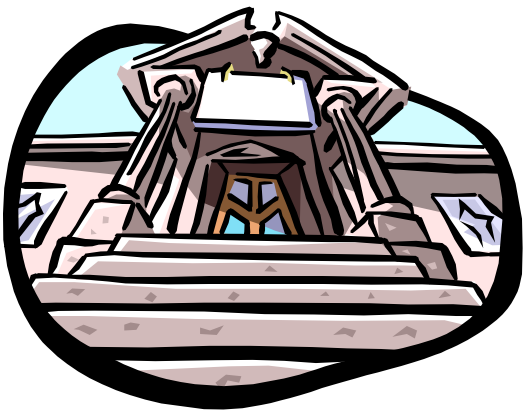

THE ESOP ADVISOR

ESOPs and Estate Planning For the Business Owner

The Employee Benefits Group

Employee Stock Ownership Plans ("ESOPs") have been around for more than 40 years. However, not all professional advisors are familiar with the advantages ESOPs offer the business owner of a closely held corporation. Let's take a little quiz:

1. Can an owner sell some or all of his/her stock at a fair market value, but continue to control the Company?
2. Can an owner sell some or all of his/her stock at a fair market value without paying capital gains tax or state income tax on the profit?
3. Can employees purchase their employer using fully tax deductible dollars?
4. After the purchase by the employees, can all future federal income tax on corporate profits be eliminated?

If you answered no to any of these questions, you need to brush up on the advantages of ESOPs and how they can be used as an estate planning tool for the business owner.

WHAT IS AN ESOP?

An ESOP is a qualified retirement plan, similar in structure to a 401(k) or profit-sharing plan. Each participant has an account which accumulates benefits to be paid at retirement or other termination of employment. However, unlike its cousins, an ESOP is designed to invest primarily in stock of the sponsoring employer.

As with other qualified retirement plans, ESOPs must meet general rules concerning eligibility to participate, vesting, and non-discrimination. However, there are several special rules which only apply to ESOPs.

One is that an ESOP may borrow funds to purchase stock of the employer. This "leveraging" capability leads to many creative uses of an ESOP which cannot be duplicated by other plans.

The general tax attributes of an ESOP are the same as for other qualified retirement plans. Contributions to the ESOP are fully tax deductible; employees accumulate benefits under the plan without paying current income tax; the plan assets are held in a tax-exempt trust so no tax is currently paid on the earnings, and; terminated participants may rollover their distributions from the ESOP to an IRA and continue the tax deferral.

SPECIAL ESOP TAX INCENTIVES

Congress has provided many major tax incentives to encourage creation of ESOPs, including:

1. **Fully deductible loan repayments**. Employer contributions to the ESOP are fully deductible, and can be used to repay an ESOP loan. Therefore, deductions are available for payment of principal as well as interest.
2. **Avoidance of capital gains and state income tax on sale of stock**. An individual who sells stock of a closely held corporation to an ESOP may defer or completely eliminate taxes on the realized gain if (i) immediately after the sale the ESOP

owns at least 30% of the employer stock, and (ii) within 12 months the sale proceeds are reinvested in stock or bonds issued by other U.S. corporations. The individual's basis in the employer stock is carried-over to the replacement securities. If the replacement property is sold, the tax will be paid at that time. However, if the individual holds the replacement securities until death, the heirs receive a step-up in basis, so the taxes will never be paid.

3. **Dividends paid on ESOP stock are deductible**. Cash dividends paid to an ESOP are deductible if they are distributed to plan participants (or retained by the ESOP at the participant's election) or used to repay an ESOP loan. If the corporation does not normally pay dividends, but desires to pay deductible dividends on ESOP stock, it may consider a recapitalization, with a separate class of dividend paying common stock being sold to the ESOP.

4. **Reduction or elimination of corporate income tax**. An ESOP is an eligible shareholder for an S Corporation. Since the ESOP is a tax exempt entity, this creates a tremendous tax planning opportunity. Corporate profits attributable to the stock owned by an ESOP will escape federal income tax. The larger the ESOP ownership the greater the tax savings. If the ESOP owns 100% of the S Corporation stock, federal income tax is completely eliminated.

