

## AVAILABLE PERPETUATION OPTIONS



There are many options available in the perpetuation planning process. Most often, a combination of methods must be employed to reach an optimum financial structure. Before proceeding with a description of our recommendation, we have outlined some of the major options available in the perpetuation planning process. These options most often never stand alone but are used in conjunction with one another.

### GIFTING

Gift giving is usually a perpetuation option when family members are involved. In most states, an individual can gift up to \$12,000 per year (\$24,000 for married joint tax filers) to another individual for the year 2006. Subsequent years will be indexed for inflation. For gifts exceeding the annual limit a lifetime gift tax exemption is available through a unified credit. In 2002 the unified credit for gift tax was increased to \$345,800, exempting \$1,000,000 of lifetime gifts from tax and currently remains at this level. The total amount of unified credit used during a lifetime against the gift tax reduces the credit available to use against an estate upon death. The recipient of the gift is not taxed on the value of the gift at the time it is received. In the case of stock, they would incur tax on any increase in the value of the stock at the time the stock is sold.

### STOCK OPTIONS

There are various types of employee stock option plans available. They are either "statutory" or "nonstatutory" from a tax viewpoint. Statutory stock option plans include an incentive stock option plan and an employee stock purchase plan (qualified under IRS Code section 423) and offer tax advantages but contain numerous restrictions. An **incentive stock option plan (ISO)** provides an option to purchase stock typically at the market value as of the grant date for a period of years not greater than ten. An employee participating in an ISO can own up to 10% of corporate stock at the time of the grant. The recipient must be an employee according to IRS guidelines and must hold the stock for a specified length of time. As the value of the stock increases relative to the option price, the employee has the potential to benefit from the increase in value. The employee does not recognize ordinary income at the option grant or exercise date (although the spread between the option price and the stock's fair market value is an item of adjustment for alternative minimum tax purposes at the time of exercise). The employee is taxed at capital gains rates when the stock is sold (provided the stock is held for the longer of two years from the date of grant or 1 year from the date of exercise). Similar to an ISO, an **employee stock purchase plan** gives employees an opportunity to share in the growth of the company's stock. An employee stock purchase plan is primarily intended for rank and file employees as all employees of the company must be included, although the plan limits the favorable tax treatment to employees owning 5% or less of the voting stock and/or 5% or less of the value of all of the shares.

Stock appreciation rights (SARs) and Phantom Stock are other incentive vehicle options when the company's owners want to share the economic value of equity but not the equity itself or complement other ownership opportunities. Phantom Stock is a promise to pay a bonus in the form of the equivalent of either the value of company shares or the increase in that value over a period of time. SARs are similar to Phantom Stock except it provides the right to the monetary equivalent of the increase in value of a specified number of shares over a specified period of time. SARs can be paid out as cash or in shares of stock. The recipient receives stock or cash for the increase in

value of a stock between the grant date of a right and the end of a stated time period. For both Phantom Stock and SARs the recipient is taxed when the right to the benefit is exercised. The value of the award is taxed as ordinary income and is tax deductible to the employer. SARs that provide the reward in shares result in a tax as ordinary income for the value at the time it is exercised. Any subsequent gain in value is taxable as a capital gain at the time the stock is sold.

All of the methods discussed above provide significant benefits to the recipients if the stock price increases. The recipient is thus motivated to help increase the stock's value.

## **STOCK BONUS**

Stock bonuses involve the corporation issuing new stock in the name of the bonus recipient. This will increase the amount of stock issued and outstanding and will dilute the percentage ownership of the existing shareholders. While a stock bonus is in effect "giving away" agency stock, it can be an effective tool in a perpetuation plan. A stock bonus is a way of bringing key employees into the perpetuation plan without costing the bonus recipients a considerable amount of money. The stock bonus is also a way for the current owners to somewhat pre-ordain what the balance of power will be after the transfer of ownership. The value of the stock bonus is normally deductible to the agency when transferred. The recipient, however, will be taxed on the bonus as ordinary income. Since no cash is exchanged, the recipient must come up with the money to pay the tax. This cost is much less of course than paying for the stock outright. One way to delay the tax liability and spread it over time is to establish a vesting period. A vesting period also helps prevent the recipient from taking the bonus, leaving the agency and requiring the agency to buy back the stock immediately. The stock bonus agreement should contain provisions protecting against a premature termination, which may require the repurchase of the bonused stock.

