



ESOPs in Business Succession and Estate Planning

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Topics Covered

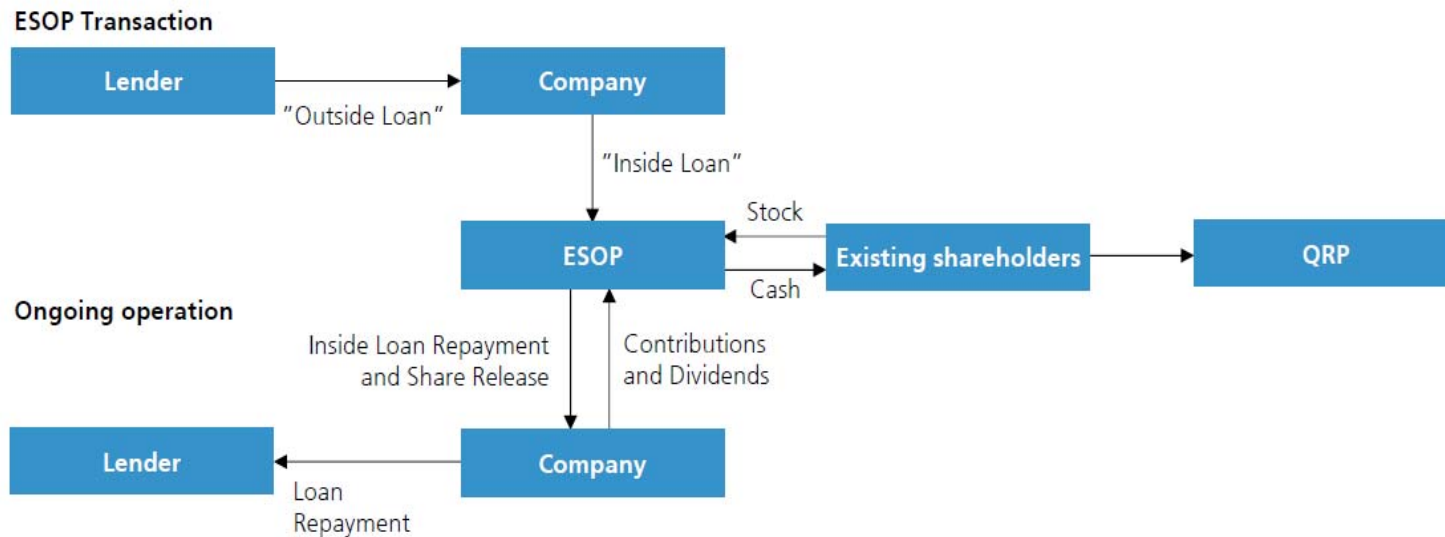
- ESOPs in Brief
- Attributes of Ideal ESOP Candidates
- Trends in Industry
- ESOPs as a Business Succession Tool
- ESOP Uses in Estate Planning

ESOPs in Brief

What is an ESOP?

- An ESOP is a flexible tax efficient exit strategy that may allow for a selling owner to meet their objectives of:
 - Liquidity
 - Deferring and/or eliminating their tax liability
 - Retaining operational control
 - Incentivizing/giving back to management and employees

Transaction Detail



- Company creates ESOP
- Company borrows funds from Lender ("Outside Loan") and re-lends the proceeds to the ESOP ("Inside Loan")
- ESOP uses funds from Inside Loan to purchase shares from existing shareholders
- Company services the new debt by:
 - Making tax-deductible contributions and/or dividends/distributions to the ESOP
 - ESOP repays Inside Loan to Company
 - Company repays Outside Loan to Lender
 - As the Inside Loan is repaid, shares held as collateral for the Inside Loan are released and allocated to the employee accounts

Timeline of ESOPs

- Business owners have been leveraging ESOPs as a business succession and estate planning tool for many years
- 1956 – Louis Kelso invents first ESOP for *Peninsula Newspapers*
- 1974 - Senator Russell Long introduced ERISA tax policy for ESOPs
- 1986 – Tax Act introduced §1042 Deferral for C Corporations
- 1987 – AVIS ESOP transaction
- 1998 – ESOPs are permitted to own stock in S Corporations
- 1998 and forward – ESOP transactions begin to resemble traditional M&A transactions including financial structures including warrants and market rate sub-debt

What makes a good ESOP candidate?

