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How to Obtain a $5 Million to $50 Million Client

Donald Moine | 07-07-04

During the course of our lives, we all meet a few of them. The rich. And the truly wealthy.

In the mid-1990s, I worked for a couple of years for a man whose net worth *Forbes* estimated at more than $150 million. Another client of mine sold his private financial firm for nearly $100 million. I've known several business owners and entrepreneurs who sold their firms for between $10 million and $50 million.

I am sure you know or have met some of these ultra-high-net-worth individuals. What does it take to acquire them as clients?

I recently reviewed a paper written by one of my clients and obtained some clues about how to attract extremely wealthy clients. Robert W. Smiley Jr. is founder and chairman of the Benefit Capital Companies, with headquarters in Logandale, Nev., and offices in several major cities around the country. You may have heard of Bob Smiley. Bob and his associates have successfully completed more than *$5 billion* in transactions.

Smiley is not a financial planner or asset manager. In my first conversation with him earlier this year, he told me that he does occasionally work with financial advisors. Imagine what it would do for your practice if you managed just a fraction of the $5 billion in transactions Bob Smiley and his associates have completed.

When I say that Smiley does "transactions," I am not referring to stock, bond, or mutual fund sales. Smiley helps business owners sell their businesses--but he does not do conventional sales. He uses a special set of strategies and tax laws that offer the business owners far more financial benefits than those offered by a regular sale. In the process, he and his associates have freed up more than $5 billion in wealth that needs to be managed.

I asked Smiley to describe to me what it is he does and how he regularly gets an audience with individuals worth between $10 million and $100 million or more. As we all know, many of the wealthiest people in America are business owners. These wealthy business owners are Smiley's clients. Smiley explained that to get in front of these people, you must have solutions to their two most pressing problems, *wealth illiquidity* and *taxes*. Smiley has those solutions and that is why his companies have been able to complete billions of dollars worth of transactions.

I then asked Smiley to send me some information on how he works with financial advisors. He sent me a document that fewer than one dozen financial advisors have ever seen, "Wealth Creation for Business Owners." I obtained his permission to share parts of it with you in this article.

How Are You Building Your Practice?

Every financial advisor wants to rapidly grow his or her assets under management--yet most advisors go about building their practices the slow, old-fashioned way. If you are lucky or fortunate, a few times in your career, you may acquire a big client who brings you $5 million or more in new assets. These large clients can often be the determining factor in whether you end up with a small struggling practice or a large lucrative practice.

Imagine what your practice (and your income) would be like if you could bring in several $5 million to $20 million clients during the next several years. You must believe that it is possible. Some of the best prospects of all are business owners who may be thinking of selling all or part of their businesses anytime in the next several years.

I have previously written about how advisors can work with business brokers. I have received e-mail from dozens of financial advisors all over the country who are now successfully working with business brokers. As you will learn, an expert of Employee Stock Ownership Plans (ESOPs) can be even more effective than a business broker in helping you build your practice.

Every community in America has businesses that are going to be put up for sale. Someone will be assisting these business owners with their exit strategies and will be helping the sellers manage their wealth. *Why not you?*

You will not be selling the business or setting up the ESOP. You simply refer the business owner to an expert in this field and you will have the probability of getting millions to tens of millions of dollars in new assets under management *and* large insurance sales. Make sure that the experts to whom you make these referrals do *not* manage assets. Asset management is your specialty. You want to work with experts who focus *exclusively* on helping the business owner sell their businesses. Tens of millions of dollars will then be freed up for investment purposes. You get to manage those assets.

As you will learn in this article, the gold standard in exit strategies for business owners is the ESOP-assisted buyout. Simply put, an ESOP is established and then, using incredibly generous tax benefits (which are written into the law), employees buy the company through a special ESOP structure. Employees do not have to be rich to buy the company. Most ESOP-assisted buyouts are done for average employees. Financing is readily available for these transactions if they are properly structured.

You do not need to be an ESOP expert. You only need to work with a top ESOP-assisted buyout expert. If you find just a few good candidates, you may acquire $10 million or more in new assets to manage.

Why All the Excitement?

Why all the excitement about ESOP-assisted buyouts? A buyout using an ESOP can bring more than 100% of the transaction value in *additional* financial benefits to the buyers and sellers of a business. What this means is that if a business is sold for $10 million, there is an additional $10 million (approximately) of tax breaks and other financial benefits to be divided among the buyers and sellers. This is an additional $10 million of assets you can potentially manage.

