Using ESOPS to Fund Owner Buyouts and Provide Business Capital

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October 2012

What Is An ESOP

- An ESOP is a tax-qualified employee retirement plan (similar to a 401(k) plan).
- Instead of mutual funds, etc., employee accounts are primarily invested in the employer's stock.
- A trustee is the legal owner of the stock and votes the stock (although participants can direct the vote on mergers, recaps, etc.)
- Growth of accounts is tax-deferred.
- Employees vest in their accounts over time
- Upon termination of employment, employees receive distributions of their vested accounts.

Why Your Clients Might Have Interest in Establishing an ESOP

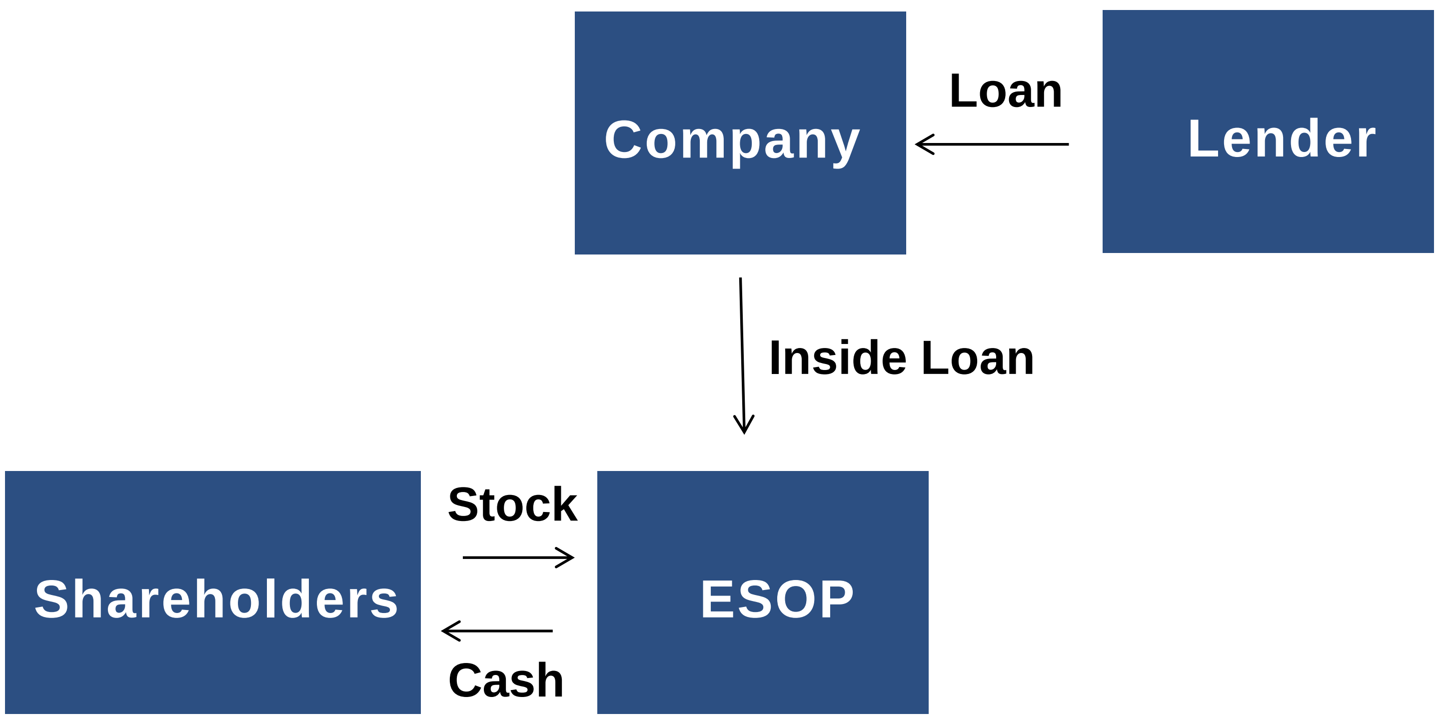
- An ESOP can provide a market for acquiring a founder's stock.
  - In a C Corporation, the sale to the ESOP can be on a tax-deferred basis with a so-called 1042 election.
  - In an S Corporation, income of the business on shares held by the ESOP is tax-exempt.
- ESOPs can be part of a succession plan.
- An ESOP could also be established to acquire newly issued shares on a tax favored basis from the company to provide capital.
- ESOP's incentivize employees to act like owners.

Overview of How to Establish a Leveraged ESOP

- ESOP borrows from a bank, either directly or in a "back-to-back" loan via the company.
- ESOP uses loan proceeds to purchase employer stock
  - Can purchase newly issued or treasury stock from the employer, to provide a source of capital for the company.
  - Can purchase stock from an owner, to serve as a liquidity source for buyout of the owner.

Overview Cont’d

- **Summary of “Back to Back” Leveraged ESOP Transaction**



Overview Cont'd

- The purchased stock is collateral for the bank loan.
  - ESOP maintains the purchased stock in an "unallocated" account. Each year, the employer makes contributions to the ESOP for the benefit of its employees.
  - The ESOP uses the employer contributions to repay the loan. As the loan is repaid, shares are removed from the "unallocated" account and allocated to participants.

