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ESOPs 101 (What / Why / How) Webinar

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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
 - Permitted to borrow
 - Trustee
- Corporate Finance Tool
 - Tax-advantaged financing for the Company
 - Deductible dividends in some cases
 - S corporation ESOPs (1998) – tax exempt



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ESOP History in Brief...

- The Employee Retirement Income Security Act of 1974 (ERISA) created a formal legal status for ESOPs
- Over 11,500 ESOPs in US covering over 14 million employees
- 3,000 ESOP companies are majority-owned by the ESOP
- At least 75% of ESOP companies are or were leveraged

Source: NCEO, www.NCEO.org, February 2011



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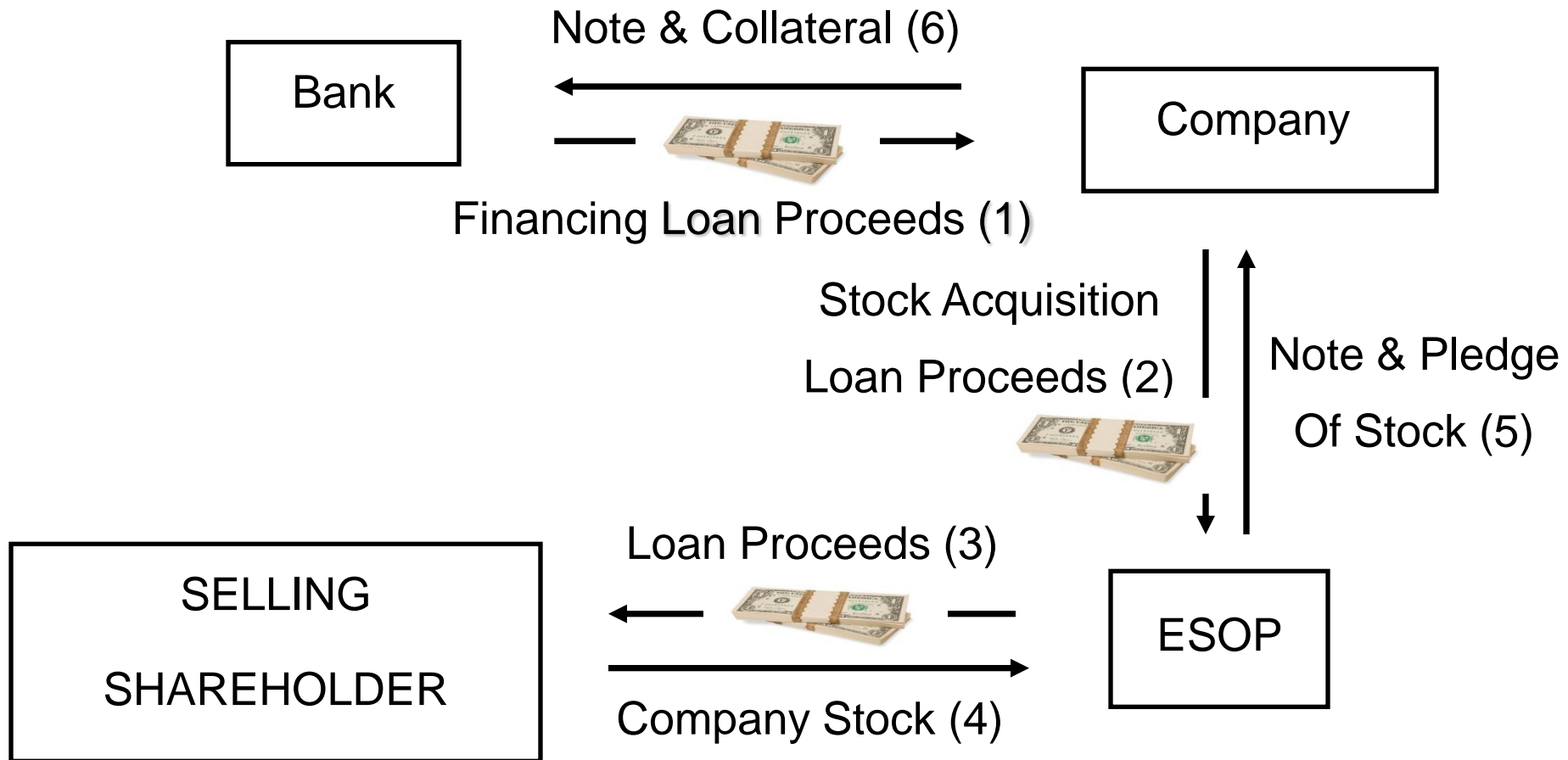


