

Attorney  
CLE Series



# Employee Stock Ownership Plans

UNDERSTANDING ESOPs & THEIR  
USE IN EXIT PLANNING STRATEGIES

October 10, 2013

presented by  
GYF Business Valuation Services



**GROSSMAN YANAK & FORD** LLP  
Certified Public Accountants and Consultants

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## Melissa A. Bizyak, CPA/ABV/CFF, CVA

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**M**elissa has practiced in public accounting for over 19 years and has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Melissa's business valuation experience is very diverse, including valuations of professional practices, as well as companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as Employee Stock Ownership Plans (ESOPs), marital dissolutions, buy/sell transactions, dissenting shareholder disputes, value enhancement and gift and estate tax purposes.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent more than two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

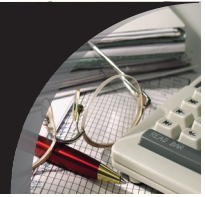
Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA), as well as the Estate Planning Council of Pittsburgh. She is also a member and serves on the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

Melissa has authored articles appearing in professional publications and has written business valuation course-related materials for NACVA and the AICPA. She serves as a national instructor for NACVA.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is a mentor for women business owners in Chatham University's MyBoard program and serves on Robert Morris University's Professional Advisory Council.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.



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## Robert J. Grossman, CPA/ABV, ASA, CVA, CBA

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Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. He is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA) and served as an adjunct professor for Duquesne University's MBA program. Bob has also written many articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board. Currently Bob is the Chair of NACVA's Professional Standards Committee; he previously chaired its Education Board.

Bob received the NACVA "Thomas R. Porter Lifetime Achievement Award" for 2013. One award is presented annually to a single member, from the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period of time.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held many offices and directorships in various not-for-profit organizations. He received PICPA's 2003 Distinguished Public Service Award and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

# *Robert J. Grossman Recognized for Lifetime Achievement in the Field of Business Valuation*

Robert J. Grossman was recently presented with the “Thomas R. Porter Lifetime Achievement Award,” by the National Association of Certified Valuators and Analysts (NACVA). This award is presented annually to a single professional, selected from the organization’s 6,500 members.

Chosen from approximately 25 nominees, Bob is the fifth recipient of the award. This honor is reserved for an individual who has demonstrated exemplary character, leadership and professional achievements within the NACVA organization and the business valuation profession in general, over an extended period of time.



Bob was selected for the award primarily due to his professional contributions to the organization and to the business valuation profession over the last 20 years, as well as for his lifetime of involvement in numerous community causes.

For over 25 years Bob has focused on business valuation issues, and has risen to a level of national prominence. He is a frequent speaker, locally, regionally and nationally, on tax and valuation matters, and has served as a course developer and national instructor for the AICPA and NACVA.

Bob is a Certified Public Accountant (CPA) in the States of Pennsylvania and Ohio and is accredited in Business Valuation by the AICPA. He also carries the well-recognized credentials of Accredited Senior Appraiser (ASA), Certified Valuation Analyst (CVA) and Certified Business Appraiser (CBA).



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## Table of Contents

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<i>Introduction .....</i>	<i>1</i>
<i>I. ESOP Overview .....</i>	<i>5</i>
<i>II. Tax Considerations in ESOPs .....</i>	<i>14</i>
<i>III. Establishing an ESOP .....</i>	<i>27</i>
<i>IV. Understanding the Need for a Feasibility Study .....</i>	<i>30</i>
<i>V. Understanding Repurchase Obligation Liability .....</i>	<i>35</i>
<i>VI. Valuation Considerations .....</i>	<i>41</i>
<i>VII. Examples .....</i>	<i>50</i>
<i>Conclusion and Practical Observations .....</i>	<i>54</i>

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# Understanding ESOPs & Their Use in Exit Planning Strategies

## *Introduction*

In response to a previous CLE presentation introducing Employee Stock Ownership Plans (ESOPs) as an excellent mechanism to accomplish various operational and strategic initiatives for corporations and their owners, many of our program attendees suggested that we provide a more-detailed discussion and analysis of this concept. Today's program is intended to address that request.

ESOPs are, first and foremost, qualified retirement plans. The key benefit of any qualified retirement plan is that ability to provide a future retirement benefit to current and past employees of the Company, without invoking current taxation of the economic value of that benefit to the employee. The deferral leads to a greater economic return as earnings accumulate, effectively, tax-free, while remaining in the plan and allows for greater compounding. In addition, the qualified retirement plan rules generally allow a current income tax deduction for amounts contributed to the plan by the sponsoring organization in the year contributed.

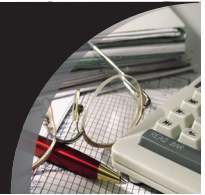
These valuable tax benefits come at the cost of a complex scheme of rules designed to protect the plan participants and limit top-heavy contributions. In this light, potential users of ESOPs must consider the qualified plan rules carefully, determine exactly how the ESOP will integrate into current qualified retirement plans and, ultimately, decide whether the qualified plans currently being offered require modification to allow for the effective use of an ESOP.

The easiest way to understand how an ESOP might work is to think of it as a variation on the traditional profit-sharing plan. Just like contributions to a profit-sharing plan, contributions that a sponsoring employer Company makes to an ESOP are deductible (within limits), and income earned by the ESOP is exempt from tax. Further, ESOP plan participants do not recognize any taxable income on either the employer contributions or the earnings on their accounts so long as those amounts remain in the plan. The primary difference between an ESOP and other qualified plans is the investments within the plan. While traditional plans typically recommend diversification as a means to future retirement benefit protection and risk reduction, ESOPs, by design, are invested primarily in capital stock of the sponsoring employer Company.

As every strategic initiative reduces to a cost/benefit analysis and comparison, it is important to understand the overriding benefits to the stockholders, the sponsoring Company and the employees. Each of these "stakeholders" is important to the ultimate decision to adopt an ESOP as a mechanism for accomplishing some corporate purpose. Thus, a critical element of exploring the use of an ESOP is to address the effect on each stakeholder group.

## *Benefits to Stockholders*

From the perspective of stockholders, the most common and popular use of an ESOP is to allow for a ready market wherein shares in the Company can be sold without time delays and the economic risks associated with those



## Understanding ESOPs & Their Use in Exit Planning Strategies

delays. For controlling shareholder(s), an ESOP can serve as a valid and effective means to exiting the Company. For minority shareholders, a properly-funded ESOP often serves as the only means by which their vested ownership in the capital stock of the Company can be monetized and/or diversified.

Two other important considerations affect stockholders with controlling ownership interests in consideration of adopting an ESOP. First, given the appropriate entity structure and circumstances, the selling shareholders can sell their shares to an ESOP so that the transaction can be accomplished in a tax deferred manner, often with “permanent” tax deferral and savings. Second, a controlling shareholder can sell either a portion or all of his/her shares to an ESOP. By selling some portion of his/her ownership in the capital stock, the controlling shareholder may be able to retain control while still diversifying his/her portfolio and spreading his/her investment risk.

### *Benefits to Company*

From the perspective of the sponsoring Company, the implementation of an ESOP can, and should, be viewed as an avenue of corporate finance. We have observed the corporate finance features of ESOPs being used in many different capacities, including fresh equity capital raises, refinancing and debt restructurings, and asset acquisitions with external third-party lending institutions.

In addition, as the ESOP rules allow for funding annual contributions with stock, the plan can be used as a means of generating additional operating cash flow. Finally, as qualified plan contributions are tax deductible, use of an ESOP as a device to facilitate stock acquisitions with debt allows for the funding of both principal and interest on that acquisition debt with pre-tax dollars.

A very special incentive of ESOPs is the fact that dividends paid on ESOP stock are tax deductible if they are used to fund repayment of debt principal that was borrowed for the purpose of acquiring the stock on which the dividends are being paid. In combination with pre-tax funding of debt principal and interest, tax-free dividends can lead to greater Company cash flows than might be possible under alternative strategies.

It is well-documented that employee ownership serves to increase employee morale, as well employee productivity. Participation in an ESOP has also been found to be a deterrent to employee turnover. One well-known study conducted by the National Center for Employee Ownership (NCEO) during the 1980s found that ESOP companies grew more than 5% faster than non-ESOP companies. These findings, confirmed by later studies, clearly point to the conclusion that employee ownership and participation in management leads to faster-growing business enterprises.

### *Benefits to Employees*

From the perspective of an employee, an ESOP presents a potentially powerful way to accumulate retirement savings while also providing an opportunity to directly contribute to the growth in value of his/her retirement ac-



## Understanding ESOPs & Their Use in Exit Planning Strategies

count. As each year's contribution is made to the plan, either in stock or cash, the participating employee's account is increased for his/her allocation. These accounts are maintained within a trust that is set up as part of the ESOP program. Once vested, these accounts are distributable to plan participants upon retirement or some other trigger event, such as a departure from employment.

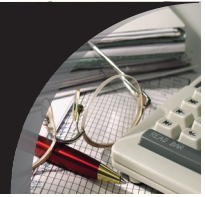
To protect ESOP plan participants, the rules generally require that those employees ages 55 and older, and with 10 or more years of ESOP participation, be provided the opportunity to diversify their investment risk by selling shares back to the sponsoring Company (or plan) and reinvesting those proceeds into other diversifying investments. So long as all amounts are retained within the plan, there is no taxation to the employees.

The road to obtaining the above-noted benefits is one that is fraught with regulation and complexity. However, while the exercise of due care is especially important in the consideration, assessment, implementation and operation of an ESOP, that regulation and complexity should not, in of itself, serve to dismiss this strategy as an option. In fact, given the appropriate facts and circumstances, ESOPs can accomplish many financial, operational and strategic goals not otherwise possible within the parameters of alternative planning initiatives.

### Overview of Materials

The presentation of today's program is segregated into the following key areas which should be considered when giving thought to using an ESOP to answer the needs of your clients.

- *What is a good ESOP candidate and what considerations drive a recommendation of an ESOP?*
- *Why is there a need to obtain a feasibility study?*
- *Initial transaction mechanics and plan structure*
- *ESOP funding alternatives*
- *Operational issues for ESOP-owned companies*
- *Repurchase obligation liability considerations*
- *Valuation requirements and considerations*
- *Illustration of concepts through examples*
- *Conclusion and practical observations*



## Understanding ESOPs & Their Use in Exit Planning Strategies

Obviously, our limited time together will not allow for as in-depth a discussion as we all might like. We have prepared what we think is a comprehensive handout, however, you might have additional questions after today's program. We would be glad to explore further any information glossed over and deemed important to you and/or your client. Please feel free to contact us directly:

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Grossman Yanak & Ford LLP has extensive experience in looking at each one of these areas of consideration and we can certainly assist in those cases where legal representatives are in need of a deeper base of knowledge. We realize that many of those attending today are well-versed in the ESOP area from a technical standpoint. To those individuals, we hope that the program offers reinforcement of core concepts that you are already using. We also ask that you give careful consideration to the need for quality business valuations to protect those that have fiduciary responsibility, as well as those that are plan participants.

To those participants who have little experience with ESOPs, we stand ready to assist in any way we can with helping you to better understand this dynamic planning tool.

Thank you for attending our program. We appreciate that your time is very limited, and we hope you find that your time spent with us today is beneficial and helpful as you return to your practices.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## Chapter I – *ESOP Overview*

### Fundamentals

A Company that wants to set up an ESOP creates a trust to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. A number of different formulas may be used for allocation. The most common is allocation in proportion to compensation, but formulas allocating stock according to years of service, some combination of compensation and years of service, and equal allocation, have all been used. Typically employees might join the plan and begin receiving allocations after completing one year of service with the Company, where any year in which an employee works at least 1,000 hours is counted as a year of service.

The shares of Company stock and other plan assets allocated to employees' accounts must vest before employees are entitled to receive them. Vesting is a process whereby employees become entitled to an increasing percentage of their accounts over time. The least liberal vesting schedule allowed by law is 25% per year, until employees are fully vested after six years of service. Some companies, however, vest employees' entire accounts sooner, as permitted by law.

When an ESOP employee, who has at least 10 years of participation in the ESOP, reaches age 55, he or she must be given the option of diversifying his/her ESOP account up to 25% of the value. This option continues until age 60, at which time the employee has a one-time option to diversify up to 50% of his/her account.

Employees receive the vested portion of their accounts at either termination, disability, death or retirement. These distributions may be made in a lump sum or in installments over a period of years. If employees become disabled or die, they or their beneficiaries receive the vested portion of their ESOP accounts right away.

In a publicly-traded company, employees may sell their distributed shares on the market. The form of distribution of a privately-held firm can vary, depending on the plan document or whether the ESOP sponsor is an S corporation (an S corporation does not have to make distributions in stock). But if a privately-held company makes the distribution in stock, it must give the employees a "put option" on the stock for 60 days after the distribution. If the employee chooses not to sell at that time, the Company must offer another put option for a second 60-day period, starting one year after the distribution date. After this period the Company has no further obligation to repurchase the shares.

An ESOP Company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a retirement distribution, within five years for a pre-retirement distribution, and not to exceed five years in duration in either case. The Company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.





# Understanding ESOPs & Their Use in Exit Planning Strategies

## Tax Incentives

Congress has enacted a host of significant tax incentives designed to encourage employers to create ESOPs. While tax reform legislation has slashed the benefits available from so-called “tax shelter” investments, and has nearly eliminated other important tax planning techniques, the tax benefits associated with ESOPs have grown. As a result, ESOPs are the “big winner” under tax reform over the last several decades.

The most important special tax incentives created by Congress to encourage ESOPs may be summarized as follows:

- An individual can sell stock of a closely-held corporation to an ESOP on a tax-deferred basis if (a) the ESOP owns at least 30% of the stock of the sponsoring Company immediately after the sale, and (b) the sale proceeds are reinvested in securities of other domestic corporations.
- If a corporation uses an ESOP to obtain a loan, it can take tax deductions for both the interest and the principal payments on the loan, instead of being limited to deducting the interest only, as in the case of a conventional corporate loan. (For most companies, this can cut borrowing costs by at least one-third).
- Dividends paid in cash on shares held by an ESOP are tax deductible by the sponsoring corporation (a) if they are passed through to the participants in the plan or (b) if they are used to pay off a loan taken out to finance the purchase of Company stock.
- ESOPs qualify as shareholders in an S corporation. The income “passed-through” to the shareholder (ESOP) is not taxable as ordinary business income or unrelated business income and is, effectively, tax free.

