ABC'S OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Brian D. Hector, Morgan Lewis
Renee Stadtmueller, Blue Ridge ESOP Associates

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The ESOP Association

Morgan Lewis

Presenters

Brian D. Hector
Morgan Lewis

Renee Stadtmueller
Blue Ridge ESOP Associates

The ESOP Association

Morgan Lewis

What is an ESOP?

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- Employee benefit plan
- Subject to the Internal Revenue Code and ERISA
- Primarily invests in qualifying employer securities
- Employees are the beneficial owners of the stock

Purposes an ESOP Can Serve

- Employee benefit (studies have shown that ESOP companies tend to retain and attract talent in the competitive marketplace)
- Ability to exit without selling to a competitor or third party
- Transition ownership through partial or full sale
- Ensures legacy of the company
- Selling shareholders can retain roles in the company post-transaction
- Provide tax-advantaged buyout/succession planning for business owners considering retirement

Beneficial vs. Direct Ownership

- Shares purchased by the ESOP are owned in a trust, not by plan participants
  - Eligible employees are “beneficiaries” of the trust
- Trustee acts in a fiduciary capacity and is the legal owner of the shares
- Trustee exercises shareholder rights in the best interest of the participants

Which Owners Should Sell to an ESOP?

Owners…

- With a significant amount of wealth in their business and who desire partial diversification
- Looking to exit over time or diversify wealth away from the operating entity
- With a low basis in stock
- Who want to reward employees
- With children both inside and outside of the business

Which Companies Should Consider an ESOP?

- Privately held businesses looking for a succession plan
- Companies that recently went through a failed auction
- Companies that need a competitive bid for a sale to a third party
- Companies with partners who have different liquidity horizons
- Companies that want to facilitate a C→S Conversion
- ESOP serves as a nonthreatening source of liquidity today and annually into the future
- ESOP is a ready buyer at any time at fair market value

Common Misperceptions About ESOPs

- Participants own and vote the stock
  - Untrue, unless your business is a public company or shareholders get to vote on a major corporate issue (which does not include voting for the Board)
- Participants are entitled to your financial statements
  - Untrue, unless you are a public company
- You have to sell all your stock to an ESOP
  - Most ESOPs do not own the entire stock
  - A company must be a C corporation to sponsor an ESOP
- A company must use debt to sell stock to an ESOP
- ESOPs are only for large companies

Parties Involved in an ESOP Transaction

ESOP's Advisors

- ESOP Trustee
- Independent Valuation Firm
- Trustee's Counsel

Company's Advisors

- ESOP Deal Investment Banker/ Financial Advisor
- ESOP Attorney
- Third-Party Administrator
- CPA Firm
- Personal Wealth Advisor

