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C O U N S E L O R S A T L A W

ESOP LOGIC

How to Cash Out Tax-Free and Still Keep Your Business

**A Practical Guide for Business
Owners and Their Advisors**

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INTRODUCTION – THE MAGIC OF ESOPs

Employee stock ownership plans, commonly referred to as ESOPs, can provide substantial benefits to employees. As a result, corporations that sponsor ESOPs may profit from enhanced employee productivity. In addition, ESOPs can be used to meet the needs of corporations and their owners for financing and liquidity. Because of these and other advantages that can be obtained from ESOPs, Congress has enacted important tax incentives for the creation of ESOPs. All parties to an ESOP transaction can obtain substantial benefits.

Tax advantages arise in these ways:

- 1) **The Business Owner as Seller.** If shareholders of a private company sell 30 percent or more of their stock to an ESOP and satisfy certain other requirements, they can defer tax on the sale proceeds as long as the proceeds are reinvested in certain qualified investments. Thus, ESOPs enable business owners to create tax-advantaged liquidity; and they can be used to facilitate a transfer of ownership without a forced sale of the business.
- 2) **The Company as Sponsor.** Companies that sponsor ESOPs may deduct the value of their contributions from their tax liability. In addition, if a company uses an ESOP to borrow money, the company can deduct the principal payments it makes on the loan, as well as the interest. Moreover, by directly linking employee performance and rewards, an ESOP can lead to increased productivity and enhance the sponsoring company's ability to withstand the threat of foreign and other competition.
- 3) **The Employees as Owners.** Employees who acquire all or part of their company through an ESOP gain an opportunity to build wealth by holding stock in their company, without having either to buy the stock or to pay current taxes on their benefits, and without risking personal liability.

This booklet will briefly explain how ESOPs work and will illustrate how you can use an ESOP to solve some problems faced by virtually all private companies and their owners. First, we'll explain the legal mechanics involved in creating and operating an ESOP. Next, we will describe in detail the special tax incentives available to you when your company adopts an ESOP. Then, we'll outline the various purposes that an ESOP can serve. Finally, we will describe real-life examples to

show how ESOPs solve common business and estate-planning problems. These examples will demonstrate how you can use an ESOP either to facilitate a transition in the ownership and management of your closely held corporation or to diversify your personal wealth on a tax-free basis while maintaining control of your company.

I. HOW ESOPs WORK

A. WHAT IS AN ESOP?

At first glance, ESOPs may seem complex and intimidating. But the basic rules are easy to understand; and with a basic understanding of how ESOPs work, you will have an important strategic and economic tool at your command.

An ESOP is simply a tax-qualified employee benefit plan that is designed to invest primarily in stock of the sponsoring employer. Think of it as a variation on the traditional profit-sharing plan or Section 401(k) plan. Just like contributions to a profit-sharing or Section 401(k) plan, contributions that your company makes to an ESOP are deductible (within limits), and income earned by an ESOP is exempt from tax. Further, participants in an ESOP do not recognize any taxable income as a result of employer contributions or earnings on their accounts until their benefits are withdrawn from the plan. The critical factor that distinguishes an ESOP from other types of employee benefit plans is that the funds of an ESOP are invested primarily in the stock of the sponsoring employer, while other employee benefit plans invest in stocks and bonds of other companies.

B. SPECIAL TAX INCENTIVES FOR ESOPs

Congress has created a host of major tax incentives designed to encourage employers to create ESOPs. The most important of these special tax incentives for ESOPs may be summarized as follows:

- 1) An individual can sell stock of a closely held corporation to an ESOP on a tax-deferred basis if (a) the ESOP owns at least 30 percent of the stock of the sponsoring company immediately after the sale, and (b) the sale proceeds are reinvested in securities of other domestic operating corporations.
- 2) If a corporation uses an ESOP to obtain a loan, it can take tax deductions for both the interest and the principal payments on the loan, instead of being

limited to deducting the interest only, as in the case of a conventional corporate loan. (For most companies, this can cut borrowing costs by one-third.)

- 3) If a corporation that sponsors an ESOP makes the S election for federal income tax purposes, then its income will escape taxation, both at the corporate and the shareholder levels, to the extent of the ESOP's proportionate ownership of the corporation.
- 4) Dividends paid in cash by a C corporation on shares held by an ESOP are deductible by the sponsoring corporation (a) if they are passed through to the participants in the plan, (b) if they are used to pay off a loan taken out to finance the purchase of company stock, or (c) if they are reinvested in shares of the plan sponsor's stock.

C. PURPOSES ESOPs CAN SERVE

As a result of these tax incentives, ESOPs are attractive not only as employee benefit plans, but also as a technique of corporate finance and as a business and estate-planning tool. Because of these new tax incentives, ESOPs are being adopted by more and more companies, both large and small. The number of ESOPs has increased from approximately 1,600 in 1975 to more than 10,000 in 2005, and the number of employees covered by these plans has mushroomed from approximately 250,000 in 1975 to an estimated 11 million in 2005.

In its simplest form, an ESOP is a tax-qualified employee benefit plan that provides a special kind of benefit to employees — an ownership interest in their company. A common objective of an ESOP is to increase employee productivity, as employees benefit directly from increases in the profitability of their company.

ESOPs can also be used for the following purposes:

- 1) to serve as a tax-advantaged technique of corporate finance;
- 2) to facilitate transitions in ownership and management of closely held corporations;
- 3) to enable business owners to diversify their investment portfolios on a tax-free basis; and
- 4) to provide a market for a thinly traded stock (and serve as an alternative to going public).

II. GENERAL DESCRIPTION OF AN ESOP

A. BASIC LEGAL REQUIREMENTS

An employee stock ownership plan is an employee benefit plan that is designed to invest primarily in stock of the sponsoring employer. Like other tax-qualified employee benefit plans, an ESOP must take the form of a formal written plan adopted by the sponsoring employer. The plan document must set forth all of the provisions required for qualification of the plan under the Internal Revenue Code, including provisions relating to the following matters:

- eligibility for participation in the plan;
- allocations of contributions to the plan and of earnings on the plan assets;
- vesting of participants' rights under the plan;
- distributions of benefits to participants; and
- procedures for claiming benefits.

