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The ESOP's Role in Business Succession and Estate Planning

Presented by:

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Overview

- ❑ **ESOP Basics**
- ❑ **The Role of ESOPs in Business Succession Planning**
- ❑ **The Role of ESOPs in Estate Planning**



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ESOPs as a Strategy for Succession & Estate Planning

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Employee Stock Ownership Plans (ESOP)



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How are ESOPs used in Succession Planning and Ownership Transitions?

- Why ESOP?
- How is ESOP good for American business?
- What are the Pros and Cons of ESOPs?
- Why are ESOPs considered a financial SUPER-TOOL for ownership transitions and succession?– Useful Strategies
- Recognizing Opportunities



Why ESOP?



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- Business Succession/Ownership Transition Plan for Company Owners and Estate Planning Tool.
- Employee Benefit – 401(a) Retirement Plan – Follows same legal requirements as any other Defined Contribution Plan (401k P/S) – builds retirement wealth for employees with a perpetual succession mechanism.
- Favorable Tax Strategy for Individuals and Corporation
 - ✓ Selling Shareholders in C-Corporations
 - ✓ C-Corps
 - ✓ S-Corps



IRC 1042 – ESOP Tax Benefits



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Created by Congress to encourage company owners to sell to an ESOP instead of an outside buyer.

Tax advantages specific to ESOP:

- Seller may defer capital gains from sale
- Company receives net tax deduction equal to purchase price through tax deductible contributions to a qualified retirement plan.
- Sale Proceeds must be invested in “Qualified Replacement Securities” by seller within a 15-month window.

Only available to C-Corps (S-Corps not eligible)

Seller must have a 3 year holding period of stock sold

Immediately after sale, ESOP must hold at least 30% of ownership.



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Current Bills in Congress



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Positive ESOP legislation is put to Congress every year.

- Today: 114th Congressional session and current bill has been introduced as S.1212 and H.R. 2096, known as ***Promotion and Expansion of Private Ownership Act of 2015***, seeks to amend TRA '86 and the Small Business Job Protection Act to expand availability of ESOPs in S-Corporations.
- The main change, if passed, is the expansion of the tax-deferred/tax free provision of IRC Section 1042 to S-Corporations. Currently, the tax deferral for gains attributed to the sale of a company to an ESOP is only available for C-Corporation owners.

To review the background and text of the bills, go to:

<https://www.congress.gov/bill/114th-congress/senate-bill/1212/text> and

<https://www.govtrack.us/congress/bills/114/hr2096>

- Proposed Changes to IRC Sec 2704 eliminating the use of minority interest and marketability discounts in FMV relating to the transfer of ownership in FLP's and other business entities.



Using ESOP for Ownership Transition



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- You are a Company Owner and need an Exit/Succession Strategy
- You are a Company Owner who desires to share the benefits of growth and success with your employees and leave a positive LEGACY vs a third-part sale of your life's work
- Private companies need a flexible market to buy out owners
- Provides liquidation for an “equitable” distribution of inheritance to family members in the case of an owner's death.
- Management needs a proven way to draw and retain talent.
- Your company is PROFITABLE and needs tax savings strategies.



Why is ESOP good for American Business?



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* **Statistics show:** Difference in Post-ESOP to Pre-ESOP Performance

Annual sales growth +2.4%

Annual employment growth +2.3%

Annual growth in sales per employee +2.3%

More likely to stay in business than non-ESOP companies

More likely to offer more benefits than non-ESOP companies

(The relative growth numbers might seem small at first glance, but projected out over 10 years, an ESOP company with these differentials would be a third larger than its paired non-ESOP match.)

*2000 Study by Douglas Kruse and Joseph Blasi of Rutgers University

Job Retention vs Job Creation





Technical Considerations – Things to KNOW ABOUT

- ✓ Making a Transition
- ✓ Appraisal
- ✓ Fiduciary Issues
- ✓ Leveraging / Sources of Capital
- ✓ Plan Design and Compliance Issues
- ✓ Developing an ESOP “Culture” – maximizing the benefits for everyone.

