BUSINESSDIMENSIONS

FINANCIAL STRATEGIES FOR THE ENTREPRENEUR FALL 2026

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Selling your business to those who helped you build it

How an employee stock ownership plan offers a tax-advantaged path to succession

When owners of closely held businesses think about succession, two paths usually come to mind: hand the company down to family or sell it to an outside buyer. But there's a third option worth considering. An employee stock ownership plan, or ESOP, lets you sell your stake to a trust that holds the company stock on behalf of your employees. The mechanics take some unpacking, but the approach holds many advantages.

HOW THE TRANSACTION WORKS

An ESOP begins with establishing an employee stock ownership trust. The company then borrows money – from a bank, or from you – and lends those funds to the ESOP trust, which uses them to purchase your shares at their appraised fair market value. Over time, the company makes regular contributions to the trust out of its operating earnings, and the trust uses that money to pay down the initial loan.

It is important to note that the ongoing contributions to the plan are returned to the company immediately to repay the load provided by the company. Because the IRS treats company contributions to the trust as stock-based employee compensation, which is fully deductible, the company repays its original loan with money it has already deducted. As the loan is repaid, shares are released from the trust and credited to individual employee accounts. Over time, each employee accumulates a meaningful stake in the company – one whose value rises and falls with the business itself. When employees retire or leave, the company buys back their shares – often over time rather than in a single payment.

RAYMOND JAMES

Selling your business to those who helped you build it (cont.)

TAX ADVANTAGES FOR ALL INVOLVED

The tax case for an ESOP is what makes it stand out from a conventional sale. If your business is structured as a C corporation, Section 1042 of the tax code allows you to defer capital gains on the sale, provided that you have sold at least 30% of the common stock and reinvest the proceeds in qualified replacement property (QRP) within 12 months. Typically, a QRP involves stocks or bonds of other US operating businesses, and you can build a diversified portfolio rather than concentrating in a single holding. Only the gain portion of the sale needs to go into QRP – the rest of the proceeds comes out free of any reinvestment requirement. Done well, a Section 1042 rollover combines meaningful liquidity for the owner at closing and lifetime capital gains deferral.

After the owner sells the company to the ESOP, the new owner – the ESOP trust – often elects S corporation status because the company's income then passes through to the trust tax-free, since the trust itself is a tax-exempt retirement plan. A 100% ESOP-owned S corporation can therefore operate without paying federal income tax on its earnings. The sequencing matters: Most owners sell as a C corporation to capture the Section 1042 rollover, and the company then elects S-corporation status to layer in the entity-level tax exemption.

FACTORS TO CONSIDER

ESOPs aren't a fit for every company. Setting one up carries certain upfront costs with valuation, legal and trustee fees, though these costs are typically offset by the tax savings achieved in a transaction. And because the trustee has independent fiduciary duties to the employees under the Employee Retirement Income Security Act of 1974, the trustee will negotiate appropriate valuation and terms for the transaction that the trustee believes are in the best interests of the employees.

The company also needs durable cash flow to fund trust contributions year after year, especially while the loan is being paid off. As such, ESOPs tend to work best for profitable, established companies with 30 or more employees and a management team capable of running the business after you step back. A startup or a small partnership generally won't have the structure or scale to make an ESOP viable.

A REWARD FOR YOUR EMPLOYEES

In addition to all the financial advantages of selling your company to a trust that holds it for the benefit of the employees, an ESOP is a powerful way for owners to share their company's success with the employees that contribute to it.

Although an ESOP doesn't confer upon your employees any day-to-day operational control over the company, it gives them financial benefits. Conferring these financial rewards and giving your employees an ownership stake through the ESOP trust is a great way to say thank you. ■

AI guardrails for business owners

A short checklist for using generative AI at work

Used well, generative AI can save time, sharpen drafts and handle the kind of routine work that used to eat up afternoons. A few rules help you get those benefits while staying ahead of the risks:

1. **DON'T SHARE CONFIDENTIAL INFORMATION**

   Anything you provide to an AI model may be retained or used to train future models. Keep client data, trade secrets and privileged communications out.

2. **WATCH FOR SPECIALTY GAPS**

   AI may struggle to generate accurate content about industry-specific topics.

3. **TREAT OUTPUTS AS DRAFTS, NOT FACTS**

   Large language models predict plausible text, not verified truth. Check claims, citations and numbers before relying on them.

4. **COORDINATE WITH YOUR IT TEAM**

   They can develop detailed policies for how AI should be used at work. ■

Protecting your business with insurance

A review of business liability insurance options

If you're starting a business, you already know how you structure it matters. A sole proprietorship, partnership, LLC or corporation will each affect your exposure in different ways, but none of them removes risk entirely. That's where business liability insurance comes in, as it can help fill the gaps left by entity choice alone.

WHAT BUSINESS STRUCTURE COVERS AND WHAT IT DOESN'T

Each choice of business structure offers a different level of personal liability protection. A sole proprietorship offers no separation between you and the business at all. Every debt, judgment or lawsuit lands on your personal assets. A general partnership works similarly, with each partner exposed to the others' actions.

An LLC or corporation generally shields owners from company debts and liabilities, limiting claims to business assets. But that protection is not absolute. Courts may pierce the veil in cases such as commingling, fraud or abuse of the entity. Moreover, lenders often require personal guarantees that can expose personal assets. Separately, owners can still face personal liability for their own negligent or wrongful acts.

THE COVERAGES WORTH KNOWING

Although insurance doesn't eliminate personal exposure for fraud or intentional misconduct, it does protect against certain business risks. Here's the menu of potential business insurance options:

- General liability insurance is the foundation. It pays for bodily injury, property damage and personal injury claims, plus the cost of defending against them.
- Professional liability adds protection if you sell services and could be sued for malpractice or errors.
- Product liability does the same for physical products that cause harm.
- Cyber liability covers losses from data breaches, ransomware and other digital incidents – a near-essential coverage for any business that stores customer data.
- Employment practices liability protects against claims from employees, including discrimination, harassment and wrongful termination.
- Commercial property insurance covers buildings, equipment and inventory against fire, theft and the like.
- A business owner's policy bundles general liability and property coverage at lower combined cost.

In addition, if you have employees, most states require workers' compensation and unemployment insurance, with a handful also mandating short-term disability coverage. Crime coverage is also worth considering for businesses that handle cash or have meaningful theft exposure.

For high-exposure businesses, an umbrella policy sits on top of the primary policies and adds another layer of coverage when the underlying limits aren't enough.

WHEN YOU HAVE MORE TO PROTECT

Higher personal net worth can make you a larger target for plaintiffs, even when the underlying claim is weak. Standard general liability policies often have limits of $1 million per occurrence and $2 million aggregate, which may be insufficient to protect your business and preserve your wealth. A commercial umbrella policy can extend that limit by several million dollars at a relatively modest cost. And if you also serve on company boards, directors and officers insurance protects against personal liability for board-level decisions.

WHAT GOOD COVERAGE BUYS

Insurance offers a measure of relief from the fear that some bad event will destroy everything you've built. Talk with an insurance broker who works with companies in your industry, compare quotes from more than one carrier and revisit the coverage you select each year. When done well, insurance coverage doesn't just protect what you've built. It also frees you to hire more people, sign larger contracts and expand into new markets without putting everything else at risk. ■