



ESOP “Hot” Topics



MAC ESOP
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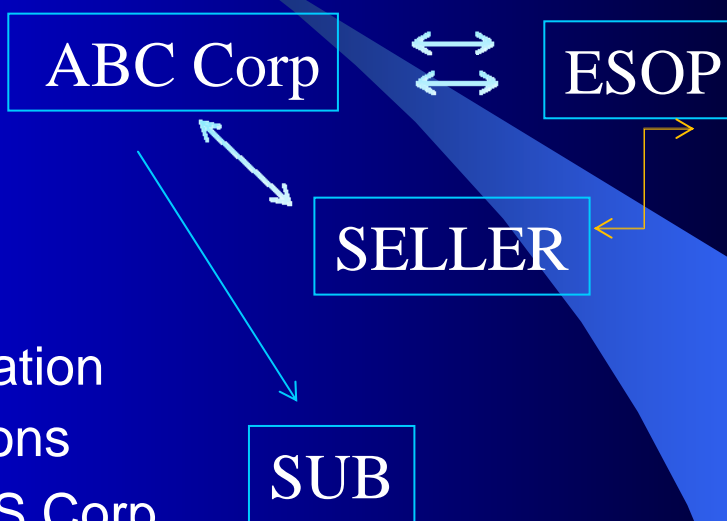
Topics



1. What do you need to know about structuring (or restructuring) "inside" ESOP loans?
2. What can you do if seller has ESOP note but company runs into cash flow problems?
3. What are the advantages/issues for a "simultaneous" exchange between seller/company/ESOP?
4. How can stock warrants be used in ESOP deals?
5. Can you "releverage" using the PTE for short-term ESOP loans?
6. How can you use your ESOP to help you buy a non-ESOP company?
7. Infusion of private equity to an ESOP company: how does it work?
8. What are the major C Corp. to S Corp. conversion issues?
9. What is the latest on account "segregation"?

“Big Picture” Goals

- No current tax
 - S Corp. ESOP
 - 1042
- LTCG vs. ordinary income
 - Warrants, not interest
 - Avoid dividend characterization
- Maximize contribution deductions
 - C Corp or less than 100% S Corp.
- Flexibility & Risk Reduction
 - If things go south
 - Repo Liab / Benefit %
 - Have / Have Nots



Structuring “Inside” Loans

- Ground Rules
 - “Primarily for benefit of participants”
 - Interest rate “not in excess of reasonable rate”
 - Terms at least as favorable to ESOP as comparable loan resulting from arm’s-length negotiations
- Key considerations
 - Since the share release is tied to repayment of the inside loan, its terms drive benefit levels to employees

Restructuring “Inside” Loans

- Weigh cost/benefit to ESOP, including consequences of failure to “refi” – e.g., does employer have enforceable obligation to make contributions
- Consider expectations of participants as well as relevant plan and loan document provisions
- Consider trust as a whole (current/future)
 - Longer term for note to benefit future participants is not sufficient by itself to extend

Restructuring (cont.)

- Overall Fairness of Refi
 - Fairness opinion
 - ESOP liability under new loan should not be greater than previously
 - Loan terms should be at least as favorable to ESOP as terms from third party lender
 - New terms must be at least as favorable to ESOP as old loan terms
 - ESOP must be able to comply with new terms

Restructuring (cont.)

- Should Trustee Negotiate Enhancements?
- What are Some Potential Enhancements?
 - Accelerated vesting
 - Higher 401(k) match contributions for a term
 - “Drag” rights
 - Covenant not to terminate ESOP for certain length of time
 - Additional diversification rights
 - Limits to executive incentive plans for a certain term
 - Promise not to use suspense shares to repay internal loan
 - Decrease in interest rate

Seller Note Issues

What if a Default?

- If Seller is “disqualified person” (likely), then same considerations for refi as with “inside” loan
- More options if deal was 1042?
 - “Pass thru” the contribution
- Seller waive payment? Discharge of indebtedness (taxable). Shares in suspense related to waived payment released?
- Seller foreclose on collateral? Can only foreclose on shares equal to missed payment (assuming party in interest)
- Have company assume note to seller and create inside loan with ESOP

Exchanges with Company

- If no desire for or availability of 1042 tax-deferred treatment, why sell directly to the ESOP?
- Have the Company redeem your outstanding stock and then sell authorized but unissued shares to the ESOP

Exchanges with Company

Structuring the Transaction

A. Non-simultaneous Arrangement

- Company redeems shares at FMV and ESOP then purchases authorized but unissued shares for amount = the remaining equity value (check for dividend treatment if not 100% sale)
- *Example.* Company enterprise value = \$11M. It redeems 100% of stock from shareholders for \$10.8M; then the ESOP purchases authorized but unissued shares from Company for \$200k. Company decides how many shares to issue.