PROS



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- **FLEXIBILITY:** Designed completely around Shareholder Timeframe. The ability to borrow capital allows transition to be gradual or immediate.
- Creates an on-going internal market in private companies for multiple ownership transitions.
- Rewards loyal employees with retirement incentives AND a stake in the growth of the company while preserving founder's legacy.
- Tax Advantages – Personal and Corporate:
 - Deferred Capital Gains Tax to Seller under IRC 1042 in C-Corporations.
 - Allows buyout with fully tax deductible dollars
 - Increased Tax Deductions for C-corporations under IRC 404 if leveraged
 - Deductible dividends paid on company stock in C-Corporations.
 - 100% Tax shield on ESOP ownership percentage in S-Corporation
- Company owner may still maintain control of the company.
- Often less expensive than 3rd party sales



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CONS



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- Costs to small companies
- S-Corporation Anti-Abuse Rules -IRC 409(p)
- Availability of Financing
- Effect of Debt on Company Financial Statements
- Valuation – Fiduciary responsibility of Trustee to see fair market value of the company stock.
- Liquidity and Repurchase Obligation
- May not address critical objectives for transitioning in generational or management ownership.



Managing Succession Planning Objectives



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- ESOPs transfer ownership to the employees
- But what if ownership is to be transferred to the next generation?
 - The next generation of the owner's family
 - The next generation of partners, principals, or key employees
- A qualified retirement plan can be used to turn payments to selling owners into payments to retiring employees



Cash Flow ESOP



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COMPANY

1. Annual Contribution in Company Stock

ESOP

Strategy: Increase CASH FLOW through TAX SAVINGS

- 1. Company issues new stock to ESOP (dilution considerations)**
- 2. Company gets tax deductible contributions for FMV of the stock**



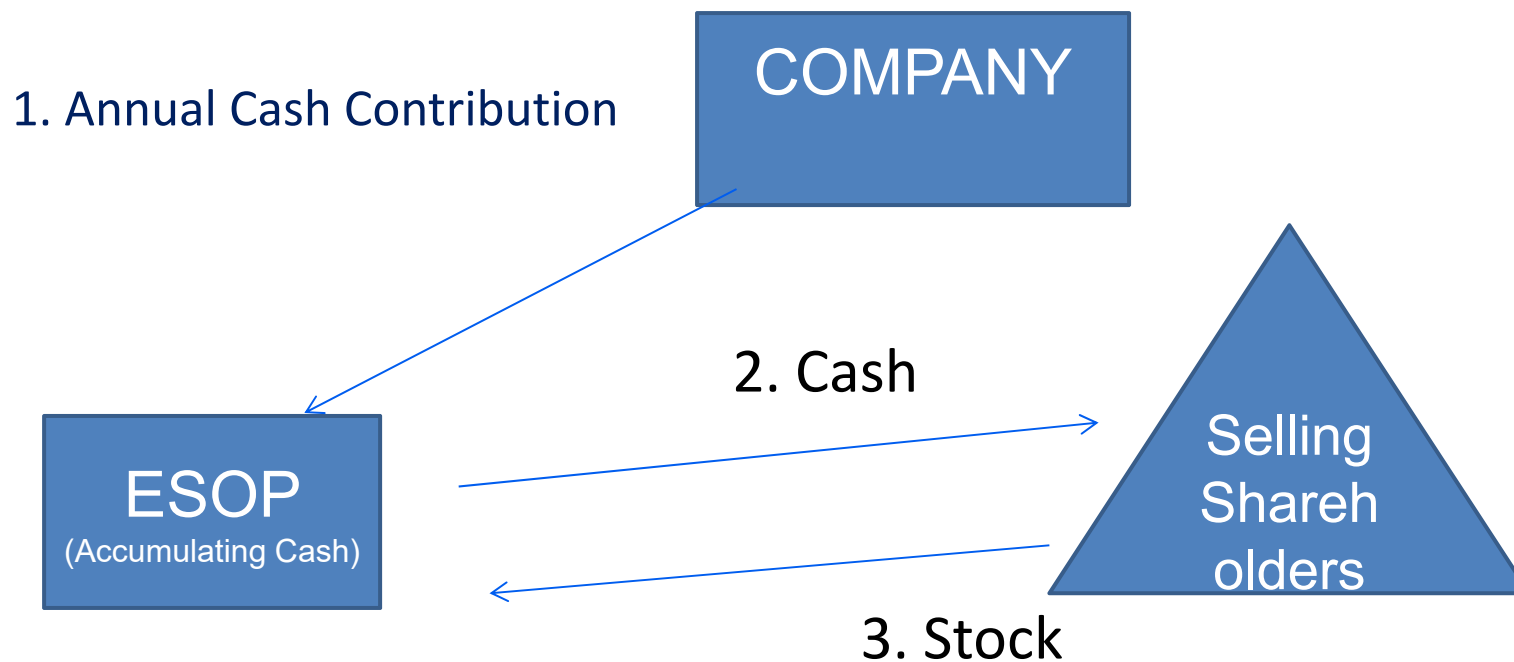
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Step Transaction / Prefunding / Funding "as you go"

