A Tax-Smart Way to Transfer Ownership – Employee Stock Ownership Plans

By

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Ready to retire and looking for a way to transfer ownership in your business? Concerned that too much of your wealth is tied to one asset? If you are the owner of a closely held business and are worried about potentially hefty tax bills when you sell some or all of your shares, you should consider a tax-smart alternative - an employee stock ownership plan (ESOP). An ESOP can allow you to diversify part of your stake in your company while simultaneously helping to secure its future profitability.

You may be unfamiliar with ESOPs, even though they've been around for a while. They are, however, remarkably flexible plans that permit business owners to accomplish a variety of business and financial objectives.

In addition to serving as the centerpiece of a business succession plan, an ESOP is a cost-effective way to motivate key employees and boost productivity. It also provides a mechanism for business owners to raise money to finance an expansion, make an acquisition, or spin off a division.

What follows is a brief overview of how ESOPs allow you to use tax-deductible dollars to fund the sale of all or part of your business interest. We also look at how an ESOP can help owners and employees diversify their retirement portfolios and protect their future financial security from the dangers of a portfolio that is highly concentrated in just one stock.

How an ESOP Works

An ESOP is essentially a tax-qualified employee benefit plan that owns stock in the sponsoring company. The employer establishes a plan trust and names a trustee. The employer makes annual contributions of cash or stock to the ESOP. And the plan trustee holds the stock for the benefit of the employees who participate in the ESOP. When participating employees retire, they receive employer stock, or its cash equivalent, from the plan. Within tax-law limits, employer contributions to an ESOP are tax deductible.

Tax-free Sale

Here's where it gets really interesting: An owner of a closely held C corporation can defer capital gains taxes indefinitely on the sale of company stock to an ESOP by taking advantage of a Section 1042 rollover. Section 1042 of the Internal Revenue Code permits owners to defer capital gains taxes on the sale of company stock to an ESOP - as long as the sales proceeds are reinvested in qualifying replacement securities within a set time frame (and various other technical requirements are met).

If the owner sells the replacement securities, substantial capital gains taxes could result. However, if the securities are still in the owner's portfolio at the time of his or her death, the deferred gain escapes capital gains taxes permanently. (This tax break will be limited in 2010, the year the federal estate tax is repealed.)

Spreading the Risk for Owners and Employees

By selling to an ESOP, the owner of a closely held business can obtain liquidity for all or a part of his or her ownership interest. Instead of having the bulk of his or her personal wealth tied up in the just one company, the owner can use the proceeds from the sale to invest in a well-diversified portfolio of securities.

We've already noted that an ESOP can be an effective mechanism for rewarding key employees. Properly implemented, an ESOP can motivate a company's key employees to continue working to enhance the value of the company's shares.

However, an ESOP can also protect employees from the danger of a portfolio concentrated in the stock of a single company. Here's how: When an employee who has participated in an ESOP for at least ten years reaches age 55, he or she must be given the option of diversifying up to 25% of the total value of his or her account. This option must be available until the employee reaches age 60, after which the employee has a one-time opportunity to diversify up to 50% of his or her account.

Confused? You are not alone. ESOPs are not common topics of discussion. For clarification and more information on ESOPs, please contact us for a confidential discussion.

For more information on how ESG and its national platform of M&A firms and Investment Bankers can help sell your business, please call us at 201-556-4618 or 1-866-807-0325, or email us at DPrisciotta@equitystrategiesgroup.com.

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