National Tooling & Machining Association

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Business Management Advisory

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WS10 **File: WAGES AND SALARIES**

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

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 a 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 Buyers.** 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.

How can you sum up all of these benefits?. . . TAX MAGIC!

This Business Management Advisory is designed to provide you with a framework for understanding ESOPs. It presents - in simple language - the legal, financial, and economic issues involved in setting up and running an ESOP. As you read this Advisory, you will learn how you and your company can benefit from the tax and other benefits that ESOPs allow.

I. HOW ESOPS WORK

A. What is an ESOP?

An ESOP is simply a tax-qualified 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 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. 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.

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B. Special Tax Incentives for ESOPs

Congress has enacted the following major tax incentives designed to encourage employers to create ESOPs:

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 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. Dividends paid in cash on shares held by an ESOP are deductible by the sponsoring corporation (a) if they are passed through to the participants in the plan or (b) if they are used to pay off a loan taken out to finance the purchase of company stock.

C. Purposes An ESOP Can Serve

The tax incentives enacted by Congress to encourage the establishment of ESOPs make them attractive vehicles for a variety of purposes. 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, which should result because, when there is an ESOP, the employees benefit directly from increases in the profitability of their company.

ESOPs also can 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 markets for a thinly-traded stock (and serve as an alternative to going public).

II. GENERAL DESCRIPTION OF AN ESOP

A. Basic Tax Attributes

An employee stock ownership plan is an employee benefit plan that is designed to invest primarily in stock of the sponsoring employer. 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 trustees 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 usually 15 percent of the compensation paid to all employees participating in the plan for the taxable year. However, the maximum deductible amount is increased to 25 percent of compensation if a money purchase pension plan is included as part of an ESOP.

Increased limits for employer contributions also are provided for contributions used to repay an ESOP loan taken out to finance the purchase of employer stock. Contributions used to pay interest on this kind of a loan are fully deductible. In addition, contributions used to pay the principal amounts of these types of loans are deductible up to 25 percent of the compensation of participating employees. These increased limits apply to the repayment of ESOP loans even if the employer makes contributions to another qualified employee benefit plan.

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 25 percent of his or her compensation or $30,000, whichever is less.

B. 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 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.

III. SPECIAL PROVISIONS APPLICABLE TO ESOPS

A. VOTING RIGHTS

The key question is always the same: "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 that the trustee of the plan retains 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 - 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 to persons who are terminated for any reason other than death, disability, or retirement. 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 $500,000, the distribution period may be extended an additional year for each $100,000 (or fraction thereof) over $500,000. However, the distribution period cannot be extended for more than an additional five years, regardless of the amount of the participant's account balance.

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. An exception is allowed when the articles of incorporation or by-laws of the sponsoring employer restrict the ownership of substantially all outstanding employer securities to employees or to a qualified retirement plan. If the participant does not demand stock, his or her benefits may be distributed in cash.

The participants in an ESOP 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 exercised 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.

IV. SPECIAL TAX INCENTIVES FOR ESOPS

A. Tax-Free Rollover

1. **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 corporations that you have owned for at least three years. A sale of such stock to an ESOP will qualify for tax-free treatment if the following conditions are satisfied:

   a. Immediately after the sale, the ESOP owns at least 30 percent of the total value of your company;

   b. You reinvest the sales proceeds within 12 months in "qualified replacement property", a specially-defined term; and

   c. 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 <u>after</u> 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, within twelve months, 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 bond of U.S. operating companies. Government securities and shares in mutual funds do <u>not</u> 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 <u>deferral,</u> 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.

2. **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.

   a. **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 borrowed, an ESOP can be used to reduce the financing costs (This is explained in Section V).

   b. **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.

   c. **Buying Out Dissident Shareholders.** 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 buy-out.

B. Dividends-Paid Deduction

Generally, corporations cannot deduct dividends paid to stockholders. However, an exception applies to dividends paid 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, or (3) if they are used to repay a loan obtained in order to purchase the company stock on which the dividends are paid.