In addition, a trust must be established to hold the employer securities and other properties contributed to or otherwise acquired by the plan. Like the plan, the trust must be in writing, and it must take the form of an agreement between the plan sponsor and the trustee. The trust agreement sets forth the terms and conditions under which the trustee will hold the assets of the plan for the benefit of the beneficiaries of the trust, who are the participants in the plan. In addition to setting forth the general rights, powers, and duties of the trustee, the trust agreement must provide that the trustee will hold the trust properties for the exclusive benefit of the participants.

The trustee generally is appointed by the sponsor of the plan. Typically, it is desirable to designate a bank or trust company to serve as trustee because of its experience in handling assets and in assuming fiduciary responsibilities. Alternatively, one or more individuals, including officers or employees of the sponsoring employer, may be selected to serve as trustees; but they will be personally responsible to the participants for any breach of trust or for any other violation of the many laws and regulations that govern the administration of tax-qualified employee benefit plans.

B. BASIC TAX ATTRIBUTES

The basic tax attributes of an ESOP are similar to those of a qualified profit-sharing or pension plan. Contributions to an ESOP are deductible by the sponsoring employer (within limits), income earned by an ESOP is exempt from tax, and the participants in an ESOP are not required to recognize any taxable income arising out of allocations of employer contributions or earnings to their accounts until their benefits are withdrawn from the plan. What distinguishes an ESOP from other types of employee benefit plans is that the funds of an ESOP are invested primarily in the stock of the sponsoring employer. Other employee benefit plans invest in stocks and bonds of other companies.

Employer contributions to an ESOP may take the form of stock of the employer, cash, or other property. If cash is contributed, the trustee of the ESOP may use the cash to purchase stock of the employer. The maximum amount that a corporation may deduct with respect to contributions to an ESOP is 25 percent of the compensation paid to all employees participating in the plan for the taxable year (not counting any compensation in excess of \$210,000 paid to any one employee). Contributions by a C corporation used to pay interest on an ESOP loan taken out to finance the purchase of employer stock do not count against the 25-percent limit.

The deduction limitations described above are supplemented by limitations on the amounts that may be allocated to the account of any individual participant. Generally, the amount that may be allocated to the account of a participant in one or more defined contribution plans for any year may not exceed 100 percent of his or her compensation or \$42,000, whichever is less.

C. REQUIREMENTS FOR TAX QUALIFICATION

The general requirements for qualification by an ESOP for the tax benefits described above are the same as for other qualified profit-sharing and pension plans. Here are the most important requirements:

- 1) contributions must be made to a trust, which must be administered for the exclusive benefit of the participants in the plan and their beneficiaries;
- 2) participation in the ESOP must be available to a broad cross-section of employees (but union employees may be excluded);

- 3) benefits provided under the ESOP must not discriminate in favor of officers, shareholders, or highly compensated employees (but benefits may be allocated in proportion to the relative compensation of participating employees);
- 4) the plan must comply with certain minimum vesting standards;
- 5) distributions of benefits must begin by certain specified dates;
- 6) the plan must be intended as a permanent and continuing program, and the terms of the plan must be communicated to the employees of the plan sponsor; and
- 7) the plan and trust must be administered in compliance with the general fiduciary rules applicable to all qualified plans.

In addition to these general rules that apply to all tax-qualified plans, a number of special provisions apply to ESOPs. These special provisions are discussed in the next section.

III. SPECIAL PROVISIONS APPLICABLE TO ESOPs

A. VOTING RIGHTS

A common question is “Will I lose control of my company if I set up an ESOP?” You’ll like the answer, which is “No.” You will not lose control for two reasons. First, employee ownership is not an all-or-nothing affair. An ESOP can own all of the stock of your company, but it does not have to. On the contrary, most ESOPs hold minority interests in their sponsoring employers. In other words, you can set up an ESOP and still retain more than 50 percent of the outstanding stock of your company.

Moreover, the voting rights connected with the stock held in the ESOP usually do not have to be passed through to the participants in the plan. Only companies whose stock is publicly traded are required to pass the voting rights on ESOP stock through to the participants in the plan. If the stock of your company is not publicly traded, you can provide for the trustee of the plan to retain the right to vote the stock. Voting rights connected with stock of private companies that sponsor

ESOPs need be passed through to the participants only when certain extraordinary transactions are proposed, such as a merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of the assets of the business.

The stock that is contributed to or purchased by the ESOP will be voted by the trustee, who may be you or another key officer of the company or, perhaps, a friendly bank. Your employees will not have a right to vote on the day-to-day management of the business. Rather, their voting rights will be limited to a few once-in-a-lifetime types of transactions, such as a merger or liquidation. Therefore, you need not fear that you must share with your employees your right to set business policies.

B. DISTRIBUTION RULES

Unless a participant in an ESOP elects to receive benefits at a later time, the distribution of his or her benefits under the plan must begin no later than one year after the close of the plan year:

- 1) in which he or she terminates employment as a result of reaching normal retirement age, disability, or death; or
- 2) which is the fifth plan year following the plan year in which he or she otherwise separates from service (i.e., his or her employment is terminated for a reason other than death, disability, or retirement), unless the participant is reemployed by the employer before that year.

Under one circumstance, the employer may delay distribution of benefits: if the sponsoring employer's stock that otherwise would be distributed was acquired with the proceeds of a loan, distributions to terminated employees may be delayed until the close of the plan year in which the loan is repaid. This is an important provision because it allows a corporation to avoid being required simultaneously to make loan repayments and to purchase stock under the put option described below.