America's Largest Majority Owned ESOPs

Blue Tree Corp.	New York	NY	ESOP	steel distribution	5,000
Cooperative Home Care Assocs.	Bronx	NY	Co-op	health care	1,600
Crucible Materials	Syracuse	NY	ESOP	steel manufacturer	1,900
Kinney Drugs	Gouverneur	NY	ESOP	drug stores	2,800
Lewis Tree Service	Rochester	NY	ESOP	tree service	2,950
National Spinning Co.	New York	NY	ESOP	textiles	2,000
Osiose Holdings	Buffalo	NY	ESOP	wood preservatives/utility services	1,200
Price Chopper dba Golub Corp.	Schenectady	NY	ESOP	supermarkets	24,000
Alliance Holdings	Abington	PA	ESOP	holding company	7,700
Bradford White	Ambler	PA	ESOP	water heaters	1,219
CentiMark Corp.	Canonsburg	PA	ESOP	roof repair	2,500
STV Group	Douglassville	PA	ESOP	architecture/engineering	1,700
Weston Solutions	West Chester	PA	ESOP	environmental engineering	1,897
W.L. Gore & Associates	Newark	DE	ESOP	manufacturing	8,600

Source: NCEO, www.NCEO.org, February 2011

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
- Diversification for seller
- Seller/management can retain control
- Can defer income tax potentially forever



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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
 - Restrictions on allocations to seller, children, brother/sister, spouse or parents; or >25% shareholder
 - Purchase Qualified Replacement Property (QRP) within 15 month period



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Additional Consideration for 1042...

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



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Tax Savings Comparison

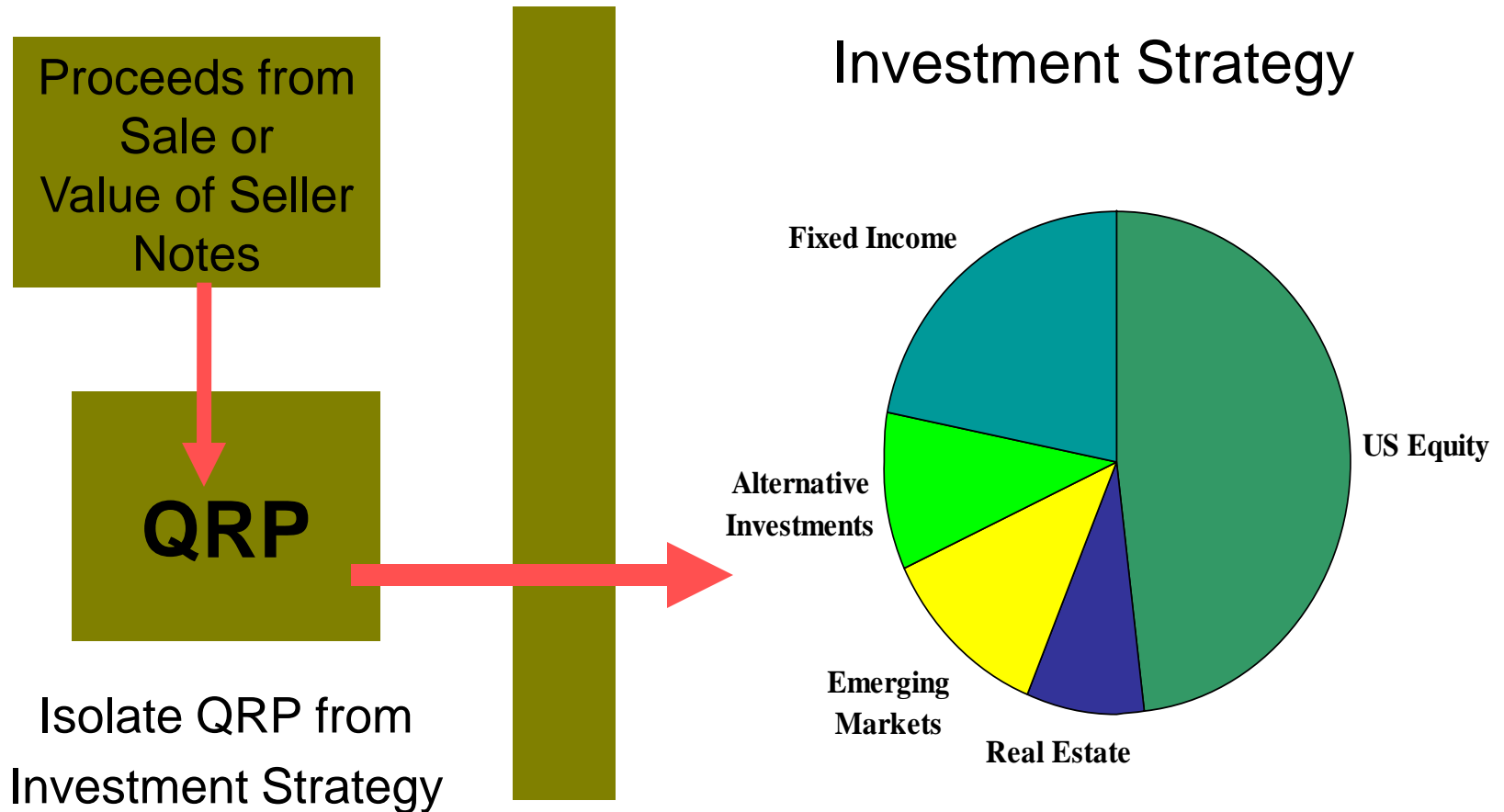
ESOP Federal Tax Savings of Sale to an ESOP

