Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about ESOPs, which is a topic that has a mistaken reputation for being easy to understand (very few advisors can help their clients implement the plan).

Most advisors have business owners as client who will ultimately sell their interest in their company(s). While many clients talk about having a business succession plan which will dovetail with a retirement plan, few actually implement a plan such a plan. An ESOP is a very powerful business succession plan that also has unparalleled retirement plan components because of the tax deferred treatment on the sale of C-Corporation stock.

The following material was created to give readers insight into the different types of ESOPs and how they can be used to help particular clients achieve their long term planning goals. We have attempted to present the technical material in a fairly lay manner, so those who have tried to learn ESOPs from hyper technical writings, and found that frustrating, will now be able to learn and understand the topic.

Employee Stock Ownership Plans (ESOPs)

Introduction

Most advisors who have business clients of varying types have heard of the term ESOP. Many advisors think the term ESOP stands for Employee Stock *Option* Plan when the O in ESOP is really the term Ownership. An ESOP is a “qualified” benefit plan that is designed to transfer ownership in a company to the employees.

Even those advisors who understand that an ESOP is an employee benefit plan that can be used as a tool to benefit the majority business owners struggle with the many nuances that make up an ESOP transaction. While ESOP experts will nearly always state that ESOPs are simple transactions, this is not the case. To make matters worse, there is very little material that explains ESOPs in simple English. This material will clearly and simply explain ESOPs so advisors will be able to apply the information in a practical manner for business clients.

What is an ESOP?

An ESOP is a special kind of employee benefit plan (which is governed by ERISA) that enables employees to acquire beneficial ownership in their company (own stock) without having to invest their own money.

Several features make ESOPs unique as compared to other employee benefit plans.

First, only an ESOP is required by law to invest primarily in the securities (stock) of the sponsoring employer (most other plans are allowed to invest no more than 10% of their assets in employer securities). This helps insure that employees will have a significant ownership stake in the company where they work.

Second, ESOPs are unique among "qualified" employee benefit plans in their ability to borrow money. As a result, "leveraged ESOPs" can be used as a technique of corporate finance.

The most common application for an ESOP is to buy the shares of a departing owner of a closely held company. Owners can **defer tax on the gain** they have made from the sale to an ESOP **if the ESOP holds 30%** or more of the company's stock (and certain other requirements are met). Moreover, the purchase can be made in pretax corporate dollars.

A Brief History

Employee ownership has a long history in the United States, but ESOP in its current form was invented in 1956 by a San Francisco attorney, Louis Kelso. Kelso believed that unless more people owned significant amounts of capital, many economic and social problems would prove intractable, making an expansion of government's role in the economy, and perhaps socialism, increasingly unavoidable. Accordingly, he set out to design devices to broaden the ownership of capital. The ESOP was one of those devices.

Kelso won a powerful supporter in Senator Russell B. Long (D-LA). Under Senator Long's leadership Congress passed more than 17 laws encouraging the growth of ESOPs, starting with the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"). Over 17 states also have laws fostering employee ownership.

Congress encourages employee ownership with tax incentives in order to broaden the ownership of capital. The ownership of corporate stock is more concentrated than either the distribution of income or of any other kind of asset.

Studies have shown that ESOPs can provide employees earning very modest amounts of income with tens and even hundreds of thousands of dollars of stock.

How to Establish an ESOP

A company interested in establishing an ESOP enjoys a wide range of options in tailoring a plan that is best suited to its own particular needs and goals. Since no two companies are exactly alike, neither is one company's ESOP quite like any other. A large, publicly traded company, for example, would be likely to handle the creation of its ESOP somewhat differently than would a smaller firm. Therefore, the following is only a basic guideline summarizing the steps a company might take in designing and implementing its ESOP.

Exploring the ESOP Concept

The first step is to decide which type of plan that will best serve a company's interests. Companies have created ESOPs not only as an employee retirement plan, but for business continuity, financing, enhanced employee motivation and many other reasons.

Designing the Specifics

Once a client has a general picture of the kind of ESOP wanted, a qualified consultant can work with the client to design the specifics of their plan. Working together, a client and a qualified ESOP expert can explore the actual feasibility of an ESOP for a company and fashion custom-tailored answers to the many questions that will need to answered.

Among those questions are: 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 ESOP Association can provide advisors with the names of such consultants throughout the country. A qualified consultant (often an attorney) will work to integrate a client's ESOP goals with applicable laws and regulations and will conduct a financial analysis to assure that any financial commitments posed by the ESOP will not exceed the ability to the firm to meet such obligations. He or she may also offer options clients and their traditional advisors may not have been aware of. The consultant may also arrange to bring in 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 the 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 plan will affect the value of their stock and the company's financial condition. Often an ESOP will cause a dilution of their equity interest in the corporation.

Finally, while not a requirement for establishing an ESOP, a plan for meeting the company's obligation to repurchase the stock of departing employees should be projected. This "repurchase liability" arises from the fact that in privately held companies, ESOP participants have a put option when leaving the company. The repurchase liability and its growth over time may be affected by factors such as the size of the annual ESOP contributions, 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 the choices eligible employees make about their diversification option.

Companies may plan for and meet their ESOP repurchase liability in a variety of ways, including making substantial cash contributions on an annual basis, and buying insurance to cover the plan's liabilities. If the likely growth of repurchase liability 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.

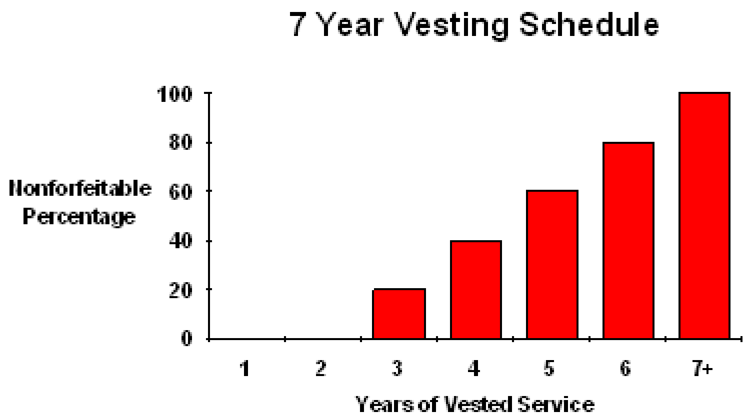
How do ESOPs Work?

A company which 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 relative compensation, but formulas allocating stock according to years of service, some combination of relative compensation and years of service, or equally to each participant, have all been used. Typically, employees would 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 1000 hours is counted as a year of service.

Vesting

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 20% after three years, increasing by 20% per year until the employees are fully vested after seven years of service. A faster vesting schedule applies where the ESOP contribution is used as a match to employee 401(k) deferrals. There, "cliff" vesting (no ownership until the stated time as passed) must be complete in three years and graduated vesting must start after two years and be completed no later than after six years.

The following an illustrations of a typical vesting schedule.



Distributions

Participants have the right to demand distributions in company stock unless restricted by the corporate bylaws. IRC Sec. 409(h).

