Investing After You Sell Your Business to an ESOP

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From the NCEO book Selling to an ESOP
Chapter 5

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To the owner of a successful business, the company represents much more than a workplace: it is his or her life’s work. Hence, the decision to sell is often fraught with emotion. Sellers may struggle with issues such as ceding control, preserving their legacy, or deciding what to do each morning.

A host of financial issues add to sellers’ uncertainty. Business owners who have relied on the relatively stable earnings of their private companies must now live off the far less predictable returns from the capital markets. Ultimately, how sellers choose to invest may make the difference between success and failure in meeting their goals and securing their financial future.

In this chapter, we explore the key tax and investment planning questions faced by sellers to an employee stock ownership plan (ESOP) and provide a framework for making thoughtful decisions by examining a hypothetical case similar to several we have encountered and answering the hypothetical clients’ questions.

Essential Facts of the Case

John and Jane, a 64-year-old married couple in Los Angeles, are in the process of selling their business so that they can retire. Their company

1. The authors work in Bernstein’s Wealth Strategies Group. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.
has produced stable profits, benefiting from a committed management team and hardworking employees. John initially considered selling to a strategic buyer, but he decided not to because many employees would have lost their jobs. Eventually, his strong desire to reward employees led John to sell the company to them through an ESOP.

Sales to ESOPs sometimes occur in stages, often with the seller financing part of the deal by accepting a note. For the sake of simplicity, however, we assume that John and Jane are selling 100% of the business to the ESOP for $10 million in cash.

Like many business owners, John and Jane have long dedicated most of their financial resources to building the company. Over the years, however, they managed to save around $1 million in liquid assets, including $600,000 in qualified retirement accounts through the company’s 401(k) plan. They would like to spend around $225,000 per year after taxes and inflation in retirement. Only a portion of that budget will be covered by Social Security when they turn 66 and 4 months.

The couple has one adult child who has a successful career outside the business. John and Jane were generous with his education but aren’t overly concerned about maximizing his inheritance. They’ve discussed leaving something to charity in their wills.

While excited about this new phase of their lives, John and Jane are also anxious about the transition. They have a number of critical questions:

• Will we be able to meet our spending needs?
• How do we choose an asset allocation that balances our need for return with our desire for safety?
• What is a 1042 election, and should we make one to defer tax on the sale?
• If we make the 1042 election, how should we invest the proceeds?
• What are our options for donating to charity?

Will It Be Enough?

For many sellers, the single most important question is the first: “Will we be able to meet our spending needs?” Investors have reason to be
concerned: The headwinds to a secure retirement are strong. Increased longevity means a portfolio must last longer: For a 64-year-old couple, there’s a 50% chance that one of them will live past age 91. Taxes continue to take a high toll, with the highest federal tax rate for long-term capital gains and qualified dividends at 23.8%, and the top rate on investment income at 40.8%. State taxes can add as much as 13.3%. Inflation has been dormant for many years but could awaken in the years ahead. And interest rates are now very low, which makes bond investing a challenge.

John and Jane need an investment plan that can withstand these headwinds. To stress-test a plan for long life, high inflation, and poor markets, we use a financial modeling tool that starts from today’s conditions and simulates 10,000 plausible paths for the economy, inflation, and a wide range of financial asset classes. From there we determine the probability of various investment outcomes.

We believe a plan should succeed even if markets are hostile and the investor lives a long life. We model 10,000 different futures and look for plans that would achieve the investor’s goals in at least 90% of them. That conservative standard is prudent, in our view.

### Defining Core Capital

Our first step in formulating a plan is to determine how much “core capital” the investor needs. This is the amount of capital required to fund after-tax spending needs, through hostile markets, for the rest of the investor’s life, even if he or she lives longer than expected.