Exchanges with Company Non-simultaneous Arrangement

- Pros

- Easy fiduciary decision for the ESOP to purchase 100% of enterprise for \$200k (no issue of overvaluation) and the low purchase price can be easily amortized over a long period creating an appropriate stock release schedule for the ESOP participants

- Cons

- If S Corp. ESOP tax benefits are repealed, the Company would be left with very small deductions

Exchanges with Company Structuring the Transaction

B. Simultaneous Arrangement

- Have the redemption/subscription transactions occur simultaneously
- *Example.* Company enterprise value = \$11M. It redeems 100% of the stock from shareholders for \$11M and simultaneously with the redemption the ESOP purchases authorized but unissued shares from the Company for \$11M.

Exchanges with Company Simultaneous Arrangement

- Pros
 - If the S Corp. ESOP tax benefit is ever repealed, the Company still will have an \$11M tax shield
 - ESOP put in place before y/e can be retro 1/1 and large contribution may reduce taxable income to shareholders for such period
- Cons
 - Fiduciary decision process re “value” paid
 - ESOP loan may not be easily amortizable by contributions within legal limits

Exchanges with Company Seller Perspective

- Better creditor protection b/c the loan (the seller note) is from the Company (not the ESOP) and can be secured by Company assets (instead of just the stock sold as required by exempt ESOP loan rules).
- If not sec. 1042 Xn and “swap” note from ESOP for note from Company, may lose installment treatment
- Company can issue junior subordinated debt with warrants to the seller. ESOP cannot issue warrants.

Exchanges with Company Company Perspective

- With non-simultaneous arrangement, the Subscription Transaction (the sale of stock from the Company to the ESOP) can have a low purchase price that is easily amortized within legal limits
 - Helpful if Company has a low payroll base and only a low amount of deductible contribution to the ESOP can be made
 - Also, no need for dividends or S corp. distributions to help amortize debt thereby avoiding any potential “make whole” payment issues

Using Warrants

- Typically used with junior financing (sub debt, seller financing) where interest rate below market b/c prefer tax efficiency (interest = ordinary income; warrants exercised = LTCG)
- Right to acquire shares of the Company in the future at a pre-determined price; participate in increase in future value (potential upside)
- More tax efficient than LLC structure b/c no tax leakage out of S Corp. ESOP model
- *Example:* 15% total IRR with 8% cash pay (interest) = 7% of note balance to represent a predetermined # of warrants (a certain ownership %) in Company for sellers to acquire future shares at the pre-determined price
- Holders often have right to put warrants to Company for cash once all transaction debt has been repaid.
- Company should request a “call” feature to prevent actual equity issuance (e.g., cashless exercise).

Short-Term Loan PTE

- Companies make long-term “inside” loans to the ESOP so ESOP can buy stock from selling shareholders, but company also can lend cash to ESOP on a “short-term” basis to pay benefits.
- DOL PTE 80-26 is a class exemption that permits company to make interest free, unsecured loan to the ESOP to pay benefits. Loan must be documented and eventually repaid by the ESOP out of future company cash contributions.
- Process not commonly used simply to fund ESOP distributions. However, approach more appealing if all ESOP shares have been allocated and the company uses multiple short-term loans as an indirect way to re-leverage the ESOP.
- “Short-term” not defined in PTE but has been applied to loan periods of several years. Trustee “swaps” the borrowed cash for shares eligible for distribution. Cash is paid to eligible participants and their swapped shares are then held in “suspense” inside the ESOP until released by the company’s future cash contributions and ESOP repayment on loan.

Using Your ESOP To Buy a Non-ESOP Company

Principal Concerns

- Financing the transaction (leveraging the assets)
- How can financing be obtained that supports the purchase price?
- Possible solution –
The 2-Day ESOP Acquisition Format

Why involve an ESOP?

- Due to the tax advantage of a tax-deferred sale, this deal can be structured to both:
 - Make it possible for the ESOP-owned company (the “Acquirer”) to obtain the financing necessary to fund the acquisition
 - Maximize “net” sale proceeds to selling shareholders while paying less than it would otherwise b/c of the tax advantages

Sale Proceeds

Assume total purchase price of \$10M

Shareholders	Ownership %	Sale Proceeds (taxable at 20%)	Sale Proceeds (tax deferred)
Bill	60%	\$4,800,000	\$6,000,000
Suzy	23%	\$1,840,000	\$2,300,000
Chad	17%	\$1,360,000	\$1,700,000
	100%	\$8,000,000	\$10,000,000

*Assumes shareholders have zero basis in their stock.

How can this be done?

Day 1

1. Target adopts ESOP.
2. Target shareholders sell 100% of Target stock to Target ESOP in 1042 sale and take back notes from the Target ESOP for the purchase price.
3. Target is now wholly owned by the Target ESOP.