Non-leveraged ESOPs: An Overview

- Non-Leveraged ESOP: not a capital raising or owner buyout device.
  - ESOP does not borrow funds, and does not make an upfront acquisition of employer stock.
  - The employer issues and contributes stock each year. The stock is allocated to participant accounts as it is contributed.

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Leveraged ESOPs: List of Players

- Company ESOP consultants, legal counsel and valuation adviser.
- ESOP institutional trustee, with appointed ESOP counsel and appraiser.
- ESOP record keeper.
- Company legal counsel.
- Lending bank and its legal counsel.
- Need to determine allocation of costs of transaction between employer, selling shareholder (if applicable) and ESOP.
- Venable can make referrals as to above players

Leveraged ESOPs: A Closer Look

- Employer adopts ESOP.
- Employer appoints ESOP institutional trustee to negotiate stock purchase.
- ESOP institutional trustee appoints appraiser and counsel.
- ESOP uses bank debt, and often a note to the selling entity, to purchase Employer stock from the employer or its owners.
- Effective after the transaction, the Employer appoints new “internal” ESOP trustee or continues institutional ESOP trustee on an ongoing basis to hold shares.

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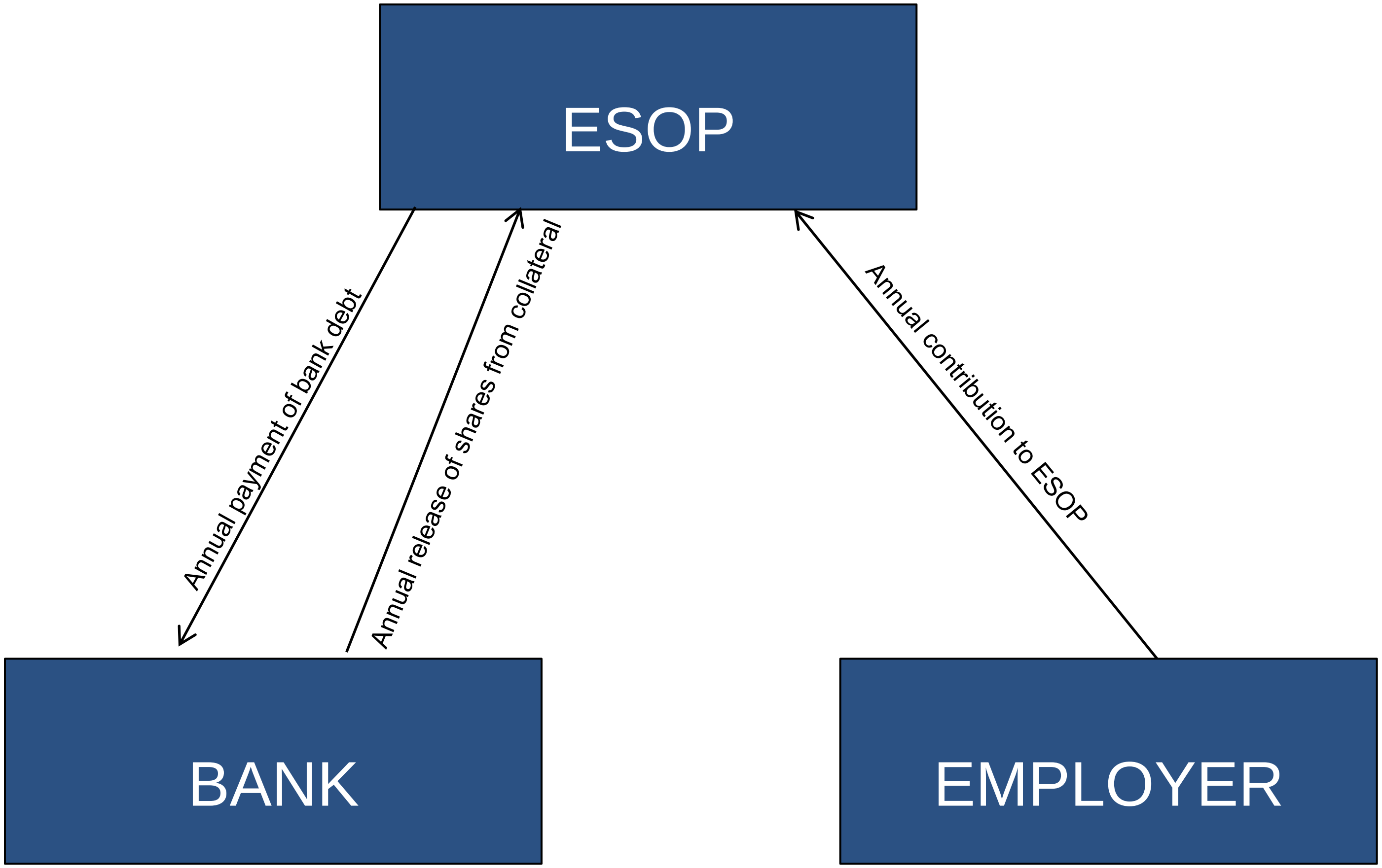
A Closer Look Cont'd

- Bank loan may be directly to the ESOP, or a back-to-back loan to the employer (which loans to ESOP).
  - The Bank may require a guaranty from employer and possibly selling shareholder (if applicable).
  - In a back-to-back loan, the Bank may also require a security interest in the employer's assets.
- Instead of purchasing 100% of the stock, the ESOP could purchase only a portion of employer's stock. However, to qualify for Section 1042 nonrecognition treatment, the ESOP must purchase at least 30%. To avoid a minority discount, the ESOP must purchase at least 50%.

