

ESOPs as Estate Planning Tools to Create Liquidity for Closely Held Stocks

By Richard A. Schlueter, ASA
President

At times it can be difficult to find advantageous ways to transfer a closely held business interest held in a trust, an estate or by retiring employee shareholders. Using a leveraged ESOP to accomplish the transfer can provide several tax advantages, as well as advantages to both the selling shareholder, management, and the employees of the company.

How an ESOP Works

In the first step of a leveraged ESOP transaction, the bank lends money to the ESOP with a company guarantee. As an alternative, the bank could lend the money directly to the company, which would, in turn, lend the money to the ESOP. Second, the ESOP uses the proceeds of the loan to buy stock from the existing shareholders. Third, the company makes annual, tax-deductible contributions to the ESOP, which in turn repays the bank (see the diagram below). In the fourth step, when employees leave the company, they can keep their stock or put the stock to the company and receive cash.

A leveraged ESOP enables exiting shareholders to diversify their asset holdings while allowing ownership, and in some cases management responsibilities, to be transferred to the remaining employees of the corporation.

Chicago Office

129 W. Wesley Street
Wheaton, IL 60187
phone 630.462.9100

Cincinnati Office

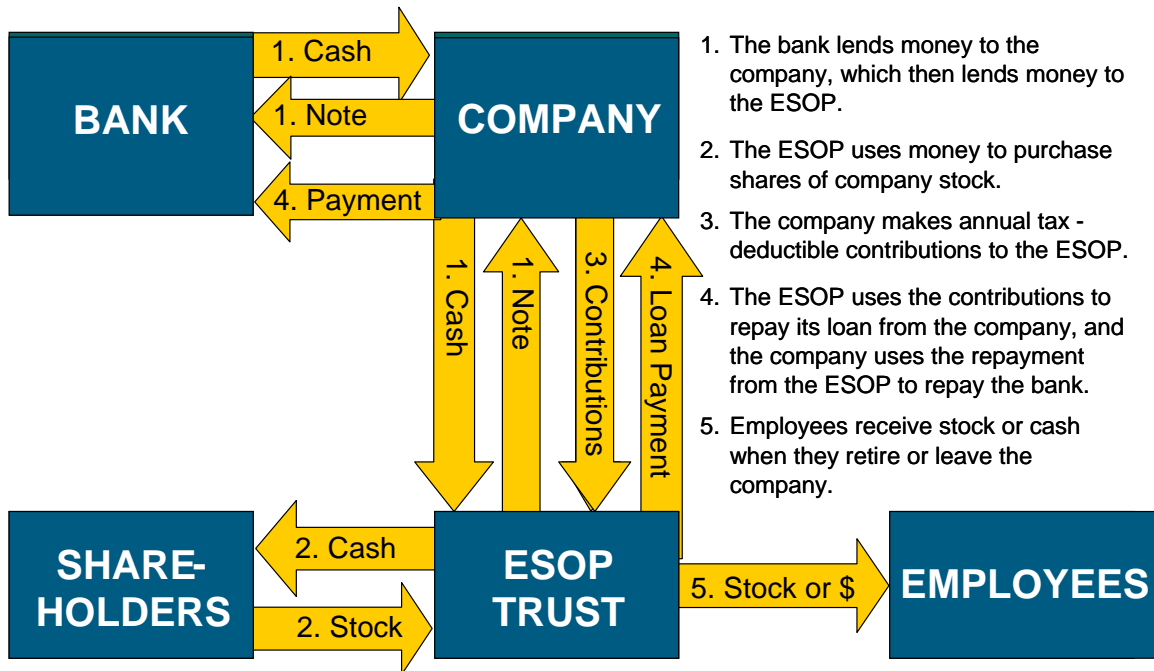
1 Levee Way, Suite 3109
Newport, KY 41071
phone 859.957.2300

Columbus Office

1335 Dublin Road, Suite 225-A
Columbus, OH 43215
phone 614.485.9470

Winston-Salem Office

4400 Silas Creek Parkway, Suite 103
Winston-Salem, NC 27104
phone 336.765.1155



1. The bank lends money to the company, which then lends money to the ESOP.
2. The ESOP uses money to purchase shares of company stock.
3. The company makes annual tax - deductible contributions to the ESOP.
4. The ESOP uses the contributions to repay its loan from the company, and the company uses the repayment from the ESOP to repay the bank.
5. Employees receive stock or cash when they retire or leave the company.

Advantages for all the Parties in the ESOP Transaction

Advantages for the Company

Every year the company makes tax-deductible contributions to the ESOP, which uses the funds to repay the ESOP loan. The company may deduct up to 25 percent of covered payroll for contributions to repay the principal on an ESOP loan. However, the amount of the contribution applicable to the interest payment on the loan is fully deductible. Total contributions per employee to defined contribution plans must not exceed the lesser of \$46,000 or 25 percent of compensation for 2008.