An ESOP may provide that each participant's benefits will be distributed in substantially equal installments over a period of not more than five years (rather than in the form of a lump-sum distribution). If the balance credited to a participant's account exceeds \$830,000, the distribution period may be extended an additional

year for each \$165,000 (or fraction thereof) more than \$830,000. However, the distribution period cannot be extended for more than an additional five years, regardless of the amount of the participant's account balance. Thus, even if the participant's account balance exceeds \$1,655,000, the maximum period over which his or her benefits are distributed may not be more than ten years, unless the participant elects to receive his or her benefits over a longer period of time.

C. RIGHT TO DEMAND EMPLOYER SECURITIES; PUT OPTION

Generally, an ESOP must provide that a participant who is entitled to receive a distribution from the plan may demand that his or her benefits be distributed in the form of stock of the employer. Two exceptions are allowed: (1) when the articles of incorporation or by-laws of the sponsoring employer restrict the ownership of substantially all outstanding employer securities to employees and to qualified retirement plans; and (2) when the sponsoring employer has elected to be treated as an "S corporation" for federal income tax purposes.

The participants in an ESOP who receive their benefits in the form of employer stock must also be given a put option. That is, they must have the right to require the employer (not the ESOP) to repurchase any employer stock distributed to them, using a "fair valuation formula." (Exception: no put option need be provided where the employer's stock is traded on an established market.)

If a participant exercises his or her put option for shares received in a distribution of the full balance credited to his or her account within one taxable year, the employer may elect to pay the purchase price over a period of up to five years. These payments must be made in substantially equal installments, paid at least once a year. Interest at a reasonable rate must be paid on the principal balance of the purchase price remaining unpaid from time to time, and the employer must provide adequate security. The payments must begin within 30 days after the participant exercises the put option. If a participant exercises his or her put option for shares being distributed on an installment basis, the employer must pay the entire purchase price for each installment within 30 days of the exercise of the put option.

D. DIVERSIFICATION REQUIREMENT

An ESOP must offer to participants an annual election during the “qualified election period” to direct the investment of a portion of their account balances. At least three investment options must be offered, or the plan must provide for the distribution to a participant of cash equal to the amount he or she otherwise could have directed.

The “qualified election period” is the six-year period beginning with the plan year of the ESOP that follows the later of (1) the plan year in which the participant attains age 55, or (2) the plan year in which he or she completes ten years of participation in the ESOP. For the first five years during the election period, a participant must be allowed to direct the investment of at least 25 percent of the balance credited to his or her account. For his or her final year’s election, a participant must be allowed to direct the investment of at least 50 percent of the balance credited to his or her account. The election must be made within 90 days after the close of each plan year. If a participant directs the investment of a portion of his or her current account balance, the amount that he or she may direct in the future will be reduced by the amounts previously directed.

IV. THE TAX-FREE ROLLOVER

A. GENERAL

As we mentioned earlier, ESOPs are currently experiencing rapid growth in the United States, due in part to Congress’ expansion of the tax incentives for employers to adopt ESOPs. This section describes the special opportunity for a tax-free rollover of the proceeds of a sale of stock to an ESOP. In Section V, we discuss the rules that make ESOPs a tax-favored technique of corporate finance. Section VI describes the tax deduction available for dividends paid on stock held in an ESOP and, finally, Section VII describes the benefits available for S corporations with ESOPs.

B. DESCRIPTION

The tax incentive that has spurred the most interest in ESOPs for private companies is the opportunity provided under Section 1042 of the Internal Revenue Code for a tax-free “rollover” of the proceeds of a sale of stock to an ESOP if the proceeds are reinvested in

securities of other corporations. This special tax treatment is available only for sales of common stock of closely held C corporations that you have owned for at least three years. A sale of this kind of stock to an ESOP will qualify for tax-free treatment if the following conditions are satisfied:

- 1) immediately after the sale, the ESOP owns at least 30 percent of the total value of the common stock of your company;
- 2) you reinvest the sales proceeds within 12 months in “qualified replacement property,” a specially defined term; and
- 3) for certain periods, no portion of the assets of the ESOP attributable to the stock that you sold to the ESOP may accrue for your benefit, for the benefit of any member of your family, or for any other person who owns more than 25 percent of the outstanding stock of the company.

It is important to note that the first requirement for rollover treatment — that the plan must own at least 30 percent of the outstanding stock of your corporation — is applied immediately *after* the sale is closed. Because this 30-percent requirement is applied after the sale, you may establish an ESOP for the purpose of selling all or a significant portion of your stock to the ESOP on a tax-deferred basis.

The second requirement for tax-free rollover treatment is that you must reinvest the sale proceeds in certain kinds of property. There are two components to this requirement. First, the reinvestment must be made within what is referred to in the Internal Revenue Code as the “replacement period.” This period begins three months before the date on which the sale occurs and ends 12 months after the date of the sale. Thus, you are provided with a 15-month tax-planning period.

The second component of the reinvestment requirement is that you must purchase “qualified replacement property” with a cost equal to the amount realized on the sale to the ESOP. You will be subject to tax on the sale to the ESOP to the extent that the sale proceeds exceed the cost to you of the replacement property. “Qualified replacement property” is defined to mean stocks and bonds of U.S. operating companies. Government securities and shares in mutual funds do not qualify as replacement property for purposes of the ESOP rollover.

If the requirements of Section 1042 of the Internal Revenue Code are satisfied, you pay no tax on the sale of your stock to the ESOP. However, your basis in the replacement property will be reduced by the amount of the untaxed gain on the sale. Thus, Section 1042 operates to provide a tax deferral, not a complete avoidance of tax. The gain deferred on the sale of the stock to the ESOP will be taxed when you sell the replacement property. However, even this deferred tax can be avoided if you hold the replacement securities until your death. At that time, your heirs will be entitled to a stepped-up basis in the replacement securities equal to their fair market value at the date of your death. Your heirs could then sell the replacement properties without incurring any capital gains tax.