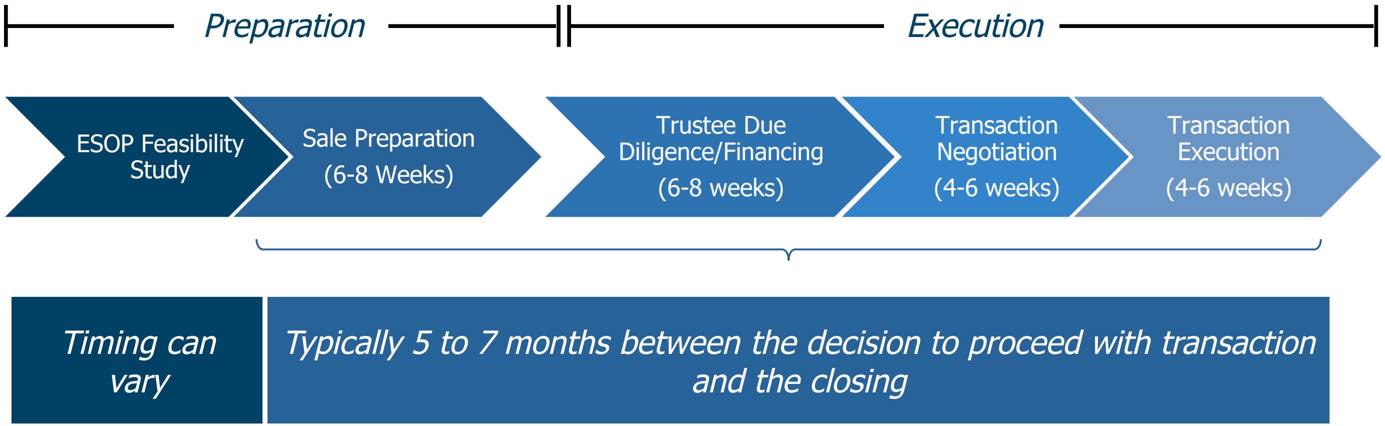
Summary of Tax Incentives

- Benefits to Selling Shareholder
  - If eligible, the shareholder can defer (or altogether avoid) paying capital gains tax on the sale (more on that later)
- Benefits to Sponsoring Company
  - Contributions are deductible
  - Deductions for dividends paid to ESOP are deductible
- Benefits to Employee-Participants
  - Earnings and contributions accumulate tax-free
  - Employees are not subject to tax on contributions or earnings allocated to their accounts until benefits are distributed to them upon the termination of their employment

How Are Purchase Prices Determined in ESOP Transactions?

- ERISA prohibits ESOPs from paying more than (or receiving less than) adequate consideration (i.e., fair market value) for company stock
- ESOP transactions are negotiated between the seller(s) and the ESOP trustee. As the buyer, the trustee (with help from an ESOP valuation firm) ultimately determines how much an ESOP can pay (by issuing an opinion of fair market value)
- Selling shareholders will not see the ESOP trustee's valuation analysis, nor will they know the maximum or minimum price the ESOP can pay. As such, it is helpful for selling shareholders to have an experienced ESOP investment banker/financial advisor on their side
- The DOL has repeatedly and aggressively challenged prices paid (and other financial terms) in ESOP transactions

Sample ESOP Transaction Timeline



ESOP Valuations

- A typical ESOP company is a privately held company—its shares are not publicly traded, so the value of the ESOP shares must be determined by the trustee pursuant to an established appraisal process.
- The trustee hires an experienced, independent ESOP valuation firm to perform an appraisal of the ESOP stock.
- The valuation firm works for the ESOP trustee, not for the company or its owner.
- The stock must be valued at least once each year but can be valued on a more frequent basis.

ESOP Transaction Structures

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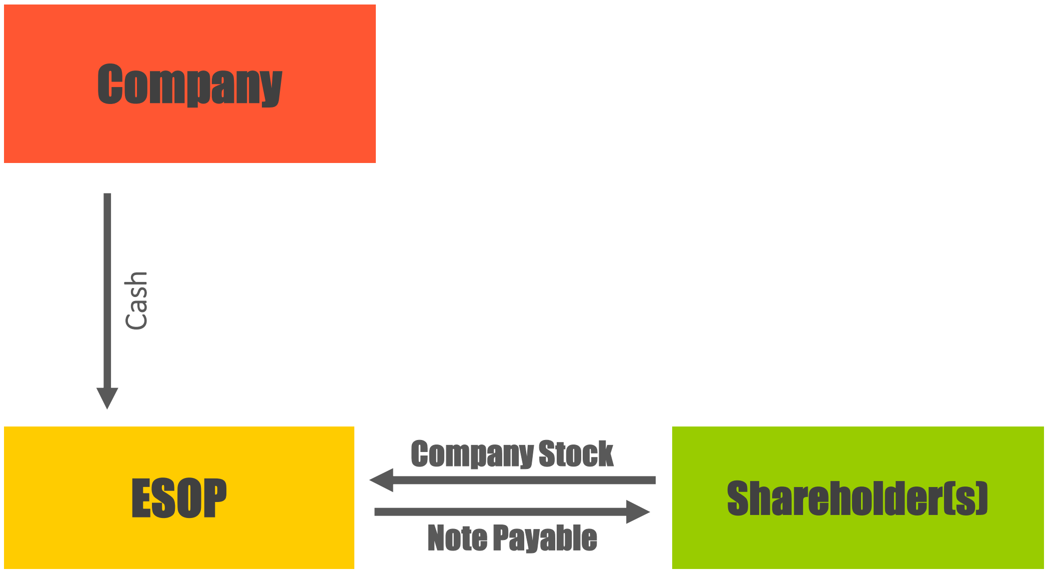
Sale Structure Options

- **Partial or 100% sale**
  - Affordability
  - Financing/liquidity – sell as much as you can borrow
  - "Ease into" an ESOP
  - Consider timing of future sales. This may influence the design of the transaction and duration of financing.
  - How will the stock be paid for? Installments? How long?
  - Accelerating payments to an ESOP reduces taxable income but increases benefit expense (repurchase obligation).
  - The structure affects the benefits policy. Quicker payments early on means that employees in early years receive larger benefits. Spread out payments; balance over time.
  - Future capital needs

