Capital Notes

Mid-year Update for Friends & Clients of CCR

Summer 2012

Corporate Capital Resources Newsletter

Summer 2012: Halfway to Where?

The 'liquidity events' produced by management buyouts, ESOP stock purchases and asset sales are now, more than ever, bringing up the question: "What about Taxes?" Halfway through a hot summer, nobody can say where we will come out: Capital gain rates are currently scheduled to increase from 15% to 20% on January 1, 2013. In addition, capital gain income will also be subject to an additional 3.8% Medicare tax. The current $5 Million per person estate tax exemption will revert to the $1 Million level with punishing consequences for a failure to plan. Further, the federal legislative failure to reach budget cut compromises will produce mandatory cuts, "sequestration," impacting defense contractors, among others. An Ernst & Young study predicts a drop in economic output of $200 Billion as well as real, long-term declines in jobs (down 710,000) and investments from these broad increases in top tax rates. Ouch.

What to Do?

Avoid any and all wishful thinking on decisions coming out of Washington. Take advantage of 2012 tax rates (estate, income, capital gains) where possible, as soon as possible. There is still time to implement coordinated business succession, gift and estate plans. Every situation is unique, but if you are concerned and have questions, Cindy Mendoza can schedule a call with our group without obligation (540-345-4190).

Publications

Chapter Six in the book, "Selling to an ESOP," which Michael co-authored earlier this year, is now in print. His discussion of the IRC Section 1042 tax-free ESOP rollover deals with strategies to counter increasingly volatile capital markets. The book is available from the National Center for Employee Ownership and can be ordered here: www.nceo.org/Selling-Your-Business-ESOP/pub.php/id/31/.

Quick Links

Check Out Our Website

Meet Our Professionals:

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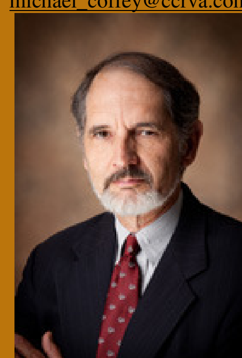

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The CCR team also co-authored "The ESOP Handbook for Banks." It is both a strategic overview of how ESOPs function in the banking space and a more technical treatment of their effect on capital, leverage ratios and employee benefits. It is designed to help any director or officer of a closely-held bank or bank holding company evaluate ESOP alternatives to outside capital in the era of stress-testing and TARP. The book is available at: www.amazon.com/ESOP-Handbook-Banks-William-Gust/dp/0982536445.

ESOP Strategy Notes from Our Technical Corner

Beware the "Set and Forget" ESOP! With the continuing DOL audits of ESOPs (and the DOL is even in some cases auditing the plan auditors), we are finding that plan sponsors must be actively engaged in the management of ESOP compliance and obligations to avoid problems and minimize costs. In several recent engagements, we have discovered issues in plan operation and accounting which could have cost the company both money and headaches. The mechanism we have in place to ascertain and maintain the health of an ESOP is our annual "Strategic Support and Maintenance Program." Please contact Lisa Tilley at 540-345-4190 for further information on this program as well as literature on Fiduciary responsibilities, DOL audits and our stock repurchase analyses for plan sponsors. Her notes below on ESOP payouts to former participants are particularly timely in this regard.

ESOP Participant Distribution Methods and Related Repurchase Obligation Observations

There has been a lot of discussion recently on distribution (payout) policies that balance the intrinsic competition for cash between the company and the ESOP, while meeting plan participant expectations.

The majority of ESOP distributions are due to normal employee terminations and retirements. Fewer payouts are due to death and disability. Forecasting the future obligation is complex if studied on an actuarial basis while accounting for the multiplicity of factors influencing the liability. A full study should be conducted every few years to measure the corporate obligations and make sure the strategy for meeting them is still viable and prudent. A request for such studies is a routine part of DOL audits.

The main factors affecting the future payouts from an ESOP are the share price appreciation, the rate of share allocations, number of shares to be allocated and how quickly distributions are made to participants. The latter factor is surprisingly influential. In one analysis for a company assuming average annual share price appreciation of 5%, the cumulative 10-year repurchase costs were nearly **two times higher** when former participants were paid lump sums as soon as possible as compared to installment payouts over time.

We receive quite a number of questions regarding the mechanics of simply recycling shares in the plan vs. corporate redemptions from former participants. Without discussing the merits of each, the short answer is:

Recycling

- The company makes tax deductible contributions to the ESOP.
- The ESOP buys shares from the departing participants; it "recycles" the shares in the plan.
- Shares are transferred to the remaining participants in relation to their cash balances used to purchase the shares of those receiving a distribution.
- The shares remain in the plan and are considered outstanding.
- All tax withholding, remittance and reporting as well as all check writing is done by the ESOP.

Redemption

- The ESOP distributes shares to the departing participant (or current participant if the distribution is for a diversification election amount or a minimum required distribution).
- The company buys shares from the participant as redemption, a non-deductible expense for the corporation.
- The shares are not considered outstanding unless they are later re-sold or re-contributed to the ESOP or issued again and sold to another shareholder.
- There is no tax withholding required when the company provides sales proceeds to the participants after the exercise of the put option.
- The check is written from the Company and it is responsible for reporting the distribution on form 1099-R to the participant.
- New stock certificates will need to be written.
- Please note that any vested **cash** balances plus **cash** for fractional shares are distributed from the ESOP and subject to withholding. The withholding is at the lesser of the cash paid by the ESOP or 20% of the taxable amount of the entire distribution including the FMV of the shares redeemed. In this case, for the cash portion only, all check writing, federal and applicable state tax withholding, tax remittance and reporting is done by the ESOP.

If you are redeeming shares, please let your accountant, the party keeping your stock book, your record keeper and independent appraiser all know new share counts at the end of the year and check to make sure your stock ledger and certificates agree to those counts.

Please call anytime. Yesterday's strategy and today's assumptions may or may not work tomorrow. Remember, flexibility is key and we are dealing with the government...in an election year no less!

The above summary is an educational discussion and must not be construed as tax, accounting, fiduciary, investment or legal counsel.