As a result of these tax incentives, ESOPs now are attractive not only as employee benefit plans, but also as a technique of corporate finance and a business and estate-planning tool. ESOPs are being adopted by more and more companies, both large and small. The number of ESOPs has increased from approximately 1,600 in 1975, to over 11,000 currently, according to the National Center for Employee Ownership (NCEO). The number of employees covered by these plans has mushroomed since 1975 from approximately 250,000 to over 10 million. This equates to employees controlling approximately 8% of corporate equity.

## Uses for ESOPs

The many tax incentives enacted by Congress to encourage the establishment of ESOPs make them attractive vehicles for a variety of purposes. While there are a number of traditional time-honored applications for ESOPs as they relate to privately-held companies, many newer, cutting-edge strategies have been developed to make optimal use of the tax incentives noted above. Some of these strategies are detailed on the following pages.





## Understanding ESOPs & Their Use in Exit Planning Strategies

- *Provide liquidity and diversification for shareholders* – Typically, older shareholders wishing to retire may sell all or a portion of their stock to the ESOP. Selling stock to the ESOP is often a preferred option rather than selling to a third party that may not continue operating the Company in the historical manner.

The ESOP may also be used to provide liquidity for other shareholders, typically minority owners. These minority shareholders are often inactive members of a family that acquired the stock through gifts or estates. The ESOP provides a means of converting stock in an illiquid closely-held Company, to another more liquid investment.

- *Provide a means of capital formation* – A plan sponsor may contribute stock to an ESOP and, thereby, take a deduction for the fair market value of the stock contributed to the plan. This tax deduction provides an expense without a corresponding cash outlay.

The tax savings of this “paper” transaction stay in the Company, and become part of the equity of the Company. The tax savings are typically computed as the ESOP contribution multiplied by the marginal tax rate of the Company. When marginal tax rates are approximately 40% (combined Federal and state), the tax savings can be significant.

- *Finance corporate acquisitions* – An ESOP may be creatively used to acquire another company with “pre-tax” dollars. The Company may also use the ESOP to acquire equipment and facilities using pre-tax dollars.
- *An incentive to increase employee productivity and retain personnel* – Studies have demonstrated that employees are more productive when they understand they have a direct, vested interest in the success of the Company. Providing an ESOP, and communicating the benefits of employee ownership, is typically a winning combination that increases the sales and profitability of the employer.
  - As the markets become more competitive, employers often understand that it is increasingly difficult to retain the best employees. Employers install ESOPs with the purpose of providing a vested interest among the employees in the financial outcome of the Company.
  - When associates are respected and treated as “owners,” many companies discover that turnover is decreased significantly. This is particularly important when employees possess a high level of skills.
- *Provide a succession plan* – The ESOP is used as part of an overall succession plan to pass control of a Company to the next generation of managers and employees. If the ESOP uses debt to acquire the stock in the Company, both the interest on the loan and the debt principal are deductible for tax purposes. This tax savings,



## Understanding ESOPs & Their Use in Exit Planning Strategies

deducting debt principal, is often significant. It means that the Company may pass to the next generation of owners using “pre-tax” dollars.

- ***Provide liquidity in divorce situations*** – The traditional use for an ESOP is as an exit vehicle for a shareholder, typically one facing such events as retirement or a significant reduction of involvement in the business. This application may also be invoked when there is a divorce, and one of the major assets in the family is a closely-held business. Divorce situations involving closely-held companies often become highly-complicated and very emotional. Use of an ESOP under such circumstances may be a viable alternative for the parties to consider.

In this situation, an equity interest in the business is sold to an ESOP, and liquidity is raised for settlement purposes. If debt is incurred to purchase the stock, the debt will be repaid with pre-tax dollars, as the contributions to the ESOP within payroll limits are deductible.

If an ESOP is installed, the employees of the Company gain an equity interest in the business. Under such circumstances, it is hoped that the potential ESOP is still created with the spirit of providing employees with a benefit that will ultimately be beneficial for all parties.

- ***Provide negotiating leverage for any proposed transaction*** –Typically, if business owners are considering a transition, they will be in a stronger negotiating position if options exist. An ESOP is not necessarily the best choice for many potential applications for any number of reasons. However, knowledge of a potential ESOP will frequently enhance negotiating positions. The consideration of an ESOP is almost always an option that is controlled by the controlling shareholder(s) of a Company.

If an ESOP is to be considered under such circumstances, it is important to underscore that the standard of value for a potential ESOP transaction is “fair market value” (as defined by the IRS) and “adequate consideration” (as defined by the Department of Labor).

The statutes related to the creation of ESOPs provide for a wide range of flexible options for employers. The above examples are only the most common ESOP applications. If the determined Company goals are compatible with the requirements of an ESOP, it is very likely that an ESOP may be designed and installed to achieve those objectives.

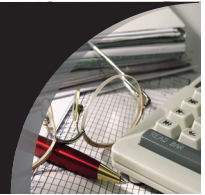
### Alternatives to an ESOP

The overall strength of an ESOP is often related to shareholders understanding what options exist. Typically, an ESOP is an integral part of a shareholder transition strategy. The transition is from the current shareholder(s) to a successor team. Several examples of alternative transition methods are included on the following pages.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- *Sell or transition the business to family members* – This is often the wish of owners in a closely-held business. If family members exist to assume the ownership of the business, this is often the preferred option. However, in many cases, there are complications in that the family member candidates are not direct lineal descendants, such as a son or daughter.
- *Sell to management or key employee* – This option has strong emotional appeal to shareholders. Typically, a limited number of key employees have disproportionately contributed to the success of the business. Such contributions, loyalty and commitment may be rewarded with the opportunity to acquire a portion or all of the business. In many instances, such candidates do not typically have the personal resources to acquire the equity interest in the business. If the key employees require financial assistance, the relatively unfavorable tax climate for passing the equity interest from the shareholders to the success team must be considered.
- *Sell or merge with a third party (financial buyer)* – This is often an exceedingly difficult task. Financial buyers may have investment dollars they are willing to extend for an opportunity, but they typically have very high financial expectations for the investments they make. Most closely-held companies fall short of such financial expectations, therefore, this is a limited option. Unfavorable taxes can also hurt this idea as an option.
- *Sell or merge with a third party (strategic or investment buyer)* – This is more common, but such transactions are still very difficult to complete. The significant problem for most company owners is revealing too much confidential information to competitors and/or employees. Competitors are typically the potential investors with the most requisite knowledge and financial resources to purchase the Company. The most common fear is that the competitor will gain the confidential insights into the target company, and the deal will fail to be completed. Such confidential knowledge could easily be turned against the shareholder. There is also the very real risk of key employees learning that the Company is being shopped. Confidentiality is always a challenge to maintain, but where a competitor is involved, the challenge is much more daunting.
- *Sell stock through an Initial Public Offering (IPO)* – While an IPO is an option, the journey and requirements are so onerous, as to prevent it from being a viable consideration for most closely-held companies. The public markets have very high expectations for IPOs. Considerations such as disclosure requirements, audited financial statements, projections and professional fees are very intrusive and negative. Most investors do not favor an IPO as an exist strategy for current shareholders. They prefer to find companies that need the financial strength of public markets to grow the business and take advantage of market opportunities.
- *Liquidate the business* – This option is not very common due to very unfavorable tax consequences in most instances, but on occasion, the option may be the best alternative. The circumstances under such a scenario



## Understanding ESOPs & Their Use in Exit Planning Strategies

are often extreme, since most companies are worth far more as a going concern. One instance of liquidation being the best choice is when the underlying assets of the business have considerable value that is not really related to the core business. An example would be a marginal business with a long stretch of prime waterfront property owned by the Company. Because the land may be far more valuable than the operating company, liquidation may be the best option.

The transition journey for shareholders in a closely-held company is a harrowing and emotional experience. There are a myriad of options and alternatives to consider. The sheer number of considerations is often enough to discourage business owners to the point where literally nothing is completed.

### Basic Features of ESOPs

#### *Operating Considerations of an ESOP*

The following items are intended to highlight a number of important factors surrounding the installation of an ESOP. The orientation is general and is not an exhaustive listing of all considerations, as such an effort is beyond the scope of this presentation.

- *ESOPs are tax qualified, defined contribution, deferred compensation employee benefit plans* – An ESOP is a benefit plan intended to be “primarily invested” in the securities of the employer. An ESOP must meet the requirements of IRC Section 401(a) and IRC Section 4975(e)(7). The employer is also referred to as the “plan sponsor.” An ESOP is “tax qualified,” which means that certain rules have been adopted by the plan intended to protect the interests of the plan participants. In return for the adoption of protective rules, the ESOP receives certain tax benefits.
- *ESOPs are intended to be primarily invested in the securities of the Company* – Clearly, the intent of an ESOP, according to ERISA, is to be a vehicle to provide an equity interest to employees in the securities of their employer. There is no precise definition of what is meant by the term “primarily invested,” but the general understanding is that an ESOP will have more than 50% of its assets invested in the stock of the employer. Often, an ESOP in a closely-held company is even more-substantially invested in the securities of the Company.

From a practical standpoint, most ESOPs in closely-held companies invest in the common stock of the employer, although an ESOP may own other classes of stock, such as convertible preferred stock that may be converted into common stock. There are circumstances where having convertible preferred stock is beneficial because of the dividends. The ESOP may only hold the class of stock with the highest ownership rights.



## Understanding ESOPs & Their Use in Exit Planning Strategies

Unlike other qualified employee benefit plans, only an ESOP may borrow money to acquire Company stock.

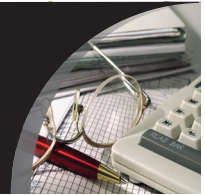
- ERISA added the provision that the ESOP is a stock bonus plan intended to be invested in the securities of the employer. The stock bonus plan is similar to other qualified profit sharing plans, with the additional provision that distributions may be in the stock of the employer. ERISA permits both leveraged and non-leveraged ESOPs, indicating the anticipation that the percentage of employer stock in the ESOP may range from a nominal amount to 100%.
- ESOPs are exempted from the rule that generally prohibits a qualified plan from owning more than 10% of the fair market value of the assets in the plan in employer securities, ERISA 407(b).
- Employer Securities are defined in IRC Section 409(1). In today's program, focus is on the employer securities that are not publicly-traded on an established market. The stock in a closely-held company that is sold to an ESOP must have voting and dividend rights that are equal to or exceed that of the common stock of the plan sponsor having the greatest voting and dividend rights.
- ***A legal entity, the Employee Stock Ownership Trust (ESOT) must be created*** – It is important to note the distinction between the ESOT (Trust) and the ESOP (Plan). The ESOT is the legal entity that will eventually own stock for the beneficial interest of the plan participants. The ESOP is the document that provides instructions to the ESOP Trustee on managing the assets for the benefit of the plan participants. ERISA 403(a) dictates that to establish an ESOP, the employer must first create a trust for the employees, the ESOT. The Trust is funded for a closely-held Company, typically by any of several methods to acquire Company stock.
- ***Common funding methods for an ESOP*** – Once the legal entity is created, assets are initially contributed to the ESOP. The ESOP is designed to be primarily invested in the stock of the plan sponsor, so most assets are eventually intended to be employer stock. The assets may originate from a number of sources, including cash, Company stock and debt proceeds.

Stock in the ESOP will come from one of three traditional sources:

- Newly-issued stock
- Treasury stock
- Outstanding stock (typically owned by an individual)

Most commonly, stock is sold to the ESOP from a shareholder. No new shares of stock are created, and there is no dilution regarding outstanding shares. If newly-issued stock or treasury stock is issued, the number of shares outstanding increases, and there is dilution.





## Understanding ESOPs & Their Use in Exit Planning Strategies

- **Stock ownership** – The ESOT actually owns the shares for the benefit of the plan participants. The Trustee buys, sells and holds shares for the plan participants. The plan participants do NOT actually own the stock as ESOP members.

Upon leaving the ESOP, Federal statutes allow the ESOP participant the option of either taking cash or taking the stock as settlement of the account balance. The ESOP participant may “put” his or her stock back to the Company, and the Company is required to purchase the stock. The Company may either direct the Trustee to purchase the stock back into the ESOP, or the Company may redeem the stock to its treasury.

Generally, closely-held companies do not want any former ESOP participants with Company stock, as the potential rights of minority shareholders may invite unintended and potentially negative consequences. Prior to the ESOP installation, most companies amend such items as articles of incorporation and by-laws to allow stock ownership in the Company to only a select, designated group such as existing employees, existing officers and directors. This effectively eliminates the option granted to ESOP participants to gain Company stock directly. *The practical application is that the Company will be able to “call” the stock in an ESOP account and remit the balance in cash.*

- **Voting rights** – The voting rights of the stock in the ESOP are generally exercised by the plan trustee acting as a fiduciary. Certain major corporate actions, such as the sale of the Company, require a pass-through vote to the plan participants. Plan participants generally may vote shares of stock allocated to their account, and the Trustee generally votes unallocated shares of stock in the plan. IRC Section 409(1) states that the stock owned by the ESOP must have the greatest voting and dividend rights.
- **Multiple qualified benefit plans** – ESOP companies often have multiple benefit plans. The most common situation is that the Company has separate stand-alone plans, such as an ESOP and a 401(k) plan. The plans are separate, but the plans in total are subject to overall payroll limits for both Company and employee contributions. The ESOP is primarily invested in the Company stock (not well diversified) and the 401(k) plan often provides a wide range of diversification options. The combination of the two provides employees with a more-comprehensive retirement program.
  - An ESOP may actually be legally combined with another qualified benefit plan. One common example is an ESOP combined with a 401(k) plan (often referred to as a KSOP). While this is technically possible, most applications are with publicly-held companies or very large, closely-held companies.
  - Potential combinations require the careful review of legal counsel. There may be significant personal liabilities and penalties to the plan fiduciary if a combination subsequently proves to be a financial disaster.