	<u>Taxable Sale</u>	<u>ESOP Sale</u>
Sale Price	\$30,000,000	\$30,000,000
Basis	<u>5,000,000</u>	<u>5,000,000</u>
Appreciation	\$25,000,000	\$25,000,000
TAX @15%	\$3,750,000	\$0
Net Proceeds	\$26,250,000	\$30,000,000

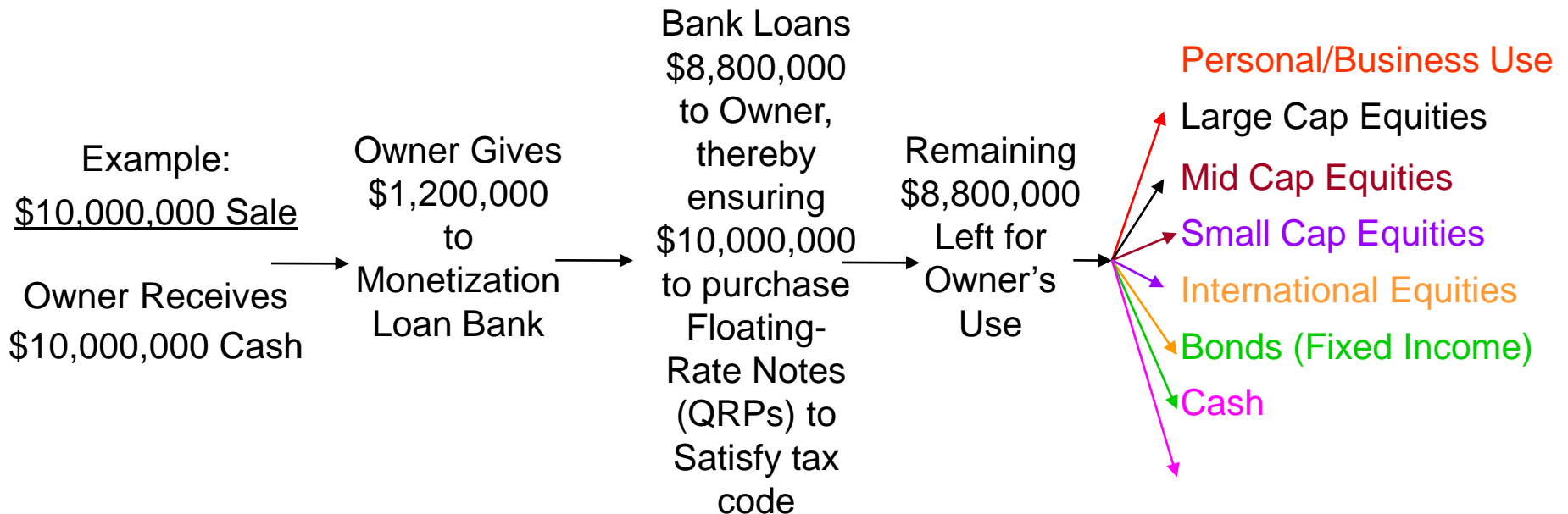
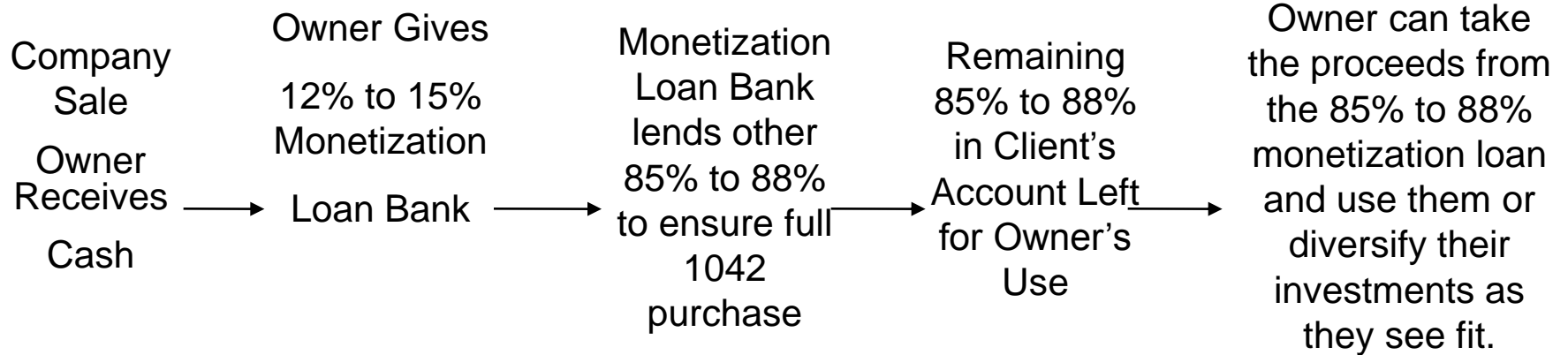
Qualified Replacement Property – 1042(c)(4)