Day 1

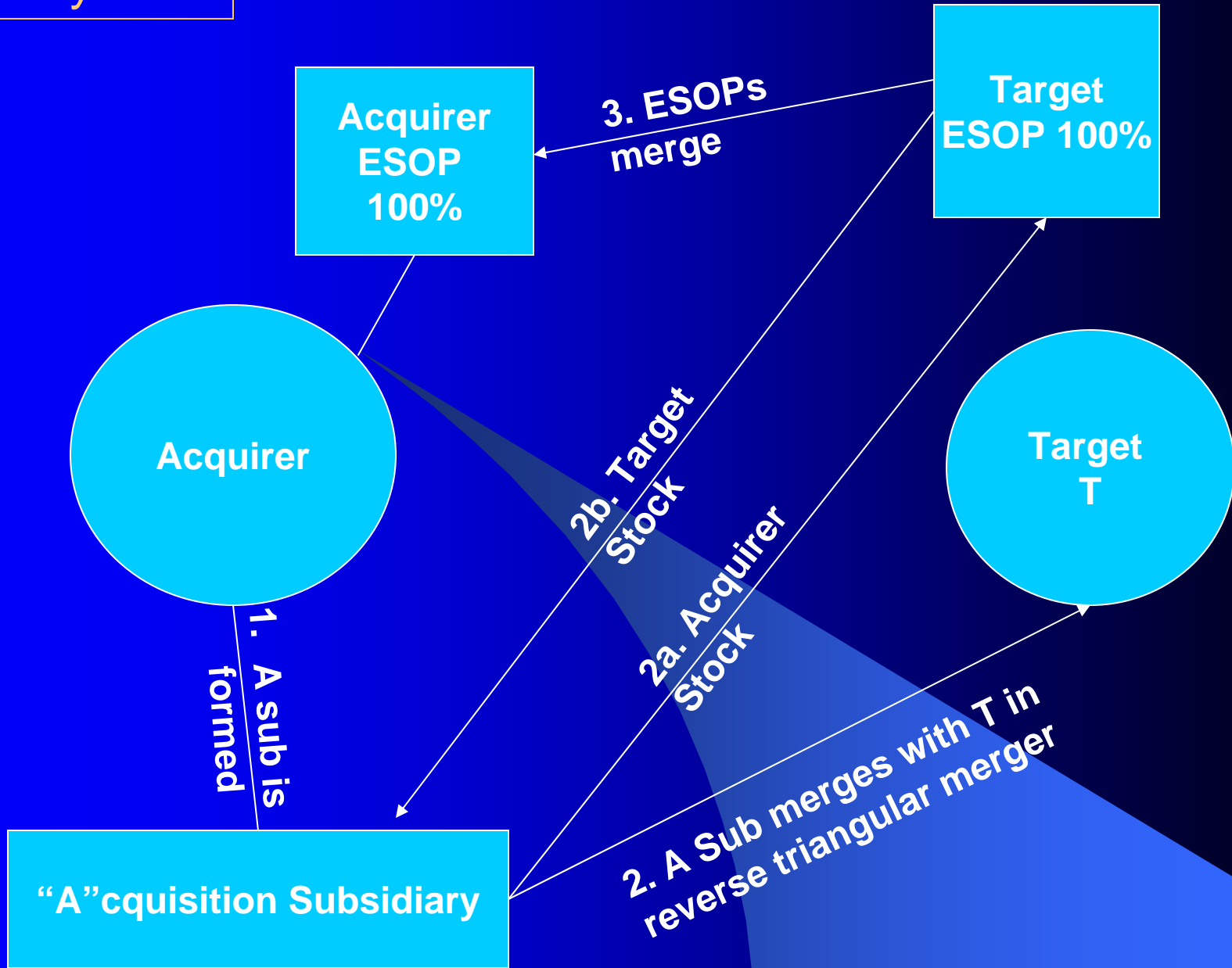


How can this be done?

Day 2

1. Acquirer forms Acquisition subsidiary (“A Sub”).
2. A Sub merges with Target in a “triangular” merger where portion of Acquirer stock is exchanged by A Sub for 100% of the Target Stock from the Target ESOP.
3. Target ESOP then merges into Acquirer ESOP and Acquirer ESOP assumes the obligation of paying the former Target shareholders.
4. Acquirer, if an S Corp., makes a Qualified Sub. S Sub election for Target so that Target now is an S Corp. wholly owned by the Acquirer ESOP.

