Employee Stock Ownership Plans ("ESOPs")

In appropriate situations, ESOPs can be extremely effective tools for transferring ownership interests in corporations on a highly tax-advantaged basis. An ESOP is a qualified retirement plan. It is not uncommon for a qualified retirement plan, particularly a profit sharing plan or a 401(k) plan to hold employer securities as an investment. An ESOP has an advantage not available to other types of qualified retirement plans. It can borrow money from a related person (such as an existing shareholder), or the funds can be borrowed from a financial institution by the employer and loaned to the ESOP. This ability to borrow from a related person (or have a related person guaranty the loan) is characteristic of an ESOP which makes it such a useful tool in purchasing significant amounts of stock from existing shareholders where a partial or complete exit strategy is desired, or from the employer itself where the employer desires to raise cash for use in the business.

Tax Advantages

The principal tax advantages available to ESOPs are as follows:

- With a C corporation, stock can be sold by a shareholder to the ESOP on a tax-advantaged basis, provided the shareholder has held the stock at least three years. If the total amount of stock owned by the ESOP after the sale is at least 30% of the value of the total employer stock outstanding, the individual can elect IRC § 1042 treatment and reinvest the proceeds in qualified replacement property ("QRP"). In that case, the seller may never pay any capital gain on the sale. Instead, if the individual does not elect § 1042 treatment and reinvestment of the proceeds in QRP, the sale would result in long-term capital gain even though it was for less than all of the stock owned by the individual. (Normally, an individual who sells less than all his or her stock to the issuing corporation or must report the gain as ordinary income rather than long-term capital gain. If the corporation is an S corporation, avoidance of recognition of income on the sale through § 1042 is not available. However, a corporation which has S status can elect, immediately prior to the sale, to convert to C status, and the seller can obtain these tax advantages.

- If the stock is sold on a leveraged basis to the ESOP (either because funds are borrowed from a financial institution or because the selling shareholder takes back seller notes rather than cash), payment of the loan can be fully deducted as to both interest and principal. Both interest and principal paid by the ESOP are deductible because the company will make deductible contributions to the ESOP to enable it to pay off the bank loan or seller note, which consist of both interest and principal.

- If the corporation elects S status, income from stock owned by the ESOP will not be subject to state or federal income taxes. This has been a strong inducement to many S corporations to become 100% ESOP-owned companies, so that they pay no state or federal income taxes.

- Dividends paid by C corporations on employer stock held by the ESOP are tax deductible if used (i) to repay "exempt loans" used by the ESOP to acquire the stock, or (ii) are distributed to participants (from their ESOP accounts) within 90 days of payment. Typically, this requires a C corporation to pay down more quickly a loan used to acquire employer stock.

Special Requirements for ESOPS

A number of requirements must be met by an ESOP, most of which are contained in the Internal Revenue Code, and some of which are in Title I of ERISA. Many of the requirements under the Internal Revenue Code are those that apply to defined contribution qualified retirement plans, such as profit sharing and 401(k) plans, generally. These are not discussed in this material. The principal special requirements for ESOPs are as follows:

- The plan must specifically state that it is an ESOP; and, should state that its assets are intended to be invested primarily in qualifying employer securities. The plan and trust must provide that the employer can hold qualifying employer securities in excess of the 10% of plan assets limitation normally applicable. Typically, the plan and trust will require that the trustee may hold up to 100% employer securities unless to do so would be a violation of its fiduciary duties under ERISA.

- The plan must provide that participants who have 10 years or more of participation in the plan and who have attained age 55 will have the right to diversify their plan investments in employer stock. For a period of five years, they must be permitted to diversify up to a total of 25% of their account invested in employer securities either (i) into other investments, or (ii) cash by receiving distributions from the plan of the liquidated amounts of those employer securities. In the sixth year, they must be permitted to diversify up to a total of 50% (taking into account previous diversifications) in the same manner.

- If the employer securities held by the plan are not publicly traded, participants must be permitted to have a pass-through vote with respect to securities allocated to their account with respect to a merger, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of a trade or business. However, normally other votes, such as the annual election of the board of directors of the employer, will be by the trustees of the ESOP, without participant direction.

