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The ESOP Two Pager

OK. It's Not Possible in Two Pages...But Sometimes the Short Answer Helps

Concept

An ESOP is a retirement plan mandated to be primarily invested in company stock. It can accept company stock or cash contributions and allow the corporate sponsor a tax deduction for the contributions. Cash contributions can buy stock directly, be accumulated tax-free in the plan for up to about three years to fund a deal, or pay off a loan used to purchase shares. The ESOP is indifferent to the source of the stock, but cannot pay more than the independently appraised 'Fair Market Value' specific to the given transaction. The ESOP can only buy the highest and best class of stock. The plan must comply with IRS, DOL, and ERISA regulations.

The sponsor must be an S or C corporation. When an ESOP acquires stock, it becomes a single, tax-exempt shareholder. The employees are not the direct shareholders. The ESOP Trustees are the legal owners and vote the stock for most issues. Private company ESOP participants can vote the shares in their accounts in about seven major corporate issues, such as a sale or liquidation of the company. Public company ESOP participants proxy their vote to the Trustee in all cases of shareholder voting. The Board of Directors and the ESOP Trustee(s) are fiduciaries and need fiduciary liability insurance (not just the usual qualified plan ERISA bond). Consider using an independent transaction Trustee for complex stock sales. Control is not a concern in a properly designed plan.

S corporation sellers can receive capital gains tax treatment for stock sale proceeds. C corporation sellers can either pay capital gains taxes or, if selling to create a 30% or larger ESOP, can often elect a tax-free rollover of the proceeds. Technically speaking, an ESOP can buy any percentage of a company; most ESOP purchases are 25% to 75% of the stock due to many considerations (not just financial).

Once there is stock in the ESOP retirement trust, participants will ultimately retire, die, terminate...thus there is an ultimate obligation to pay out these stock account values – but as cash. This represents a long-term emerging 'stock repurchase liability' for the corporation. The board of directors as prudent fiduciaries should quantify and have a plan to meet these obligations.

Basic rule: An ESOP is never the answer; it can be the centerpiece of an attractive coordinated strategy which ties together tax favors, shareholder objectives, estate planning, employee benefits, and key executive programs. Please note: there are many myths about ESOPs in circulation – always check with folks who have been-there-done-that and got the T-shirt to prove it.

Feasibility

A corporation must have sufficient payroll, taxable earnings (beneficial tax savings), employee benefit objectives, and share value to justify the cost of installation and operation. Companies with about 20 or fewer employees, less than \$250,000 of 'adjusted' pre-tax income, or an enterprise value below \$1 million are probably not viable candidates. There are exceptions.

The overall cost of ESOP implementation can run from \$20,000 for starting a simple plan ("cash warehouse" ESOP) to many times that for large transactions with multiple classes of stock and complex designs. Annual operating costs are basically the annual appraisal, plan record keeping, and additional accounting work – typically runs about \$15,000 to \$20,000 for companies with less than 100 employees.

There are limits on tax deductions by the company: 1) C & S corporations are allowed annual deductions of 25% of eligible payroll for stock or cash contributions; 2) "Reasonable" C corporation dividends can be deducted, if used to retire ESOP debt or if passed through to participants; 3) The 25% of payroll limit does not include dividends (some companies are deducting over 50% of pay to support transactions) or earnings on S corporation shares; 4) C corporations may get to count only the principal payments against the 25% limit while S corporations must count both principal and interest in the limit calculation; 5) Some companies are tax-exempt operations as 100% ESOP owned S corporations with no practical regulatory limit on the funds flow to the ESOP. There are practical limits for other reasons, i.e., reasonable benefit expenses; 6) Small S corporation ESOPs must be careful to comply with the "anti-abuse" rules - IRC §409(p).

A feasibility review or study by an experienced firm is always a wise investment – few professionals outside the field are skilled at integrating the corporate finance, employee benefits, and shareholder objectives. Good quarterbacks will save money through cost effective ESOP team selection. Experience is key: any practitioner should have dozens of ESOPs in their 'portfolio.'

Stock Valuation

The stock appraisal must be performed by an entirely independent valuation firm, preferably with a multi-year history of appraising at least a few dozen ESOPs. The appraiser should know all relevant facts about the company – even the money going to the condos for the kids.

An ESOP is a 'financial buyer,' not a strategic buyer or an investor looking to get out in a few years. Thus, the key driver of value is generally the long-term dividend-paying capacity or discretionary cash flows for stock purchases. EBITDA is often used as a proxy for these measures; many private companies have stock values at a multiple of five to ten times EBITDA. Your mileage may vary. Other multiples can play a part: e.g. price-to-book, price based on market comparables, etc.

