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HOW TO CASH OUT TAX-FREE, YET KEEP YOUR BUSINESS...Go ESOP

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HOW TO CASH OUT TAX-FREE, YET KEEP YOUR BUSINESS. . . . Go ESOP

DAVID ACKERMAN

Congress has created a number of truly remarkable tax incentives designed to encourage employers to establish employee stock ownership plans (or "ESOPs" as they commonly are called). These tax incentives make ESOPs attractive not only as employee benefit plans, but also as a technique of corporate finance and as a business and estate planning tool. For owners of family businesses and other private media companies, ESOPs can be used to provide creative solutions to the financial and estate planning problems that typically confront them. For example, if you own stock of a private corporation and if certain conditions that are described below are satisfied, you can sell some or all of your stock to an ESOP on a tax-free basis. This provides a tax-favored means for you to diversify your investment portfolio and to assure a source of estate liquidity. If you are ready to retire, an ESOP can be used to buy out your interest and may serve as an attractive alternative to selling the business to outsiders, which may be important if you desire to keep control of the business within your family or within a key-employee group.

When the opportunity for you to sell some or all of your stock to an ESOP on a tax-free basis is combined with the opportunity for your company to borrow the funds to purchase your stock on a fully-deductible basis, the ESOP concept presents tax-savings opportunities that cannot be matched by any other planning technique.

General Description of an ESOP. An ESOP is an employee benefit plan that is designed to invest primarily in stock of the sponsoring employer. Probably the easiest way to understand how an ESOP works is to think of it as a variation on the traditional profit-sharing or Section 401(k) plan. Just like contributions to a profit-sharing plan, contributions that your company makes to an ESOP are deductible (within limits) and income earned by an ESOP is exempt from tax. In addition, participants in an ESOP do not recognize any taxable income as a result of employer contri-

butions or earnings on their accounts until their benefits are withdrawn from the plan.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.

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 officers, shareholders, or highly-compensated employees (but benefits may be allocated in proportion to the relative compensation of participating employees); and*
- 4) *the plan must comply with certain minimum vesting standards.*

Tax-Free Sales to ESOPs. If you have owned common stock of a closely held C corporation for at least three years, you may sell some or all of that stock to an ESOP on a tax-free basis if the following conditions are satisfied:

- a) *immediately after the sale, the ESOP owns at least 30 percent of the total value of the common stock of the company; and*
- b) *you reinvest the sales proceeds within 12 months in "qualified replacement property," a specially-defined term.*

It is important to note that the first requirement for tax-free treatment – that the plan must own at least 30 percent of the out-

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standing stock of your corporation – is applied immediately after the sale is closed. Therefore, you may establish an ESOP for the purpose of arranging for a tax-free sale of some or all of your stock.

The second requirement for tax-free treatment is that you must reinvest the sale proceeds within one year in “qualified replacement property” with a cost equal to the amount realized on the sale to the ESOP. The term “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 this purpose.

If these requirements 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. Technically, you obtain 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 property until your death. At that time, your heirs will be entitled to a stepped-up basis in the replacement properties equal to their fair market value at the date of your death. Your heirs then will be able to sell the replacement property without incurring any capital gains tax. A common planning technique by which to transform the tax deferral into permanent tax avoidance involves purchasing long-term corporate bonds as qualified replacement properties and then borrowing against the bonds and using the loan proceeds to purchase any kind of property that you want. No tax is triggered because the qualified replacement property (the bond) has not been sold.

One additional requirement for a tax-free sale of stock to an ESOP is that the sale price must not exceed the fair market value of the stock, as determined by an independent professional business appraiser.

Leveraged ESOPs. An ESOP also can be used to reduce financing costs. If your corporation uses an ESOP to obtain a loan, the corporation will be able to deduct both the interest and the principal on the loan, instead of merely deducting the interest as in the case of a conventional corporate loan. The difference arises because your company obtains a deduction for plan contributions that are used to repay principal on an ESOP loan.

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 stock of your company, either (a) from the company, in which case your company then has the use of the loan proceeds, or (b) from you or another stockholder (and you or the other seller then may elect tax-free treatment of the sale); and*
- 3) *your company makes annual cash contributions to the ESOP in amounts sufficient to amortize the loan and deducts the amounts so contributed.*

In effect, your company will only have to pay back two-thirds of the loan. The remainder can be repaid out of the tax deductions that your company will obtain in connection with the principal payments.

Using ESOPs in Ownership Succession Planning. The use of an ESOP to purchase your shares or to purchase the shares of another retiring stockholder 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 within a key-employee group. The sale can be arranged on a tax-free basis; and if the funds needed to finance the purchase of the stock must be borrowed, an ESOP can be used to reduce the financing costs.

Tax-Free Diversification of Wealth. If like most successful business owners, you have most of your wealth tied up in the stock of your corporation, you may desire to diversify your investment portfolio. Unfortunately, if you are not ready to retire and, therefore, are not willing to sell a controlling interest in your business, it will be very difficult to find someone willing to purchase a minority interest. However, an ESOP is happy to be a minority owner of a private corporation. An ESOP sale also addresses another potential obstacle to selling some of your stock – income taxes. If the conditions described above are satisfied, you can sell a portion of your stock in your company on a tax-free basis. In other words, with an ESOP, you can diversify your personal wealth on a tax-advantaged basis and still keep control of your business.

Example. Assume that you own all the stock of a corporation and that the fair market value of 30 percent of your stock is \$3 million. You could sell 30 percent of your stock to a newly-established ESOP for \$3 million, and you would not be required to pay any tax in connection with the sale if you purchased \$3 million worth of qualified replacement properties within one year. Your total federal income tax savings could be as much as \$450,000. In addition, assuming that the funds to finance the purchase were borrowed, the corporation

would be entitled to \$3 million in tax deductions over the term of the ESOP loan that otherwise would not be available, which would save your company approximately \$1,050,000 in federal taxes alone. Thus, the total federal tax savings on a \$3 million ESOP transaction could be \$1.5 million, or 50 percent of the total transaction. Additional state income tax savings also would be available.

Voting the ESOP Stock. Voting rights connected with the stock held in an ESOP usually do not have to be passed through to the participants in the plan. Unless your company's stock is publicly traded, voting rights are passed through to the participants only when certain extraordinary types of transactions are proposed. The stock will be voted on all other matters 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.

Stock Repurchases. When participants in an ESOP retire or otherwise terminate employment, they are entitled to receive their benefits, which may be distributed in the form of stock or cash. Participants who receive their benefits in the form of company stock have the right to sell that stock back to the company at its fair market value. The company is entitled to pay benefits in installments and to repurchase distributed shares in installments. ■

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