

# Employee Stock Ownership Plans

A business-perpetuation planning tool worth considering

By Chuck Coyne, ASA

**T**he following article will provide a basic overview of what an Employee Stock Ownership Plan is, and how it aids in agency perpetuation planning.

## Why consider ESOPs?

ESOPs have been around for many years. Unfortunately, they remain one of the most misunderstood financial tools available to closely held business owners and their advisers. ESOPs provide a powerful and flexible mechanism for planning a business's internal perpetuation. The special tax benefits they provide are attractive to the selling shareholders, employees and the business. Often agency owners would prefer to sell their business to certain key employees/management. However, these key employees typically lack adequate personal financial resources to buy the agency at a fair value. In some cases, these key employees would most likely manage better with a sale to an ESOP than if the agency was sold to a competitor. With an ESOP in place, key employees can continue to grow the business and be rewarded with allocations of company stock in their own ESOP accounts. Often, key employees are provided with an additional incentives outside the ESOP (i.e., stock, stock options or stock appreciation rights).



Furthermore, because ESOPs make all eligible employees beneficial owners of the agency's stock, these agencies can experience increased productivity driven by employees who are motivated by sharing in the resulting stock value increase.

## What is an ESOP?

An ESOP is a special kind of qualified plan governed by the Employee Retirement Income Security Act and the Internal Revenue Code (the "Code").

Although there are some exceptions, generally all full-time employees older than 21 participate in the ESOP. A company that wants to create an ESOP sets up the plan and a trust qualified under the Code. An ESOP trust is designed to hold annual company contributions that are monitored by a trustee. These contributions can be made by the company in the form of cash, shares of company stock, or a combination of cash and company stock. Unlike all other qualified plans, ESOPs can and must invest primarily in stock

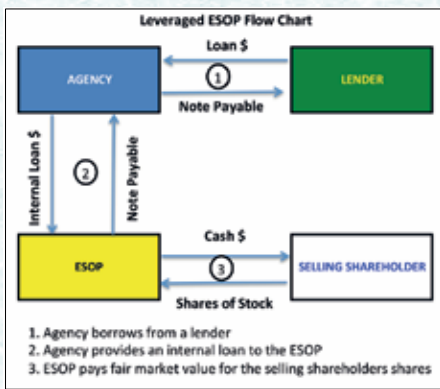
of the sponsoring company and are permitted to hold 100 percent of the stock of a company. An ESOP provides the company's employees the opportunity to become *beneficial* owners of company stock through annual allocations in the plan. It is important to recognize the distinction between being *beneficial* owners of company stock as opposed to actual shareholders of the company. The ESOP's trustee votes the shares held in the plan (with few exceptions) and employees do not gain access to any additional company financial information as beneficial owners. As with other qualified plans (e.g., profit-sharing plans), ESOPs must be operated for "the exclusive benefit of plan participants."

### What price can an ESOP pay for stock?

An ESOP can pay "fair-market value" for shares of the sponsoring agency's stock. This requires that a qualified and independent business appraiser value the stock. This is because the IRS and the Department of Labor both require that the ESOP not pay more than fair-market value for company stock. Once the ESOP holds company stock, an annual updated company valuation is required for plan administration purposes.

### How does a leveraged ESOP work?

Leveraged ESOPs are those that borrow to finance the purchase of their sponsoring company's stock. The chart below shows the flow of a typical leveraged ESOP.



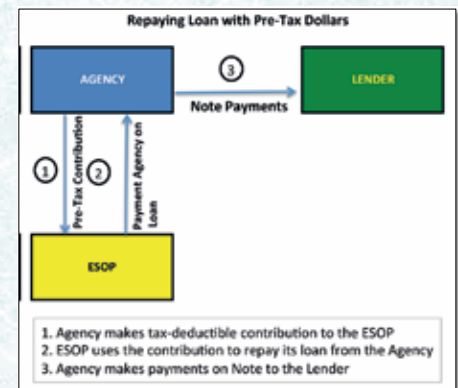
### Allocation of shares to employee accounts

As the ESOP's internal loan is repaid, the shares purchased are released within the trust from a suspense account to individual participant accounts. Allocations in the ESOP generally are allocated to individual participants based on a ratio of their individual pay to the total of all eligible plan participants' pay. There are limits on the amount of contributions that can be made to the plan, as with other qualified plans. As employee-participants continue to work at the company they vest in the shares that are allocated to their individual ESOP accounts. Employees must be 100 percent vested within three to six years, depending on whether vesting is "cliff vesting" (100 percent after three years) or gradual (20 percent per year beginning the second year).

