INSURANCE INDUSTRY KNOWLEDGE FROM OAK STREET

the bridge

FALL 2012

EXPLORE YOUR SUCCESSION POSSIBILITIES

Your Succession Plan
Ensure business perpetuation and a financially sound retirement

Why Consider an ESOP?
Benefits to you and your employees

The Art of the Acquisition
Acquire an agency the right way

OAK STREET FUNDING

Fall 2012

the bridge

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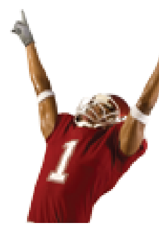

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Leading Your Agency to GROWTH & SUCCESS

Letter from the Founder/CEO

When was the last time you took a break from your daily routine of emails and phone calls and asked yourself two important questions: 1) What stands in the way of you reaching your strategic goals? 2) What is your end-game plan? Sometimes, we need to do some serious thinking about these topics.

What do you need to reach your strategic objectives in the agency? Another producer to generate more business or an office worker to help with administrative services? Acquisition of another's book? New or upgraded technology to increase efficiency or take advantage of new capabilities? A second office in a fast-growing geographic area?

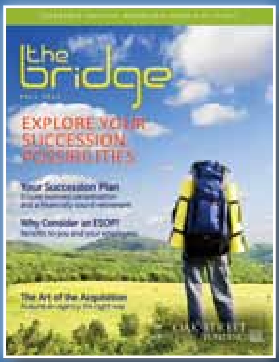
What will happen when you retire or exit your agency? Will a family member take over? Will the capital be available to allow you to exit? Will you sell the agency to the highest bidder? What tax changes will occur?

Oak Street Funding is here to help with your strategic and succession strategies. Despite lingering signs of a credit crunch, we continue to offer financing to insurance professionals and provide resources to help you manage and grow your business. If you haven't before, please visit our website to take advantage of white papers, videos, webinars and articles prepared especially for your unique challenges. We also have a site dedicated to helping agency buyers and sellers connect.

In our last issue we were excited to report closing almost $10.0 million of loans in one month. At press time in September, we had already exceeded $12.0 million with expectations of ending the month near $20.0 million. Year-to-date, Oak Street Funding has funded more than two times the dollar volume we funded for all of 2011. We don't share this news to brag. Rather, we hope you find encouragement knowing there is a viable option available when you have capital needs for your business. Next year will mark our ten-year anniversary and we expect to continue our growth so we can be a resource to the insurance industry for years to come.

Rick Dennen
Founder, President and CEO

Don't miss our next issue of *The Bridge*. Call or visit our website to sign up or renew your subscription today!



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Oak Street Funding Vision Statement

Oak Street Funding utilizes industry knowledge, well-developed technology and passion to deliver best-in-class service and capital products to insurance and finance professionals nationwide. Our customer-focused mind-set and access to capital will allow us to continue to fulfill customer needs, identify growth opportunities and provide an empowering work environment for employees.

How to take a new producer from second-string to Superstar

Identify and mentor the right talent for business growth and perpetuation

Some of the best quarterbacks in NFL history sat on the bench, virtually unknown for years before they got their start. No one could predict they were destined for the Hall of Fame, but their coaches saw potential.

Without Joe Montana and Bill Walsh, what would've become of Steve Young, former quarterback for the San Francisco 49ers? Could Tom Brady have led the New England Patriots to four championship titles if not for the example of Drew Bledsoe and leadership of Bill Belichick?

Although these less experienced and less talented second-string players weren't ready to be number one, their insightful coaches knew that given time to observe and learn the complex game of football, they could also reach greatness.

Many future leaders in the insurance agency business are also virtually unknown. They have exhibited the propensity to be excellent producers – they just need the right veterans to mentor them to success. The right mentoring can not only help develop producers to help agencies grow organically, it can also provide the right individual or individuals the ability to envision and execute a succession strategy for owners who are planning to exit the agency business.

