Using an ESOP to Create a Tax Free Entity

(A Case History)

Meet Jeff and Rebecca Gardner. Jeff's dad, Wilbur, started an independent property and casualty insurance brokerage firm, WG Insurance, shortly after his return from serving in the United States Army. Jeff joined WG after his graduation from college and he has been working in the business for over 25 years. Rebecca has been the HR Director of WG over the last 10 years. Jeff has noticed that his Dad's generation in now retiring as they enter their late 60s and early 70s. Jeff has spotted opportunities in his community to purchase those retiring property and casualty insurance businesses, including WG. To accomplish this "roll up" of the business, Jeff knows he needs as much free cash flow as possible.

After discussions with his accountant, his accountant asks if he wants to explore **Using an ESOP to Create a Tax-free Entity** to assist him in his roll up of the property and casualty businesses. After hearing that an ESOP can create a tax free entity, Jeff is interested in learning more.

ESOP Overview:
An ESOP is a qualified retirement plan very similar to a profit sharing plan. When the transaction is complete the ESOP owns a part of or all of the equity of the business. The ESOP then allocates a portion of the equity of the business that it owns to the ESOP participant/employee accounts over time. An ESOP can be used as a succession planning strategy for almost any successful business. Typically, businesses with 20 or more employees and that have EBITDA of $1,000,000 or more are good candidates for the ESOP Strategy. The business typically has a team of senior managers that currently manage the day to day operations of a business or will, in 1 – 5 year time frame, be able to manage the day-to-day operations. If such senior management team does not exist, the business owner needs to be willing to develop a senior management team over the next 1 - 5 year time frame.

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Jeff decides to implement the ESOP after completing an ESOP Feasibility Design due to tax benefits:

- Jeff will first create an S-Corporation ESOP Holding Company (the "Company") to purchase 100% of his dad's property and casualty insurance business **at price of $3.5 million (mm).**
- Financing will be 50% cash at closing obtained with bank loan (5 year term, prime) and 50% with seller note (10 year term, prime plus 2%, interest-only until the bank is fully paid).
- After the transaction, the ESOP Trust owns a 100% of the shares of the Company
- The ESOP Trust is a tax-free trust, i.e. it pays no federal income tax and in almost all states pays no state income Tax. The K-1 from the company is issued annually to the ESOP Trust.
- Assuming Jeff is in the combined 42% tax bracket, Jeff would need to earn approximately $6mm without the ESOP to pay the required purchase price of $3.5mm with after tax dollars, a cost of approximately **$2.5mm.** **However, with the ESOP, Jeff can earn the $6mm and use the entire earnings including the "tax cost" of $2.5mm allowing for a more rapid payoff of the purchase price.**
- Then Jeff will purchase 3 – 5 property casualty insurance businesses over the next 3 – 5 years using the same fact pattern over and over as the revenue, profits and tax savings grow.
- By using the ESOP, Jeff will have available to him the full amount of the tax cost available to the Company to pay the purchase price of the acquisitions
- **All net income** in excess of the cash flow needed to pay purchase prices will also be **tax free**
- The **ESOP saves** the Company approximately **$14.7mm** in taxes over the next 10 years once all the acquisitions are closed.
- **Jeff and Rebecca participate in the ESOP** and as a result of being the two highest compensated employees in the Company, they will have the **largest ESOP Accounts** in the Plan over time.