Only an ESOP-assisted buyout (not a regular business sale) offers these unique and powerful financial benefits. Due to the effective doubling of the purchase price in an ESOP-assisted sale, more and more business owners want to sell their companies through an ESOP-assisted buyout. You can help them.

Economic Benefits of an ESOP-Assisted Buyout

In one of his in-house documents, Smiley uses a $50 million example. He has done ESOP-assisted transactions for companies of all sizes--however, his specialty is companies valued at $5 million or more. There are probably companies like this in your neighborhood.

To attract wealthy business owners as clients, you must know something about ESOP-assisted buyouts. If the $50 million business is sold the conventional way (to outsiders and not to employees), the seller must pay all the taxes due on the $50 million sales price. Let's compare this conventional sale with an ESOP-assisted sale. Remember that with an ESOP-assisted buyout, there is an additional $50 million in extra financial benefits available to the buyers and sellers--on top of the original sales price of $50 million. That results in a huge increase in the effective proceeds received by the seller and more assets and cash for you to manage.

With an ESOP-assisted buyout, the seller may be able to defer paying taxes on some or all of the profits received from selling the business. There are also ways that enable some sellers to avoid *all* taxes on the sale of the business. A 10- or 20-year deferral on paying those taxes could save the seller millions of dollars, which you can also manage.

Why ESOP Bids Usually Win

Virtually all ESOP-assisted buyouts can match the bids as well as the amount of cash offered by an outside buyer. That is why more than 20,000 of these transactions have been done across America. Frequently, management and the employees work together to buy a company using an ESOP-assisted buyout, and any extra funds needed are supplied by banks, institutions and/or investors. This is why employees do not have to be rich to buy a company.

Owners frequently think that their employees do not have enough money to buy a company. They are then pleasantly surprised to receive their full asking price. Many banks, institutions, and investors are eager to supply any needed funds for an ESOP-assisted transaction because the economics are very strong if they are properly structured. In some cases, Smiley said, owners may receive more than their asking price when selling using an ESOP. This is because the sales price is set by an objective outside fiduciary, as required by law.

An ESOP-assisted buyout will beat a sale to outsiders almost every time because it doesn't need to pay the very high (and sometimes unrealistic) rates of return demanded by venture capitalists and leveraged-buyout specialists. In rare instances, an ESOP-assisted buyout cannot match the price outsiders offer for a company if the outsiders make a wildly overpriced offer. Such extreme offers are infrequent to non-existent today, but were seen during the stock market bubble of the late 1990s.

ESOP-Assisted Buyouts in Partial Sales

You may think you do not know a business owner who is thinking of selling his or her business. Think again. If you know of a company or owner who is thinking of selling just *part* of a business, you may be able to acquire $10 million or more in new assets under management.

An ESOP-assisted buyout can be used to buy all or part of a company. You may know a company that only wants to sell one division. For example, many multibillion-dollar companies sell or divest divisions or subsidiaries. The purchase of even a "small" division of a multibillion-dollar corporation can make many employees and managers very wealthy. If you have clients who are executives at a large company, ask if they know of any division or subsidiaries that may be put up for sale in the next few years.

Important Facts About ESOPs

The parties to an ESOP-assisted buyout include the sellers, employees, management, financial institutions and/or investors and an ESOP trustee, who is a fiduciary representing the employees.

An ESOP is both a technique of corporate finance *and* a tax qualified employee benefit plan. An ESOP is similar in certain respects to a profit sharing plan. The big difference between an ESOP and other plans is that other plans are usually designed to invest in everything except company stock. An ESOP is mandated to invest primarily in the stock of the employer.

ESOPs are the only tax qualified and tax-exempt employee benefit plan that can borrow to purchase company stock from the sponsoring company or from its stockholders. An ESOP does not have to borrow money. If it chooses, the company can simply make annual contributions to the ESOP to buy stock. However, this legal ability to borrow to buy company stock has made many people very wealthy.