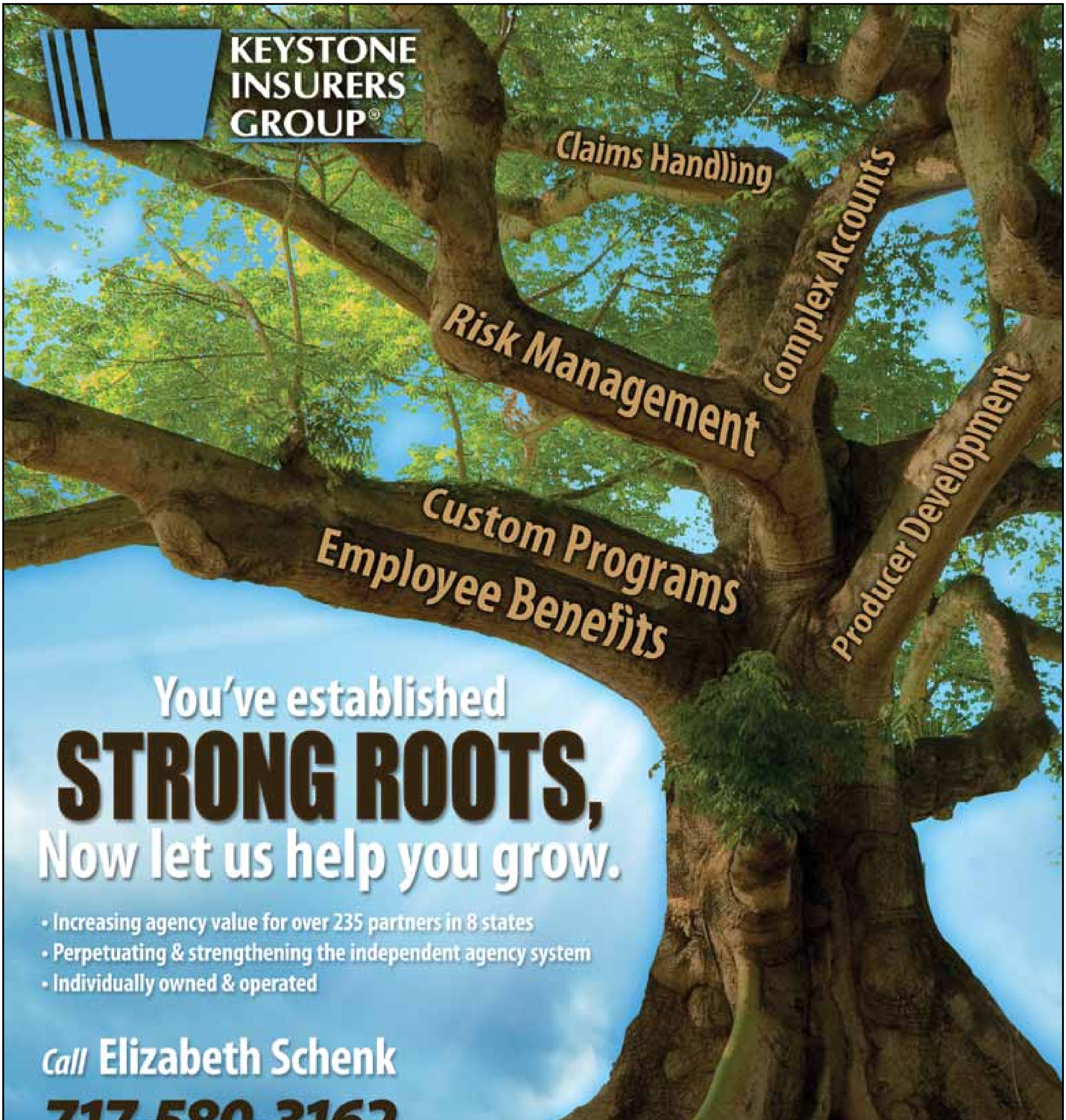
Concern over the lack of talent is a major issue for the insurance agency industry. Lloyd's Risk Index (Lloyd's Risk Index 2011) indicated that a shortage of talent and skills was the second largest risk facing businesses in 2011 — up from 22nd place in 2009. It will become increasingly critical as the majority of agency owners, who are boomers, prepare to retire and exit the business.