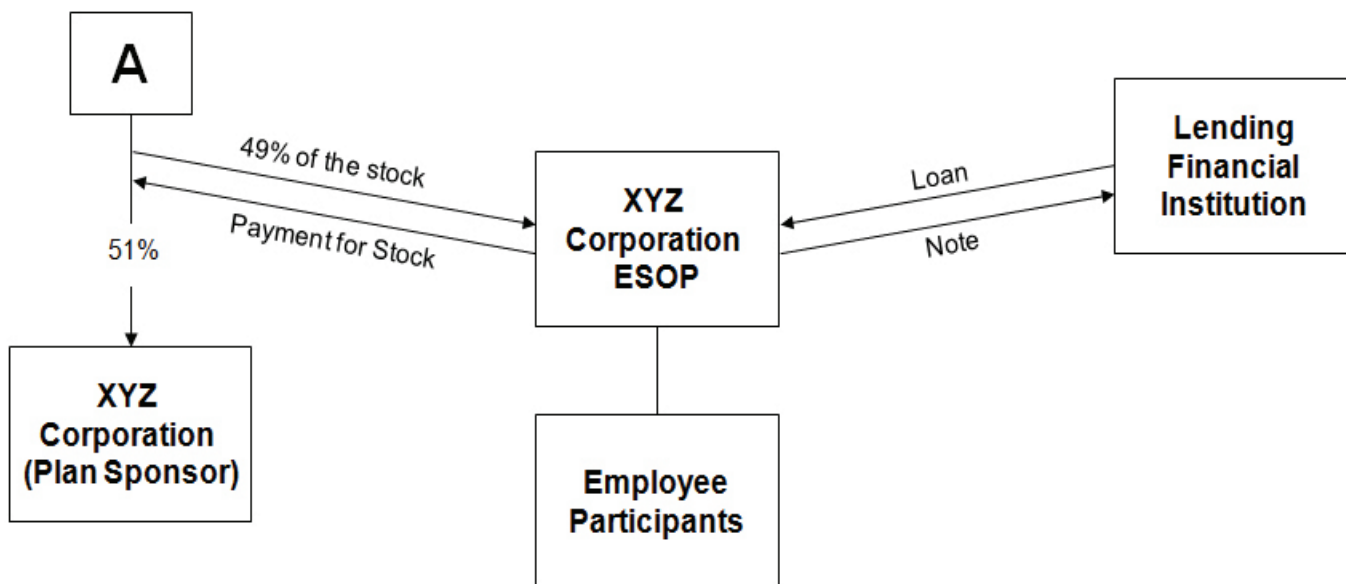


# Understanding ESOPs & Their Use in Exit Planning Strategies

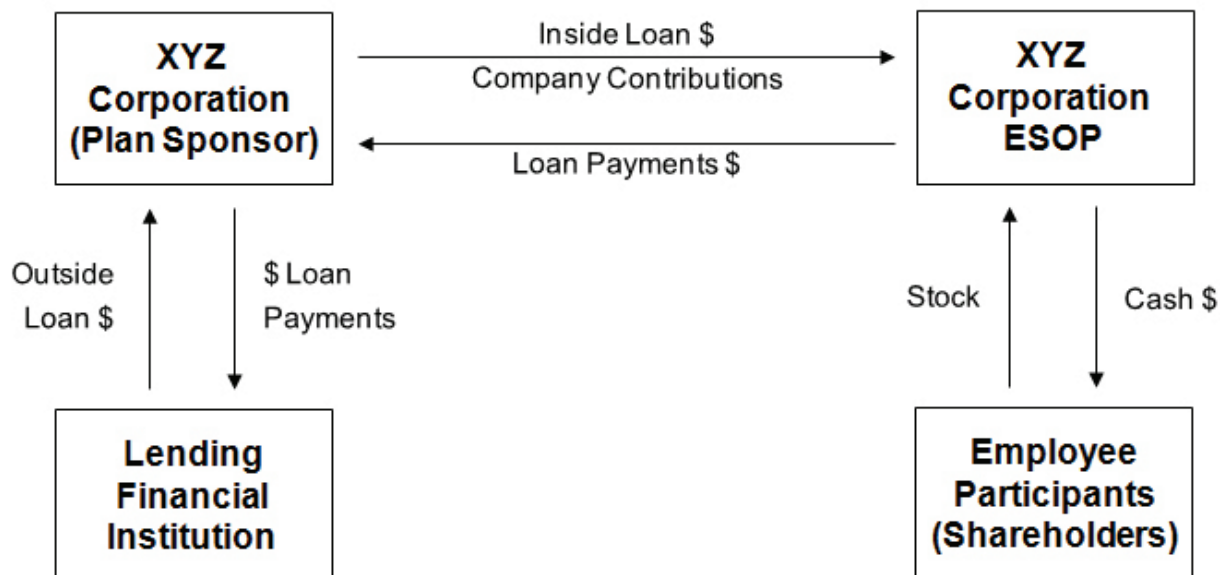
## Alternative Leveraged ESOP Structures

The graphics below illustrate two leveraged ESOP alternatives

### Alternative 1



### Alternative 2





# Understanding ESOPs & Their Use in Exit Planning Strategies

## Chapter II – *Tax Considerations in ESOPs*

### Regular C Corporations vs. S Corporations

This section will consider the tax environment relating to ESOPs in both C corporations and Subchapter S corporations (S corporations). It is emphasized that there are a number of different tax considerations, and they do not equally apply to C and S corporations.

#### *Overview of Major C Corporation and S Corporation Attributes for ESOP Purposes*

ESOP legislation often makes the distinction between a plan sponsor that is either a C corporation or an S corporation. As the following sections illustrate, there are a number of tax-related issues that must be carefully monitored for applicability to a client depending on the corporate tax election. The following list is a limited number of major corporate attributes that may have an impact in the installation of an ESOP.

#### Major C corporation attributes

- Potential multiple classes of stock provides enhanced planning flexibility. Different classes of stock with varying dividend preferences and voting rights may be available to meet the requirements of the Company.
- Unlimited number of shareholders.
- No limitations on the types of shareholders permitted. There is no chance of voiding a tax election as in the case of an S corporation.
- Potential use of dividends for ESOP-related obligations.
- Corporation pays income taxes. This is potentially a significant disadvantage if the Company is subsequently sold, often resulting in double taxation to selling shareholders.

#### Major S corporation attributes

- Limited to a single class of stock (only voting rights may vary). All shareholders, correspondingly, are treated similarly with regard to such things as percentage distributions.
- Total shareholders limited to 100 (ESOP counts as single shareholder, and a husband and wife count as a single shareholder).
- Many restrictions on the types of shareholders. Care must be taken to avoid inadvertent termination of S election by allowing unauthorized shareholder. A trust for an employee qualified benefit plan may be a shareholder (such as an ESOP), but not an Individual Retirement Account (IRA).



## Understanding ESOPs & Their Use in Exit Planning Strategies

- Dividends are not permitted, but Company may make distributions.
- Corporation pays no income taxes, income passed through to shareholders. Having the income tax liability passed through to the shareholders may be very positive in the case of a Company with a high percentage of its stock in an ESOP.

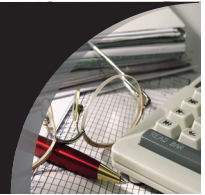
### Tax Incentives Related to ESOPs – C Corporations vs. S Corporations

Contributions to an ESOP are tax deductible within statutory limits. Participants in an ESOP acquire an equity interest in the plan sponsor with tax deductible contributions. This is a significant tax incentive, particularly when the ESOP borrows funds to purchase stock from a selling shareholder. Debt principal payments are typically not deductible for Federal income tax purposes. Debt principal payments for virtually all transactions except ESOPs, must be made with after-tax funds. ESOP-related debt principal becomes tax deductible. Assuming the ESOP borrows funds to purchase stock, the Company makes a contribution to the ESOP in an amount to amortize the debt principal and pay the interest expense within statutory limits. This has the practical effect of making the ESOP-related debt principal and interest tax deductible.

#### *Tax Deductible Contributions to the ESOP in a C Corporation*

Periodic contributions to an ESOP, which can be made in either cash or stock, are tax deductible within established limits set by statutes. Contribution levels are subject to certain specified payroll limitations and contributions allocated to the accounts of highly compensated employees under certain circumstances. Generally, the ESOP contribution limits are found in IRC Section 415. The Economic Growth Tax Relief Reconciliation Act (EGTRRA) may also apply.

- *All qualifying contributions to the ESOP are tax deductible* – If the ESOP uses the contributions for the repayment of ESOP-related debt, then the employer has, in effect, made the debt principal a tax deduction. Debt is repaid with pre-tax dollars, a considerable saving considering the effective tax rate.
- *25% contribution limit* – The maximum deductible contribution is 25% of qualifying annual payroll, subject to a number of limitations. [IRC Section 404] Based on EGTRRA, the 25% limit will not apply to the participant's deferral contributions to a 401(k) plan. The total annual addition limit (which includes such things as forfeitures) is the lesser of 100% of qualifying pay or \$51,000, and this amount will be indexed in increments of \$1,000. [IRC Section 415(c)(1)]
  - This amount may be used for pre-funding the ESOP or repaying ESOP-related debt.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- **Keypoint:** this contribution limit does not include interest expense on ESOP-related obligations if no more than one-third of the plan sponsor's contributions are allocated to the accounts of highly compensated employees, within the meaning of IRC Section 414(q). This is a significant advantage for leveraged ESOPs, as the entire ESOP-related interest expense is deductible without regard to the 25% contribution limit.
- **Allocation limit increased** – There is a difference between the “contribution” amount and the “allocation” amount (which includes participant forfeitures). Under EGTRRA, allocation amounts are significantly expanded for all qualified retirement plans, including ESOPs. The limits for allocation amounts are the lesser of \$51,000, or 100% of the participant's salary. The dollar amount will be indexed to inflation in the future in \$1,000 increments. [IRC Section 415(c)(1)] For an ESOP that is leveraged, the higher allocation limits are a tremendous benefit in long-term planning.
  - Prior to EGTRRA, the rules regarding ESOP contributions to a C corporation were more complex. Briefly, the payroll contribution limit was 15% of qualifying payroll with an unleveraged ESOP. If the ESOP borrowed money (becoming leveraged), the qualifying payroll percentage jumped to 25%. Planning could become complex if a Company wanted the 25% payroll limit during a pre-funding phase because the ESOP could be combined with a money purchase pension plan, thereby increasing the limit to 25%.
- **401(k) contributions by employee do not count against ESOP contribution limit** – Under EGTRRA, 401(k) employee deferral contributions are not counted against the ESOP contribution limits. This is a significant benefit, as it permits leveraged ESOPs to offer employees the benefit of the employee ownership (a non-diversified investment) and another retirement plan with diversified investment options.
- **Excess contributions** – If the employer contributes more than what may be deducted, it is subject to a 10% excise tax on the excess amount. [IRC Section 4972]
- **Excess allocations** – If the employer contributes more than what may be allocated to plan participants' accounts, the plan may be subject to disqualification.

### *Tax Deductible Contributions to the ESOP in an S Corporation*

Periodic contributions to an ESOP, which can be made in either cash or stock, are tax deductible within established limits set by statutes. Contribution levels are subject to certain, specified payroll limitations. Many contribution issues are the same as with C corporations, but there are a number of key distinctions, especially the treatment of interest expense on an ESOP loan.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- *All qualifying contributions to the ESOP are tax deductible* – If the ESOP uses the contributions for the repayment of ESOP-related debt, then the employer has, in effect, made the debt principal a tax deduction. Debt is repaid with pre-tax dollars, a considerable savings, considering the effective tax rate.
- *25% Contribution Limit* – The maximum deductible contribution is 25% of qualifying annual payroll, subject to a number of limitations. [IRC Section 404] Based on EGTRRA, the 25% limit will not apply to the participant's deferral contributions to a 401(k) plan. The total annual addition limit (which includes such things as forfeitures) is the lesser of 100% of qualifying pay or \$51,000, and this amount will be indexed in increments of \$1,000. [IRC Section 415(c)(1)]
  - This amount may be used for pre-funding the ESOP or repaying ESOP-related debt. Key point, this contribution limit does include interest expense on ESOP-related obligations.
  - A key distinction between C and S corporations for ESOP purposes is the treatment of interest costs associated with ESOP-related debt. C corporations can deduct all interest on ESOP debt, and none of the interest is counted toward the 25% contribution limit. [IRC Section 414(q)] An S corporation must include ESOP interest costs toward its 25% contribution percentage. In highly-leveraged S corporation ESOPs, the practical impact of this rule is that it takes longer for the ESOP to complete payment for its stock purchase.
- *Allocation limit increased* – There is a difference between the “contribution” amount and the “allocation” amount (which includes participant forfeitures). Under EGTRRA, allocation amounts are significantly expanded for all qualified retirement plans, including ESOPs. The limits for allocation amounts are the lesser of \$51,000 or 100% of the participant's salary. The dollar amount will be indexed to inflation in the future in \$1,000 increments. [IRC Section 415(c)(1)] For an ESOP that is leveraged, the higher allocation limits are a tremendous benefit in long-term planning.
  - Prior to EGTRRA the rules regarding ESOP contributions to an S corporation were more complex. Briefly, the payroll contribution limit was 15% of qualifying payroll with either an unleveraged or leveraged ESOP. Planning could become complex if a Company wanted the 25% payroll limit. The ESOP could be combined with a money purchase pension plan, thereby increasing the limit to 25%. As noted, interest expense on the ESOP Note was counted against the payroll contribution percentage.
- *Excess contributions* – If the employer contributes more than what may be deducted, it is subject to a 10% excise tax on the excess amount, the same as a C corporation. [IRC Section 4972]
- *Excess allocations* – If the employer contributes more than what may be allocated to plan participants' accounts, the plan may be subject to disqualification, the same as a C corporation.





# Understanding ESOPs & Their Use in Exit Planning Strategies

## *S corporation Anti-abuse ESOP Provisions*

Congress reacted to a number of abuses with S corporation ESOPs that created certain windfall economic advantages that were unintended. In addition to ending these abuses, the resulting legislation imposed a series of complex compliance rules on the ESOP community. A few overriding considerations are briefly discussed herein.

## *Contributions to an ESOP Based on Dividends (C Corporation)*

Dividends from a C corporation are generally not deductible for Federal income tax purposes. There is one exception to this rule – dividends paid on ESOP stock may be deductible. [IRC Section 404(k)] C corporations can deduct dividends paid on ESOP stock in two primary ways:

- *Applying dividends directly to loan principal* – The first and most common method of dividend deduction is to apply the dividends directly to the ESOP loan repayment.
- *Paying dividends to ESOP participants* – The second method of dividend deduction is to pay the dividend directly to the ESOP participants. Plan participants (and their beneficiaries) have the option of taking dividends paid to them and investing in additional qualifying employer securities. This option is used primarily by larger and financially-sophisticated companies.

With this method, participants are making an investment in the Company by applying dividends received to the purchase of stock. This activity makes them investors, and will subject the Company to certain investment disclosure statutes. This is a step that many closely-held companies will likely avoid.

