Attorney
CLE Series

Special Purpose Valuations

UNDERSTANDING THE NUANCES OF VALUATION IN THE CONTEXT OF ESOPs AND BUY-SELL AGREEMENTS

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GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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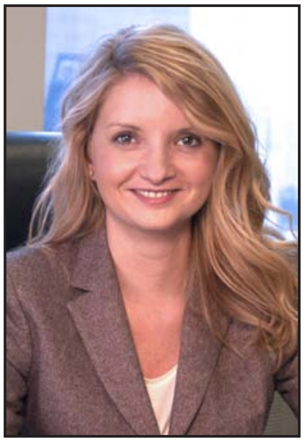

Melissa has practiced in public accounting for over 19 years and has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Melissa's business valuation experience is very diverse, including valuations of professional practices, as well as companies 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.

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

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

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

Chapter I – *Introduction*

Employee Stock Ownership Plans, more commonly referred to as ESOPs, are qualified retirement plans designed to invest primarily in the stock of the companies that adopt and sponsor the plans. The underlying theme behind the creation of ESOP legislation is that by participating in these plans, over time, employees can become their own employers and share in the capital appreciation of their companies.

Probably the easiest way to understand how an ESOP works 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 company makes to an ESOP are deductible (within limits), and income earned by an ESOP is exempt from tax. Further, participants in an ESOP do not recognize any taxable income as a result of employer contributions or earnings on their accounts until their benefits are withdrawn from the plan. The critical factor that distinguishes an ESOP from other types of employee benefit plans is that the funds of an ESOP are invested primarily in the stock of the sponsoring employer, while other employee benefit plans invest in stocks and bonds of other companies.

Most of the guidance enabling the use of ESOPs in the United States is contained in the Internal Revenue Code of 1986, as amended (IRC), and the Employee Retirement Income Security Act of 1974 (ERISA).

From an historical perspective, ESOPs developed almost solely as a product of the self-developed economic theories and vigorous lobbying of a single, now semi-obscure, private individual. In the middle of the last century, Louis O. Kelso, a lawyer in San Francisco, became convinced that (1) in general, the economic value of any given worker's labor would be insufficient to support a living wage for that worker; (2) as a result, it was essential to encourage more widespread ownership of capital among laborers as a means of providing them with supplementary income; and (3) a good way to accomplish that goal was by encouraging investment by employee retirement plans in stock of the participant's employers.

Kelso publicly advanced these view over 50 years ago, in 1958, in the book The Capitalist Manifesto, which he co-authored with Mortimer Adler. The title suggests the authors' ambitions. Like Karl Marx, Louis Kelso believed he had stumbled upon a profound, previously unrecognized scientific truth that had the power to explain every economic problem and raise working people from poverty; the only difference was the prescription. "It's one of the most important discoveries in the history of mankind," he once told a reporter. In The Communist Manifesto, Marx had demanded an end to capitalism, whereas in The Capitalist Manifesto, Kelso demanded more of it.

Kelso quit his law job, formed a consulting firm, and from 1958 until his death, devoted most of his time to promoting ESOPs. It was an uphill battle. In 1958 – and now, and at all times in between – the reaction of mainstream

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

economic academia to Kelso's theories has been one of annoyed contempt. Kelso seems to have been one of those people, however, with a level of self-certainty that renders them impervious to rejection.

Kelso kept trying, and in 1973 he experienced the kind of breakthrough very few academic economists ever will; he convinced the Chairman of the Senate Finance Committee of the rightness – in fact, of the urgent importance – of his views. Such was the power at the time of the Senator, Russell Long of Louisiana, that the day after his meeting with Kelso, an ESOP provision was inserted into the Railroad Reorganization Act, on the fast track to enactment.

With a proper understanding and astute planning at the front of an ESOP transaction, users will find that this technique and its accompanying strategies can provide a number of sophisticated and economically beneficial business solutions to a broad array of issues and problems for employers and employees alike.

Today's program will serve as a refresher for many of today's participants, while a number of the attendees will encounter some new information. As with all of our seminars, it is our hope that everyone will be benefit in some way from attending, and that each of you will be able to return to your practices with a better understanding of those nuances that should merit your attention and consideration in advising your clients on topics related to valuation.