(Non-Leveraged ESOP)



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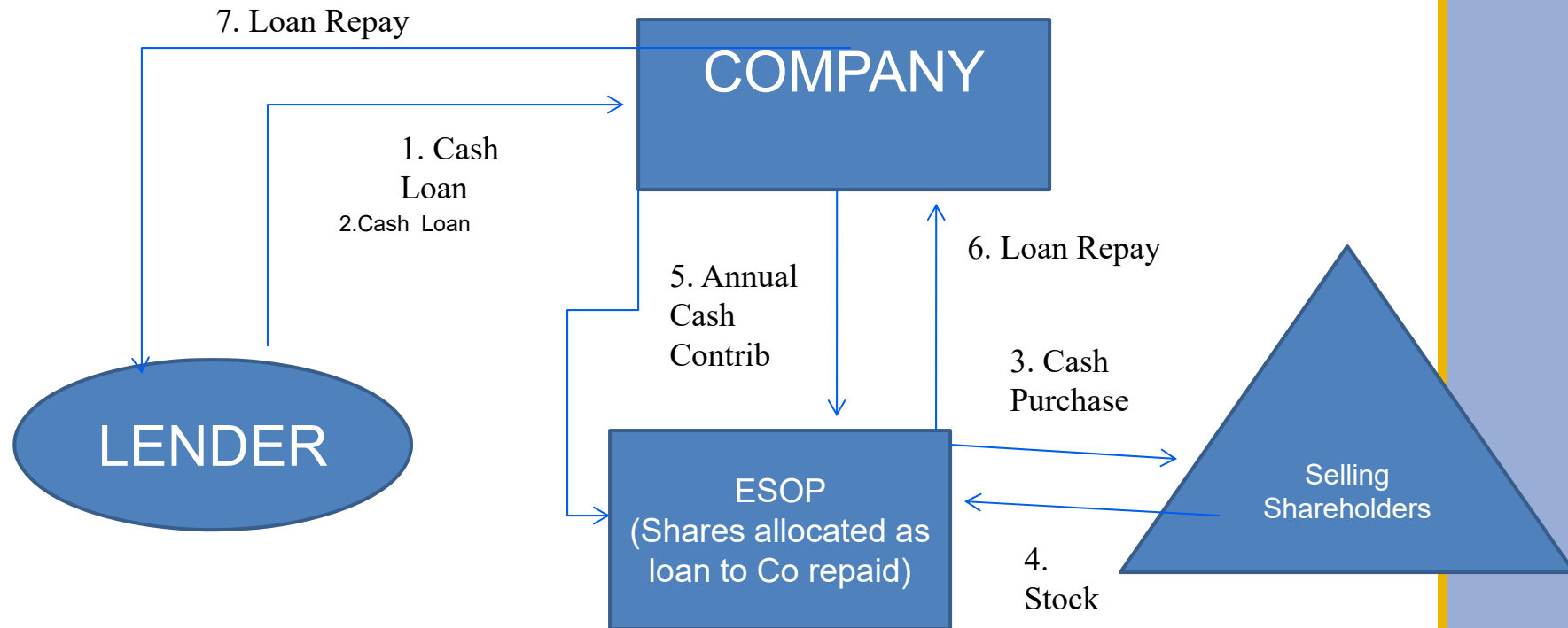
Strategy: Step Buyout (gradual) or Diversification for shareholder(s)