By implementing a simple mentoring strategy, agencies can fill this void. Mentoring an up-and-comer is as easy as allowing them to shadow an established producer for the majority of their workdays. The key is to remember that preparing to sell insurance coverage is a long learning process.

Sometimes agencies make the mistake of thinking good mentoring is having new producers shadow an established producer for a few weeks with periodic follow-up meetings. But an effective and thorough mentoring process takes much longer and is more involved. In addition to gaining the knowledge required to obtain sales licenses, newbies have to develop the techniques and skills needed to manage the sales cycle and pipeline, deal with a diverse range of customers and prospects, handle administrative details, maintain carrier relations and more. Allowing several months to a year is a more realistic timeframe for development.

Agencies should financially prepare to cover the cost of a new head-count without seeing a return for a while and this may require tapping into savings or obtaining a loan. Mentoring is an investment, but can result in tremendous business growth.

A simple mentoring strategy can fill a void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Free online resources are ple

Insurance agents and agency owners are continually challenged with how to best manage and grow their business. Well, there is no shortage of help for agents. In addition to information for businesses in general, there's a plethora of resources tailored to insurance agents. And they're available at no cost.

While there are times when agents need to invest in tools and services for their agency, they can gather information, conduct research, and get step-by-step instructions and advice from professionals who share their knowledge and expertise online. Sometimes there's enough just to scratch the surface and identify the need for a paid professional, and sometimes there's enough for an agent to actually accomplish a major goal.

Developing an online strategy, for example, eludes many insurance agents who may be of the baby boomer age and don't have a passion for the latest technology. Social media companies, industry trade organizations, email marketers and others recognize this need. They have published thousands of articles, blogs and videos on how to get started.

Oak Street Funding also offers resources to go beyond providing loans and financing to agents. The company has

ONLINE WEBINARS

Attend monthly online seminars on various topics - from your office

AGENCY LISTING

Search or list agencies for sale at web marketplace

WHITE PAPERS

Manage and grow your business with insight from professionals

entiful for agents

added new resources to its website designed to educate insurance agents and brokers on strategies to buy, build and sell an insurance agency. Visitors to www.oakstreetfunding.com will find articles, white papers, videos and blog posts related to topics that are integral to growing, acquiring and selling insurance agencies. Oak Street Funding also hosts monthly educational webinars and publishes a quarterly print and electronic magazine accessible online.

In addition to our own staff of people who have rich experience in insurance and finance, Oak Street Funding has teamed up with professionals who offer even more expertise. Our combined efforts provide tips, insight and information on anything from optimizing websites for greater online search results to succession planning.

"Our team of loan officers and servicers talk with hundreds of insurance agents and brokers every day, and we have learned there is a great need for information about how to buy, build and sell insurance agencies," said Carissa Newton, chief marketing officer at Oak Street Funding. "We are trying to fill this void by providing helpful content on topics that extend beyond funding."

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online to our e-newsletter and receive resources via email. Visit our newsletter page.

BLOGS & ARTICLES

Get information and news on the latest insurance market trends

Safest driving cities ranked

The national average for years between auto collisions is 10 years. Allstate's eighth annual "Allstate America's Best Drivers Report™" revealed Sioux Falls, South Dakota, as the safest driving city. The report was based on a study of internal property damage claims from January 2009 to December 2010. Allstate publishes the findings to help increase awareness of safe and responsible driving.

Source: Allstate America's Best Drivers Report™

Top 5 Cities Overall

Rank	*City*	*Likelihood**	*Years**
1.	Sioux Falls, SD	27.6% less likely	13.8
2.	Boise, ID	27.3% less likely	13.8
3.	Fort Collins, CO	26.7% less likely	13.6
4.	Madison, WI	23.0% less likely	13
5.	Lincoln, NE	19.3% less likely	12.4

Top 5 Cities with 1 Million+ Population

Rank	*City*	*Likelihood**	*Years**
53.	Phoenix, AZ	1.6% less likely	10.2
124.	San Diego, CA	14.0% less likely	8.8
141.	San Antonio, TX	20.4% less likely	8.3
152.	Chicago, IL	25.9% less likely	7.9
153.	Houston, TX	25.9% less likely	7.9

* Likelihood is collision likelihood compared to the national average. Years is the average number of years between collisions.