Day 2



End Result

Acquirer
ESOP

Acquirer
(S Corp)

Target
T
(QSUB)

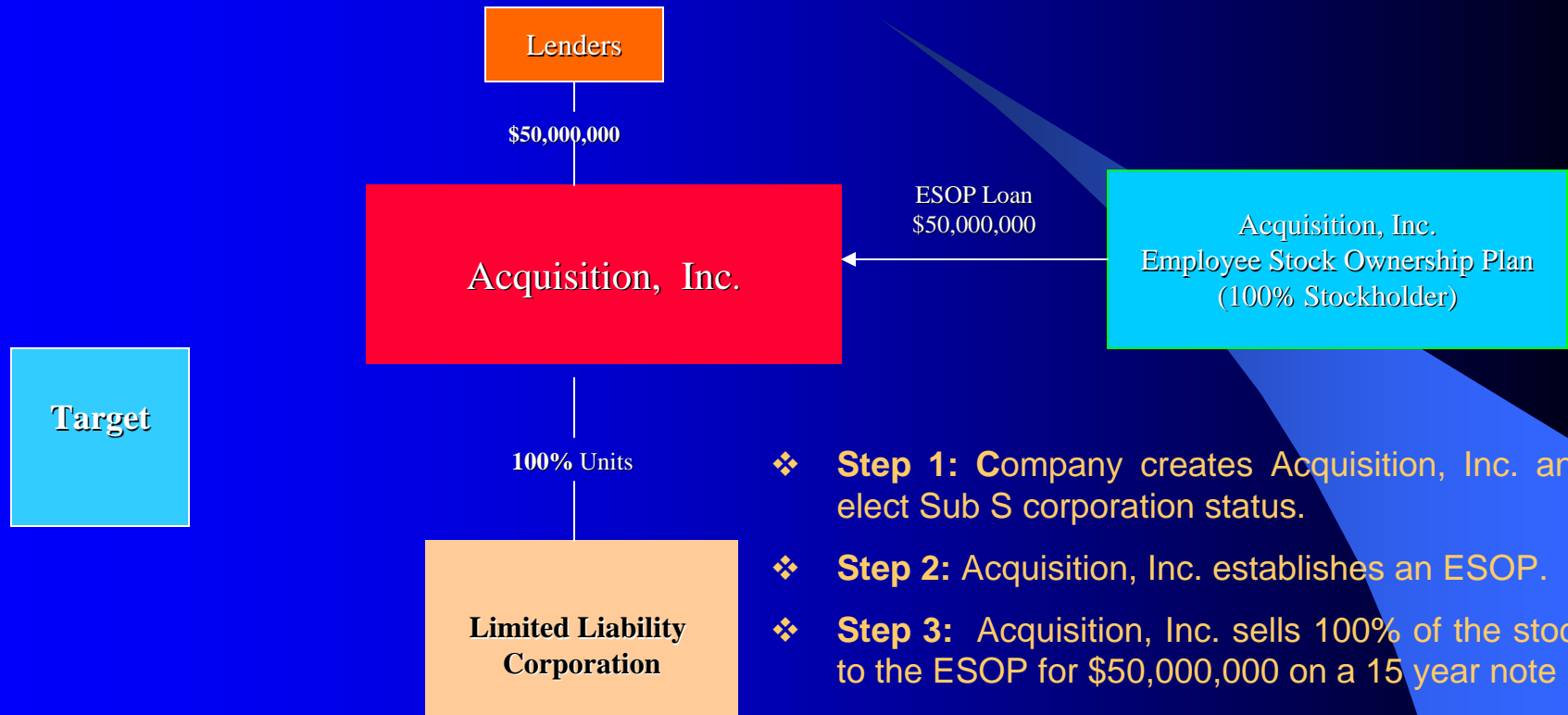
Continuity of Interest Satisfied

- Final Regs. Code Section 368 (Jan. 28, 1998)
 - For “continuity of interest” purposes, both the sale of Target stock prior to a potential tax-free transaction and the sale of company stock received in a tax-free transaction are disregarded, as long as the stock is sold to an “unrelated” third party
 - Related Party is defined very narrowly and should not include the ESOP. Thus, sale to an ESOP, either before or after a merger, should not jeopardize the tax-free nature of the transaction (even if the sale to the ESOP were pursuant to a binding written agreement)