Checklist:

- Profitability of firm & trend of revenue growth
- Annual payroll in excess of \$1 million & at least 30 employees
- Moderate to significant debt capacity
- Enterprise value greater than \$5 million
- Strong executive team
- Firm seeking significant corporate income tax savings
- Currently making contributions to an employee benefit plan
- Would current executive team be incentivized by equity-based compensation
- Selling shareholder interested in participating in future growth of company after sale

Evaluating readiness of liquidity event

In order to prepare for a tax-efficient exit strategy, selling shareholders must make critical and complex decisions:

- ❑ Evaluating any strategic or financial buyout offers
- ❑ Need of retaining control after sale
- ❑ Importance of tax-efficiency within business
- ❑ Importance of diversifying portfolio
- ❑ Evaluate if the timing is right
- ❑ Strategy for implementing and completing §1042 rollover

Mutual Alignment of Interests

Benefits for the company...

- May reduce tax liability
- Ability to repay debt with pre-tax dollars
- Motivated management and employees who are now owners and participants

Mutual Alignment of Interests, Continued

Benefits for management...

- Provide meaningful wealth building opportunity as recognition for service
- Gradual transition to lead the company

Mutual Alignment of Interests, Continued

Benefits for the employees...

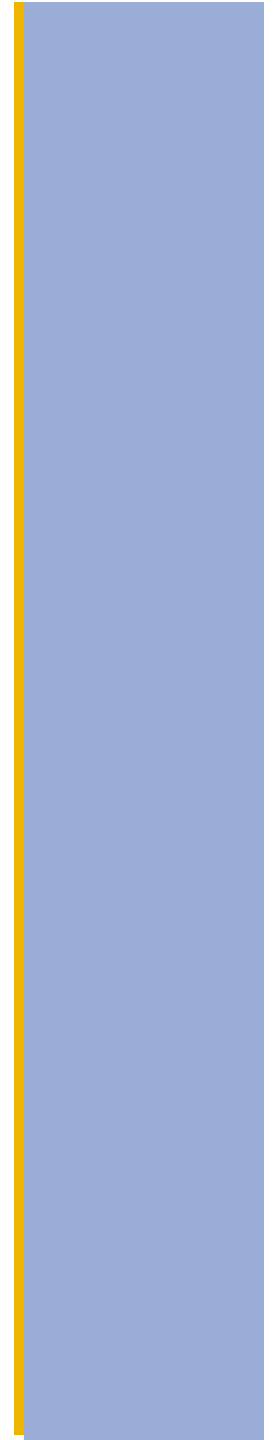
- Rewards employees with retirement benefits at no cost
- Program can be combined with other benefit plans
- Annual valuations provide transparency to value and vesting

Mutual Alignment of Interests, Continued

Benefits for the owner...

- Tax-mitigated sale of stock, if structured properly
- Seller financing to provide attractive cash flows
- Confidential, controlled and quiet process with all parties aligned
- Create meaningful legacy and perpetuate values

Trends in the Market Place



Market Update¹

- As of 2015, approximately 9,300 ESOPs existed in US, covering 15 million employees
- 92% of ESOPs are sponsored by private companies
- Over 10% of US private workforce is a participant in ESOP
- Total assets held by ESOPs in US are estimated to be \$1.3 trillion.

¹Sources: The National Center for Employee Ownership – www.nceo.org
The ESOP Association – www.esopassociation.org

Trends in Market Place

- Detailed pre-transaction analysis
- Investigation of ESOP with other alternatives
- Exploring tax planning opportunities
 - Philanthropic gifting
 - Allowing a market process

Pre-Transaction

- Companies continue to seek specialized advice
- Model economic impact:
 - Partial ESOP sale vs. 100% ESOP Sale
 - S corporation to C corporation conversions
- Understanding selling shareholder and company objectives
- Implementing a 'process'
 - Avoid unnecessary costs
 - Increase probability of achieving goals