You might think that it is risky to use borrowed money to buy company stock. However, in this case, due to incredibly generous provisions written into the tax code for ESOPs, all principal *and* interest payments are fully tax-deductible. Also, employees are *not* liable for the loan. This totally changes the economics and removes a great deal of risk from these transactions. In addition, some companies are able to operate on an almost tax-free basis after the ESOP-assisted sale. This puts the company in a very strong competitive position.

To understand how being able to write off all principal and interest payments removes much of the risk in these transactions, compare it to buying a home. Most of us don't think twice about taking out a home loan. The ability to write off interest makes it a very appealing proposition.

Imagine how much wealthier you would be if you could buy a home and deduct all *principal* and interest payments on your taxes. Being able to do so could make you hundreds of thousands of dollars wealthier. An ESOP-assisted transaction in which the principal and interest costs can be written off to buy company stock can easily bring millions to tens of millions of dollars in additional personal wealth to the employees and managers who buy a company.

ESOP-assisted buyouts use a special type of ESOP structure--not just a regular ESOP. Since ESOPs are getting to be so popular, many newcomers are jumping on the ESOP bandwagon. You may know a local consultant, accountant, or attorney who attended a few ESOP workshops and now claims to be able to do ESOP-assisted sales. Be careful. These transactions can be very complex. You don't want to have a newcomer try to gain experience by using one of your clients as a guinea pig--especially when your client could bring you $5 million to $50 million in assets to be managed.

In my next article, I will explain which companies are eligible for either full or partial ESOP-assisted buyouts. I will also compare ESOP-assisted buyouts with other exit strategies an owner can use, such as doing an initial public offering, selling to outsiders and selling to management.

The ESOP Checklist

Bob Smiley has developed a fascinating tool he calls the "ESOP Best Candidate Checklist." This is a set of friendly questions you can ask any business owner to determine if that business is eligible for the many financial and tax benefits of an ESOP-assisted sale. If you would like to receive a free copy of this checklist, send an e-mail to DrMoine@aol.com with "ESOP Checklist" in the title and it will be promptly sent to you.

Several of the financial advisors I work with have obtained clients who have $10 million to more than $50 million that needs to be invested. I hope that some day you will have the experience of working with such a client. ESOP-assisted buyouts may open the door to these wealthy clients for you.

Dr. Donald Moine, trained as a research scientist, has specialized for the past 23 years in practice building, investment psychology, behavioral finance, and the development of low-risk, high-reward investment methods.

Based in Palos Verdes, Calif., Dr. Moine is an investment advisor, consultant, and coach to financial advisors, CPAs, mutual fund companies, brokerage firms, insurance companies, law firms, investment bankers, Fortune 500 companies, and top investment managers around the world. To receive information on his coaching and consulting work, visit DrMoine.com or write to DrMoine@aol.com and request a free copy of his report "How I Help Financial Advisors Rapidly Build Highly Profitable Practices."

Dr. Moine is co-author of the best-selling book *Ultimate Selling Power: How to Create and Enjoy a Multi-Million Dollar Sales Career*.

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How to Rapidly Build Your Practice with ESOPs

Donald Moine | 07-21-04

Nearly 100 financial advisors from around the country sent me e-mail to request a copy of the "ESOP Best Candidate Checklist." I mentioned this checklist in my previous article, How to Obtain a $5 Million to $50 Million Client. The interest in ESOPs and ESOP-assisted buyouts is rapidly growing among financial advisors--especially those advisors seeking high-net-worth clients.

In my previous article, I interviewed Robert W. Smiley Jr. and obtained his permission to quote from several papers he has written on ESOP-assisted buyouts. Bob Smiley is founder and chairman of the Benefit Capital Companies, with headquarters in Logandale, Nev., and offices in several major cities around the country. Smiley and his associates have successfully completed more than $5 billion in transactions.

Smiley is not a financial planner or asset manager. He specializes in setting up employee stock ownership plans (ESOPs) and selling businesses to ESOPs. There are special tax laws that offer incredibly generous tax benefits to business owners who sell to an ESOP. When that $5 million to $100 million transaction is complete, you have the opportunity to manage the now liquid wealth of the business owner. You can now see the tremendous practice-building implications of ESOP-assisted buyouts.

Smiley is a co-author and co-editor of the definitive reference work in the field, Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation, which is currently sold out and is being totally revised for publication in early 2005. The other co-editors are Ronald Gilbert, David Binns, Ronald Ludwig, and Corey Rosen. This 1,300-plus-page book is considered the "bible" in the field and will be updated annually.

