

# Acquisitions For S-Corporation ESOPs

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# ESOP-OWNED S-CORPORATION STRUCTURES

## Structure One

Newly-formed ESOP: Tax Deferred to Seller

## Structure Two

Newly-formed ESOP: Taxable to Seller

## Structure Three

Existing ESOP: Tax Deferred to Seller

## Structure Four

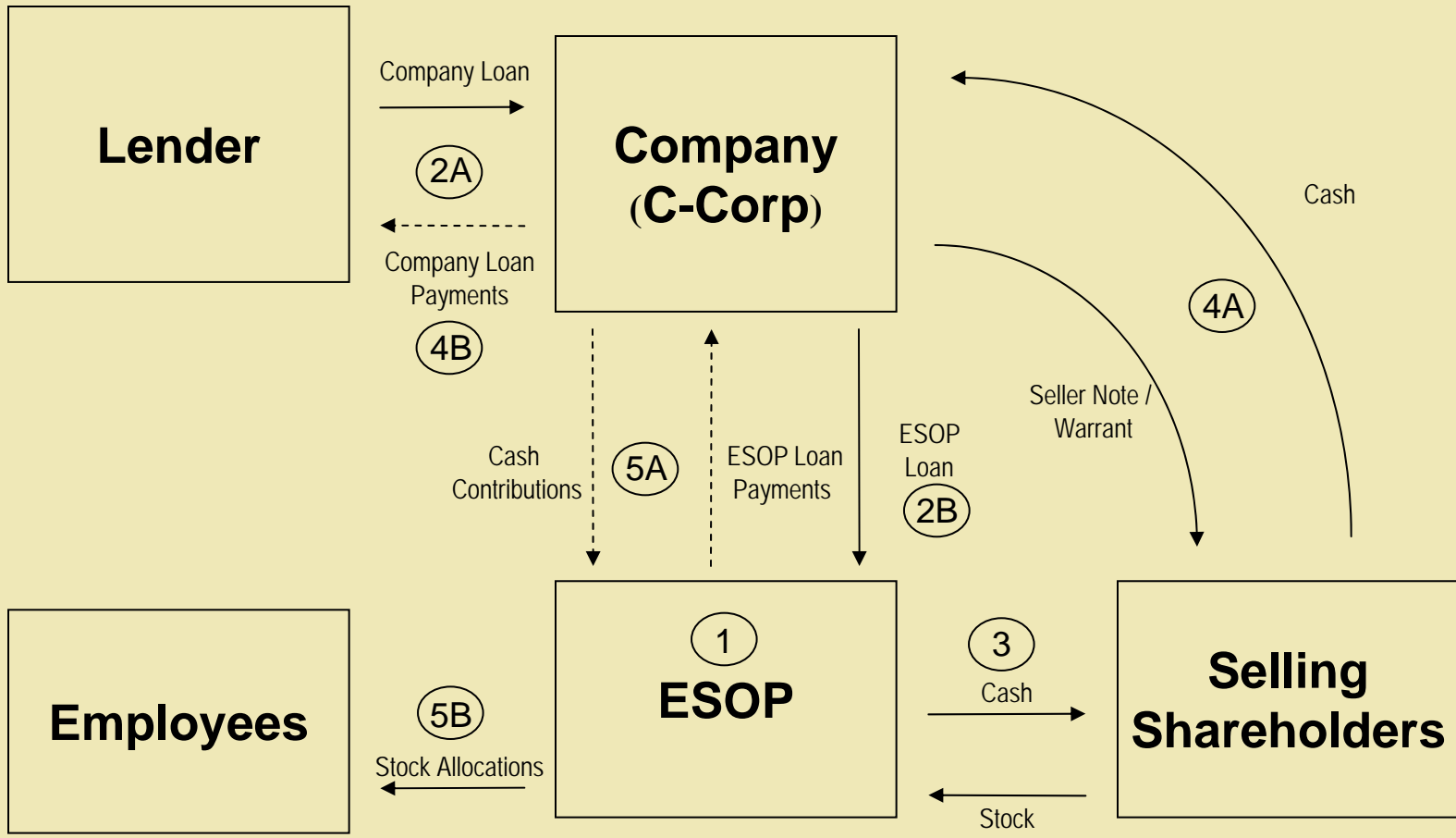
Existing ESOP: Taxable to Seller

# Newly-Formed ESOP: Tax Deferred to Seller

## Transaction Steps (Company is a C-Corp)

- Step One: Formation of ESOP
- Step Two:
  - A. Company borrows from lenders
  - B. Company loans money to ESOP
- Step Three: ESOP buys stock from selling shareholders
- Step Four:
  - A. Selling shareholders loan money to the company in exchange for a note and warrant to partially finance the transaction
  - B. Money used to partially repay lenders
- Step Five:
  - A. Contributions made by the company to repay ESOP loan which, in turn, are used to repay lenders
  - B. Stock allocated to participant accounts
- Step Six: Company elects S-corporation status

