair market value, and defer income taxes on the gain.

To better understand how an ESOP can be used as an exit strategy, let's look at a hypothetical case that perhaps might be similar to your situation. Jervis Manufacturing Company was started 25 years ago by Bob Jervis. Bob is currently 65 years old and owns 60% of the company. His two children own the remaining 40% equally. The fair market value of the company is $10,000,000. The company has realized a steady growth over the past years. The company has 35 employees and two key executives (other than the Jervis family). The children have received their equity interest in the company through wealth transfer planning by Bob and his spouse.

Like most business owners, Bob's wealth is reflected in his company. He wants control to remain in the family and wants to convert his equity into cash for retirement. He considered selling his interest to his two children, but was concerned about burdening the company's and his children's cash flows since they would undoubtedly have to buy him out in installments. In addition, each installment payment would reflect capital gains and interest that had to be reported as income. Furthermore, after-tax funds would be used to pay for the stock.

Bob's financial representative realized that all of his business and financial goals could be achieved by having the company create an ESOP to purchase his stock.

The steps are as follows:

1. The company borrows $6 million from a lender. Interest on the loan would be based on current rates and the financial stability of the company.
2. The company, in turn, would loan the $6 million to the ESOP.
3. The ESOP would use the funds to purchase the stock from Bob.
4. During the valuation process, a "repurchase liability study" is usually performed. This study shows the liquidity needs of the plan to buy out those participants who will be retiring. The ESOP may not have enough liquidity in the early years and must resort to loans. Life insurance is usually purchased on the older and/or major stock holders as a funding vehicle for the future "repurchase liabilities" of the plan.
5. To assure an arm's length transaction, an independent appraiser values the company, and the ESOP hires an independent trustee.
6. The loan is repaid by having the company make income tax-deductible contributions to the ESOP. Remember, an ESOP is a defined contribution plan and the company can contribute the lesser of 100% of compensation or $69,000 (2024 amount as indexed for inflation) for each plan participant.
7. The plan trustee uses corporate contributions to repay the loan made by the company, and the company uses the same dollars to repay the lender.
8. Stock is held in a suspense account in the trust and is only allocated to plan participants as the loan is repaid.

Once Bob receives his $6 million, he can elect to purchase "qualified replacement securities", as defined by Sec. 1042 of the Internal Revenue Code. If Bob holds the replacement securities until death, his beneficiaries will realize a step-up in basis and no income tax will ever be paid on the gain on these investments. If Bob wants to further diversify his portfolio, he can pledge his securities for a loan and use the cash to purchase other types of investments. Eligible securities that fit the definition of "qualified replacement securities" include common stocks, convertible bonds, fixed-rate bonds, and corporate floating rate notes, or other securities of operating companies incorporated in the US. It does not include government bonds, mutual funds, real estate investments trusts, or ownership through means other than a security.

After the transaction, Bob's children have control over the company. While a large portion of the stock is owned by the ESOP trust, they have indirect control since they can appoint the trustee. As plan participants retire and the company purchases their stock, the children's equity percentage in the company will increase.

An ESOP makes financial sense to the children since it effectively reduces the cost of the buyout of their father. In a traditional purchase, the company or the children would have to use after-tax funds to pay their father. The ESOP, however, enables the company to finance the transaction with pre-tax funds through employer contributions.

ESOPs are not for every business owner who wants to sell and have his children remain in control. There are many rules and complexities not discussed here. However, ESOPs are often not considered by business owners and advisors because of a lack of knowledge. Working with your other professional advisors, this option may be attractive to you if you wish to retire from the business and have family employees maintain control of your legacy.

Please consult with your Guardian financial professional if you have any questions concerning this document.

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