How much core capital do John and Jane need? John would prefer a conservative approach to investing, so let’s suppose they choose to invest 20% of their portfolio in globally diversified stocks and 80% in bonds. In that case, we estimate John and Jane would need a portfolio of $7.4 million today to sustain their $225,000 after-tax spending through hostile markets and a long life. Again, that is a very conservative estimate. If markets are typical, they would leave behind a sizable legacy, even after decades of spending from the portfolio.

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3. This is the Bernstein Wealth Forecasting System, described in a bit more detail at the end of this chapter.
This should be comforting news to John and Jane. The combination of their existing $1 million in liquid assets and the after-tax proceeds from the sale will fund a portfolio well above their core capital benchmark.

**How Do We Choose an Asset Allocation?**

John and Jane’s core capital requirement is driven largely by their age, spending level, and asset allocation. They need a portfolio that provides enough return to meet their spending needs but will allow them to sleep at night.

For many business owners, choosing an asset allocation is like navigating through uncharted waters. Entrepreneurs build wealth by focusing their expertise and capital in their business ventures. They often prefer to tackle the familiar risks facing their company over the uncontrollable risks of investing in the capital markets. Quantifying the likely impact of their investment choices can help sellers better understand their tolerance for risks beyond their control.

If John and Jane are willing to increase their exposure to stocks to 40% of the portfolio, they could reduce the core capital required from $7.4 million to $6.8 million (table 5-1). The higher expected return potential of stocks would allow them to meet their needs with a smaller nest egg while building a greater legacy. By year 30, when John and Jane turn 94, we estimate their portfolio would be worth $2.4 million more in typical markets with the 40/60 allocation.

John and Jane might be tempted to pursue even greater wealth creation potential by investing in a portfolio with 60% in stocks and 40% in bonds, but as the bottom row in table 5-1 illustrates, adding stocks increases the risk of sizable losses along the way. Here we define risk as the probability that the portfolio will undergo a peak-to-trough loss of at least 20% at some point over the next 30 years. In our experience, such a large, short-term loss is hard for most investors to tolerate.

While the portfolio with 40% in stocks has a fairly low risk of incurring a 20% peak-to-trough loss, raising the stock allocation to 60% ups the odds to over 1 in 2. John and Jane felt this was too much risk for them; it runs counter to their objective of preserving wealth. When
they weighed the trade-off between creating a larger legacy and facing a higher risk of a large loss, they embraced the portfolio with 40% in stocks and 60% in bonds.

The current investment environment is challenging, but we believe investors can navigate the landscape by following a few key tenets:

- Adopt a sound investment plan tailored to their needs and circumstances.
- Remember that bonds remain key diversifiers, even though their returns are likely to be low for the next few years.
- Don’t abandon foreign stocks, despite recent turmoil overseas. U.S. stocks have outperformed their foreign counterparts in eight of the last ten years. Stronger U.S. stock market returns in recent years have left foreign stocks at lower valuations.
- Diversifying beyond traditional stocks and bonds can reduce risk without reducing returns.
- Active risk management and investment selection can help mitigate the impact of challenging market conditions.

### Table 5-1. Trading off risk and return for three asset allocations

<table>
<thead>
<tr>
<th>Asset allocation</th>
<th>20% stocks/80% bonds</th>
<th>40% stocks/60% bonds</th>
<th>60% stocks/40% bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Required core capital</td>
<td>$7.4 million</td>
<td>$6.8 million</td>
<td>$6.2 million</td>
</tr>
<tr>
<td>Median wealth: year 30</td>
<td>$6.6 million</td>
<td>$9.0 million</td>
<td>$11.3 million</td>
</tr>
<tr>
<td>Probability of peak-to-trough loss ≥ 20%</td>
<td>3%</td>
<td>21%</td>
<td>55%</td>
</tr>
</tbody>
</table>

Projections are based on the Bernstein Wealth Forecasting System as of December 31, 2019. See Notes on Bernstein Wealth Forecasting System at the end of this chapter.

Median wealth values assume the seller pays federal and California state long-term capital gains tax on the sale of the company to the ESOP. See the discussion later in this chapter regarding the ability to defer tax under Internal Revenue Code Section 1042.