We do appreciate that you have taken time from your busy schedule to join us today and also thank you for your attendance at the Grossman Yanak & Ford LLP Continuing Legal Education series. Our seminars have proven to be a great success, and we hope that you also find the content to be informative and helpful.

Should you have further general questions or a specific concern, please feel free to contact us directly.

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Special Purpose Valuations: ESOPs and Buy-Sell Agreements

Chapter II – *ESOP Mechanics*

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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, 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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).

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- 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 lessor 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- *Key point:* 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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 lessor 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 <u>does</u> 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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 divided 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

  <u>EXAMPLE: Selling stock to the ESOP with IRC Section 1042 – One Shareholder</u>

  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

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

- *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.

<u>QRP transaction documentation</u>

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, 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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 participants, 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)

	C Corporation	*S Corporation*
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	$ 650,000	$ 1,000,000

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- ***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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

ESOP Summary Chart Comparing C Corporation and S Corporation Tax Provisions

	C Corporation	*S Corporation*
Payroll contribution deduction	25% eligible compensation. Excludes elective contributions to 401(k).	25% eligible compensation. Excludes elective contributions to 401(k).
ESOP loan interest deduction	Not counted against 25% eligible compensation.	Yes, it is counted against 25% eligible compensation.
Dividend deduction	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.
IRC Section 1042	Yes, tax deferral election permitted. Several restrictions apply to relatives and 25% owners.	Not available.
Classes of stock	Multiple classes available. May use a separate class of stock for ESOP to enhance dividend deduction.	Single class of stock.
Attributes of ESOP stock	Must have highest voting and dividend preference.	Must have highest voting and dividend preference.
Number & type of shareholders	Unlimited number, few shareholder restrictions.	Maximum is 100 (ESOP counts as 1). Restrictions on type of shareholders.
Federal income taxes	Paid by company.	Paid by shareholders. ESOP as a shareholder is not subject to income tax.
ESOP anti-abuse provisions	Not applicable.	Substantial penalties if ESOP is determined to violate Federal statutes.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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-

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

Chapter IV – *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. The

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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
- pay/not pay dividends
- buy/sell assets
- start/discontinue a product line
- hire/fire employees
- borrow/pay down a loan
- merge/liquidate the company
- 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 valuators 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- 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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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

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."

The repurchase obligation originates with Internal Revenue Code – specifically, Code Section 409(h)(1)(B), which states in part:

> *"(If) the employer securities are not readily tradeable on an established market, (the participant) has a right to require that the employer repurchase employer securities under a fair valuation formula."*

This is known as the "put option requirement." This requirement places an obligation squarely on the shoulders of 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)

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.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

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.

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 valuators will serve best to protect the fiduciaries from scrutiny and challenges by plan participants.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

Chapter V – *Buy-Sell Agreements*

The use of buy-sell agreements has become commonplace in conjunction with the formation of most businesses. They are important, as they represent an agreement between the company and its owners regarding how future transactions contemplated by the agreement will occur. In undertaking the process of drafting a buy-sell agreement, it forces all parties to the agreement to have an understanding of the nature of the agreement, its provisions, and how certain mechanisms will work in the future, and how it impacts each party. At the time of executing the agreement, no one knows who will be the buyer and who will be the seller. The general definition of a buy-sell agreement follows:

> *Buy-sell agreements are agreements (contracts) by and among the shareholders (or equity partners of whatever legal entity) of a business and, perhaps, the business itself. They establish the mechanism for the purchase of equity interests following the death (or other adverse or significant changes) of one of the owners. In the case of corporate joint ventures, they also establish the value for break-ups or for circumstances calling for one corporate venture partner to buy out the other partner.*[1]

Triggering Events

As members of the legal community, you understand that it can be difficult to bring your client on board with drafting a buy-sell agreement. After the initial transaction or formation of the business, there is a reluctance to spend more funds on legal fees and even more reluctance to discuss mortality, potential fall-outs, retirement or disability.