Under certain conditions, dividends paid on ESOP stock are also tax deductible for the company. As long as they are used to make ESOP loan payments or are paid to the participants, the dividends are deductible. Furthermore, dividends paid on ESOP stock are not part of the contribution limits.

From a cultural perspective, the company benefits by giving employees an ownership stake in the company, which will likely lead to

greater job satisfaction and improved productivity. ESOP benefits can also help the company attract employees by giving the company an edge in this tight employment market.

Advantages for the Selling Shareholder

A leveraged ESOP can provide the selling shareholder with an exit vehicle that will allow him to pass the business on to the employees who helped build the company. In fact, those employees may be the most logical buyer for certain companies. An ESOP can also serve as an anti-take over defense that allows for an efficient transfer for ownership.

The selling shareholder may be eligible for certain tax advantages when selling stock in a regular C corporation to an ESOP. As long as his proceeds are invested in qualified replacement securities, the selling shareholder can defer taxes on the gain from the sale of his stock in the corporation. To qualify for this tax treatment, the ESOP must own at least 30 percent of the participating stock of the company after the sale. In addition, the selling shareholder must have owned his stock for at



least three years before the sale. Furthermore, the capital gains tax from the sale can be completely eliminated if the selling shareholder retains the qualified replacement securities until his death, at which time the estate's basis in the investments are stepped-up to the fair market value at the time of death.

By investing the proceeds in replacement securities, the selling shareholder achieves a more diversified portfolio to ensure security in retirement. A leveraged ESOP also allows for the purchase of marketable assets to provide liquidity to satisfy estate tax liabilities.

Advantages for Management

ESOPs can ultimately result in improved performance from management by providing them with an ownership stake in the company. Aside from enhancing the performance of current managers, it can also improve company performance by attracting key personnel from the outside.

An ESOP can be thought of as an additional employee benefit. It can serve as an alternative to a pension or profit sharing plan. ESOPs can also help the company defend against hostile management takeovers. Alternatively, in cases where management does not have sufficient wealth to finance an outright purchase of the company, an ESOP can provide a way for them to buyout major shareholders.

Advantages for Employees

Similar to management, ESOPs may provide employees with greater incentives to improve productivity by making them partial owners of the company. Furthermore, the ESOP will give employees the opportunity to enjoy capital growth. In fact, it may provide this benefit to many employees who might not otherwise have the opportunity to participate in capital markets.

Trustee Considerations

Aside from the numerous advantages outlined above, the trustee of an estate or an estate planner might recommend selling shares of a closely held business to an ESOP for a number of reasons.

- An ESOP can provide liquidity. Selling shares of a closely held corporation to an ESOP can provide an exit strategy in situations where there may be few potential buyers. There is a limited market for interests in closely held corporations. In many instances, the only potential buyers may be the company, management, or perhaps other shareholders. If none of these parties are interested in buying the existing shareholder's interest, an ESOP can provide a way to obtain liquidity in a very restricted market.
- The selling shareholder may receive higher net proceeds by selling his shares to an ESOP. If the shareholder is able to roll the proceeds of the sale into qualified securities, his net proceeds will be higher because of the deferral (or avoidance) of capital gains taxes.
- The selling shareholder may receive a higher price for his shares from the ESOP. Under current regulations, an ESOP company must make a market for the ESOP shares when the employee leaves the company. In contrast, a third-party buyer will not have this ready-made market when he decides to sell his shares and may therefore demand a discount because of the investments lack of liquidity.
- An ESOP can help the trustee fulfill his obligation to diversify the holdings of the trust. In many situations, a closely held business represents a significant portion of the trust's holdings. By selling the shareholder's stock in the company and rolling the proceeds over to qualified securities, the trust achieves much-needed diversification.
- The sale to an ESOP can help a trust provide income benefits. An income beneficiary of a trust that holds a



closely held business can be at a disadvantage if the company does not pay dividends. In cases where income is needed, the trustee can recommend selling the shares in the company to an ESOP and reinvesting the proceeds in income-producing assets.

