

Closely held business owners, listen up! An Employee Stock Ownership Plan Can Benefit Your Estate Plan...

As an owner of a closely held business, you're likely familiar with how an employee stock ownership plan (ESOP) can offer an exit strategy and provide a tax-efficient technique for sharing equity with employees.

What you may not be aware of is that an ESOP can be a powerful estate and retirement planning tool. Indeed, ESOPs can help business owners address several planning challenges, including lack of liquidity and the need to provide for children outside the business.

ESOPs basics

An ESOP is a qualified retirement plan, similar to a 401(k) plan. But instead of investing in a selection of stocks, bonds and mutual funds, an ESOP invests primarily in the company's own stock. ESOPs are subject to the same rules and restrictions as qualified plans, including contribution limits, minimum coverage requirements and nondiscrimination testing. They also require an annual stock valuation by an independent appraiser.

Also, by definition, ESOPs are available only to corporations. Both C corporations and S corporations are eligible, but the two entity types are subject to different rules. For example, S corporation owners, unlike their C corporation counterparts, can't defer gain on the sale of their shares.

But as pass-through entities, S corporations have a big tax advantage: Because ESOPs are tax-exempt, corporate income passed through to the plan as an owner of S corporation shares avoids federal and often state income taxes. That means an S corporation that's 100% ESOP-owned avoids income tax altogether.

ESOPs in action

Typically, businesses make tax-deductible cash contributions to the ESOP, which uses the funds to acquire stock from the current owners. This doesn't necessarily mean giving up control, though. The owners' shares are held in a trust, and the trustees — usually officers or other insiders — vote the shares (except on mergers or other major issues). A “leveraged ESOP,” which borrows the funds used to acquire stock, offers the greatest tax benefits. The company's contributions cover the loan payments, essentially permitting it to deduct both interest *and* principal.

An ESOP's earnings are tax-deferred: Participants don't recognize taxable income until they receive benefits — in the form of stock or cash — when they leave the company, die or become disabled. In closely held companies, employees who receive stock can sell it back to the company at fair market value for a period of time. This creates a potentially significant “repurchase obligation,” which the company should prepare for by setting aside reserves or purchasing key man life insurance.

Estate planning benefits

If a large portion of your wealth is tied up in a closely held business, a lack of liquidity can create challenges as you approach retirement. Short of selling the business, how do you fund your retirement and provide for your family after your death?

An ESOP may provide a solution. By selling some or all of your shares to an ESOP, you convert your shares into liquid assets. Plus, if the ESOP owns 30% or more of the company's outstanding common stock immediately after the sale, and certain other requirements are met, you can defer or even eliminate capital gains taxes. How? By reinvesting the proceeds in qualified replacement property (QRP) — which includes most securities issued by U.S. public companies — within one year.

QRP provides a source of retirement income and allows you to defer your gain until you sell or otherwise dispose of the QRP. From an estate planning perspective, a simple but effective strategy is to hold the QRP for life. Your heirs receive a stepped-up basis in the assets, eliminating capital gains permanently.

If you want more investment flexibility, you can pay the capital gains tax upfront and invest the proceeds as you see fit. Or you can invest the proceeds in qualifying floating-rate long-term bonds as QRP. You avoid capital gains, but can borrow against the bonds and invest the loan proceeds in other assets. In addition, you can use a QRP to fund a charitable remainder trust (CRT). Not only does a CRT provide you with a current charitable income tax deduction and an income stream for life, but it can dispose of QRP without triggering tax liability.

If estate taxes are a concern, you can remove QRP from your estate, without triggering capital gains, by giving it to your children or other family members. These gifts are subject to gift and generation-skipping transfer taxes, but you can minimize those taxes using traditional estate planning tools, such as grantor retained annuity trusts (GRATs).

In addition, an ESOP can be an effective strategy when some of your children are active in the business, and some aren't. For example, you might sell a portion of your stock to an ESOP and use the proceeds to provide for children outside the business, and give the remaining stock to children in the business. Ideally, gifted stock would be sufficient to keep control of the business in the family.

Is an ESOP right for you?

An ESOP can be a valuable component of your estate plan, offering a tax-efficient way to transition business ownership while helping preserve your legacy. By selling shares to an ESOP, you may be able to generate liquidity for your family, diversify their personal wealth and potentially reduce estate tax exposure. Because every business and family situation is unique, it's important to work closely with your estate planning and business advisors.