The "Dual Track" ESOP

- Selling shareholders are increasingly seeking multiple avenues for monetization
 - An ESOP is consistently alongside offers from strategic and financial buyers
- Specialists providing trusted advice
 - Deconstruct financial returns from each transaction
 - Weigh tax savings against strategic multiples
 - Determine impact of valuations and letter of intent

Post-Transaction

- Coordinate seller and company tax planning
 - 1042 Transaction allows for deferral of gains on the sale to the extent such amounts are invested in qualified replacement property within one year post-sale
- Adopting best governance practices
- Preservation of...
 - Shareholders' legacy
 - Company and community jobs
 - Presence in the industry community

ESOPs and Estate Planning

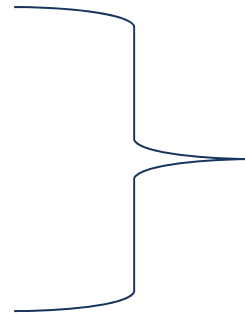
Estate Planning Objectives

- Minimize income taxes by maximizing basis step up opportunities in a decedent's estate
- Minimize estate taxes
- Assets are put to intended use
 - Trusts
 - Creditor protection

Estate Planning Objectives, Continued

- Phase I Planning

- Basic estate plan
- Medical directives/
powers of attorney
- Capturing exemptions



Pre-Transaction

- Phase II Planning

- Tax deferral strategies: § 1042
- Lifetime gifting
- Charitable planning



Post-Transaction

Estate Planning after ESOP

- Providing for family members and heirs in a tax-advantaged manner
 - What age should heirs receive assets?
 - Trusts to protect from divorcing spouses
- Ensure assets are properly utilized after death
 - Trusts
 - Creditor protection

2018 Tax Figures

- 2018 exemptions: \$11,180,000
 - Unified Credit (estate and gift tax)
 - Generation Skipping Transfer Tax
- Estate tax rate: approx. 40%
- \$15,000 gift exclusion per donee
- Can double exemption if married and using portability or marital deduction planning techniques
- Long-Term Capital Gains rate still: 23.8%
 - Brackets are now 0%, 15%, or 20% + 3.8% NIIT = 23.8%

Case Studies: Family Dilemmas

- Company founder has desire to transfer ownership to next generation:
 - There is a logical heir, but business is too large for gift or effective estate tax transfer
 - Some family members are involved in the business, some are not. Business owner faced with how to distribute assets equitably, without selling whole business
- Establishing an ESOP can achieve the intended goal to these and numerous other scenarios

Estate Planning Options

- § 1042 Treatment on partial or 100% of sale to ESOP
 - Capital gains may be deferred for up to +40 years by completing the § 1042 Qualified Replacement Property Rollover
- Family Limited Partnerships (FLPs) and ESOPs
 - QRP transferred from owner to taxable FLP
 - Stock transferred to FLP and then sell top ESOP
 - FLP then makes the § 1042 election
- Minimize value of estate
 - Family Limited Partnerships (or LLCs)

General § 1042 Qualifications

- Selling shareholder
 - 3 year ownership
 - Taxpayer must be an individual, trust, or partnership
- Company
 - C-corporation
 - Privately held stock
 - ESOP must own at least 30% of outstanding shares
 - Consent to penalties

Qualified Replacement Property (QRP)

QRP must meet certain qualifications:

- Must be issued by a US domiciled operating company
- 50% must be used in active conduct of trade or business
- No more than 25% of gross receipts can come from passive sources

QRP includes common stock, preferred stock, bonds, and convertible bonds of "operating companies" incorporated in the United States

QRP Does not include:

- FDIC insured certificates of deposit, mutual funds, municipal bonds, or hedge funds.

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Disposition of QRP

Before death

- Taxable event – voluntary or involuntary
- Basis in stock sold to ESOP applies

Upon Death

- Basis in QRP is stepped up
- Capital gains tax on sale to ESOP is eliminated
- Assets transferred to heirs and/or charitable endeavors

Tying it all together...