A Closer Look Cont'd

- Pledge of Shares: Shares purchased with loan proceeds are pledged as collateral for the loan.
- Sources of Loan Repayment
  - Typically, annual contributions are used to make loan payments.
  - Dividends may also be used by the ESOP to make payments on the loan.
  - In the case of a C Corporation, Employer receives preferential deduction treatment for such dividends.

A Closer Look Cont'd



A Closer Look Cont'd

- Stock purchased with loan proceeds will be pledged to lender as collateral for shares.
  - Each year a portion of pledged shares will be released from collateral by lender based on portion of loan payments paid that year.
  - Two possible release formulas: one based solely on principal paid and the other based on principal plus interest paid.

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A Closer Look Cont'd

- Shares released are generally allocated annually to ESOP participant accounts based on pro-rata amount of compensation. However, if loan payments are made with dividends on stock allocated to participant accounts, released shares are allocated to those accounts.
- ESOP can require a year of service and age 21 to participate
- ESOP can also require up to 1000 hours of service and/or employment at year end to participate that year.

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Non-Recognition of Gain under Section 1042 of the Internal Revenue Code (C Corporation ESOPs)

- Shareholder sells appreciated C corporation stock to an ESOP.
- After the sale, the ESOP must own at least 30% of the outstanding common stock of the C corporation.
- Shareholder uses proceeds to purchase “qualified replacement property” within 3 months before or 12 months after the sale to the ESOP.
- Section 1042 defers recognition of long-term capital gain until disposition of the qualified replacement property.

Non-Recognition of Gain under Section 1042 of the Internal Revenue Code (C Corporation ESOPs)

- Qualified replacement property must be a security (equity or debt) issued by an operating common, not a passive investment vehicle such as a mutual fund.
- Basis in qualified replacement property is reduced by the amount of deferred gain.
- Shareholder files Section 1042 election by tax return due date (including extensions) for the year of sale.

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Non-Recognition of Gain under Section 1042 of the Internal Revenue Code (C Corporation ESOPs)

- The employer must agree to the 1042 election, because the employer is subject to an excise tax if the ESOP holds the acquired stock for less than 3 years.
- An excise tax also applies if shares purchased by the ESOP are allocated to the selling shareholder or a family member within 10 years following the sale (or if later, before any loan used to acquire the stock is repaid in full).

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S Corporation ESOP Anti-Abuse Rules

- S corporation ESOPs are subject to anti-abuse rules designed to prevent owners from avoiding taxes (through use of ESOP) while maintaining control (indirectly through their ESOP account).
- If “disqualified persons” own at least 50% of the S corporation stock during a plan year, no S corporation stock may be allocated to disqualified persons during the plan year.
- “Ownership” includes shares held through the ESOP (whether allocated or unallocated), and “synthetic equity.”

Corporate Governance

- ESOP Trustee is in same position as shareholder in a corporate structure:
  - Legal owner of the ESOP held shares in Employer.
  - Votes on issues requiring shareholder approval such as election of directors and officers, mergers, reorganizations, etc.
  - Participants must be permitted to anonymously direct the Trustee as to the vote on mergers, reorganizations, and similar transactions.
- Board of Directors sets corporate policy on Employer and Officers carry out corporate policy.

Effect of ESOP Transaction on Valuation

- Leveraged ESOP transactions have a substantial effect on the company's valuation.
- Debt incurred in a leveraged ESOP transaction typically must be recorded on the company's balance sheet (whether the company incurred or guaranteed the debt, or is expected to satisfy the debt through future contributions to the ESOP).
- Therefore, the ESOP loan usually causes the per-share value of the company to decline, often substantially below the per-share amount paid by the ESOP.
- This will dilute any owners who do not sell to the ESOP until the loan is substantially repaid.
- Floor-price protection can be used to protect existing ESOP participants from diminishment in valuation upon second-stage purchases.

Distributions

- ESOPs must generally provide terminating participants a right to have account distributed in stock.
  – However, solely cash can be distributed by ESOPs of S corporations and companies whose governing documents limit ownership substantially to employees.
- Non-publicly traded companies must permit diversification of a portion of accounts, either by distribution or transfer to other investments, by participants who are over age 55 with 10 years of ESOP participation.

Distributions, cont'd.

- Non-publicly traded companies must provide a put right under which a participant can choose to sell the stock back to the company. (The ESOP often elects to purchase the stock, instead of the company doing so.)
- Whether an ESOP is sponsored by a C corporation or an S corporation, consideration must be given to ensure that there will be sufficient future liquidity to handle payments to departing participants.

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Any Questions?

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