# Newly-Formed ESOP: Tax Deferred to Seller



# Newly-Formed ESOP: Tax Deferred to Seller

## Tax Treatment

Tax deferred to selling shareholders if certain qualifications satisfied

No tax on earnings if S-election made

# Newly-formed ESOP: Tax Deferred to Seller

## Target Characteristics

C-Corporation required to qualify for tax deferral

S-Corporation conversion to C-Corporation possible

Limitations on conversion back to S-Corporation

Built-in gains (BIG) Tax

# Newly-Formed ESOP: Tax Deferred to Seller

## Seller Characteristics

Individuals

Trusts

Other entities

Limitation: Gain includable in gross income of a C-Corporation

# Newly-Formed ESOP: Tax Deferred to Seller

## Structure Requirements

C-Corporation only

ESOP can only purchase stock; no asset purchase

# Newly-Formed ESOP: Tax Deferred to Seller

## Structure Requirements (continued)

One-class-of-stock requirement

Debt verses equity

Safe harbors for warrants and deferred compensation plans

# Newly-Formed ESOP: Tax Deferred to Seller

## Required Approvals

Trustee approval mandatory

ERISA requirements

Opinion of financial advisor

Board approval required

No shareholder approval required

# Newly-Formed ESOP: Tax Deferred to Seller

## ESOP Issues

Limitations on participation in the ESOP

Leveraged transaction

# Newly-Formed ESOP: Tax Deferred to Seller

## Financing

Senior

Mezzanine

Subordinated Seller financing with possible warrants

# Newly-Formed ESOP: Tax Deferred to Seller

## Transaction Benefits

Tax-deferred to Seller

Possible Seller participation in growth of company

Management incentivized through management incentive plan

Broad based employee-participation

# Newly-Formed ESOP: Taxable to Seller

## Transaction Steps

Step One: A. Formation of Newco  
B. Formation of ESOP

