AUTHOR

John A. Wilhelm, Partner
Venable, LLP
8010 Towers Crescent Drive
Suite 300
Vienna, VA 22182

PH: 703.760.1917
FAX: 703.821.8949
JAWilhelm@Venable.com

CONSIDERATIONS IN ESTABLISHING A LEVERAGED ESOP

In order to assist ABC Corporation ("ABC"), a privately held corporation, in considering the ramifications of implementing a proposed employee stock ownership plan ("ESOP"), summarized below are the basics of a leveraged ESOP, the pros and cons of adopting an ESOP, and the requirements imposed by the Internal Revenue Code and the Employee Retirement Income Security Act.

BASICS OF LEVERAGED ESOP

NATURE OF AN ESOP

An ESOP is a tax-qualified retirement plan that is designed to invest primarily in the stock of the sponsoring employer or a parent or subsidiary corporation. A leveraged ESOP uses the proceeds of a loan to buy employer stock, as further explained below. Under a non-leveraged ESOP, shares, or cash to buy shares, are simply contributed by the employer.

ESOP LOAN TRANSACTION

A leveraged ESOP uses the proceeds of a bank loan to purchase company stock from the company or its existing shareholders. The sale price is established by an independent appraiser. The lending bank holds the purchased shares as collateral and generally requires payment guarantees from the company, the selling shareholders and/or the remaining shareholders.

ESOP CONTRIBUTIONS AND ALLOCATIONS

If it adopts a leveraged ESOP, ABC will make cash contributions to the ESOP each year in an amount sufficient to pay the principal and interest due under the loan schedule. As payments are made on the loan by the ESOP, a prorata amount of the purchased shares are released by the lending bank from loan collateral and allocated to the accounts of participating employees generally based on their proportional annual compensation. (Covered compensation is generally limited to $245,000, as indexed, per participant per year.)

SIZE OF ESOP LOAN

Because of deduction limitations under tax laws, employer contributions to make loan payments each year must not exceed 25 percent of participating employees' annual compensation. In the case of a C Corporation, if certain nondiscrimination rules are met, contributions to make interest payments are not counted towards this limit. Thus, the amount of ESOP loan possible is limited by the size of ABC's payroll. Under certain circumstances, a larger ESOP loan is possible if dividends on the shares held by the ESOP are used to partially repay the ESOP loan. Of course, other factors such as the credit-worthiness of the company and the value of its stock also limit the size of the ESOP loan.

HOLDING AND DISTRIBUTION OF PURCHASED SHARES

The shares released by the bank are held by a Trustee or Custodian appointed by ABC. Participating employees "vest" in their allocated shares after completing a certain number of years of service with ABC. At some point after terminating employment, employees receive distributions of their vested account balances.

Because it is privately held, ABC must agree to repurchase distributed stock at the fair market value set by an annual appraisal.

USES OF ESOP

All ESOPs serve as a form of retirement plan which is invested primarily, or wholly, in employer stock. In addition, a leveraged ESOP can be used to finance corporate growth and provide a market for the stock of existing shareholders. An ESOP also has several specialized uses. For example, ESOPs also can be used to provide matching contributions under a 401(k) plan (a "K-SOP").

PROS AND CONS OF ESOP FINANCING

SELLING SHAREHOLDERS

PROS

- Market for Shares. The ESOP provides a market for ABC stock.
- Tax Deferral for C Corporation Share Sale. If ABC is a C Corporation and consents, shareholders (other than C Corporations) can engage in a so-called 1042 transaction and elect to defer taxation of the gain on ABC stock sold to the ESOP. The stock must have been acquired at least three years earlier other than through Employee Stock Purchase or Stock Option Plans. In order to qualify for this tax benefit, the ESOP must hold at least 30 percent of ABC stock outstanding following the sale. The selling shareholders must, within 12 months after the sale, reinvest the proceeds received in securities of certain operating companies and must file certain information with the IRS. If the requirements for a 1042 transaction are met, the selling shareholders are not taxed until those securities are sold or exchanged.

CONS

- Restricted Allocations after a 1042 Transaction. If the selling shareholders defer taxation of their gain in a 1042 transaction, the selling shareholders, any shareholder holding over 25 percent of ABC stock (considering attribution rules), and certain family members cannot receive ESOP allocations for a 10-year period or until all of the purchased shares are allocated to participants, if later.
- Premature Disposition after a 1042 Transaction. If the selling shareholders defer taxation of their gain in a 1042 transaction, the company is subject to a 10 percent excise tax on the amount realized by the ESOP in a disposition of the shares by the ESOP within 3 years from the date of the 1042 transaction. There are exceptions for dispositions in connection with a tax-free reorganization or certain ESOP distributions to participants.
- Guarantee of Loan. Often times the lender will require selling shareholders, as well as the company, to guarantee the ESOP loan.