1. Company issues tax deductible cash contribution to ESOP
2. ESOP accumulates enough cash to buy stock
3. ESOP buys stock from shareholder(s) at current FMV



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Leveraged ESOP



Strategy: Faster Ownership Transition or IRC 1042 (C-Corps)

1. Lender loans cash to Company / 2. Company loans the cash to ESOP
2. ESOP buys stock from shareholder(s) at current FMV – pays cash to shareholder
3. Stock transferred to ESOP Suspense account – “Owner” = ESOP Trust
4. Company makes tax deductible ER Contribution TO ESOP (sufficient to pay P&I)
5. ESOP repays P&I ON COMPANY LOAN – shares allocated to participant accounts
6. Company repays LENDER (loan terms do NOT have to be the same)

Starting the ESOP Process:



Team Members

- Company – Plan Sponsor
- Financial Advisor/Planner
- Company Accountant
- ERISA attorney
- Plan Trustee
- Valuation Firm
- Plan Auditor
- Plan recordkeeper (TPA)



Recognizing ESOP Opportunities



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1. ESOP can only be used in C & S-Corporations. S-Corp must have enough employees to pass IRC 409(p) Test.
2. Profitable companies that might need tax saving strategies.
3. Private companies that need a flexible market to buy out owners.
4. Business Owners who need an Exit Strategy or a Flexible transitioning of ownership among family members or employees.
5. Company needs a Management Succession Plan – use ESOP as a funding vehicle to transition ownership.
6. Owner desires to share benefits of growth & success with employees and leave a legacy.



The Role of the ESOP in the Business Succession Planning Process

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The Business Succession Journey

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***“If you don’t know where you’re going,
you’ll probably end up somewhere else!”***

- Laurence J. Peter



You've Built A Successful Business... *Now What?*

**Present
Situation**



Today



**Long Term
Objectives ?**



Tomorrow

Long Term Strategic Plan



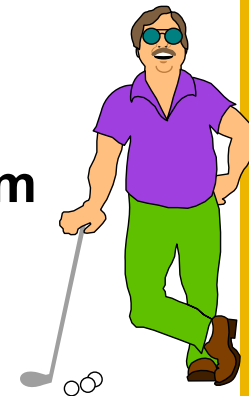
**Ownership and
Management Succession**



**Create path to Personal
Liquidity**



**Retirement and/or Freedom
of Action**



Perpetuation or Exit?

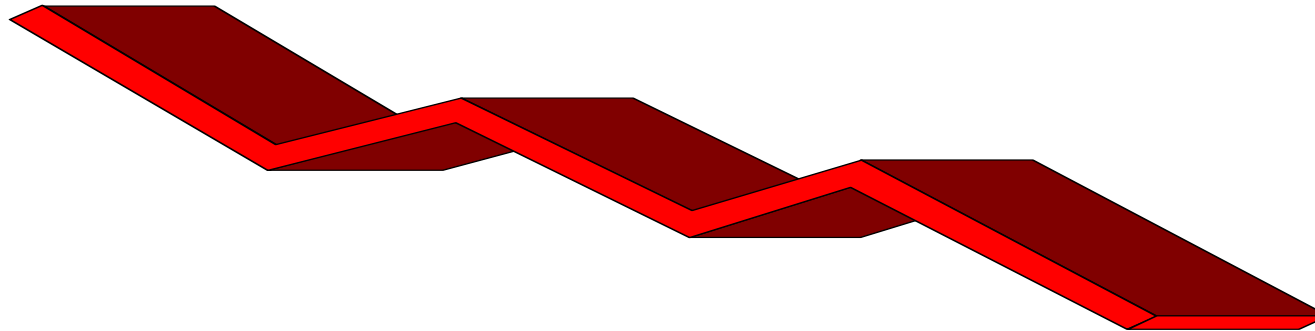


- ❑ 1.5%
- ❑ *Reasons*
- ❑ *Critical Issues*
- ❑ *Sell in or Sell Out?*
- ❑ *Other factors*

