Guardian

Business Succession and Estate Planning with an ESOP

As the owner of a privately held corporation, you've worked long and hard to build up the business and make it a success. Now that there is some stability and certainty for the future of the business, you know that you need to start thinking about your future – retirement as well as what's next for the business without you. But, you also want to take care of your employees because without them, you would not have succeeded. It would be nice to be able to share some of the success with them. What can you do?

One Solution – an Employee Stock Ownership Plan (ESOP)

An ESOP is a form of qualified retirement plan similar to a profit sharing plan, and must comply with eligibility and participation rules. Used correctly, however, the ESOP can also be used as a business and estate planning tool. Hence, a business owner can fulfill many of his or her needs, whether personal or business. The retirement plan aspect of an ESOP helps to provide a valuable employee benefit to the employees as well as the owner. The plan also provides employees an ownership interest in the company which improves productivity and morale. For the business owner, the plan provides a way to transition out of the business and to convert business wealth to personal financial wealth.

How Does it Work?

A good candidate for an ESOP is a corporation that:

- is either an S or C corporation, but preferably a C corporation;
- is privately owned with significant ownership held by one or a few individuals;
- can reasonably be expected to have revenues and payroll expenditures sufficient to maintain an ESOP over the next 5-10 years to accomplish the ownership transfer;
- has at least a 5 year history of steady earnings;
- expects to pay significant federal income taxes in the future and has paid them in the past;
- has made contributions to another qualified employee retirement plan; and
- has a culture where the owners have an interest in sharing ownership with the employees

The company sets up an employee stock ownership plan that includes an Employee Stock Ownership Trust (known as an ESOT). The ESOT is the vehicle that holds the stock on behalf of the employees. The company contributes new shares of its own stock or cash to enable the trustee to buy the company shares for the benefit of the employee participants. Company contributions to the plan are generally tax-deductible. Shares in the plan are then allocated among the employees based on the contribution formula -- usually on a proportionate basis as determined by each individual employee's compensation as a percentage of total compensation. Employees who meet the eligibility requirements of the plan become plan participants. Employees become vested based on the schedule set in the plan. This is similar to a profit sharing plan. Employees must be fully vested after 5 years (5-year "cliff" vesting) or six years (6-year graded vesting). This is the retirement planning and employee benefits aspect of the ESOP. This plan also gives employees an ownership interest in the company, along with the pride and productivity it brings.

Business and Estate Planning Benefits of an ESOP

Owners of privately held companies can use an ESOP to create a ready market for their shares. This is one of the most common uses of an ESOP. When employees terminate employment, they receive their stock from the plan, but the company ESOP must buy the shares back from the employee at its fair market value (the "repurchase obligation"). The company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares. (When an ESOP borrows money to meet its obligations, it is usually called a "leveraged ESOP.")

When the employee is a business owner, and the business owner dies, the repurchase obligation can create significant financial difficulties for the company because large sums of cash must be on hand to handle the purchase of a large block of shares. As a result, life insurance is typically used to help fund this future repurchase obligation.

Since the business is often the largest asset in the estate of a business owner, that fact can create liquidity problems when estate taxes are due. The estate, however, can raise cash through the sale of stock to the ESOP. Generally, a sale to an ESOP will result in no capital gains due to a "step-up" in basis of the stock to fair market value on the date of death. And, as in the business planning situation, corporate owned life insurance will help to ensure that the ESOP has sufficient cash to buy the stock.

Additional Considerations

1. Contributions to the ESOP are tax deductible.

2. Contributions of corporate stock to an ESOP are tax deductible.

3. Contributions are deductible up to 25% of eligible compensation. For C corporations, however, there are additional deductions available for contributions made to repay principal and interest on a plan loan: (a) up to 25% of covered payroll for principal payments; and (b) unlimited to repay plan interest.

4. Contributions made by the company to an ESOP can be in the form of newly issued or treasury shares. Alternatively, the company can contribute cash, buying shares from existing public or private owners.

5. ESOPs provide shareholder and/or corporate liquidity.

6. In C corporations, the seller can reinvest the proceeds of the sale of the corporate shares in certain publicly traded securities ("qualified replacement property") and defer any taxes on the gain, provided the ESOP owns at least 30% of all the shares in the company.

7. If the company is an S corporation, the ESOP's share of earnings from the corporation is not subject to federal or, in many cases, state corporate income taxation.

8. Increased owner control of business identity.

9. ESOPs are a defense against a hostile takeover.

10. ESOPs can be a vehicle for gifting.

11. ESOPs can improve employee morale.

12. Life insurance can help fund the company's repurchase liability.

13. Employees of privately owned companies must be able to vote their allocated shares on major issues, such as closing or relocating the business, but the company can choose whether to provide other voting rights on other issues (e.g., for the board of directors). Employees of public companies must be able to vote on all issues.

14. A private company must have a valuation appraisal done each year to determine the price of its shares.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

The Guardian Life Insurance Company of America

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Guardian Financial Representatives may call the Business Resource Center at (800) 871-7780, Option 3, for additional information.