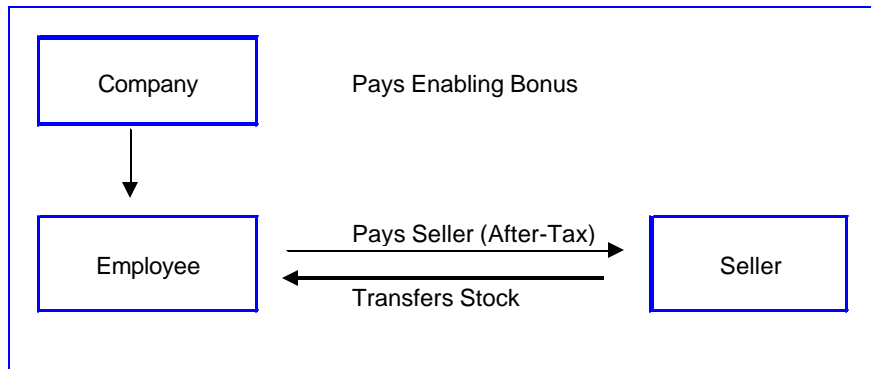
Ideally both stock bonuses and stock options should be tied to performance, namely new business production, the size of the book of business or management performance.

Valuation is an important factor in gifting, stock options, and stock bonuses. Often, appraisals will be needed to determine gift and compensation amounts that will be acceptable to the IRS.

## **PERSONAL BUY OUT**

One option that can be used alone or in combination with others is that of the personal buy out. In a personal buy out, an employee of the agency purchases stock from the retiring shareholder. Under such a plan, the buying employee could fund the purchase through his existing salary or personal funds. Alternatively, the corporation can establish an incentive bonus plan. Such an incentive plan should be structured in such a way to encourage the maximization of growth, profit and agency value. If earned, these bonuses can enable employees to buy stock. In this report we call this type of bonus an "enabling bonus". The enabling bonus provides employees who otherwise could not afford a large block of stock with the means to do so. The diagram below illustrates this method.

Diagram #1  
Personal Buy Out



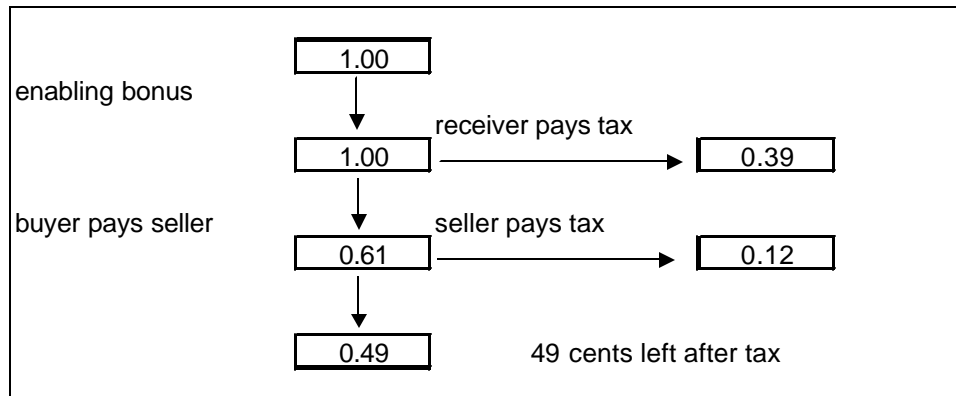
The enabling bonus must be looked upon as more than a simple gift to buyers. The selling shareholders could alternatively divert the agency's future earnings to profits, the profits to retained earnings and the retained earnings to a stock redemption. Responsibility for the generation of funds used in either a redemption or enabling bonus ultimately rests with the buyers. It is their burden to create the funds and eventually it is their money to spend. If they wish to spend it wisely, they will probably see that the tax costs of a redemption are equal to or greater than the tax costs associated with an enabling bonus. However, the enabling bonus offers a far greater advantage if also used as an incentive. Buyers could, for example, be expected to produce a predetermined amount of new business to validate the bonus. While the bonus might appear liberal or generous by industry standard, it nevertheless serves a critical purpose.

Likewise, there are disadvantages. In a personal buy out, the enabling bonus paid by the corporation is tax deductible. However, the bonus received by the buyer of stock and proceeds received thereafter by the seller of stock are taxable. The tax benefits derived by a corporate tax deduction are thus wiped out in large part by the taxes imposed on both the buyers and sellers of stock. So that the buyer of stock is not overwhelmed with a tax burden he can not handle, the enabling bonus must be adjusted upward, thus making the transaction more expensive. The enabling bonus may consist of the following components:

- Principal payment made to seller
- Interest payment made to seller
- Tax step-up on principal payment
- Tax step-up on interest payment

For every dollar spent to fund a personal buy out about \$0.51 is lost to federal and state taxes. This assumes personal tax rates of 6% for the state and 35% for federal. The long-term capital gains rate (federal) is 15%. The diagram that follows illustrates the taxes paid on \$1.00 bonused to buy stock.