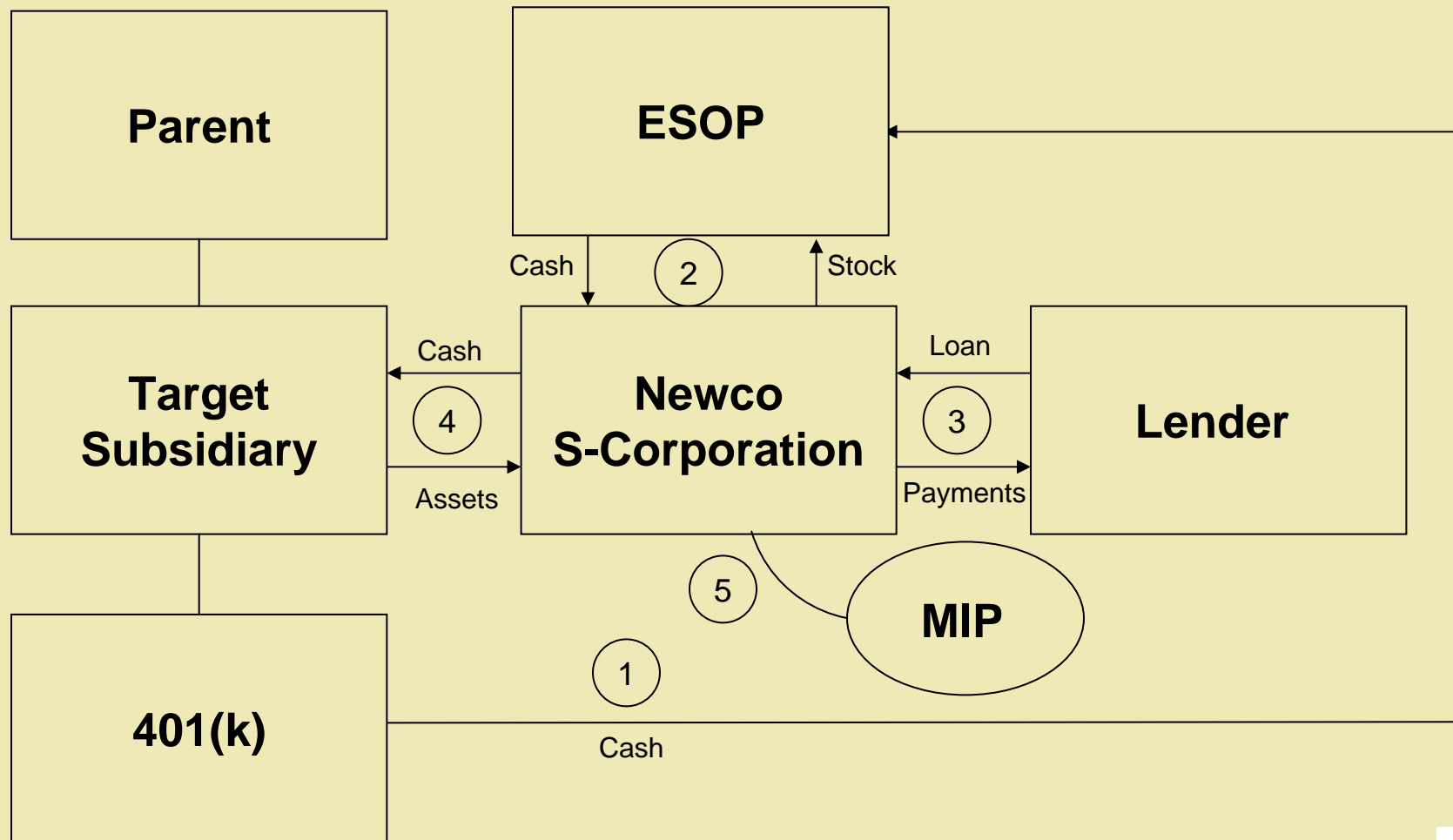
Step Two: A. 401(k) participants offered the opportunity to invest in the ESOP  
B. ESOP uses proceeds to capitalize Newco

Step Three: Lenders loan money to Newco

Step Four: Newco acquires assets from target in exchange for cash and a seller note

Step Five: Implement management incentive plan (MIP)

# Newly-Formed ESOP: Taxable to Seller



# Newly-Formed ESOP: Taxable to Seller

## Tax Treatment

### Taxable to Seller

Amount of tax dependent on transaction structure and tax status of Target

No tax on Target's earnings because ESOP-owned S-Corporation is the acquiror

# Newly-Formed ESOP: Taxable to Seller

## Target Characteristics

Any entity

Target can be S-Corporation or C-Corporation

# Newly-Formed ESOP: Taxable to Seller

## Seller Characteristics

Individuals

Trusts

Other entities

# Newly-Formed ESOP: Taxable to Seller

## Structure Requirements

Stock or asset purchase permissible

*But*, no tax benefit to a step up in basis from an asset purchase for the ESOP-owned S-Corporation

Asset purchase generally offers superior insulation from liabilities

If stock purchase, the Target must become a Qualified subchapter S-Corporation subsidiary (QSSS) or LLC

# Newly-formed ESOP: Taxable to Seller

## Structure Requirements (continued)

One-class of stock requirement

Debt verses equity

Safe harbors for certain warrants and deferred compensation plans

# Newly-Formed ESOP: Taxable to Seller

## Required Approvals

Trustee approval required

ERISA Requirements

Opinion of Financial Advisor

Impact of use of assets of qualified plan

Board approval required

Typically, no acquiror shareholder approval required

# Newly-Formed ESOP: Taxable to Seller

## ESOP Issues

No limits on participation in ESOP

Section 409(p)

