Unleash the Financial Potential Of Your Business

What Every Business Owner Needs to Know About ESOPs

Business owners are faced with critical decisions every day. In order to make sound strategic decisions, information is crucial. In today's market, every business owner should be well versed on the topic of Employee Stock Ownership Plans (ESOPs). Whether you are considering options for retirement, financing, acquisition, or even divestiture, ESOPs can provide outstanding results.

WHAT IS AN ESOP?

An ESOP is a powerful exit strategy and tax planning tool for shareholders of closely held companies. An ESOP is also a type of profit sharing retirement plan, designed to invest in company stock.

Its strength comes from the ability to indefinitely defer taxation on any gain resulting from the sale of the company's shares. Additionally, another very attractive feature is that an ESOP can borrow money to buy stock with the loan repayments being fully tax deductible. This makes the ESOP more capable of servicing debt on the money that it borrows. An ESOP also allows for higher contribution and deduction limits than are normally available to profit sharing plans.

WHAT BUSINESSES ARE GOOD CANDIDATES FOR AN ESOP?

In general, to be a good candidate for an ESOP, your business needs to have a minimum of 20 employees, an employee payroll of at least $500,000 and a good management team in place.

THE RETIREMENT BENEFITS OF AN ESOP

Most small-to-middle market business owners have a substantial amount of their entire net worth tied up in their business. For most business owners, this illiquid business equity is what they are planning to use to fund a substantial portion of their retirement. If your business is a good candidate for an ESOP, you can sell your stock to the ESOP and rollover the funds that you receive - tax deferred under section 1042 of the tax code - into a long term floating rate bond. Then, you can borrow 90% of the value of the bond and invest that money in a portfolio that returns conservatively 8% per year on average, after expenses and fees.

If the business owner's remaining life span is less than the length of time before the bond matures, at the time of the business owner's death the capital gain taxes that were deferred from the sale of his or her stock to the ESOP are now permanently avoided. The tax on the capital gain from the sale of the business owner's stock to the ESOP is permanently avoided because under federal tax law, the capital assets in one's estate receive a "stepped up" basis upon death. This "step-up" in basis means that there is no longer a capital gain and therefore no longer capital gain tax due.

IMPLEMENTING AN ESOP – THE SOONER THE BETTER

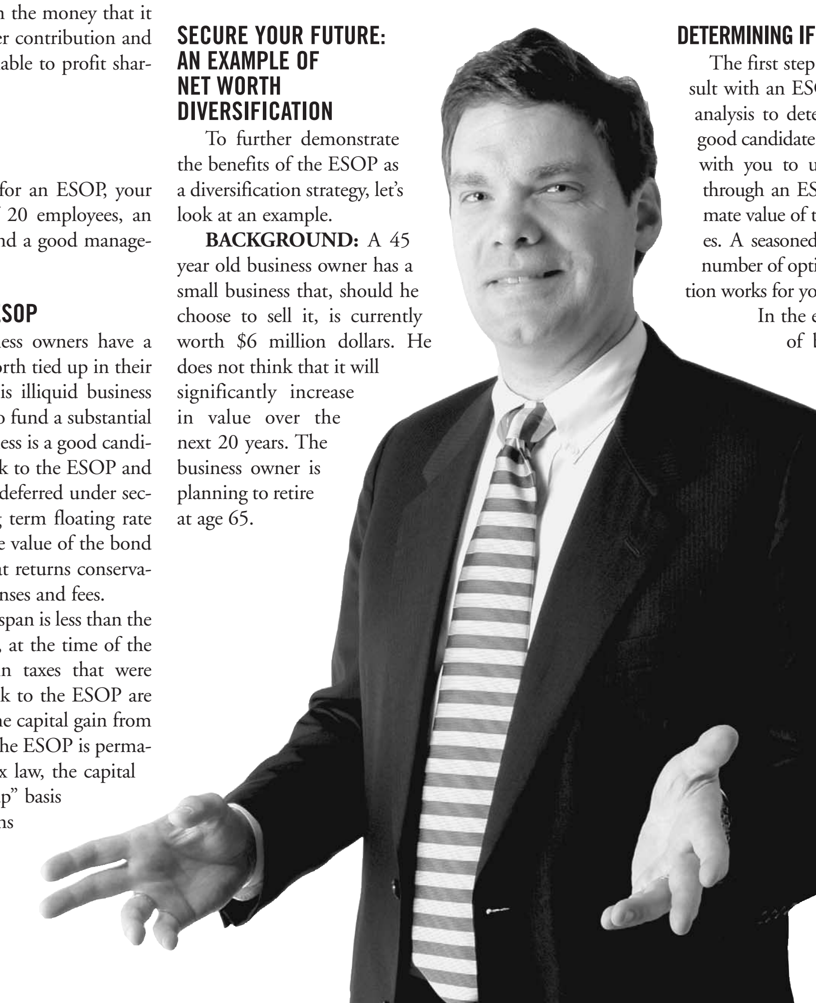
No matter how old – or young - you are, it's never too soon to consider the advantages of an ESOP. Even if you plan to continue working for five years or more, ESOP advantages should be considered NOW as opposed to later, so that the business owner can benefit from the long term compounded growth of the tax deferred funds that have been taken out of the business.

As a diversification strategy, for a portion of their ownership, business owners can roll money out of their business now - tax deferred - into a long term floating rate bond. Then, with the help of a professional financial advisor, they can borrow 90% of the bond value and invest that in a more diversified portfolio, conservatively returning 8% per year on average after expenses. When it comes time to retire, the business owner can sell the portion of the stock to the ESOP that they did not sell to the ESOP years earlier. This allows for a second pay-out, based on the value of the stock in their company at the time of retirement. If the value of the company has increased significantly, the business owner will benefit from the company's increased value and receive a second substantial payout.

SECURE YOUR FUTURE: AN EXAMPLE OF NET WORTH DIVERSIFICATION

To further demonstrate the benefits of the ESOP as a diversification strategy, let's look at an example.

BACKGROUND: A 45 year old business owner has a small business that, should he choose to sell it, is currently worth $6 million dollars. He does not think that it will significantly increase in value over the next 20 years. The business owner is planning to retire at age 65.



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DECISION: He decided to implement a 49% ESOP. He takes $3 million dollars out of the business and rolls it, tax deferred, into an 80 year maturity floating rate bond. He then borrows 90% or $2.7 million from the bond and has a professional financial advisor manage the funds to an average yearly return of 8% (net of fees and expenses).

A LIKELY SCENARIO: Twenty years later, when the business owner is ready to retire, the $2.7 million has grown to approximately $12.5 million. If the business is still worth $6 million, the 51% share that he now owns is worth approximately $3 million giving him a total of $15.5 million from the business with which to retire.

WORST CASE SCENARIO: If the business closes and is worth nothing when he reaches 65, this business owner still has $12.5 million with which to retire.

BETTER SCENARIO: If the business doubled in value, his 51% share will be worth $6 million and he would have $18.5 million with which to retire.

DETERMINING IF AN ESOP IS RIGHT FOR YOUR COMPANY

The first step any business owner should take is to consult with an ESOP expert. They will perform a feasibility analysis to determine whether or not your business is a good candidate. Your ESOP advisor will also spend the time with you to understand the goals you wish to achieve through an ESOP. Next, they will determine an approximate value of the business to be used for planning purposes. A seasoned ESOP advisor will be able to examine a number of options to determine which, if any, ESOP solution works for your company.

In the end, virtually every business owner dreams of benefiting from the hard work that has gone into running their business. No matter how far off retirement might be for you, considering, and possibly implementing an ESOP could be the best retirement planning decision you have ever made.

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