



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Transferring a Business to Key Employees

Volume 5, Issue 11

Often, business owners who are looking to retire from their business are unaware of the many options available to them. In fact, frequently owners think the only options they have are to give the business to family members (and continue to take a salary) or sell to a third party. That's why it is important for us to understand various business transfer opportunities.

In this issue of *The Wealth Counselor*, as we continue our series on planning opportunities related to business exit planning, we will examine two methods of transferring a business to employees: Management Buyout Options and Employee Stock Ownership Plans (ESOP).

First, let's review some of what we have previously discussed.

Understanding Transfer Motives and Methods

There are many different ways to transfer a business, depending on the client's motives. Does the owner want to keep the business in the family? Is the owner charitably inclined? If so, charitable trusts can be included. Buy-sell agreements are popular between business owners. Some owners, especially those with no family members involved in the business, like the idea of transferring their business to long-time faithful employees who have contributed greatly to the company's success over the years.

Most business owners do not know their options or understand how their motives impact the decision process. They do not understand the opportunity cost of one option over the other, or that their business has multiple values on the same day, depending on the type of transfer chosen.

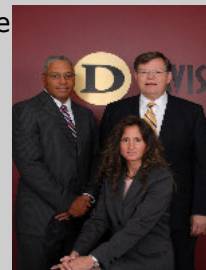
Planning Tip: Uncover your client's true motives and desires early in the planning process, before you spend much time on any one transfer method, and be prepared to spend time educating your client.

Planning Tip: Liquidation is the lowest value of all. Sometimes reminding a client that

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the business will probably end up with a liquidation value if he or she "does nothing" is all it takes to get him or her motivated to do some planning.

Understanding the Seller's and Buyer's Motives

Most business owners want to leave a legacy behind; they want their business to continue beyond their retirement. They want to extract value in an efficient manner that will not negatively impact the company's legacy, and they want to remain in control for a period of time.

The new owners want to grow the business and take more risk. They want to create value that will first pay off the seller, and then increase *their* personal wealth. They want the control to pass in an efficient but determinable manner, and eventually they want to extract the value they have paid for and created in order to enhance their personal wealth.

Now that we've had a refresher on the importance of transfer motives and methods and the differences between the seller's and buyer's motives, let's move on to transferring a business to its employees.

Management Buyout Options

Motivating the Seller

The seller must first understand that the transition from owner to employees is a process, not an event; it will take time to accomplish. However, this will be quicker and more confidential than a third party sale, and the deal structure can be more flexible. The seller will also have some personal satisfaction: the legacy of the company will continue, and he or she may feel that the management has earned the opportunity to buy the business with its loyalty and hard work.

There may be some growth potential for both the seller and management. The seller may be able to provide some continued service to the company as an officer and/or director. The seller may even be able to continue in some part of the business that he or she enjoys. And the seller may be able to keep some control over the company.

Concerns

The seller and the buyers will be concerned about the structure of the deal: how much cash, debt, and earn-out will be involved? When will transfer of control occur? The seller will also worry about losing control while still liable for outstanding debt or on personal guarantees. If management has little or no capital, which is generally the case, where will they get the money for the buy-out? Will a private equity company need to be involved? Do the buyers' concerns include whether a private equity company takes a minority interest or a controlling interest? What will be the exit strategy for the private equity company? Will management have the money to pay off the private equity company? Will management be willing to work that hard and stay that long? If a key member of management receives a larger percentage, will the rest maintain their enthusiasm?

Planning Tip: All of these issues and concerns will need to be reviewed, discussed and

resolved before the plan is finalized and implemented.

Employee Stock Ownership Plans (ESOPs)

An ESOP is a qualified plan under ERISA and has been around since 1974. It is similar to a management buyout, but with tax benefits.

From a gift and estate tax perspective, an ESOP is considered an independent third party buyer, so transactions are very different from those that would occur between family members.

Tax Advantages of an ESOP

With an ESOP, the seller is selling stock in the company, not selling assets, so the taxes are capital gains, not ordinary income taxes. Code Section 1042 allows the seller of a C corporation (but not an S corporation) to defer capital gains tax on the sale indefinitely. If taxes do not need to be paid, replacement income for the seller can be created more quickly. The company (whether a C corporation or an S corporation, with limits on the latter) can deduct the principal and interest on the ESOP buyout loan. Since 1998, an S Corporation ESOP that owns 100% of the company stock pays no income tax on its pre-tax earnings. In effect, when done properly, an ESOP will turn an after-tax buyout into a pre-tax buyout.