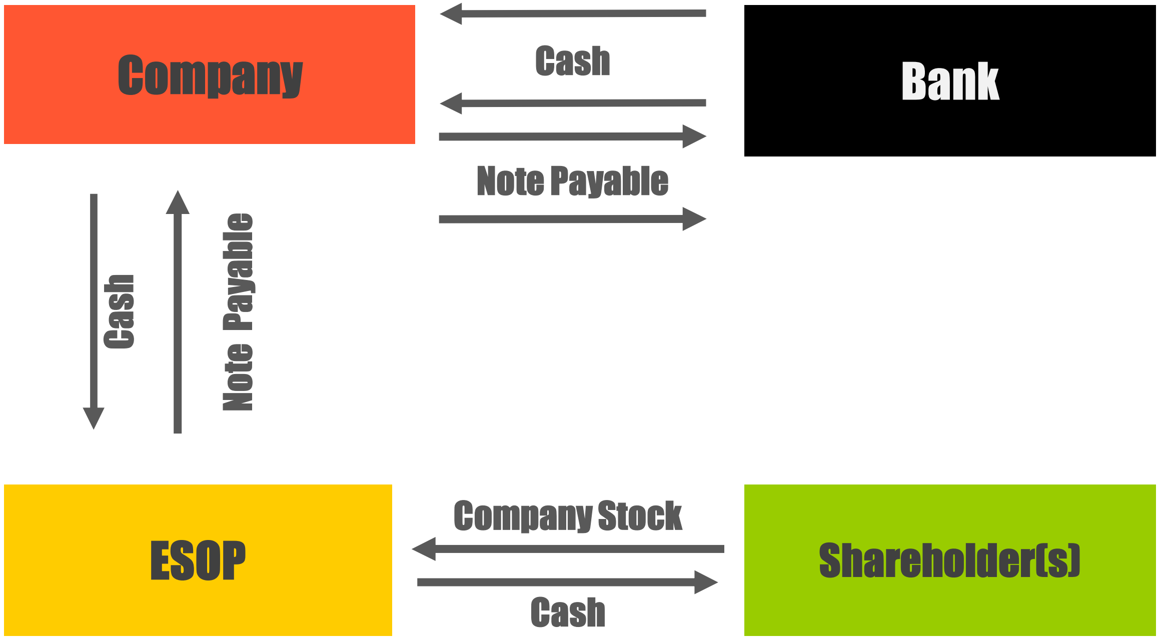
Sale Structure Options (Cont.)

- **Leveraged**
  - ESOP/Company borrow money
  - Contributions to an ESOP are tax deductible (principal and interest)
  - Debt obligation on the Company
  - C corporation dividends are tax deductible
- **Nonleveraged**
  - Purchase outright
  - If treasury stock and 1,000 shares are authorized, but 500 shares are outstanding, the corporation can contribute treasury stock to the ESOP and receive a tax deduction for the fair market value of the contributed stock, without the transfer of cash. This will have the effect of dilution.

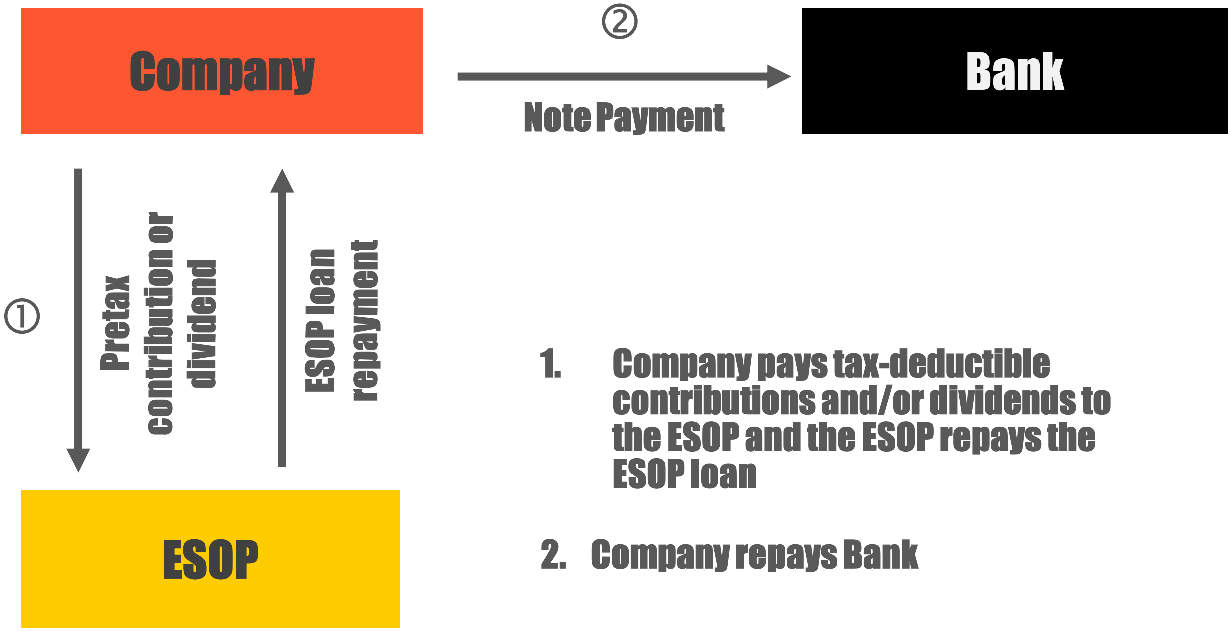
Typical ESOP Transaction – Seller Financed



