

## CASE STUDY

This Case Study should increase your appreciation of the significant value that an ESOP/FLP can provide to you, your family and your business. In this Case Study, the client, his family and his company will receive a little over \$20,000,000 of direct economic benefit. Total fees and expenses for consulting, financing, legal, accounting, valuation, and fairness opinions amounted to less than 2% of the direct economic benefit.

### What is an ESOP/FLP?

The ESOP/FLP represents the strategic coordination of a Family Limited Partnership (FLP) and an Employee Stock Ownership Plan (ESOP) designed to accomplish a number of bona fide business purposes. The ESOP is a comprehensive PRE-TAX financial strategy that can be used as a tool of capital formation, shareholder liquidity, business succession and wealth preservation.

There are about fifteen significant financial attributes to this plan, and in our view, the four most important attributes of the strategy are:

- 1) The plan can create a **TAX FREE** market for the diversification of your closely held stock. You can sell all or a portion of your stock and reinvest 100% of your sale proceeds into a diversified portfolio of stocks and bonds. Most of our clients choose to reinvest in highly rated long term bonds of Fortune 500 companies geared to provide a long term income stream.
- 2) The plan can use **TAX DEDUCTIBLE** corporate dollars to fund capital investment strategies for your company or to fund shareholder liquidity for you. To finance capital growth, the plan can be structured to effectively result in your company being able to **DEDUCT AND DEPRECIATE** its next acquisition, plant expansion or other major capital investment. Even **PRINCIPAL** payments and **DIVIDENDS** on ESOP shares become deductible expenses to your corporation.
- 3) The plan can shield almost all of your assets, including the stock in your closely held company, from being seized by future judgment creditors.
- 4) The plan can reduce your personal estate tax liability by 40% - 50%.

### Case Study Background

We were engaged to provide a "FLP Strategy Study" for the CEO of a highly profitable manufacturing and distribution company. We completed the FLP Strategy Study and over the next six months, we assisted the client's legal counsel in implementing the tools described herein. For purposes of this Case Study, we will refer to this valued client as "Big Man" and we will refer to his company as "Widgets, Inc."

Big Man and his spouse acquired Widgets, Inc. in the early 1970's. Widgets, Inc. is headquartered in a rural community in the Midwest and maintains significant warehouse operations in Kansas City. Widgets, Inc. employs about 130 full time employees and 1999 revenues exceeded \$40,000,000. Widgets, Inc. is extremely well

managed and consistently posts operating profits that significantly exceeds industry averages.

Big Man and his spouse are in their early 60's and have a combined personal net worth of about \$17,400,000. Like most entrepreneurs, about 90% of that wealth consists of their closely held stock in Widgets, Inc. Like most entrepreneurs, Big Man and his spouse have a very low tax basis in their stock of Widgets, Inc. (@ \$200,000) compared to the stock's nonmarketable controlling interest fair market value (@ \$15,300,000).

### **FLP Project**

When Big Man and his spouse first hired us in 1998 to provide FLP consulting services, they did not have much of an estate plan – a boiler plate Will and Testamentary Trust that was about 10 years old and they maintained personal ownership of their life insurance policies. It is a fact that a Testamentary Trust does not become effective until after being approved by a judge in Probate Court and the assets of that Trust become public knowledge. It is also a fact that life insurance proceeds are includible in your taxable estate if the decedent is deemed to have any “incidents of ownership” in the policy.

Big Man and his spouse have two grown children and four grandchildren. Before the implementation of the strategy described herein, the government stood to receive a \$9,300,000 inheritance from our client. Big Man was motivated to do some serious planning because of the recent death of a close friend who also owned a business. Big Man's friend did no estate planning and his company was now on the auction block at a steep firesale discount to pay a multi-million dollar estate tax bill. Because of this experience, Big Man and his spouse wanted to make concrete plans to protect and transfer as much of their wealth as possible to their children and grandchildren and to ensure the job security of their 130 employees would not be jeopardized by a draconian government tax bill. In addition to minimizing their estate tax liability, they also wanted to share about \$1,000,000 of their wealth with a very well known public charity.

During our fact finding meetings with Big Man, a number of concerns surfaced. Widgets, Inc. is an industry where litigation is not a stranger. Big Man was concerned about being a litigation target and facing the possibility of losing a significant portion of his assets via court judgment. Big Man was also very concerned that if he did manage to avoid judgment creditors seizing his assets during his lifetime, the government would take 55% after his death. Big Man was also concerned about the public disclosure of his family's financial affairs as a result of the Probate Court procedures that would be required to put his existing Testamentary Trust into effect.