Private Equity Investment in ESOP Company LLC Structure

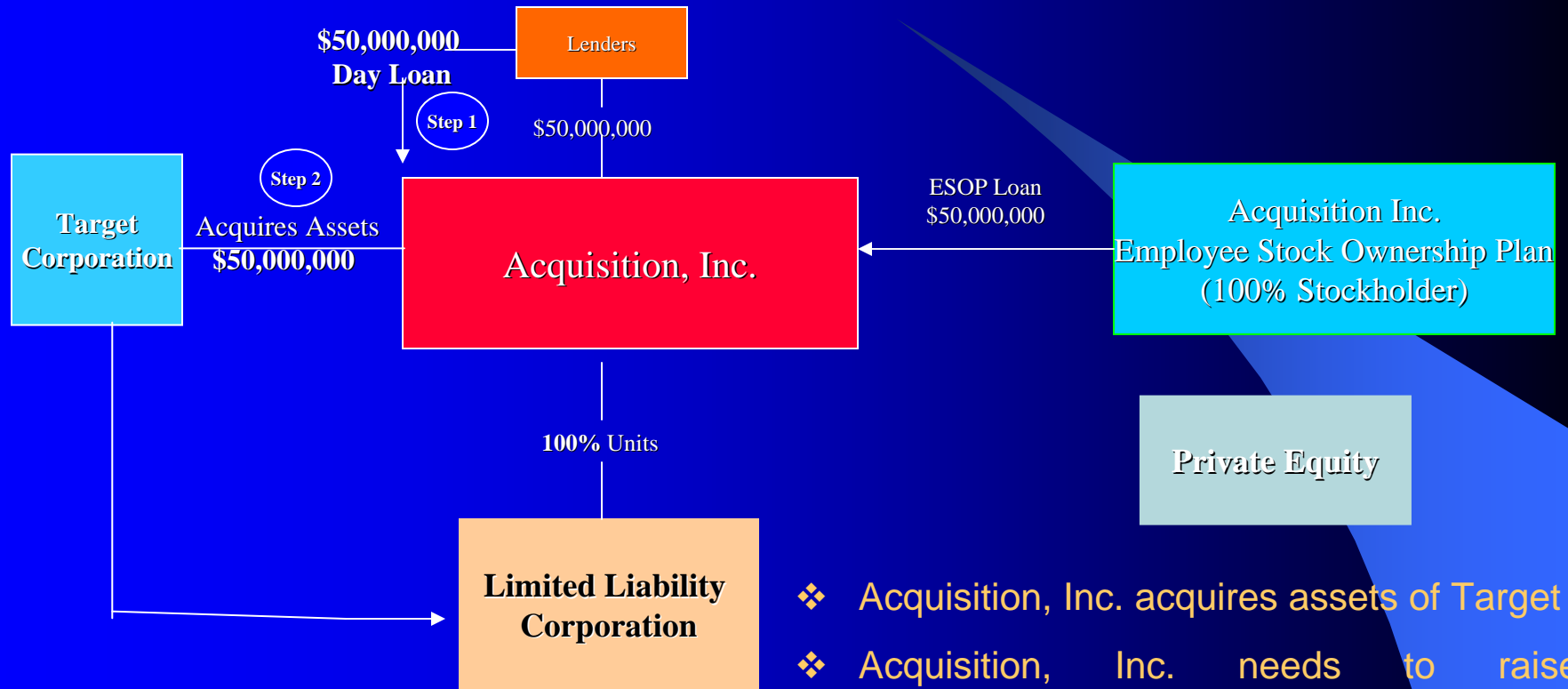
- LLC structure can help private investors realize various benefits:
 - Significantly improved cash flows through the elimination or reduction of federal taxes;
 - Achievement of acceptable equity rate of return;
 - Deleverage the Company with pre-tax dollars; and
 - Ability to fund future acquisitions through the improved cash flows.