In this article, I will share additional financial benefits of ESOP-assisted buyouts and will answer some of the questions readers sent in.

Do Business Owners Already Have Financial Advisors?

While my previous article generated a tremendous amount of excitement among financial advisors interested in rapidly growing their practices, some wondered if these business owners already had advisors. Some do. In fact, you may have clients who own businesses worth $5 million to $20 million or more. These businesses could be perfect candidates for an ESOP-assisted buyout.

However, many business owners have almost all of their wealth tied up in their business and have relatively few holdings in the stock or bond markets. For example, in the mid-1990s, one of my clients was the CEO of a large company. His net worth of more than $150 million was almost entirely in the stock of his company and real-estate holdings. I've known many other business owners who have had the vast majority of their wealth tied up in their companies. I am confident that you have, too. This spells opportunity for you.

What if the business owner already has an advisor? In one case with which I am familiar, a business owner sold his business for $16 million. Like many business owners, he had little idea of the true value of his business. He thought it might have been worth $9 million or $10 million. This business owner had a stock portfolio of less than $500,000. When he sold his business, he thought his current stockbroker was not sophisticated enough to help him manage $16 million, and he changed financial advisors.

I've seen several similar scenarios. In another case, the business owner changed financial advisors both because he thought his current advisor could not manage the large sum of money he now had and because he was profoundly unhappy with how much money his stockbroker's "buy and hold" strategy had lost him in the stock market meltdown of 2000-2002. Another business owner wanted a new advisor who was ultraconservative. He changed to an advisor who specialized in annuities and tax-free municipal bonds.

I could cite many more examples and case histories, and I am sure you have a few of your own. What all of this teaches us is that there is a tremendous practice-building opportunity when a business owner in your community starts to sell all or part of his or her ownership interest in the business. Do not discourage yourself by saying, "He or she probably already has a financial advisor. I shouldn't even try to contact this person." A financial advisor with a more positive attitude will likely gain this person as a major client.

What we also learn from studying case histories of business owners who monetize their wealth is that all assets are up for grabs. Do not assume that your business-owning client of 11 years will be your client for life. If another financial advisor shows him the many powerful financial and tax benefits of selling to an ESOP, he may be very impressed with the knowledge and sophistication of this new financial advisor. When his once-illiquid wealth is monetized, he may turn to this new financial advisor for help in managing that wealth.

Therefore, if you have business owners as clients or wish to have high-net-worth business owners as clients, you may be extremely well compensated for your efforts in learning more about ESOPs. In the 23 years I have been consulting with advisors, I have only found a few truly effective ways of attracting $10-million-plus clients. ESOP-assisted buyouts are one of the most powerful methods for attracting such wealthy clients because they solve business owners' two greatest problems, wealth illiquidity and taxes.

Financial Benefits of ESOP-Assisted Buyouts

In my previous article, I covered the basics of ESOP-assisted buyouts and showed that employees do not have to be rich to buy a company. Most ESOP-assisted buyouts include average employees, and financing is readily available if these transactions are properly structured. If you missed that article, please read it to develop an understanding of the essentials of ESOP-assisted buyouts.

One of the key points you must understand is that an ESOP-assisted buyout can bring more than 100% of the transaction value in additional financial benefits to the buyers and sellers of a business. For example, if a business is sold for $10 million, there is an additional $10 million (approximately) of tax breaks and other financial benefits to be divided among the buyers and sellers. This is an additional $10 million of assets you can potentially manage. Only an ESOP-assisted buyout (not a regular business sale) offers this powerful financial benefit.

With an ESOP-assisted buyout, the seller may be able to defer paying taxes on some or all of the profits received from selling the business. A 10- or 20-year deferral on paying those taxes could save the seller millions of dollars--which you can also manage. And with proper planning, the tax deferral can become permanent tax savings.

When an ESOP buys a business, all principal and interest payments are fully tax deductible. Also, employees are not liable for the loan. This removes a great deal of risk from these transactions. In addition, some companies are able to operate on an almost tax-free basis after the ESOP-assisted sale, due both to the extremely generous write-offs for principal and interest as well as the opportunity to elect to pay no future federal income taxes. This can easily bring millions to tens of millions of dollars in additional personal wealth to the employees and managers who buy a company.

