



Employee Stock Ownership Plan (ESOP)

The establishment of an ESOP often leads to significant sales of life insurance, investments, or both. A closely held business that sponsors an ESOP is required to purchase an employee's interest in the company stock when the employee experiences a qualifying event such as retirement, disability, or death. Many companies plan for these milestones by purchasing individual life insurance. The policy's death benefit protects the company against the death of a key person while the company can access the policy's cash value to purchase the employee's stock held in an ESOP.

Variable universal life insurance allows the policy owner to invest cash values in a wide range of highly diversified, professionally managed, equity-based investment options. Policy values can be transferred among different investment options without tax consequence.

Once there is enough cash accumulation, your client charges are different for each VUL product; some may vary by age, gender, face amount, underwriting class, premiums, and policy duration. These charges are reflected in each product's prospectus. Registered representatives should review them with their clients. These charges will have a significant effect on policy account values. Policy account values vary with actual underlying fund performance.

To avoid a capital gains liability, the business owner must invest any proceeds from the sale of the company's closely held stock to the ESOP in qualified replacement property. The proceeds can be invested in stocks or bonds of publicly held U.S. corporations.

ESOP Candidates

The best candidates for ESOPs are usually large to mid-size privately held C-corporations. The company must be profitable, produce excess cash flow, and have unused debt capacity.

Additionally, the company needs to have enough scale and experience, including the following:

Annual revenues of at least \$5 million, Annual payroll of at least \$1 million and the salaries of the selling shareholders

Business tenure of at least five years, S-Corporations can establish an ESOP but they are subject to a variety of stringent rules that will not be addressed in this article. S-Corps are not eligible for tax deferral under the IRC Section 1042 rollover of sales proceeds to qualified domestic securities, which will be addressed later in this article.

Creating an ESOP

Perhaps the biggest reason to establish an ESOP is to satisfy the business owner's desire to prepare for retirement, sell the business, or both. An ESOP can help the business owner achieve a tax-deductible buy-out. Here's how it usually works:

1. Borrow cash from a third-party lender to contribute or loan to the ESOP. Interest payments that the company makes to the third-party lender are deductible as an ordinary and necessary business expense. There is no reason to borrow if the company has enough cash.
2. Loan the borrowed cash to the ESOP to purchase the closely held stock from the company's owners. In order to enable the ESOP to pay interest and principal on the loan, the company makes annual contributions to the ESOP, subject to qualified plan contribution limits. The company can also distribute dividends on the shares owned by the ESOP. The dividends can then be used to pay interest and principal on the note. The company can deduct contributions to the ESOP and any dividend distributions used to repay the principal on the loan. This means that the principal and interest payments on the third party loan are deductible.