- 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

Deferring Capital Gains



Investing The Proceeds



S Corporation ESOPs

- Corporate Income Tax Exclusion
- 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



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S Corporation ESOPs

- ESOP owns Less than 100%
 - Tax exclusion in proportion to ESOP ownership
 - ESOP entitled to its share of S-distributions paid if corporation makes distributions to non-ESOP shareholders to cover payment of taxes on the passed through corporate income
 - Example
 - ESOP owns 30% of company
 - 2010 taxable income was \$1 million
 - Non-ESOP shareholder income allocation = \$700,000. Corporation distributes \$245,000 to cover federal tax liability
 - Corporation also required to distribute \$105,000 to the ESOP
 - Cash in ESOP can be used for ESOP debt service, repurchase obligation or to purchase additional shares
 - If cash from S distributions builds up in ESOP, it may not be available to company for investment or expansion

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



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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



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Stock Valuation

- 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)



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ESOP Financing Alternatives...

- Bank Financing
 - Asset based lenders
 - Cash flow lenders
- Mezzanine Lenders
- Seller Note
- ESOP cash pre-funded
- Other plan assets rollover



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ESOP Financing Considerations...

- General Lender Considerations
 - Collateral Base (real estate, inventory, receivables, etc.)
 - Cash Flow
 - Character
 - Strength of the management team
- Additional Considerations for ESOP Transactions
 - ESOP transaction is a highly leveraged transaction
 - Unlike debt financing for operations, the proceeds of the loan “leave the company”
 - Enhanced cash flow available for debt service from ESOP tax benefits



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ESOP Contribution Limitations...

- 1) Deductible limitation
 - 25% of covered payroll
 - Limit of \$250,000 individual compensation included as of 2012 (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 \$50,000 (as of 2012 (415(c)(1)(A))



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Common ESOP Fables...

- Employees will Run the Company
- Employees will Access Financial / Confidential Information
- Seller Will Not Receive Fair Market Value
- Seller Must Guarantee the ESOP Loan Considerations
- Because the Business Owner Controls the Transaction, Timing is Not Important
- An ESOP will Prohibit the Business Owner's Children From Inheriting the Company



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Benefits of Selling Stock to an ESOP...

- Liquidity With Control
- Personal Tax Benefits to Owners
- Capital Gains Tax Deferral / Estate Tax Benefits
- Corporate Tax Benefits
- Upfront cost of implementing an ESOP transaction can be mitigated by the substantial tax savings moving forward
- Maintain Confidentiality – Personal / Business
- Employee Motivation & Benefits
- Diversification
- Sale Could Occur via Fractional or Total Liquidity
- S – Election
 - Companies that are 100% owned by an S-Corp. ESOP Trust pay no federal taxes

Questions

Thank You

Circular 230 Disclosure: Pursuant to Regulations Governing Practice Before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer.



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