Saving Taxes and Transaction Fees with ESOPs

(A Case History)

Meet Jimmy Good. Jimmy owns a company that is a manufacturer of precision wire-based materials such as wires, cables, composites, and assemblies for use in medical and industrial applications. After thirty years in the business, Jimmy is looking to retire. He recently discussed selling his company with an investment banker. The investment banker discussed conducting a private equity auction to create a competitive bidding process for the company with the plan to maximize the purchase price. The company's estimated valued is $20,000,000. The company has been operating as an S-Corporation and the tax basis is only $3,000,000. His accountant has also estimated in the event of an asset sale, depreciation recapture is at $10,000,000.

Jimmy has enjoyed the benefit of a best-in-class five member senior management team. Jimmy is very concerned on what will happen to his senior management team and to his employees in the event of the sale of the company to a third party. The average age of his senior management team is 50 years old. He has asked for and received the loyalty of his senior management team over the years, many of them starting in the company right after college. After attending a webinar presented by the National Center of Employee Ownership ("NCEO") Jimmy has decided to explore implementing an ESOP to purchase his shares in the company prior to going all in with the investment banker to sell the company to a third party.

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.

After further investigation, Jimmy decides to implement the ESOP. Prior to implementing the ESOP, the company converts from an S Corporation to a C Corporation. Jimmy's decision was based on the benefits of an ESOP compared to a sale to a third party:

- By converting to a C Corporation prior to the transaction, Jimmy obtains tax deferral and potential elimination of capital gains taxes by qualifying for Section 1042 which saves approximately $6,000,000 in income and therefore capital gains taxes
- Saves approximately $800,000 in investment banking/business brokerage fees (while fees to sell the ESOP are less, fees for the sale to a third party could be 5-7% of value of the company or potentially over $1 million).
- Creates the necessary cash flow for advanced estate planning strategies and his favorite charitable projects
- Leaves a lasting legacy in his community, provides for the executives and employees, and enhances the opportunity for the continuation of the business
- Allows for annual tax deductions to the company for ESOP loan payments while a C corporation reducing or potentially eliminating federal income taxes while a C corporation
- 5 years after the ESOP transaction, it is planned that the company will convert to an S Corporation creating a 100% income tax free entity
- Creates a "We Can" attitude vs. an "Us and Them" attitude
- Provides employees with increased retirement plan contributions and an equity interest without requiring the employees to make additional contributions
- Creates a competitive advantage in employee retention and recruiting by offering employees a benefit not available from other employers in the community
- Allows employees to maintain positions and remain employed
- Allows Jimmy together with senior management to maintain control
- Provides senior management with additional executive long-term deferred equity incentive compensation

Eliminating Taxes on A Business Sale – The Power of IRC §1042

What is Section 1042?

- Allows sellers to ESOPs to defer or potentially eliminate capital gains
- Requirements contained in Section 1042 of the Internal Revenue Code ("IRC")
    - It is available **only** to **C Corporation** ESOPs
    - After sale ESOP owns 30% of Outstanding Stock
    - Selling Shareholder(s) has owned shares for the last 3 years
    - Selling Shareholder purchases Qualified Replacement Property ("QRP") within 15 months of ESOP Sale (3 months before and 12 months after)
    - Company consents to Section 1042 Treatment

- If requirements of Section 1042 are met, there is no realized gain on the sale of the shares

- Gain is recognized if and when the QRP is sold

- If not sold prior to death, Jimmy's spouse will receive a "step up in basis" in the QRP to fair market value on Jimmy's death eliminating any pre-death unrealized gains (including unrealized gains from the sale of shares to the ESOP) on the sale of QRP after Jimmy's death

- QRP is:
    - Securities (stocks) of domestic (U.S.) operating corporations
    - Bonds (debt) of domestic (U.S.) operating corporations

- QRP is not:
    - US Government Agency Bonds
    - Municipal Bonds
    - Mutual Funds
    - ETFs
    - Real Estate Investment Trusts (REITs)
    - Securities of Foreign Corporation
    - Seller Financing Notes

- The requirement to buy QRP is not all or nothing. They can do a portion of the rollover but pay capital gains taxes on what is not rolled over