Data do not represent past performance and are not a promise of actual future results or a range of future results.
What Is the 1042 Tax Deferral?

It is no secret that taxes take a big bite out of the income of higher earners. Still, some business sellers are surprised by how much taxes reduce the sale proceeds. The top federal long-term capital gains tax rate is 20%, and the 3.8% net investment income tax applies to gains on the sale of C corporation stock, even if the shareholder actively participates in the business. There may also be state capital gains taxes. John and Jane live in California, where the state capital gains tax rate can reach 13.3% and taxpayers can pay tax on gains at a top rate of 36.6%.

Fortunately, selling to an ESOP may allow John and Jane to defer these taxes or even avoid them entirely. Internal Revenue Code Section 1042 provides that owners who meet certain requirements and sell their company shares to an ESOP can defer the capital gains tax on the shares sold to the ESOP.

The rules surrounding Section 1042 are complex, and the seller should obtain the advice of experienced legal and tax counsel, but generally, to be eligible for 1042 treatment:

- the company must be a closely held C corporation;
- the seller must have held the company stock for at least three years before the date of sale;
- the shares must not have been acquired in a distribution from a qualified retirement plan, stock option plan, or any other Section 83 compensatory stock plan; and
- immediately after the sale, the ESOP must own at least 30% of the outstanding stock and must adhere to rules limiting the allocation of that stock to the seller, family members, and more-than-25% shareholders.

John and Jane are clearly eligible for a 1042 tax deferral. Now, they must meet some additional requirements to defer the tax on the sale:

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4. While S corporation shares may be sold to an ESOP, they do not qualify for the 1042 tax deferral. In certain cases, it may be advantageous for shareholders to terminate the company’s S election status in order to sell C corporation shares to the ESOP.
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• The seller must reinvest the proceeds into “qualified replacement property,” or QRP, defined in plain English as stocks and bonds issued by U.S. operating companies. QRP does not include government bonds such as U.S. Treasuries and municipal bonds, foreign stocks, REITs, and mutual funds.

• The seller must reinvest the proceeds of the sale into QRP within a period beginning 3 months before the date of sale and ending 12 months after.

• The seller must file the appropriate documentation with his or her tax return.

Voila! If they take all these steps, the cost basis from the closely held C corporation shares sold to the ESOP will “roll over” into the newly purchased QRP, and the potential tax from the sale will be deferred at least until the QRP securities are sold. At that point, the embedded gain would be realized. Sellers may be able to avoid the tax entirely by holding the QRP until death, when the replacement property would receive a step-up in cost basis.

The Buy-and-Hold Dilemma

Aversion to paying tax is powerful, so the idea of buying and holding a diversified portfolio of stocks and bonds designated as QRP may be very appealing. After tailoring the asset allocation to meet their risk profile, sellers who invest in QRP typically want to sell as little as possible, in order to defer tax indefinitely.

But applying this strategy to the entire proceeds of a sale is risky: It means maintaining a static portfolio as the market evolves. In 1958 the average company inside the S&P 500 Index could expect to stay there for

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5. Technically, QRP are securities issued by domestic operating companies that do not have passive income exceeding 25% of gross receipts for the preceding taxable year, that have more than 50% of their assets in an active trade or business, and whose securities are not issued by the ESOP sponsor corporation or a corporation under its control.

6. Filings include an irrevocable statement of election, a statement of corporate consent, and notarized statements of purchase of QRP.
61 years. By 2016, the average tenure was down to 24 years.\textsuperscript{7} Purchasing a portfolio based on a market index today inherently favors stocks that have performed well in the past—but they may not perform well in the future, as table 5-2 shows. A long-term investor must be able to adapt to the accelerating pace of change in today’s world.

| Table 5-2. Passive investing in cap-weighted indexes is risky |
|---------------------------------|---|---|---|
| Date                   | 1980 | 1999 | 2006 |
| Component              | Energy | Technology | Financials |
| Share of S&P 500       | 27.0% | 29.2% | 22.3% |
| Subsequent two-year sector performance | –51.1% | –56.2% | –63.6% |

Source: FactSet, Standard & Poor’s, and Bernstein
Past performance does not guarantee future results.

