ESOPs and Baby Boomer Business Owners: A Demographic Imperative

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A Demographic Imperative

The "Baby Boom" is a demographic age wave that occurred between 1946-1964. The first cohort of Baby Boomers reaches age 65 in 2011, with the final cohort reaching age 65 in 2029; thus, there is an 18 year window. This will result in an unprecedented opportunity for AALU members to offer services and products to aging Baby Boomer Business Owners, or "BBBOs," looking for assistance with Ownership Succession Planning.

According to a recent PricewaterhouseCoopers (PwC) report:

- 72% of privately held U.S. Companies plan to monetize their value,
- With 62% of the companies planning to do so in the next 5-6 years.
- The desire to monetize is being driven by the need to realize and diversify wealth (66%) and owners desiring to retire (34%).
- Owners anticipate the Value Realizing Event being:
- Sale to Insider/ESOP (46%)
- Sale to Outsiders (41%)
- Unsure (13%)

And while according to the CMI 2008 Exit Planning Study, 90% of business owners recognize the importance of Ownership Succession Planning, only 10% has a written Plan. According to the CMI Study, 90% of business owners want to learn more about Ownership Succession Planning with 50% stating that it is a "Top" or "High" priority.

According to Hoovers, Inc., the "target market" is significant with there being 195,533 privately held U.S. companies with revenues of $5M - $500M.

Market Opportunity

There are numerous marketing opportunities for AALU members whose clients implement an ESOP. ESOPs create liquidity to pay life insurance premiums and ESOPs create corporate liabilities to be funded with Corporate Owned Life Insurance (COLI).

The most immediate insurance need when an ESOP is established is key person coverages to insure the ESOP debt. In a typical ESOP, a company borrows 100% of its value from a combination of bank debt and seller financing. Thus, in a company with a fair market value of $10M, the company will take on new debt of $10M to finance the ESOP. Therefore, prudent business practice would dictate that the company purchase $10M of insurance to mitigate the risk of the company's key employee(s) dying or becoming disabled and the company not being able to repay the loan. If a premature death or disability causes a loan default not only would the default hurt the selling shareholders' family(s) but it also could result in a catastrophic loss of value in employees' ESOP accounts. Therefore, not only do best practices suggest life and disability insurance but there may be a fiduciary obligation to purchase coverages to protect employees' retirement benefits.

Companies that sponsor ESOPs are required to convert the stock in employees' accounts to cash upon the occurrence of one of the following distributable events: Death, disability, retirement and termination of service. In addition, when an employee reaches age 55 and has participated in the ESOP for 10 years, the participant becomes entitled to diversify a portion of his or her ESOP account. The requirement to convert this illiquid closely held company stock to cash is known as the "ESOP repurchase liability." This company liability should be quantified by an ESOP consulting firm in an ESOP Repurchase Liability Study and it can be funded using COLI.

ESOPs create a number of other insurance planning opportunities including funding wealth replacement trusts in conjunction with charitable ESOPs (sometime referred to as CHESOPs) and create liquidity to pay premiums for long term care insurance.

What is an ESOP?

There are three different parties or constituencies involved in ESOPs and the answer to this question depends upon which constituency's perspective you consider.

- To an owner of a closely held company, an ESOP is a way to get money out of his company on a tax-advantaged basis and to transition control of his company to key employees or family (insiders).
- To the company's employees, an ESOP is a retirement plan (like a 401k) that allows employees to share in the value of their company.
- To the Company, an ESOP is a vehicle of corporate finance that offers tax benefits not available anywhere else in the Internal Revenue Code.

How Does an ESOP Work?

An ESOP works in many respects like any other type of qualified retirement plan. But there are three distinct differences between an ESOP and every other type of qualified retirement plan. And it is these

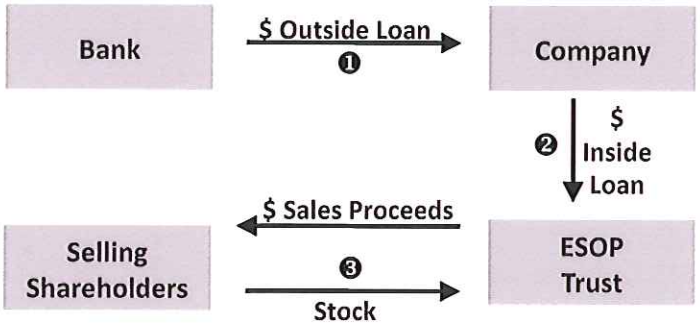
RETIREMENT
AHEAD

three differences that make an ESOP work as effectively as an ownership succession strategy.

- An ESOP can borrow money.
- It can engage in transactions with parties in interest. In this case, "parties in interest" would be the owner or owners of the business.
- An ESOP is required to invest primarily in the stock of the Company that sponsors the plan.

The chart labeled A and step-by-step description illustrate how stock is sold to an ESOP in a typical Ownership Succession Planning scenario:

CHART A



In Step 1, the Company obtains a loan, often from its current bank. This is referred to as the "Outside Loan." Due to technicalities in the lending laws, banks almost never loan money directly to an ESOP. Instead, a bank loans money to the company which then lends it to the ESOP.