- The plan must provide that, in the case of death, disability or retirement of a participant, the employer securities account of the participant will be distributed no later than the last day of the plan year following the plan year in which the event occurs. In all other cases, distributions must begin by the end of the sixth year following the year in which the participant terminates employment. Distributions may be made in one year or in installments over as much as five years. In the case of very large employer security account balances ($850,000 in 2005), distribution may be limited in amount to a maximum of $170,000 per year with the result that distributions will exceed the five-year installment period, although they cannot exceed 10 years. The plan may provide (and most do) that distributions from a C corporation are not required to be made with respect to stock acquired by an exempt loan until after that exempt loan has been repaid. The statutory exception only applies explicitly to C corporations.

- The plan must permit participants to receive benefit distributions in the form of employer securities, rather than cash, if they so elect. However, this requirement does not apply to stock of an S corporation or stock of a corporation which has adopted a rule in its articles of incorporation or bylaws that stock ownership will be exclusively or primarily limited to plan participants and active employees, and the stock of certain banks subject to legal limitations on redeeming their stock.

- The plan must provide that if employer stock is distributed to a participant, the participant will have a put-option to the employer company with respect to the stock. This put-option will be for a period of 90 days following distribution of the stock. If the put-option is not exercised the first year, the participant will have a put-option for 90 days in the following plan year. The employer may purchase the stock for cash or give the participant a promissory note which provides for payments in five annual installments (with the first installment being paid at the time of the sale), provided adequate security is given for the note.

- If the corporation is a C corporation, ESOP participants are permitted to directly receive dividends paid on stock allocated to their accounts or to have such dividends distributed to them by the ESOP as in-service distributions and without paying the 10% excise tax normally due for premature distributions. Provided that the dividends are distributed directly to participants, or distributed by the ESOP to participants within 90 days of the end of the plan year in which they are paid by the employer to the ESOP, they are deductible by the employer corporation if the corporation is a C corporation.

Examples of Leveraged Financing

As noted above, there are two principal ways in which an exempt loan is made to an ESOP. Assume that one individual owns the stock of a company which is valued at $10,000,000. The individual wishes to sell 40% of the stock to the ESOP and, after taking into account minority discount and other factors, the value of the 40% interest is determined to be $3,000,000. The company has a payroll of $2,000,000, excluding the compensation of the shareholder. The corporation is a C corporation. The corporation is not in a position to pay $3,000,000 cash in the first year for the purchase of the stock, and, even if it were, most of the payment of an amount that large would not be deductible. (The special deduction limitation(s) under IRC § 404(a)(9) for an ESOP maintained by a C corporation are: (i) all interest payments for the year, and (ii) all principal payments up to an amount equal to 25% of the covered payroll for the year.) The corporation can afford to purchase the stock in equal annual installments over a 10-year period. These payments will equal $325,000 a year, interest and principal.

Seller Notes

If the shareholder will take back seller notes, the sale will be made to the ESOP, and the seller will receive a promissory note payable in level annual installments over ten years. Each year, a contribution will be made by the employer to the ESOP in the amount of $325,000. The ESOP will receive the contribution and use it to make the $325,000 payment on the note. The shares which were purchased from the seller will be held in a suspense account initially. Each year, as payments are made on the seller note, a proportionate amount of stock will be allocated to the accounts of participants. The company may make larger contributions than the $325,000, and these contributions can be used by the trustee to accelerate payment of the note. In that case, a larger amount of stock will be released for the year and allocated to participants' accounts. Further, the employer may declare reasonable dividends on the stock. In that case, the trustee can use the dividends to further pay down the loan. Dividends which are paid with respect to stock which has already been allocated to participants' accounts can be used to pay down the exempt loan, but will need to be replaced by shares of stock held in the suspense account equal in value to the dividends taken from the participant's account to pay down the exempt loan, so that the participant will be made whole.