Buy-sell agreements include mechanisms for buying and selling equity interests upon a "triggering event." Triggering events typically include leaving the business (quitting or termination), retirement, death and disability. If all parties agree, the agreement can also encompass divorce, declaration of insolvency or bankruptcy. In the event of divorce, the agreement could prevent the non-employee spouse from gaining any stock ownership. Also, if a partner/shareholder declares bankruptcy or becomes insolvent, the company may exercise its right to purchase the stock to prevent dispersion to creditors.

Benefits of Buy-Sell Agreements

There are many motivations to adopt a buy-sell agreement, including the following:

- It allows for an orderly transition of ownership at certain terms, if specifically-identified events (triggering events) occur, by setting the purchase price or formula for determining the price.

[1] *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?*, Z. Christopher Mercer, p. 3

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- It provides a guaranteed market for an ownership interest upon occurrence of a triggering event.
- Clarity in the agreement minimizes potential need for adversarial legal intervention.
- Funding mechanisms may minimize the business or purchasing owner's stress relating to payment for the selling owner's interest.
- Having the agreement in place provides income protection and financial security.
- It provides protection from sharing control of the business with an inexperienced or untrustworthy outsider.
- It can provide certainty and continuity.

Detriments to Buy-Sell Agreements

The lack of clarity relating to any number of provisions in a buy-sell agreement can lead to owner disappointment, controversy, and even litigation. It may be discovered upon a triggering event that there is a conflict between the language in the agreement and the intentions of the parties. It is critical for all parties to the agreement to understand how the agreement will operate in order to determine prices and terms for future transactions.

The funding device is critical to the parties' ability to transact the repurchase envisioned in the agreement. Often times, too little focus is provided to this aspect of the buy-sell agreement. There are three common funding mechanisms including insurance, sinking funds and pre-agreed payment terms. What happens all too often is that the amounts of the funding mechanisms are not adjusted as value changes, leading to issues upon a triggering event.

As we will address in this presentation, a routine valuation matter could turn into a very high-anxiety and intense experience for all parties involved. It is always best practice to have the valuation-related language in a buy-sell agreement reviewed by a qualified business appraiser.

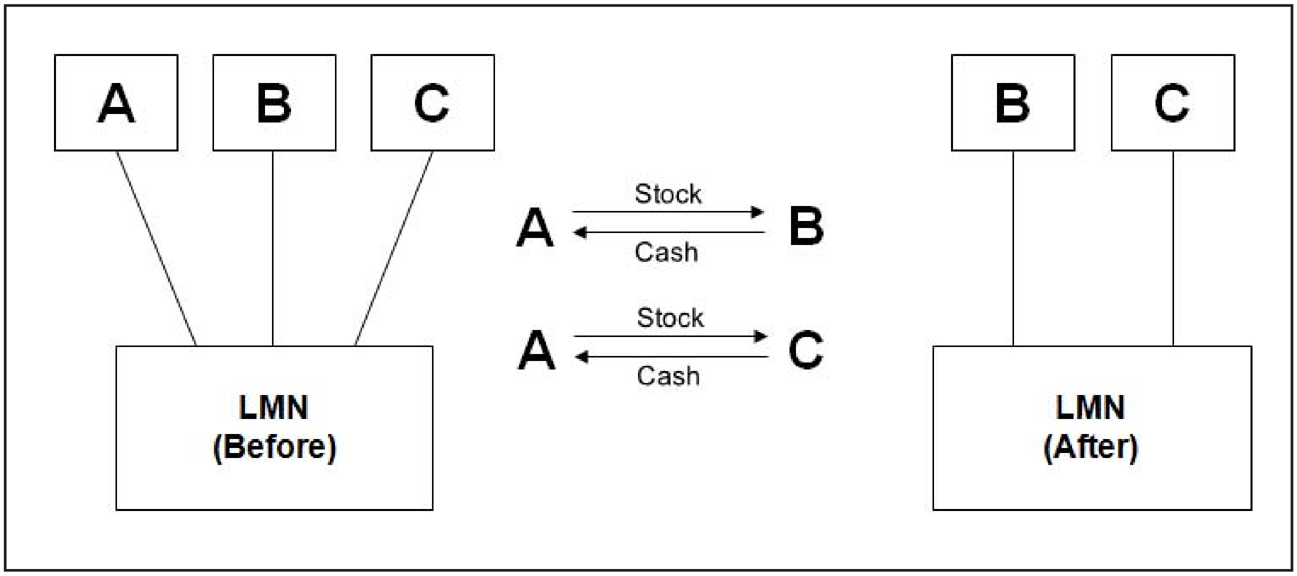
Categories of Buy-Sell Agreements

There are generally three categories of buy-sell agreements including cross-purchase, redemption (or entity-purchase) and hybrid agreements.