ESOPs Compared to Other Monetization Options

Tens of thousands of business owners, including some in your own community, want to retire. Many of their children have other professions or interests and do not wish to or are unable to take over the business. Due to the smaller size of the next generation, there are not enough buyers to absorb all the businesses being offered for sale. Business owners in this position usually consider the following options:

- Do an initial public offering.
- Sell to an outside third party or supplier.
- Sell to management.
- Sell through an ESOP-assisted buyout.

Instead of undergoing the expense and uncertainty of a public offering or instead of attempting to sell their equity to an outside buyer, business owners can sell to the ideal, ready-made, built-in buyer, the employees of their own company. In so doing, they can enjoy tax and financial benefits unrivalled by any other exit strategy.

How does an ESOP-assisted buyout compare to the other options? If owners sell their stock to the public, they will incur an immediate capital-gains tax, become subject to the jurisdiction of the SEC, and risk loss of control. In addition, the company will now have to comply with the onerous restrictions and scrutiny of Sarbanes-Oxley, which could add $1 million a year or more to compliance costs.

If the owners sell their company to another company or third-party buyer, they will pay an immediate capital-gains tax, lose control of their company, and probably not be able to retain any residual equity.

If they try to sell their company to management, they may find that the managers do not have enough money to buy it. Without the tax-benefits of an ESOP-assisted buyout, lenders may not be as willing to lend. Also, unless employees are included, the managers buying a company may find they now have a de-motivated workforce. And they don't get any of the additional financial benefits only available through an ESOP-assisted buyout.

If they sell through an ESOP-assisted buyout, they can defer the federal capital gains tax, maintain local control and management of the company, retain residual equity, and invest the proceeds in a diversified, low-risk portfolio of stocks and bonds (with your help!). At the same time, they will be rewarding the loyal people who helped them build their business and the business will have a highly motivated workforce.

For all of these reasons, an ESOP-assisted buyout may be the best wealth creation and monetization strategy for both business owners and the employees buying the business.

What Are the Disadvantages of ESOP-Assisted Buyouts?

Just as no investment strategy is perfect for all investors, there is no business monetization strategy that is perfect for all business owners. There are four aspects of ESOP-assisted buyouts that might be considered disadvantages.

First, an ESOP-assisted buyout will usually require some debt. However, since both principal and interest are tax deductible with ESOP-assisted buyouts, much of the debt risk is minimized. In essence, virtually the total cost of buying the business is tax deductible.

Second, if an ESOP is used, as in most private companies, the company will have an obligation to provide liquidity to participant-owners. This is an obligation to purchase stock from the accounts of participants who die, retire, become disabled, or otherwise terminate service.

Third, some people perceive an ESOP-assisted buyout as complex. This does have some truth in it. However, you do not have to become an ESOP expert. You only need to work with an ESOP expert. The ESOP expert can keep the process simple and stress-free for the owners selling the company and the employees and managers buying it. By working with an ESOP expert, you may pick up a $5 million to $20 million (or more) client.

The fourth disadvantage is that while more than 20,000 ESOP-assisted buyouts have been completed all over the United States, they are still relatively unknown. This "disadvantage" can be an advantage if you are one of the first advisors to clearly explain the many benefits of an ESOP-assisted buyout to business owners in your community.

Resources to Build Your Practice with ESOPs

Bob Smiley gave me permission to share one of his tools, the "ESOP Best Candidate Checklist" with readers of this column. This is a set of friendly questions you can ask any business owner to determine if that business is eligible for the many financial and tax benefits of an ESOP-assisted sale. Nearly 100 financial advisors from around the country have requested a copy of the checklist.

Smiley has also developed a set of "Instructions and Tips on Using the Best Candidate Checklist." If you would like to receive a free copy of these tools, send an e-mail to DrMoine@aol.com with "ESOP Checklist and Instructions" in the subject line, and I will arrange for them to be promptly sent to you.

In my third and final article on this topic, I will examine the sale of a business to an ESOP and will detail the exact benefits received by the sellers, the employees, the company, and by you, the financial advisor.