Estate Planning examples using an ESOP

- Example #1 – Owner sells directly to ESOP, elects 1042
- Example #2 – Owner gifts shares to Family Limited Partnership (FLP), then FLP sells to ESOP elects 1042
- Example # 3 – Owner gifts warrants to child shortly after ESOP Transaction
- Example # 4 – Owner gifts part of Seller Debt shortly after ESOP Transaction

Example #1

Owner sells 100,000 shares of OpCo stock to ESOP at \$100/share for total sale price of \$10,000,000 in cash

Owner's basis in OpCo stock was \$1,000,000 (\$10/share)

1042 Election is made and Owner timely buys QRP worth \$510,000,000

Example #1

Owner saves federal capital gains taxes of \$2,142,000 ($\$9,000,000 \times 23.8\%$)

Owner holds QRPs until he dies

During holding period, QRPs have increased in value to \$15,000,000 at time of Owner's death

Example #1

Owner's estate gets step-up in basis of QRPs to \$15,000,000 and all-together saves \$3.33M of federal capital gains (\$14,000,000 x 23.8%)

Therefore, if beneficiaries of Owner's estate divest (sell) the QRP, they would only be taxed on any increase or decrease in value of the QRPs from the time of Owner's death (assuming they avoid state inheritance taxes)

Depending on the value of the other assets in Owner's estate, and assuming Owner was married in order to double the estate exemption, Owner's entire estate could also escape estate taxes

- (2 x \$11.18M estate exemption = \$22.36M > \$8M QRP)

Example #2

What if OpCo shares are worth more than \$25M?

Owner contributes 100,000 shares of OpCo stock to FLP (basis of \$100/share or \$10,000,000), and Owner takes partnership interests

Some time later (usually when Owner retires), FLP sells 100,000 shares of OpCo stock directly to ESOP for \$250/share, or \$25,000,000, in cash

Example #2

FLP uses cash proceeds to purchase \$25M worth of QRPs and elects § 1042 gain rollover and saves \$3,570,000 ($\$15M \times 23.8\%$) in capital gains taxes

Over time, Owner gifts FLP interests to beneficiaries

Example #2

At time of Owner's death, QRPs increased in value to \$30,000,000—the new stepped up basis

- The FLP would save ~\$4.76M in capital gains taxes (\$20M x 23.8%)
- Due to the gifting of FLP interests to beneficiaries and proper application of valuation discounts, the value of the FLP interests remaining in Owner's estate would be reduced
- This would decrease the amount of any estate taxes due or, even, take it below the estate tax exemption (\$22.36M for 2018)

Example #2

Can also be used in conjunction with charitable contribution (direct to charity or through charitable remainder unitrust) that then sells to ESOP

- Helps when Seller has charitable intentions;
- It allows Seller's family members still working at the company to participate in the ESOP when they would otherwise be precluded if 100% § 1042 sale to ESOP by Sellers; or
- Helps to decrease value of assets in the estate (and a deduction) on the frontend prior to the sale to the ESOP

Example #3

Owner recently sold all of his stock in privately held company to ESOP for \$30 million

Owner received \$10 million in cash and \$20 million of seller notes with warrants to acquire 25% of the company

Immediately following the ESOP transaction, the warrants have a fair market value of \$1 million

Example #3

Owner gift all of the warrants to child and uses \$1 million of Unified Credit

Company repays all debt and grows business value to \$35 million after eight years.

Warrants are redeemed by company for \$8 million

Owner has passed \$8 million to next generation and saved potentially \$3.2 million in estate taxes

Example #4

Owner recently sold all of his stock in privately held company to ESOP for \$30 million

Owner received \$10 million in cash and \$20 million of seller notes (with a 2% interest rate) with warrants to acquire 25% of the company

Immediately following the ESOP transaction, the seller notes have a fair market value of \$8 million – due to below market interest rate

Example #4

Owner gifts all of the warrants to child and uses \$5 million of Unified Credit and gifts seller notes with a face value of \$12 million to child

Company pays 2% interest annually on seller notes and outstanding principal on tenth anniversary of ESOP transaction.

Owner has transferred \$2.4 million of interest payments and \$12 million of principal payments to child

Owner has saved potentially \$5.8 million in estate taxes

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Questions ?