A ***cross-purchase agreement*** is one that is structured to allow non-selling owners to purchase selling owner's interests, subject to the buy-sell agreement, upon the occurrence of a triggering event. Cross-purchase agreements are often funded by life insurance, which is owned by partner(s)/shareholder(s) on the lives of other partner/shareholders. A cross-purchase agreement becomes difficult and eventually unworkable as the number of partner/shareholders and market value increases.

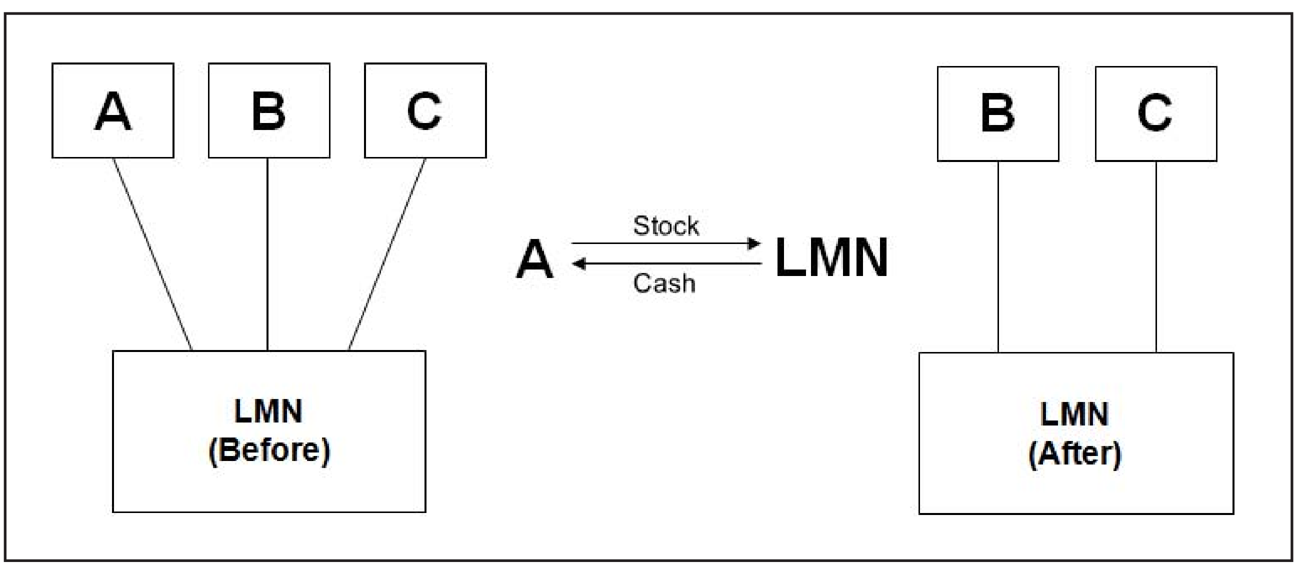
Special Purpose Valuations: ESOPs and Buy-Sell Agreements

The following illustrates the structure of a cross-purchase agreement for LMN Company:



A ***redemption or entity-purchase agreement*** is structured to allow the business to purchase (redeem) the selling owner's interest upon the occurrence of a triggering event. Under this structure, the company is responsible for defining and providing the funding mechanism, which may be the purchase of life insurance, financing by a third party or the selling owner, cash on hand, or a combination of these.

The following illustrates the structure of a redemption agreement for LMN company:



Special Purpose Valuations: ESOPs and Buy-Sell Agreements

Hybrid agreements are typically structured for the company to have the right of first refusal (ROFR) to purchase the selling owner's shares upon the occurrence of a triggering event. If the company declines to purchase the shares, it may have the right to offer the selling owner's shares to the other owners on a pro rata basis or to selected shareholders. Hybrid agreements often give the company a final option to purchase the shares, if they are first refused and other shareholders do not wish to purchase the shares. These agreements are generally used to facilitate non-pro rata changes in relative ownership of the company. Funding a hybrid agreement can be through a combination of life insurance, notes from the selling shareholder, and financing by the company.