❖ Using ESOP LLC for Acquisition



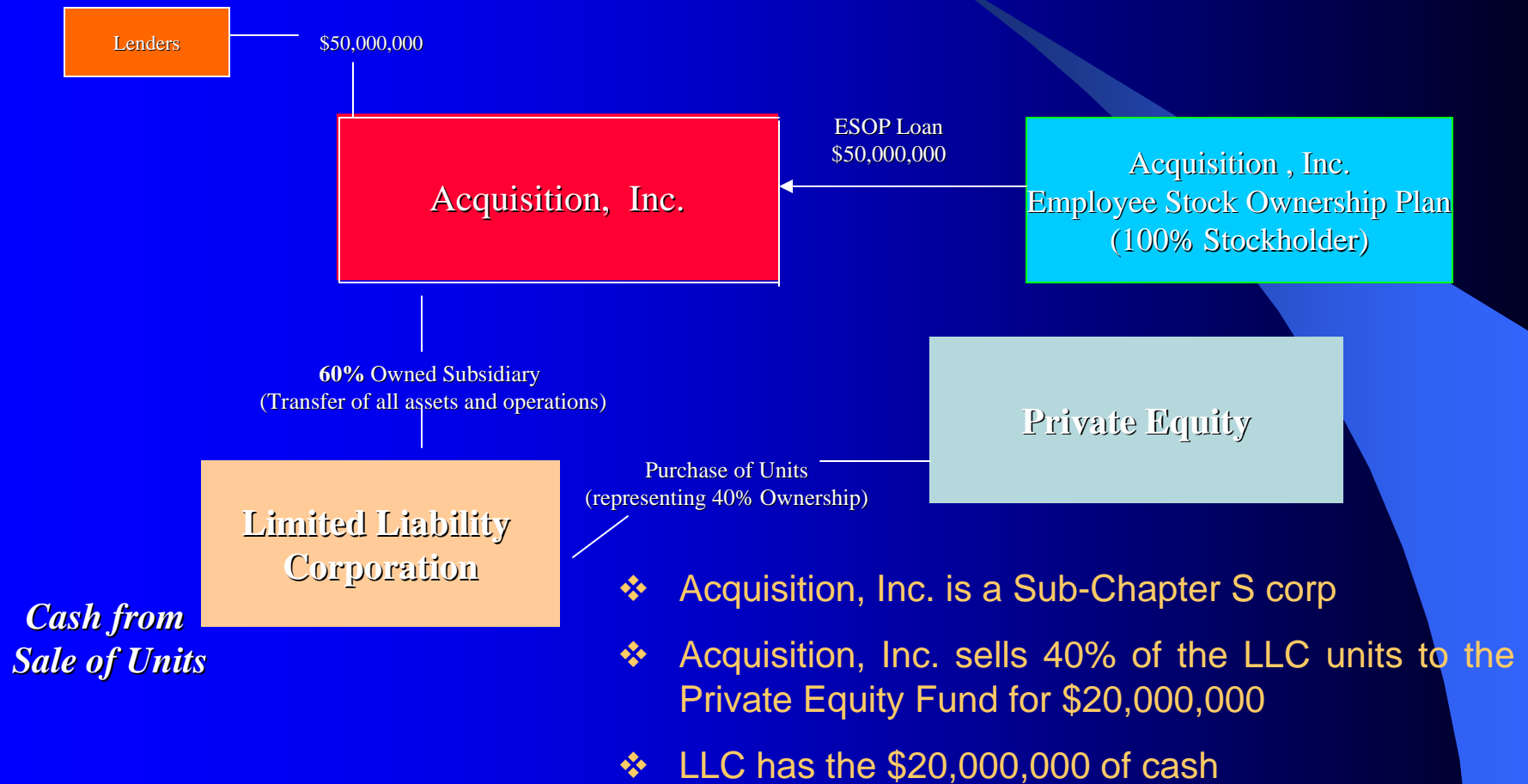
- ❖ **Step 1:** Company creates Acquisition, Inc. and elect Sub S corporation status.
- ❖ **Step 2:** Acquisition, Inc. establishes an ESOP.
- ❖ **Step 3:** Acquisition, Inc. sells 100% of the stock to the ESOP for \$50,000,000 on a 15 year note
- ❖ **Step 4:** Acquisition, Inc. creates a 100% owned LLC subsidiary
- ❖ **Step 5:** Acquisition, Inc. borrows \$50,000,000 from lender to purchase the Target for \$50,000,000.

- ❖ The following diagram of the Acquisition, Inc. making an asset acquisition on Pretax Basis (Assume the Purchase Price is \$50,000,000 and that Acquisition, Inc. can borrow \$30,000,000 (Need Private Equity of \$20,000,000)):