Big data and analytics help insurers understand and retain customers

Technology can cause challenges, especially because it can change so drastically and rapidly. But the trend to use what is called 'Big Data' to help the insurance industry can offer carriers and agents huge benefits. Insurance companies are using technology to cross analyze structured data about customers with unstructured information from outside sources like demographics and social media information. When the two are mined for data and analyzed, sellers of insurance can better target their markets at a micro level, identify customers who are at risk of leaving, find other selling opportunities for insureds, and guide transactions to build and maintain long-term relationships. Overall, Big Data should improve the effectiveness of marketing and sales and lower costs.

Source: http://www.insurancetech.com/business-intelligence/240006997

Healthcare cost increases
greatly outpace wage increases

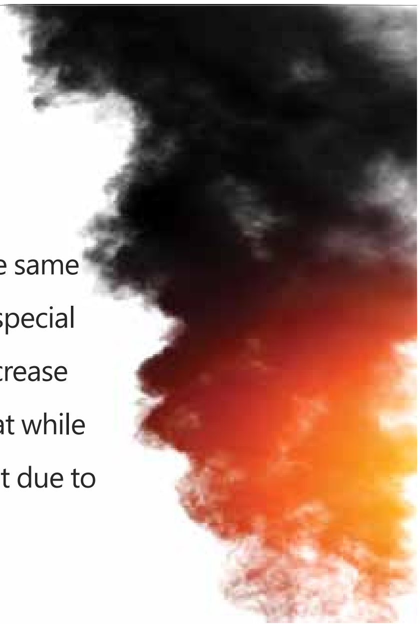
The Kaiser Family Foundation and the health Research & Educational Trust conducted a national survey of employers that resulted in statistics that highlight concerns over growing healthcare costs. Since 2002, average premiums for employer-sponsored family health coverage have increased 97 percent while workers' wages have increased by only 33 percent and inflation by 28 percent. A moderate increase in the national average for premiums in 2012 (up only 4 percent compared to 9 percent) may be due to a slowly recovering economy. The average annual premium this year for family coverage is $15,745. *Source: http://ehbs.kff.org/*

Isaac's slow movement caused more damage than expected

Hurricane Isaac has been compared to Hurricane Gustav, which resulted in $2 billion in insurance claims. Both storms caused more damage than expected, but didn't wreak havoc on the nation and insurance industry like Katrina and Irene. A catastrophe modeling company estimated damage could be between $500 million and $1.5 billion, which excludes property insured by the Federal government and off-shore energy losses. Although Isaac was only a Category 1, its lingering presence caused much of the damage for which it was responsible.

Source: http://money.cnn.com/2012/08/29/news/economy/hurricane-isaac-damage-estimates/index.html

Decrease in CATs improves income, but numbers still high



Income for insurers for the second quarter of 2012 increased significantly from the same period last year. In fact, it rose 343 percent for 26 P&C companies, according to a special comment posted by Moody's Investors Service. The rise can be attributed to a decrease in catastrophes in the first half of the year and premium growth. Moody stated that while catastrophic losses have been lower compared to 2011, 2012 has still been difficult due to severe weather and wildfires that pushed catastrophes past the 10-year average.

Source: http://www.propertycasualty360.com; August 22, 2012

Your *Succession* Plan

There will come a day when unlocking the agency's doors isn't going to be part of your daily routine. When that happens, what will you do?

Some people envision a relaxing life on well-manicured fairways. Others see a second chance to do something they've always wanted to do. And some envision a family member or employee gradually picking up a bigger share of the responsibility. Making that "exit" demands serious thought because it can have big implications for your family's financial health, taxes, your employees, and your valued clients.