Buy-and-hold bond strategies are also risky. Even if Fed tightening is slow, interest rates will eventually rise in the U.S. That would cause prices of long-duration bonds to decline significantly. While buy-and-hold investors may not be troubled by these “paper” losses, they are likely to be less than thrilled with their fixed coupon payments in a few years if they have locked in today’s historically low interest rates.

**An Active Approach to Investing in QRP**

There is a technique, however, that allows John and Jane to diversify their portfolio broadly, manage it in response to changing market conditions, and/or spend some of their principal without onerous tax consequences. To accomplish all of this, they would buy corporate floating-rate notes (FRNs) that qualify as replacement property (QRP) and hold them for many years. The couple can borrow against these bonds to fund a liquid portfolio at full basis that can be actively managed without the restrictions of Section 1042. Financial institutions lend against these specialized securities at a loan-to-value ratio as high as 90%, but since the credit crisis, loan-to-value ratios have typically been lower, often in the 75% to 80% range.

The FRNs are highly specialized to serve as both QRP and as collateral for a loan. Typically, FRNs are very long-term bonds with maturities of 30 to 50 years and not callable for many years because the deferred tax becomes due when the bond matures or is called. The interest paid by the bonds floats along with a benchmark interest rate, usually with quarterly resets. The current benchmark, the London Interbank Offered Rate (LIBOR), is being phased out in 2021 and replaced by the Secured Overnight Financing Rate (SOFR). The floating-rate coupon keeps the price of the bonds relatively stable and results in increasing cash flows in a rising interest-rate environment (and decreasing cash flows in a falling interest-rate environment).

Most FRNs are issued by highly rated companies and carry put options allowing the holder to sell the bond back to the issuer at close to par value on each anniversary date, if the bond’s credit quality worsens materially. Issuers include established companies, such as Procter & Gamble, 3M, UPS, Colgate-Palmolive, and certain banks.

The FRN market is small and relatively illiquid, so it takes time to build a portfolio with even a handful of names. Thus, it is imperative for sellers to begin building a QRP portfolio as quickly as possible after closing the sale to meet the 12-month investment deadline.

The cost of this arrangement is that the FRNs generally pay an interest rate below LIBOR (or its successor rate), while the monetization loans typically charge an interest rate above this benchmark rate. In other words, investors pay a spread or annual “cost of carry” to finance the deferral of capital gains tax. Furthermore, at least 10% of the sale proceeds will return only the FRN interest rate, since the banks will lend no more than 90% against the FRNs’ value. Finally, transaction costs on FRNs can be significant. Sellers must carefully consider the impact of these costs, especially for sales under $5 million.

The benefit is that they could defer 36.6% in federal and California capital gains tax, potentially forever.

When Sellers Finance the ESOP

For simplicity’s sake, we assumed above that John and Jane sold the company to the ESOP for cash, but most ESOP transactions involve seller financing for at least some portion of the deal. This means that
the seller agrees to accept payment over time, with interest. While this offers a number of advantages to sellers and makes larger deals possible, it creates credit risk: If the economy weakens or the business weakens for some other reason, the ESOP may not be able to make payments on the seller note. This was the case for several ESOP deals during the recession after the credit crisis of 2008.

Seller financing can also raise practical hurdles to making a 1042 election. Let’s say John and Jane provided seller financing for 60% of the transaction and received 40% of the $10 million sale price in cash up front. In this case, the deal wouldn't provide enough cash to purchase $10 million of QRP within the 15-month window to make full use of the 1042 deferral.

But John and Jane could borrow money to buy the FRNs, as in the example above, and repay the bank loan as they receive payments from the ESOP on the seller’s note. In this way, FRNs also can help sellers to clear the practical hurdle to making a 1042 election that seller financing erected.

