ESOPs in Government Contracting Firms: A Natural Fit

Mid-Atlantic Chapter of the ESOP Association

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Michael R. Holzman of Morgan, Lewis & Bockius, LLP

Robert B. Webb III of Squire, Sanders & Dempsey LLP

Government Contractors

Professional, technical services

Service Contract Act

FAR -- Part 16

fixed-price contracts

cost-reimbursement contracts

allowable incurred costs

FAR -- Part 31 31.205-6 – Compensation for Personal Services.

ESOPs

Employee Stock Ownership Plan

ESOP Plan

vesting

ERISA

participant

Plan Assets

ESOP Trust

Plan Administrator

Trustee

contribution

Allocated shares

Leveraged ESOP

Unallocated shares

5500

IRC 1042

valuation

S-Corporation

Fiduciaries

Pass-through voting

SPD

Corporation

Corporation

Board of Directors

Articles of Incorporation, Charter, or Certificate of Incorporation

Bylaws

Put Rights

shareholders

State of Organization

Advantages for the Selling Owner

- Can sell some, up to all, of the stock of the company for full fair market value as determined by an independent appraiser
- If certain conditions are met, a business owner can sell their stock to an ESOP and defer the tax incurred on the sale of the stock
- Can the company maintain 8(a) status?

1042 Tax-Free Sale

- Advantages of 1042
  - Seller of stock to a C corporation's ESOP pays no income tax on sale proceeds that are reinvested in Qualified Replacement Property (QRP) (note that this need not be just a deferral if coupled with monetizing)
  - Corporation deducts the cost of paying the seller
  - Example of tax-saving potential --

Sale to ESOP at $7,000,000
vs.
Sale to Company at $7,000,000

	After-Tax Benefits to Seller	After-Tax Cost to Company
ESOP Alternative	**$7,000,000**	**$4,200,000**
Non-ESOP Alternative	**$5,600,000**	**$7,000,000**
Differential	**$1,400,000**	**$2,800,000**

Total Tax Savings Using ESOP $4,200,000

It gets even better with a government contractor

- If there are cost-plus contracts in place, the ESOP’s costs associated with purchasing the business owner’s stock is a reimbursable cost

1042

- Only ESOPs sponsored by C Corporations can consummate a 1042 Election
- Only “Qualified Securities” can be sold
  - Best common or convertible preferred
  - Domestic corporation
  - 3-year holding period
  - Not received pursuant to "another plan"
  - Sale otherwise eligible for LTCG

1042

Qualified Replacement Property (QRP) must be:

- Stocks, bonds or notes of an --
  - Active U.S. corporation
    - That is not the employer, or
    - A member of a controlled group with it
- Purchased within a 15-month period starting three months prior to the sale and ending 12 months after it
- Rollover of Basis

1042

- Tax on dispositions of QRP
  - Triggers LTCG that was initially avoided
  - Exceptions - no tax where disposition is due to
    - 368 reorganization
    - Death of seller
    - Subsequent 1042 sale
    - Gift

1042-What’s the catch?

- All of the sale proceeds must be reinvested within one year of the date of the sale in order to effectively defer the tax
- Selling shareholder, their relatives, and other 25% shareholders cannot participate in the allocation of their stock purchased by the ESOP

How do you break the lock-in effect of a 1042 sale?

- Monetize
- Reinvest in another venture

How do ESOPs work?

- An ESOP Is A "Qualified Deferred Compensation Plan”
  - There must be a written plan and a trust;
  - The Trust (Employee Stock Ownership Trust - ESOT) must be "primarily" (more than 50%) invested in employer securities

The ESOP Must:

- Be for the exclusive benefit of employees
- Meet qualified plan employee coverage and vesting requirements
- Not discriminate in favor of Highly Compensated Employees (HCEs),
  - But, if not a 1042 rollover, owner/employees can be participants in the ESOP.

How do the employees benefit?

