



An educational guide for business owners



# A business financing tool for your succession plan

**Discover the benefits of an Employee Stock Ownership Plan**

# If you would like to eventually sell your business

...but you find you have no family members or employees willing or able to take over the reins, there's a solution you may wish to consider.

It's called an Employee Stock Ownership Plan (ESOP). While this strategy isn't for everyone, many closely held business owners who want to receive fair market value when selling their company — and care about the success of their business and the welfare of their employees, even after the sale — find it to be a viable approach. In addition, an ESOP may provide your business tax advantages that can help you save a good deal of money.

## Could this strategy be right for you?

You may wish to consider implementing an ESOP if:

- You want to sell all or a portion of your company, but care about your employees and company culture.
- You want to continue working and maintaining control.
- Your business is stable or growing, with a strong cash flow, with EBITDA<sup>1</sup> of at least \$1.5M and 20+ employees.
- Your business has a strong management team that can facilitate succession (i.e., as leaders leave, there are strong candidates to replace them) or that has the willingness/ability to create such a team over time.



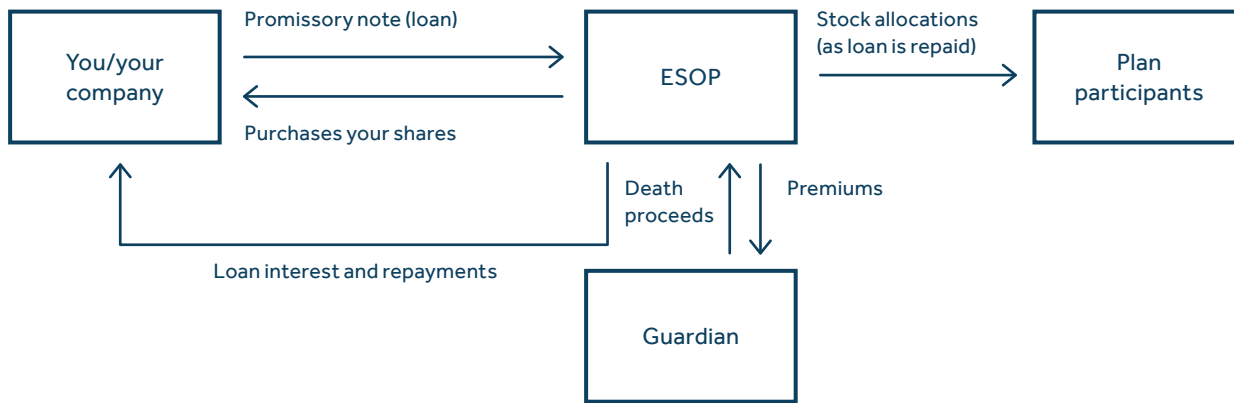
# What is an ESOP?

An ESOP is an employee benefit plan that is set up as a trust and gives key employees ownership interest in the company. As a qualified pension plan, an ESOP permits the plan trustee to purchase shares of an employer's stock. Shares are allocated to each plan participant's account and, at retirement, the stock is usually sold back to the employer for cash to fund the retirement benefit.

## **An ESOP:**

- Is often used to motivate and retain employees.
- Can be used when you don't have an obvious successor lined up to buy your business.
- Can provide both a ready buyer as well as flexibility for you, as you can sell all or only a portion of your stock to the business.
- Allows you to continue to participate in the business (after creating the ESOP).
- Enables you to defer income taxes on the gain from the sale.

## How an ESOP can work



- 1 Your company forms a trust and establishes the ESOP.
- 2 Your company may take out a loan and lend the proceeds to the ESOP.
- 3 The plan trustee buys out some or all of your shares in the company.
- 4 During the valuation process, a "repurchase liability study" is usually performed to calculate the plan's liquidity needs to buy out participants who will retire in the future. In the early years, the ESOP may not have enough liquidity and therefore may have to use loans.
  - a. To assure an arm's length transaction, an independent appraiser values the company, and the ESOP hires an independent trustee.
  - b. Life insurance is usually purchased on the older and/or major stockholders as a funding vehicle for the future "repurchase liabilities" of the plan.
- 5 The loan is repaid by having your company make income tax-deductible contributions to the ESOP.<sup>2</sup>
- 6 The plan trustee uses corporate contributions to repay the loan made by your company, and your company uses the same dollars to repay the lender.
- 7 Stock is held in a suspense account in the trust and is only allocated to plan participants as the loan is repaid.



### **The repurchase obligation of the ESOP**

The ESOP repurchase obligation is the liability created when vested participants are entitled to receive distributions from the plan. The usual repurchase triggers are retirement, death, disability, termination (voluntary and involuntary), and the option to diversify.<sup>3</sup>

### **Funding options for the repurchase obligation**

- Pay as you go (i.e., no funding)
- Loans
- Sinking fund, either owned by the ESOP or the corporation outside of the ESOP
- Life insurance, either owned by the ESOP or the corporation outside of the ESOP

### **Using life insurance to fund the repurchase obligation**

Purchasing permanent life insurance on the older and/or major stockholders as a funding vehicle for the future repurchase liabilities of the plan can be much more cost effective than your company funding the obligation through current cash flow, or through the use of a loan.