Typical ESOP Transaction – Bank Financed



Repaying the ESOP Loan



1. Company pays tax-deductible contributions and/or dividends to the ESOP and the ESOP repays the ESOP loan

2. Company repays Bank

How Does the Money Flow?

First, the Company contributes cash to the ESOP.

Second, the ESOP uses contributions to repay the loan to the Company.

Third, the Company then uses ESOP payments to repay the loan to the bank and/or the seller.

- When the ESOP loan is paid, the shares are allocated to participants' accounts.
- Shares remain in a suspense account within the ESOP until the ESOP loan payment is made.

Deductibility of ESOP Contributions

- Internal Revenue Code Section 404 provides that up to 25% of covered compensation of eligible participants is deductible by the company.
- Example: Covered compensation of the eligible participants is $5,000,000. $1,250,000 is the maximum deductible contribution the company can make to the ESOP.
- Increased limits for amounts allocated to repay an ESOP loan (C corporations only)
  - contributions for interest – fully deductible
  - contributions for principal – deductible up to 25% of compensation
  - dividends are deductible, if reasonable

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1042 Transactions

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IRC 1042 Election

1. **Section 1042 of the Internal Revenue Code provides an opportunity for a taxpayer to defer the recognition of tax on the proceeds of a sale of stock of a C corporation to an ESOP if the proceeds are reinvested in securities of other corporations**
   - Available only with respect to sale of common stock of C corporations that are not publicly traded
2. **Requirements:**
   - The stock must have been owned by the seller for at least three years
   - Immediately after the sale, the ESOP owns at least 30% of the employer's stock
   - Sale proceeds must be reinvested in Qualified Replacement Property (QRP)
   - Cannot be invested in mutual funds
   - Reinvestment must occur within 12 months of the date of the sale to the ESOP
3. **The seller's shares must not be allocated back to the seller, to related parties of the seller, or to 25% stockholders**
4. **The gain deferred on the sale of the stock to the ESOP is taxed when the QRP is sold**
5. **However, if QRPs are held by the taxpayer until death, the taxpayer's estate gets a "step up" in basis at death, resulting in permanent tax avoidance**
6. **The ESOP-sponsoring company can elect S corporation status after the sale for greater tax advantage, as described in later slides**

IRC 1042 Election (cont.)

- **QRP defined as:**
  - Stocks, bonds, notes, debentures of US corporations, public or private, floating rate notes (FRNs)
  - Can be a brother/sister, but not a subsidiary of the ESOP-sponsoring company
  - 50% or more of assets must be used in active conduct of business, and passive revenue cannot exceed 25% of gross receipts
  - FRNs – If a seller purchases FRNs, the seller may borrow up to 90%, which means 90% of sale proceeds are “freed up” to use as the seller pleases
- **Investments that are not considered QRP:**
  - Municipal Bonds
  - Treasury Securities
  - Federal Agency Securities
  - International Domiciled Companies
  - Limited Partnerships

Tax Advantage of a 1042 ESOP Sale

	Regular Sale	1042 ESOP Sale
Sale Price	$10,000,000	$10,000,000
Basis	100,000	100,000
Taxable Gain	9,900,000	9,900,000
Federal LT Capital Gains Tax (23.8% with Medicare tax) State Capital Gains Tax (Minnesota, e.g., is 9.85%)	2,356,200 975,150	0 0
After-Tax Proceeds	$6,568,650	$10,000,000
Tax Deferral Savings		$3,431,350

Proposed Tax Reform Impact on ESOPs

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What Type of Tax Changes Could We See in 2022 That Could Impact ESOPs?