In Step 2, the Company lends money to the ESOP. Generally, the Company loans the same amount it borrowed from the bank in Step 1, although the Company could lend the ESOP more or less. This is referred to as the "Inside Loan." The terms (repayment period, interest rate, etc.) of the Inside Loan often mirror the terms of the Outside Loan but there may be reasons, in certain situations, for the terms of the Inside Loan to be different from the Outside Loan.

In Step 3, the ESOP Trust, or ESOT, uses the cash it received in the Inside Loan to purchase Company stock from the selling shareholder(s). The stock that is purchased will be held initially in the ESOT's "Suspense Account."

The chart labeled B and the step-by-step description illustrate the annual activities involved in an ESOP.

WHAT ARE THE ESOP TAX INCENTIVES?

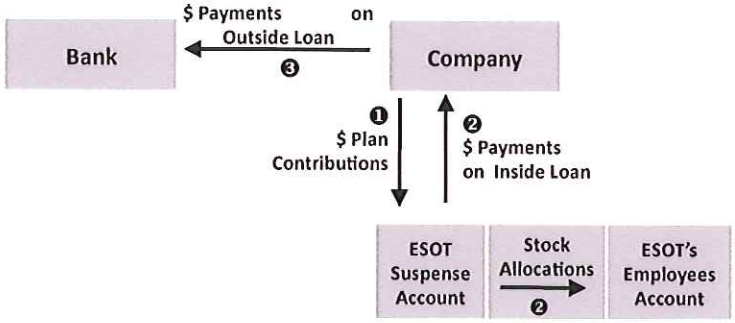
Owners who sell stock to an ESOP will pay tax at the 15% long-term capital gains tax rate (worst case scenario). If the Company is a C corporation, the seller(s) may be able to defer tax, perhaps even permanently.

Employees participating in the ESOPs are not taxed on the stock allocated to their accounts or on its earning until distributed generally at death, disability, retirement or termination of service (subject to vesting).

Companies that sponsor ESOPs are able to deduct ESOP contributions (subject to certain limitations). This results in a Company converting what would have been a non-tax deductible principal payment on a loan into a tax deductible retirement plan contribution. This tax benefit is available for C and S corporations.

C Corporations also are able to deduct dividends paid on ESOP held stock under certain conditions. This is the only way a company can get a tax deduction for dividend payments and it may allow a company an avenue to get money into its ESOP in excess of the contribution limits referenced above.

CHART B



S corporations are "flow-through" entities for tax purposes, which means that they do not pay tax. Instead, their income "flows through" to their owners who include their share of the company's taxable income and on their tax return. Let's follow a corporation through the process.

- Assume an S corporation has $5 million of taxable income and 2 equal shareholders; each of them would receive an IRS form K-1 for $2.5 million.
- Assuming that they pay tax at the 35% federal tax rate, each of them would pay $875,000 in federal income tax on the S corporation earnings.
- However, since an ESOT, like all qualified retirement plan trusts is tax exempt, its portion of the Company's income is free from taxation.
- Therefore, in the example above, if an ESOP were one of the two owners, the tax liability on the Company's income would be reduced in half, saving $875,000.
- If an ESOP owned all of the Company in this example, the Company's $5 million of taxable income would be

ESOP Power Phrases

- Would you like to sell your company, pay no tax on the gain and at the same time significantly reduce your estate tax?
- Did you know that your company can purchase your stock and fully deduct the entire purchase price?
- Are you interested in getting liquidity out of your company on a tax-favored basis so that you can diversify your wealth while still retaining control of your company?
- Did you know that as a 100% ESOP owned S-corporation you can achieve a significant competitive advantage by eliminating all income taxes on company earnings?
- Did you know that you can help creditor proof yourself by selling all or a portion of your company to an ESOP?
- Did you know that employees do not own the stock in their ESOP accounts and almost never get to vote it?
- Have you ever had your company valued by a professional? Did you know that as many business owners undervalue as overvalue their companies?
- Did you know that an ESOP can supplement a sale to an Insider(s) (including key employees and family members) and an estate planning disposition of your company?
- Did you know that you can sell all or a portion of your company to an ESOP today and subsequently sell the company to a 3rd party?
- Did you know that an ESOP is the most tax-efficient strategy for getting cash out of your company to pay financial obligations under a divorce decree and avoid having to sell your company or give stock to an ex-spouse?

completely free from federal income tax, saving $1.75 million in income taxes.

As can be seen, Congress has created powerful tax incentives for business owners to use ESOPs as an ownership succession planning vehicle.

Conclusion

The aging of Baby Boomer Business Owners will result in an unprecedented opportunity for the creation of new ESOPs and the insurance products that are integral to their success. I believe this represents one of the best emerging markets for AALU members to consider adding to their practice either by developing ESOP expertise in-house or by partnering with an experienced ESOP consulting firm.

Kelly O. Finnell, J.D., CLU, AIF® is one of the nation's premier ESOP and Ownership Succession Planning consultants and one of the most sought – after speakers on this subject. He has spoken at more than 200 conferences and meetings throughout the U.S. and in London and Sydney, Australia. He has published more than 10 articles on the use of ESOPs in Ownership Succession Planning and is the author of one of the most highly acclaimed books on the subject, The ESOP Coach. Kelly is the president of Memphis based Executive Financial Services, Inc. and can be reached at 901.259.7979 or at kfin@execfin.com. He has been an AALU member since 1988.