When an ESOP employee who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying the investment of up to 25% of the ESOP account. This option continues until age 60, at which time the employee has a one-time option to diversify up to 50% of the 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 immediately.

In a publicly traded company employees can simply sell their distributed shares on the market. In a privately held firm, the company 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 second put expires, the company has no further obligation to repurchase the shares. Each year, the trustee is required to set the value of the company shares in the ESOP based on an appraisal delivered to it from an independent valuation firm.

An ESOP company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period beginning within one year for a retirement distribution, within five years for a pre-retirement distribution, and the payout period not to exceed five years in either case. The company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.

Uses of ESOPs

The two most common uses of ESOPs are to buy the stock of a retiring owner in a closely held company, and as an extra employee benefit or incentive plan. These two uses probably account for over two- thirds of all the ESOPs now in existence. The proportion of ESOPs created to buy out a retiring owner can be expected to increase with time, because since 1984 additional tax provisions have become law which encourage them to sell to an ESOP. Other companies have used ESOPs as a technique of corporate finance for a variety of purposes—to finance expansion, make an acquisition, spin off a division, take a company private, etc... In a small number of cases, ESOPs have been used to buy out a failing firm that would otherwise have closed.

Buying the Stock of a Retiring Owner

Many closely held companies have no plans, or incomplete plans, for business continuity after the departure or retirement of the founder or major shareholder. If the company repurchases a retiring or departing owner's shares, the proceeds will be taxed as capital gains. A sale to another company will also be taxed as capital gains, and **finding a buyer is not always easy** even for a profitable closely held company. Even when possible, it is not always desirable. Especially in a family business, a retiring owner may face the unpleasant choice of selling to a competitor or conglomerate, or liquidating.

An ESOP can provide a ready made market for the equity of a retiring owner, or any interested major shareholder, of a closely held company, and provide a benefit and job security for employees in the process. Retiring owners of closely held companies that are C corporations incur **no taxable gain on a sale of stock to an ESOP**, provided that the plan owns at least 30% of the company immediately after the sale (sales by two or more stockholders may be counted in this 30% if these sales are part of an integrated transaction), and that the sale's proceeds are reinvested in "qualified" securities within a 15 month period beginning 3 months before the date of the sale. This **tax-free** rollover is the most tax favored way for an owner of a closely held company to sell his or her stock, and thus encourages the owners of closely held companies to help create new owners through ESOPs.

Employee Benefit or Incentive

Most ESOP companies had the desire to create an employee benefit or incentive as one reason for starting their plan, but for many companies that's the only reason. These companies hope that by making employees owners, they will increase their dedication to the firm, improve work effort, reduce turnover, and generally bring a more harmonious atmosphere to the company. Research has shown that giving workers a significant stake in their companies can improve employees' attitudes towards their companies, and that these improved attitudes will boost the bottom line.

Some companies are not particularly looking for improved performance, but just feel that it's time to establish a generous benefit plan; and an ESOP seems like the best alternative. A small, growing company, for example, may not have the spare funds to establish benefit plans, however, if it reasonably expects to have cash in a few years, the company can start an ESOP with no current cash cost. **The company simply contributes shares of stock to the ESOP** (this is called a non-leveraged ESOP). Further, since these contributions are deductible, the company's **cash flow will actually improve**. If the company is privately held it will eventually have to repurchase the ESOP's shares, of course.

The participants in an ESOP are not the shareholders of record; only the trustee or trustees of the ESOP are the shareholders of record. Accordingly, the participants (employees) have no right to examine the books and records, receive financial statements, or otherwise become involved in the affairs of the corporation.

However, those shares which have been allocated to the accounts of the participants become **eligible to vote** by the participants themselves where a major transaction is involved, such as a sale of all, or substantially all, of the assets and business of the corporation, or a merger transaction in which shareholders are given voting rights. However, sales of the stock owned by the ESOP can be authorized and approved by the trustees themselves without approval of the participants.

Often, key officers or directors of the corporation act as trustees. This retains control of the corporation within the key management group. However, many corporations elect to use independent trustees or combine independent trustees with key management personnel.

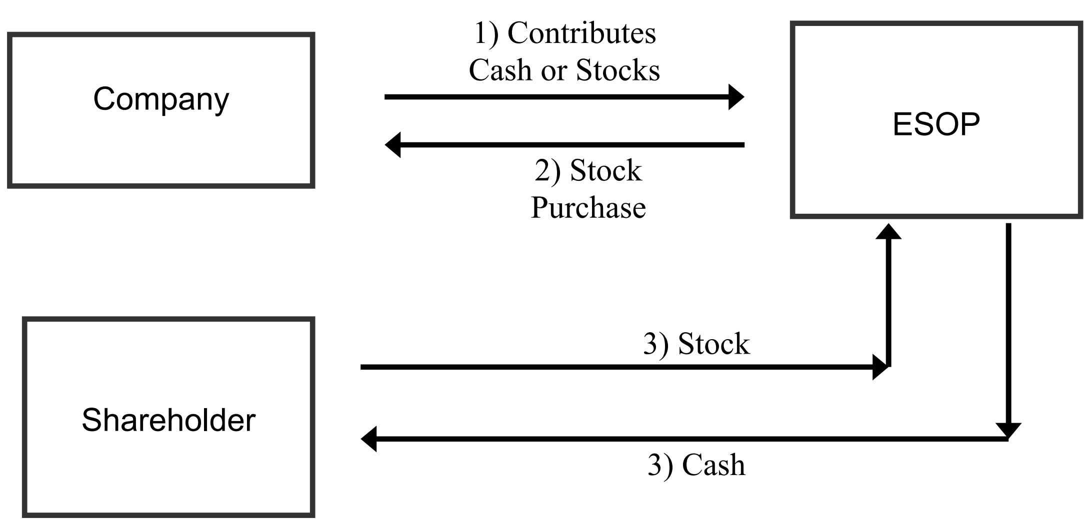
Types of ESOPs (Leveraged and Non-Leveraged)

Non-Leveraged ESOPs

This first type of ESOP is one which does not involve borrowing any funds to acquire stock of the sponsoring employer. It is funded by contributions of cash or stock directly from the employer sponsor. Shares of stock contributed by the corporation are “newly issued shares.” New shares are issued to the ESOP and **a deduction is taken by the corporation** for their appraised fair market value as of the date of contribution. Alternatively, cash can be contributed to the plan in annual discretionary amounts as cash flow permits, to purchase shares at a later date, or simultaneously, from either the corporation or from another shareholder.

A tax deductible annual contribution up to **25% of payroll can be made each year to the ESOP** in stock and/or cash. This plan is commonly known as a Stock Bonus Plan (SBP).