**Should We Take the 1042 Deferral?**

To help John and Jane evaluate the trade-off between paying the tax and electing to take the 1042 deferral, we project their wealth under both scenarios. In each case, the 64-year-old couple has $1 million in liquid assets, including $600,000 in a 401(k); they sell 100% of the business to an ESOP for $10 million; they have $0 cost basis in the stock; and they want to spend $225,000 per year after taxes.

In Scenario A, they pay the capital gains tax on the sale and reinvest the proceeds in a portfolio with 40% in stocks and 60% in bonds. In Scenario B, they use the proceeds of the sale to purchase $10 million of FRNs with an average coupon of LIBOR minus 0.3%, and they use the FRNs as collateral to borrow $9 million at an interest rate of LIBOR

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8. FRNs purchased in the secondary market are immediately eligible to collateralize a loan. FRNs purchased as new issues are subject to additional regulations. The institution selling the new issue FRN cannot lend against the FRN for 31 days. Thus, new issue FRNs must be purchased with cash or funds borrowed from another source.
Table 5-3. An active 1042 strategy can significantly boost wealth

<table>
<thead>
<tr>
<th></th>
<th>Scenario A: pay tax</th>
<th>Scenario B: active 1042 strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-year wealth in typical markets</td>
<td>$9.0 million</td>
<td>$13.1 million</td>
</tr>
<tr>
<td>30-year wealth in hostile markets</td>
<td>$2.9 million</td>
<td>$5.1 million</td>
</tr>
</tbody>
</table>

Projections are based on the Bernstein Wealth Forecasting System as of December 31, 2019. See Bernstein Notes on Wealth Forecasting System at the end of this chapter.

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plus 0.9%, for a 1.2% cost of carry. They reinvest the $9 million from the loan in a portfolio with 40% in stocks and 60% in bonds.

Table 5-3 shows that in either scenario, John and Jane are likely to increase their liquid wealth, even after spending from the portfolio for the next 30 years. If they decide to pay the capital gains tax on the company sale, we project that they will accumulate $9.0 million in typical markets. If markets are hostile, we project that there is a 90% chance that John and Jane will have at least $2.9 million remaining at age 94.

But the active 1042 reinvestment strategy offers a clear advantage. We project that in 30 years, John and Jane will accumulate $13.1 million in typical markets and $5.1 million in hostile markets.\(^9\) Both outcomes are more than 40% higher than the related projection for paying tax now.

To put this in perspective, we calculated the pretax sale price John and Jane would need to negotiate today in a taxable sale in order to accumulate $13.1 million in 30 years (the same wealth achieved by selling to the ESOP). We estimate that they would need to sell the company for $11.9 million before taxes, or 19% more than the $10 million the ESOP would pay, to achieve the same wealth in 30 years.

In our analysis, the benefit of deferring the tax on the sale of the company shares to the ESOP clearly outweighs the annual cost of carry and the cost of investing 10% of the proceeds in a low-coupon FRN. The active 1042 reinvestment strategy essentially finances the tax deferral,

\(^9\) This assumes the FRNs are held for the entire 30 years and receive a step-up in cost basis when John and Jane die. If they sell the FRNs, the embedded capital gains tax comes due.
while providing liquidity and freedom to manage the capital. At this transaction size, we think it is wise to make use of the 1042 election and deferral, when possible.

What Are Our Options for Donating to Charity?

Like many business owners, John and Jane wanted to share their good fortune with charitable causes dear to them. While working on the sale, they began to wonder what charitable-giving strategies to consider and whether to implement them before closing the deal.

It’s wise to raise these questions early. If John and Jane were selling their company to a third party, there would be a material advantage to making the charitable donation before closing the sale. When donating cash to charity, the donor receives a charitable income tax deduction for the value of the cash donation. For a donor in the 40% income tax bracket, donating $10,000 would save $4,000 in income tax, reducing the effective cost of the donation to $6,000. But if the donors give company shares with a cost basis of 0, they also avoid the embedded capital gains tax on the sale, reducing the effective cost of the gift even more.