USING AN ESOP IN ESTATE PLANNING

A critical concern in estate planning for an owner of a closely held corporation is business succession. What will happen to the company when the owner retires or dies? Are other family members active in the business and can they afford to buy it? Are key employees willing and able to purchase the company? Is a sale to an outsider feasible and desirable?

In answering these questions the use of an ESOP should be considered. An ESOP may be an ideal solution for the owner. Let's look at some situations where an ESOP might be a good choice:

Example 1: Owner is age 55 and owns 100% of a corporation which was established 25 years ago. Owner has a very low basis in the stock, and the company has grown to a current value of $5,000,000. Owner has no children active in the business and key employees are unable to purchase the company. Owner's net worth consists primarily of the corporation's value. Owner would like to begin diversifying his/her estate, but is not ready for retirement and sale of the corporation.

1. Owner could begin diversifying his/her estate by causing the company to establish an ESOP. The ESOP would borrow perhaps $1,500,000 to purchase 30% of the owner's stock. Owner could choose to reinvest the $1,500,000 in other securities, with an immediate capital gains and state income tax savings of approximately 20%, or $300,000.

2. The ESOP loan would be repaid with tax deductible contributions made by the corporation. The borrowing cost is substantially reduced because the corporation can deduct the principal payments as well as the interest, resulting in an approximate tax saving of $500,000.

3. If the corporation had redeemed a portion of owner's stock the result would have been ordinary income to Owner. Instead, by choosing to rollover the capital gain, Owner pays no current tax, and if the replacement securities are held until death, no tax will ever be paid on the gain.

Example 2: Assume the same facts, but Owner is now age 60. The ESOP loan has been repaid. Owner is still not ready to retire and completely sell the corporation, but would like to continue the diversification of his/her estate.

1. Additional stock purchases can be made by the ESOP with the same tax benefits described in Example 1.

2. Future sales could be made with another ESOP loan, or Owner could sell a small amount of stock each year for cash. The cash contributed to the ESOP by the company is fully deductible.
3. Even if the ESOP owns more than 50%, Owner may continue to control the corporation by virtue of controlling the board of directors.

Example 3: Assume the same facts, but Owner is now age 70. The ESOP owns 60%. Owner is ready to retire and sell the remaining 40%.

1. Owner could arrange for a sale to a competitor or another outsider. This would provide retirement security, but Owner would be subject to capital gain and state income tax on the sale proceeds. There would be no employment security for the long-term employees and key management.
2. Owner could cause the corporation to redeem the stock by using a commercial loan. However, the redemption would be expensive because Owner would pay tax on the sale proceeds, and the corporate loan would be repaid with "after-tax" dollars.
3. Instead, the remaining stock can be purchased by the ESOP with the same tax benefits described in Example 1. Owner can choose to pay no capital gain and state income tax on the proceeds, and the loan can be repaid with "pre-tax" dollars, significantly reducing the cost of the sale.
4. If instead of retirement Owner dies owning the stock, the ESOP can still be used to purchase the shares. Although the rollover of gain would not be necessary because of the stepped-up basis in the company's stock at death, using the ESOP would substantially reduce the cost of the transaction.

Example 4: Assume the same facts, but the ESOP now owns 100% of the corporation. The board of directors is looking to grow the business and become more competitive.

1. The board can direct the ESOP, as the company shareholder, to cause the corporation to be taxed as an S Corporation. Since the ESOP owns 100% of the stock, all federal income tax on business profit is eliminated.
2. This reduction in cost of doing business allows the company to retain additional cash for growth, and to reduce prices, increase margins and become more competitive.

CONCLUSION

An ESOP may not be appropriate for every corporation. Many factors need to be explored before implementing an ESOP. However, when the desire for shareholders to sell some or all of their stock on a tax-free basis is combined with the company's opportunity to borrow funds on a fully tax deductible basis, the ESOP presents tax-savings possibilities which are unequaled by any other alternative.

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