- As cash is contributed to the ESOP and deducted by the company, the ESOP repays the debt it incurred to purchase the stock
- As the ESOP debt is repaid, the stock is released from a "suspense account" within the ESOP and allocated to all participants pro rata to compensation
- Employees get a "piece of the rock" and understand that their hard work is directly correlated to the value of their ESOP retirement account

Employer Contributions To An ESOP Can Exceed Limits That Apply To Other Types Of Defined Contribution Plans –

Where you have a C Corporation and no more than 1/3 of that year's employer contributions are allocated to HCEs you need not count either –

- Interest
- Forfeitures

against the 25% of covered compensation contribution limitation.

Dividends Paid On ESOP Stock By a C-Corporation Can Be Deductible To The Corporation If They Are –

- Used to pay down a loan incurred to purchase the stock that gave rise to the dividend
- Passed through to plan participants
- Used, at the direction of the plan participants, to purchase more Company stock in that participant's ESOP Account

Tax On Net Unrealized Appreciation (NUA) On Company Stock In ESOT Can Be:

- Deferred Until Ultimately Sold By The Plan Participant;
- Converted from Ordinary Income to Long Term Capital Gain

How Is an ESOP Stock Sale Financed?

- Traditional bank loan
- Seller financing
- Mezzanine lenders
- Private equity
- Employees’ monies from other qualified plans

S Corporation

- Tax Classification Only
- Pays no federal corporate level tax
- May pay state taxes
- Taxable Income passed through to Shareholders
- Shareholders must make election unanimously
- If election revoked-must wait 5 years to re-elect
- Must satisfy certain Internal Revenue Code Criteria
  - Only one class of stock
  - Only certain types of Shareholders permitted
  - An ESOP qualifies as an S Corp. Shareholder

S Corp. Shareholders

- Pay tax on Allocable Income passed through
- ESOP Trust is a tax exempt entity – thus pays no tax
- Income passed through to ESOP is added to "basis" of ESOP shares
- Only "basis" is taxable if stock distributed to participants

Built-In gain

- Excess of FMV of S Corp Assets above Basis at time of S election is taxable if assets sold within 10 years of election
- A/R taxed as collected
- Importance of Appraisal at time of election
- If sold and 338(h)(10) election made-Corp pays tax as though assets sold

Corporate and Governance Issues

- Board of Directors governs Corporate affairs
- ESOP has right to vote Shares and exercise shareholder oversight
- By law, certain shareholder votes must be passed through to ESOP participants

Board of Directors

- Elected by Shareholders
- Retains all Decision making power unless state law, corporate charter requires a shareholder vote
- Independent Directors vs. Inside Directors
- Fiduciaries, have power and duty to select, oversee, monitor, and remove or replace Trustees

Shareholders

- By law, only required vote is annual election of Board (may be elected on staggered basis – one-third each year)
- By law, vote upon merger, dissolution, sale of assets, amendment of charter is subject to shareholder vote
- Requisite Vote – state law governs.
- Virginia - specifies default – 2/3, but charter may provide a higher or lower level, but not less than majority of votes cast at meeting with quorum present.
- Delaware – specifies default – majority of shares entitled to vote, but charter may provide a higher level.
- Continuing Owner can use this to retain negative control
- Voting must be by shareholder or proxy holder – written ballots absent presence **does not work**.

ESOP Participants

- No Direct right to Vote
- Have right to direct vote of allocated shares in certain matters – IRC 409(e) provides must have right to direct trustee on voting for "any corporate matter which involves the voting of such shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as the Secretary may prescribe in regulations."

Unique Issues for Govt. Contractors

- Timing of Contributions for Employees subject to Service Contract Act.
- valuation (and allowable costs) of shares released from ESOP suspense account.
- Allowability of cost of interest expense for leveraged ESOPs.
- Can an ESOP owned corporation qualify as an 8(a)?
- Can an ESOP owned corporation qualify as Service Disabled Veteran Small Business?

Questions & Answers