To ensure permanent avoidance of tax on the gain realized from an ESOP sale, you can purchase long-term, noncallable corporate notes or bonds. For example, 40-year AAA-rated noncallable floating-rate notes issued by major U.S. corporations are available for purchase by persons who have engaged in tax-deferred sales to ESOPs. After these long-term notes are purchased, they can be pledged to secure loans in amounts of up to 90 percent of their face value, often on a nonrecourse basis. In other words, you can “monetize” the notes and invest the proceeds of the loans free of the restrictions on what constitutes “qualified replacement properties.” Because the notes have terms well in excess of most purchasers’ life expectancies, the tax deferral from an ESOP sale can be turned into permanent tax avoidance since, regardless of how the proceeds from the monetization loan are used, you will not have disposed of the “qualified replacement properties” (which are the floating-rate notes).

C. PLANNING OPPORTUNITIES

The tax-free rollover provisions of Section 1042 of the Code provide some of the best tax and financial planning opportunities now available to owners of closely held businesses. Under Section 1042, you can address a number of common business planning problems in a way that reduces your tax burden.

Ownership Succession. You can use an ESOP to buy out your interest in your business or the interest of another retiring stockholder. This may be an attractive alternative to selling your business to outsiders, especially where there is a desire to keep control of the business

within a family or key-employee group. If the funds needed to purchase your or another retiring stockholder’s interest must be borrowed, an ESOP can be used to reduce the financing costs (as explained in Section V).

Selling While Keeping Control. You may have most of your wealth tied up in the stock of your corporation, and you may want to diversify your investment portfolio well before retirement. Section 1042 provides a tax-favored means for doing this.

Buying Out Dissident Stockholders. You can also use an ESOP to buy out dissident stockholders. Because of the opportunity to obtain tax-free treatment when they sell their shares, the dissident stockholders may be willing to sell at a reduced price, and the tax benefits associated with ESOP loans can reduce the cost of financing the buyout.

Buying Another Company. You can use an ESOP to buy the stock of another company. If the acquisition is properly structured, the shareholders of the selling company will be able to defer the tax on the gain realized by them on the sale under the provisions of Section 1042.

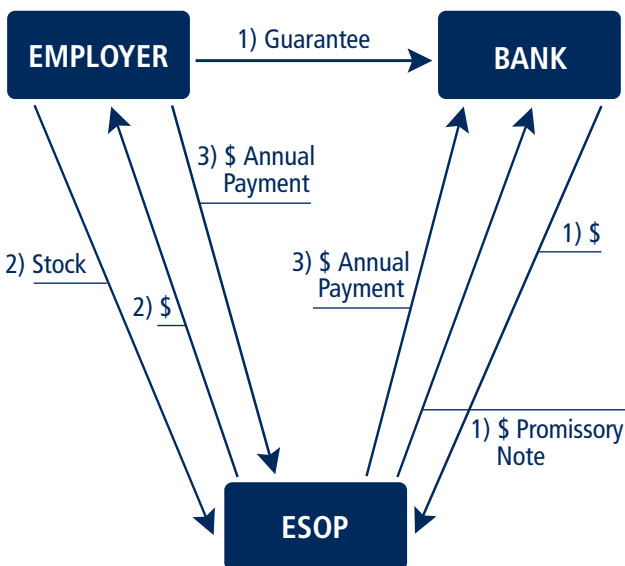
V. LEVERAGED ESOPs

The fiduciary rules that apply to tax-qualified employee benefit plans generally provide that a sponsoring employer cannot (1) lend money to a qualified plan, (2) guarantee a loan to a plan, or (3) provide collateral for a loan to a plan. However, there is a special exemption for loans to ESOPs where the loan proceeds are used to acquire common stock of the sponsoring employer. The loan must be without recourse against the ESOP, but the loan may be guaranteed by the sponsoring employer, and employer securities acquired with the loan proceeds may be pledged as collateral. If employer securities are pledged, they must be released in installments over the term of the loan. There are a number of other technical requirements that must be satisfied, designed to ensure that the terms of the loan are fair and to protect the plan participants.

This special exemption for ESOP loan transactions provides an incentive to use an ESOP as a financing tool. The advantage to your corporation of using an ESOP to obtain a loan is that your company may deduct both the interest and the principal payments on the loan, instead of merely deducting the interest as it

does when a loan is made directly to the corporation. This difference arises because your company obtains a deduction for plan contributions that are used to repay principal on an ESOP loan.

To illustrate, a simple leveraged ESOP transaction can be arranged in the following manner:



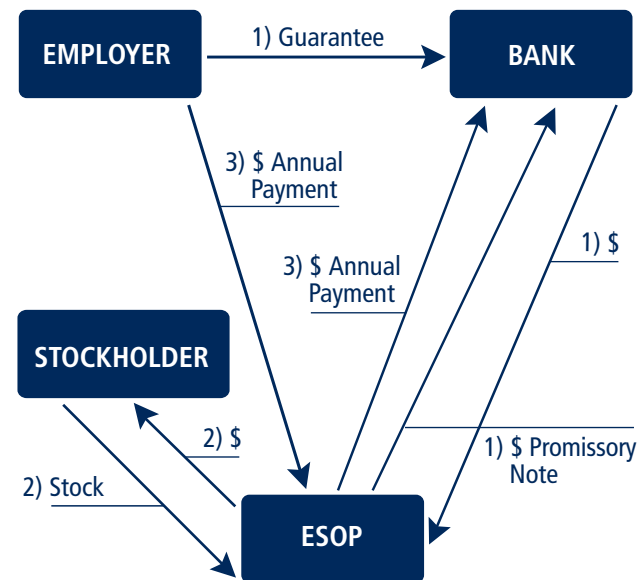
- 1) the ESOP borrows funds from a commercial lender;
- 2) the ESOP uses the loan proceeds to purchase shares of your company, and your company then has the use of the loan proceeds; and
- 3) your company makes annual cash contributions to the ESOP in amounts sufficient to amortize the loan and is able to deduct the amounts so contributed.