Valuation Elements of Buy-Sell Agreements

When a business valuator is engaged to determine the price of the selling owner's shares, certain areas must be addressed in the buy-sell agreement to provide proper instruction to the valuator. The more an agreement elaborates on the following, the less likely uncertainty and controversy will result.

Standard of Value

In order to determine the value of the subject shares, the meaning of *value* must be clearly defined in the buy-sell agreement. These provisions in the agreement are normally binding on business valuators who prepare valuations in accordance with them. In circumstances where the standard of value provision in the buy-sell agreement is not clear, the valuator may be placed in the unfortunate position to interpret what the words mean, or the parties involved will be required to agree on a standard of value to provide instruction to the valuator. Further, valuators placed in the position to determine what the language means in the agreement, may differ in their interpretations.

There are numerous definitions or standards of value including fair value, fair market value, investment value and intrinsic value. The most common standard of value is "fair market value."

This standard is applied in income, estate and gift tax, divorce[2] and, often, non-shareholder oppression litigation. Fair market value is defined in the United States Treasury regulations (20.2031-1(b)) and Revenue Ruling 59-60, 59-1 CB 237 as:

> *"the price at which the property could 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, both parties having reasonable knowledge of relevant facts."*

[2] Many states use the term "fair market value" in their marital dissolution cases. The definition of fair market value may vary from state to state and will not necessarily be the same definition applied for federal tax purposes.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

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.

The definition of fair market value requires that the valuation result be driven by a hypothetical sale transaction. Given the required consideration of a hypothetical sale, it stands to reason then, that focus and attention must be given, by a valuator, to those hypothetical buyers and sellers and types of concerns and issues a potential hypothetical buyer and seller might consider prior to entering into a transaction.

In the definition of fair market value, the "hypothetical buyer" is a critical consideration. As fair market value is clearly understood to be a "financial" value without strategic buyer considerations, it is commonly and widely held within the business valuation community that this is a "non-strategic" value. As a result, the potential hypothetical buyer does not come from a specific, strategic investment group, nor is any single specific buyer relevant. Rather, a broad universe of typical potential buyers must be considered so as to drive an overall financial value, without the taint of certain specific buyer motivations or synergies that might drive the value to a strategic standard of value.

Fair value is the applicable standard of value in nearly all states in matters pertaining to rights of shareholders under dissenters' right statutes. The Uniform Business Corporation Act (UBCA) defines fair value as follows:

> *"Fair value with respect to dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."*

When fair value is defined in a particular state's statutes, it must be interpreted judicially. Valuators will look to legal counsel to provide interpretation as to the type of value that the courts have described in relevant case law.

The fair value standard is also associated with financial statement reporting. The definition and relevant considerations are contained in accounting pronouncements. This fair value standard is not typically used in the context of buy-sell agreements.

Investment value is the value of the shares from the perspective of a specific buyer. The motivations of the specific buyer must clearly be defined. Differing interpretations of these motivations can lead to large variances in value between valuators.

The following are some examples of language contained in buy-sell agreements that have presented us with issues in performing a valuation:

- *"The value of the departing shareholder's shares will be determined based upon the market value..."*

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

- *"Value will be determined based upon the fair market value of the shares, which will be the shareholder's pro rata interest of the enterprise value of the Company."*
- *"The departing shareholder shall be bought out at the current value of his or her shares."*
- *"The price will be determined based upon the fair value of the shares and consider applicable discounts for lack of control and lack of marketability."*

Having ambiguous language, regarding the definition of value in a buy-sell agreement, can lead to disagreements upon a triggering event at which time the parties involved are in an emotional state. As noted herein, having a qualified valuator review valuation-specific provisions in the agreement prior to any event, will prevent most, if not all, disagreements when it is time to rely on the document.