V. LEVERAGED ESOPS

The rules that apply to tax-qualified employee benefit plans generally provide that sponsoring employers 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 you may deduct both the interest and the principal payments on the loan, instead of merely deducting the interest as you do 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, you 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 designed especially 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 then invests 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 "minor 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.

VI. 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 question 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 interest 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, 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 purpose 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 may deny participants the right to receive their benefits in the form of employer securities 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 companies plan 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 contribution 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).

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 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 (since a contribution of company stock to an ESOP is tax-deductible).

Insurance can be used to manage the repurchase liability. 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 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 his or her fiduciary duties. 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 either must 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. Other Things You Should Know

1. **ESOPs for S Corporations.** For many years, S corporations were not allowed to sponsor ESOPs. The Small Business Job Protection Act of 1996 has authorized S corporations to adopt ESOPs in years beginning after 1997. However, a sale of stock to an S corporation ESOP will not qualify for tax-free treatment, contributions to an S corporation ESOP in excess of 15 percent of the compensation of the plan participants used to pay down the principal of an ESOP loan will not be deductible. If you desire to obtain these tax benefits and your company has made the S election, its status as an S corporation will have to be terminated.

2. **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 non leveraged 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 these obligations are covered either by a guarantee of the employer or a com-

mitment 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.

VII. 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, make ESOPs a tax-favored form or 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 additional incentive to employees to improve productivity since their benefits will be provided in the form of employer stock. There is evidence that ESOP companies have grown much faster than they would have 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, employee benefit plans and 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 also can 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.

> **Example.** Owner owns all of the stock of a corporation. He is 70 years old and is ready to retire. The owner's son, who is 40 years old, has been working for the company for several years and desires to take over management of the business. The value of the business is about $3,000,000. There are several key employees at the company who have worked for the company for many years. The owner's objectives are to retire with an adequate and assured income, to transfer control of the business to the son, and to protect the company's long-term employees. The son's objectives are to take over management of the business, to ensure retirement security for his father, and to provide incentives for the key employees to remain with the company and to help him expand the business.

Several alternatives are available in this situation. First, and most obviously, the owner could arrange for 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, the owner will not be able to pass control of the business on to his son, and there will be no guarantee of employment security for the company's long-term employees.

Moreover, the owner would be subject to federal and state taxes of one-third or more of the sale proceeds. Assuming that the owner sells his stock for $3,000,000 and that he has only a nominal basis in his stock, the total tax liability will be approximately $1,000,000, depending upon applicable state tax rates.

As an alternative to selling the business to outsiders, the 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 the owner to pass control of the business on to his son and to ensure continued employment for long-term employees. However, a redemption would be expensive because the owner's stock would have to be repurchased by the corporation with "after-tax" dollars. Moreover, the owner would still be subject to a large tax upon the sale of his stock back to the corporation.

Another alternative would be for the owner to sell his stock to an ESOP. As long as the 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 the owner sells one-third of his stock to the ESOP for $1,000,000, he would save the $280,000 in federal capital gains tax that he would otherwise incur in connection with a sale, and he would be able to

reinvest the full $1,000,000 in sale proceeds.

If the corporation borrows the funds it uses to repurchase the 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 $1,000,000 purchase price is borrowed, the corporation will be entitled to an additional $1,000,000 in federal income tax deductions in connection with the repayment of the loan. These are deductions that it would not otherwise have. The result is a tax savings of $340,000 over the term of the loan (assuming that the corporation is in the 34 percent tax bracket). Combined with the $280,000 in taxes that the owner will have deferred, the total federal tax savings is $620,000, or 62 percent of the total price!

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

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 ESOPs and obtain these tax advantages in connection with many different corporate transactions. You should consider using ESOPs in connection with virtually all corporate debt-financed transactions including, in particular, stock redemptions and leveraged buy-outs. In addition, consider using ESOPs as a vehicle to facilitate ownership successions in private companies and as an attractive alternative to a sale to outside parties.

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 company 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.

If you would like to discuss whether an ESOP would be appropriate for you and your company, call McBride Baker & Coles, attorneys specializing in employee stock ownership plans. Their phone number is (312) 715-5700. Ask for Dave Ackerman. You can call Dave directly at (312)715-5728.

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