Generally, a non-leveraged ESOP is established to promote growth of the sponsoring company by creating tax deductions from the newly issued shares, thus improving cash flow and reducing taxes. It is also one of the best plans for gradual accumulation of retirement benefits tied to the value of the company stock, and for promoting participatory management structures. The purpose of the ESOP can be to purchase shares from a shareholder on a cash flow basis where the tax incentives attributable to leveraged ESOPs are either not important, or do not require borrowing funds. Using a non-leveraged ESOP will avoid the impact of debt on the corporation’s value and balance sheet. Also, funding an ESOP on a cash flow basis suggests that the company’s obligation to repurchase shares from departing participants may be easier to manage than with a leveraged plan.



Steps:

1) Company makes a tax deductible contribution of cash or stock to the ESOP.

2) ESOP purchases stock from company or shareholders.

3) Company increases its cash flow and net worth or shareholder receives liquidity for company stock.

Example: If the company contributed new shares of stock to the ESOP to fund the ESOP, the company receives a "deduction" for the fair market value of the stock (which in a cash flow analysis did not cost the company anything to issue and contribute).

If we assume the stock in a typical contribution was valued at $50,000, the company would receive a deduction for the contribution of stock to the ESOP. The deduction will allow the company to pass through more money to the shareholders in the year of the contribution. Remember, the company's cash flow was not lessened by the contribution of newly issued stock.

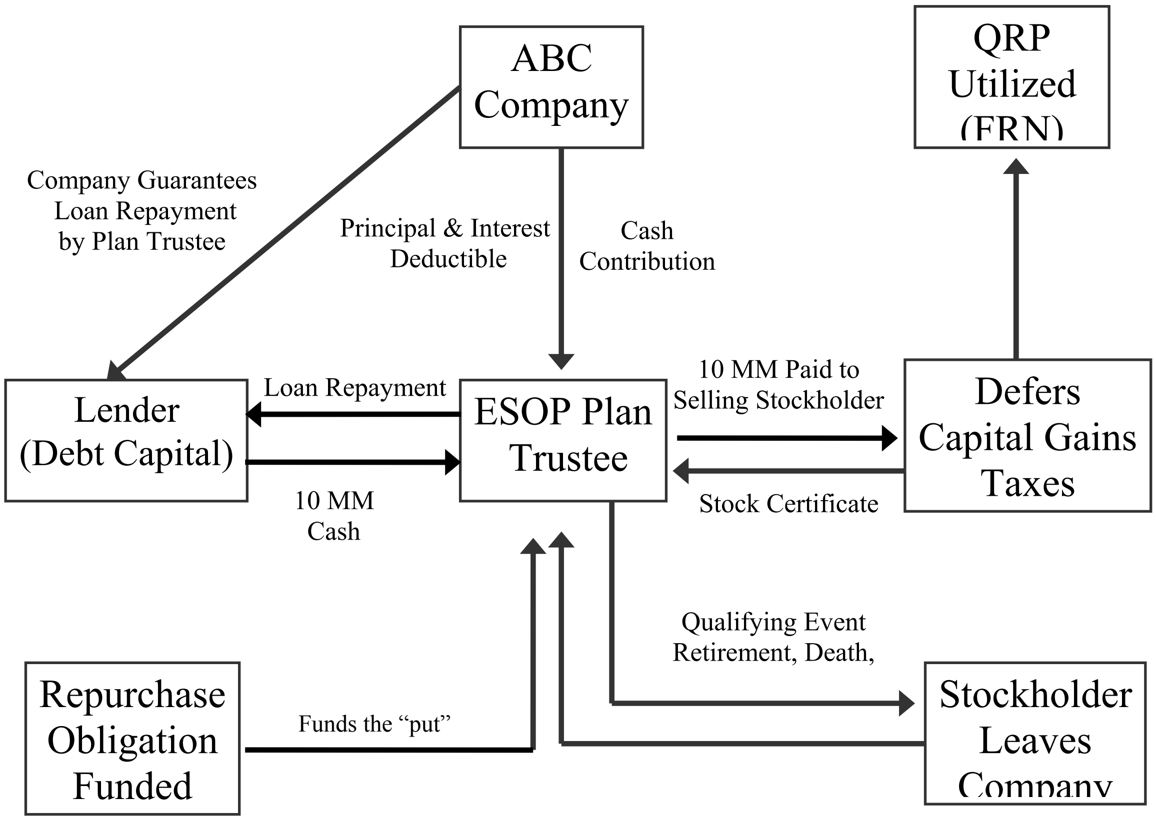
Leveraged ESOPs

In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust, which enables the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make the loan to the ESOP.

If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division, the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly traded stock, or for any other corporate purpose.

Two tax incentives make borrowing through an ESOP extremely attractive to companies that might otherwise never consider financing their employees' acquisition of stock. **Since ESOP contributions are tax deductible, a corporation which repays an ESOP loan, in effect, gets to deduct principal as well as interest from taxes.** This can cut the cost of financing to the company significantly, by reducing the number of pre-tax dollars needed to repay the principal by as much as 34%, depending on the company's tax bracket.

This is a schematic of a Leveraged ESOP.



Example outlined above: The client is an owner of a closely held business with an interest (stock) in the company worth $10,000,000. The client has no ready market for the sale of his company and he would also like to sell the stock with no current income tax or capital gains taxes. The best way to help this client is with the creation of an ESOP which will purchase the owner's stock for a "fair market value."

	Scenario A	Scenario B
	"On The Street"	*ESOP Sale*
	Discounted Sale	Premium Sale
A. Selling Price	$8,000,000	10,000,000
Cost Basis	$1,000,000	$1,000,000
B. Capital Gain Tax	$1,859,200	0
C. Net Proceeds from Sale	**$6,140,800**	**10,000,000**
D. Company Loan Repayment Deductions	$0	All Interest & Principal

Source: UBS Paine Webber, ESOP Transactions Report, Issue I, 4/16/01.

The above example illustrates how a company can have a fair market value of $10,000,000, but no viable buyer at hand. If a seller does not want to wait for a buyer or simply wants to transfer ownership in the company to the employees, he/she could choose to implement a leveraged ESOP (assuming the company meets the criteria to obtain the needed loan).

If the FMV is $10,000,000 and the seller would have to discount the sale price to $8,000,000 in order to sell quickly , the seller got an extra $2,000,000. In addition and, as with any ESOP transaction, the seller is able to use a Section 1042 rollover to defer the capital gains with the sale of the stock.

As you can see from the numbers above, a leveraged ESOP can be a very powerful tool to help clients sell their business and fund their retirement in a tax favored manner. Clients do need to understand that they can not use an ESOP to artificially inflate the value of their company when selling it to an ESOP. While there is nothing wrong with selling a company's stock to an ESOP when there is no active market for the stock, the sale price of the stock must still be the FMV (which is determined by an independent evaluation).

The specifics of how a company postures itself to qualify for an ESOP loan is a very important issue, but due to space constraints, the topic is not fully discussed in this material. For a further discussion on the specifics on the lending process in an ESOP transaction, please contact The Wealth Preservation Institute for further information.

