

Abstract: When business owners consider the feasibility of an employee stock ownership plan (ESOP), they think primarily of its value as a qualified employee benefit plan — one that creates strong incentives for hard work and devotion to the company. But business owners can also realize estate planning and tax benefits for their businesses. This article examines how an ESOP works and its business-related benefits.

## **ESOPs Offer Business Owners Planning Options**

When business owners consider the feasibility of an employee stock ownership plan (ESOP), they think primarily of its value as a qualified employee benefit plan -- one that creates strong incentives for hard work and devotion to the company. The theory is that when employees are stockholders, they are more motivated to help the company succeed than if they are only salary earners.

But as a business owner, you can also realize other benefits from setting up an ESOP. For example, you may:

- Use an ESOP as a succession planning tool to provide a source of funds to buy out a retiring co-owner,
- Leverage an ESOP to raise new capital for expansion or capital improvements, and enjoy significant tax advantages, or
- Sell a portion of your company shares to your ESOP to shelter capital gains.

Before we discuss those benefits, let's review how an ESOP works.

### **ESOPs: A Primer**

An ESOP is a trust to which a company makes annual, tax-deductible contributions of cash or company stock. The trustee -- typically an employee or a financial institution -- uses the cash contributions to purchase company stock and then allocates the shares to individual employee accounts within the trust. Allocations are based on each participating employee's annual W-2 compensation, years of service or a combination of both.

The shares of company stock -- and other plan assets, if any -- in the employees' accounts must vest before they can withdraw them. Through vesting, employees become entitled to an increasing percentage of their accounts each year, over a maximum of seven years, by which time they must be 100% vested.

Employees receive the vested portion of their accounts when they resign, retire, are terminated, become disabled or die. In some cases, except in the event of death or disability, the employer may distribute the vested shares, with interest, over five years.

Employees of a publicly traded company may sell their distributed shares on the market. But in a private company, selling stock to outside buyers may not be possible or practical. So, ESOPs are commonly obligated to buy back those shares at an appraised fair market value. And though employees own the stock that resides in the trust, the owners of a closely held company can control trust voting on most significant issues.

## **Estate Planning and Tax Benefits for Your Business**

In addition to offering a valuable employee benefit that allows you to attract and retain employees, your business may reap tax benefits as well. Here are three ways ESOPs can benefit your business:

***Succession planning.*** Using an ESOP, your company can buy back a departing owner's shares. Use tax-deductible dollars to make the purchase. Assuming you adequately fund the ESOP, this tax-advantaged buy-back capability helps ensure that the departing owner won't sell out to another company, which would dilute your company's independence.

***Debt financing.*** An ESOP can borrow money from a bank or other lender to purchase company stock. Your company can then use tax-deductible contributions to the ESOP to repay the loan principal as well as interest. This makes the ESOP loan an attractive form of debt financing. You may use the loan proceeds for any legitimate business purpose.

***Defer capital gains.*** A shareholder can sell his or her stock to your company's ESOP and defer federal tax on the gain. But to qualify for this benefit, the sale must meet several requirements. For example, the ESOP must own at least 30% of your company's stock (after the sale), and the seller must roll over or reinvest the proceeds in another U.S. operating company's stock or bonds.

### **Determine ESOP Feasibility**

Depending on an ESOP's complexity and the number of participants, it can be costly. Aside from the expense of setting up and funding an ESOP, deciding whether the plan is right for your company depends on your profitability, the size of your payroll, management's acceptance of employee ownership and other factors. We can help you assess an ESOP's feasibility for your company. Please give us a call.