The Statistics

Long Term Survival Rates for *Winners!*

- ❑ Family Businesses
 - **30% survive to 2nd generation**
 - **13% to 3rd**
- ❑ ALL Private Businesses
 - **1.5% survive to 3rd generation!**



Business Succession Considerations

- ❑ Founder's desire to continue involvement
- ❑ Next generation of management
 - Management experience & talent
 - Family ties
 - Personal loyalties
- ❑ Founder/Company ties to community
- ❑ Owner's legacy
- ❑ Long term financial incentives

Succession Planning Considerations

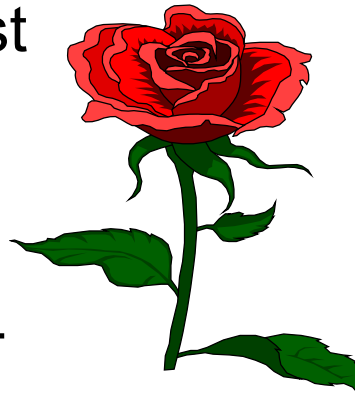
- ❑ Succession – Transfer of Both:
 - Ownership
 - Managementto the next generation
- ❑ Planning considerations:
 - Transfer of founder stock (ESOP, charities, heirs, etc.) in a tax advantaged way
 - Providing for family members and heirs in a tax advantaged manner
 - Preservation of wealth
- ❑ Don't forget about your legacy!

Creative Succession Strategies

Diversify Activities and Investments & Strengthen The Business

If you could:

- Sell a Minority Interest
- Secure Tax favored Liquidity
- Reduce Business Involvement by 20%+
- Do this in ≤ 6 months
- No Adverse Effects on the Business



and have:

- **NO** New tax Liability
- **NO** Minority Stockholder Issues
- **NO** Control issues

Would you be interested?

Why An ESOP ?

- ❑ A possible answer to the question:
“What are my alternatives for business perpetuation and creating liquidity?”
 - Sale to Third Party
 - Merger
 - Sale to Management
 - Corporate Stock Redemption
 - Initial Public Offering
 - Gift or Other Transfer to Heirs
 - Wind-Up Business and Liquidate
 - Leveraged Recapitalization
 - **Sale to Employee Stock Ownership Trust (potentially tax deferred (“tax-free”) dollars)**

- ❑ **Creates liquidity, in part or whole, enabling business owner(s) to diversify their portfolios**

ESOP Candidates

- ❑ Closely held U.S. based company
- ❑ “C” or “S”- corporation
- ❑ Owner desire to perpetuate company
- ❑ Willingness to share ownership
- ❑ Capable successor management
- ❑ Sufficient payroll
- ❑ Track record of profitability
- ❑ Debt capacity
- ❑ Desire to inculcate ownership culture

Summary of ESOP Uses

- ❑ Very flexible financial and equity instrument
- ❑ Uses corporate tax deductible (or tax-free) dollars for individual and corporate objectives:
 - Shareholder liquidity
 - Perpetuation/continuing independence
 - Capital generation
 - Acquisitions
 - Philanthropy

Advantages for the Company

- ❑ Substantial tax savings (40% to 100%)
- ❑ Corporate perpetuation
- ❑ Cash flow increased
- ❑ Pre-tax dollars repay debt
- ❑ “S” Corp stock owned by ESOP not subject to federal tax (most states mirror)
- ❑ Tax-deductible “C” Corp dividends
- ❑ Justifies accumulated retained earnings
- ❑ Avoids disruption attendant to a sale



Advantages for Stockholders

- ❑ Creates liquidity at fair market value (determined by independent appraiser)
- ❑ Maintain control (if desired)
- ❑ “Tax-Free” rollover available to sellers in “C” Corp (IRC § 1042)
- ❑ Preserves Founder/Company legacy
- ❑ Establishes value, provides liquidity for estate planning
- ❑ Selling shareholders excluded from ESOP can be “made whole” by corporation (deferred compensation)
- ❑ Other equity incentives still available (stock option, bonus, purchase, phantom stock, etc.)