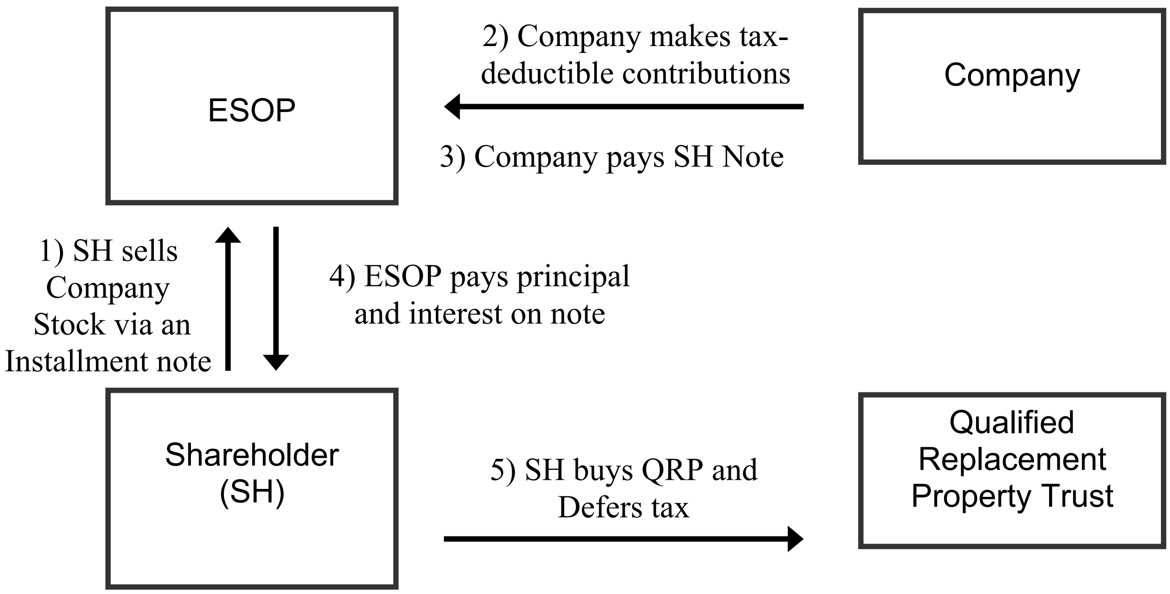
Additionally, sellers need to be careful not to implement a leveraged ESOP if they would create a situation where the financial viability of **the company suffers due to the debt service** on the ESOP loan. A seasoned ESOP expert can help advisors and their clients avoid a negative outcome with a properly constructed leveraged ESOP.

Finally, leveraged ESOPs will not work for companies that can not qualify for an ESOP loan due to lack of assets to pledge as collateral and/or a lack of cash flow to service the debt on the loan.

Seller Financed ESOPs

If the corporation does not have the cash flow to fund the ESOP which in turn would buy the selling shareholder's stock, where does the money come from? As you will read, the ESOP could borrow the money which would create a "leveraged" ESOP. Many small companies will not qualify for such a loan and those that can, may not want to for the typical reasons companies do not want to have sizable loans on the books.

A way for a company to create a non-leveraged ESOP without a loan from a traditional lending source is to have a seller financed ESOP. The seller of stock is typically the owner of the company. Instead of being paid with borrowed money (see leveraged ESOPs), the owner will take a note payable from the ESOP as payment for the purchased stock. See the following schematic.



Steps:

1) A Shareholder sells his/her stock to the ESOP in exchange for a note payable from the ESOP. The note has repayment terms as negotiated and will pay interest and principal to the Shareholder over a specified period of time.

2) The company makes tax-deductible contributions to the ESOP for up to 25% of the annual payroll.

3) Shareholder receives principal and interest payments from the ESOP tax-free.

4) Shareholder defers the tax due on the sale of stock by rolling the money into QRP (Qualified Replacement Property).

A seller financed ESOP allows the company owner to collect the interest on note payable from the ESOP and allows **much more flexibility should the company have problems funding the principal and interest payment** on the note to the ESOP every year.

Tax Deferral Dilemma

One problem that arises with a seller financed ESOP is that the seller MUST invest the sale proceeds from the stock in qualified replacement property (QRP) within 12 months of the sale. If the installment note payable to the seller from the ESOP is due to pay over a several year period, the seller still must fund the QRP within 12 months for the entire proceeds of the sale. Few sellers have the liquidity to fund the QRP without actually receiving the funds from the sale of the stock and so, many times a seller financed ESOP will still involve a loan from an outside lender and the use of "Floating Rate Notes" (FRNs).

Using FRNs in conjunction with QRP is discussed in an upcoming section specifically dealing with FRNs as an investment tool.

What is important to understand with a seller financed ESOP is that the structure is very user friendly for the company (because of a friendly lender), that the client will be earning the interest on the loan (instead of a bank). Most importantly, if the client desires to roll the sale proceeds from the sale of stock into QRP, the client must use an outside lender (which usually involves the use of FRNs) and fund the QRP within 12 months of the sale of stock.

Tax Advantages for Business Planning

Introduction

In order to broaden the ownership of capital and provide employees with a stake in the ownership of their employing corporation, Congress has granted a number of specific incentives meant to promote increased use of the ESOP concept. This is especially true for a leveraged ESOP, which, through the use of borrowed funds, provides a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer and can significantly improve the corporate financial picture.

Deductibility of Dividends

A deduction is available for dividends paid on ESOP leveraged stock to the extent that the dividends are used to reduce the principal or pay interest on an ESOP loan incurred to buy that stock. Dividends used to repay ESOP debt in this fashion must be "reasonable." Dividends used in this manner are not included in the 25% contribution limit for leveraged ESOPs. Some ESOPs have purchased convertible preferred stock rather than common stock to assure a relatively reliable stream of dividend income to service the loan.

Employers are also permitted a tax deduction for cash dividends paid on stock which has been purchased with an ESOP securities acquisition loan, to the extent that the dividends are passed through to the employees, or, at the election of ESOP participants or their beneficiaries, paid to the them or held in the plan and reinvested in company stock. This provision allows companies to share current benefits of stock ownership with their employees to complement the long term benefits of capital ownership. The dividends paid to employees are taxable as current ordinary income to then S-Corporations/Special Tax Considerations.

ESOP "Section 1042" Rollover

An Additional ESOP incentive provided by the 1984 Tax Reform Act allows a major shareholder of a closely held company to sell his stock in the company to the firm's ESOP and defer federal income taxes on the gain from the sale. In order to qualify for this Section 1042 rollover:

1) The ESOP must own at least 30% of the company's stock immediately after the sale; and,

2) The seller must reinvest the proceeds from the sale in the securities of domestic operating corporations within twelve months after the sale.

The seller, certain relatives of the seller, and 25% shareholders in the company are prohibited from receiving allocations of stock acquired by the ESOP through a rollover. Generally, the ESOP may not sell the stock acquired through a rollover transaction for three years.