The wealth preservation strategy that we designed for Big Man and his spouse included the implementation of a Family Limited Partnership, Revocable Living Trusts, Irrevocable Living Trusts, and a Charitable Lead Annuity Trust (CLAT). The CLAT was funded with about \$1,000,000 of Widgets, Inc. stock and that stock was subsequently purchased by the Widgets, Inc. ESOP. The CLAT is geared to provide a \$60,000 annual income stream to our client's desired public charity during the lifetimes of Big Man and his spouse. Upon the last of Big Man or his spouse to decease, the remainder interest of the CLAT will be paid tax free to a Trust that has also been recently established for the benefit of their current and future grandchildren.

The tools described above, working in concert with one another, result in the following “before and after” picture of the wealth preservation strategy for Big Man and his spouse:

	<u>Big Man’s Current Strategy</u>	<u>Our Proposed Strategy</u>
Personal Net Worth	\$17,400,000	\$17,400,000
Taxable Estate	\$17,636,000*	\$7,623,000**
Estate Tax Exposure	\$9,340,000	\$3,833,000
Net Transfer to Heirs	\$8,060,000	\$12,567,000
Net Transfer to Charity	\$0	\$1,000,000
1999 Income Tax Savings	\$0	\$316,000
Judgment Creditor Protection	\$712,000 (4.1% of assets)	\$16,180,000 (98.6% of assets)
Probate Court Costs	\$300,000 +	\$0
Family’s Financial Affairs	Publicly Disclosed	Remains Private

\* *Includes adjustments for the unified credit exemption and life insurance ownership.*

\*\* *Includes adjustments for 45% FLP valuation discount, unified credit exemption, \$1,000,000 charitable donation and replacement of life insurance via irrevocable trust.*

Of particular interest is the relationship between the CLAT and the ESOP. According to the published IRS tables that govern the calculations of deductions for donations to charitable trusts, Big Man and his spouse will realize a personal income tax deduction of about \$700,000 in 1999 for the donation of about \$1,000,000 of Widgets, Inc. stock to the CLAT. As the ESOP will purchase the CLAT’s stock in Widgets, Inc., Big Man’s company will also realize an income tax deduction of \$1,000,000 for that stock purchase. At the end of the day, the client and his company are achieving a combined income tax deduction of about \$1,700,000 to facilitate a \$1,000,000 charitable donation.

### **ESOP Project**

After earning the client’s trust and confidence via the FLP project, in March 1999, Big Man asked us to help him plan an ESOP for Widgets, Inc. In addition to the economic advantages described below, Big Man was committed to creating an employee ownership culture as a means to ensure his family’s business legacy continues in his local community. It should be noted that in most client projects, educating clients on the advantages of an employee ownership culture is a challenge. In this particular case, this issue was fully resolved before we began our work so we were able to concentrate on the financial aspects of the project.

As with most successful entrepreneurs, about 90% of Big Man's wealth is concentrated in the illiquid closely held stock of Widgets, Inc. Big Man had been studying the ESOP concept for a number of years, so he was relatively familiar with the major financial concepts that are involved with an ESOP. Of particular interest to Big Man was the ability to utilize the IRS Sect. 1042 rollover to achieve a significant level of tax deferred diversification of his closely held stock in Widgets, Inc.

There are about 11,000 ESOP companies in the United States and as a practical matter, the IRS Sect. 1042 rollover is associated with the vast majority of those ESOPs as a tool to accomplish the tax deferred conversion of illiquid closely held stock into a portfolio of publicly traded income producing securities, usually AA or AAA rated long term bonds from Fortune 500 companies. Most of our clients have no intention of ever selling their companies – they just want to get some money out of their company without paying current taxes and diversification of their investments.

With a \$200,000 tax basis and a fair market value of \$15,300,000, Big Man and his spouse would face federal and state capital gains taxes of more than \$3,900,000 if they sold their shares to a third party or if Widgets, Inc. were to redeem their shares via traditional corporate redemption. With proper planning, the tax deferred rollover of the ESOP portion of the plan can result in the elimination of about \$3,900,000 of capital gains tax liability and the valuation discounts of the FLP portion of the plan can result in the elimination of about \$3,800,000 in estate and gift taxes.