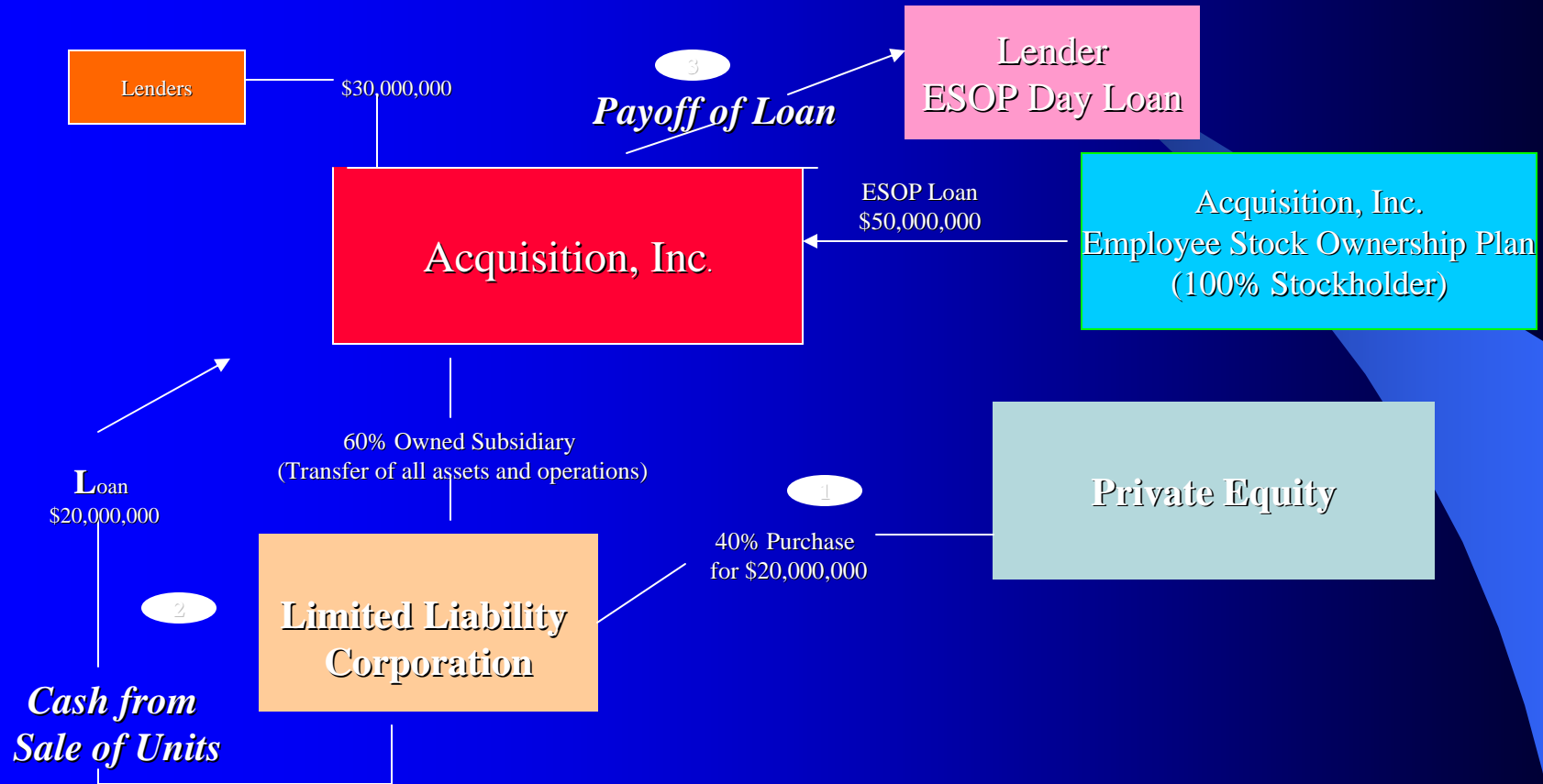


- ❖ Acquisition, Inc. acquires assets of Target
- ❖ Acquisition, Inc. needs to raise \$20,000,000 in equity from Private Equity to repay the Day Loan
- ❖ Acquisition, Inc. is an S corp. owned 100% by the ESOP company