Identifying Good Candidates for Leveraged ESOP's

Under the right circumstances, ESOPs can provide advantages to all parties involved in the transaction and can be a powerful estate-planning tool. Some companies and certain selling shareholders are better fits for ESOPs than others. In general, one or more of the following conditions must be present for an ESOP to be a viable alternative:

- **The company has excess cash and/or marketable securities on its books.**
Under these conditions, the company doesn't have to use outside financing. It can simply loan the funds necessary to purchase the stock directly to the ESOP. It provides the added advantage of getting the cash off the company's books without incurring a capital gains tax or an accumulated earnings tax.
- **The company is making reasonably high contributions to another qualified plan.**
In this situation, the company can redirect those contributions to a qualified ESOP. Furthermore, under another qualified plan, the contributions leave the company and go into a separate trust. Under an ESOP, those funds can be used to pay down the ESOP debt.
- **The company has no or low debt.**
These low-debt companies are better able to take on the debt required for the leveraged ESOP buyout.
- **The selling shareholder has a very low basis in the stock of the corporation.**
In this situation, the shareholder faces the possibility of significant capital gains tax. An

ESOP may be particularly attractive if it can help the shareholder defer or avoid taxes through a tax-free rollover of the proceeds into qualified replacement securities. However, it is important that the selling shareholder's block of stock be large enough in value to justify the cost of the transaction. Although size is not a legal constraint, leveraged ESOPs can be cost prohibitive for blocks of stock that are worth less than \$500,000.

- **The company has valuable collateral assets.**
Manufacturing companies in particular often have significant investments in fixed assets, such as machinery, equipment and land. A company will be a better candidate for an ESOP if it has such assets that can be used as collateral to secure the ESOP loan.
- **The company is an S Corporation.**
Companies that have elected S corporation tax status may be particularly good candidates for a leveraged ESOP because of their ability to repay a substantial portion of the ESOP loan via tax savings.
- **The company has an existing ESOP.**
If a company already has an ESOP in place, the ESOP can simply purchase additional shares. In addition, this company has already been through the ESOP process and has an ESOP culture in place.
- **The company has a strong existing management team that will continue on after the ESOP Transaction.**
A company with a solid, consistent management team will likely make the transition to an ESOP culture more successfully than a company that has to endure a managerial transition as well.
- **The company's payroll is a high percentage of revenue.**
These circumstances make it easier to come in under the contribution limits. In addition, companies that have this characteristic are likely service companies whose employees



are motivated to own an equity interest in the business.

- **The company must be a corporation.**

An ESOP can be implemented in both a regular corporation and a corporation with an S election. Sole proprietorships, partnerships, limited liability companies, and limited liability partnerships would need to change to corporate status to implement an ESOP.

- **The selling shareholder has charitable intentions.**

The shareholder may choose to take advantage of the rollover tax benefit an ESOP provides, and then donate the qualified replacement securities to a charitable organization. He can also achieve his objectives by donating his stock in the corporation directly to the charity, which can then sell the shares to the ESOP.

Determining the Feasibility of a Leveraged ESOP

The first step in implementing an ESOP is to assess its abilities to meet the needs of the parties involved. For an estate or trust, the next step is to contact the company to discuss the possibility of implementing an ESOP in order to provide an exit strategy for the selling shareholder.

If the objectives of the parties run counter to the benefits of the ESOP, then another method of transferring ownership may be more appropriate. For example, if the owner's objective is to keep control of the company entirely within the family by transferring ownership to his children, an ESOP may not be the most efficient means to achieve that goal.

Furthermore, the level of debt required to establish an ESOP must also be considered. The leverage transaction can weaken the balance sheet of the corporation. An already highly leveraged company may not have sufficient borrowing capacity to incur the additional debt caused by the ESOP transaction.

Those considering initiating an ESOP should also consider the cost to implement and maintain an ESOP. Companies will incur legal and financing fees at the outset as well as the cost of the initial valuation. The IRS also requires that the company be valued annually by an independent appraiser. In addition, the ESOP will incur annual administrative expenses and will incur trustee fees if a professional fiduciary is retained. The benefits of the ESOP will usually greatly outweigh the ongoing costs, but it is important to be aware of them at the outset.

Conclusion

An ESOP can be an effective and advantageous estate-planning tool. ESOPs provide many tax advantages for the company and the selling shareholder. It can also provide for a more productive and motivated management team and workforce.

Trustees often find ESOPs useful as a way to provide an exit strategy for interests in closely held corporations. In addition, ESOPs can help a trustee meet his obligation to provide diversification for a trust portfolio. ESOPs can also help a trustee achieve income for beneficiaries of a trust.

When looking for situations where ESOPs work best, it's important to consider the characteristics of the company as well as the intent of the selling shareholder. Companies that can support debt and can successfully adjust to an ownership culture are the best candidates for ESOPs. In addition, selling shareholders who have a low tax basis or are in need of liquidity may also find an ESOP an attractive exit strategy.

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About the Author

Richard A. Schlueter



Rick is a Senior Member of the American Society of Appraisers and is a cofounder of ComStock Advisors. He has over 20 years of experience in the valuation and management of closely held business interests, as well as securities comprising their capital structure. He has extensive background in trust and estate planning, Employee Stock Ownership Plans (ESOPs), litigation support, and related financial advisory service. He has acted as an arbitrator and has served as an Expert Witness or Consulting Expert regarding financial issues in the United States Federal Tax Court and the United States District Court.