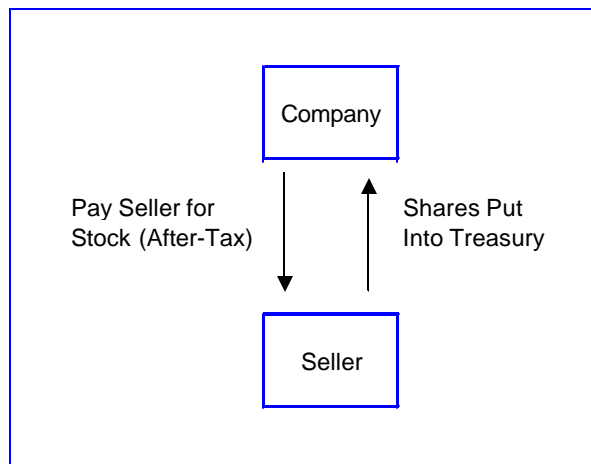
Diagram #2  
Tax Effect of a Personal Buy Out



**STOCK REDEMPTION**

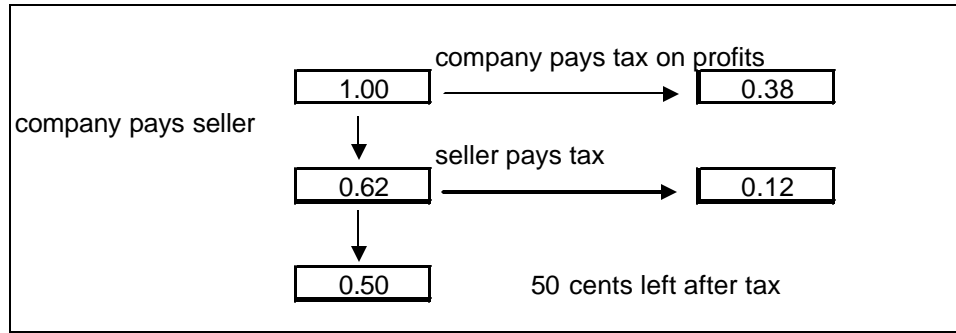
A method commonly used in the perpetuation process involves the corporation buying outstanding shares of common stock and retiring these shares into treasury stock. A clear disadvantage with this method is that the payment for the stock must come from after-tax dollars. However interest associated with a stock redemption is tax deductible. The net effect of a stock redemption is to reduce the number of outstanding shares and thus increase the percentage ownership of the remaining shareholders. In addition, the sheer simplicity of this method is appealing though costly from a tax point of view. The diagram below illustrates this method.

Diagram #3  
Stock Redemption



For every dollar spent to fund a stock redemption about \$0.50 is lost to federal and state taxes. The corporate taxes assume an [STATE] rate of 6% and a federal rate of 34%. The personal tax rate is the same as that assumed for the personal buy-out. The diagram below illustrates the taxes paid on \$1.00 used for a redemption. The tax impact for both the personal buy out and redemption are fairly close.

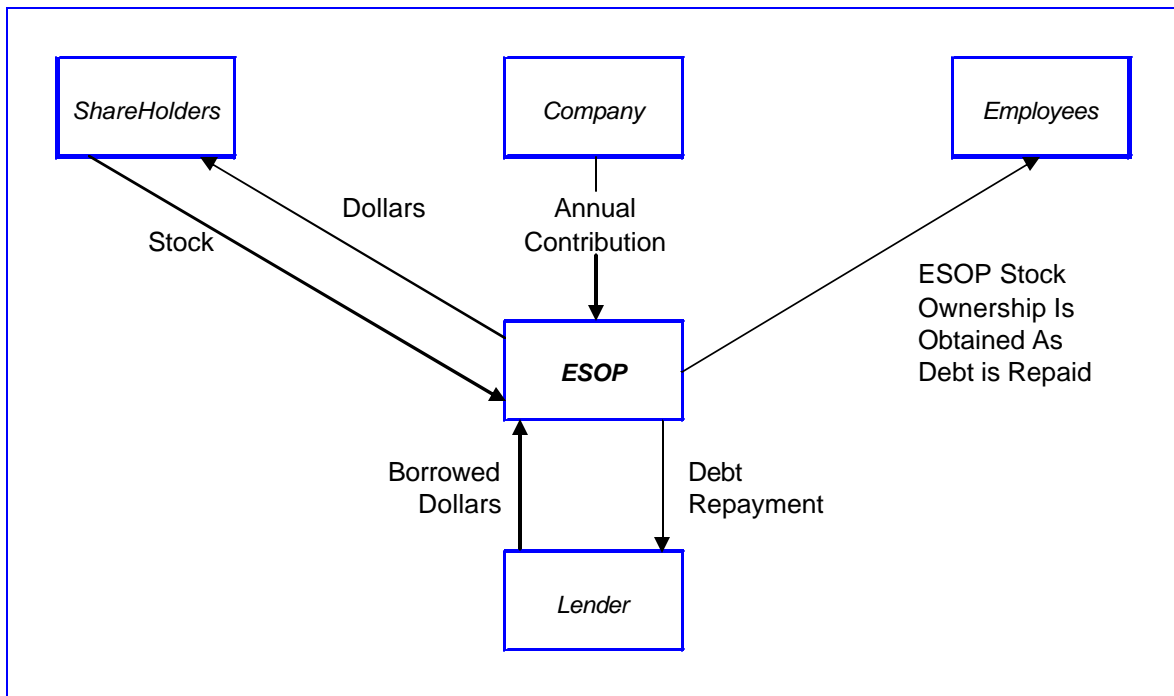
Diagram #4  
Tax Effect of a Stock Redemption