While important, value should not be the only consideration. Ultimately, ESOP funding derives from earnings, tax savings, and employee benefit restructuring.

The seller may want the maximum, but the ESOP can only pay what is fair and what the corporation can afford without impairing the long-term viability and operation of the company. Avoid over-leverage. Be sure the appraiser has measured the effect of all the pieces of the puzzle (such as the impact of discriminatory key executive plans) on value before the deal.

Plan and Transaction Design

The provisions of the ESOP relative to vesting, how annual allocations are made to participant accounts, eligibility, payouts to former participants, and the like must comply with retirement plan rules – much like 401(k) plans. An ESOP can be written as a stand-alone plan or combined with a 401(k) to create a "KSOP." In KSOPs, the 401(k) match can be made with company stock – boosting cash flow.

These design provisions are important in determining how employees perceive the benefits and the resulting magnitude of stock repurchase obligations. Work with knowledgeable ESOP legal counsel to design the plan in coordination with the financial projections – so that you get a favorable IRS determination letter and there are none to few unforeseen costs later. Choose a firm with 'depth of field' in the area of ERISA law. A group of attorneys bodes well for accuracy, defensibility, and someone to be there, if you need them later.

A good transaction quarterback can often provide a range of options inexperienced practitioners might miss: 1) The seller(s) can take back a note from the ESOP and allow the corporation to pay off the note through the plan; 2) The company can borrow the money from a bank (the leverage often results in more restrictions than a seller note), and negatively impacts 'book' value; 3) Cash can be 'warehoused' in the plan for a few years (less than four typically) to minimize or eliminate borrowing; 4) The company can sell newly-issued shares to put tax-free cash on the balance sheet for a corporate stock redemption...the alternatives are legion.

Key Executives and Successor Management

This group is critical to your company – ESOP or not. You not only can, but should, implement discriminatory plans, pre-deal, to keep the key players on board and appropriately rewarded for performance. Tie their selective benefits to ESOP success. As part of the initial strategic design, there are good options: restricted stock, deferred compensation, and contingent bonuses. An integrated strategy is key.

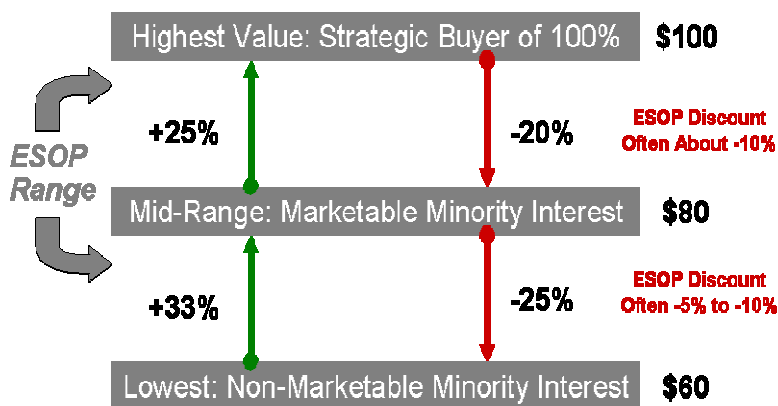
Ongoing Plan Operation

Don't handle the annual plan administration 'in-house.' Engage a third party ESOP administrative specialty firm to prepare the annual trust reconciliation and accounting, the participant account statements, and the filing of the 5500 tax return for the plan. Assure good communications between your corporate operations, the independent valuation firm, and the plan administrator.

Finally: Do not, please, do not 'roll your own.' Begin the process by consulting with various practitioners; assemble a collegial and competent team. Choose a design and implementation quarterback who will work: a) With your CPA, corporate counsel, and other existing advisors, and b) Under a capped fee arrangement - preferably in stages, with at least a cutoff point after a 'discovery phase.' Be prepared to deal with complexity and be part of the process. This process has saved many shareholders and companies millions in taxes, made a controlled market for the stock and rewarded the loyal, long term employees very generously.

Stock Valuation: Three Basic Levels of Value

Public thinly-traded and private company ESOP shares require an independent 'fair market value' appraisal; ESOP Trustees cannot pay more than the FMV



These percentages illustrate approximate ranges of independent valuations of closely-held corporation stock showing difference between discounts for family gifts and some key executive stock plans versus possible discounts for stock sales to an ESOP.