As of Date

The "effective date" or the "as of date" is the specific point in time as of which the valuator's opinion of value applies.[3] The "as of date" is extremely important, as all relevant information, including company financial data, industry and economic data, will be from the perspective of this date. Any event occurring thereafter is not typically considered unless it was reasonably known or knowable as of the effective date of the valuation.

Issues can arise when there is a significant change in a business subsequent to the effective date. The party benefiting from the post date of the valuation event may put forth the argument that the event or circumstance was reasonably knowable at the date of valuation.

All parties should clearly define the "as of date" from which the valuation will be prepared. Due consideration should be given not only to the date of the triggering event, but also to the availability of reliable financial information. For instance, an agreement can specify the month end, quarter end or year end prior to the triggering event.

Level of Value

This element of the buy-sell agreement is often the most misunderstood. Confusion over the level of value required in the valuation can result in a conclusion that is either too high or too low.

The levels of value concept contemplates the broad spectrum of ownership characteristics generally associated with the attributes of control and marketability. Across this spectrum of ownership characteristics attributable to a specific block of equity ownership, it is commonly accepted that an ownership of a block size sufficient to provide the holder with

[3] American Society of Appraisers Business Valuation Standards, 2009, Glossary

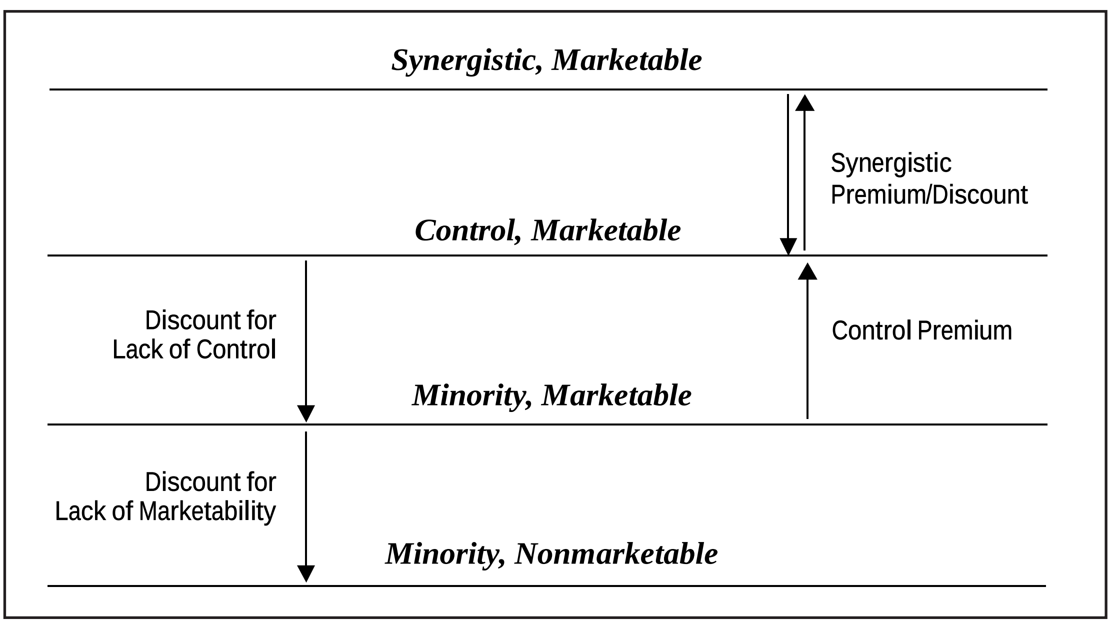
Special Purpose Valuations: ESOPs and Buy-Sell Agreements

the ability to invoke control owner's initiatives, thereby altering the course of the business's operations, is significantly more valuable than an ownership interest that does not provide the holder with control. Likewise, an equity ownership interest that is able to be quickly converted to a more liquid asset or cash is assumed to be considerably more valuable than an identical equity ownership interest for which no market exists, and for which a quick conversion to a more liquid asset or cash is not possible.

Historically, business valuation and finance professionals have assumed three basic levels of value:

- Control, marketable interest value
- Minority, marketable interest value
- Minority, nonmarketable interest value

Currently, the position of most valuators in the profession is that market observable control premiums include a synergistic or investment premium. Such thinking has led to an expansion of the traditional levels of value model, as illustrated below.



