



Business Succession Planning: How to Coordinate an ESOP Exit Strategy with an Estate Plan

By: *Cory R. Lancaster, J.D., LLM.*



In the right situation, an Employee Stock Ownership Plan (“ESOP”) can be an effective business succession planning tool for helping owners of closely-held businesses successfully exit the business while preserving the future viability of the business. Furthermore, when an ESOP exit strategy is properly coordinated with the owner’s estate plan, the cost of transferring wealth to the next generation can be significantly reduced. On the business side, an ESOP can help motivate employees, increase productivity, allow employees to acquire an ownership interest in the business and increase the value of the business.

Generally, an ESOP is a defined contribution retirement plan designed to invest in shares of a closely-held business. The investment strategy involves contributing the stock of the business to a trust, which is a separate entity from the business. In turn, the trust allocates the ESOP assets to the employee-participants’ accounts. The employee-participants’ accounts may vest immediately or according to a vesting schedule over time. Then, each employee-participant is eligible to withdraw the vested portion of his or her account after certain “triggering” events occur such as termination, disability, death or retirement.

Business Exit Strategy

Traditionally, ESOPs have been used as a means of redeeming the owner’s stock in the closely-held business. An example of an exit strategy using an ESOP operates as follows:

Step 1, the ESOP borrows money from a bank to acquire the business owner’s stock.

Step 2, the business guarantees the promissory note.

Step 3, the business owner sells his or her stock to the ESOP.

Step 4, the ESOP uses the acquired stock as collateral for a bank loan.

Step 5, the business makes contributions to the ESOP which the ESOP uses to pay back the principal and interest on the bank loan. The ESOP’s stock used as collateral is released as the bank note is paid. The business gets a deduction for contributions to the ESOP.

Step 6, the owner does not recognize any capital gains tax on the stock sale as long as: (i) the ESOP owns at least thirty percent (30%) of the business after the sale and, (ii) the sale proceeds are reinvested by the owner in the securities of other U.S. businesses (hereafter, the “replacement property”). The business owner’s tax basis in the replacement property is the same as the business owner’s tax basis in the business’s stock prior to the sale of the stock to the ESOP.

Thus, the business owner has successfully executed a tax-free business exit plan.

Estate Planning

Now that the former business owner has successfully exited the business, the former business owner needs an estate plan which minimizes the cost of the transfer of the replacement property. First, the easiest wealth transfer strategy is to simply have the former business owner hold the replacement property until death so that the replacement property can receive a stepped-up basis equal to the replacement property’s fair market value as of the date of death. Under this strategy, the former business owner’s gain on the initial sale of business stock to the ESOP is never recognized.

Second, the former business owner could also use basic estate and gift planning to transfer the replacement property. Popular wealth transfer planning options may include using:

Business Succession Planning: How to Coordinate an ESOP Exit Strategy with an Estate Plan

By: Cory R. Lancaster, J.D., LL.M.

- the former business owner's annual gift tax exclusion to transfer the replacement property to his or her family;
- a grantor retained annuity trust ("GRAT") to receive gifts of the replacement property;
- a charitable remainder trust ("CRT") to provide the former owner with a tax-deductible contribution of the replacement property, an income stream for the remainder of the former owner's life and a completely effective way to remove the replacement property from the former owner's estate (additionally, the trustee of the CRT could sell the replacement property in order to diversify the CRT's assets); and
- the income from the CRT to fund an irrevocable life insurance trust.

The aforementioned ESOP exit and wealth transfer strategy is ideal for retiring business owners who have a majority interest in a "C" corporation with a low tax basis in the stock and a substantial predictable stream of annual income.

Cory R. Lancaster is a tax attorney with Holland, Ray, Upchurch & Hillen, P.A. His practice specializes in estate planning, asset protection, business operations and tax consulting. He received his LL.M. from the University of Florida and his J.D. from the University of Mississippi. Cory practices law in Mississippi and Tennessee.