Why do you need an exit plan?

You may already have a good idea of what you want that next step to be, so what's the point of developing a formal plan? As with so many things in business, if you don't manage the process, you may find yourself in a crisis situation. It normally takes at least two to three years to prepare an insurance agency for a transition.

Most business owners who approach exit planning unsuccessfully do so largely because they don't take the time to develop a written succession plan that addresses:

- How you'll transfer control and assets.
- Who the owner(s) will be.

Structure the transition

Planning means that you'll be able to think through all of the aspects carefully. It also reduces the risk that you'll be backed into a corner by external events. A gradual transition will protect the health of the business and reduce everyone's stress.

Who will succeed you?

A succession plan gives you some say in determining your successor, along with time to prepare that person for the eventual transition. No two agencies are exactly the same. That's why it's important to take the time to envision the future you want for your agency.

Children may have plans of their own, or their personalities may not be well-suited to running an agency. Employees may appreciate the opportunity to become owners. If your business is already a partnership, one of your partners may be interested in acquiring your share. Or, you may find a complete stranger who wants to buy you out.

Assemble an expert team

Successful business people know how to tap into knowledge and advice from a variety of experts. Build a team you trust, including your CPA and attorney, and keep them involved. They will provide additional viewpoints and identify issues you may not have considered.

Create a transition strategy

Assess your agency's strengths and weaknesses. Look for ways to enhance what you already do well, and develop strategies for resolving other issues. Develop a clear understanding of your agency's fair market value. Today, average small agencies sell for four to five times their adjusted EBITDA (earnings before interest, taxes, depreciation and amortization).

How you'll determine a fair value

Before you negotiate a price and terms, work with your attorney and CPA to identify and develop the structure that best fits your objectives and tax situation. Three common approaches are leveraged buyouts, earn-outs, and seller-assisted transactions. If you can help the buyer access third-party financing, you stand a better chance of receiving more for your agency.

Once the papers have been signed, the transition between owners is full of make-or-break moments involving carriers, customers, and employees. Employees want to know that they're not facing significant changes. Clients want to continue to receive great service.

Before you know it, your former agency may be a well-running machine that doesn't need much of your time or advice. That means you did a great job of planning, your plan succeeded, and you can now focus on your dreams.

Download the full white paper today.
www.oakstreetfunding.com/succeed

Does purchasing or generating leads produce greater results?

There's no shortage of resources for leads if you want to purchase them. Companies are lined up to sell them to agents. You can buy a mass amount of leads to permanently upload to your database and contact as you wish, rent leads from a provider that contacts them on your behalf via email or direct mail, or get one-off leads from various sources that capture quote requests from consumers. There's also a plethora of ways to generate leads - from friend and family referrals, to social media, to cold calling. But what is the best way to generate leads? Which method sees the greatest conversion to sales?

Most agents utilize a combination of resources to achieve the right balance. Purchased leads provide a high volume of contacts agents can quickly reach through direct marketing efforts or nurture through a sales process over a period of time. But since these leads are available to other agents, they are "shared" leads that come with greater competition.

On the other hand, generating leads from scratch can produce quality contacts who haven't been bombarded by other agents. The downside, however, is that a lot of time and effort is required to find enough of them to meet your goals. What's the right answer? As with most practices, there is no single formula for success. Each agent has to test different approaches to find what works for them. The key to achieving results with any lead is good, timely follow-up. Automate and personalize responses as much as you can and implement a drip campaign to ensure enough marketing touches to get contacts' attention and continue the conversation. The chosen strategy must be well planned and executed. What's more, you will need to track the results of each lead so you can gauge the effectiveness of both the source and marketing strategy utilized to nurture and develop that lead.

The Art of the Acquisition

Only a handful of dreamers are actually successful. How you can be one of them.

By Michael Mensch

I've spoken with hundreds of would-be agency buyers over the last few years. Many have the same master plan; use someone else's money to go out and acquire agencies to build an empire. The reality is that only a small percentage of the dreamers are actually successful at it and those that are successful close more deals than 90% of the rest combined. Investors and partners also flock to them for their ability to make deals happen. So what are the differences between the few and the many?