For the seller who wants to try out the ESOP concept with a part of his ownership, establishing an Employee Stock Ownership Trust is an option. An Employee Stock Ownership Trust (ESOT) is a trust established by a corporation for the benefit of its employees. It has three unique features:

- It must own "principally" stock in its sponsor company;
- It is the only qualified plan under ERISA that is allowed to borrow money; and
- It can purchase the company stock in stages or multiple transactions.

ESOP Example

Assumptions

John's business has annual gross revenues of \$50 million. Annual revenue growth rate is 10%. Depreciation is equal to capital expenditures at 2% of revenue. Working capital increases at 12% of revenue growth. There is no existing debt at this time. Taxes are 0%, because the "S" corporation pays no income tax. EBITDA (earnings before interest, taxes, depreciation and amortization) is 10% of revenue or \$5 million.

The current value of the business is five times EBITDA, or \$25 million. The expectation is that the EBITDA multiple will increase to six by the end of five years. John takes a seller's note for the full \$25 million, so management will not need to raise any capital. 100% of the excess cash flow will go to pay down the debt.

Results for the Seller

John "sells" for \$25 million. Interest on the note is over \$7 million during the five-year

term. If he takes the 1042 election, he can defer paying tax on the \$25 million. By year three or four, after the note to John is paid down to about \$15 million, EBITDA will have increased enough so that a bank loan could be sought and John could receive a lump sum for the remaining balance. He remains on the board of directors and an officer of the company. He may receive cash incentives for growing the company. The company can deduct the principal and interest on the note to John. There is continuity during the transition, as management starts earning equity from day one. There is no private equity group involved, and John can be a more flexible lender in case of economic downturn.

Results for Management

Management has not had to come up with any down payment, does not guarantee the loan and has immediate ownership in the ESOP as participants. There is no private equity group on the board of directors. There is continuity of management's position, board representation, and a clear understanding of the process from the beginning. They can earn additional equity via synthetic equity, they can have increased compensation under "cash-based" incentive plans and, depending on the number of employees and their salaries, they can accumulate more equity value in the ESOP than with a management buyout option.

Concerns

As with any strategy, there are concerns. For example, 100% of the excess cash flow is used to pay debt instead of grow the company. The company must set aside money to meet repurchase obligations on the ESOP when employees retire, die, become disabled or terminate their employment after vesting. A concern for management is that the seller could be in control until the note is paid off. At the end of the five years, the company would still have \$17 million in total debt. There will still be a need for shareholder and management agreements for continuity. Owner motives outweigh management motives, but the Department of Labor has strict rules regarding sales prices, etc.

Stock in an ESOP is allocated based on payroll, so there are no extra management incentives. There are administrative requirements for managing an ESOP. The Trustee of the ESOP will have some say in management of the company, but these relationships tend to be cordial.

Planning Tip: In the ESOP example above, in order to satisfy the 1042 option and defer the capital gains tax, the seller would need to invest the \$25 million within three months before to 12 months after the sale. Currently, bonds called floating rate notes can be used to satisfy this requirement; these require 10% equity for purchase. The principal and interest payments on the note would need to equal \$2.5 million to give the owner the \$2.5 million needed to buy the \$25 million in floating rate notes. These options would need to be discussed with the owner and let him make the decision based on his facts and circumstances.

Conclusion

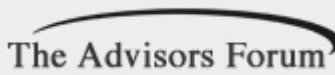
Both management buyout options and employee stock ownership plans are options that

should be considered when a business owner is interested in transferring his business to employees at his retirement. The ESOP can provide some interesting and more attractive tax benefits, but at the cost of including non-management employees and having to buy out the employees who leave the company. Both provide some unique planning opportunities for your clients and excellent networking opportunities for the entire planning team.

Estate Tax Update

There continues to be uncertainty among clients and other professionals as to what clients should do given the changing landscape of the federal estate tax. At this date, it appears unlikely that Congress will intervene, and thus the federal estate tax exemption may revert to \$1 million on January 1, 2011. This is an excellent time to exercise leadership by reaching out to clients as a team, to encourage them to move forward in their planning. Being able to work together effectively and understanding strategies that you can implement together is key.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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