Advantages for Employees

- ❑ Employees share directly in equity growth of company
- ❑ ESOP employer contributions tend to be larger than profit sharing contributions
- ❑ Proven motivator and builds unity and team spirit
- ❑ Helps retain key employees (30 years of studies)
- ❑ Accounts accumulate tax-free and are tax-favored at distribution
- ❑ Employees may realize dividend income
- ❑ Buy/sell agreements ensure future employee ownership through the ESOP



ESOP Tax Benefits

- ❑ “C” Corp Sellers may defer/avoid capital gains tax (IRC § 1042)
- ❑ ESOP debt payments (including interest) deductible
- ❑ Deduction for dividends paid to ESOP
- ❑ ESOP’s share of “S” Corp. earnings not subject to Federal tax

ESOP Financial Benefits - Seller

IRC §1042 Rollover Benefit Comparison

	<u>Non-ESOP</u>	<u>ESOP</u>
Gain on Sale	\$ 10,000,000	\$10,000,000
Tax (Combined Fed & State - 25%)	<u>2,500,000</u>	<u>-0-</u>
Net Proceeds	\$ 7,500,000	\$10,000,000

Reinvestment Benefit

Additional After-Tax Proceeds	\$ 2,500,000
After-Tax Reinvestment Return	5%
Life Expectancy - Years	21
Total Future Value of Reinvestment Benefit	<u>\$ 6,964,906</u>
Seller Reinvestment Benefit	\$ 4,464,906

ESOP Financial Benefits - Company

Deductible Principal & Interest Payments - Company

	<u>Non-ESOP</u>	<u>ESOP</u>
Pretax Earnings Required to Service \$10M of Debt	\$16,666,667	\$10,000,000
Tax (Combined Fed & State - 40%)	<u>6,666,667</u>	<u>0</u>
After-Tax Earnings Available To Service Debt	<u>\$ 10, 000,000</u>	<u>\$ 10,000,000</u>

Total ESOP Financial Benefits

ESOP Financial Benefits - Summary

“Tax-Free” Rollover Benefit - Seller	\$ 2,500,000
Reinvestment Benefit - Seller	\$ 4,464,906
Principal Repayment Tax Benefit – Company	<u>\$ 6,666,667</u>
Total ESOP Financial Benefits	<u>\$13,631,573</u>

ESOP Loan Advantage

<u>\$3M Loan (\$000)</u>	<u>Standard Loan</u>	<u>ESOP Loan</u>
Total Cost of Loan*	\$4,215	\$4,215
Deduct Principal	No	Yes
Deduct Interest	Yes	Yes
Tax Savings	<u>(\$486)</u>	<u>(\$1,686)</u>
Net After Tax Cost	\$3,729	\$2,529

Difference: \$1.2M After Tax Cash Flow w/ ESOP Loan

* 8 year loan at 8% interest, \$3M principal, \$1.2M interest

Repurchase Liability

- ❑ Traditional stock retirement design.
- ❑ Corporation has the obligation.
- ❑ Funding Reserve should be a Corporate liquid asset.
- ❑ Repurchase Liability grows rapidly after 5 years, especially after 10 years.
- ❑ Currently no requirement to recognize as an Accounting Liability.

The ESOP's Role In Estate Planning

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Mid-Presentation Refresher—

What is an ESOP?

- D.C. plan invests primarily employer stock
- Can borrow money from related parties to purchase stock
- Stock is allocated to employees as loan is repaid over time
- Stock remains in the ESOP; not owned directly by employees
- Upon a distribution event, cash value is usually distributed

Estate Planning Considerations

- Estate planning considerations:
 - Transfer of founder stock (ESOP, charities, heirs, etc.) in a tax advantaged way
 - Providing for family members and heirs in a tax advantaged manner
 - Preservation of wealth
- Don't forget about your legacy!

