Using an ESOP to Liquidate a Portion of the Value of a Family Business

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Family Business Consultants should be aware of the opportunities available through the innovative application of an employee stock ownership plan (ESOP).

Consider Bill Fisher and his wife Joan, who had built a business that had recently been valued at $20 million. They had also built a great family. Their oldest, Bill Junior, worked in the business, taking increasing responsibility for operations. At just 32, many said he was too young for that role, but having grown up working summers and after school in the stock room or on maintenance, he knew the business very well. Daughter Suzie was a school teacher and the youngest, John, was in medical school.

At age 62 and 60, respectively, Bill and Joan were convinced that it was time to retire and pursue their lifelong ambitions to travel while they still had the vigor to do so. Bill Junior had made it clear that he hoped to run the business one day - something the parents hoped to see. But what about Suzie and John? "And what about us," thought Bill and Joan. "We certainly want to be financially comfortable."

The challenge, in short, was devising a plan that would assure attractive futures for themselves and their loved ones. For that they turned to Fred, an experienced financial advisor.

The Nature of the Challenge
Fred worked with Bill and Joan to identify a short list of goals that pretty well defined their aspirations:

• Give Bill Junior the opportunity to take over the business
• Provide equally for all their children –they don't want to give the $20 million business to Bill Junior and then leave Suzie and John with only the modest remainder of their estate (about $3 million).
• Avoid giving too much, too soon, to the kids; they love them, but the kids didn't earn it and it wouldn't be healthy for their character development.
• Provide for the philanthropic causes that mean a lot to them.
• Assure that they themselves will be financially secure and have the means to pursue their retirement dreams for travel, etc. They feel that an annual income of $400,000 would cover their needs.

A financial analysis of the business showed that, while it was solidly profitable, it could not be expected to generate enough

cash from operations to provide for all the needs listed above. Bill Junior and his management team would need to be compensated; and the company itself would need cash to fund continuing growth. The projected cash flow simply wouldn't be sufficient to meet the needs of the business and provide $400,000/year for Bill and Joan and fund philanthropic contributions and provide for Suzie and John.

The ESOP-Based Solution

Fred suggested that they consider an ESOP. Technically, an ESOP is a retirement plan and serves the purpose of accumulating retirement savings for the company's employees. In practice, however, there is more to it. While it's true that these programs have accumulated significant retirement savings for the covered employees, the biggest reason for the popularity of ESOPs is that they can *act as a cash buyer of private company stock, thus creating a source of liquidity for the company's owners.*

Unlike other tax-deductible retirement plans, an ESOP is authorized to invest its assets entirely in the stock of the sponsoring company – *and to borrow money to buy such stock.* Loans to an ESOP must be backed by the company itself, but this borrowing capability turns an ESOP into a potent – and friendly – buyer of stock from company shareholders.

There are also substantial tax advantages that add to the attractiveness of an ESOP. The main ones:

- **Tax-deductibility of company contributions.** Money contributed by a company to an ESOP is fully tax-deductible – even though the money will be used to buy stock from a shareholder. In contrast, if the company bought the stock directly from the shareholder, the company could not deduct the purchase price. With combined Federal and state corporate taxes in the average state running at around 40%, this means the government is paying about 40% of the stock redemption cost.
- **Elimination of capital gains tax on the seller.** Total Federal and state capital gains taxes run about 20% in the average state. But a sale of stock to an ESOP can be structured so that the seller can avoid paying capital gains taxes.
- **Untaxed award of stock to employees.** If a company simply gave shares of stock to employees as bonus, the value of the stock would be taxable as current income to the employees. But stock that goes into an employee's

ESOP account remains untaxed, until the employee leaves the company and cashes in the stock.

Bill and Joan's Succession Plan

The challenge in meeting your goals," said Fred, "is not that you don't "have enough wealth." You are financially successful people! Rather, your challenge is that so much of your wealth is tied up in an illiquid asset – the family business. If you could liquidate some of that wealth you could easily achieve all of the goals you have laid out. That's where an ESOP can help. Here is the full plan, step by step.

1. Fisher Enterprises establishes an ESOP, to which Bill and Joan will sell 51% of their company stock (the company will arrange with its bank for a loan to the ESOP for this purpose). Based on the company value of $20 million, this sale will bring them $10.2 million. They will claim the special ESOP capital gains tax deferral to avoid the $2 million in capital gains taxes they would otherwise have to pay. At this point they have liquidated 51% of their shares without losing any of the proceeds to taxes and can now diversify those assets to reduce the family investment risk. Moreover, they retain control of the company (despite having sold 51%), since the ESOP laws allow them to control the ESOP. Still, at this point the $10.2 million in sales proceeds remain part of their estate and will eventually be subject to estate taxation. And the assets still carry the original tax basis of their company stock (virtually zero). The capital gains tax is only deferred, not eliminated.