Under the Biden administration's current proposed tax reform, known as the American Families Plan (AFP), we could see the following tax changes that affect ESOPs:

- Increase in capital gains tax rate
- Increase in corporate tax rate
- Elimination of step-up in basis in QRP at shareholder's death

What Type of Tax Changes Could We See in 2022 That Could Impact ESOPs?

- Under the AFP, the current 23.8% capital gains tax could increase to 43.4%, inclusive of the 3.8% Medicare surcharge—a roughly 82% increase in the capital gains tax rate!
- With this proposed capital gains tax rate increase, a business owner stands to lose a large portion of the wealth that he or she has worked hard over several years to accumulate when he or she sells his or her business.
- Also, if a selling business owner lives in a state with high income tax rates, such as Minnesota or New York, the owner would be subject to an additional 9% to 13% capital gains tax in addition to the federal capital gains tax rate. Thus, taxes on the transaction could eliminate more than half of the business owner's wealth, regardless of whether the owner's stock is redeemed or sold to a third party.

What Type of Tax Changes Could We See in 2022 That Could Impact ESOPs?

- The chart below illustrates the tax savings a business owner could enjoy by selling his or her stock to an ESOP in a 1042 transaction versus the more conventional sale of stock to a third-party buyer, applying the proposed capital gains tax rate under the AFP. The example in the chart below assumes that the business and business owner are in New York.

	Regular Sale	1042 ESOP Sale
Sale Price	$100,000,000	$100,000,000
Basis	10,000,000	10,000,000
Taxable Gain	90,000,000	90,000,000
Federal LT Capital Gains Tax (43.4%)	$39,060,000	$ 0
Minnesota LT Capital Gains Tax (9.85%)	$8,865,000	$ 0
Total Tax	$47,925,000	$ 0
After-Tax Proceeds	$56,790,000	$100,000,000
Tax Deferral Savings		$47,925,000

- As the chart shows, the tax savings from an ESOP transaction would be quite significant if the capital gains tax rate under the AFP is passed into law.

What Type of Tax Changes Could We See in 2022 That Could Impact ESOPs?

Another significant proposal under the AFP is the increase in the federal corporate income tax rate from 21% to 28%. Such a higher income tax rate obviously increases the value of corporate deductions. The chart below shows the tax savings using an ESOP, again assuming the corporation is a C corporation in Minnesota.

Taxable Income Per Year	State Corp. Tax Rate	AFP Federal Corp. Tax Rate	Taxable Income Without ESOP	Taxable Income with ESOP
$50,000,000	9.8%	28%	$50,000,000	$40,000, 000*
Tax Savings from Principal and Interest Deductions **Per Year over 10 Years (life of ESOP loan)			$0	$5,670,000 – Year 1 $5,481,000 – Year 2 $5,292,000 – Year 3 $5,103,000 – Year 4 $4,914,000 – Year 5 $4,725,000 – Year 6 $4,536,000 – Year 7 $4,347,000 – Year 8 $4,158,000 – Year 9 $3,969,000 – Year 10
Total Tax Savings from Principal and interest Deduction over 10 Years (life of ESOP loan)***			$0	$48,195,000

*Calculated as $50,000,000, less the $10,000,000 ESOP loan payment
**Deduction calculated based on the $10,000,000 plus a 5% interest rate x 34.4% (28% federal corporate tax rate plus 9.8%. Minnesota state corporate tax rate, less 3.4% federal deduction for state income tax expense). This calculation does not take into account any additional taxes that may apply under current local law.
***The term of an ESOP loan can vary and can be as long as 50 years.

S Corporation ESOPs

Advantages

- S Corporations are pass-through entities for tax purposes (no double taxation)
- ESOPs are exempt from federal income tax
- The portion of a company owned by an ESOP is exempt from federal income taxes
- *Therefore*, if an ESOP is 100% S corporation ESOP, *no tax!*
- Increased cash flow to repay debt
- Seller and related parties may participate in the ESOP

Disadvantages

- No 1042 tax-free sale to S corporation ESOP (may change under SECURE ACT 2.0)
- Deduction limits on contributions are less for an S corporation than a C corporation
- Anti-abuse limitation (Section 409(p))
- Any distributions must be made pro rata
- ESOP distributions remain as cash in a plan or accelerated stock allocation