The key aspect of interpreting the expanded model of levels of value is understanding that the three levels from the traditional model are based upon a financial value, whereas the fourth level included in the expanded model is based upon strategic or synergistic value.

In most cases where the level of value is not clearly defined, the seller will look for a buy-out price that would reflect the amount expected to be received for the entire business upon a sale (at the strategic, control, marketable level),

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

following the rationale that sellers always look to maximize the proceeds. Obviously, this type of value would not be equitable to the remaining owners. Further, following this logic, rational buyers will be looking to minimize their cash outflow, and therefore seek a minority, nonmarketable level of value, which would not be equitable to the departing owner. There can be a large disparity between these values, and therefore, a consensus should be reached upon drafting the buy-sell agreement as to the level of value that will be determined by the valuator upon a triggering event.

Valuator Qualifications

The buy-sell agreement can name a specific firm and valuator to perform the valuation upon a triggering event, or it can list the specific minimum requirements for any valuator selected in accordance with the agreement. The valuator qualifications that may be considered include the following:

- Education;
- Training in the valuation discipline;
- Credentials held by the valuator;
- Specific valuation experience including valuing the type of business or industry for which the buy-sell agreement is being prepared; and
- Speaker or author of publications in the business valuation field.

There are quite a few credentials that a business valuator can obtain, all with varying experience, examination, and continuing professional education requirements. The following is a listing of credentials of which most qualified valuators will have two or three:

- *American Society of Appraisers* – Accredited Senior Appraiser (ASA) and Accredited Member (AM)
- *American Institute of Certified Public Accountants* – Accredited in Business Valuation (ABV)
- *National Association of Certified Valuators and Analysts* – Certified Valuation Analyst (CVA)
- *Institute of Business Appraisers* – Certified Business Appraiser (CBA)
- *CFA Institute* – Charted Financial Analyst

Having a qualified valuator selected, or including specific qualifications of a valuator in the buy-sell agreement, should minimize or eliminate the controversy over engaging a competent professional for the project. It is common for the buy-sell agreement to require one valuator to prepare the valuation for both sides (buyer and seller). However,

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

agreements can require a valuator for both the company and the departing owner, and in the event that the valuators arrive at opinions that are materially different, a third valuator will be appointed to settle the matter.

Examples of Problem Areas in Buy-Sell Agreements

The following section presents some examples where certain provisions (or lack thereof) in a buy-sell agreement led to uncertainty on the part of one or both parties. Oftentimes, as evidenced below, these circumstances potentially lead to litigation.

Typically, a court will follow the valuation mechanism depicted in the subject operating agreement in the event that the particular situation is addressed. Two 2006 court cases emphasized the fact that the courts will look to a buy-sell agreement's definition of value to help settle a dispute.

Matter of the Estate of Maurice F. Frink, No. 6-433 (Iowa App. October 25, 2006)

- The buy-sell agreement stated that the redemption of the decedent's stock be at "book value"
- Beneficiaries claimed that "book value" actually meant "fair market value"
- Court found that dictionaries consistently noted the difference between the two values
- Court also noted that the company had consistently utilized "book value," as defined under generally accepted accounting principles (GAAP), when it made redemptions in the past
- The court enforced the buy-sell agreement

Etienne v. Miller, No. F049110 (Cal. App. 5 Dist. October 23, 2006)

- Consideration was whether a buy-sell agreement between two brothers should be enforced against a trust holding the brothers' businesses and business interests
- The trust documents directly mentioned the obligations under the buy-sell agreement
- Beneficiaries argued that the enforcement of the agreements would create a significant federal estate tax burden because it provided for lower-than-market value prices
- The court found that the trustee should enforce the agreements as non-enforcement would negate the purpose of the trust

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

There are pros and cons with respect to using a formula valuation provision in a buy-sell agreement, such as book value. Advantages of using a formula include that they are relatively straightforward, easy to understand, and less expensive, in that there is less involvement of other professionals. The main drawbacks are that goodwill is excluded from the calculation, the potential that the company's accounting method includes unpaid liabilities, and that the parties' situations may have changed since the buy-sell agreement was initially signed.

