The Charitable ESOP *(an ESOP case study)*

The Charitable ESOP Strategy is ideal for business owners with 20 or more employees and at least $1,000,000 EBITDA who desire to:

- Transition their business over the next 5 – 10 years
- Keep their business in the community in which it is currently located
- Reward employees
- Avoid capital gains taxes on sale
- Create a charitable deduction
- Diversify their portfolio
- Use significant C-Corporation retained earnings
- Leave a legacy by giving back to the community, religious, or other charitable organizations that are meaningful to the owner
- Reduce or eliminate estate taxes
- Give what is "appropriate" to their children/descendants
- Consider using a Wealth Replacement Trust with life insurance to provide for children & grandchildren

This strategy is designed to accomplish the combination of charitable and succession planning. The owner uses an Employee Stock Ownership Plan ("ESOP") to purchase the business for the benefit of the employees. When the transaction is complete the ESOP owns all or part of the equity of the business. The ESOP then allocates a portion of the equity to the participants (i.e. eligible employees) over time.

Prior to the sale to the ESOP the business owner creates a charitable planning entity such as a Private Family Foundation, a Donor-Advised Fund at a Community Foundation, or a Charitable Remainder Trust. By transferring the shares of the business to the charitable planning entity prior to agreeing to sell the shares to the ESOP, the owner can sell the shares without paying capital gains tax, while giving back to the organizations that are meaningful . This strategy also provides the owner a charitable deduction on his/her individual income tax return in the year of transfer.

EAGLE & FEIN

ATTORNEYS & COUNSELORS AT LAW

A PROFESSIONAL CORPORATION

The Story

Meet Dan Jr., age 60, and wife Pat age 58. They have three sons in their 30s and none of them are interested in being involved in the business. Dan is the owner of an international manufacturer and distributor of commercial, residential, and golf course lawn mowers, "Dan's Mowers." Dan's Mowers owns the patent on the best technology in zero turn mowers creating a competitive advantage. The company sells directly through its international distributors and branch offices and also "private labels" its mowers for some of the biggest brands in the industry. Dan's Mowers also manufactures and distributes a full line of accessories and its distributors and branch offices provide maintenance services. Dan's Mower's workforce average age is 45. A preliminary valuation of Dan's Mowers pegged the value in the $30 - $35 million range, with a tax basis of $20,000,000.

With its 400 plus employees, it is the largest employer in the county in which it is located.
Dan Jr. also grew up in the same small town as the company and he feels a responsibility to it.
Dan Jr. has a loyal set of well-groomed managers who run the daily operations. Dan has regularly rewarded them with annual bonuses and all employees with a profit sharing contribution.

Dan Jr. and Pat have regularly given (at no cost) their mowers to youth sports and religious organizations. The company has a generous charitable matching program encouraging its employees to give back. Dan Jr. and Pat have been recognized by being rewarded the annual "Philanthropist of the Year Award."

Dan Jr. and Pat plan to retire when Dan reaches age 65 in five years. Over the last several years they have been approached by various private equity firms as well as strategic buyers to purchase Dan's Mowers. They have also explored the use of an ESOP.

The Solution

Dan Jr. and Pat created a charitable remainder trust ("CRT") for 25% of the ownership of Dan's Mowers, 24% for a Private Foundation to be controlled by them and then their children and grandchildren, and 51% they retained for a future sale to the ESOP, senior management transfers and/or family transfers. After first creating the CRT and Private Foundation and contributing the shares representing 49% of the ownership interest to the CRT (25%) and Private Foundation (24%), the CRT and Private Foundation then sold its shares to the ESOP for cash.

The ESOP obtained the cash by a Company internal loan. To accomplish the internal loan, the Company arranged for financing to be provided by a bank. The Company then loaned 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 used the internal loan proceeds to purchase Dan Jr. and Pat shares from the CRT and the Private Foundation.

The Results

Based on purchase price of **$30 Million** the planning produced the following results:

- **Capital Gains Tax Savings** [23.8 % Federal & 5.0% State; Tax Basis $9.8 M]: **$1,411,200**
- **Charitable Income Tax Deduction**: $**6,047,500**
- **Charitable Foundation Endowment – Immediate**: $7,200,000 providing the community a minimum of $**360,000** annually assuming a 5% annual investment return
- **Charitable Foundation Endowment – On Second Death of Dan Jr. and Pat**: an additional $7,500,000 providing the community an additional minimum of $**375,000** annually assuming no appreciation or depreciation in the value of the CRT property until the second death and a 5% annual investment return
- **CRT "Unitrust" Distribution to Dan Jr. and Pat** - $**450,000** annually assuming a 6% unitrust amount and a 6.5% rate of return that may be used annually by Dan Jr. and Pat as they desire
- **A Company Tax Deduction** equal to $**14,700,000** to be deducted annually over 15 years based on annual limit of 25% of eligible payroll
- **Equity Value Distribution to Employees** - $**14,700,000** over 15 years and then replenished thereafter assuming recycling of shares upon termination, retirement, disability, or death
- Potential for **49%** of the Company's **net income** being **tax free** if S-Corporation status is elected
- **Eliminates** income on sale and estate tax on death
- Assures that **jobs remain in the community**
- Leaves a **legacy** of the owner and family in the community for many generations