ESOP | Employee stock ownership plan

A little planning goes a long way.

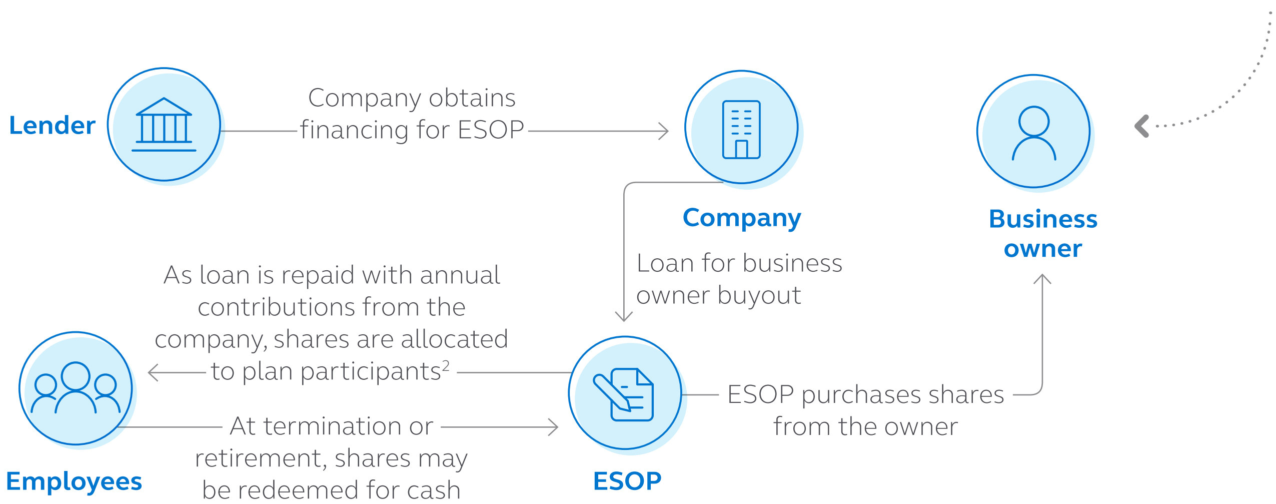
A guide to making your ESOP even more successful.

After working hard to build a successful business, you want to see it live on. Who knows your business better than you and your employees? This may be why so many businesses choose an employee stock ownership plan (ESOP) as a business succession strategy. It establishes an employee-owned company, and offers a flexible, tax-favorable way to exit the business, provide retirement benefits, and retain and motivate employees.

Here's how it works

An ESOP is a tax-qualified retirement plan in which the funds of the plan are primarily invested in stock of the business sponsoring the plan. First, the business forms an ESOP trust and establishes the retirement plan. From there, it can work like this:

The feature that makes ESOPs unique is that the plan can borrow to buy the employer stock. In the practical sense, this means that the ESOP can provide owners with a market for their shares, while contributions are generally income tax deductible.[1]



Who benefits from an ESOP?

An ideal ESOP candidate is a business that:

- Is profitable
- Has a strong management team in place
- Has sufficient payroll, employees, and business value to justify the plan

But, to make the ESOP successful, a little more planning may be helpful.

What **type of planning** should be done?

Establishing an ESOP is a beneficial step towards financial security for its owners and employees. The last thing you want to see is for its effectiveness to be derailed by unplanned or even planned events. So, there are a few long-term planning strategies you can put in place to help protect your business, yourself (along with any other owners), and your employees.

Key person protection

With an ESOP-owned business, the death of an individual who is critical to the company's success can create a significant financial challenge. But, that can be lessened with life insurance coverage on key employees. It can provide some peace of mind. And, it helps assure that the business has the resources to meet creditor demands, as well as recruit and hire the talent needed to replace the employee.

Loan protection

An ESOP often requires a loan to help acquire a selling owner's shares. Life insurance owned by the business can be used as collateral to secure a loan, and can contain an assignment that helps assure the lender that some or all of the death benefit proceeds will be used toward the loan. In addition, disability loan protection can be acquired to help protect the business and the lender against an unexpected disability of an owner who is actively involved in the business, or a key employee.

Buy-sell planning

While many ESOPs own 100 percent of their sponsoring company, most do not. In those that do not, the long-term stability of the company makes buy-sell planning critical. Individual owners have several succession options:

- Buy one another out
- Sell to the ESOP at their death or retirement
- Have the company buy back their shares

In any event, making sure funding is available, through life and disability insurance, for the eventual buyout can assure that an unexpected death or disability does not disrupt the growth and stability of the business.

Business protection

For the most talented employees, an ESOP can present both questions and opportunity:

- Will the business succeed under the new tier of management?
- Will the employee have better prospects at a larger company, or striking out on their own?
- Will the growth potential of the ESOP company's value compensate employees for the inherent risk they take by having their qualified plan accounts largely invested in one company?

You don't want these concerns to drive those key employees to the competition. Their work is critical to your company. Key employee benefits can help retain and reward them. For example, a nonqualified deferred compensation or bonus plan can require a key employee to remain with the company for a specified period in order to receive a promised benefit.

Repurchase liability

Over time, the ESOP trust will be required to buy back the ownership shares held by employees. This repurchase could be triggered by the employee's departure, retirement, death, or reaching age 55.[3] For employees benefiting most from the ESOP (who might also be key employees and drivers of the company's success), this can be a significant expense. But the business can plan for it.

Many plan for this expense, at least in part, through a sinking fund (investments the company uses to accumulate the necessary funds to address this need). Life insurance can be one solution to accumulate these funds for lifetime buyouts, particularly because it can cover unexpected buyout expenses triggered by death, as well as transfers during life. Tax-deferred accumulation makes life insurance an effective option for accumulating funds for a lifetime buyout.

Income and estate tax planning

A selling business owner may make a gradual transition out of the business or sell their interest all at once. Either way, an ESOP sale can trigger capital gains. This means a little personal planning is also needed.

For C corporations, the replacement of the business interest with certain domestic securities can provide an opportunity to diversify, yet defer and potentially eliminate the capital gains taxes.[4]

C corporation and S corporation business owners may face a potential estate tax liability. In these cases, life insurance held in an irrevocable trust may help. Income tax-free death benefits can help meet the liquidity needs of the estate and potentially provide creditor protection to family members.

What's next?

While ESOPs create unique planning needs, a little planning goes a long way. Protecting the ESOP with company-owned life and disability insurance products can help manage risk and potentially provide tax advantages, so your ESOP can be even more successful.

Let Principal® help you figure out which options are best for your business.

Learn more

Contact your financial professional today or visit **principal.com.**

[1] Within limits, which depend in part on whether the ESOP is maintained by a C corporation or an S corporation. See IRC Secs. 404(a)(3), 404(a)(9), 404(k)(1).

[2] Although employees are allocated shares in the ESOP, qualified plan rules may limit the amounts that can be allocated.

[3] Employees who have reached age 55 and have at least 10 years of participation must be permitted to begin diversifying their accounts. See IRC Sec. 401(a)(28).

[4] See IRC Sec. 1042. The acquisition of the replacement securities is subject to certain time limits.

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