Consideration should be given to the withdrawal of a member, partner or shareholder dissension, as any of these situations could be a triggering event for a buy-sell agreement. Take note of the following case in which a shareholder dissented over the formula valuation provision in the LLC agreement.

Tynes E. Mixon, III, M.D. v. Iberia Surgical, LLC, No. 06-878 (La. App. 3 Cir. April 18, 2007)

- Court determined whether an LLC member was undercompensated when the LLC repurchased his interest after he was expelled from the LLC
- The operating agreement stated that a member could only be expelled upon a unanimous vote by all other members:
  - In the event of expulsion, that member's shares would be repurchased at fair market value as illustrated in agreement exhibit
  - Agreement exhibit showed that book value meant fair market value
- Accountant computed a book value of Mixon's interest at $71,357
- Mixon appealed and obtained his own CPA to value his interest
  - CPA used a 9.89 net income multiple to compute a $483,100 value
  - CPA argued that book value and fair market value are not the same
- Court agreed that book and fair market value are not the same, but parties signed agreement defining fair market value as book value
- Court rejected Mixon's appeal and sided with the Company (and operating agreement) as Mixon never contended that the book value was improperly calculated

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

The following case addresses the potential problems that can occur when a triggering event, a divorce, is not addressed in a buy-sell agreement.

In re the Marriage of Barnes, No. 2006AP3020-FT (Wis. App. May 17, 2007)

- Husband was general partner, and parents were limited partners
- Parties' interest in a LLP under the withdrawal provision of the partnership agreement rather than the dissolution provision also contained in the agreement
- Agreement contained a clause noting that in the event of a withdrawal by a partner, the limited partner would receive a return of capital of $250,000
- In the event of a dissolution, the limited partner was to receive a return of capital of $300,000
- Agreement did not outline how partner interests were to be handled in the event of a divorce
- The trial court adopted the wife's position, valuing the business as if a partner had withdrawn; husband appealed
- Appellate court confirmed the trial court's decision and noted that the partnership agreement "quite simply did not make any provision for valuation in the event of divorce"

The Tax Court case below addresses the use of a buy-sell agreement for estate planning purposes.

Estate of Blount v. CIR. T.C. Memo. 2004-116

- Buy-sell agreements can be critical for estate planning purposes. In some cases, the fair market value of the interest for federal estate tax purposes may be defined in the agreement.
- In order for this to be the case, a number of factors must be true:
  - The price must be fixed and determinable under the agreement;
  - The agreement must be binding in life and death;
  - The agreement must have a bona fide business purpose;
  - The agreement must not be a testamentary device; and
  - The agreement must be similar to those entered into at arm's length.

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

As evidenced in these court cases, buy-sell agreements are complex. Many factors need to be addressed in an agreement (as detailed herein) to avoid future struggles in interpreting the document. It is important to consider the purpose of the buy-sell agreement, as well as addressing trigger events and valuation method possibilities. A detailed and clearly written buy-sell agreement will largely benefit business owners. One of the most crucial questions to ask all parties to the agreement is the following: if a triggering event occurs, will the valuation mechanism in the buy-sell agreement accomplish the objective of providing a price for the company's stock at the level the partners/shareholders agree to be reasonable?

Special Purpose Valuations: ESOPs and Buy-Sell Agreements

Chapter VI – *Conclusion and Practical Considerations*

As you are well aware, valuations are performed for a multitude of purposes and applications. This material serves to familiarize members of the legal community with elements of the valuation process that are specific to ESOPs and buy-sell agreements. It will also allow you to have an understanding of the issues that can arise during the preparation of valuation for these purposes and insight with regard to reviewing other expert reports.

In addition to having an intimate knowledge of the valuation considerations that are specific to valuing equity interests in the context of ESOPs and buy-sell agreements, the valuator should be familiar with the mechanics of ESOPs and buy-sell agreements. This will allow for both an effective and efficient valuation engagement.

The authors of this material understand that we are a member of the team in serving the client. Assistance can be provided to legal counsel at the outset of implementing an ESOP or buy-sell agreement, which will serve to reduce or eliminate controversy over issues related to value at some point in the future.

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 business valuation process. 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:

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

Grossman Yanak & Ford LLP

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