According to an Arthur Andersen study, leadership of 39% of all family-owned businesses will change hands from 2003-2008. A study by J.H. Astrachan and M.C. Shanker found that family firms compose 80% to 90% of all business enterprises in North America and that the greatest part of America's wealth lies in family-owned businesses. I hope that by increasing your knowledge about ESOP-assisted buyouts, you may be able to help some of the business owners in your community and bring from $10 million to more than $50 million in assets to your practice.

Dr. Donald Moine, trained as a research scientist, has specialized for the past 23 years in practice building, investment psychology, behavioral finance, and the development of low-risk, high-reward investment methods.

Based in Palos Verdes, Calif., Dr. Moine is an investment advisor, consultant, and coach to financial advisors, CPAs, mutual fund companies, brokerage firms, insurance companies, law firms, investment bankers, Fortune 500 companies, and top investment managers around the world. To receive information on his coaching and consulting work, visit DrMoine.com or write to DrMoine@aol.com and request a free copy of his report "How I Help Financial Advisors Rapidly Build Highly Profitable Practices."

Dr. Moine is co-author of the best-selling book *Ultimate Selling Power: How to Create and Enjoy a Multi-Million Dollar Sales Career*.

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A $100 Million ESOP Success Story

Donald Moine | 08-11-04

As of early August, more than 400 financial advisors from around the country have sent me e-mail messages to request a copy of the "ESOP Best Candidate Checklist." I mentioned this checklist in my two previous articles, How to Obtain a $5 Million to $50 Million Client and How to Rapidly Build Your Practice with ESOPs. In addition, many advisors wrote in with questions and success stories.

A few of you have already been involved in ESOP-assisted buyouts and know that they can attract clients with $5 million to $20 million or more to invest. Some of you have told me about prospects you have acquired using the information I provided in the two previous articles and Robert W. Smiley Jr.'s "Best Candidate Checklist."

So far, the leader is an advisor in Northern California who now has several business owners in his area interested in ESOP-assisted buyouts. Potentially, he could acquire more than $120 million in new assets under management. If just one or two of these transactions go through, he could acquire more than $50 million in assets under management.

In my previous articles, I interviewed Smiley and obtained his permission to quote from several papers he has written on ESOP-assisted buyouts. Smiley is founder and chairman of the Benefit Capital Companies, which have successfully completed more than $5 billion in transactions.

To save time and space, I am not going to repeat information presented in the previous articles. I encourage you to read them before you read this article, which is the final piece in the series. Smiley is not a financial planner or asset manager. He specializes in setting up employee stock ownership plans and selling businesses to ESOPs. Special tax laws offer incredibly generous tax benefits to business owners who sell to an ESOP. When the transaction is complete, you have the opportunity to manage the now liquid wealth of the business owner.

Time Frame for an ESOP-Assisted Buyout

A number of readers asked me how long an ESOP-assisted buyout takes. This depends on the structure of the business, its financial strength, and other variables. If you work with an ESOP expert who has done a number of these deals, an ESOP-assisted buyout can take less time than selling the business to an outsider. For example, a business broker told me about two businesses he listed in December. He still has not been able to find buyers. ESOP-assisted buyouts could have been completed during that time.

According to Smiley, some ESOP-assisted buyouts take only a few months, and he has done some in 60 days. Once they are complete, you will have millions to tens of millions of dollars in new assets to manage.

A surprising number of business owners have relatively little money in the stock or bond markets because the majority of their wealth is tied up in their businesses. If they do have a little money in the market, they frequently change advisors once they sell the business because they think their existing advisor is not skilled enough to manage the millions or tens of millions they now have to invest. This is why ESOP-assisted buyouts are such an outstanding practice-building opportunity for you.

Adding Asset Protection and Estate-Tax Savings

An important subject I was not able to cover in my previous articles is how an ESOP can provide asset protection. Many financial advisors are very interested in offering asset protection and estate-tax savings to their clients. A newer form of ESOP-assisted buyouts offers both.

IRC Sec. 1042 covers tax-deferred rollovers available to owners who sell to an ESOP. With good planning, the tax-deferred 1042 rollover can turn into the permanent elimination of capital-gains tax. Even if the business owner made $50 million or more on the sale of his or her business, no taxes may be owed. This means there is even more money for you to invest.