ABC AND REMAINING SHAREHOLDERS

PROS

- Deduction of Principal Payments. ABC can deduct ESOP contributions not only for interest payments, but also for principal payments, creating significant cash flow savings during the loan repayment period over conventional financing. (Note, however, the initial cash flow savings may be offset by the repurchase requirement, described below, which arises when distributions are made to participants.)
- Deduction for Dividends Paid by C Corporation. Dividends paid on the ESOP shares of a C Corporation are deductible by ABC if passed through to participating employees or paid on the ESOP loan or, in certain circumstances, at the election of the participant either passed through to the participant or reinvested under the ESOP in employer stock.
- S Corporation Income Allocable to ESOP is Exempt. Since an ESOP is an exempt organization, it is not generally taxable on income except in the case of unrelated business taxable income ("UBTI"). The Code was amended to provide that the pass through income allocable from an S Corporation sponsor is not UBTI.

CONS

- S Corporation ESOP Non-Allocation Years. An ESOP of an S Corporation is prohibited from allocating assets attributable to company stock to “disqualified persons” during certain “nonallocation years.” A “disqualified person” is an individual with at least 10 percent of the company's "deemed owned shares" or who is a member of a family group with 20 percent of the "deemed owned shares". "Deemed owned shares" are shares allocated under the ESOP, an allocable portion of any unallocated shares under the ESOP and, if it results in classification of any individual as a "disqualified person", certain “synthetic equity” such as stock options and other rights to stock. A “nonallocation year” is a plan year during which at any time “disqualified persons” hold at least 50 percent of the S Corporation’s outstanding stock, including deemed owned shares held by the ESOP, or such stock together with the corporation’s synthetic equity. For purposes of these rules, ownership is attributable from certain family members and certain entities. A prohibited allocation to a disqualified person is treated like a distribution and also results in an excise tax against the corporation.
- Shareholder Dilution and Company Liability. ABC shares held by remaining shareholders will be diluted as a result of the ESOP purchase and the ESOP loan will be reflected as a liability on the company’s financial records.
- Repurchase Requirement. When ESOP distributions are made to participating employees who have terminated employment (generally after the ESOP loan is repaid in full), ABC must agree to repurchase their vested, allocated shares at the most recent appraised value unless ABC has since become a publicly held corporation.
- Legal and Administrative Costs. Establishment of the ESOP will entail significant legal and administrative services, described later in this memorandum.
- Comparison to Conventional Financing. The cost of ESOP financing is greater than the cost of conventional debt financing alone. The cost of ESOP financing is similar to a combination of straight debt financing and a comparable retirement program for ABC’s employees. Therefore, the comparison with conventional financing is more favorable if the ESOP is substituted for another qualified employee retirement plan.
- CODE and ERISA Requirements. The ESOP must meet complex qualification rules under the Internal Revenue Code (“Code”) and additional requirements under the Employee Retirement Income Security Act (“ERISA”), some of which are summarized below.

EMPLOYEES

PROS

- Tax Deferred Benefit. Participating employees are not taxed on the ABC shares allocated to their accounts until distributions are received, generally after termination of employment. Even then special tax rules may apply and taxation can generally be further deferred by a rollover to an IRA or another qualified plan.
- Stake in Company. Participating employees are further incentivized to perform well since they share in the productivity and success of ABC through appreciation of the stock held in their ESOP accounts.

CONS

- Investment Risk. To the extent the ESOP is substituted for another type of qualified retirement plan, the retirement benefits of the employees are subject to the investment risk entailed by holding ABC stock. This risk is partially relieved by diversification requirements discussed later.

SUMMARY OF SELECTED QUALIFICATION REQUIREMENTS

INVESTMENTS

Generally, an ESOP of a privately held company must be invested primarily in the class of the company’s common stock which has the greatest voting and dividend rights. Under certain circumstances, however, preferred stock which is convertible to that class of common stock may be used.

COVERAGE

If desired, participation in the ESOP can be limited to employees who are over age 21 and have completed one year of service (during which 1,000 hours were credited) with ABC. Participation can be further limited, as long as the percentage of participating non-highly compensated employees is at least 70 percent of the percentage of participating highly compensated employees (i.e. annual compensation in the previous year of at least $110,000, as indexed).

CONTRIBUTION LIMITATIONS

Allocations each year to a participant's account are limited to 100 percent of his or her compensation or $49,000, as indexed, whichever is lower. This limitation generally takes into account the employer contribution to make principal and interest payments on the ESOP loan. However, neither forfeitures nor interest paid on the ESOP loan in the case of a C Corporation are counted towards this limit, if no more than one-third of the released shares are allocated to highly compensated employees. Also, the limit with respect to contributions used to make ESOP loan payments can be based on the fair market value of stock released by the bank for allocation to participants' accounts, if less than the loan payments. Dividends on shares held by the ESOP are not generally counted towards these limitations. All qualified plans of the company and certain affiliates are considered when doing limitation testing.