Leveraged or non-leveraged transaction

Repurchase liability

# Newly-Formed ESOP: Taxable to Seller

## Financing

Senior

Mezzanine

Seller financing

Possible use of qualified plan assets

*But*, stock fully allocated in ESOP

Possible private equity investment through LLC

# Newly-Formed ESOP: Taxable to Seller

## Transaction Benefits

Increased after-tax cash flow to service debt or for other corporate purposes

Increased leverage possible

Availability of assets of other qualified plans to fund transaction

Possible management participation with or without buying in

# Existing ESOP: Tax Deferred to Seller

## Transaction Steps

Step One: Formation of Target ESOP

Step Two: Target shareholders sell stock to ESOP in exchange for a note with the following terms:

- Term of 1 year
- Becomes due on sale
- Guaranteed by Target

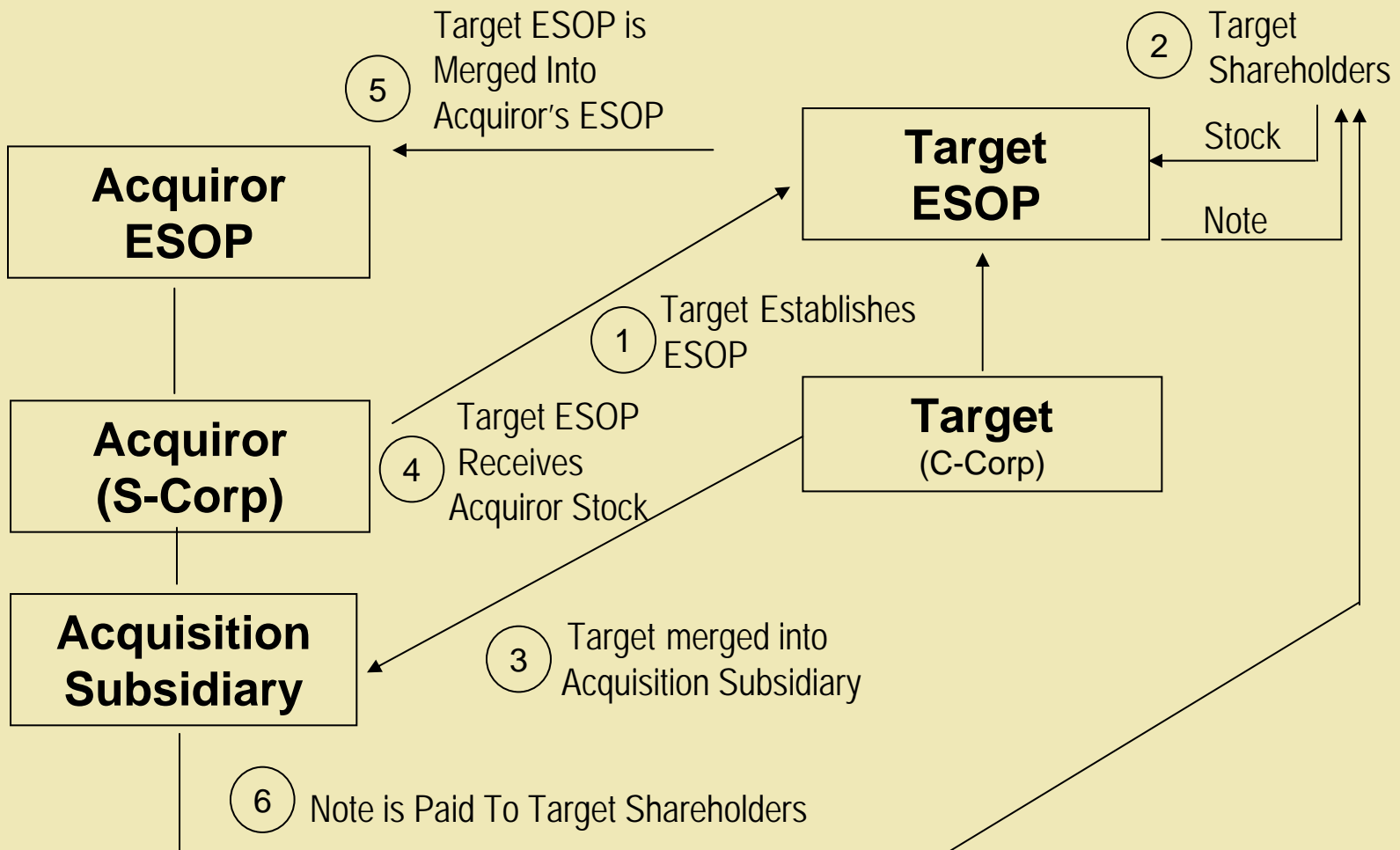
Step Three: Target merged into Acquisition Subsidiary

