INCREASING BUSINESS CASH FLOW WITH AN ESOP

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In the current economic environment, business owners are searching for strategies to increase their available cash flow. This becomes critical when the business owner, struggling to find capital to expand his business, must then find the resources to pay taxes on his business income. This perpetual burden on cash flow can be reduced, almost to zero, with proper planning.

One such strategy involves the utilization of an Employee Stock Ownership Plan (ESOP). The owner of the corporation will sell all of his or her shares to an ESOP where immediately after the transaction the sponsor corporation, if an S corporation, maintains its S election or, if a C corporation, converts to an S corporation. This technique substantially reduces the tax burden on the business income coupled with the benefit of allowing the owner to withdraw funds at the capital gains tax rate.

Tax Shield

Regular corporations (C corporations) are subject to tax at the corporate level. However, a corporation may elect to be treated as a pass-through entity (S corporation) for tax purposes. If an S corporation is 100% owned by an ESOP, all of its taxable income flows through to its sole ESOP shareholder, and since an ESOP is tax exempt, there is no current federal or state income tax on its annual income. Since there is no current federal or state income tax on the business income, more money can be kept in the business for working capital, capital improvements or to meet the cash operating needs of the business.

For example, if a company that is not owned by an ESOP has an annual profit of $2 million and is paying 40% in federal, state and local income taxes, it would then have $1.2 million available after taxes for working capital and capital improvements. However, if the same company is an S corporation and is wholly-owned by an ESOP, the entire profit of $2 million is retained, as there is no Federal or State tax on the business income, resulting in an additional $800,000 in free cash flow.

Sale Structure and Terms

In a typical structure involving a 100% stock sale to an ESOP sponsored by an S corporation, the selling shareholder receives as the purchase price of his stock a combination of cash, an installment note from the ESOP and warrants to purchase additional stock of the company, thereby preserving his upside potential. Annually, the S corporation will make a tax deductable pension contribution to the ESOP. The ESOP will use the proceeds from this contribution to make its annual payment on the installment note. The exercise price for the warrants will generally be equal to the value of the shares immediately after the sale which will be reduced by the indebtedness incurred by the company to finance the ESOP purchase transaction. The selling shareholder will ultimately realize value through the warrants by selling them to a third party or having them redeemed by the corporation; provided he holds the warrants for a year or more, he will be taxed at long-term capital gains rates at such time.

Owner Participation in ESOP

Subject to certain limitations contained in Internal Revenue Code Section 409(p), which prohibits concentrated direct and indirect ownership of S corporation ESOPs, the selling

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shareholder may also participate in the ESOP, with his share allocation based on his proportionate share of the company's payroll (subject to a limit on maximum compensation of $245,000 in 2011). For companies with high employee turnover, allocations will benefit longer-term employees over time, including the selling shareholder, since allocations to employees who leave prior to vesting (generally on a graded basis over a six-year period) will be forfeited and reallocated based on participant compensation in the year of the forfeiture. Moreover, once the installment note to the selling shareholder is repaid, the net profits of the company (free of federal and state income taxes) can be distributed to the participants' tax-deferred ESOP accounts, thereby building up cash accounts within the ESOP.

Benefits to Owner

The selling shareholder thereby achieves the best of all worlds. First, principal payments on the installment notes will generally be taxable at capital gains rates as received, thereby converting ordinary income previously received in the form of compensation and/or corporate earnings into capital gains. Second, the corporation pays no tax and thereby has more available cash flow to service the note obligation to the selling shareholder. Third, the selling shareholder continues to benefit from future appreciation in the value of the company through his warrants and ESOP stock account, both of which increase in value as the company prospers.

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