The ESOP rollover provides a substantial tax advantage that might otherwise be unavailable to a retiring owner. Normally, his options would be to sell his shares back to the company, if such a transaction is feasible, or to sell out to another company, either for cash or for a block of shares in the other company. Selling to an ESOP, on the other hand, allows a retiring shareholder to exchange his interest in the company for a safely diversified portfolio of securities—or the stock of a single new company—without paying any taxes on the transaction.

The seller's tax basis in the employer stock which he sells will be carried over to the replacement property in which he invests the proceeds. **If the replacement property is held until death, however, a stepped-up basis for those securities is provided**.

In addition to the substantial tax advantages, selling to the ESOP preserves the company's independent identity. A sale to an ESOP also provides a significant financial benefit to valued employees and can assure the continuation of their jobs. Moreover, selling to an ESOP allows the seller to sell all or just a part of his interest in the company, and to do this gradually or all at once, as he prefers.

To qualify for rollover treatment, the stock sold to the ESOP must be common or convertible preferred stock of a closely held domestic corporation and must have been **owned by the seller for at least three years**. Additionally, at this time Section 1042 tax deferral is only available to selling owners in a C-Corporation, not an S-Corporation.

Practical Planning: The Use of Floating Rate Notes (FRNs)

In the Leveraged ESOP example, the majority owner of the company sold $10,000,000 worth of his stock to the ESOP and rolled the entire $10,000,000 into "qualified replacement property" (QRP). By rolling the money into QRP, the seller had to pay NO capital gains on the proceeds from the sale and the money is allowed to grow tax deferred for use at a future time.

The example is something that could happen in real life, but most clients who sell $10,000,000 in stock will want to use some of that money for multiple purposes. Without other planning, in order for a client to have access to the money, at the very least the client will have to pay capital gains tax when accessing the money.

As stated earlier, the roll over money can be re-invested in U.S. securities, but most of the clients selling significant amounts of stock to an ESOP will be older and will not want to have limits on how they can re-invest the money and many will want to re-invest in something with principal protection (like an equity indexed annuity).

In addition to U.S. securities, "floating rate notes" also qualify U.S. securities and therefore qualify as QRP. What is a FRN? It is a bank or lender "note" similar to a home or business loan. The client through a QRP trust would invest in these FRNs, purchased in the open market as an investment.

A FRN has a variable interest rate. Adjustments to the interest rate are usually made every six months and are tied to a specific money-market index. FRNs protect investors against a rise in interest rates, but carry lower yields than fixed notes of the same maturity. FRNs can be used to balance risks incurred through other interest rate instruments in an investment portfolio. For example, a bond that pays a fixed rate coupon will lose value if interest rates rise, but the value of an FRN will be less sensitive to interest rate changes as its coupon moves in step with other interest rates changes, for better or for worse.

Creating a "margin" account

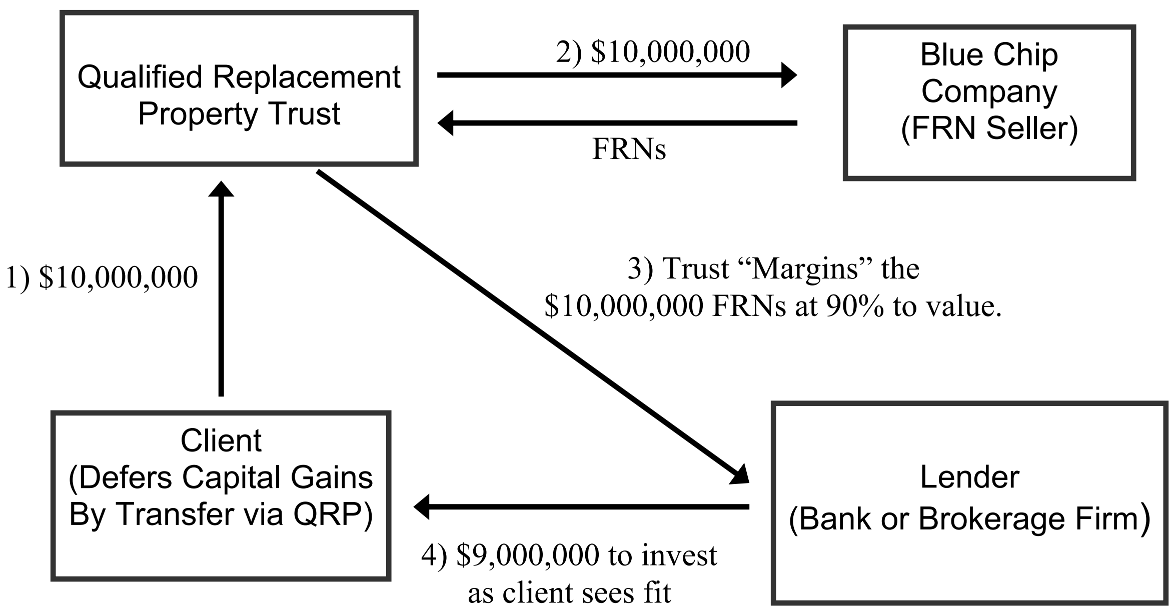
Before continuing, a discussion/explanation of how clients use FRNs in conjunction with roll over money from an ESOP, it is important understand what a **"margin" account** is and how it works. A margin account is typically created when a client has a stock portfolio and pledges that portfolio as collateral on a loan. The client receives cash from a lender and the stock account is considered "margined" as collateral.

Margin loans can be called by the lender (a call is a demand for immediate payment of the note), so when using a margin loan in conjunction with an ESOP and QRP, it is important to find a margin loan with a long callable period, meaning the lender cannot call the loan for many years (sometimes up to 30 years).

With a typical ESOP transaction, the client will find a lender (which could be the same brokerage house that helped the client purchase the FRNs) who will lend directly sizable amounts of money to the client, and will create a "margin" account using the FRNs as collateral.

The main reason clients have the QRP trust purchase FRNs is to create a stable investment that will track interest rates charged on "margin" loan. The client is trying to create a situation where the return on the FRNs is greater than the interest charged on the margin loan. There are no taxes due inside the QRP trust and the returns from the FRNs will be used to pay the interest on the margin account. See the following schematic for an illustration for how to incorporate FRNs and margins account money to benefit the client.

In the following schematic, assume **the client has already received $10,000,000 from the ESOP** for the sale of his company stock.



What was accomplished with this strategy?

-The client paid NO capital gains when he received $10,000,000 from the ESOP (due to the fact that the money was rolled into the QRP trust).

-Since the QRP trust margined the FRNs, the client received $9,000,000 income and estate tax free to invest or spend as the client sees fit.

-The $9,000,000 FRN investment creates an investment return that will move up and down with interest rates charged on the margin account. In doing so the QRP should not be in a situation of dipping into principal to pay interest on the margin account.

Example with numbers

Suppose the owner of a company sells 30% of his ownership to an ESOP for $10 million. This transaction is tax-free because he invests the $10 million in a FRN, which bears interest at 7% per annum. The owner decides he needs money to invest short term, so he borrows $9 million against the security of the FRN. The loan can bear (for this example) a floating interest rate as high as 7.8%, and the owner will still have enough income on the FRN to cover the interest obligation. Since both the FRN and the loan are pegged to the same market index, the owner will always have enough income on the FRNs to cover the interest cost of the loan, whether market interest rates rise or fall. He or she is then free to spend or invest the $9 million in any way.