Step Four: Target ESOP received Acquiror's stock as merger consideration

Step Five: Target is merged into Acquiror's ESOP

Step Six: Note is paid to Target shareholders by Acquisition Subsidiary

# Existing ESOP: Tax Deferred to Seller



# Existing ESOP: Tax Deferred to Seller

## Tax Treatment

Tax deferred to selling shareholders if certain qualifications satisfied

No tax on Target earnings post-transaction

Merger must qualify under Section 368(a)(1) to avoid excise tax

Valid business purpose to satisfy step transaction doctrine

# Existing ESOP: Tax Deferred to Seller

## Target Characteristics

C-Corporation to qualify for tax deferral

S-Corporation conversion to C-Corporation

# Existing ESOP: Tax Deferred to Seller

## Seller Characteristics

Individuals

Trusts

Other entities

Limitation: Gain includable in gross income of a C-Corporation

# Existing ESOP: Tax Deferred to Seller

## Structure Requirements

C-Corporation only

ESOP can only purchase stock; no asset purchase

# Existing ESOP: Tax Deferred to Seller

## Required Approvals

Trustee approval mandatory

ERISA Issues

Opinion of Financial Advisor

Valuation issues

Board approval required

# Existing ESOP: Tax Deferred to Seller

## Required Approvals (continued)

Shareholder approval required for merger

Pass-thru voting

Acquiror, if stock needed for merger

Target, to effectuate merger

# Existing ESOP: Tax Deferred to Seller

## ESOP Issues

Limitations on participation in the ESOP

Non-leveraged transaction

# Existing ESOP: Tax Deferred to Seller

## Financing

Seller financing typically required

# Existing ESOP: Tax Deferred to Seller

## Transaction Benefits

Tax-deferred to Seller

No tax on Target's earnings post-transaction

Broad based employee participation