Estate Planning/Tax Considerations

- 2017 exemptions: \$5,490,000
 - Unified Credit (estate/gift tax)
 - Generation Skipping Transfer Tax (GST)
 - Separate tax and exemption
- Estate tax rate ~40%
- Capital gains rate 23.8%
- \$14,000 gift exclusion per donee
- Can double exemptions if married

Estate Planning Options

- Planning to minimize value of estate
 - Family limited partnerships (or LLCs)
 - Importance of non-tax purpose
- Family limited partnerships and ESOPs
 - QRP transferred from owner to FLP taxable
 - Transfer stock to FLP and then sell to ESOP
 - FLP then makes the 1042 election

Section 1042 Basic Requirements

- 30% ESOP ownership; 3 year period
- ESOP sponsored by C corp; not public
- Seller not a C corp or underwriter
- Source of stock rule
- Qualified Replacement Property (QRP)
- Purchase 3 month before ESOP sale or 12 months after sale
- Affirmative elections made with IRS

Looking at 1042 Options

- 1042 election: if available whether to elect
 - S Corp selling shareholder—not eligible
 - C Corp selling shareholder—*if* eligible
 - Pay capital gains tax or
 - Review deferral option on 23.8% federal plus any state taxes
 - With the capital gains rate up from 15%, 1042 is again compelling
 - Impact of state taxes and AMT

1042 Timing and Election

- Corp consent for excise taxes if
 - Nonallocation rules violated
 - ESOP disposes of stock within 3 years
 - Subject to exceptions
- Seller's Statement of Section 1042 Election
- Seller's Statement of Purchase of QRP

What is QRP?

- Securities issued by Domestic Operating Corporation
 - DOC status determined by combining controlled corporations
 - Unrelated to ESOP sponsor
 - Issuer must be a corporation and not another type of entity
 - Issuer must be domestic

What are QRPs (cont.)

- No more than 30% passive income
- Ineligible investments include: ETFs, mutual funds, closed end funds, treasuries, muni or agency bonds, hedge funds, structured products

Disposition of QRP (before death)

- Taxable event—voluntary or involuntary
 - Sale, puts, calls, attachment by creditor
- Basis in stock sold to ESOP applies
- Non-taxable examples: certain tax-free transactions involving issuer, transfer to former spouse and gifts

What Happens at Death?

- Basis in QRP is stepped up to current market value
- Eliminates previously deferred capital gains tax on sale to ESOP
- Additional strategies can be used to defer capital gains tax on sale of QRP and diversify into unrestricted investments

Funding Charitable Activities

- Gifting stock to charities
 - Put contract for charity
 - Call for company
 - Example: endowing a university chair

Giftting Stock to Family Members

- Family bank as vehicle for later transfer of stock to minors
- Gifting over time to avoid taxes

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 #1

- Owner sells 100,000 shares of OpCo stock to ESOP at \$50/share for total sale price of \$5,000,000 in cash
- Owner's basis in OpCo stock was \$1,000,000 (\$10/share)
- 1042 Election is made and Owner timely buys QRP worth \$5,000,000

Example #1

- Owner saves federal capital gains taxes of \$952,000 ($\$4,000,000 \times 23.8\%$)
- Owner holds QRPs until he dies
- During holding period, QRPs have increased in value to \$8,000,000 at time of Owner's death

Example #1

- Owner's estate gets step-up in basis of QRPs to \$8,000,000 and all-together saves \$1.6M of federal capital gains (\$7,000,000 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 \$5.49M estate exemption = \$10.98M > \$8M QRP)

Example #2

- What if OpCo shares are worth more than \$10M?
- Owner contributes 100,000 shares of OpCo stock to FLP (basis of \$10/share or \$1,000,000), and Owner takes partnership interests
- Some time later (usually when Owner retires), FLP sells 100,000 shares of OpCo stock directly to ESOP for \$100/share, or \$10,000,000 in cash

Example #2

- FLP uses cash proceeds to purchase \$10M worth of QRPs and elects 1042 gain rollover and saves \$2,142,000 ($\$9M \times 23.8\%$) 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 \$14,000,000—the new stepped up basis
 - The FLP would save ~\$3.1M in capital gains taxes (\$13M 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



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