Welcome and thank you for joining!

The webinar will begin shortly.

ESOPs 101 (What/Why/How)

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What is an ESOP?

"Employee Stock Ownership Plan"

- Retirement Plan - Qualified Defined Contribution Plan
  - Internal Revenue Code / ERISA
    - Tax deductible contributions for employer
    - Tax deferred growth for employees
    - Designed to invest primarily in employer stock (vote pass through)
    - Permitted to Borrow
    - Trustee (internal or external)

- Corporate Finance Tool
  - Tax-advantaged financing for the Company
  - Deductible dividends in some cases
  - S corporation ESOPS (1998) – tax exempt

ESOP History in brief…

- The Employee Retirement Income Security Act of 1974 (ERISA) created a formal legal status for ESOPs
- Over 9,774 ESOPs in US covering over 11.2 million employees.
- 3,500 ESOP companies are majority-owned by the ESOP
- At least 75% of ESOP companies are or were leveraged.

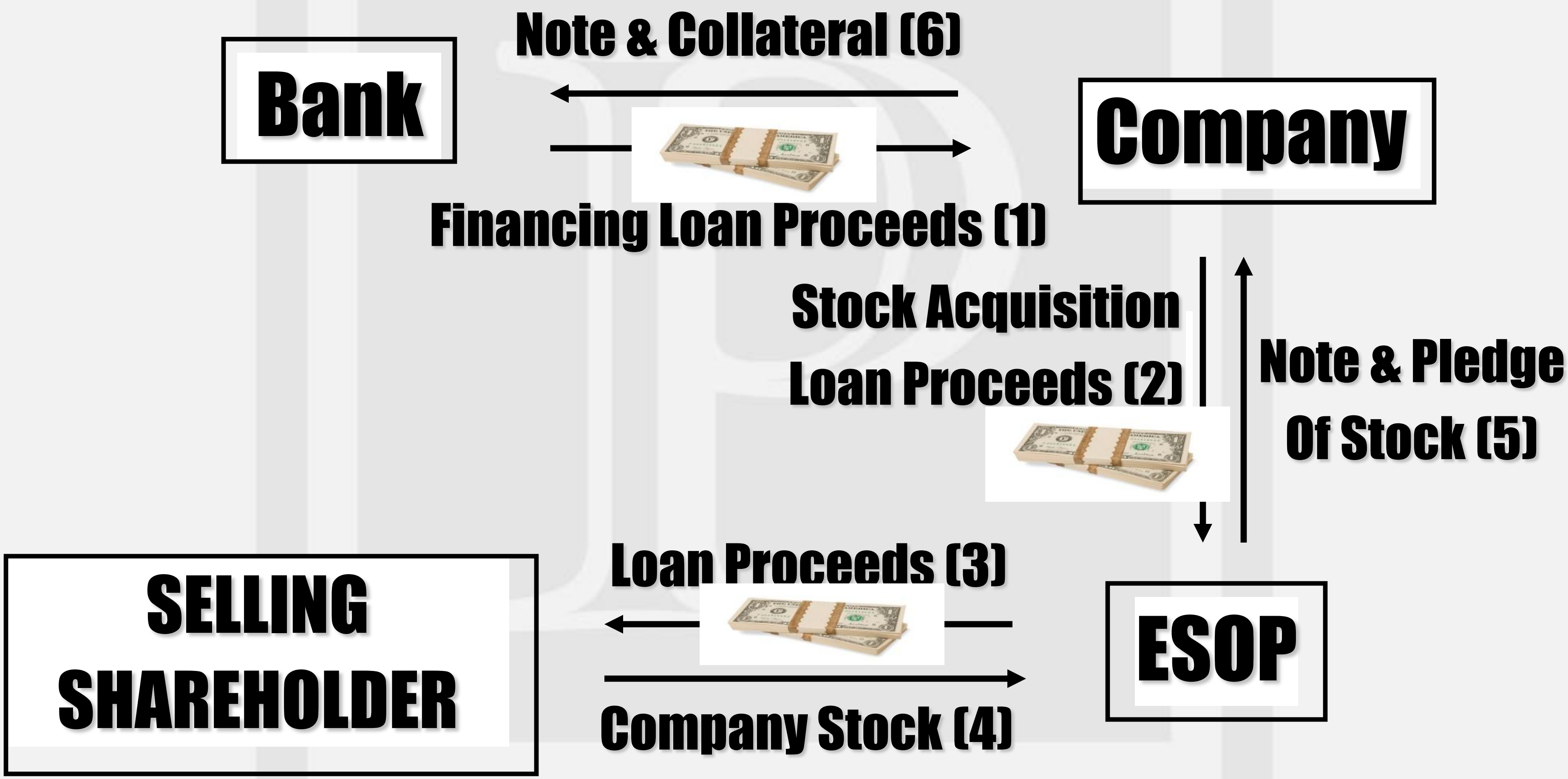
Source: NCEO, www.NCEO.org, August 2008.

America’s Largest Majority Owned ESOPs

Okonite Co.	Ramsey	NJ	ESOP	wire & cable	1,494
Cooperative Home Care Assocs.	Bronx	NY	Co-op	health care	1,600
Crucible Materials	Syracuse	NY	ESOP	steel manufacturer	1,000
Kinney Drugs	Gouverneur	NY	ESOP	drug stores	3,000
Lewis Tree Service	Rochester	NY	ESOP	tree service	3,100
National Spinning Co.	New York	NY	ESOP	textiles	2,000
Osmose Holdings	Buffalo	NY	ESOP	wood preservatives/utility services	1,200
Price Chopper dba Golub Corp.	Schenectady	NY	ESOP	supermarkets	24,000
Bradford White	Ambler	PA	ESOP	water heaters	1,361
CentiMark Corp.	Canonsburg	PA	ESOP	roof repair	2,220
STV Group	Douglassville	PA	ESOP	architecture/engineering	1,500
Weston Solutions	West Chester	PA	ESOP	environmental engineering	1,800
W.L. Gore & Associates	Newark	DE	ESOP	manufacturing	8,000

Source: NCEO, www.NCEO.org, August 2008.