To enjoy enhanced asset protection, a well-conceived family limited partnership (FLP) or limited liability company (LLC) can own 1042 rollover investments. An FLP or LLC can provide four important advantages:

1. Enhanced protection of assets from seizure.
2. Estate tax relief from estate taxes of 35%, 40%, or more.
3. Valuation discounts.
4. If the seller provides financing for the ESOP transaction (there are many advantages in doing so), an FLP or LLC can prevent the outstanding balance of the promissory note from being treated as "income in respect to a decedent" (IRD). If an asset incurs IRD treatment, the asset is subject to both ordinary income taxes and estate taxes that can total 80% to 85%. An FLP or LLC can help avoid or minimize these confiscatory taxes.

The IRS has addressed the use of an FLP and LLC in 1042 rollovers. FLPs were addressed in Private Letter Ruling 9846005. In addition, Revenue Ruling 2000-18 affirms most of the informal guidance provided in PLR 9846005. Private Letter Ruling 200243001 addresses technical issues regarding the use of an LLC as the owner of 1042 rollover investments. These rulings provide legitimacy to these powerful asset-protection and estate-tax-reduction techniques. One of the most popular combinations of these strategies has become known as the FLPSOP.

A $100 Million ESOP-Assisted Buyout

Smiley uses the example below to show all the financial benefits of an ESOP-assisted buyout. In this example, the transaction value is $100 million, and there is a negligible or zero tax basis in the company stock being sold. Smiley has done deals of this size, smaller ones and much larger ones. Regardless of the size of the transaction, these benefits can be enjoyed by buyers and sellers. If your client is selling a business for $10 million, just divide the figures given by 10.

Section 1042 Tax Deferral Benefit Comparison

	Non-ESOP	ESOP
Gain on sale	$100 million	$100 million
Tax (20%, combined federal and state)[1]	$20 million	0
Net proceeds	$80 million	$100 million

[1]Assumes state of residence sale where this benefit is recognized for both state and federal tax purposes (rounded).

There are additional benefits beyond this example. For example, the transaction costs are generally lower for ESOP-assisted buyouts than they are for conventional sales, saving the business owner even more money.

Benefits to the Seller: Defer the Taxes and Keep the Earnings

In an ESOP-assisted buyout, Section 1042 of the Internal Revenue Code enables qualifying shareholders of privately held C corporations to defer gains on the sale. The seller must have a three-year holding period and must reinvest the proceeds of the sale in the securities of domestic, active corporations (debt or equity, public or private). You can help them reinvest their money and receive significant assets under management, fees, or commissions. With proper planning, these tax deferrals can become permanent tax savings. The seller gets to keep both the tax savings and the earnings on the tax savings.

Reinvestment Benefit

Assumes a let-it-ride and compound approach

Additional proceeds from ESOP-assisted sale (taxes saved)	$20 million
After-tax reinvestment return (assumed rate)	5%
Assumed additional life expectancy of seller	21 years
Additional benefit from reinvestment of tax savings	$56 million

Some financial advisors are not comfortable talking about tax savings, reinvesting tax savings, or earning 5% per year. However, this is not an exotic tax shelter. These generous tax provisions are written into the law. In addition, you can earn 5% per year in returns. If you search the Morningstar database, you will find stocks that yield 3% or more per year in dividends. With even a slight gain in the value of the stock, a skilled advisor can easily earn 5% per year.

As shown above, the total additional benefits to the seller attributed to the ESOP-assisted buyout are about 50% of the sales price. In essence, by selling to an ESOP, the seller of a company can sometimes receive 50% more in additional economic benefits. If the rate of return is 10% per year (instead of the assumed 5%), the seller could potentially receive 100% more in economic benefits by selling to an ESOP. If the seller lives longer than the 21 years assumed in this example, the economic benefits are even greater.

The magnitude of these additional financial benefits makes ESOP-assisted buyouts the most compelling exit strategy of all.

Benefits to the Company: ESOP Principal Payments are Tax Deductible

Principal payments on the ESOP financing are tax deductible for the ESOP portion of the ESOP-assisted buyout. This delivers a financial benefit of about $40 million on a $100 million transaction (or 40% of the sales price). In a conventional sale, the corporation has to earn $167 million and pay $67 million in taxes (if it is in the 40% tax bracket) to be able to pay, after tax, the $100 million due toward principal. That's about $67 million in taxes saved by an ESOP-assisted buyout, and this benefit is enjoyed by the employees who now own the company.