When the loan comes due, the owner can sell the FRN at face value and pay off the loan. The owner is subject to taxation only on the interest earned, and can deduct from the taxable amount all the interest paid on the $9 million loan. Taxes must also be paid on any gains realized from the $9 million of short-term investments.

Results

The result of the rollover is that the seller can become completely liquid on the portion of the proceeds from the sale to an ESOP represented by the amount borrowed against the FRNs. Let's assume the advance rate is 90%. The balance, 10%, remains as a high-quality asset owned by the seller.

Older Clients

Because most ESOPs benefit older owners looking to sell their companies, the example above can be tweaked so that the “call” on the margin account will happen after the client dies. If the client dies prior to having a call on the margin account, the margin account would be paid off and the remaining assets in the QRP would pass to the heirs with a “stepped-up basis.” This creates a very beneficial situation for both the client and the heirs.

If the client uses some of the money from the margin loan to purchase life insurance in an irrevocable life insurance trust, the client can assure that the entire value in the QRP trust passes to the heirs (because the life insurance can pay for the taxes due on the QRP).

An ESOP with the use of QRP property, FRNs and a margin account is a very unique and powerful tool for a clients looking to sell an interest in their company(s).

Putting the ESOP in Place

When the process of analyzing and designing the ESOP has been completed, the company will typically have an attorney prepare a formal plan document which will set forth the specific terms and features of the plan. An appraiser will then prepare a finished and formal valuation report, based on the most recently available data at the date the ESOP will be 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 circumstances for establishing the ESOP, it may be prudent to address any future contingencies in the plan document.

Clients will also need to decide who will serve as the ESOP's trustee and who will administer 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 which may be given to a professional administration firm or handled by the sponsor. The administrator is responsible for maintaining all the 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, arrangements must be made for securing the financing needed to complete the trans-action. Banks, savings and loans, investment banking firms, mutual funds, and insurance companies in the business of lending money may all qualify as ESOP lenders.

The company must formally adopt the plan and trust documents which establish the ESOP and its attendant trust. Also, the firm must submit a copy of these documents to the Internal Revenue Service (IRS) with an application for confirmation (called "determination") of the plan's tax-qualified status (Form 5500). The plan must be a qualified ESOP under sections 401(a) and 4975(e)(7) of the Code in order to be eligible for the various tax benefits. However, it is not normally necessary to wait for a letter of determination from the Internal Revenue Service 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. However, contributions and leveraging for a given year may occur up until the company files its corporate tax return, including extensions.

What Are The Initial Costs of an ESOP?

Feasibility Study

Most corporations considering an ESOP should first engage the appraisal firm to prepare an ESOP feasibility study. The study details the benefits to corporation and Owner over a 10 year period of:

(i) non-leveraged ESOP;
(ii) leveraged ESOP;
(iii) Subchapter S election;
(iv) immediate outright sale; and
(v) no sale until the end of the term.

Costs of $3,500 to $10,000 are not uncommon for this study.

Appraisal Cost

The most important initial step is appraising the corporation appraisals (which are not required every year, but are required whenever there is a transaction). Owner(s) will not approve an ESOP sale without knowing the proposed stock price. For closely held corporations, appraisal fees of $5,000-$15,000 are common.

Usually, an owner engages the appraiser if the owner is contemplating selling. If the corporation will sell to the ESOP, the appraiser should represent the ESOP trustee to assist in properly discharging its fiduciary duties before agreeing to the purchase. An ESOP trustee in some circumstances might wish to **secure an appraisal from another firm**.

An appraiser should disclose:

(i) initial appraisal's price;
(ii) cost of later years' appraisals;
(iii) appraiser's specific ESOP experience;
(iv) experience testifying in court;
(v) impressive appearance to make a good witness?

(vi) cost of a repurchase liability study;
(vii) how long it will take to produce the initial appraisal; and
(viii) how long it will take each year, after the Corporation has supplied the appropriate updated financial information, to produce the updated appraisal.

Lawyers are also involved when forming an ESOP and typically:

(i) review the ESOP plan and trust documents; and
(ii) represent the plan, or plan sponsor, or the individual owner.
(iii) consult, e.g., coordinating bank loan with ESOP funding, restructuring the buy-sell agreement, etc.

It is difficult for us attorneys to be involved for less than $2,000.

Legal fees also depend upon how many law firms are used. More firms equal more fees. In some situations there may be four different law firms representing:

(i) ESOP trustee;
(ii) Corporation;
(iii) Owner;
(iv) Bank.

Administration

The other initial cost is plan administration. Plan administration costs (keeping records, filing reports, sending plan account statements, etc.) depend on the number of employees. There are certain fixed costs, however, so there are some economies of scale for larger firms. A firm of 20 employees might reasonably expect to pay around $2,000 per year as a base cost, plus $30 to $60 per employee.

S-Corporations/Special Tax Considerations

Effective for tax years beginning after December 31, 1997, the Internal Revenue Code (the "Code") was amended to permit qualified plan trusts to be S-Corporation shareholders. As a result, ESOPs may be S-Corporation shareholders. However, the other tax benefits described in the previous material (Deductibility of ESOP Contributions, Deductibility of Dividends and ESOP Rollover) do not apply to S corporations.

Subsequent legislation corrected certain technical flaws in the original S-Corporation/ESOP legislation and made advantageous changes in the method of taxation of ESOPs that hold S-Corporation stock. The 1997 Tax Act enacted the following provisions:

(1) The prohibited transaction provisions of the Code and ERISA were amended to permit plans sponsored by S-Corporations to use the exemption for the sale of company stock previously available only to C-Corporations. Without this change, most common ESOP stock purchase transactions would have been prohibited for S corporation ESOPs.

(2) Amended the distribution requirements to provide that an S-Corporation ESOP may deny participants the right to demand their distributions in the form of company stock in the same manner as a corporation whose charter or bylaws restrict ownership of its employer securities to current employees or a trust defined in Code §401(a). Without this change, any former employee could have terminated the corporation's subchapter S status simply by demanding his distribution in stock and then transferring the stock to an IRA on a permanent basis, which is not a permitted holder of S corporation stock.

(3) Repealed the "unrelated business income tax" rules imposed on the ESOP's share of S-Corporation's earnings. This change achieves the single level of tax regime for ESOP participants that other S-Corporation shareholders enjoy. As a result of this change, neither the corporation nor the shareholders pay current income tax on the ESOP's pro rata share of the S-Corporation's earnings.

An S-Corporation is a corporation for state law purposes that generally is not required to pay federal corporate income tax. (Many, but not all, states accord S-Corporations similar treatment.) Instead, the shareholders must pay tax on their proportionate share of the S-Corporation's income. This means that S-Corporation income is not subject to the two layers of tax applicable to other corporate income: a tax on corporate earnings payable once by the corporation, and a second tax payable by the shareholders when those earnings are distributed as dividends or liquidation proceeds.

