

# Tools <sup>For</sup> The Trade

**Business and clinical solutions for the home care industry**

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New York State Association of  
Health Care Providers, Inc.

Representing home and community-based care

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## **ESOPs: a succession strategy for business owners**

**By Stanley Bulua and Paul Essner**

An Employee Stock Ownership Plan (ESOP) is a powerful tool that can be used by an owner of a closely held business to create a successful and financially rewarding succession strategy. In the home care industry, for example, an ESOP can permit a business owner to (1) sell for cash a portion of their business to the employees in a tax-advantaged manner; (2) retain operational control of the company; and (3) provide employees with a substantial tax-deferred benefit which will strengthen the connection to the future profitability of the business.

ESOPs are particularly useful for owners who have most of their net worth tied up in their agency. An ESOP permits an owner to achieve personal asset diversification by providing a ready buyer for the company stock.

ESOPs can also be used to address another thorny issue. Business owners are frequently faced with the prospect of either having to sell the businesses or face a substantial liquidity need upon death to fund estate taxes. These may not be viable choices if there is no available buyer or the owner wishes to perpetuate their business and strengthen the employees' attachment to the agency beyond his lifetime.

**How does an ESOP work?**

An ESOP is a type of qualified employee benefit plan that is designed to invest in company stock. The business owner takes the first step, by having their agency adopt an ESOP. The ESOP trust then purchases a block of company stock from the business owner based upon a fair market value purchase price determined by an independent appraiser. In most cases the company obtains the funds to finance the ESOP purchase through a combination of internal cash and bank loans. Furthermore, the employees do not have any out-of-pocket cost because the ESOP typically borrows money from the company to fund the purchase price and the ESOP loan is paid back through annual contributions

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**Aware:  
promoting  
your agency  
with a byline  
article**

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# Owners should consider an ESOP . . .

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made by the company to the ESOP. In some cases, the employer will curtail its contribution to other retirement plans in order to limit the total retirement benefit provided to employees.

*An ESOP can be an effective means of motivating and rewarding increases in employee productivity through long-term equity incentives.*

The tax benefits provided to the business owner by an ESOP's purchase of stock are the fuel for the transaction.

First, the ESOP transaction permits the business owner, under certain circumstances, to defer recognizing gain upon the sale of C corporation stock. Furthermore, in order to qualify for tax-deferral, the selling shareholder must reinvest the sales proceeds in qualified replacement property, defined as stocks and bonds of U.S. operating corporations. Although the selling shareholder or members of the family cannot participate in the ESOP, the benefits of deferring tax on the sale far outweigh the loss of participation in the plan.

Second, one of the most significant income tax benefits provided by an ESOP transaction is the company's ability to finance the purchase price of the owner's stock through the ESOP on a fully tax-deductible basis. An ESOP is the only vehicle in the tax law that permits the deductibility of principal payments on corporate debt. Although contributions to pay down principal are generally limited to 25% of employee compensation, dividends are only subject to the consideration that they be reasonable. Through the combination of deductions for contributions and dividends, the company is able to generate substantial tax benefits during the years in which the ESOP loan is outstanding.

Third, as a result of tax law changes that were made in the late 1990s, an S corporation may now be owned, in whole or in part, by an ESOP. Generally, to the extent that an S corporation is owned by an ESOP, there is no corporate level tax or pass-through tax to the ESOP shareholder, placing the ESOP company in a highly competitive position and providing it with significant additional funds (after repayment of the debt incurred to finance the transaction) with which to expand or pursue acquisitions.

An ESOP can also be combined with effective estate planning. The owner has several options for their retained ownership interest in the business:

**First case – no children as successors.**

If there are no family members in the business, the owner can remain in the business and, over a period of years, groom a management team to eventually take over, with a view toward a possible subsequent second sale of stock to the ESOP or to the management group. The owner thereby retains control over the transition of the business, gains liquidity, and avoids selling the business to unfriendly outsiders.

**Second case – children are to be successor owners.**

If there are children involved in the business, the business owner may consider gifting some or all of the company stock to one or more of the children immediately following the ESOP transaction. Because in the typical leveraged ESOP transaction the company borrows money which is used by the ESOP to purchase the stock from the selling shareholder, the value of the company and its stock, which is now burdened by the additional debt, is automatically

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depressed for a short period following the transaction. In addition, the value of the company stock will be further reduced after taking into account minority and lack of marketability discounts. As a result, more stock can be transferred by the owner to the children without the payment of gift tax than would be the case had there not been an ESOP transaction.

## Employee Motivation

Finally, but certainly no less important, an ESOP can be an effective means of motivating and rewarding increases in employee productivity through long-term equity incentives.

Employees who have an equity stake tend to be more attuned to their individual and group productivity, sales and profitability than employees with no vested financial stake in their employer other than a regular paycheck. Not surprisingly, recent studies have confirmed the positive impact that ESOPs have on the bottom line.

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## Revised I-9 form now required

A revised version of Federal form I-9 must now be used by all employers. This employment verification form, designed to combat immigration document fraud, must be completed for all new hires. The new employees then have three days to provide documents.

The revised I-9 has "(Rev. 06/05/07)N" printed on the lower right corner of the form and is now the only version valid for use. Key changes to the form relate to the acceptable forms of identification and work eligibility. The form became mandatory at the end of 2007.

A revised version of the "Handbook for Employers, Instructions for Completing the Form I-9" was also produced with images of acceptable documents. The significant revision to the Form I-9 is the removal of several "List A" documents which previously could be used for proof of both identity and employment eligibility. The omitted documents include: Certificate of U.S. Citizenship (Form N-560 or N-570); Certificate of Naturalization (Form N-550 or N-570); the Alien Registration Receipt Card (Form I-151); the Reentry Permit (Form I-327); and the Refugee Travel Document (Form I-571). These documents were said to be easily faked. Also, the most recent version of the Employment Authorization Document (Form I-766) was added to the List A of acceptable documents.

Employers are not required to complete new I-9s for existing employees. Rather the 2007 I-9 Form only needs to be used for new employees and existing employees who require re-verification. The new form has an expiration date June 30, 2008, implying that an updated version may be forthcoming.

Employers have had to complete I-9 forms for all new employees since 1986. The revised form is available in the *Members Only* section of the HCP website ([www.nyshcp.org/members/pdf/08revisedi9.pdf](http://www.nyshcp.org/members/pdf/08revisedi9.pdf)). The revised Handbook for Employers, can be found at [www.uscis.gov/files/nativedocuments/m-274](http://www.uscis.gov/files/nativedocuments/m-274).