After the ESOP trustee uses the loan proceeds to purchase some of your company's stock, your company will be able to use the loan proceeds for any proper corporate purpose; and your financing costs will be dramatically reduced. In effect, your company will have to pay back only two-thirds of the loan. The remainder can be repaid out of the tax deductions your company will obtain in connection with the principal repayments. Think of this as a special government "matching

funds" program customized for you. (For every two dollars that your company pays in principal on an ESOP loan, the government will provide one dollar in tax savings.)

Your company will probably have to provide a guarantee to the lender, which may be secured by your company's assets. This is because the loan is based on your company's credit. The collateral that secures the loan may consist also of the stock purchased with the loan proceeds, but the loan must otherwise be without recourse against the ESOP. The company guarantee will require your company to contribute sufficient funds to the ESOP to ensure that the ESOP trustee can make all payments due under the terms of the loan.

The opportunity for your company to borrow funds on a fully deductible basis can be combined with the opportunity for you to sell some of your stock to an ESOP on a tax-deferred basis. This would work as follows:



- 1) the ESOP borrows funds from a commercial lender;
- 2) the ESOP uses the loan proceeds to purchase shares of your company's stock from you, and you then invest the sale proceeds in qualified replacement properties; and
- 3) your company makes annual cash contributions to the ESOP in amounts sufficient to amortize the loan and deducts the amounts contributed.

A variation on the loan structures described above would be for the lender to make the loan to your company, followed by a second “mirror loan” from your company to the ESOP on essentially the same terms as the company loan. The tax results will be the same as in the case of a direct loan to the ESOP. The principal repayments still will be deductible because your company will make annual tax-deductible contributions to the plan in amounts sufficient to amortize the loan from your company to the ESOP. The amounts paid by the ESOP trustee to the company to amortize the company loan will constitute tax-free loan repayments and can be used by the company to amortize the bank loan.

In most situations, lenders prefer the “mirror loan” structure because it provides them with a stronger security interest in the assets of the sponsoring employer that are pledged to secure the loan. In the case of a default, the lender will be in a better position to defend against claims of fraudulent conveyance if it has taken collateral directly from the borrower, rather than from a guarantor of the loan.

VI. DIVIDENDS-PAID DEDUCTION

Generally, corporations cannot deduct dividends paid to stockholders. However, an exception applies to dividends paid by C corporations on shares held by an ESOP. These dividends may be deducted (1) if they are paid in cash to plan participants, (2) if they are paid to the plan and passed through to the participants within 90 days after the end of the plan year, (3) if they are used to repay a loan obtained in order to purchase the company stock on which the dividends are paid, or (4) if they are used to purchase additional shares of the plan sponsor's stock.

This deduction for dividends paid on stock held by an ESOP can be a useful mechanism for increasing the amount of stock that may be placed in an ESOP. As we mentioned in Section II, the maximum amount that an employer can contribute to an ESOP each year is limited to a specified percentage of the compensation paid to the plan participants. In addition, there are limitations on the amounts that may be allocated to the account of any individual participant.

These deduction and allocation limitations may raise problems in leveraged ESOP transactions. These problems are illustrated in the following example:

Success Corporation wants to raise \$1 million by selling stock to a leveraged ESOP. The ESOP will borrow the \$1 million and will repay the loan at the rate of \$100,000 per year for 10 years, with simple interest at the rate of five percent per year.

At the end of the first year, the first payment of principal must be \$100,000, plus interest of \$50,000. If the corporation's covered payroll is at least \$400,000, the entire \$150,000 payment will be deductible. This is because the corporation may deduct an ESOP contribution equal to the interest on the ESOP loan (\$50,000), plus 25 percent of covered payroll (here \$100,000, which is 25 percent of the covered payroll of \$400,000).

However, if the company's covered payroll is less than \$400,000, the company cannot deduct the entire \$150,000. But it may be possible to solve this problem by declaring dividends on the ESOP stock and then using the dividends to repay the loan. Dividends on stock held by an ESOP are fully deductible if used for this purpose. This deduction is available without regard to the general limitations on tax deductions for contributions to ESOPs. Moreover, because dividends paid on stock held by an ESOP constitute earnings of the trust fund, they do not count against the limitation on annual allocations to individual participants' accounts (which is \$42,000 or 100 percent of compensation, whichever is less).

A potential pitfall that may be encountered with the use of the dividends-paid deduction is exposure to the alternative minimum tax. The problem arises because even though the dividend may be fully deductible for regular income tax purposes, it will not reduce “adjusted current earnings” for purposes of the alternative minimum tax. The alternative minimum taxable income of a corporation must be increased by 75 percent of the excess of the adjusted current earnings of the corporation over the corporation's alternative minimum taxable income.

VII. ESOPs FOR S CORPORATIONS

A. TAX SAVINGS

In addition to the remarkable tax-savings opportunities described in prior sections of this booklet, there are even more tax-savings opportunities available when an

ESOP company makes the S election for federal income tax purposes. If an eligible corporation makes the S election, it generally will not be subject to tax on its annual income; but the income is “passed through” to its shareholders, who must report their proportionate shares of the corporation’s income on their personal income tax returns.

Although the same rules apply in the case of an S corporation that sponsors an ESOP, the portion of the corporation’s income which is attributable to the ESOP escapes taxation at the shareholder level, as well as at the corporate level, because the ESOP is a tax-exempt entity. Where an S corporation is wholly owned by an ESOP, no income tax will be payable because, although all of the corporation’s income must be reported by the ESOP, it is not subject to tax. In other words, an S corporation that is wholly owned by an ESOP is a tax-exempt, for-profit entity! (There are exceptions to this rule for small corporations with few employees and for corporations whose ownership interests are concentrated among a small group of employees.)