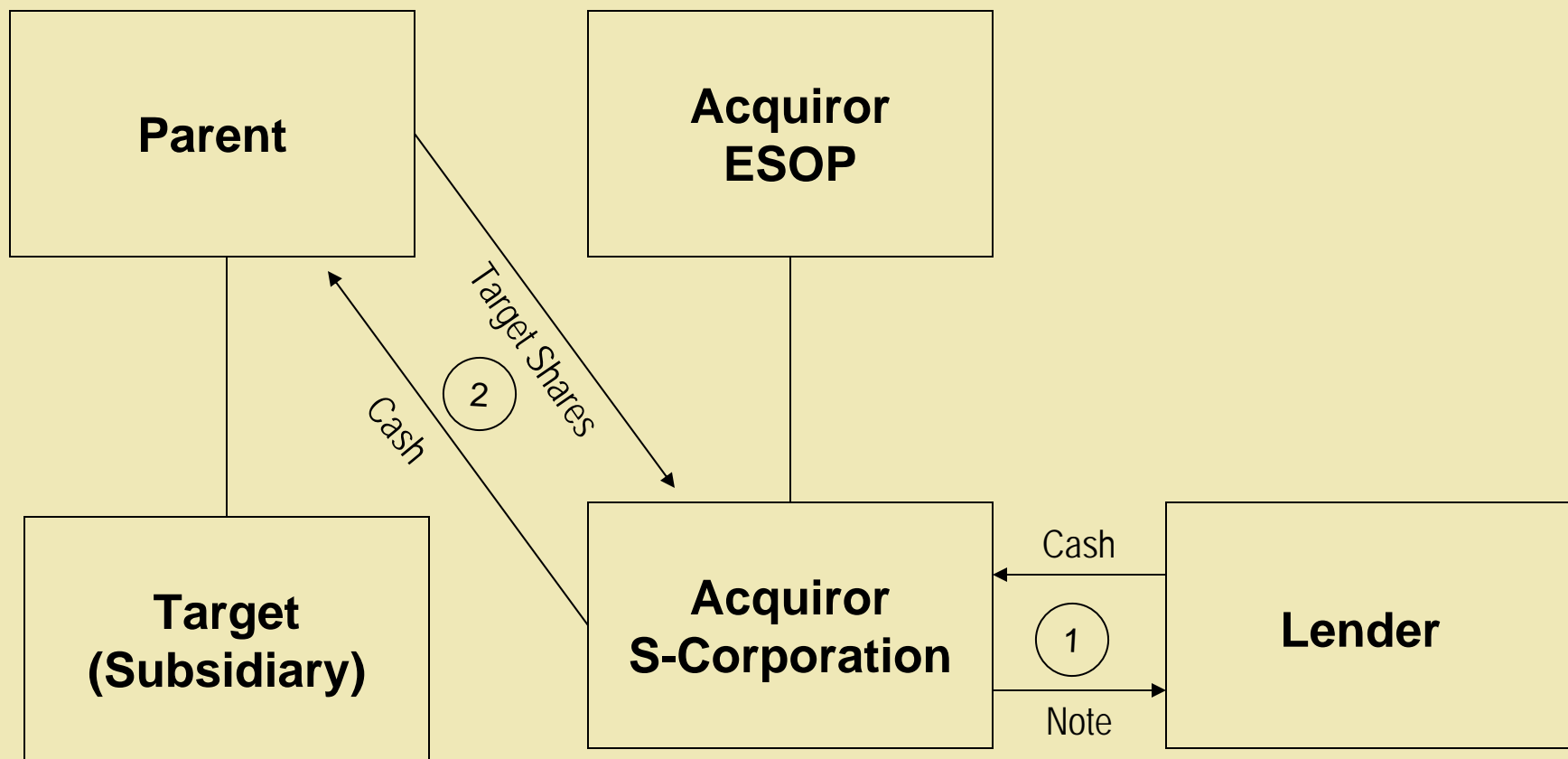
# Existing ESOP: Taxable to Seller

## Transaction Steps

Step One: Lenders loan money to Company

Step Two: Company acquires stock or assets from Target

# Existing ESOP: Taxable to Seller



# Existing ESOP: Taxable to Seller

## Tax Treatment

Taxable to Seller

No tax on earnings of Target because ESOP-owned S-Corporation is the acquiror

# Existing ESOP: Taxable to Seller

## Target Characteristics

Any entity

Target can be S-Corporation or C-Corporation

# Existing ESOP: Taxable to Seller

## Seller Characteristics

No limitations

# Existing ESOP: Taxable to Seller

## Structure Requirements

Stock or asset purchase

*But*, ESOP-owned S-Corporation derives no benefit from step up in basis

If stock purchase, the entity must become qualified subchapter S-Corporation subsidiary (QSSS) or LLC

# Existing ESOP: Taxable to Seller

## Required Approvals

Trustee approval not required if no new stock authorized

Trustee approval as a means to provide protection to the Board

Board approval required

Typically, no shareholder approval required unless additional stock authorized in connection with the transaction; if additional stock authorized, pass-thru voting required

# Existing ESOP: Taxable to Seller

## ESOP Issues

No limits on participation in ESOP

No leverage in the transaction

# Existing ESOP: Taxable to Seller

## Financing Issues

Traditional leveraged buyout sources

No special ESOP issues

# Existing ESOP: Taxable to Seller

## Transaction Benefits

Acquiror has increased cash flow to fund acquisitions

Target pays no tax on earnings post-transaction

ESOP-owned S-Corporations competitive bidders for S-Corporation Targets because no benefit from Section 338(h)(10) election