Institutional Financing

If, instead of taking seller notes, the seller wishes to receive cash for his or her shares, the typical arrangement is that the corporation will borrow $3,000,000 from a financial institution. The $3,000,000 will be loaned to the ESOP in what is often called a "mirror loan". The ESOP will then purchase the $3,000,000 of stock from the selling shareholder. Even though the loan from the corporation to the ESOP can be referred to as a "mirror loan" (sometimes also called an "inside loan"), it is not required to have the same payment terms and frequently does not. If the loan from the bank and the mirror loan contain exactly the same provisions, so that payments are equal under each, the most typical way of making payment would be that the employer would make a contribution to the ESOP, the ESOP would make a payment on its loan to the company, and the company would make a payment of equal amount to the bank to repay its loan to the bank. The company will receive annual deductions equal to $325,000 for its contributions to the ESOP. When it receives the payment from the ESOP of $325,000, a portion of that amount will be interest income to the corporation. However, the corporation will then make a payment to the bank of principal and interest, and will receive a deduction for the interest paid. The net effect is that the employer receives a deduction equivalent to both principal and interest. Where there is a mirror loan or an inside loan, the terms of the inside loan and the bank loan often differ, at least slightly. For example, banks normally require monthly loan repayments, and the inside loan usually provides for an annual payment. Because the payment of the inside loan causes release of stock to participants, the employer often wishes to provide for fairly constant payments of this amount, with a result that the employer may pay the bank loan off more quickly than the inside loan.

Examples of Successful Use of ESOPs

The significant tax advantages of ESOPs open the door to planning opportunities because the tax advantages are such that the economic expectations of the parties can be much more easily met. Here are some examples of situations in which an ESOP can be particularly effective:

<u>Example #1</u>

The stock of a well run family business is owned principally by one shareholder, several of whose children work for the company and eventually expect to take over management of the company. The company has been appraised at $5 million. It has a payroll of $1 million annually, excluding the compensation of the owner and his family. The owner wishes to sell a minority interest in his business. However, his children are not able to pay for the purchase and it would be difficult to find an outside shareholder interested in buying a minority interest.

<u>Solution</u> The owner establishes an ESOP and sells $1,500,000 worth of stock to the ESOP (representing 30% of the value). The corporation is a C corporation, so the owner can elect § 1042 treatment. The loan for payment of the purchase is made at a 7% annual interest rate, payable annually, amortized over 7 years.

The annual payment will be $298,035.78, starting 1 year after the closing. This amount exceeds 25% of the covered payroll of $1,000,000. Although this amount is slightly higher than 25% of the eligible payroll, until the last year of the loan, less than $250,000 of the annual payments will be principal, so there should not be a significant problem with the 25% limitation on deduction. If this becomes a problem in the last year or two of the loan, small dividends can be declared and applied to reduce the loan so that principal payments will remain below 25% of covered payroll and the dividends will be deductible. In order to permit the selling shareholder to elect § 1042 installment treatment, either bank financing is obtained with respect to the sale and the cash proceeds are used to purchase QRP; or, the individual receives a long-term note which is used as collateral to purchase QRP in he form of a long-term floating rate note.

Result The individual has realized $1,500,000 from the sale of a minority interest in his corporation, which he can reinvest in QRP to defer the taxes. Over a period of 7 years, employees will be allocated 30% of the value of the company. When the owner wishes to transfer shares to his children, he will still be able to transfer control but will have less total stock to transfer, minimizing gift and estate tax costs.

Example #2

The owner of a business with a covered payroll of $1.5 million dollars (excluding the owner's compensation), would like to sell the business, but wishes to remain in active management of the business for a number of years and would like to help his employees eventually develop management to replace him, at which time he would retire. Presently, the business is valued at $10 million dollars.