As discussed in Section IV, the opportunity for a tax-free sale of stock to an ESOP applies only to shares of a C corporation. If shares of an S corporation are sold to that corporation’s ESOP, a capital-gains tax will be imposed on the gain realized. However, it may be possible for a shareholder who desires to arrange for a tax-free sale to an ESOP to obtain the best of both worlds by arranging for the sale to close in a year when the plan sponsor is a C corporation and for the S election to be made effective for the next year. Subsequent sales of stock to the ESOP then will not qualify for tax-free treatment, unless the S election first is terminated; and once an S election is terminated, it cannot be reinstated for five years.

B. ELIGIBILITY TO MAKE S ELECTION

The following requirements must be met by a corporation in order for it to be eligible to make the S election:

- 1) the corporation may not have more than 100 shareholders (for this purpose, an ESOP counts as only one shareholder, regardless of the number of employees who participate in the ESOP);
- 2) all shareholders must be U.S. citizens or U.S. residents, and they must be natural persons, estates, or certain types of trusts (including employee benefit trusts); and

- 3) the corporation may have only one class of stock outstanding (but different voting rights are permitted for different shares of stock).

VIII. POTENTIAL PROBLEMS AND PITFALLS

A. DILUTION OF EQUITY AND OF VOTING POWER

You must weigh some important potential disadvantages associated with ESOPs against the tax and other benefits described above. One important issue that you should consider is whether it will be beneficial for your employees to share in earnings and, perhaps, control of your company.

Title to shares of stock contributed or sold to an ESOP initially will be held in the name of the trustee of the trust that must be set up to hold and manage the assets of the ESOP. The trustee may be an officer or shareholder of your company, but the plan must be established for the exclusive benefit of the plan participants and their beneficiaries; and the trustee will be under fiduciary obligations to act in the best interests of the participants and their beneficiaries. Difficult conflict-of-interest situations may arise if the trustee is an officer or shareholder of your company.

ESOPs sponsored by closely held corporations can limit the voting rights of participants to extraordinary transactions (such as mergers, recapitalizations, bulk sales of assets, and liquidations). However, even if voting rights are not passed through (except for extraordinary transactions), a significant dilution of equity and voting power eventually can result if the participants demand that their benefits be distributed in the form of company shares. Of course, this is not a problem where the reason for establishing the ESOP is to transfer control of the business to the employees and thereby avoid the need for a sale of the business to an outside party. Moreover, in most cases, retiring employees will prefer to receive their benefits in cash rather than in shares of the company’s stock (and therefore will exercise their options to sell their stock back to the company). In addition, an ESOP company may deny to participants the right to receive their benefits in the form of employer securities if it has made the S election for federal income tax purposes or if the articles of incorporation or by-laws of the corporation restrict the ownership of substantially all

outstanding employer securities to employees and to qualified pension, profit-sharing, and stock bonus plans (including ESOPs).

B. REDEMPTION COSTS

An area that is often neglected when a company plans to set up an ESOP is that of the stock repurchase liability of the plan sponsor. As noted in Section II, participants in an ESOP generally have the right to demand payment of their benefits in the form of shares of the company. In addition, if the shares are not publicly traded, the participants have the right to demand that the sponsoring employer repurchase any shares distributed to them. Before establishing an ESOP, you should consider whether this put option requirement might impose an undue financial burden upon your company at any time in the future.

Although the repurchase liability initially may be modest, it will grow, perhaps rapidly, as the ESOP matures and as more shares of stock are allocated to the accounts of employees. Moreover, if your company is successful, the value of the shares themselves should increase. Even with modest growth in the value of these shares, the repurchase liability can become a significant obligation over time. For a consistently profitable company, the ultimate repurchase liability will far exceed the value of the original contributions made by the company to the plan or the price paid by the trustee for the stock.

The repurchase liability can be managed if it is planned for in advance, before the need for large amounts of cash arises. The starting point in planning for the repurchase liability is to estimate potential future costs. Factors that should be taken into account in making this estimate include the size of the annual contributions that your company will make to the plan, projections of the future value of the company's stock, and employee census factors (such as age, seniority, turnover, and disability and mortality rates). Computer models can be used to calculate projected future repurchase liabilities. Ideally, a repurchase liability study should be conducted both before an ESOP is adopted and periodically thereafter.

After you obtain a projection of your repurchase liability, you should take steps to ensure that cash will be available to fund the projected payments. There are

several methods your company can use to satisfy its repurchase obligations. Some companies simply meet their obligations on a pay-as-you-go basis. These companies anticipate that they will be able to repurchase their stock out of future earnings and cash flow. Obviously, however, there is no guarantee that future earnings and cash flow will be sufficient for this purpose, and it is generally advisable to develop a more sophisticated plan to avoid difficult cash flow problems in the future.

Another method for dealing with ESOP repurchase liability is for the sponsoring employer to establish cash reserves, either within the ESOP or in a "sinking fund" controlled by the company. To the extent that cash is contributed to the plan for this purpose, the repurchase liability will be funded with pre-tax dollars (because the company will be entitled to a deduction for the cash contributed to the plan). The same result can be achieved if the company repurchases the stock of retired, terminated, or deceased employees and if the repurchased stock then is contributed to the plan (because a contribution of company stock to an ESOP is tax-deductible).

The sinking fund approach has several weaknesses. First, in small and mid-size private companies, it is difficult to develop accurate actuarial assumptions simply because the employee group is so small. Second, many companies cannot or will not maintain their reserves if they encounter financial difficulties. Finally, the timing of deaths and disabilities cannot be accurately predicted. Where several large account balances must be paid out in one year, a substantial cash drain can result.

One way to protect against the problem of unforeseen deaths or disabilities is through the use of insurance. For example, your company might take out key-person life insurance policies on several of its more highly compensated employees. This approach is especially effective in cases where a relatively large portion of the repurchase liability is attributable to a few participants. Group policies may be appropriate where it is desirable to insure a larger number of employees.