Let's first start with why you might want to invest in acquiring an agency. If you currently own or manage an agency, the first reason is simple; it's an investment that you understand. The reward will outweigh the risk if you know how to effectively run an agency and structure a transaction. The second reason is that most transactions yield a 25% or higher return on invested capital because there are a number of third party lenders for buyers of insurance agencies, such as Oak Street Funding, that allow buyers the ability to leverage their capital significantly. A buyer can often acquire an insurance agency with less than 20% of the purchase price as a down payment and then use the cash flow of the business to pay back the loan. Try to get that type of return on any other investment. The third reason is that, if the buyer owns an agency, acquiring another agency will allow them to realize economies of scale such as revenue and expense synergies and an overall enhanced stability that comes with being bigger. Finally, and of no less importance, as an agency grows in size the value as a multiple of revenue and earnings goes up increasingly, provided that the profitability is not diminished of course. None of these should be surprising but it doesn't hurt to point them out.

Finding opportunities

If you are seeking agencies to purchase, you have a few options. The first is to scour the internet for agencies that are actively for sale. The top websites for agency listings are www.bizbuysell.com, www.agencyequity.com and www.osfagencyexchange.com. If you do not contact the owner of the ad within a week or so of it hitting the internet, then your chances of getting a deal done are greatly reduced. Agencies actively for sale undergo an auction process and there is often a limited amount of time to throw your name in the hat before the seller receives an acceptable offer. Nevertheless, agency-for-sale websites are a good tool because you can see what the market is like.

The second option is to do your own prospecting. Network with agents or marketing reps and let them know you are actively looking for an agency or book of business to buy. You could also make phone calls or send letters to local agencies announcing your intent. Based on my conversations with agents, this is not as effective as one might expect and might not yield a result for years, if at all. There is a large trust gap that has to be bridged between you and the owner in terms of your ability to maintain confidentiality, that your offer is fair and that you can consummate a deal.

The third option is to contact business brokers or merger and acquisition specialists that sell insurance agencies. The goal is to introduce yourself and let them know what you are looking for and can afford. You can either wait for them to contact you on new opportunities as they arise, or hire the intermediary to solicit agency owners on your behalf. Using an intermediary helps to bridge the trust gap with a seller and gives them a higher confidence that you can get a deal done since the intermediary has likely sold a number of other agencies and is compensated on a successful transaction. Serious buyers hire an intermediary because it greatly improves the chances of finding opportunities and they will most likely be proprietary ones where you have little or no competition.

Competition

When out there searching for opportunities, your competition will be fierce. In fact, I would argue that property and casualty insurance agencies are possibly the most in-demand type of small businesses in the country. Depending on what type of agency you are trying to acquire, the competition can come from national/ regional insurance brokerages, financial institutions, private equity groups, local agency owners, and licensed agents. Even a very high net worth individual buyer will find it hard to compete against the "big boys", the institutional buyers like Brown & Brown that pay in cash and close one to three deals a month.

The highest EBITDA multiple that a leveraged transaction can support is usually around 5.0-5.5 times. If the buyer needs to draw a salary from the business, then the highest EBITDA multiple that the buyer can afford will be even less. A public brokerage or bank on the other hand may be trading at 8-10 x EBITDA, giving them a hefty cushion, and they will have significantly more synergies to capitalize on. Professional buyers target lower risk acquisitions which are usually agencies with over $1M in revenue, a well-branded reputation and strong management in place. The solution for most buyers is then to fish in a smaller pond. Look for smaller agencies or ones that may have higher risk attributes.

Increase your chances

Going back to my original question, what are successful acquirers doing that others are not? The answer is simple. They are vigilant and dedicated to their search. They move quickly in sizing up an opportunity and making an offer. They understand the process including where they can get the deal financed and how the lender will underwrite the transaction. They are flexible in their search geography and in negotiating terms to meet a seller's objectives. The most successful buyers are professional acquirers and spend nearly all of their time, or hire people to do so, seeking out, negotiating, closing and integrating agencies. To play in their realm, you need to understand the process and follow their lead.