- *Dividends must be reasonable* – Dividend deductions are not subject to C Corporation payroll contribution limits. The dividend payments must be reasonable. [IRC Section 404(k)] Since the dividends are not subject to payroll contribution limits, this effectively allows C corporations a great deal of flexibility in meeting ESOP debt obligations.
  - Strategy: in a C corporation a separate class of stock is established for the ESOP. Typically, this is a convertible preferred stock that pays a stated dividend amount. The dividend is used to repay ESOP debt during the leveraged period. Once the ESOP debt is retired, there is often no need to have the deductible dividend feature. At this point the convertible preferred stock is exchanged for common stock at a predetermined exchange rate.
  - A critical tax planning issue: the dividends are not deductible from income when computing the alternative minimum tax.
  - S corporations may not deduct dividend payments, but they may make distributions to the shareholders.





## Understanding ESOPs & Their Use in Exit Planning Strategies

### *Contributions to an ESOP Based on Distributions (S Corporation)*

The S corporation does not pay dividends in a traditional sense of dividends paid by C corporations. Income from the Company is prorata taxed directly to the shareholders individually, based on the percentage of stock owned. It is common for the S corporation to make cash distributions to shareholders in an amount adequate for the shareholders to pay their personal income taxes. The distribution percentage is typically at the highest end of the personal income tax rate percentage. There is a single class of stock requirement for S corporations, therefore, the percentage distribution must be the same for all shareholders.

- *The S corporation deductible ESOP payroll contribution limits are the same as the C corporation* – Assuming the S corporation has multiple shareholders, comprised of both individuals and the ESOP, the individuals will require some percentage cash distribution to meet Federal personal income tax obligations.
- *The cash distribution from the S corporation will be made to all shareholders* – The ESOP counts as a single shareholder for the purposes of determining the number of qualifying shareholders for S corporations (currently 100 shareholders are permitted, with the ESOP counting as a single shareholder). Any shareholder may receive the distribution, including the ESOP.
- *There is a difference between a payroll-based contribution and a distribution* – The contribution is allocated to the ESOP account balances according to qualifying payroll. The distribution is allocated to all shareholders according to the amount of stock they own.
  - In the case of the ESOP, the collective distribution made to the plan will be allocated to the ESOP participants according to the stock allocated to their account (both vested and unvested). Stock in the ESOP that is unallocated (typically stock held as collateral against the ESOP debt), will also receive its prorata share of the distribution.
- *The cash distribution allocated to individual ESOP account balances will remain in the individual account balance* – The cash allocated to the unallocated shares of stock held as collateral may be used by the trustee to repay additional ESOP debt.
- *The distribution to the ESOP will be made according to the stock in each participant's account, not the participant's qualifying payroll.*
- *Computations regarding payroll limits and individual allocations may become very complex* – An employer is recommended to use an experienced plan administration company.



## Understanding ESOPs & Their Use in Exit Planning Strategies

### *IRC Section 1042 Tax-Free Rollover (C Corporation)*

One ESOP-related tax advantage is extended only to a C corporation subject to certain conditions. A qualifying sale to the C corporation ESOP will earn significant tax benefits for a selling shareholder. Offsetting the benefits in part, are numerous restrictions that apply to the transactions.

- ***IRC Section 1042 tax-free rollover on the sale of stock by a C corporation*** – An investor in the closely-held C corporation selling stock to an ESOP may qualify for a tax-free rollover of the proceeds into Qualified Replacement Property (QRP).

The ESOP may only buy qualified employer securities. Employer securities qualifying for the IRC Section 1042 provisions must meet several criteria, which include:

- Stock must be an employer security as defined in IRC Section 409(1).
  - Stock must be issued by a domestic corporation.
  - The corporation (and each controlled group member) must not have any outstanding readily traded publicly held stock.
  - The stock cannot be acquired by the selling shareholder from any of the following: a qualified retirement plan; a stock option from the Company; or any other right to acquire stock granted by the Company.
  - The stock must have been held by the selling shareholder for at least three (3) years prior to the IRC Section 1042 transaction.
- ***30% Test*** – The sale of the Company stock will qualify for the IRC Section 1042 tax-free rollover election if the ESOP owns at least 30% of the fully diluted outstanding stock, or 30% of the overall value of the Company after the sale. The taxable gain received from the sale by the shareholder subject to the IRC Section 1042 limits is deferred from capital gains taxes, if the shareholder reinvests the proceeds in QRP within a period of three months prior to the sale and 12 months after the sale to the ESOP. Two or more shareholders may combine their stock to meet the 30% threshold to qualify the entire transaction for the IRC Section 1042 rollover.

### EXAMPLE: Selling stock to the ESOP with IRC Section 1042 – One Shareholder

The Company has a single shareholder owning 100% of the stock. To qualify for the IRC Section 1042 tax-free rollover, the shareholder must sell at least 30% of the outstanding stock in a single transaction. The following schedule illustrates the minimum number of shares to be sold to the ESOP.

Shareholder A: 1,000 shares x 30% = 300 shares to the ESOP



## Understanding ESOPs & Their Use in Exit Planning Strategies

- *Qualified Replacement Property* – QRP must be purchased within the specified period of time (3 months before and 12 months after the transaction date). IRC Section 415(c)(4) and various Private Letter Rulings (PLR) have expanded the understanding of what does and what does not qualify as QRP.

### QRP includes such things as:

- Securities of domestic (U.S.) operating corporations, both public and private, where 50% or more of the assets must be used in the active conduct of a trade or business
- Individual Company securities, including stocks, bonds, notes and debentures
- Brother/Sister companies are possible
- The corporation issuing the QRP may not have passive investment income in excess of 25% of gross receipts in the preceding taxable year in which the purchase occurs

### QRP does not include such things as:

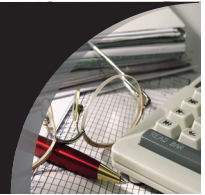
- Mutual funds
- Real estate
- Subsidiary of the plan sponsor
- Government securities and municipal bonds
- Foreign securities
- Partnerships and Limited Liability Companies (LLCs)

It is important to note that the tax-free rollover election extends only to the QRP. If the QRP is sold prior to the property going into the estate of the owner, a taxable event will likely occur.

### Active or passive investment of the QRP

The tax-free rollover is extended only to the QRP. If the QRP is sold, the selling shareholder will then pay taxes on the transaction. The gain will typically be the difference between the basis of the stock in the ESOP plan sponsor (often a very low or nominal basis), and the transaction price of the QRP (often much higher than the basis).

- *Passive investment of the QRP* – Many selling shareholders are of retirement age and wish to exercise the IRC Section 1042 rollover by purchasing QRP with a long-term view of investment. The intent is typically to hold the QRP for many years to defer taxes. If the QRP is held until death, under current statutes, the QRP will become part of the selling shareholder's estate and be subject to estate taxes after a "step-up" in basis. The step-up in basis, effectively, permanently defers all capital gain or income taxes on the QRP.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- *Active investment of the QRP (ESOP Notes)* – One such financial product suited to IRC Section 1042 rollovers where active investment of the proceeds is desired is generally referred to as an “ESOP Note.”
  - ESOP Notes are generally long-term corporate bonds. Common attributes of these long-term bonds typically include: a maturity date ranging from 50-60 years combined with long-term call protection ranging from 20-30 years. ESOP Notes may pay a variable interest rate, so the investor is somewhat protected from interest fluctuation risk.
  - The ESOP Note serves as the QRP. The ESOP Note may be used as security for an account with a brokerage firm that will advance (lend) in cash a percentage of the face amount of the ESOP Note to the selling shareholder. What the shareholder opens in essence is a “margin account” with the broker. The shareholder may, in turn, invest the cash in virtually any investment, since the restrictions of the QRP only apply to the ESOP Note. The cash advance percentage may range from 75% to 90% of the face amount of the ESOP Note, depending on the source of the funds.
  - Traditional brokerage companies may be more restricted on the percentage they may advance on a margin account. Specialty financial institutions may be able to advance a higher percentage of funds against the margin account. Accordingly, such specialty capabilities may have other collateral aspects that permit the higher advance percentage.
  - Caution, the total interest income on the ESOP Note may not pay for the interest expense on the loan from the brokerage firm. The difference may be small, but there may still be an expense that will erode gains on the other investments. The margin account with the broker will almost certainly be subject to margin calls if the equity balance falls below certain prescribed amounts.
  - Before investing in any securities, it is always advisable to talk to experienced professionals. IRC Section 1042 transactions have numerous unique qualities, and it is best to deal only with professionals that are knowledgeable about ESOP-based transactions.

### QRP transaction documentation

All procedural paperwork must be completed in a timely manner for the IRC Section 1042 election to be successfully completed. It is important to emphasize that a voluntary election must be made to defer the taxes of the sale of stock to the ESOP. Three basic procedural documents must be completed: Statement of Election, Statement Consenting to the Imposition of Excise Tax and Statement of Purchase.

- *Subsequent sales of stock to the ESOP* – Any subsequent sales of stock to the ESOP in any amount will also qualify for the IRC Section 1042 tax-free rollover election if the ESOP maintains its 30% ownership. Therefore,



## Understanding ESOPs & Their Use in Exit Planning Strategies

even a small additional sale of stock to the ESOP (i.e., just 5% of the remaining stock) will also qualify for the IRC Section 1042 rollover if the ESOP owns more than 30% of the outstanding shares after the transaction.

- **IRC Section 1042 restrictions** – If a shareholder elects to use the Section 1042 rollover provision, there are a number of limitations to note. [ IRC Section 409(n)]
  - **Rules of attribution.** The shares sold to the ESOP as part of the IRC Section 1042 rollover may not be allocated to ESOP accounts of a number of specified individuals. Prohibited allocations apply to the selling shareholder; family members of the shareholder (spouse, ancestors and siblings); lineal descendants of the selling shareholder (child, grandchild, great grandchild, legally adopted child); other shareholders owning more than 25% of the stock individually or by rules of attribution.

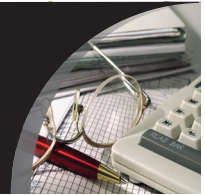
IRC Section 409(n)(3)(A) provides a limited exception to the prohibited allocation rule. Allocations may be made to lineal descendants of the selling shareholder if the total amount of stock allocated does not exceed 5% of the amount sold by the selling shareholder. This exception does not apply to lineal descendants of any 25% shareholder.
  - **Holding period.** The selling shareholder must have owned his stock in the Company for at least three years prior to the sale to the ESOP. The selling shareholder cannot qualify for the Section 1042 rollover if the proposed stock was acquired through exercising stock options.
  - **Excise tax penalty.** If the ESOP sells shares subject to the IRC Section 1042 election within three years after the sale, the employer is generally subject to a 10% excise tax on the proceeds. The selling shareholder must have owned his stock in the Company for at least three years prior to the sale to the ESOP. The selling shareholder cannot qualify for the Section 1042 rollover if the proposed stock was acquired through exercising stock options.

### ***Non-taxable Income Related to ESOP Stock (S Corporation)***

The S corporation is generally referred to as a “pass through” entity for Federal income tax purposes. The taxable income (or loss) of the Company is passed through (or reported to the shareholders on tax form K-1) to the shareholders, and the shareholders will pay Federal income taxes on the reported income at their personal income tax rates. Our discussion will assume an S corporation that is profitable. Typically, the shareholders will be receiving the reported S corporation income in addition to any other income that is either earned (W-2) or is investment income. The income from the S corporation is often taxed at the highest marginal tax rate for the individual shareholder.

- ***The ESOP has no Federal income tax liability*** – The ESOP is a qualified retirement plan, and it has no Federal income tax liability. Income taxes are typically paid only when plan assets are distributed to retiring partici-





## Understanding ESOPs & Their Use in Exit Planning Strategies

pants, and then, it is the participants that pay the income tax. If the ESOP is one of several shareholders in the S corporation, the other shareholders will have a Federal income tax liability, but not the ESOP.

- *An S corporation that is 100% owned by the ESOP will not pay Federal income taxes* – All of the stock is owned by the ESOP, as a non-tax paying qualified retirement plan. The long-term financial implications for the Company are positively impacted because of the tax environment.

### EXAMPLE: Comparing a C Corporation and an S Corporation (100% ESOP)

	<u>C Corporation</u>	<u>S Corporation</u>
Pretax income before ESOP payment	\$ 1,200,000	\$ 1,200,000
Less: ESOP contribution	200,000	200,000
Pre-tax income	\$ 1,000,000	\$ 1,000,000
Federal income taxes (at 35%)	350,000	0
Net income to Retained Earnings	\$ 650,000	\$ 1,000,000
Distribution to all shareholders – None	0	0
Retained by Company	<u>\$ 650,000</u>	<u>\$ 1,000,000</u>

In this case the effective tax rate between the C corporation and S corporation shareholder is striking. The C corporation has an effective Federal income tax rate of 35%, while the S corporation with the 100% ESOP has no corporate Federal income tax obligation. The S corporation has no tax obligation, and the sole shareholder is a qualified benefit plan with no income tax obligation. When participants leave the ESOP, their ESOP distribution is similar to any other distribution from a qualified benefit plan and will eventually be subject to ordinary individual income taxes.

The S corporation in this example clearly has an advantage over the Federal income-tax paying C corporation. The tax savings realized by the S corporation ESOP may be retained by the employer for any number of good business reasons. Note, the tax savings are a deferral of obligations only. Eventually the S corporation ESOP participants will leave the Company and distributions will be made. Those distributions are the obligations of the Company. However, the deferral of income taxes, for possibly many years, is a very attractive attribute of ESOPs in such circumstances.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- *Assets in ESOP remain untaxed until retirement* – Assets in the ESOP increase free of income taxes until withdrawn. Most typically, the largest asset in the ESOP is the block of Company stock. If the company grows and prospers, the likelihood of substantial stock valuation growth is substantial. Since the ESOP is a qualified retirement plan, such asset growth will not be taxable to the plan participants until they retire.

This benefit is true of virtually all qualified benefit plans, including the ESOP. When all of the other tax related benefits are considered, the ESOP enjoys many compelling advantages. As discussed, there are numerous differences between ESOPs in C corporations and S corporations. The summary chart on the next page highlights these major differences.

### Conclusion

ESOPs can prove extremely useful to accomplish a wide array of business, economic and tax strategies. So long as care is given to the complex nature of such strategies, the ESOP as a planning tool, can be very beneficial.