The repeal of the unrelated business income tax may provide a strong incentive for some C-Corporations to convert to S-Corporation status.

> *Example*: An S corporation is owned 50% by an ESOP and 50% by an individual and has $1 million of earnings for its taxable year. The individual will owe a tax on his $500,000 share of the corporation's earnings on his tax return, but the ESOP will owe nothing because it is a tax-exempt entity. Presumably, either the value of the stock of the company will increase to reflect its share of the earnings, or those earnings will be distributed to the ESOP, so that when participants receive their ultimate taxable distributions, they will then pay tax on their share of the earnings. The date of that tax payment could be many years off, however, because participants have the right to roll their ESOP distribution directly into an IRA.

In order for a C-Corporation to convert to an S corporation, the following requirements must be satisfied:

(1) *100 shareholder limit.* An S-Corporation cannot have more than 100 shareholders. An ESOP is considered a single shareholder.

(2) *Eligible shareholders*. An S-Corporation can have as shareholders only individuals, estates, certain trusts, and for tax years beginning after 1997, certain tax-exempt organizations, including qualified plan trusts. Non-resident aliens cannot be S-Corporation shareholders.

(3) *One class of stock*. An S-Corporation must have only one class of stock issued and outstanding. A corporation is treated as having only one class of stock if all the outstanding shares confer identical rights to distribution and liquidation proceeds.

As a result of the single class of stock requirement, in the case of a less than 100% ESOP-owned company, the ESOP must receive an S-Corporation dividend distribution in an amount equal to the distribution made to the other shareholders. Although the dividends paid to an ESOP are not tax-deductible under Code §404(k), dividends paid on the unallocated shares may still be used to make payments on an ESOP loan and will not count against the contribution (§404) or annual addition (§415) limitations. Depending on the amount of accumulated earnings and profits, dividends on allocated shares may not be used to repay ESOP indebtedness.

It should be noted that certain tax benefits may be lost upon conversion to S-Corporation status. For the 10-year period following its conversion to S-Corporation status, the corporation will be subject to a “built-in gains” tax on the disposition of any asset which it held on the day of its S-Corporation election. This tax, which is in addition to the tax payable by the shareholders, is imposed on the gain that had accrued in the asset before the corporation’s conversion to S status. Corporations on the cash method of accounting may owe built-in gains tax on the amount of their receivables as of the date of their S-Corporation election.

In addition, “LIFO recapture tax” must be paid by a C-Corporation on the LIFO method when it converts to S-Corporation status. Also, certain fringe benefits for 2% or more shareholders are excludible from income if they are employed by C-Corporations, but not if they are employed by S-Corporations.

No Section 1042 Rollovers

A significant limit on S-Corporations ESOPs is that the selling shareholders are NOT allowed to take advantage of the 1042 rollover rules that allow the sellers to defer tax on the sale of their stock to the ESOP. Since many small business owners sell to an ESOP because of the 1042 rollover rules, the use of S-Corporation ESOPs is not a viable option for those types of clients.

Anti-Abuse Rules

While the abuse of S-Corporation ESOPs has not been discussed due to space limitations, know that abuse of the concept by unscrupulous advisors forced congress to act.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act which contained several important changes to S-Corporation ESOPs. The laws affecting S-ESOPs were meant to curb the following abuse:

Single employee S-Corporations. The sales pitch with a single employee S-ESOP was that a client could set one up and then defer significant amounts of income into the ESOP and not pay tax on that income. This was not looked upon favorably by Congress since ESOPs originated as a tool to help promote employee ownership in companies.

As a general rule, S-Corporation ESOPs will not be viable planning tools for the vast majority of clients (especially small business owners), and if a client is interested in creating an ESOP he/she is better off being a C-Corporation and implementing an ESOP under the traditional C-Corporation rules. If you believe your clients might benefit from an S-Corporation ESOP, please contact The Wealth Preservation Institute for further information.

Conclusion

The cost of establishing a simple, non-leveraged stock bonus ESOP is usually not greatly different than for other defined contribution plans. A leveraged ESOP would entail a considerably higher cost to establish, since the process of designing and installing a leveraged plan is lengthier and more complicated, with the additional work of lenders and/or investment bankers.

The process of setting up an ESOP is complicated, but that should not discourage interested firms from investigating employee ownership. 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 great.

Special Fiduciary Liability Rules Under ERISA for ESOPs

There are special fiduciary liability rules under ERISA for ESOPs. The primary purpose of a stock bonus plan (the ancestor and major building block of an employee stock ownership plan) is "to give employee-participants an interest in the ownership and growth of the employer's business" (Revenue Ruling 69-65). This distinction is critical to interpreting the fiduciary responsibility provisions of ERISA. ERISA Section 404(a)(1) requires that fiduciaries act for the "exclusive purpose of providing benefits to participants," and serving as a "prudent man acting in a like capacity . . . would . . . in the conduct of an enterprise of a like character and with like aims. "

The purpose of ESOP financing is two-fold:

1) To use corporate credit to acquire ownership of employer stock for participants.

2) To finance the capital requirements of the employer corporation.

No other qualified plans may incur debt to be used to finance corporate capital requirements, or may be used as vehicles for debt financing transactions involving parties-in-interest. Revenue Ruling 79-122 properly recognizes the ESOP "as a technique of corporate finance." The *prudent man, exclusive purpose*, and *document rule* requirements of ERISA Section 404(a)(1) and the *exclusive benefit* rule of IRC Section 401(a) must be analyzed and interpreted with the understanding that the ESOP is a technique of corporate finance. The *diversification rule* is generally not applicable to ESOPs.

As long as an ESOP prudently acquires and holds company stock as the benefit to be provided to employees, ERISA's Sections 404(a)(2) and 407(b)(1) (which specifically permit an ESOP to be wholly invested in employer stock) are satisfied. Also under Revenue Ruling 69-494, the exclusive benefit rule generally is satisfied if:

1) The purchase price does not exceed fair-market value.

2) The prudent man standard also is complied with.

The Tax Reform Act of 1976 makes it clear that Congress intended for ESOPs to be used under ERISA as a technique of corporate finance. Code Section 4975(d)(3) and ERISA Section 408(b)(3) provide for prohibited-transaction exemptions, which are available only to an ESOP and are not applicable to conventional stock bonus or profit-sharing plans.

The legislative history of the Tax Reform Act of 1986 (TRA '86), including statements by a number of Senators on the floor of the Senate, indicate Congress's clear intention that ESOPs be a technique of corporate finance.

