Family Transitions with ESOPs

Family Transitions with ESOPs are ideal for business owners with 20 or more employees and at least $1,000,000 EBITDA who desire to:

- Transition their business to their Family
- Purchase minority family owned interests
- Keep their business in the community in which it is currently located
- Reward employees
- Diversify their portfolio
- Reduce or eliminate estate taxes
- Consider a Wealth Replacement Trust with a second-to-die life insurance policy to equalize distributions for children working in the company and children not, and/or to reduce estate taxes.

This strategy is designed to accomplish the transition of a business to family members or from family members who own a minority interest in a company. The owner uses an Employee Stock Ownership Plan ("ESOP"), a qualified employee benefit plan, to purchase a partial interest in the business for the benefit of the employees with the remaining interest being owned by the owner or family members. When the transaction is complete the ESOP then allocates its ownership in the equity of the company to the participants (i.e. eligible employees) over time by making contributions to the ESOP.

The ESOP obtains the cash for the purchase by a company internal loan. To accomplish the internal loan, the Company arranges for financing to be provided by a bank or may negotiate with the owners for Seller Notes. The company then loans such funds to the ESOP in exchange for a note between the ESOP and the company. The ESOP will pay back the loan be receiving annual deductible contributions from the company which will be immediately used by the ESOP to repay the internal loan. The ESOP then uses the internal loan proceeds to purchase the selling interests in the company.

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The Story – Transition to Family

Meet Bob age 70 and wife Mary age 68. They have three sons in their 40s and all of whom are actively leading the business. James is in charge of accounting, Mike is in charge of sales, and Kevin is in charge of operations. Bob has complete confidence in their ability to manage the company without him. They also have two daughters who are not involved in the business. The company, JKM Industries founded by Bob 40 years ago, manufactures and sells boosters and compressors in the oil and gas industries throughout the world and has 150 employees. Bob and his family know that their success is directly attributed to the company's ability to equip the employees for success. Last year, the company had $40 million in sales, net profit of $4 million dollars and recently was **valued** in the **$25 million** range.

Bob and Mary were excited to learn about recent income tax rates cuts however they are concerned that government spending will cause taxes to rise in the future. With a recent reduction in C Corporation income taxes they are considering switching to be taxed as an S Corporation to a C Corporation. Bob and Mary are ready to transfer the business to their sons but want to provide for all their children equally, and they are concerned about pending estate taxes as their estate is valued at $40 million.

Using an ESOP after death – No Lifetime Planning

Bob and Mary suddenly pass away prior to any business succession planning. Upon their deaths, their estate will pay approximately **$7,000,000** in estate taxes **plus more** as **future appreciation** of the value of the business will continue to accrue in their taxable estate prior to their deaths. Bob and Mary's estate plan provides that all of their children will share in their estate equally after their home is sold and after the estate pays the taxes. As a result of this, $33 million is divided between the five children meaning each child receives a 20% interest in the business and $1.6 million of cash/ marketable securities.

After Bob and Mary's deaths, the family can still use an ESOP to purchase the sisters' shares:

- Provides the sisters with liquidity and cash flow not otherwise available
- Provides a deduction over time equal to the purchase price for the company reducing the cash flow necessary for the purchase by 25% effectively reducing the purchase price
- Rewards the employees for their service and equips them for retirement
- Maintains the company culture
- Establishes a vehicle for the sons to sell in the future to the ESOP potentially creating a 100% tax free entity upon such sale.

Solution – Lifetime Planning

Bob and Mary decide to be proactive with their planning prior to their death. After meeting with their attorney, accountant, and financial advisors, Bob and Mary decide to implement the following plan:

- Convert from an S Corporation to a C Corporation
- Create an ESOP and sell 40% interest to the ESOP using bank or seller financing
- Upon sale to the ESOP, they elect Section 1042 to eliminate capital gains taxes on $6 million realized gains saving approximately **$1.6 million.**
- Value of the company after implementation of the ESOP is an estimated $15 million (approximately $25 million less transaction debt $10 million for the ESOP transaction); $6 million is allocated to the ESOP and $9 million is allocated to Bob and Mary.
  - Each $3,000,000 [$9 million divided by 3 sons] remaining interest will be discounted for lack of control and lack of marketability by approximately 30%
  - Results in (after debt and discounts) gift tax value of $2.1 million each ($6.3 million total gift transfer as compared to above estate tax value of $25 million)
- Gift the remaining 60% interest to their sons in equal shares
  - Future appreciation of the business is now in the sons' estates
  - Leaves estate of $25 million instead of $40 million (Bob and Mary reduced the value of their estate by giving their sons the 60% interest in the Company – originally valued at $15 Million at a gift tax value of $6.3 million)
- Modify their existing estate plan to provide that the first $10,000,000 be shared equally between their daughters (because the son's had received the gifting shares) with the balance being shared equally by all of their children
- Considered implementing a Wealth Replacement Trust with a second-to-die policy to reduce the cost of the remaining estate taxes and/or provide for the daughters with a death benefit of $5 million
- The benefits of the planning:
  - Bob and Mary can diversify their net worth by selling 40% to the ESOP now without capital gains tax
  - Saves approximately **$3,480,000** in gift and estate taxes
  - Uses a Wealth Replacement Trust or Charitable Planning Options to **further reduce or eliminate** the remaining **estate taxes** estimated at approximately $3.6 million
  - Provides all **future appreciation** of the business to be **excluded** from Bob and Mary's estate resulting in **additional estate tax savings** as the company continues to grow
  - Rewards the employees for their service and equips them for retirement
  - Leaves a legacy of a thriving company and maintains its culture
  - Establishes a vehicle for the sons to sell in the future to the ESOP potentially creating a 100% tax free entity upon such sale.