The process

The acquisition process can be broken into six steps.

- Identification of an opportunity
- Disclosure and discussion
- Negotiation
- Due diligence
- Contract closing
- Post-closing transition and integration

Step 1 was discussed briefly above so I'll move to the disclosure phase or, in candidate language, the "you show me yours and I'll show you mine" step. Prior to releasing information, a savvy seller will want you to sign a confidentiality and non-disclosure agreement that protects them from you telling the world about your conversations. Aside from that, they will want to know who you are and if you have the experience and finances to buy their business. Once they approve you, then it's time to get some detailed information. You should look to receive three years of financials, a breakdown of the book of business and some basic information on the employees and general business operations. You should also ask the seller's expectation on the price and terms, why they are selling and what they plan on doing after the sale. Understand that the more information you request up front, the slower the process will be and the higher the probability they might start talking to another buyer.

After you have a good feel for the agency, then it's time to put together an offer for the seller. The intent here is not to detail everything that goes into an offer or how to best negotiate one (Step 3). I covered much more depth in my webinar which is available on Oak Street Funding's website.* I will summarize simply with a few rules:

1. Know what you can afford, your risk tolerance and your cash flow and return on investment requirements.
2. Consider what the seller wants and their motivation. Sometimes the owner wants out completely, other times they just don't want the headache of running a business but aren't completely ready to retire. Engage them by recognizing their priorities.
3. Put everything in writing and have it drafted by an attorney and M&A advisor. If you try to make a rushed ad hoc offer, then you may find yourself back in negotiations once you realize that you did not outline all of the terms properly.
4. Know that time is of the essence. Delays kill the enthusiasm and add stress on the parties. Work diligently to move forward.
5. Have a discussion with your financier before agreeing to any modifications. There are usually three parties to the transaction; you, the seller and the lender. Don't forget the last one as it is the most important!
6. Be reasonably flexible. There is more than one way to skin a cat. If the seller is adamant about one negotiating point, look to get what you want from another.
7. Use an intermediary. Tensions rise during a negotiation. It will take a lot of goodwill between the parties to close the deal and you don't want that destroyed during the negotiations so use a buffer.

The fourth step is due diligence. This is where you take a quantitative and qualitative assessment of the agency. I provided a fairly thorough due diligence list in the webinar slides. Depending on the complexity of the agency, you may want to use a due diligence expert to assist you. Also take into consideration that smaller agencies will be less organized than larger ones so some items that you request may not exist or may take considerable time to put together.

If a lender is involved, put a priority on getting them what they need so that the underwriting process gets moving. The due diligence phase can vary from a week to months; it can be overwhelming and it can make or break the deal. Expect surprises to come up, communicate with the seller on any questions that you have and know when to throw up a red flag.

Once you have worked through the due diligence and signed a final purchase agreement, then it's time to focus on closing the deal (Step 5). The closing is subject to certain third party approvals such as from a lender, leaseholders and carriers (as much of an approval as they'll give prior to closing). An attorney should draft the final closing documents which everyone should review and approve in advance of the actual closing. After closing your work really begins.

Hopefully you have negotiated for the seller to stick around for a transition (Step 6). During that period, you will need to execute new employment agreements with the staff and producers, familiarize yourself with the day-to-day business, take care of the mundane tasks like transferring utilities and filing licenses and undertake the major project of getting the carriers to transfer the book of business which might take two to three months to finalize.

My advice for the first three to six months is to not make any significant changes to the agency. You don't want to put the staff into culture shock or, worse, revolt. You also don't want to sound the alarm to the customers that something is going on internally. A smooth transition is a sign of a professional buyer and seller.

What to expect

If you chose to play the acquisition game then you should expect to commit time and resources, stops and starts to happen along the way, problems to arise unexpectedly, and stress and emotion to boil to the surface. The first deal is always the most difficult. Like anything, the more that you practice at it, the better you'll become. If you can master the art of the acquisition, then you will join the ranks of the few and see your net worth climb exponentially.