## Understanding ESOPs & Their Use in Exit Planning Strategies

### ESOP Summary Chart Comparing C Corporation and S Corporation Tax Provisions

	<u>C Corporation</u>	<u>S Corporation</u>
<i>Payroll contribution deduction</i>	25% eligible compensation. Excludes elective contributions to 401(k).	25% eligible compensation. Excludes elective contributions to 401(k).
<i>ESOP loan interest deduction</i>	Not counted against 25% eligible compensation.	Yes, it is counted against 25% eligible compensation.
<i>Dividend deduction</i>	Permitted. Must be reasonable. May be paid to participants (rare) or to repay loan directly. Deductible from taxes.	Distributions made in same percentage to all shareholders. ESOP distribution allocated by shares in each account. Not tax-deductible.
<i>IRC Section 1042</i>	Yes, tax deferral election permitted. Several restrictions apply to relatives and 25% owners.	Not available.
<i>Classes of stock</i>	Multiple classes available. May use a separate class of stock for ESOP to enhance dividend deduction.	Single class of stock.
<i>Attributes of ESOP stock</i>	Must have highest voting and dividend preference.	Must have highest voting and dividend preference.
<i>Number &amp; type of shareholders</i>	Unlimited number, few shareholder restrictions.	Maximum is 100 (ESOP counts as 1). Restrictions on type of shareholders.
<i>Federal income taxes</i>	Paid by company.	Paid by shareholders. ESOP as a shareholder is not subject to income tax.
<i>ESOP anti-abuse provisions</i>	Not applicable.	Substantial penalties if ESOP is determined to violate Federal statutes.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## **Chapter III – *Establishing an ESOP***

A company interested in establishing an ESOP has a wide range of options in tailoring a plan that is best suited to its particular needs and goals. A large, publicly-traded company, for example, would handle the creation of its ESOP somewhat differently than would a smaller firm.

The first step in the process of establishing an ESOP is to develop an idea of the type of plan that will best serve the Company's and its owners' interests. Companies have created ESOPs as an employee retirement plan, for purposes of business continuity, financing, enhanced employee motivation or as a combination of several of these objectives.

### **Initial Considerations**

Once the general picture is developed for the kind of ESOP required, the specifics of the ESOP need to be determined. The actual feasibility of an ESOP needs to be established. Custom-tailored answers to the many questions need to be formulated. Who will participate in the plan? How will stock be allocated to participants? What vesting schedule will be adopted and how will distributions of ESOP accounts be handled? How will voting rights be handled? The Company must integrate the ESOP goals with applicable laws and regulations and must conduct a financial analysis to assure that any financial commitments posed by the ESOP will not exceed the ability of the firm to meet such obligations. In addition to an ESOP advisor, attorneys and accountants, the overall planning process often requires other professionals, such as an appraiser or a lending institution, as appropriate.

In the case of a privately-held company, the feasibility and design phase of the process is not usually complete until three additional points have been addressed. First, the firm's stock must be valued by an independent appraiser before shares are put into the ESOP. Initially, a careful estimate will be prepared for use as a working figure in the feasibility and design process. This initial appraisal will likely take several weeks or longer, since a significant amount of business data must be collected and analyzed. Only when the design process is completed and ready for implementation will a final and formal valuation report be prepared.

Second, the ESOP's effect on existing stockholders should be estimated. Stockholders will want to know how the ESOP will affect the value of their stock and the Company's financial condition. Often an ESOP will cause a dilution of their equity interests in the corporation.

Finally, while not a requirement for establishing an ESOP, a plan for meeting the private, closely-held Company's obligations to repurchase the stock of departing employees should be projected. This "repurchase obligation" arises from the fact that in privately-held companies, ESOP participants have a put option when leaving the Company. The repurchase obligation and its growth over time may be affected by factors like the size of the annual ESOP contribu-



## Understanding ESOPs & Their Use in Exit Planning Strategies

tions, the change in the value of shares between the dates of contribution and repurchase, the vesting and distribution provisions of the ESOP, employee turnover and, for shares contributed after December 31, 1986, the choices eligible employees make about their diversification option.

Companies may plan for and meet their ESOP repurchase obligation in a variety of ways, including making substantial cash contributions on an annual basis, and buying insurance to cover the Plan's obligations. If the likely growth of repurchase obligation over time is projected at the outset, however, the Company is in the best possible position to plan for it and design the ESOP accordingly.

### Implementation

When the process of analyzing and designing the ESOP is complete, the Company will typically have an attorney prepare a formal plan document, which will set forth the specific terms and features of the ESOP. An appraiser will then prepare a finished and formal evaluation report, based on data, preferably no more than 60 days old, at the date the ESOP is created.

The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, Company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures and provisions for plan amendments. Depending on the particular circumstances of the establishment of the ESOP, it may be prudent to address any future contingencies in the plan document.

Other key decisions include determining who will serve as the ESOP's trustee and who will assume the functions of administering the ESOP. The stock (as well as any other assets) held by the ESOP must actually be held in the name of the trustee, who usually has fiduciary responsibility for the plan's assets. Increasingly, plan sponsors are turning to professional trustees, such as a bank or trust company, although companies sponsoring an ESOP can and do handle this role in-house. The job of ESOP administration is, likewise, a function that may be given to a professional administration firm or handled internally by the sponsor. The administrator is responsible for maintaining all individual records of the plan in order to keep track of exactly who are the current participants in the plan, what percent is each participant vested, what is the content and value of each participant's account, etc.

In the case of leveraged ESOPs (an ESOP which used borrowed funds to acquire employer securities), arrangements must be made for securing the financing needed to complete the transaction. Banks, savings and loans, investment banking firms, mutual funds and insurance companies in the business of lending money may all qualify as ESOP lenders. Lending institutions are becoming increasingly familiar with how ESOP loans are structured.





## Understanding ESOPs & Their Use in Exit Planning Strategies

The Company must formally adopt the plan and trust documents that establish the ESOP and its attendant trust. Also, the Company usually submits a copy of these documents to the Internal Revenue Service with an application for confirmation (called “determination”) of the plan’s tax-qualified status (Form 5300). The plan must be a qualified ESOP under sections 401(a) and 4975(e)(7) of the Internal Revenue Code in order to be eligible for the various tax benefits associated with ESOPs. It is not normally necessary, however, to wait for a letter of determination from the IRS to begin the plan. If there is nothing unusual in the plan’s design, any required changes will almost certainly be small ones, which can be made after the plan has begun operation.

A Company must adopt an ESOP by the end of its fiscal year to claim a deduction for its contribution for that year. Contributions and leveraging for a given year, however, may occur up until the Company files its corporate tax return, including extensions.

### Reporting Requirements

In 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement*. This ASU requires companies to disclose any significant methodologies and assumptions used in the fair value determination of non-publicly-traded company securities. The effective date for nonpublic entities was beginning in December 2011, impacting ESOPs with December 2012 year-ends. The required disclosure would appear in a footnote to the ESOP audit report, which is filed with Form 5500. The concern of the ESOP community was that the details to be disclosed could provide a significant amount of information on how the fair market value of the ESOP’s stock was determined. Essentially, this would provide the public with information on a private ESOP company that would not otherwise be so readily available.

In April 2013, the FASB decided to give ESOP companies an indefinite deferral on the requirement to disclose quantitative information on the valuation. However, qualitative information will still need to be disclosed. This qualitative information to be disclosed includes the valuation method and main inputs, presented in a manner which would not allow competitors or others to back into a valuation figure.

### Conclusion

The process of setting up an ESOP may at first seem complicated, but that should not discourage interested companies from investigating employee ownership. In fact, in many ways selling or contributing stock to an ESOP is less complicated and costly than selling stock to an outside third party. The process is understandable and manageable, and the many benefits which flow from ESOPs, such as increased employee motivation, a market for existing shareholders shares, and tax and financial advantages, are substantial.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## *Chapter IV – Understanding the Need for a Feasibility Study*

ESOP feasibility studies, as the name implies, are designed and conducted to preliminarily assess whether an ESOP will work to achieve the goals of the current shareholders and the management group, going forward. While ESOP feasibility studies are broadly defined and can vary widely from assignment to assignment, depending on facts and circumstances, the common denominator of the undertaking is the importance of a critical first look at the effects of the implementation of such a plan. The ultimate goal is to prevent expensive errors and future mistakes that might otherwise arise from a full implementation. The ESOP feasibility study is that tool by which the final decision to establish an ESOP is most often made.

Important questions and issues, though not likely all-encompassing, which should be addressed in the course of conducting an ESOP feasibility study include the following:

- What are the specific motivations and goals of the current shareholders to become involved in an ESOP transaction?
- What are the specific motivations and goals of management (i.e., the Company) to become involved in an ESOP transaction?
- What are the intended motivations and goals of the employees to become involved in an ESOP transaction?
- If the adoption of an ESOP is intended to facilitate an acquisition of shares from current shareholders, who will be selling their shares?
- Is the transaction to be fashioned as a partial sale of a particular shareholder's ownership interest as a final transaction, or will the plan contemplate future stock purchases, as well?
- What is the preliminary assessment of value of the proposed purchased shares, and where will the funds to finance this purchase come from?
- What is the effect of the debt service requirements related to any proposed ESOP stock acquisition debt on the future cash flows of the sponsor Company?
- What is the estimated cash flow available for debt service, based upon the qualified retirement plan rules, as a percentage of applicable compensation?
- With respect to sponsor Company expected future cash flows, what is the effect on the ESOP of variations (plus or minus) in forecasted financial performance at the date of adoption?
- What are the qualified plan design alternatives and how is the specific plan best designed?
- How do the alternatives to an ESOP compare, when addressing the motivations and goals of the current shareholders, the management group (the Company) and the employees?



## Understanding ESOPs & Their Use in Exit Planning Strategies

In making an initial exploratory assessment of an ESOP, there is no need to involve either financial advisors or attorneys. Quite simply, management and the selling shareholders can quickly evaluate whether an ESOP presents a viable option for accomplishing their goals.

Numerous services and commentaries address the prototypical (or ideal) ESOP candidate but, in reality, there is no optimal ESOP candidate. While setup and maintenance costs can sometimes seem daunting, even those can be controlled with proper focus.

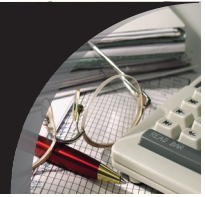
Keep in mind that facilitating debt service requirements is most often the key ingredient to successful implementation of an ESOP. The funding of these debt service requirements is predicated upon cash retirement plan contributions from the sponsoring Company. In turn, the amount of the annual pension contribution is based upon “eligible wages” of employees participating in the plan. As such, companies with certain higher numbers of employees are often better able to use ESOPs effectively.

Given that maintaining a higher number of employees generally requires greater revenue and profitability, it is reasonable, then, to conclude that the following companies, with the following criteria would be better able to facilitate the most-advantageous use of an ESOP:

- A privately-held United States corporation,
- Participating workforce of 20 employees or more,
- Strong historical growth in profits,
- Expected future revenue of \$2,000,000 or more,
- Specifically-motivated current stockholders (diversity and succession), and
- Future management acceptance.

Note that feasibility studies can range from internal personnel carefully structuring an internal business plan under the guise of such a study to engaging outside advisors to conduct a full, self-contained study. The latter strategy is most often used in conjunction with larger ESOPs and in those circumstances where implementation and maintenance of the ESOP carries greater complexities, due to sponsor Company operating issues and broader employee participants.

These full studies are very comprehensive and usually focus on four primary aspects of the ESOP consideration process: a preliminary valuation study; a sponsor Company financial analysis to determine the effect of the ESOP and corresponding debt service requirements on future Company health; an ESOP transaction formation assessment; and repurchase obligation liability impact. These four considerations are further detailed on the following pages.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## Preliminary Valuation

Valuation is at the heart of the ESOP decision-making process. Early on in the process, the valuers have not been able to conduct all necessary steps to have complied with generally-accepted business valuation procedures and business valuation standards. Thus, the number obtained in this process is not a determinative indication of value but, rather, an early “rough estimate.” Often, the preliminary estimate of value is set in a range, and the ramifications of this range may be established by looking at the second phase of the feasibility study under varying value estimates

The point of this exercise is to establish an idea of value for the purpose of confirming the selling stockholder’s acceptance of a value in that range. In addition, this process allows the feasibility study to include an assessment of the borrowing capacity and debt service requirements of the sponsor Company, as well as examining how an ESOP transaction conducted at that value will affect future operating performance.

Note that, rarely, does the preliminary valuation assessment result in a conclusion of value upon which the legal and tax requirements imparted by the Department of Labor (DOL) and the Internal Revenue Service (IRS) can be met. In most cases, a business valuator, experienced in the nuances of ESOPs, will need to proceed with a full business valuation conducted under professional standards in order to comply with DOL and IRS requirements.

## Financial Analysis

The second element of a full feasibility study is a sponsor Company financial analysis. This analysis is conducted to determine the effect of the ESOP and corresponding debt service requirements on future Company health. In effect, this part of the process requires looking to future expected cash flows and ensuring that the funding of the annual ESOP pension plan contributions is possible, not only from an “eligible compensation” basis, but also from a cash outflow basis, without harming the Company’s ability to perform.

This step in the process will also allow for consideration of dilution on remaining (non-selling) shareholders, and how that dilution affects the value of their remaining shares.

Sometimes referred to as a “stockholder’s equity capital study,” this exercise is most-often conducted under several varying scenarios that examine the ramifications of the ESOP implementation under differing valuation estimates.

## ESOP Transaction Formation Assessment

The ESOP transaction formation assessment is that part of the feasibility study process that focuses on plan design. Essentially, these details are critical to imparting final results that accomplish the goals of all three groups of stakehold-



## Understanding ESOPs & Their Use in Exit Planning Strategies

ers (current shareholders, the Company and the employees). Many of the considerations in this analysis parallel those that might be observed in considering the adoption of any qualified retirement plan. Such considerations include participant eligibility and vesting terms, employer contribution levels, contribution allocation formulas, treatment and allocations of forfeitures, etc. Although this analysis is beyond the scope of this presentation, it is imperative that the parties carefully consider all of the alternatives in plan design, as well as the ramifications of differing options.

Keep in mind that it may be possible to combine the proposed ESOP with existing qualified retirement plans maintained by the plan sponsor. Additionally, there is an ability to use, in some instances, different classes of stock in ESOP sponsor companies. These types of considerations are addressed in the ESOP transaction formation assessment.

Tax considerations are also part of the feasibility study. These considerations, as discussed in detail in Chapter II of these materials, run the entire gamut from the selling shareholder's potential deferral of capital gains tax, to tax-deductible dividends in certain circumstances, to S corporation tax benefits. All of these tax considerations can, and will, have a substantial impact on the final feasibility study.

### Repurchase Obligation Liability Impact

The repurchase obligation liability impact is that part of the feasibility study that looks to the long-range cash flow needs to satisfy the "put" requirement in the ESOP mandated by the IRS and the DOL. In this part of the process, the feasibility study looks to address the future repurchase liability determined by the employee participant ages, their likelihood to require that their shares be liquidated, and the Company's ability to fund the repurchases, at the times forecasted and in the amounts forecasted. The repurchase liability obligation can also arise from the termination of an employee, as well as death, disability and retirement.