Solution The owner sells 49% of the business to an ESOP for $4,000,000 for a promissory note. (The $4,000,000 takes into account a minority interest discount.) The owner elects IRC § 1042 treatment. The initial interest rate is 8%, although it is based on a floating rate note which adjusts every 6 months to the LIBOR rate. The amortization and payment will be over a period of 10 years. The amount of the annual payment is $730,244.49. After the 3rd year, the principal component of these payments will be in excess of the $375,000 which is 25% of the covered payroll. Because the business is expanding, the owner expects that the payroll will increase to at least $2 million dollars within 3 years. This will permit deduction of the full 25% up until the 7th year of the loan. If the payroll does not continue to expand sufficiently, the owner anticipates paying reasonable dividends from the corporation to be used to pay down the loan. Because the corporation is a C corporation, these dividends will be deductible. (If instead the corporation had qualified for and elected S status, the dividends would not be deductible, but the income flowing to the ESOP would not be taxable.) Because the owner does not want to have dividends payable to him he provides before the sale for a recapitalization of the stock, creating a second class of stock which has preferential dividends included. The preferred stock is sold to the ESOP. The increased value of the stock sold to the ESOP offsets the fact that it is a minority interest. On or about the time of completion of payment of the first loan, the owner plans to sell his remaining stock to the ESOP with the value of the stock at that time to be amortized over a period of approximately 10 years, although the length of the amortization will depend upon the value of the stock at the time and the covered payroll. The owner enters into a long-term employment agreement with the company for a period of 5 years, automatically renewable annually thereafter unless either party gives notice to terminate the agreement. In order to permit the selling shareholder to elect § 1042 installment treatment, bank financing is obtained with respect to the sale and the cash proceeds are used to purchase QRP.

Result The owner is able to gradually liquidate his investment in the company, but to do so without recognizing taxable income. Even though the annual required payback amount is very large in relation to the covered payroll, by use of dividends, additional amounts are used to pay down the loan. By entering into an employment agreement with the company, as well as retaining a majority control until the initial loan is substantially repaid and the additional stock is sold, the owner continues managing the corporation and is in a position to ensure that the business is able to repay his loan. Also, he is able to continue to develop the successor management.

Example #3

An individual owns an S corporation which is appraised at $6 million dollars. However, she is having difficulties finding a purchaser for the business. She has done an excellent job of training employees to take over the management of the company. The covered payroll is only $800,000, excluding the individual's compensation. However, the business produces $1,500,000 per year profit.

Solution The individual enters into an agreement to sell all of her stock to the ESOP for $6 million dollars. Before closing, she elects C status so that the sales proceeds can be invested in QRP. The interest rate is 8% fixed, and the loan is amortized over 15 years, for annual principal and interest payments of $_________. This amount exceeds the $200,000 which is a permissible deduction (i.e., 25% of covered payroll) for principal amount, although a significant portion will be interest in the early years. However, the corporation also plans on paying an annual dividend not to exceed the greater of (i) 10% of the net worth of the company, or (ii) 20% of annual pre-tax income. (The amount of the dividend cannot exceed an amount comparable to that paid by public companies on their stock in order to be deductible, but the selling shareholders and her advisors believe this standard can be met.) This will be dividend initially of approximately $500,000, which will be used to pay principal on the loan. (The $6 million dollar value of the company will decline immediately after the acquisition loan is closed and then gradually increase, assuming the company continues to do well.) After several years, if the company increases in profitability, as the owner expects, the amount of the dividend can be increased and the loan will be repaid even faster. The selling shareholder remains on the Board of Directors, so that she can help oversee the company until the loan is paid off.

In order to permit the selling shareholder to select § 1042 installment treatment, either bank financing is obtained with respect to the sale or the individual enters into an arrangement in which she receives a long-term note, which constitutes qualified reinvestment property.

After five years, the corporation can re-elect S status. Because it then pays no income tax, the 25% limitation is only significant for purposes of avoiding the excise tax for a non-deductible contribution. The corporation makes distributions with respect to its stock sufficient, when added direct contributions by the employer, to fully amortize the loan payments.

Result The owner, who would have had a difficult time finding a suitable purchaser for her business, is able to sell it at fair market value. Even though the payroll is small in relation to the value of the business, through the use of dividends, the purchase can be completely paid for in less than 15 years. Normally, purchasing a business for $6 million dollars by an ESOP with a covered payroll of only $800,000 would be unworkable because of the length of amortization of the exempt loan. Because of the high profitability of the company, by paying continuing "reasonable" dividends so that the combination of annual loan amortization and dividends equals the total annual profitability of the company, the loan is able to be paid off in less than 7 years.

After the loan is paid off, the company may wish to elect S corporation status so that future income will escape taxation. At that point, the employees own the company completely. They may decide to use the additional money generated by continued high profitability to acquire additional companies through the ESOP so that the continued tax-free growth of the company can continue.