For a 1042 sale to an ESOP, however, there’s typically no advantage to making a charitable donation before closing the sale: QRP with a low-cost basis can be given to charity at any time. In some cases, it may be advantageous to donate company shares before the sale to the ESOP, especially if the shares are ineligible for 1042 treatment. Sellers should not contribute the shares to charity on the understanding that the ESOP will buy the stock at a prearranged price, because the ESOP trustees can’t be compelled to do so. It’s important to discuss these issues with qualified tax and legal counsel.

For John and Jane, the issue wasn’t the timing of the gift, but the best vehicle to use. They considered two vehicles that are attractive today and would potentially fit their situation: a donor-advised fund and a charitable remainder trust.

A donor-advised fund is an account that the donor creates with a sponsoring charitable organization. The donor funds the account with cash or securities that can be sold and reinvested in a tax-free
environment. Over time, the donor uses these funds to make grants to charities. The donor-advised fund can be an excellent way to pre-fund charitable gifts the donor intends to make over the next many years, while receiving an income tax deduction today.

In a charitable remainder trust (CRT), by contrast, the donor contributes low-basis assets to a trust that can sell and reinvest without immediate tax consequences, and the trust makes a taxable distribution to the donor each year. The donor receives an upfront charitable income tax deduction based on the actuarial value of the assets that will pass to the charity at the termination of the trust, which usually occurs at the death of the donor and spouse.

John and Jane chose to use the CRT because it gave them greater confidence that they could meet their retirement spending needs and because it offers very attractive tax benefits.

Today’s high, progressive tax rates make CRTs more attractive. While selling a valuable low-basis asset would almost certainly push business sellers into the top bracket, a CRT can spread this gain over many years of distributions. As California taxpayers, John and Jane can save nearly $80,000 in tax by running $1 million of realized capital gains “through the brackets,” instead of paying top marginal rates.

To estimate how much the CRT would help John and Jane, we assumed that they sell the $10 million business to the ESOP and make a 1042 election, choose the active 1042 reinvestment strategy for only 75% of the sale proceeds, and contribute the other 25%, or $2.5 million of low-basis assets, to a CRT. We also assumed that the couple is willing to take more risk inside the CRT than in their personal portfolio to maximize cash flow: they decide to invest 70% of the trust assets in stocks and 30% in bonds. We then evaluated CRTs with three different unitrust payout rates: the 5% minimum, 8%, and the 10.6% maximum allowable for people their ages.

As table 5-4 illustrates, the CRT would increase their median projected personal wealth in year 30, regardless of the payout rate. With

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10. Joint filers do not reach the top federal capital gains tax bracket until taxable income exceeds $496,600, and the 3.8% net investment income tax does not apply until modified adjusted gross income reaches $250,000.

Selling to an ESOP

the 5% CRT, the personal wealth advantage is quite small, but for the 8% CRT it grows to nearly $1 million.

When we add in the trust assets that will pass to charity, the total wealth created with the CRT strategy increases meaningfully. The 5% CRT maximizes the charitable remainder and total wealth created (since less money goes to the couple). Over 30 years, the 5% CRT produces 27% more wealth than the ESOP 1042 strategy alone, and 85% more wealth than paying the tax on the upfront sale.

A CRT is not right for everyone. The decision to fund the CRT is irrevocable, and it takes time to accumulate greater personal wealth. It often requires two to three decades before the donor’s personal wealth “crosses over” the value that he or she could expect without the CRT, as table 5-4 also shows. Still, for the business owner with some charitable intent, a CRT can be a very attractive option.

