ESOPs

By Christine Kolm

Employee stock ownership plans (ESOPs) can provide tax efficient estate planning opportunities for closely held business owners by creating liquidity for their shares and business succession options for their families and employees. An ESOP is a qualified retirement plan (profit sharing or stock bonus) designed to invest primarily in stock of the employer. ESOPs provide tax advantages to the employees and employer. The Internal Revenue Code provides tax incentives for business owners to sell their company stock to the ESOP and provides benefits to employees by allowing them to participate in the growth and success of the business while having the option to receive company stock through a tax deferred vehicle.

HOW AN ESOP WORKS

With an ESOP, the company sets up a trust fund (the employee stock ownership trust) to which it makes contributions of stock or cash in order to buy existing shares. Both C corporations and S corporations can sponsor an ESOP. Provided certain requirements are met, the ESOP can also borrow money to purchase new or existing shares (referred to as a "leveraged ESOP").

Shares in the ESOP trust are allocated to separate accounts for the employee-participants. ESOPs must give participants the right to have the employer repurchase employer stock in exchange for cash (unless there is a public market for the stock).

TAX TREATMENT OF ESOPS

Contributions to the ESOP by the company are tax deductible. Further, the company may be able to deduct dividends paid on stock held in the ESOP. For the employees, ESOP accounts can grow tax deferred much like an individual retirement account (IRA) or other qualified plan. Employees do not pay tax on the stock allocated to their accounts until distributions are taken. An employee can begin taking distributions from his or her account upon reaching age 59½ without penalty and distributions must be made after the employee retires, becomes disabled, or dies, unless the ESOP is leveraged, in which case distributions may be delayed. Employees can also choose to rollover their ESOP distribution to an IRA. Another significant benefit for the owner is the ability to sell his or her company stock to an ESOP and defer, or possibly avoid,

paying tax on the realized gain, provided that certain requirements are met, including (i) the ESOP owns 30% of the company after the sale, and (ii) the proceeds are invested in qualified replacement property (QRP). QRP includes stock, bonds, or other debt issued by most, but not all domestic (US) operating companies. The disposition of the QRP will trigger the deferred tax on the gain. As a result, the investment strategy for the sales proceeds can be critically important.

PLANNING STRATEGIES INVOLVING ESOPS

Diversification of a concentrated position in a closely held business

Many closely held business owners hold much of their wealth in their business, which is illiquid and often difficult to monetize. A sale of some or all of the business owner's company stock to the ESOP allows the owner to diversify out of his or her position in the company without paying current tax, provided that the owner rolls the proceeds into QRP. If a business owner holds the QRP until death, the gain is eliminated since the basis in the QRP assets is "stepped up" to fair market value at death.

Note that the primary advantage of a sale to an ESOP over other diversification techniques is the fact that the ESOP is a willing buyer, which can be difficult to find when contemplating a sale of a closely held business. But other diversification techniques, such as charitable remainder trusts, should not be overlooked; depending on the circumstances and the business owner's goals, they could be used instead of, or even in concert with, a sale to an ESOP.

Business succession planning

ESOPs can help families transition ownership to the next generation while allowing the senior generation to retain control of the business. For example, an ESOP could purchase 30% of a corporation, while the remaining family member owners retain majority voting and management control. If the selling shareholder invests the sales proceeds in QRP, the capital gains tax is deferred. Further, the selling shareholder's estate plan can direct the liquid sales proceeds (QRP) to a family member who may not be involved in the family business, leaving the shares in the business to those who are involved. In addition, since the basis of the QRP gets stepped up at the shareholder's death, the QRP could be sold to provide liquidity to pay estate tax generated by the inclusion of the value of the business in the shareholder's estate.

CONCLUSION

ESOPs can be an important piece or complementary addition to a business owner's estate and business succession planning. Proper planning and knowledge are a must when determining whether an ESOP is a good option. Understanding the advantages and challenges of ESOPs at the earliest possible stage of planning will set you up to make a well-informed decision.

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