The use of life insurance as a funding vehicle provides additional benefits that you may wish to consider, including:

- The policy cash value grows tax deferred<sup>4,5</sup> and is an asset on your corporate balance sheet.
- The income tax-free death benefit can provide both funds for the repurchase liability, and potentially, funds for cost recovery.<sup>6</sup>
- Your corporation can selectively insure those ESOP participants with the largest account balances.

### **Advantages of an ESOP**

- An ESOP provides you with a buyer for your company, yet enables you to remain active in managing the business.
- The ESOP helps you attract, retain, and motivate top talent — and it gives your participating employees a culture of ownership.
- The ESOP can be funded with pre-tax dollars, and loan principal amounts are deductible.
- Depending on your corporate structure, you may be able to defer capital gains on the sale.

# An ESOP case study

John Marcheson, 55, owns a custom car business, Custom Rides, Inc.\* He launched his company in 1990, working out of his garage with 2-3 independent contractor employees. Over the years, he has built it up to such a success that he employs 50 associates, in three locations, and has an annual payroll of \$2.67M. John is widowed and has no children. As the sole owner of the business, he is starting to think about retirement, but has no obvious successor who can buy his \$20M company outright. The company's EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) is \$4M, with a targeted growth rate of 5% annually over the next 10 years.

Despite his wish to sell, John worries about the future of his business as well as the employees who have been with him for years, most of whom belong to his very capable management team. John's Guardian Financial Professional comes up with a solution that interests John by suggesting an Employee Stock Ownership Plan (ESOP). After consulting his tax and legal advisors, John's company forms a trust and establishes the ESOP, which enables John's eligible employees to enroll in the plan. John agrees to take an upfront cash payment of 40% of the sale price (\$8M). The company then takes out a 10-year loan for the \$12M balance at an interest rate of 2.21% and loans the proceeds to the ESOP. All told, at the stated terms of the note, John receives a value of approximately \$14,924,000. In addition, part of the plan design includes "warrants," which allow John to continue participating in the growth of the company until the balance of the \$12M has been paid in full.

The plan trustee buys out John's shares in the company, and Custom Rides takes out an \$8M whole life insurance policy on John as a means for the company to be able to repay the bank loan should John pass away prematurely. Since John is 55 and in good health, he is issued a Guardian L-99 policy with a level Q Term blend (50/50 whole life and one-year term, with the face amount of one-year term dropping off after 10 years), at a Preferred Non-Smoker rating, and an annual premium of approximately \$170K. Because the ESOP is a qualified plan, the tax savings on the company's \$4M annual earnings is around \$840K, or 21% of the \$4M, which provides Custom Rides with plenty of cash to fund the premium. The policy is projected to have a cash value of \$1.5M after the 10th year.

John's company repays the loan by making income tax-deductible contributions to the ESOP. The plan trustee uses corporate contributions to repay the loan made by the company, and John's company uses the same dollars to repay the lender. Stock is held in a suspense account in the trust and is only allocated to plan participants as the loan is repaid.

Because John had the foresight to have a feasibility study done by an independent third party, he and the trustee feel confident that the projected cash value of the whole life policy will provide sufficient liquidity to cover the ESOP's repurchase liability after 10 years. John will ultimately receive slightly more than the original \$20M asking price with the additional interest paid as per the terms of the note. If the company continues to grow as it is projected to, John stands to receive a total amount of just over \$35M—the original \$20M paid through the cash down payment, note and interest proceeds, plus the warrants that allowed John to continue to benefit from the growth of the company.

Using permanent life insurance to fund the future repurchase liabilities of an ESOP can be much more cost effective for your company than funding the obligation through current cash flow, the use of a loan, or the use of a side fund.

# Could an ESOP be right for your business?

An ESOP won't work in every case, but for those business owners looking to sell their company at fair market value, while perhaps retaining some control, an ESOP may be a consideration. In addition, an ESOP has the potential to provide you with valuable tax advantages, both now and in the future.

Companies that are good candidates for ESOPs include those that are financially strong, with ongoing revenue streams, strong management teams, and employees who are willing to share ownership in the company.

Because the techniques discussed in this guide can be complex, you may wish to seek the advice of your tax and legal advisors to help ensure that the solution you choose is best suited for you. A Guardian Financial Professional can work with your trusted legal and tax professionals to help create a customized approach based on your objectives.

**Contact a Guardian Financial Professional to begin your planning discussions today.**



<sup>1</sup>(EBITDA) Earnings Before Interest, Taxes, Depreciation, and Amortization.

<sup>2</sup> An ESOP is a defined contribution plan, so your company can contribute the lesser of 100% of compensation or \$66,000 (2023 amount as indexed for inflation) for each plan participant. Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

<sup>3</sup> The option to diversify is extended to employees who have reached age 55 with at least 10 years of participation in the plan. It allows them to have additional assets in their account so that they are properly diversified as they approach retirement, and not subject to the risk of losing everything should the corporate value go down.

<sup>4</sup> All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

<sup>5</sup> Some whole life policies do not have cash values in the first two years of the policy and don't pay a dividend until the policy's third year. Talk to your financial professional and refer to your individual whole life policy illustration for more information.

<sup>6</sup> Guardian, its subsidiaries, agents and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

\* All scenarios and names mentioned herein are purely fictional and have been created solely for educational purposes. Any resemblance to existing situations, persons, or fictional characters is coincidental. The information presented should not be used as the basis for any specific investment advice.

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