No single approach to planning for the repurchase liability is right for all ESOP companies, and many ESOP companies employ a combination of the planning approaches described above. The important point

is that a plan for funding the repurchase liability should be developed and implemented during the early years of the operation of the ESOP to avoid difficult cash flow problems as the ESOP matures. With proper advance planning, the repurchase liability can be funded without unduly disrupting your company's financial affairs.

C. VALUATION OF THE STOCK

Another problem associated with the operation of an ESOP is establishing the value of stock when it is sold or contributed to the ESOP. It will be to your company's advantage to maximize the valuation of contributed stock because that will maximize its tax deduction. And if you are selling some or all of your stock to the ESOP, it obviously will be to your advantage to maximize the sale price. However, if the ESOP trustee causes the plan to purchase stock at a price that is higher than its true value, he or she risks personal liability to the plan participants for breach of fiduciary duty.

In addition to valuing stock when it is sold or contributed to an ESOP, you must value all assets held by an ESOP at least once a year on a date specified in the plan document, which generally is the last day of the plan year. This is required so that participants in the plan may be informed at least once a year of the value of the stock allocated to their accounts.

To reduce the possibility of improper valuations of closely held stock upon sales or contributions to ESOPs, the law requires that an independent appraiser make all valuations of employer stock held by an ESOP that is not publicly traded. The appraiser must satisfy requirements similar to those imposed by the Internal Revenue Service for verifying deductions for charitable contributions. These requirements are designed to ensure that the appraiser is both qualified and independent. In particular, the appraiser must either hold himself or herself out to the public as an appraiser or perform appraisals on a regular basis, and the appraiser must be qualified to make appraisals of the type of property being valued. To be considered independent, the appraiser must not have a financial interest in the company or a relationship with any party to the transaction.

D. ACCOUNTING FOR ESOP TRANSACTIONS

Nonleveraged ESOPs—that is, ESOPs that are adopted without any associated borrowing—present no unusual accounting problems. The general accounting rules that apply to all defined contribution plans, such as conventional profit-sharing plans, also apply to nonleveraged ESOPs. If cash is contributed to an ESOP for a particular year, it is recorded as an expense in that year. If stock is contributed to a nonleveraged ESOP, the amount recorded as an expense will be equal to the fair market value of the stock on the date of the transfer.

Some special rules apply to account for leveraged ESOP transactions. First, the obligations of a leveraged ESOP must be recorded as liabilities on the financial statements of the sponsoring employer where those obligations are covered by either a guarantee of the employer or a commitment from the employer to make future contributions to the ESOP sufficient to meet the debt service requirement. Second, an offsetting debit to the liability recorded by the employer must be accounted for as a reduction of shareholders' equity. This is accomplished by setting up an "equity contra account" when the loan is recorded. This can result in a substantial reduction in your company's book value and may even result in a negative book value. The liability recorded by your company and the offsetting equity contra account both are reduced as the ESOP makes payments on the debt.

IX. CONCLUSION—PUTTING IT ALL TOGETHER

A. ESOPs AS EMPLOYEE BENEFIT PLANS

The tax deduction granted to employers for contributions to ESOPs, combined with the tax exemption for ESOP trusts, makes ESOPs a tax-favored form of employee benefit. An ESOP is similar to a conventional pension or profit-sharing plan, but it may provide an additional incentive to employees to improve productivity since their benefits will be provided in the form of employer stock. There is a substantial body of evidence that ESOP companies have grown faster than they would have grown without their employee ownership plans and that ESOPs exert a positive influence on corporate performance.

B. ESOPs AS FINANCING VEHICLES

In addition to their usefulness as employee benefit plans, substantial tax incentives make ESOPs a desirable vehicle of corporate finance. An important advantage of leveraged ESOP financing over conventional debt financing is that ESOP financing provides a mechanism for the sponsoring employer to deduct the full amount of the loan payments, not just the interest. This is because the payments to the lender will pass through the ESOP in the form of contributions to a tax-qualified employee benefit plan.

As a technique of corporate finance, you can use an ESOP to raise new equity capital, to refinance outstanding debt, or to acquire productive assets on a “leveraged” basis with the use of borrowed funds. ESOPs can also be used effectively to finance share repurchases and ownership succession plans.

C. OWNERSHIP SUCCESSION IN PRIVATE COMPANIES

The tax-free rollover provisions of Section 1042 of the Internal Revenue Code are especially beneficial for shareholders of closely held corporations. These special provisions enable shareholders to diversify their personal investment portfolios without incurring tax, and Section 1042 can be used to great advantage in structuring ownership succession transactions. The following example illustrates how an ESOP can facilitate this kind of transaction:

Owner owns all of the stock of a corporation. He is 70 years old and is ready to retire. Owner’s children have been working for the company for several years and desire to take over management of the business. The value of the business is about \$10 million. There are several key employees who have worked for the company for many years. Owner’s objectives are to retire with an adequate and assured income, to transfer control of the business to his children, and to protect the company’s long-term employees. The children’s objectives are to take over management of the business, to ensure retirement security for their father, and to provide incentives for the key employees to remain with the company and help them expand the business.

Several alternatives are available in this situation. First, and most obviously, Owner could arrange for a sale of

the business to a competitor or to another third party. This certainly would provide him with adequate retirement security; but if the business is sold to outsiders, Owner will not be able to pass control of the business on to his children, and there will be no guarantee of employment security for the company’s long-term employees. Moreover, Owner would be subject to federal and state taxes of 20 percent or more of the sale proceeds. Assuming that Owner sells his stock for \$10 million and that he has only a nominal basis in his stock, the total tax liability would be approximately \$2 million, depending upon applicable state tax rates.