2. Next, Bill and Joan establish a "charitable remainder uni-trust" (or CRUT) at the charitable institution they have long supported, to which they contribute the $10.2 million from their sale of stock. The CRUT will pay them an annual income for the rest of their lives of 7% on the principal. Upon the death of both of them, the principal will be turned over to the charity. The result of this step is:

a. The capital gains tax is eliminated, not simply deferred.
b. They get an income tax deduction for the current year of $2,040,000.
c. They will receive annual income for the rest of their lives in the amount of $714,000.
d. They have assured the charity of a $10 million endowment.

3. Step three is to provide for Suzie and John. At Fred's recommendation Bill and Joan form an irrevocable life insurance trust (ILIT). Recall that they want $400,000 for their annual income; but the CRUT will provide $714,000. The extra amount is more than enough to pay the premiums on

a $10 million life insurance policy to be held in the ILIT. Suzie and John will receive the pay-out tax free upon the deaths of Bill and Joan. Their futures are now assured.

4. What about Bill Junior, who hopes to take over the business? That brings us to step four - transferring the family's remaining interest in the company to Bill Junior. Now that Bill and Joan have sold $10.2 million of their $20 million company, one might assume that their remaining 49% interest is worth $9.8 million. Not so – and here's why. To buy that stock, the ESOP borrowed the $10.2 million. That debt is reflected as an obligation of the company itself, which reduces the value of the firm. In fact, because of the debt the actual value of the company dropped to about $12 million. In addition, Bill and Joan's 49% stake is now a minority interest. As such, it is subject to a minority discount of roughly 25%. Bottom line: the value of Bill and Joan's 49% interest is for the moment only about $4.4 million. Bill and Joan can therefore transfer shares to Junior by gift or sale over the next several years with limited tax costs.

There is one more advantage to this plan. As a result of the sale to the ESOP, each employee will receive a substantial allocation of company stock to their ESOP retire account. Studies have looked at thousands of companies with ESOPs and found that in most cases the ownership of company stock motivated employees to improve performance and drive business growth. Bill and Joan like the idea that when Bill Junior takes over as a rookie CEO, his job may be a little easier because the employees will be pulling for him to succeed.

Conclusion

That was Bill and Joan's path. Is it the right path for every family business? Of course not – one size never fits all. Consider some limitations:

• **Size of the business.** Selling an interest in a company always has significant transactional costs, and ESOPs are no exception. Implementing an ESOP at a company like Bill and Joan's may cost about $60,000-90,000 or more in professional fees, and $15,000-$25,000 annually to maintain. For a very small business, these fee levels may not be affordable.

• **Comfort with employee ownership.** While some business owners see employee stock ownership as something positive for their company, others are simply not comfortable with the idea. If you are in the latter camp, an ESOP will not be advisable, notwithstanding the attractive tax advantages.

• **The challenge of motivating employees.** The companies

that have seen performance gains as a result of putting stock in employee hands were the ones that really worked at that. Just setting up the ESOP isn't enough. It takes an ongoing initiative to explain what the ESOP is, how employees can help the company grow, and engage them in that effort.

• **Credit capacity.** The plan for Bill and Joan's sale of stock to the ESOP required that the ESOP *borrow the purchase money using the company's credit capacity.* Companies without sufficient credit may not be in a position to do this. Even those that do have the credit capacity may have growth plans for which that capacity must be reserved. An ESOP can also be structured using "seller financing" (in which the selling shareholders accept an IOU from the ESOP which is paid over time, thus bypassing the need for a bank loan). This approach, however, would not have met Bill and Joan's needs.

• **A subsequent sale of the business.** An ESOP may create some complications if a decision is later made to sell the business. One challenge is that ESOPs generally need to receive a fixed, firm price for the stock they hold, which can be problematic when a buyer's offer contains "earn-out" provisions that leave the final purchase price unresolved for a period of time.

Given these issues, it is highly advisable to consult with a knowledgeable advisor (one who isn't simply in the business of "selling" ESOPs) for assistance in exploring the ESOP idea. Serious evaluation usually begins with a "feasibility analysis" to assess the pros and cons before making a final decision on an ESOP.

In the right situations, then, an ESOP can be a very attractive tool. It is unique in the flexibility that it provides. That's partly because, in arranging the transaction, there is no adversarial buyer sitting across the table. Instead, company owners can draw up the arrangement based entirely on what they would like to see. They can choose how much of the company to sell, when to sell, and how active they will remain in management.

For Family Business Advisors, being aware of the ESOP as one of the available strategies for business succession can improve your ability to serve your clients. Encouraging your clients to explore this strategy may add immeasurable value for them.

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