Note, that in the author's experience, the feasibility study rarely looks to identify funding sources and mechanisms for satisfying the repurchase liability obligation. The exercise is simply undertaken at this early point to ensure that management is fully-informed as to the full impact of the ESOP implementation.

### Other Considerations in Feasibility Studies

The feasibility study will also include employee communications and, especially, the employer disclosure memorandum. This memorandum is intended to provide key historical and future expected financial information and performance estimates, risks related to a hypothetical investment in the sponsor Company, and any and all other information that an investor might consider in making a decision to invest in the Company.





## Understanding ESOPs & Their Use in Exit Planning Strategies

This memorandum must be distributed approximately 30 days prior to the required employee decision to participate in the ESOP. Given the general level of financial sophistication held by blue collar and less-technical personnel, there may be a disproportionate number of potential plan participants who decline the opportunity. Unfortunately, greater “non-participation” leads to lower annual retirement plan contribution levels, thus, affecting the sponsor Company’s, and the ESOP’s, ability to fund the purchase of the selling shareholder’s stock. In this way, the employer disclosure memorandum can present a very real financial risk. For this reason, it is an important part of the process of completing the feasibility study.

In instances such as that described above, it is incumbent upon the Company to communicate the information related to the employees in a manner that allows for as complete an understanding as possible, to facilitate an informed investment decision. Once fully developed, the feasibility study is presented to those decision makers within the Company that have the authority for final approval to proceed.

It is important to understand that a feasibility study is a fluid document. As such, consideration of the feasibility study requires modification and update as facts and circumstances change throughout the ESOP formation process. The best way to gain total value from the feasibility study is to refer to it often as a roadmap to the risks and issues identified in the earliest part of the ESOP adoption process. It is important to fully understand, throughout the course of the adoption, exactly why the actual circumstances veered from those set out in the feasibility study.

Finally, while a full feasibility study is not without cost, its value can be justified by the avoidance of potential later problems and expenditures it allows the parties.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## *Chapter V – Understanding Repurchase Obligation Liability*

An exclusive provision of the ESOP rules is the ability of the qualified plan to invest primarily in securities of the sponsor Company. While this rule is crucial to the accomplishment of facilitating employee ownership, it also serves to substantially increase investment risk for the plan participants. Many ESOPs are invested solely in the sponsor Company securities, thereby lacking any diversity at all. In addition, realization of the “value” of these shares (i.e., marketability) would be virtually nonexistent for privately-held companies without the creation of a plan feature to establish a market for the shares held by the ESOT.

For those companies whose shares are traded on a public stock exchange, that market serves as the mechanism by which the plan participant can monetize his/her investment in sponsor Company securities. For the privately-held company, such a market does not exist. To facilitate the establishment of a market for these shares, the Internal Revenue Code provides under section 409(h) and Treasury Regulation 54.4975-7(b)(10), and the Department of Labor provides under DOL Regulation 29 C.F.R. 2550.408b-3, a requirement that the sponsor Company must “repurchase” the shares of stock from any participant that receives a distribution in any year. This requirement is accomplished by a “put” option, which entitles the plan participants to put the shares back to the sponsor Company in exchange for cash consideration equal to the fair market value of the stock. The put option grants the plan participant the right to sell his/her shares back, but it does not require that he/she do so.

Note that some ESOP companies do not distribute stock, rather, they fund the repurchase obligation liability by virtue of ongoing pension contributions to the plan. Other variations exist and can be accommodated under the plan, such as receipt by the plan participant of a promissory note or having the shares repurchased by a related party to the sponsor Company. However, such variations do not, in any way, work to change the fundamental requirement that the sponsor Company create liquidity in some form to provide for satisfaction of this liability.

From a practical standpoint, it is rare that the shares are not put back to the sponsor Company at the earliest dates possible, but the retention of those shares does periodically occur. From a timing standpoint, the put option is usually exercisable during a 60-day period that begins on the date of distribution of the plan participant’s allocated shares, or during an alternative 60-day period beginning one year after the date of distribution.

To further mitigate the risks associated with a lack of investment diversification, the ESOP rules allow that a plan participant that is age 55 or older, and who has been a participant in the plan for 10 years or more, be able diversify a portion of his/her shares of sponsor Company stock allocated to his/her account within the plan. Internal Revenue Code section 401(a)(28)(B), provides that the qualifying plan participant can diversify up to 25% of his/her stock during the five-year period beginning when the participant attains age 55 and ending the day before he or she reaches age 60. At age 60 (again, with 10 years of plan participation), the amount allowed to be diversified increases to 50%.



## Understanding ESOPs & Their Use in Exit Planning Strategies

The funding of these two protective regimes requires sponsor Company cash flow. The put option generally requires that the sponsor Company repurchase the plan participant's shares. Alternatively, the cash required to be used to comply with the diversification rules is generally within the ESOP with funds, of course, that came from the Company initially. Together, these funding obligations are referred to as the repurchase obligation liability.

The repurchase obligation liability is not, strictly speaking, a balance sheet liability of the sponsor Company. Pursuant to the rules under generally accepted accounting principles, the liability is essentially the same as any other obligation the Company might face under a corporate buy/sell agreement among non-ESOP shareholders that requires that the Company buy back the shares of a departing shareholder. In both cases the liability is contingent and, as such, is considered an "off balance sheet" liability that will fluctuate over time with value increases and decreases.

While the statutory provisions require sponsor Company compliance with the put and diversity rules, the provisions do not, and cannot, guarantee compliance. An initial observation might assume that these provisions create a perfect market and, thereby, reduce the lack of marketability risk entirely. However, the imposition of statutory rules do not, in and of themselves, guarantee that the sponsor Company will have the economic capability at the time that the rules come onto play. As such, it is easy to understand why all those involved with the ESOP must fully understand the impact of this liability on future Company financial performance.

Various dynamics drive the amount of the repurchase obligation liability and exactly when that liability will be payable. The driving items influencing the size and timing of the repurchase obligation liability are the demographics of the sponsor Company employee population and the value of its stock. In addition, critical provisions with the plan document, itself, can very often heavily influence the computation of the repurchase obligation liability.

The key plan provisions that influence the repurchase obligation liability are those that relate to benefit vesting and the timing and manner of distribution. These critical provisions are most often addressed in the plan design phase of the feasibility study and finalized with the consent of all parties after the decision to move forward with the ESOP is made.

General rules for ESOP distributions are contained in Internal Revenue Code sections 401(o)(1)(A) through (C). Under these provisions, distributions must begin no later than the end of the plan year, after the year in which certain distribution trigger events occur. These distribution trigger events include retirement, death or disability. The rules differ for plan participant terminations. In this case, the distributions are permitted to be deferred for an additional five years or until the loans obtained by the ESOP to acquire sponsor Company stock are repaid.

Pursuant to the Internal Revenue Code, distributions from the ESOP can be made over a period of five years or more, in the event of certain "large" account balances. This statutory provision does not, however, necessitate that the sponsor Company make the distributions in this fashion, and it allows for custom payout scenarios that differ from



## Understanding ESOPs & Their Use in Exit Planning Strategies

the statutory rules. So long as the distribution period does not exceed the statutory period, the sponsor Company can vary the distribution period. Immediate distributions and lump-sum distributions are often noted as the primary alternatives. There is no such flexibility with regard to the timing of the diversity rights accorded plan participants. These are always payable on a lump-sum basis.

It should be noted that accelerating the distribution schedule will serve to increase the repurchase obligation liability. As such, understanding the impact of distribution alternatives in the plan design phase of the plan adoption process is critical. Once chosen, and adopted, such provisions are not easily modified or changed.

The mechanic of calculating the size and timing of the repurchase obligation liability is predicated upon three distinct, but inherently integrated, factors. Each of these three factors must be considered and evaluated in conjunction with the determination and understanding of the liability. These three factors include the fair market value of the stock, which must be valued by an independent appraiser annually, the speed with which the sponsor Company stock turns over and finally, the manner in which the put is handled by the sponsor Company.

The value of the stock is a key element of the process of determining the repurchase obligation liability. It is not difficult to understand that the higher the value, the higher the liability. The issue of value on ESOP planning and the liability is, of course, compounded by the amount of sponsor Company stock held by the ESOP. A Company that is 100%-owned by an ESOP has a much more significant risk than one that is 30%-owned by an ESOP. Obviously, the former represents a more significant operating issue, and management and planning to meet this liability is critical to the success of both the Company and the ESOP.

Note that the issue of growing values equating to growing repurchase obligation liabilities is not necessarily an operating problem. Increasing stock values for the sponsor Company would seem to indicate that the Company is growing and, that their financial strength, as well as future prospects, is strengthening.

The sponsor Company employee demographic, and employee resignation and turnover, offer the greatest impact on the turnover speed of sponsor Company stock. For the most part, the latter phenomenon accounts for the greatest number of trigger events, while the former can carry a greater impact in smaller companies and those with aging employee populations. This is especially true where the aging employees are long-time plan participants and carry substantial account balances.

To best “manage” the employee turnover issue, care should be taken at inception of the ESOP to ensure that vesting and forfeiture reallocation provisions are designed in such a way as to control the repurchase obligation liability as much as possible. Slower vesting results in a lower liability in employer environments with high employee turnover. Generally, counting prior service garnered prior to adoption of the ESOP, while having many positive impacts, will work to substantially increase the repurchase obligation liability.



## Understanding ESOPs & Their Use in Exit Planning Strategies

The same outcome results from the rapid reallocation of forfeited unvested shares of stock when an employee leaves the sponsor Company. Pushing out the reallocation of forfeitures as far as possible will lower the amount of the reallocated shares moving into employee accounts post exit of an ex-plan participant.

The age demographic is most important in situations where there is a small employee count with a substantial number of those employees approaching the age where they will have the right to diversify. The primary impact of this situation, while obviously driving a liability that is more near term, is that these employees are those least likely to exit early and have the more substantial account balances.

With respect to the manner in which the sponsor Company complies with the repurchase provisions of the rules, attention needs to be focused on the way the Company handles its repurchases of its stock. Essentially, there are two primary methods for effecting these repurchases: stock redemptions or, alternatively, recirculating those shares.

Stock redemptions are predicated upon the sponsor corporation distributing stock, either all at once in a single distribution, or over time, in installments. Once the shares of stock are in the hands of the departing plan participant/employee, the Company will purchase those shares. Like any stock redemption transaction, the amounts paid for the stock are not tax deductible, and the funding source for the payment must be considered carefully. Generally, companies set up sinking funds, but using operating cash flows is also common.

The recirculation alternative differs somewhat from the redemption process. Here, the sponsor Company contributes cash to the ESOP. Again, this funding can come from a sinking fund or Company operations. The ESOP trustee will then distribute cash to the departing plan participant. So long as the cash contributed works through the normal pension contribution rules, it will be tax deductible.

Note that the critical difference in the two alternatives is that the redemption alternative works to reduce the number of shares outstanding, while the recirculation alternative holds shares constant. In ESOPs where the sponsor Company owns 100% of the stock shares, the redemption will not affect the overall ownership percentage. In all other cases, a redemption will work to dilute the total ownership within the ESOP.

Since redemption works to reduce outstanding shares, it will also serve to reduce the repurchase obligation liability. This result will not occur with the shares that are recirculated. Further, employee accounts will hold fewer shares of stock if the redemption alternative is adopted.

The repurchase obligation liability is critical to the overall assessment of value. As such, a thorough business valuation should include an estimation of this liability. The purpose is somewhat obvious, in that the liability will be funded by future expected cash flows, and it is this metric that lies at the heart of valuation.





## Understanding ESOPs & Their Use in Exit Planning Strategies

To estimate the repurchase obligation liability, many ESOP trustees turn to an independent expert to conduct a repurchase obligation liability study. However, with due care and attention, the study can be undertaken internally. A properly prepared study can provide answers to numerous key questions and provide valuable insight in ESOP design and future operation. An example of these items include how changing distributions from lump sums to installments affect the repurchase obligation, how the Company's pension contribution funded in stock affects the level of the repurchase obligation, the impact of redemption strategies versus recirculation, and the effect of these choices on employee account balances. The study will also allow for assessing the viability of current funding strategies.

The repurchase obligation liability study is primarily an actuarial undertaking. Essentially, the starting point is a strong employee census with data including years of service, years in the plan, physical age, vested status and projected date of trigger events (usually, retirement, death, disabilities, attainment of the diversification age and both voluntary and involuntary terminations). Note that the ESOP document can create other additional trigger events including participant loans, hardship withdrawals, qualified domestic relations orders (QDRO) and early diversification, all dependent on plan provisions.

To address the assessment of the repurchase obligation liability, it is most common that the process be divided into distinct, separate steps. The first of these steps is to gather the necessary data on all plan participants and carefully review the demographics. The key element of this process is that portion in which the actuarial probabilities are developed, based on these demographics, and adopted as calculation assumptions. The process includes understanding mortality tables and age demographics, as well as historical trends in retirements and terminations.

Once these steps are complete, it is necessary to adopt certain financial assumptions. The most critical of these assumptions is the estimation of long-term sustainable growth and the resultant expected growth in stock value. Other financial assumptions that require focus include:

- Future expected sponsor Company contributions to the ESOP
- The rate by which the sponsor Company workforce is expected to grow
- The rate by which the sponsor Company employee compensation is expected to grow, and
- The expected future compensation for new hires

Once these assumptions are identified and developed, the repurchase obligation liability is generally run at a "base case" level. Additional iterations can be run under alternative assumptions by varying those assumptions. In some models, statistical probability analysis is used as a method to calculate "most likely" outcome scenarios. Obviously, crafting calculations of the repurchase obligation liability under varying "what if" scenarios is a mathematical process that is fraught with complexity.



## Understanding ESOPs & Their Use in Exit Planning Strategies

Keep in mind that the repurchase obligation liability study is essentially a cash flow projection. However, here the focus is on cash out – that amount of cash flow required to facilitate full compliance with the ESOP rules and regulations. As such, it is imperative that care be given to preparing the forecast on good assumptions. Like any cash flow projection, the devil is in the details, and it is extremely difficult to drive credible and useful results without exercising due care in the development of the assumptions.

As noted above, the fact that the satisfaction of the repurchase obligation liability requires funding via sponsor Company cash flow expected to be generated in the future or through debt confirms the need to consider the liability in the course of the valuation. While this issue will be discussed more thoroughly in the next chapter, suffice to say that the liability will affect value, often in a substantial fashion.