As an alternative to selling the business to outsiders, Owner could have the corporation buy back his stock. In this case, the corporation probably would need a large bank loan. If the redemption can be financed, this approach will enable Owner to pass control of the business on to his children and to ensure continued employment for long-term employees. However, a redemption would be expensive because Owner’s stock would have to be repurchased by the corporation with after-tax dollars. Moreover, Owner would still be subject to a large tax upon the sale of his stock back to the corporation.

Another alternative would be for Owner to sell his stock to an ESOP. As long as Owner sells at least 30 percent of the company stock to the ESOP, the sale should qualify for tax-free rollover treatment. For example, if Owner sells 30 percent of his stock to the ESOP for \$3 million, he would save the \$450,000 in federal capital gains tax that he would otherwise incur in connection with such a sale, and he would be able to reinvest the full \$3 million in sale proceeds.

If the corporation borrows the funds it uses to repurchase Owner’s stock by means of an ESOP loan, its financing costs will be far less than they would be if it borrowed funds for a conventional corporate stock redemption. This is because the corporation will be able to deduct the principal repayments on the loan. Assuming that the full \$3 million purchase price is borrowed, the corporation will be entitled to an additional \$3 million in federal income tax deductions in connection with the repayment of the loan. These are deductions to which it would not otherwise have been entitled. The result is a tax savings of \$1,050,000 over the term of the loan (assuming that the corporation is

in the 35-percent tax bracket). Combined with the \$450,000 in taxes that Owner will have deferred, the total federal tax savings is \$1,500,000, or 50 percent of the total price.

To summarize, if an ESOP is used in this hypothetical situation, Owner can diversify his wealth on a tax-free basis and retire comfortably. In the meantime, his children can take over control of the business, and the employees will have job security and more incentive than ever to increase their productivity.

A successful business owner need not wait until he or she is ready to retire in order to take advantage of the opportunity afforded by an ESOP for tax-free diversification of wealth. Rather, a successful business owner might sell a block of stock to an ESOP, diversify his or her wealth, and remain in control of and continue working for the corporation. With the diversification of wealth afforded by the ESOP sale, the owner avoids the risk of having all of his or her eggs in one basket while, at the same time, ensuring a source of liquid funds to pay estate taxes and to provide security for family members independent of risks of the business.

An ESOP can be useful even if Owner does not sell his stock during his lifetime. In this situation, an ESOP can ease the problems of administering his estate. Assuming that the bulk of Owner's estate consists of stock of his closely held corporation, Owner's executor may have to raise cash to pay estate taxes by selling a portion of the stock back to the corporation. As we noted above, the corporation would have to use after-tax dollars to redeem the stock. However, an ESOP can provide a mechanism for the corporation to redeem the stock on a tax-deductible basis. If an ESOP purchases the stock, the corporation then can make tax-deductible contributions to the ESOP to pay for the stock, rather than using after-tax dollars to redeem the shares directly from the estate.

D. CONCLUSION

Tax advantages make ESOPs very attractive, not only as a form of employee benefit, but also as a technique of corporate finance and as a business and estate planning tool. You can use an ESOP and obtain tax advantages in connection with many different corporate transactions. You should consider using an ESOP in connection with virtually all corporate debt-financed transactions including, in particular, stock redemptions and leveraged buy-outs. In addition, consider using an ESOP as a vehicle to facilitate ownership succession in your business and as an attractive alternative to a sale to outside parties.

Other important uses for ESOPs include the following:

- as a vehicle for enabling a business owner to diversify his or her wealth on a tax-free basis, while retaining control of the business;
- as a vehicle for funding the buyout of dissident shareholders or for funding a divorce settlement;
- as a means of providing liquidity to pay estate taxes and to facilitate estate planning for business owners;
- as a vehicle to create a market for thinly traded stock; and
- as a vehicle for management groups and private equity funds to facilitate acquisitions.

Of course, the adoption of an ESOP will not be appropriate for all corporations, but most corporations should at least consider establishing an ESOP in order to take advantage of the substantial tax incentives created by Congress to encourage their use. When the opportunity for owners of closely held businesses to sell some or all of their stock to an ESOP on a tax-deferred basis is combined with the opportunity for the companies to borrow the funds to purchase the stock on a fully deductible basis, the ESOP concept presents tax-savings opportunities for business owners that cannot be matched by any other planning technique.

ABOUT MORGAN LEWIS

Morgan Lewis is a global law firm with 1,200 lawyers in 19 offices located in Philadelphia, Washington, D.C., New York, Los Angeles, San Francisco, Miami, Pittsburgh, Princeton, Chicago, Palo Alto, Dallas, Harrisburg, Irvine, Boston, London, Paris, Brussels, Frankfurt and Tokyo. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

At Morgan Lewis, we have the experience and the resources to reach beyond traditional thinking and apply innovative ideas and methods that deliver success for clients. Like a valuable business partner, we vigorously pursue your interests, create solutions that meet your business goals, and connect you with strategic partners in the ESOP community (ESOP lenders, ESOP valuation firms, and ESOP trustees). We know the laws, procedures of governmental agencies, and legislation before Congress that can and will affect your interests. We even work to change the laws when necessary. Most importantly, we get to know your business and understand your goals and the nature of your ESOP

challenges in order to gain a perspective that makes creative solutions possible.

We work as a team with our clients, drawing on our extensive experience in all relevant areas of law and business, including hundreds of ESOP transactions, and in legislative, regulatory, and litigation proceedings of all kinds. We are able to develop for our clients innovative plan designs, practical transaction structures, and efficient solutions to problems.

We have devoted our careers to mastering the body of laws and regulations that affect our ESOP clients. In the process, we have become leaders in the ESOP community, taking on important roles in the national ESOP lobbying and educational associations, regularly lecturing at ESOP seminars, and writing articles and books on the subject of ESOPs.

Whether you're looking to complete an innovative ESOP transaction, resolve a dispute, be represented at trial, or solve regulatory problems, Morgan Lewis lawyers work with passion, integrity, and vigor to timely deliver solutions.

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