Prohibited Transactions and Special Exemptions

Fortunately for employers and shareholders, ERISA contains statutory exemptions from many of the restrictions that would otherwise prohibit ESOP transactions. ERISA's Sections 406 through 408 contain the prohibited-transaction restrictions and the related exemptions. These restrictions apply independently of the fiduciary standards. Violation of any of the fiduciary standards or of the prohibited transaction restrictions by a fiduciary may result in civil penalties and personal liability. ERISA Section 409 provides that a fiduciary in breach will be personally responsible for any losses to the ESOP as a result of the breach, and that profits must be restored. ERISA Section 502(l) provides for penalties to fiduciaries.

Several exemptions from ERISA's general fiduciary provisions apply to ESOPs. An ESOP is not subject to the prohibition on acquiring and retaining an investment in qualifying employer securities that exceeds 10 percent of the fair-market value of its assets. ESOPs also are exempt from the diversification requirement, but not from the prudence requirement.

An ESOP also may purchase stock from (or sell stock to) the employer, a major shareholder, or any other party-in-interest without violating the prohibited transaction rules, provided the transaction is for adequate consideration and no commission is charged to the plan. See, for example, Prop. Labor Reg. Section 2510.3-18.

An ESOP may leverage its stock purchases; if the interest rate is reasonable, if the loan is primarily for the benefit of plan participants and their beneficiaries, and if certain other stringent requirements are met. For example, the only collateral acceptable for certain exempt loans is the stock purchased with the loan proceeds. The employer, however, may give any collateral it may have available.

The ESOP loan documents for an exempt loan must specifically provide that all the foregoing relating conditions be met, and also that:

1) The loan will be repaid **only** from employer contributions made to enable the trustee to repay debt, earnings attributable to contributions, earnings on unallocated shares, and dividends on stock acquired with the loan proceeds or the proceeds of another exempt loan.

2) The lender's recourse on the note against the trust must be limited to the stock used as collateral and to the contributions and other amounts described in condition Number 1 above.

3) Each year, as the loan is repaid, the stock is allocated to the accounts of active participants as payments are made under the loan, according to the prescribed formulas.

4) The loan must be for a fixed term and satisfy certain requirements in the event of default, including that a party-in-interest lender may not accelerate payments in the event of default and that the loan must not be payable on demand of the lender, except in the case of default.

Accounting Considerations

ESOPs must address some difficult accounting issues, both from the employer's point of view in preparing the financial statements, and in the trust accounting and participant accounting areas. Since 1976, the American Institute of Certified Public Accountants (AICPA) has published accounting guidelines and updates.

On November 22, 1993, the AICPA published *Statement of Position 93-6 (SOP 93-6)*. While the rules in regard to the accounting treatment are beyond the scope of this chapter, the basic rules are summarized below. Prior to *SOP 93-6*'s publication, *SOP 76-3* and several updates provided guidance. The revised SOP is effective for ESOP stock acquisitions after December 31, 1992. Sponsors of ESOPs that were formed prior to the effective date can elect the new standard. The reporting in the final standard is required for financial periods beginning after December 15, 1992.

Liabilities

All ESOP debt will be recorded on the balance sheet of the plan sponsor, with no exceptions. The issue of the "push down" of an obligation to a subsidiary is still present, but is not discussed.

Equity

The contra equity account will still be an offsetting entry. The contra equity account will change as compensation is recognized. Equity recorded may be adjusted for immediate post-transaction valuation changes.

Income

The compensation cost will be based upon the fair-market value of the shares released or deemed to be released for the relevant period.

Dividends

Any compensation cost obligation will not be reduced to the extent the obligation is satisfied with dividends on unallocated shares. Dividends on allocated shares retain the character of true dividends.

Earnings per Share

Unreleased shares will not be considered to be outstanding. All convertible preferred shares will be considered to be common stock equivalents.

Disclosures

The repurchase liability, as reflected by the current value of the allocated shares, must be disclosed. The use of an actuarial estimate of this future obligation is not authorized.

As evidenced by the new SOP, the AICPA has made an already difficult area more difficult, and with no discernible increase in benefits to anyone. The underlying ESOP transactions governed by this new standard have not changed one iota. This change was not welcomed by anyone except the AICPA and its members.

Repurchase Liability

The ESOP repurchase liability has not been given much attention. Basically, it arises because the employer contributes cash or stock and the stock must be bought back, usually at an increased price. And, the employer must buy it back—for cash. Since ESOPs are relatively new, the cash needed to repurchase company stock from departed employees and their beneficiaries has not yet created a problem for many companies. But there is a clear risk it will, unless companies properly plan for it. It is the authors' opinion that this is potentially **the most serious difficulty the ESOP will experience**. Since the repurchase liability affects the value of company stock, the balance sheet and income statement, the number of shareholders, and employee morale, it must be forecast and planned for.

The first step in facing this potential problem is to develop a projection of future cash requirements. A computer model specifically suited for this purpose is particularly advantageous, because without one it is almost impossible to see how the plan operates under different assumptions, and how the company's income, cash flow, and balance sheet are affected. The final step is to analyze the various funding methods to determine what would work best in a particular situation. It is conceivable that the repurchase liability could consume more cash than the company could contribute in a given year, since the entire contribution may have to be used to make repurchases. All the more reason to plan!

The repurchase liability is partially alleviated by varying distributions over time, varying the size of the contribution, varying the stock and cash contribution mix, properly timing stock repurchases, and carefully planning for the proper use of dividends on employer securities and of income on other assets. Other solutions include going public, private placements, being acquired, or the creative use of corporate-owned life insurance.

The employee's diversification right is a concept added by TRA '86. It allows employees an elective diversification of their ESOP account balance of securities acquired after December 31, 1986. This election is extended to any employee who is age 55 or older with 10 years of participation in the ESOP. Elections for the first five years may cover up to 25 percent of an employee's account balance (less the portion diversified). The election in the final year may cover up to 50 percent of his or her account balance (less any prior portion diversified).

Companies should not be discouraged from adopting or continuing an ESOP because of the "unknown" repurchase liability, nor should a company adopt an ESOP without ample consideration of the potential repurchase liability. Instead, careful advance planning, ongoing review, good communications, increased productivity, and increased company profits, as well as continued flexibility and encouragement from Congress and the government agencies, should solve almost every problem created by the repurchase liability—but not without planning for it today. The repurchase liability plan must be implemented properly, carefully maintained, and revised as often as necessary to reflect the real world.

Conclusion on ESOPs

As stated in the beginning of this section, ESOPs "experts" will state that the transaction is an easy one to understand. The previous material should have illustrated that ESOPs as a plan might be easy to understand (the sale of stock to a trust where the seller can use a Section 1042 rollover to avoid tax), but the specifics of the plan are quite complex.

As a succession planning tool for certain small business owners, an ESOP has advantages that no other plan can offer. Clients are allowed to sell their C-Corporation stock to an ESOP, tax defer all the proceeds with qualified replacement property and, if the client dies before taking the money out of the QRP trust, the heirs will receive a stepped up basis on the stock.

Advisors who can fully understand ESOPs, their benefits and application to various business owners, will be far ahead of the game. They will be able to use ESOPs not only to benefit many clients, but also to set themselves apart from other advisors in their local area who do not have a working knowledge of ESOPs.