The issue that arises is that the consideration of the repurchase obligation liability and the valuation are interdependent and the calculation of both is somewhat circular. The value of the Company and the stock shares held by the ESOP require adjustment for the effect on value of using future cash flows, while the estimation of the future repurchase obligation liability is based on the valuation results.

Repurchase obligation liability studies should absolutely be undertaken at inception of the ESOP, and the liability should be reevaluated periodically as those assumptions driving the initial study become less relevant to the circumstances surrounding the Company and the plan. This liability is often given less-than-appropriate consideration by the parties to an ESOP, and failure to evaluate it properly can lead to very suspect results and values.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## Chapter VI – *ESOP Valuation Considerations*

The concept of valuation lies at the heart of all ESOP planning. Not only is value important at the outset of the planning process, as value necessarily equates to consideration for shareholders who are being asked to sell their shares in the transaction, but it is equally important to plan participants whose future investment may be predicated upon the performance of the ESOP stock.

Valuation must play a key role in any decision to move forward with an ESOP. As such, it is incumbent upon the parties of interest, and, in particular, the trustee(s) of the ESOP to identify a business valuation professional(s) that is experienced in such transactions, as well as fundamental principles of valuation.

Valuing ESOP Shares, a publication of the ESOP Foundation in Washington, D.C., notes that the ESOP fiduciaries, who have final responsibility for appointment of the valuator/appraiser should consider two basic criteria:

1. The valuator should be a person or firm that regularly engages in the valuation of businesses or business interests. The extent to which the DOL (Department of Labor) receives a valuation as reflecting fair market value will be affected by an assessment of the level of expertise demonstrated by the individual or parties analyzing the valuation.
2. The appraiser should be independent with respect to the issuing Company and parties to an ESOP transaction.

Treasury Regulation Section 54.4975-11(d)(5) states:

*“An independent appraisal will not, in itself, be a good faith determination of value in the case of a transaction between a plan and a disqualified person. However, in other cases, a determination of fair market value based on at least an annual appraisal, independently arrived at by a person who customarily makes such appraisals, and who is independent of any party to a transaction under Section 54.4975(b)(9) and (12), will be deemed to be a good faith determination of value.”*

Valuation of ESOP shares in privately-held companies must meet the requirements of both the Internal Revenue Service (IRS) and ERISA. The IRS relies on Revenue Ruling 59-60, the general guidelines for the valuation of closely-held corporations for tax-related matters and, as of this writing, it has not issued any supplemental revenue ruling or other guidelines specifically applicable to ESOPs. Section 3(18) of ERISA refers to fair market value determined in good faith “and in accordance with regulations promulgated by the Secretary (of Labor).”

The DOL has issued proposed regulations setting forth general guidelines regarding the determination of “adequate consideration” for the purchase of one employer security for which there is no generally recognized market. The final version of the regulations were expected to be issued after the fall of 1989, but have never been issued.



## Understanding ESOPs & Their Use in Exit Planning Strategies

The regulations come into play with respect to ESOPs upon the conversion, acquisition or sale by an ESOP of qualifying employer securities. While embracing the primary factors addressed in Revenue Ruling 59-60, the regulations also require that certain factors specifically applicable to ESOPs be addressed.

In addition, the appraiser of ESOP shares must rely on generally-accepted appraisal practices and may consider the case law developed to date.

### ESOP Valuation Fundamentals

#### *Identification of Valuation Subject*

First and foremost, it is important to clearly identify that interest which will be the subject of the business valuation. In the typical ESOP engagement, the subject will be the number of shares of that class of stock that is held by the ESOP as of the date of valuation.

It should be noted that the stock under valuation is the “total” of all stock held by the ESOP, whether those shares are fully-vested or not. Moreover, if the stock held by the ESOP is more than 50% of all outstanding shares, and this interest constitutes a controlling interest, the value per share on a controlling interest basis, will be used to meet use obligations of vested participant ownership interests, even if these particular interests are noncontrolling.

#### *Identification of Subject Ownership Interest*

All business valuations appraise the ownership interests in a subject business. That is, the valuation concludes the value of the owner’s rights in the business/security – and not the value of the business entity itself. For example, all of the standards rules in USPAP Standards 9 and 10 speak to “developing an appraisal of *an interest* in a business enterprise.” (emphasis added)

The ownership interest describes the bundle of legal rights that is the subject of the analysis. Typically, the ESOP employer stock valuation should be based on a fee simple interest. The ESOP trustee should ensure that he or she is relying on an employer stock valuation that encompasses the appropriate ownership interest.

#### *Level of Value*

The level of value focuses on two specific rights in the bundle of shareholder rights – liquidity and ownership control. Liquidity relates to how quickly and easily the appraisal subject can be converted into cash – that is, how quickly and easily the appraisal subject can be sold. Ownership control relates to whether the appraisal subject offers



## Understanding ESOPs & Their Use in Exit Planning Strategies

the owner/holder the right to control the operations of the subject business. In other words, by owning the appraisal subject, can the stockholder influence the employer corporation to implement any of the following actions:

- enter/not enter contracts
- hire/fire employees
- pay/not pay dividends
- borrow/pay down a loan
- buy/sell assets
- merge/liquidate the Company
- start/discontinue a product line
- other various prerogatives

Inexperienced ESOP valuation analysts sometimes believe that there are only three relevant levels of value:

1. a marketable, controlling ownership interest,
2. a marketable, noncontrolling (i.e., “as if publicly-traded”) ownership interest, and
3. a nonmarketable, noncontrolling ownership interest.

Experienced ESOP valuation analysts understand that the levels of value represent a continuous spectrum on two axes. One axis represents the complete investment spectrum of liquidity from perfectly liquid to perfectly illiquid. The other axis represents the complete investment spectrum of control from absolute operational control to a total lack of any operational control.

### *Contractual Rights and Restrictions*

This element of the valuation explains whether the actual asset/equity ownership interest is subject to any type of contractual rights or obligations. Common contractual rights/obligations include: put options, call options, shareholder buy-sell agreement provisions, partnership/corporation and/or partner/shareholder agreements, S corporation tax election agreements, prenuptial family ownership restriction agreements, joint venture agreements, rights of first refusal and so on.

In addition to contractual rights and restrictions, some valuers also consider state corporation law rights and restrictions as part of this element of the business/stock valuation. Such state corporation law rights may include rights related to voting, dividends, liquidation and so forth.

The ESOP valuation assignment should specify, and the ESOP valuation report reader should be made aware of, any such contractual rights or restrictions. This is because the appropriate consideration of such contractual rights and restrictions may have a material impact on the final employer corporation stock value conclusion.





# Understanding ESOPs & Their Use in Exit Planning Strategies

## *Standard of Value*

The standard of value required under DOL rules and ERISA Section 3(18)(B) is “adequate consideration” which is defined as a fair market value. In accordance with Section 3(18)(B) of ERISA and Treasury Regulation §2510.3-18, and specifically paragraph (b)(1)(B) of that regulation, adequate consideration is defined as the “fair market value” of the asset as determined in good faith by the fiduciaries. The term “fair market value” is defined, for this purpose as:

*“The price at which the property (the stock held by the ESOP) would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties having reasonable knowledge of the relevant facts.”*

In addition, court decisions frequently state that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well-informed about the property and concerning the market for such property.

Fair market value has been judicially and commercially defined to represent the price at which a willing seller and a willing buyer, both informed of the relevant facts about the business, could reasonably conduct a transaction, neither party acting under any compulsion to buy nor to sell. The definition of fair market value presumes that:

- The buyer and seller are both motivated to participate in the transaction;
- Both parties are well-informed or well-advised and each is acting in what he or she considers his or her own best interest;
- A reasonable time is allowed for exposure in the open market;
- Payment is made in cash or its equivalent;
- Financing, if any, is on terms generally available at the specific date and typical for the investment type; and
- The price represents normal consideration, unaffected by special financing amounts and/or terms, services, fees, costs or credits incurred in a market transaction.

## *Premise of Value*

The premise of value element describes the set of assumed circumstances under which the selected standard of value transaction will take place. In other words, assume that the selected standard of value is fair market value. The premise of value will describe under what set of transactional circumstances the subject operating business assets will be exchanged between the hypothetical willing buyer and hypothetical willing seller.

There are numerous alternative premises of value that may apply to ESOP employer stock valuation assignments.



## Understanding ESOPs & Their Use in Exit Planning Strategies

The five most common premises of value are:

- Value in continued use, as a going-concern business enterprise
- Value in place, but not in current use in the production of income
- Value in exchange, as part of an orderly disposition of assets
- Value in exchange, as part of a voluntary liquidation of assets
- Value in exchange, as part of an involuntary liquidation of assets

In most ESOP valuations, the subject Company is an operating entity. Therefore, the premise of value is generally “continued use” or “going concern.”

### *The Valuation Date*

The valuation date is often referred to as the “as of date” of the business valuation. The client typically determines the valuation date as part of the ESOP employer stock valuation assignment. This is an important element of the valuation because an employer Company’s business value can change materially over time. These changes in business value can result from factors that are either:

- Specific influences to the employer Company (i.e., changes in current operating results), or
- External influences on the employer Company (i.e., changes in the industry competition).

Obviously, the engagement client can select any date as the assignment valuation date. For ESOP valuation purposes, the appropriate valuation date is typically:

- A transaction date – for an ESOP transaction/financing valuation, or
- The employer corporation’s fiscal year end – for an accounting or regulatory valuation.

However, all possible valuation dates can be grouped into the following three categories:

- Contemporaneous date – the valuation date is contemporaneous with the valuator’s work. Most transactional valuations are performed on a contemporaneous basis.
- Retrospective date – the valuation date is historical compared to the valuator’s work. Most notational or litigation valuations are performed on a retrospective basis, generally because such valuations often relate to a specific historical event.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- Hypothetical date – the valuation date is sometimes in the future compared to the valuator's work. An analysis performed as of a future date will reflect an employer Company financial position that does not yet exist; thus, such business valuations are typically called hypothetical valuations.

### *The Report Date*

The valuation report date indicates the date on which the valuator completes and issues the written valuation opinion report. In the case of an oral report, the report date is the date on which the valuator presents the oral report – for example, the date that the valuator offers expert witness testimony.

The engagement client may request a certain report date as part of the valuation assignment. For example, the client may request that the valuation report be issued in time for the employer corporation to make a stock contribution to file an income tax return or to file a public report with the SEC. However, the actual report date is a matter of fact. It is the actual date on which the valuator completes and issues the ESOP valuation report document.

### *The Client/User of the Analysis*

The last two elements relate to the purpose of the ESOP employer stock valuation. The objective of the valuation indicates what the valuator intends to do in the analysis. The purpose of the valuation indicates why the valuator is performing the analysis.

The ESOP valuation report should specify (1) the party who retained the valuator (i.e., the ESOP trustee) and (2) any and all parties who may rely upon the value conclusion (i.e., the ESOP administrative committee and/or ESOP participants.) This disclosure is required by most established business valuation standards, including USPAP.

Regardless of a particular disclosure requirement, it is appropriate to let the report reader know who retained the valuator. This fact may influence the degree of reliance that the report reader assigns to the valuation report (and to the value conclusion.) It is also appropriate for the report reader to know who may (and may not) rely on the ESOP employer stock valuation report. This disclosure informs the report readers whether or not they may specifically rely on the valuation analysis. This disclosure also protects the valuator. The valuator should not have a duty to any party to whom the valuation report was not intended.

### *The Intended Use of the Analysis*

The disclosure of this element of the valuation benefits both the report reader and the valuator. And, the disclosure of the intended use (or uses) of the valuation is required by most established business valuation standards, including USPAP. The report reader should be aware of intended use of the valuation.



## Understanding ESOPs & Their Use in Exit Planning Strategies

This disclosure may influence the report reader's degree of reliance on the valuation. If a valuation is prepared for purpose A (i.e., an ESOP formation and employer corporation stock purchase), then the report reader should not rely on that valuation for purpose B (i.e., the substantiation of a charitable contribution tax deduction.) This is because the two purposes may involve different standards of value, different premises of value, different regulatory requirements and different value conclusions. Likewise, this disclosure also protects the valuator. The valuator should not have a duty to a client who uses the valuation for purpose A, when that valuation was specifically prepared for purpose B.

### Other Unique ESOP Valuation Issues

#### *Repurchase Obligation Liability*

As discussed in detail in Chapter V, the repurchase obligation liability refers to the requirement that the sponsor corporation (not the ESOP) buy back the shares of stock in a privately-held Company at certain points in time. This liability is, in a sense, fixed by a virtue of the annual valuation and the employee census data relating to timing expectations with respect to their "put option." Internal Revenue Code Section 409(h)(1)(B), known as the "put option requirement," places an obligation on a closely-held sponsor Company (with stock that is "not readily tradeable on an established market") to buy back the shares of stock distributed by an ESOP to departing employees.

This requirement reveals three important facts:

- The repurchase obligation does not apply to publicly-traded sponsor companies
- The obligation is greatly affected by the distribution provisioning of the subject ESOP documents
- The ESOP trustee may repurchase employer corporation shares, but the ESOP trustee cannot be forced to do so (i.e., the ultimate obligation lies with the employer corporation)

As previously noted, ESOPs are generally required to distribute benefits by the close of the fifth plan year following the plan year of the termination of employment; or, the close of the plan year following the plan year of termination due to death, disability, or normal retirement. Code Section 409(o)(1)(B), however, allows the ESOP to defer distribution of shares purchased with an ESOP stock acquisition loan until the loan is fully repaid.

Another source of the repurchase obligation is the diversification requirement of Code Section 401(a)(28). Once a participant has reached age 55 and completed 10 years of participation in the ESOP, the participant must be given an opportunity to liquidate 25% of his/her employer stock holdings in the ESOP. An additional 25% can be diversified six years later. Please note, pursuant to Code Section 401(a)(35) and Notice 2013-17, certain rules apply to deferred contribution plans that include investments in publicly-traded employer securities.



## Understanding ESOPs & Their Use in Exit Planning Strategies

A variety of methods may be used to reflect this repurchase obligation liability in the valuation of the sponsor Company's stock. A sample of these methods is included below.