A very unique aspect of Big Man's ESOP project included the potential merger of Widgets, Inc. with a Kansas City based company that is in the same industry, albeit this other company focuses 100% of its efforts on the distribution side of the business and does not have a manufacturing element. For purposes of this Case Study, we will refer to this second company as "Gadgets, Inc." and we will refer to the CEO of Gadgets, Inc. as Big Man II.

The business philosophies and practices of Big Man and Big Man II are very compatible and they have been friends for many years, which created an ideal platform for a successful merger. Over the years, we have been involved in a number of mergers and without question, this one was by far the most friendly and economically viable. Per Big Man's instructions, our ESOP Strategy Study was geared to focus on the merger of Widgets, Inc. and Gadgets, Inc. and then having a newly formed ESOP acquire 51% of the stock of the combined business entity, hereafter referred to as "Widgets and Gadgets, Inc."

The logic behind a 51% sale of the stock in Widgets and Gadgets, Inc. was to result in an employee owned culture and also to deliver the highest possible sale price to the shareholders of both companies via "controlling interest" price for their shares. At the same time that significant tax deferred diversification is occurring, our clients continue to hold a significant 49% equity stake in a business that has appreciation potential of 15% - 20% per year.

During the course of the ESOP project, a very interesting twist occurred. A deep pocketed third party buyer with sterling credentials contacted both CEOs (as well as dozens of other companies in this industry) with the goal of acquiring their respective companies. This consolidator had completed the acquisition of about 60 companies in

an unrelated distribution industry and was very successful achieving the necessary critical mass for a successful public offering.

The proposal from the prospective buyer was with the understanding that the operation of Widgets, Inc. and Gadgets, Inc. would probably be combined with the operations of other acquisitions the consolidator had either already completed or would complete in the future. In all likelihood, while this consolidation would result in the retention of a regional sales and marketing office in our client's home community, this consolidation would have resulted in the loss of about 90% or so of the jobs at Widgets, Inc. and Gadgets, Inc. The loss of jobs and the resulting negative impact to the community was very concerning to Big Man.

As with all ESOP projects, when we were first engaged to do the ESOP Strategy Study, one of the first issues we addressed was the fair market value of the business enterprise. We initially estimated the fair market value of a 100% controlling interest in Widgets, Inc. to be in the range of \$13,000,000 - \$15,000,000 and we estimated the fair market value of a 100% controlling interest in Gadgets, Inc. to be in the range of \$3,000,000 - \$4,000,000. Adding these two individual values without any consideration for the synergies of a merger resulted in a combined enterprise value of \$16,000,000 - \$19,000,000 for both companies.

Because of certain business synergies that would result from a merger of Widgets, Inc. and Gadgets, Inc., primarily the reduction of about \$1,200,000 or so in annual operating expenses via consolidation of certain distribution and warehousing facilities, we estimated the fair market value of a 100% controlling interest on a combined basis to be in the range of about \$22,000,000 - \$25,000,000, an increase of about 25% or so over their respective values as separate entities.

As an integral part of an ESOP consulting project, the Board of Directors of Widget, Inc. established an ESOP Exploratory Committee. The Committee subsequently hired a fully credentialed appraiser to serve as the independent appraiser for the fiduciaries of the to be formed ESOP. The appraiser provided three separate "preliminary" valuation opinions – a valuation opinion of each company on a stand-alone basis and a valuation opinion of both companies on a merged basis.

On a stand-alone basis, the valuation analysis by the independent appraiser resulted in Widgets, Inc. having a nonmarketable controlling interest fair market value of \$15,300,000 and Gadgets, Inc. having a nonmarketable controlling interest value of \$3,300,000. These values result in a combined value of \$18,600,000 before adjustments for synergies. The valuation of both companies as a merged entity, recognizing the synergies of a merger, resulted in a nonmarketable controlling interest value of \$24,200,000. Essentially, these two companies were worth about \$5,600,000 more (30%) as a merged business entity than as separate business entities.

While the ESOP process moved along, Big Man and Big Man II pursued the opportunity with the prospective buyer. After considerable back-and-forth discussion and full due diligence, the prospective buyer made a written offer of about \$17,200,000 for both companies and required the transaction to be done as an asset sale. As you may know, the buyer's main advantage to an asset sale leaves the buyer with no liabilities which results in the seller's main disadvantage – asset sales have elements of both ordinary income and capital gains to the seller. The bottom line is that on an asset

sale, the auditor for Widgets, Inc. calculated the taxes of an asset sale to be about \$5,500,000 which means the shareholders would have netted about \$11,700,00 on a \$17,200,000 sale.