### Tax deductibility of loan payments

One of the most beneficial and unique aspects of using an ESOP to finance the purchase of company stock is the pre-tax payment of the financing. That is, both the principal and interest paid by the sponsoring company are tax deductible. There are different annual tax-deductible contribution limits depending on the company's tax status (e.g., S or C corporation). In general, companies can deduct up to 25 percent of eligible payroll contributed to their defined contribution plans (e.g., ESOPs, 401(k) plans, profit-sharing plans and stock bonus plans). This is a combined limit that aggregates all these plans. However, leveraged ESOPs in a C corporation are allowed a separate 25 percent contribution level to repay principal on an ESOP loan. As with any corporate loan, interest expense is fully deductible and does not count toward this 25 percent contribution limit in a C corporation. Reasonable levels of cash dividends paid on ESOP stock used to repay the loan or passed-through to participants also are tax deductible. On the other hand, S corporations have a 25 percent limit on tax-deductible company contributions whether the ESOP is

leveraged or not. Aggregate contributions to 401(k)'s and other defined contribution plans will count toward this limit as will the interest paid on the ESOP loan. However, when made to either allocated or unallocated shares in the ESOP trust, distributions on shares in the S corporation paid to the ESOP can be used to repay an ESOP loan without limit. For example, if an ESOP purchases stock from selling shareholders of the agency at a fair-market value of \$2 million, the tax savings realized by the agency will be \$700,000. This is assuming, for illustration purposes, a combined federal and state tax rate of 35 percent (\$2 million x 35 percent = \$700,000). This is possible because the ESOP contributions, which are used to pay the loan principal, are deductible by the company as a benefit-plan expense. The table below illustrates the repayment of an ESOP loan using pre-tax dollars.



### Additional S corporation tax benefit

In addition to being able to pay the ESOP loan principal with pre-tax dollars, S corporations pay no federal income taxes (and most states income taxes) on the earnings that flow through to the ESOP. Therefore, if the agency has an ESOP that owns 50 percent of the stock of the sponsoring company, the agency pays no income tax on 50 percent of its annual earnings. This is why there is such a prevalence of 100 percent ESOP owned S corporations today. Imagine having 100 percent of the earnings generated by the agency without paying any income taxes.

## Defer taxation using Section 1042 'rollover'

Under Section 1042 of the Code, an owner of closely held C corporation stock (not allowed in S corporations) can defer capital gains tax on stock sold to an ESOP if certain minimum requirements are met. This capital gains tax deferral benefit has become even more advantageous in 2013 as the Bush tax cuts expired.

The maximum long-term capital gains tax rate is 21.2 percent (20 percent plus the extra 1.2 percent is due to the return of the 3 percent disallowance of itemized deductions for income earned above a threshold). In addition, the new federal health-care program includes a 3.8 percent tax on the investment income, including capital gains, of high-income taxpayers. Therefore, a high-wage earner will be looking at long-term capital gains at approximately 25 percent. So for example, if the selling shareholder(s) of the company sold \$2 million worth of stock to a newly formed or existing ESOP in 2013, they could potentially defer under Code Section 1042, \$500,000 of capital gains tax (\$2 million x 25 percent). In addition, many states that impose their own capital gains tax will be eligible for additional deferment under Code Section 1042.

An additional benefit for estate planning is the potential to avoid the capital gains tax forever in a Section 1042 rollover. Based on today's laws, if a seller holds the qualified replacement property until death, the qualified replacement property is passed to his or her estate with a stepped-up tax basis. This can effectively eliminate the original deferred capital gains tax on the company stock sold to the ESOP.

While the Section 1042 rollover is not available for S corporation ESOPs, there is no required length of time that a company must be a C corporation to receive the benefits of the Section 1042 rollover. This means a company can revoke its S corporation election to become a C corporation and the seller(s) can elect to receive the deferred tax benefits of Code Section 1042 immediately.

## Conclusion

The main advantages that a leveraged ESOP can provide to a closely held agency and its owners can be summarized as follows:

- 1.) The agency's ability to finance the acquisition of its shareholders' stock using pretax dollars because of ESOP loan payments.
- 2.) The seller's ability to defer capital gains tax (potentially forever) on the sale of C corporation stock to the ESOP.
- 3.) The agency's retention of income tax payments because of ESOP stock ownership in S corporations.
- 4.) The employees gain a motivating retirement benefit that can potentially increase the value of the company by leveraging an ownership mentality.

As with any complex corporate finance structure involving the Code and ERISA, it is important to get qualified and experienced professional advice and assistance before considering an ESOP as your company's perpetuation solution. Penalties for violating Code and ERISA requirements can be serious but are easily avoided with the proper planning and advice. ■

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