- *Increase the amount of projected future working capital to reflect the repurchase liability* – in so doing, the net result is a reduced amount of future free cash flow.
- *Increase the discount rate used in the Income Approach* – the discount rates should be higher due to unpredictable future revenues and earnings. This adjustment will reduce the present value of future discounted cash flows, and as a result, reduces current stock price.
- *Moderate future growth rates* – as ESOP Company value grows so do repurchase liability costs. The growth of a Company with an ESOP (as compared to an otherwise identical Company without an ESOP) will be moderated by the growth of its repurchase liability.
- *Reduce the earnings multiple used in the Market Approach* – applying a lower multiple to earnings when performing an appraisal will reduce the Company's current stock price.
- *Increase the discount for lack of marketability* – if the Company has sufficient resources to fund the put option, marketability is increased; however, a higher discount factor may be used to reflect the unpredictability of the repurchase liability obligations. See next section for more detail relative to marketability issues.
- *Make adjustments to historical and/or projected employee benefit expenses* – contributions made by the Company (either stock or cash) to implement a recycling strategy can be deductible (within limits) as employee benefit expenses. Adjustments made to reflect these expenses will result in a reduced stock price.

### *Marketability*

Marketability of a privately-held business ownership interest reflects a real risk within the economic markets. Such risk is characterized by the inability of the holder of the interest to quickly liquidate the interest or convert his or her investment to cash. Unlike publicly-traded equity interests, where the holder can quickly make this conversion via broker trades in the public stock market in approximately three days, a sale of a privately-held business interest could require an extended period of time, often in excess of one year.

The basis of marketability discounts is founded on the fact that an investment that is easily marketable is also more valuable, when all other factors are equal. Additionally, the methods applied in valuing privately-held entities generally result in an indication of value associated with that of a publicly-traded security.





## Understanding ESOPs & Their Use in Exit Planning Strategies

There is empirical data derived from discounts on sales of restricted shares of publicly-traded companies, which assists the appraisers in quantifying the discount required for lack of marketability as it relates to minority interests. The studies on marketability discounts have limited use in the context of ESOP valuations because the participants' put right under ERISA creates a market for the stock. DOL regulations require consideration of the extent to which the put rights are enforceable and the ability of the Company to meet the repurchase obligation. Other relevant factors include the past practices in the repurchases by the Company and the form and timing of payments.

There is a lack of empirical data to assist in the determination of the level of the discount for lack of marketability in the context of an ESOP. The determination includes a degree of valuator judgment based upon the facts and circumstances of the subject shares.

### Conclusion

Due to the numerous factors discussed in this section, it is easy to understand why a quality valuation is required and, further, why experienced valuers will serve best to protect the fiduciaries from scrutiny and challenges by plan participants.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## Chapter VII – *Examples*

The concepts and theory discussed through the course of today's program can be illustrated with the use of a few examples. While each transaction is different and contains any number of variations depending on facts, circumstances and planning strategies, the core fundamentals can be easily demonstrated.

The series of examples set forth in this chapter are intended to illustrate the economic impact of an ESOP transaction on the current shareholder/owner of the sponsoring corporation over an extended reinvestment period, the "annual" and cumulative operational impact of sponsor Company funding of the ESOP liability and, finally, the impact of having the ESOP deferral maintained until death of the selling shareholder.

### Economic Impact of an ESOP Transaction for a Selling Shareholder

*The following facts apply to Exhibit I:*

- Martin Miller owns 100% of the outstanding capital stock of AXIS Corporation, a Pennsylvania corporation taxed under subchapter C of the Internal Revenue Code. At age 56, Miller has decided that the time has come to consider selling his business. For personal reasons, he would like to continue working but is not certain that he wants to work for another company after he sells.
- Miller has had two competitors contact him in the last several years to determine if he might be interested in selling the Company. Thinking, now, that a current sale to one of these parties might carry with it the obligation for continuing as an employee of the acquirer for some period of time, he is seeking a way to monetize at least some portion of his personal net worth tied up in the Company.
- The fair market value of AXIS has been preliminarily estimated at \$10,000,000. From preliminary discussions with the competitors who had expressed interest in the past, Miller recollects that the offer price, set a multiple of EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) was approximately \$12,500,000.
- Miller has requested that his advisor look at the best way to accomplish his goals and maximize his after-tax proceeds. For illustration purposes, the advisor recommends looking at the "real" net proceeds under three alternative scenarios. The first is a taxable asset acquisition transaction at \$13,500,000, a taxable stock transaction at \$11,500,000 and a sale to a newly-formed leveraged ESOP at \$10,000,000.
- For simplicity and ease of comparison and understanding, it is assumed that the AXIS basis in its assets is \$2,000,000, and that Miller's basis in his stock is zero.



## Understanding ESOPs & Their Use in Exit Planning Strategies

### Exhibit I – Analysis of Taxable Asset and Stock Sale vs. ESOP

	<u>Sale of Assets</u>	<u>Sale of Stock</u>	<u>ESOP</u>
Corporation Calculation			
Net Proceeds	\$ 13,500,000		
Corporate Basis in Assets	(2,000,000)	-	-
Corporate Level Gain	11,500,000		
Tax at 40%	4,600,000	-	-
Proceeds after Corporate Tax	<u>\$ 8,900,000</u>	<u></u>	<u></u>
Individual Calculation			
Shareholder Proceeds	\$ 8,900,000	\$ 11,500,000	\$ 10,000,000
Shareholder Basis	<u>-</u>	<u>-</u>	<u>-</u>
Shareholder Level Gain	8,900,000	11,500,000	10,000,000
Tax at 20%	(1,780,000)	(2,300,000)	-
NET CASH TO OWNER	<u>\$ 7,120,000</u>	<u>\$ 9,200,000</u>	<u>\$ 10,000,000</u>

As can be observed from the analysis, the tax deferral afforded by Miller selling the stock to an ESOP is a very powerful economic tool. Even though there are premiums paid in the open market for controlling business equity interests, and oftentimes these premiums can be substantial (in this example, \$3.5 M greater for the purchase of the assets), the current income tax regime in the United States not only erodes the entire purchase price premium, but also serves to diminish even a portion of the proceeds to below the level of value permitted under the ESOP rules – fair market value. Thus, even if there is a taxable sale of the stock (an unlikely scenario, given current market conditions) at a 15% greater sales price than that allowed under the ESOP rules, at a 20% capital gains tax rate, the entire premium “plus” is paid on the transaction, thereby netting 8% less to the owner.

Assuming the proceeds are invested in qualifying replacement securities in investments generating a simple return at 4% a year, the investment earnings would be as illustrated in Exhibit I-A on the following page.



## Understanding ESOPs & Their Use in Exit Planning Strategies

Note that difference in after-tax cash proceeds to Miller in an asset transaction (the most likely transaction structure to an outside party) is \$7,120,000. That amount represents a gap of \$2,880,000 that could be obtained from the ESOP transaction. This difference grows to \$6,401,037 over a 20-year investment horizon at 4% percent annual return.

The \$800,000 difference in net after-tax proceeds in a taxable stock acquisition is less tax-intensive, but even at that level, the compounded results under the same assumptions grow to \$1,778,666 (\$22,225,821 less \$20,447,155).

### *Exhibit I-A – Analysis of Investment Return over 20 Years*

	<u>Sale of Assets</u>	<u>Sale of Stock</u>	<u>ESOP</u>
NET CASH TO OWNER	<u>\$ 7,120,000</u>	<u>\$ 9,200,000</u>	<u>\$ 10,000,000</u>
Principal Balance at the End of 20 Years	<u>\$ 15,824,784</u>	<u>\$ 20,447,155</u>	<u>\$ 22,225,821</u>
Assuming 4% return compounded monthly			

The economic power of the compounding attributes in respect to investor returns on the receipt of after tax proceeds must be part of the overall consideration of using an ESOP.

### Selling a Partial Interest to an ESOP

#### *The following additional facts apply to Exhibit II:*

- Continuing to build on the facts listed above, Miller is very interested in the potential deferral of income tax afforded by the availability of the ESOP transaction. He has decided that it is even more attractive, in that this avenue offers him a chance to diversify his estate and, at the same time, keep working. It also allows him to guarantee the future careers of his employees. He also sees the ESOP as a mechanism for growing employee morale and dedication to the Company's long term goals.
- As the transaction unfolds, Miller has decided to look at initially selling 30% of the shares to the ESOP in an initial transaction, thereby allowing him to continue in his current position. His current thinking is that once the debt is satisfied on the initial 30% interest, he will enter a second transaction to sell another substantial interest to the ESOP, so long as Company cash flows have the capacity to sustain the debt service through pension contributions.



## Understanding ESOPs & Their Use in Exit Planning Strategies

- A sale of shares to the ESOP at 30% also allows for a more comfortable debt service obligation on the part of the Company. Assuming that the ESOP is structured so that the 30% interest is valued at \$3,000,000, annual debt service from the ESOP would approximate \$510,000 a year (assuming a 5% interest rate compounded monthly on a seven-year note). The debt service includes both interest and principal.
- At the present time, compensation qualifying for pension contributions under the plan is estimated at \$3,000,000. Since the allowable pension contribution is 25% of qualifying compensation, the maximum allowable annual pension contribution to the plan is \$750,000. Thus, the limitation imposed on amounts contributed to the ESOP allows room for variations in the details as the feasibility study is completed and the final plan is adopted.

Looking at the “net” after tax cost of contributing pension payments to the ESOP in an amount sufficient to meet debt service needs on the ESOP loan, it is easy to observe the benefit of being able to deduct both the interest and the principal.

### ***Exhibit II – Analysis of Tax Savings Associated with Annual Pension Contributions***

	Annual	Total
PENSION CONTRIBUTIONS	\$ 510,000	\$ 3,570,000
Effective Tax Rate	40%	40%
Tax Savings	204,000	1,428,000
NET COST TO COMPANY	<u>\$ 306,000</u>	<u>\$ 2,142,000</u>
Normal Debt Comparison		
Interest - Total		\$ 570,000
Effective Tax Rate		40%
Tax Savings		228,000
Gross Principal Cost		3,000,000
NET COST TO COMPANY		<u>\$ 3,228,000</u>

As can be seen in the above exhibit, the ability to deduct both principal and interest via the sponsor Company annual pension contribution serves to fund 40% of the entire transaction costs, while traditional buyers of the same





## Understanding ESOPs & Their Use in Exit Planning Strategies

stock interest (or the Company in a non ESOP stock redemption scenario) would cost an additional \$1,086,000 in real dollars to accomplish the same transaction outcome. As noted earlier, the tax savings associated with ESOPs leverage debt service is one of the very few places in the Internal Revenue Code that allows such beneficial treatment.

### Assessing ESOP Permanent Deferral of Income Tax

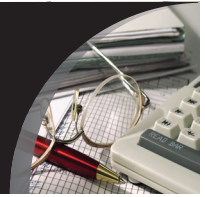
An important practical consideration of ESOP planning is that associated with the IRC section 1042 deferral and the possibility of avoiding the entire tax liability permanently by retaining investment strategies in qualifying replacement property. While payment of income taxes well into the future (Miller is 55 years old) is economically better than paying those same taxes now, given time-value of money concepts, an even better answer is to avoid income taxes altogether.

The key concept in consideration of this planning idea is to understand that while the income tax liability on the sale of AXIS Corporation stock can escape capital gains taxation forever, the funds associated with the payment of taxes that were saved due to this strategy will serve to increase the taxable estate of the selling shareholder. As such, the net savings is somewhat less than the gross tax impact.

#### *Exhibit III – Income Taxes versus Estate Taxes*

Gain on Sale of Stock to the ESOP	<u>\$ 3,000,000</u>
Date of Transaction Tax Liability (Deferred)	600,000
Estate Tax Rate (estimated)	<u>35%</u>
Estimated Estate Tax	210,000
Net Benefit of Permanent Deferral	<u>\$ 390,000</u>
Present Value at 4% at 25 Years	<u>\$ 146,296</u>

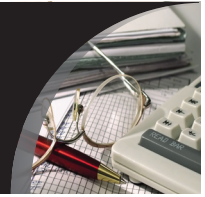
As can be noted from a review of the illustration above, the tax savings associated with permanent deferral is an important element of the ESOP consideration process. However, due to present-value mechanics and the time-value of money, the significance of this benefit is not as great as many of the other attributes associated with the use of an ESOP. The calculation will vary and gain greater economic significance as total proceeds grow (i.e., a greater deferral under IRC section 1042), and as the age of the selling shareholder(s) increase.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## Summary

There are any number of examples that can be devised to illustrate the many benefits associated with the use of an ESOP to accomplish a variety of goals and objectives. Many of these will, at the end of the day, be case-specific, and that is the reason that a careful and thorough planning and feasibility process must be undertaken prior to adopting an ESOP. As can be seen from these examples, and others throughout the program materials, there are as many substantial economic benefits as there are non-economic benefits in using an ESOP.



# Understanding ESOPs & Their Use in Exit Planning Strategies

## *Conclusion and Practical Considerations*

As can be observed from today's discussion, employee stock ownership plans (ESOPs) can provide shareholders, companies and employees with incredible tax and economic benefits not otherwise attainable under United States tax law and other transaction strategies. Unfortunately, the idea of adopting an ESOP is often dismissed as being too complex and expensive to undertake and operate. While there is a substantial initial investment, dismissing the viability of this strategy prior to undertaking a well-thought-out feasibility study is to eliminate what might be the best possible solution to many different concerns and problems.

Other sale, disposition and diversity alternatives are not particularly simple in their own right and often result in substantial professional costs incurred for legal, accounting and valuation services. The value of these costs, in the realm of ESOP planning, or some other alternative, should be made clear to selling shareholders and business owners. A business that has taken a lifetime to build should not be transferred without great care and consideration of all viable opportunities. ESOPs are no exception.

Note that the authors of this program realize, and embrace, the precept that a decision as serious as moving forward with an ESOP as an exit strategy requires a team approach. To that end, we view our role in support of legal counsel to be advisory in nature – assisting with consultative matters relating to plan design, feasibility, valuation and compliance. In this way, the coordinated efforts of our partnership with the legal community serves to ensure that the client receives the highest level of service possible, with all due consideration.

As noted at the beginning of this program, today's session is not intended to be a complete discussion and conversation on every aspect of the consideration and implementation of an ESOP. It is our hope, however, that everyone, no matter your experience level, is able to take some information away from the program which will prove valuable and helpful in your practices as you visit with clients now and in the future.

Grossman Yanak & Ford LLP continues to grow by referrals from our clients and friends. We respectfully request that you keep us in mind in the event you encounter a client in need of quality accounting, tax, technology, valuation or litigation support services. We will always do our very best to ensure that the needs of your referral are not only met, but exceeded, and that your referral of our Firm reflects positively on you.

We hope to have the opportunity to work with you in the near future. If you have questions regarding any of the information which was shared with you today, please feel free to contact either Bob Grossman or Melissa Bizyak.

Thank you for attending today and we hope to see you again at future seminars!