Lenders are often repaid more quickly, saving millions of dollars in interest. The tax savings allows larger principal payments, thus enabling the purchasers to achieve debt-free status much more rapidly, and pay less in interest. This interest savings is in addition to the savings employees enjoy because they can deduct both the interest and principal on a loan to buy the company.

ESOP-Owned S Corporations May Avoid Taxes

Once a company has been acquired through an ESOP-assisted buyout, by electing S corporate status the company becomes a virtually tax-free operating entity to the extent of the ESOP's ownership interest. In other words, if there is 100% ESOP (employee) ownership, potentially 100% of the taxes can be safely and legally avoided. This comes about as a result of the S corporation passing its tax obligations through to its shareholder, which in this case is a tax exempt, qualified trust, and not liable for the payment of federal income taxes. Any shareholders other than the ESOP will be taxed as they normally would. This is why getting to 100% ESOP ownership is a very worthwhile goal.

This tax-free operating status is an enormous benefit for the company and its new shareholder (the ESOP), because the cash flow enables the ESOP to rapidly repay the cost of buying the business. Therefore, an S corporation involved in an ESOP-assisted sale has more funds for future growth, to provide additional benefits to the employees and management, to gain market share and outperform its taxable competitors. Neither the company nor the ESOP pays any federal income taxes. This tax-free operating status also greatly reduces the risk of ESOP-assisted transactions and makes these companies very attractive lending clients for financial institutions.

For the employee buyers using an ESOP, the additional financial benefits of electing S corporation status can bring more than 50% of the original transaction value in extra economic benefits. Imagine the competitive power of a corporation 100% owned by the employees when that corporation does not have to pay any federal income taxes and you will begin to understand why so many sellers, employees, and advisors are so excited about ESOP-assisted buyouts.

ESOP-Assisted Sales as a Wealth Creation Strategy

Owners selling a business to an ESOP can enjoy 50% to 100% more in economic benefits than they could if selling to outsiders. As shown above, employees buying a business can enjoy additional economic benefits of 67% of the transaction value. In addition, the company they now own may be able to enjoy 100% tax-free status.

Employees and managers can now focus on long-term growth instead of short-term profit. The unique tax benefits they enjoy give them the ability to rapidly pay off debt. Employee-owners are highly motivated to enhance profitability and increase productivity. They enjoy vastly increased profits on which they may have to pay no taxes. Upon receipt of distributions (usually upon retirement), the employees pay a combination of low capital gains and ordinary income taxes. They win again. This blended tax rate almost always results in a much lower overall tax rate than the taxes most people have to pay on retirement distributions.

In addition to these significant economic benefits for buyers and sellers, ESOP-assisted buyouts offer many important community benefits. Companies are preserved and their competitive power is enhanced. Jobs are saved. Due to increased profits, more jobs are created. Companies stay locally owned. Why send jobs to India, China, Bermuda or elsewhere when you can enjoy tax-free status here? Why reincorporate offshore when you can write off both principal and interest on an acquisition loan here in the United States?

The ESOP Checklist

Bob Smiley has developed a fascinating tool he calls the "ESOP Best Candidate Checklist." This is a set of friendly questions you can ask any business owner to determine if that business is eligible for the many financial and tax benefits of an ESOP-assisted sale. For this final column on ESOPs, I have also persuaded him to make available his "Tips and Instructions on Using the Best Candidate Checklist" and his "Wealth Creation for Business Owners" reports.

If you would like to receive any of these, send an e-mail to DrMoine@aol.com with "ESOP Practice-Building Tools" in the subject line and the requested tools will be sent to you.

Dr. Donald Moine, trained as a research scientist, has specialized for the past 23 years in practice building, investment psychology, behavioral finance, and the development of low-risk, high-reward investment methods.

Based in Palos Verdes, Calif., Dr. Moine is an investment advisor, consultant, and coach to financial advisors, CPAs, mutual fund companies, brokerage firms, insurance companies, law firms, investment bankers, Fortune 500 companies, and top investment managers around the world. To receive information on his coaching and consulting work, visit DrMoine.com or write to DrMoine@aol.com and request a free copy of his report "How I Help Financial Advisors Rapidly Build Highly Profitable Practices."

Dr. Moine is co-author of the best-selling book *Ultimate Selling Power: How to Create and Enjoy a Multi-Million Dollar Sales Career*.

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