Table 5-4. CRTs benefit the donor and the charity (M = million)

<table>
<thead>
<tr>
<th></th>
<th>Pay tax</th>
<th>Active 1042</th>
<th>75% active 1042; 25% CRT with 5% payout</th>
<th>75% active 1042; 25% CRT with 8% payout</th>
<th>75% active 1042; 25% CRT with 10.6% payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charity</td>
<td>$0</td>
<td>$0</td>
<td>$3.37M</td>
<td>$1.35M</td>
<td>$0.6M</td>
</tr>
<tr>
<td>Total wealth</td>
<td>$9.0M</td>
<td>$13.1M</td>
<td>$16.63M</td>
<td>$15.42M</td>
<td>$14.74M</td>
</tr>
<tr>
<td>Years to median crossover; active 1042 strategy</td>
<td>29 years</td>
<td>24 years</td>
<td>22 years</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Projections are based on the Bernstein Wealth Forecasting System as of December 31, 2019. See Notes on Bernstein Wealth Forecasting System at the end of this chapter.

Median wealth values assume the seller pays federal and California state long-term capital gains tax on the sale of the company to the ESOP.

All calculations of permissible payouts and associated tax deductions for the CRT are according to Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder.

Data do not represent past performance and are not a promise of actual future results or a range of future results.
Tying the Plan Together

After evaluating all of their options, John and Jane decided that the tax deferral benefit of the 1042 election was worth the effort. Despite the annual financing cost, the active 1042 investment strategy is expected to increase their wealth by $4.1 million. They also chose to use some of their QRP assets to fund a CRT, which would pre-fund a charitable legacy and provide cash flows they could use to meet their annual spending needs. Surprisingly, the gift to charity won’t come at the expense of the legacy to their son. In time, they will likely accumulate greater personal wealth by funding the CRT.

Selling a business, to an ESOP or otherwise, can be complicated and laden with emotional concerns. For some owners, investing the liquid proceeds is a source of anxiety. Too often, the question of how to invest the proceeds is delayed until after closing. Though a portfolio can’t be built until the proceeds have been received, the investment planning process should start much earlier. Critical tax and investment decisions will affect the ability of a transaction to meet the financial objectives of the seller. As John and Jane found, careful planning and quantitative analysis can help maximize the benefit of selling to an ESOP.

Notes on Bernstein Wealth Forecasting System

Bernstein’s Wealth Forecasting System uses Bernstein’s research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indices, not Bernstein portfolios), as well as their unpredictability. Asset class projections in this paper reflect the initial market conditions as of December 31, 2019. Globally diversified equity portfolios comprise an annually rebalanced mix of 21% U.S. diversified stocks, 21% U.S. value stocks, 21% U.S. growth stocks, 22% developed international stocks, 7.5% emerging-market stocks, and 7.5% U.S. small-cap and mid-cap stocks. Bonds are modeled as intermediate-duration in-state municipals and intermediate-duration taxable bonds.
About the Authors

Christopher J. Clarkson is a senior vice president and director in Bernstein’s Wealth Strategies Group. Based in Los Angeles, he has expertise in a variety of complex investment planning issues, including selling a business, diversification of concentrated stock and option portfolios, retirement planning, multigenerational wealth transfer, and philanthropy. Clarkson is a frequent lecturer to groups of tax and legal professionals at continuing education institutes, estate planning councils, charitable organizations, and major accounting and law firms throughout the western United States. He joined Bernstein in 1995 and has been a member of the Wealth Strategies Group since 1998. Clarkson earned a BA with high honors in business/economics from the University of California, Santa Barbara, and is a Chartered Financial Analyst charterholder.

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About the Book

This chapter is reprinted from Selling to an ESOP, 11th ed., published by the National Center for Employee Ownership (NCEO), a nonprofit membership organization supporting ESOPs since 1981.

This book is designed to educate owners, managers, and advisors of closely held businesses on selling to an ESOP. It describes how ESOPs work and what the basic rules are; valuation in an ESOP transaction and afterward; financing and feasibility; the tax-deferred Section 1042 rollover; and ESOP alternatives. For more information on the book, see www.nceo.org/r/selling; also see the NCEO’s website at www.nceo.org for a wealth of practical information and research about ESOPs generally.

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