Limited Liability Corporation Sells Units to Private Equity

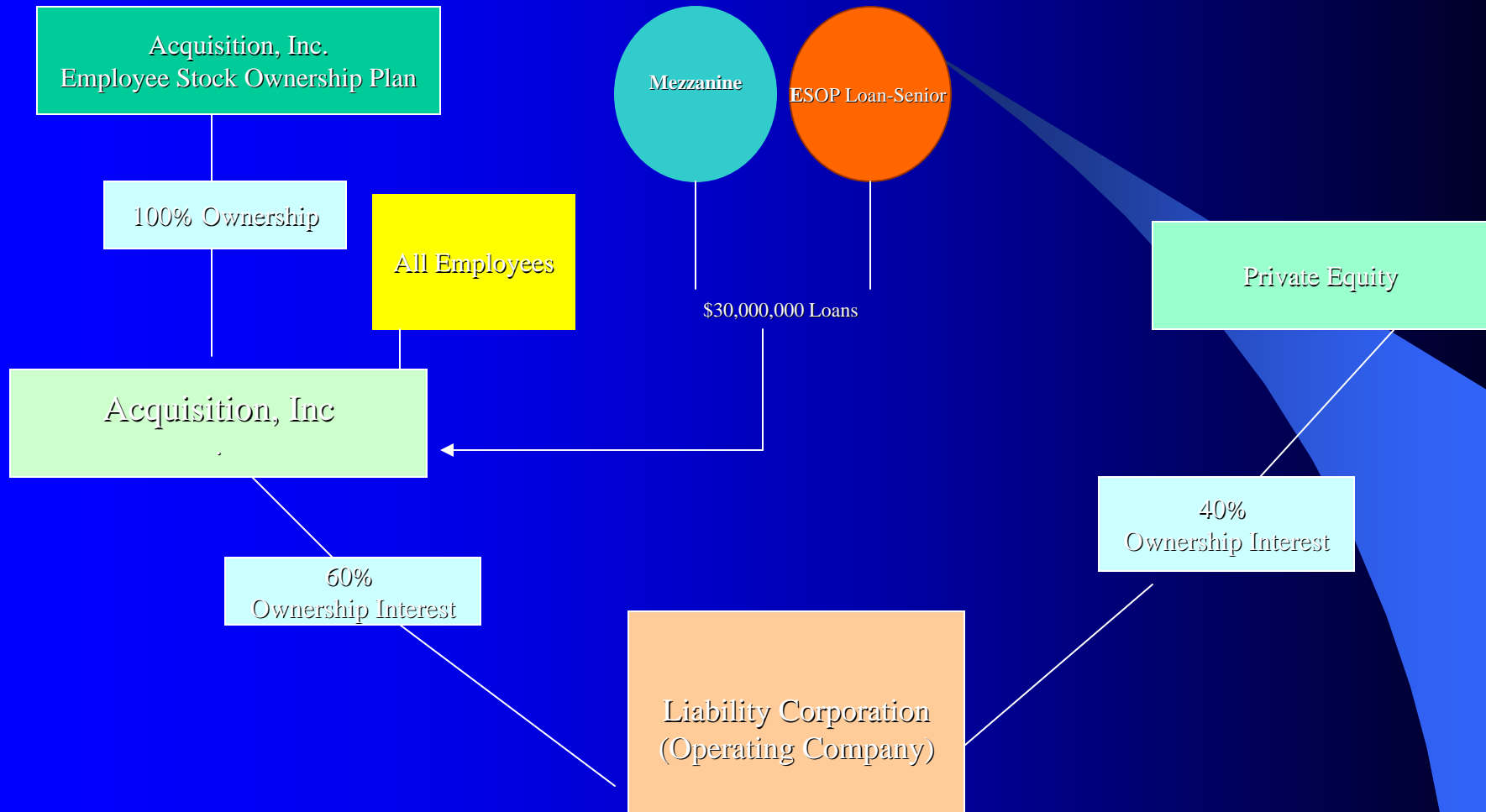


Payoff of the Day Loan



Limited Liability Corp loans \$20,000,000 to Acquisition, Inc. which uses the loan proceeds to repay the Day Loan

Final LLC Structure



Considerations in Conversions between C Corp and S Corp Some ESOP Differences

C Corp ESOP

- Contribution limit advantages:
 - Interest on Acquisition Debt not included
 - Forfeitures not included
- Distributions can be delayed until acquisition loan repaid – not applicable to S corps
- 1042 Election Available
- Dividends on Shares in ESOP are deductible in certain cases

S Corp ESOP

- S Corp Tax Shield
- Subject to IRC 409(p) – “Anti-abuse” rules
- Distributions passed through to participants subject to 10% early withdrawal excise tax

S Corp Requirements

- Shareholders
 - Number limitation – 100 – BUT shares in ESOP Trust count as 1 shareholder
 - Ineligible shareholders
 - IRAs
 - Nonresident aliens
 - Corporations
 - LLCs
 - Partnerships
 - Many kinds of Trusts

NOTE: Less than 100% S ESOPs should protect S eligibility through Shareholder Agreements with transfer restrictions

- 2% or greater shareholders treated as partners/self employed for most fringe benefits (therefore ineligible for many benefits)
 - Some fringe benefits taxed as wages, but may be deductible above the line

S Corp Requirements (cont.)

- One class of stock requirement
 - Under “governing provisions,” all shares must confer identical rights to distributions and liquidation proceeds
 - “Governing Provisions” = articles of incorporation, bylaws, applicable state law, binding agreements that affect distributions and liquidation proceeds (not necessarily buy sell provisions)
 - Differences in voting rights are OK
 - ***NOTE: Options, warrants, shareholder agreements can inadvertently create second class of stock – must be carefully structured***
- TEST for warrant/option: May be second class of stock if (1) it is substantially certain to be exercised and (2) the strike price is substantially below FMV on issue date

S Corp Conversion Issues

- Built-In Gains (BIG) Tax
 - For 10 years following date of S election, subject to corporate level tax (i.e., C corp scheme) on “net realized built in gains”
 - “Net Realized Built in Gains” means
 - *Note: Accounts receivable of cash basis taxpayer subject to BIG Tax on collections after conversion*
 - Strategy to mitigate effects
 - Have assets appraised as of date of election to have sound basis to distinguish “pre-conversion” (subject to BIG Tax) and “post-conversion” (not subject to BIG Tax) appreciation in asset values

S Corp Conversion Issues (cont.)

- Presence of C Corp Earnings and Profits (E&P)
 - Potential taxable dividends if distributions exceed Accumulated Adjustments Account (AAA) – AAA = undistributed taxable income or loss of S Corp while S election in effect; often referred to as “previously taxed but undistributed income”
 - Try to minimize distributions that would exceed balance in the AAA account to avoid taxable dividends

S Corp Conversion Issues (cont.)

- LIFO Recapture
 - C Corp that uses LIFO inventory accounting and converts to S Corp is taxed on the “LIFO Recapture” amount
 - LIFO Recapture = Amount by which inventory computed by FIFO method exceeds inventory computed by LIFO method

S Corp Conversion Issues (cont.)

- Election Timing
 - Any time prior to beginning of tax year
 - Retroactive to beginning of year if made within 2 ½ months of start of tax year
- Tax Year Limitations (calendar unless meets exception)
 - IF 100% ESOP owned S Corp, corporation can use Plan Year of ESOP

Partial ESOP-owned S Corps

- Needs of non-ESOP shareholders for “tax distributions”
- Must make pro rata distributions to ESOP – cash buildup in ESOP
- Legislation
 - “ESOP Promotion and Improvement Act of 2009”

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THANK YOU!

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