**LEVERAGED ESOP**

The leveraged ESOP (Employee Stock Ownership Plan) is another option for some agencies in the perpetuation planning process. An ESOP provides both the corporation and the individual selling his stock certain tax advantages while allowing management to retain control in most cases. With the advantages an ESOP presents comes a number of technical issues that must be addressed. The diagram below illustrates how a leveraged ESOP works.

Diagram #5  
Leveraged ESOP



We have listed below a number of advantages and disadvantages associated with an ESOP. Some advantages are:

1. If an ESOP owns at least 30% of the stock immediately after purchasing stock from former shareholders, the shareholders can rollover their proceeds tax deferred (and potentially tax-free) into qualified replacement property (for C-Corporations only – selling shareholders of S Corporation ESOPS cannot utilize the rollover tax deferral). This category of property includes the common stock and bonds of most U.S. corporations. Qualified replacement property does not include short-term notes or government securities.
2. Another advantage of the leveraged ESOP (an ESOP in which shareholders are being bought out with borrowed money) is the ability of the corporation to deduct both interest and principal from taxes. Principal can be deducted up to 25% of qualified payroll (In S-Corporations, principal and interest count when addressing the 25% of qualified payroll calculation). Qualified payroll includes employee compensation up to \$220,000 (2006 year). However, a person who owns more than 25% of the outstanding stock (including ESOP shares) cannot participate in the leveraged ESOP if the selling shareholders have elected to take the rollover (C-Corporations only).
3. Even if an ESOP achieves majority ownership, management can continue to exercise control in most situations. When the ESOP is set up, the shareholders outside the ESOP elect a trustee who votes the ESOP shares. In the event of "major corporate issues" such as a sale or liquidation, ESOP shareholders vote their individual shares. This is a potential problem that can be alleviated by careful planning. Since the new shareholders outside the ESOP will also be able to participate within the ESOP, their higher incomes will make for a proportionately larger interest within the ESOP. It is possible, however, for ESOP shares to vote against management. This must be considered carefully before implementing an ESOP.
4. A fourth advantage of an ESOP is the potential to enhance employee motivation. If presented properly, participating in the ESOP will give employees a real sense of ownership and realization that their efforts directly affect the value of their stock.

In addition, an employer that maintains an ESOP may deduct dividends on employer securities in a participant's ESOP account, if the participant is given the right to elect either to receive the dividends in cash or to reinvest the dividend in employer securities in the ESOP.

The disadvantages of an ESOP include the following:

1. Setting up an ESOP can be fairly expensive. The ESOP needs to be administered as do other regulated retirement plans and an ESOP also requires the annual valuation of the fair market value of the shares.
2. The ESOP must be adequately funded so that vested employees that quit or retire can be bought out. This repurchase liability creates additional costs to the company above and beyond the annual loan repayment. As with any perpetuation plan an ESOP entails cash flow drains as various stockholders retire. The repurchase liability associated with an ESOP is a planned and carefully calculated expense. Funding for the repurchase liability can be accomplished in several different ways ranging from a pay-as-you-go approach to developing a retirement reserve within the ESOP trust. The wide range of alternatives should be explored and a methodology determined during the ESOP implementation stage.

3. **[IF AN S-CORP]** An S-Corp may maintain an ESOP as an employee benefit, however, an excise tax is imposed on the S Corporation if share ownership through the ESOP is or becomes highly concentrated among one or more “disqualified persons” (and certain family members) who own shares of the corporation. If the provision is violated, an excise tax equal to 50% of the value of the shares allocated to the disqualified person is imposed on the corporation. A disqualified person who receives the prohibited allocation is also taxed on the value of the shares allocated to his or her ESOP account.