In considering the offer from the consolidator and an ESOP, Big Man and Big Man II were essentially faced with the following decision making tree:

	<u>Third Party Strategy</u>	<u>ESOP Strategy</u>
Value of Companies	\$17,200,000	\$24,000,000
Amount of Company Sold	100%	51%
Gross Proceeds to Shareholders	\$17,200,000	\$12,342,000
Tax on Sale Proceeds	\$5,500,000	\$0
Net Proceeds to Shareholders	\$10,700,000	\$12,342,000
Equity Retained	\$0	\$11,858,000
160 Employee Jobs	Eliminated	Retained

The merger of Widgets, Inc. and Gadgets, Inc. was successfully completed. In early 2000, the ESOP was implemented and subsequently completed the purchase of a 51% controlling interest in Widgets and Gadgets, Inc. We were retained to acquire non-recourse cash flow financing for the ESOP stock purchase. Terms of the ESOP loan were as follows:

- ❖ 20 year amortization
- ❖ Fixed interest rate of 10.75% (interest rate dependent on bond market conditions)
- ❖ No personal guarantees.
- ❖ No collateralization of ESOP rollover investments.
- ❖ Collateral of @\$2,600,000 consisting of fixed assets (@24% of loan amount).

In addition to providing non-recourse fixed rate long term financing for the ESOP stock purchase, we were also instrumental in helping Widgets, Inc. negotiate an increase in its short term non-recourse working capital credit facility from \$3,000,000 to \$12,000,000.

An ESOP is the only tool with which a corporation can deduct principal payments on corporate debt. Because of 20 year amortization from our non-recourse cash flow lender and the ESOP's ability to provide our client's company with tax deductible

**principal payments**, the annual net cash flow debt service payments amount to about 22% of the companies' historical EBITDA, which is a very comfortable margin for most industries.

To provide for the future payment of ESOP benefits, the company's Board of Directors passed a resolution that established an ESOP Reserve Fund and authorizes a first year deposit of approximately \$450,000 increasing by about 10% per year. About 90% of this funding will be generated from the income tax savings that Widgets and Gadgets, Inc. will realize from its tax deductible ESOP debt service payments. About \$150,000 of the \$450,000 annual deposit will be earmarked for the annual premium payment on a \$7,000,000 indexed universal life insurance policy on Big Man and the remaining \$300,000 will be invested into the equity markets and managed by a well experienced investment advisor.

The indexed universal life insurance contract provides for a \$7,000,000 death benefit on Big Man. The first year's accumulated cash value amounts to about 75% of the annual premium, which is great news for your balance sheet. While the tax deferred cash value account of the policy serves as a tax advantaged depository for about one-third of the ESOP Reserve Fund, the policy will serve "double duty" – the death benefit of the policy will be used to give Widgets and Gadgets, Inc. significant tax free liquidity to honor the company's stock redemption obligations in the event of Big Man's death. Even though Big Man's FLP sold about \$4,500,000 of Widgets and Gadgets, Inc. stock to the ESOP, Big Man's FLP still holds about \$6,600,000 of stock in Widgets and Gadgets, Inc.

In the event of Big Man's death, Widgets, Inc. will receive the \$7,000,000 death benefit free of income tax (but subject to AMT which the company's PA has calculated to be about \$250,000). It is intended that Widgets, Inc. will lend the life insurance proceeds to the ESOP and the ESOP will then purchase all of the Widgets and Gadgets, Inc. stock from the FLP. Any difference between the \$7,000,000 death benefit and the fair market value of the FLP's stock in Widgets and Gadgets, Inc. at the time of Big Man's death will be financed with a 10 year promissory note from the ESOP to the FLP.

By facilitating the life insurance proceeds through the ESOP, Widgets, Inc. will be able to **generate a \$7,000,000 income tax deduction** that can be amortized over a period of years to accommodate the company's tax planning needs. The income tax deduction generated by the payment of \$7,000,000 of life insurance proceeds via the ESOP will provide Widgets and Gadgets, Inc. with about **\$2,800,000 in newly found working capital** it would not otherwise have were the liquidity perfected via the traditional redemption of stock by the corporation. This infusion of new working capital at a very critical point in time ensures that Widgets and Gadgets, Inc. remains a very strong competitor and will be of great comfort to the employees, customers and suppliers of the company.