Leveraged ESOP Transaction



ESOP: Creates market to sell shares

- Sell all or part of shares
- Can combine with management buyout
- Spread sale of shares over many years; retain some shares beyond retirement
- Diversification for seller
- Seller can retain control
- Can defer income tax potentially forever

Tax Benefit to Selling Shareholder

- Tax deferral; Section 1042
  - C Corporation
  - Qualified employer securities
  - 30% sale / ownership by ESOP
  - 3 year holding period (tacking)
  - Stock Owned is not a result of stock options or other employee benefit plan
  - Limitations on allocations to seller, children, brother/sister, spouse or parents; or >25% shareholder
  - Purchase Qualified replacement property (QRP) within 15 month period

Additional consideration for 1042…

- Current capital gains rate of 15% versus projected tax rate on capital gains when seller sells the QRP

Qualified Replacement Property – 1042(c)(4)

- Stocks, bonds, debentures, or notes issued by domestic operating corporation
  - floating rate notes (FRN)
- Upon sale of any QRP, pro-rata deferred capital gains tax becomes due

- Ineligible / Non-QRP
  - Passive income exceeds 25% of Gross Revenue in last year prior to purchase
  - Less than 50% of assets are used in active conduct of business
  - Mutual funds
  - Real estate or REITS
  - Government Securities (T-Bills)
  - Foreign Securities
  - Limited Partnerships or Limited Liability Companies

Floating Rate Note Method

- Floating rate notes allow the seller/investor to maintain constant liquidity while also providing access to capital that can be managed without the restrictions of Section 1042.

- Basically, the investor monetizes the FRN by borrowing against a fully-paid security [the FRN] through a highly customized bank loan. Similar to a margin loan, the investor pledges a security that he owns to the bank as collateral for the loan – here, the FRN. The bank loan resets, or “floats” on a monthly or quarterly basis, reducing the risk associated with changes in the interest rates. When the bonds [FRNs] are monetized, the investor receives the interest coupon payment from the FRN and applies it to pay interest on the borrowed funds (up to 90% of the FRN amount). Since the costs of borrowing are greater than the interest being received from FRNs the after-tax cost of borrowing may be 0.4-0.6% of the principal amount. This monetization process provides the investor with tax-free access of up to 90% of the value of the FRN portfolio that has been designated as QRP.

- Thus the investor can actively manage the monetized funds, without the restrictions of Section 1042, and without paying capital gains tax on the sale to the ESOP for as long as the QRP [FRN] is held.

S Corporation ESOPs

- Income Tax Deferral
- 100% ESOP owned S corporation has significant tax saving opportunities.
  - – If corporation makes an S election there will be no federal tax on its annual income (most states mirror this provision).
  - – Although income will be passed through to the shareholder (the ESOP), no shareholder level tax will be imposed because the ESOP is a tax-exempt entity.
    - The income tax liability will effectively be deferred until the participants in the ESOP receive their benefits.

S Corporation ESOPs

- Company has shareholders in addition to ESOP
  - Tax savings will still be available by making S election, but S election may have a neutral impact on the corporation's cash flow.
  - Reason, in most cases, S corporation shareholders must withdraw sufficient funds to cover payment of their taxes on the passed through corporate income.
  - Example, S corp. sponsors ESOP that owns only 30% of company and taxable income for 2009 was $1 million. Non ESOP shareholder will have income allocation of $700,000 which will impose federal tax liability of $245,000. The corporation will also be required to distribute $105,000 to the ESOP. After distributions, the company will have $650,000 in retained earning. However, if the corporation was a C corporation, its tax liability would be $350,000 and would also have retained earnings of $650,000.
  - Companies that are expanding and have a need for cash to fund future expansion may not benefit from a partially ESOP owned company.

Benefit to Company…

- Contributions are deductible – pay acquisition debt with pre-tax dollars

  (25% of covered compensation limitation)

- Increased productivity / participation by participants

- Potentially avoid Taxes 100% - S corporation ESOP

Benefit to Employee Participants…

- Added Retirement benefit- Allocation of ESOP assets (cash and/or stock) usually in proportion of salary to covered payroll

- Tax deferred until payment received

- Employee owner – power to affect own wealth/retirement

Adequate Consideration

- ESOP can't pay more than "Adequate Consideration" for the shares = Fair Market Value based on independent appraisal
  - May be lower than value received in external transfer

- BUT
  - Owner can retain control
  - Owner keeps job, salary, and reasonable perks
  - Owner participates in future value of business
  - Properly installed, can increase productivity of the Company and thus value of retained shares (if any)

ESOP Financing Alternatives…

- Bank Financing
- Seller Note
- ESOP cash pre-funded
- Other plan assets rollover

ESOP Contribution limitations…

1) Deductible limitation
   - 25% of covered payroll
     (limit of $245,000 individual compensation included as of 2010 (401(a)(17); 404(l))
   - Leveraged (404(a)(9)) versus Non-leveraged (404(a)(3))
   - C Corp versus S Corp
     - Dividend (404(k))
     - Interest (404(a)(9))

2) Annual Addition limitation per participant
   - lesser of 100% of pay or $49,000 (as of 2010 (415(c)(10(A))

Questions?

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Thank you!