Governance in an ESOP Company

Governance & Control

Control

- ESOP trustees do not want to run the Company
- Employees are not shareholders but beneficiaries of the ESOP trust

Trustee's Role & Responsibilities

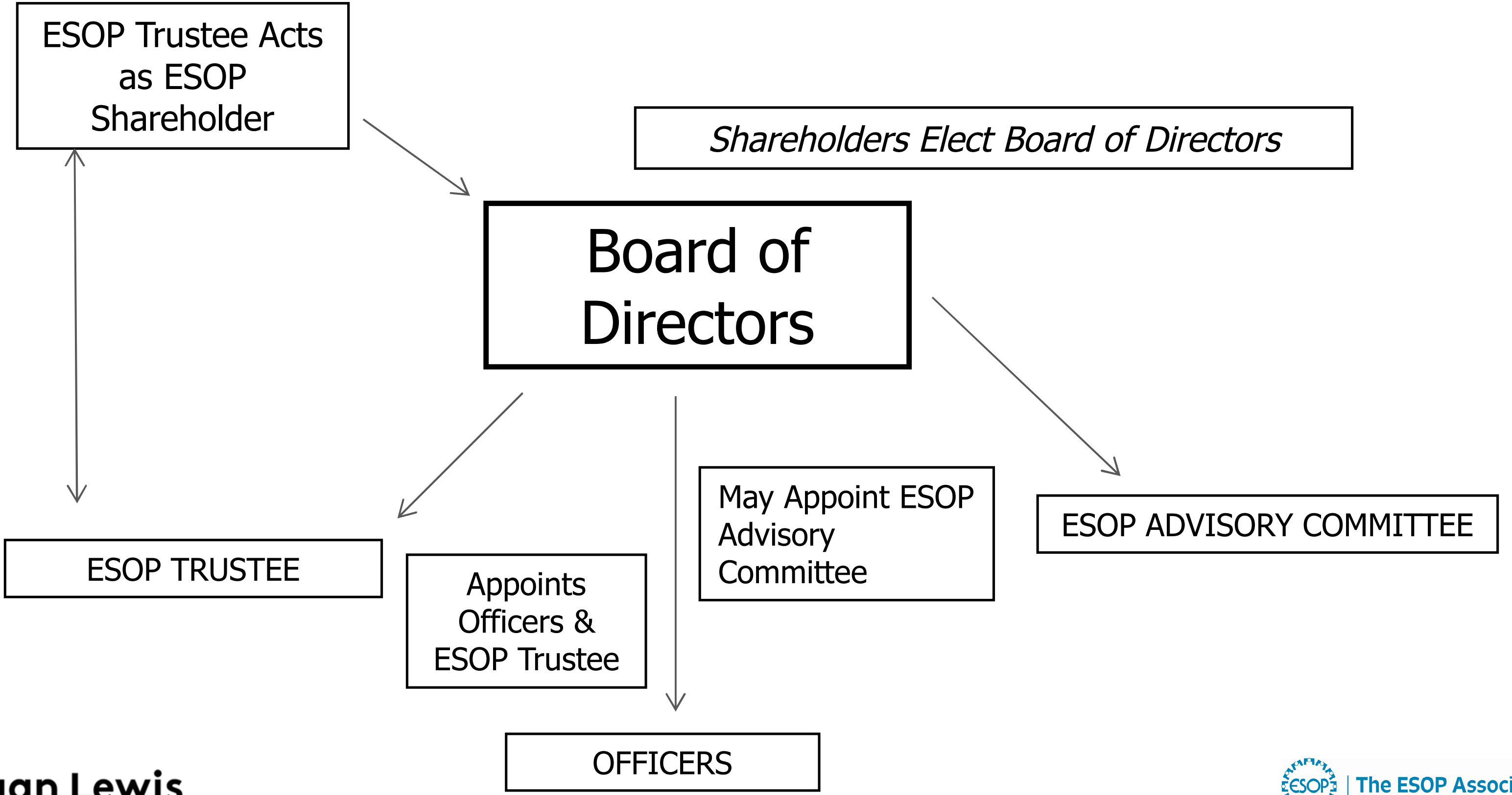
- Voting the shares held by the ESOP trust
- Serves at the pleasure of the Board of Directors
- Pass-through voting to participant in certain issues (most notably an asset sale of the business)

Trustee NOT involved in

- Management of Company
- Hiring/firing of executive management
- Operations of the business

Board composition and nomination process should be carefully considered and determined as part of the ESOP transaction

Corporate Governance



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