*Webinar archive: http://www.oakstreetfunding.com/AboutUs/Events/EventArchives.aspx

ABOUT THE AUTHOR

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Employee Stock Ownership Plans (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 advisors. ESOPs provide a very powerful and flexible mechanism for planning a company's internal perpetuation. The special tax benefits they provide are attractive to the selling shareholders, employees, and the company.

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 of the company would most likely fare better with a sale to an ESOP than if the company were 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.

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 thereby permitted to hold 100% 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 very 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."

Why consider an ESOP?

Give yourself and your employe

Often an additional incentive outside the ESOP is also provided to these key employees in the form of stock, stock options, or stock appreciation rights (SARs). 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 highly motivated by sharing in the resulting stock value increase. Here is a basic overview of what an ESOP is, and how it can be utilized in agency perpetuation planning.

What is an ESOP?

An ESOP is a special kind of qualified plan governed by the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the "Code"). Although there are some exceptions, generally all full-time employees over 21 years of age are eligible to participate in the ESOP. A company that wants to create an ESOP sets up the plan and a trust qualified under the Code. An employee stock ownership plan trust is designed to

What price can an ESOP pay for company stock?

An ESOP can pay "fair market value" for shares of the sponsoring agency's stock. This requires that the stock be valued by a qualified and independent business appraiser. 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.

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 are generally allocated to individual participants based on a ratio of their individual pay to the total of all eligible

By Chuck Coyne

ees **many reasons to celebrate**

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% vested within three to six years, depending on whether vesting is "cliff vesting" (100% after 3-years) or gradual (20% 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% of eligible payroll contributed to their defined contribution plans (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% contribution level to repay principal on an ESOP loan.

As with any corporate loan, interest expense is fully deductible and does not count towards this 25% 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 are also fully tax-deductible. On the other hand, S corporations have a 25% 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 towards this limit as will the interest paid on the ESOP loan. However, distributions on shares in the S corporation paid to the ESOP, when made to either allocated or unallocated shares in the ESOP Trust, 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 $2,000,000, 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% ($2,000,000 x 35% = $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.

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 state income taxes as well) on the earnings that flow through to the ESOP. So if the agency has an ESOP that owns 50% of the stock of the sponsoring company, the agency pays no income tax on 50% of its annual earnings. This is why there is such a prevalence of 100% ESOP owned S corporations today. Imagine having 100% of the earnings generated by the agency without paying any income taxes.

Deferring taxation with Sec. 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 will become even more advantageous in 2013 as the Bush tax cuts are scheduled to expire. The maximum long-term capital gains tax rate will rise from today's 15% to 21.2% (the extra 1.2% is due to the return of the 3% disallowance of itemized deductions for income earned above a threshold). In addition, beginning in 2013, the new federal health-care program could impose a 3.8% tax on the investment income, including capital gains, of high-income taxpayers.

These two changes amount to a combined 66 2/3% increase in the maximum federal income tax for long-term capital gains rates on the sale of stock in 2013 compared to a sale in 2012 (a 25% rate compared to a 15% rate). So, for example, if the selling shareholder(s) of the agency sold $2,000,000 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 ($2,000,000 x 25%). 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 the laws today, if a seller holds the qualified replacement property until death, the qualified replacement property is passed to his/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 during which a company must be a C corporation to receive the benefits of the Section 1042 rollover. This means that 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 without delay.

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.

Benefits of a leveraged ESOP to a closely held agency and its owners

- Agencies can finance the acquisition of their shareholders' stock using pretax dollars as a result of ESOP loan payments.
- Sellers can defer capital gains tax (potentially forever) on the sale of C corporation stock to the ESOP.
- The agency's retention of income tax payments as a result of ESOP stock ownership in S corporations.
- Employees can gain a motivating retirement benefit that might potentially increase the company's value by leveraging an ownership mentality.

ABOUT THE AUTHOR

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