VESTING AND FORFEITURES

Either a 6-year graded or a 3-year cliff vesting schedule may generally be used. Assuming 3-year cliff vesting is adopted, participants who terminate employment with ABC (other than for death or disability) before completing three years of service will forfeit their ESOP stock. The forfeited stock will be reallocated to the accounts of the remaining participants based on their proportional compensation.

VOTING ESOP STOCK

Although the Trustee appointed by ABC under the ESOP actually votes the ESOP stock at shareholder meetings, participating employees must be allowed to direct the Trustee how to vote their allocated shares. The voting rights can be limited to major corporate events such as a merger, as long as the company is privately held.

TIMING OF REGULAR DISTRIBUTIONS

Distributions from the ESOP would not generally have to be made until the ESOP loan is repaid in full. After the loan is repaid, distributions must generally be permitted no later than six years after an employee terminates (and within one year in the case of death, disability or normal retirement age). Distributions can be made in installments, generally over five years unless the employee consents to a longer period.

DIVERSIFICATION DISTRIBUTIONS

Employees who are age 55 and complete ten years of participation in the ESOP must be permitted to diversify 50 percent of their accounts over a five year period in investments other than ABC stock. To avoid the administrative burden of maintaining other investments in the ESOP, the participating employee can be offered a distribution of the required portion of the account each year during that period.

VALUATIONS OF COMPANY STOCK

All valuations of company stock under the ESOP must be performed by an independent appraiser.

FORM OF DISTRIBUTION

If ABC's charter or bylaws restrict ownership of substantially all outstanding shares to employees or if ABC is an S Corporation, the ESOP can distribute in cash the value of the vested portion of a participant's allocated company stock. Otherwise, those entitled to distributions can demand and receive their vested, allocated stock, rather than its cash equivalent. Once distributions commence, they generally must be made in substantially equal installments over 5 years or, in the case of certain large accounts, over 10 years. Unless publicly held at that time, ABC must offer to repurchase distributed stock at the fair market value established by the latest annual appraisal. Also, ABC can, through appropriate agreements, place restrictions on any distributed stock granting ABC, or the ESOP, a right of first refusal if the employee subsequently desires to sell the stock.

SUMMARY OF SELECTED ERISA REQUIREMENTS

PLAN DOCUMENT AND SPD

The ESOP must be administered in accordance with a governing Plan Document and applicable law, and a Summary Plan Description must be furnished to participating employees.

FIDUCIARY DUTIES

ABC must appoint a Trustee to hold the ESOP shares and an Administrator. ERISA requires the Trustee and Administrator to discharge their duties in the exclusive interests of participants and beneficiaries of the ESOP.

BONDING

ERISA generally requires the Trustee and Administrator to be bonded in specified amounts.

PROHIBITED TRANSACTIONS

The ESOP must not engage in certain prohibited dealings with interested parties such as ABC, the ESOP fiduciaries and participating employees. For example, the ESOP cannot pay more than fair market value for the ABC shares.

ANNUAL RETURNS AND REPORTS

Annual Returns must be filed each year on the appropriate version of Form 5500 and a summary of the return must be provided to participating employees.

LEGAL AND ADMINISTRATIVE COSTS

LEGAL

The following legal services are entailed:

1) negotiate and review loan, security and guarantee agreements with the lending bank;
2) provide the ESOP governing documents and adopting resolutions, summary plan description for participating employees and administrative forms;
3) negotiate share purchase agreement;
4) obtain a determination letter from the IRS as to the ESOP's qualification;
5) negotiate and review agreements with an independent appraiser, recordkeeper and, if desired, custodian;
6) provide legal advice as to compliance with applicable laws on an ongoing basis as needed.

INDEPENDENT APPRAISER

An independent appraisal of the fair market value of the ESOP stock must be obtained as of the date of purchase, and annually thereafter, as long as ABC is privately held. An independent appraisal of the fair market value of the ESOP stock also must be obtained at the time of any subsequent purchase or sale transaction with respect to company common stock between the ESOP and certain interested parties such as ABC.

RECORDKEEPER

A third-party recordkeeper should be retained to annually allocate the ESOP shares released from collateral by the lending bank, any forfeitures and any income or expenses to participating employees' accounts, compute vesting, account for distributions and prepare the annual return required on Form 5500, as well as the summary annual report.

ADMINISTRATOR

Generally a Committee of key employees is appointed by the Board of Directors to handle administrative functions such as interpreting ESOP provisions, filing government reports, and approving annual allocations and distributions.

TRUSTEE - Key employees may be appointed to serve as Trustee, to hold and vote the ESOP shares, or a financial institution can be appointed to be Trustee and/or Custodian.

CONCLUSION

A leveraged ESOP can serve as a tax favored means to finance corporate growth and provide a market for present shareholders. Additionally, the ESOP can motivate employees by giving them a stake in the growth and success of ABC. Since it is a combination of a financing vehicle and an employee benefit plan, ESOP financing is more costly than conventional financing. Also, significant legal and administrative services are entailed.

The above is merely a summary of the ramifications of adopting an ESOP. Please let me know if further details are needed.