ESOP -

A SUPERB PLANNING DEVICE

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ESOP – A SUPERB PLANNING DEVICE

Introduction

Employee Stock Ownership Plans (ESOPs) present the best planning opportunity for owners and managers of closely-held businesses available within our whole tax system. Congress has long favored employee ownership and ESOP is the means it has chosen to induce companies to join in this movement. This article will first summarize these ESOP advantages, then dwell upon and explain them.

A QUICK LOOK AT ESOP

ESOP Advantages.

Very briefly, advantages attainable through ESOP are as follows: By making stock, rather than cash, contributions to an ESOP companies can enhance liquidity and preserve working capital. Deductible amounts that can be contributed to ESOPs considerably exceed that which applies to other defined contribution plans (e.g. profit sharing and 401(k) plans). Employees can be furnished with tax deferral and be permitted to report their gain attributable to the portion of ESOP distributions that represents net unrealized appreciation (NUA - appraised value in excess of basis) in the company stock segment of their ESOP account when sold (rather than when received) as long term capital gain (LTCG) rather than ordinary income. Through ESOPs, stockholders of closely-held businesses can obtain tax-free diversification by having their company adopt an ESOP, sell stock to it, reinvest the proceeds into something called Qualified Replacement Property, and pay no tax on their gain. While they are getting full 100-cents-on-the-dollar value for the stock they sell, they are being paid with 60 cent (100 cents less a tax savings of 40 cents) dollars that have been deducted by their company. They can even sell all of their stock to the ESOP and still maintain both a major equity interest in, and continued control of, their company. And, long-term (i.e., ten years or more) employees who reach age 55 can compel the ESOP to diversify up to 25% of the company stock in their ESOP account, then another 25% when they reach age 60.

Last, but certainly not least, the most dramatic advantage of ESOPs is that, through their use, up to all of a company's earnings can be made to be ***tax free***. There is no other way that this can be accomplished within our tax system. Normally a tax-exempt entity that is engaged, either directly or as a Subchapter S shareholder, in an active business must pay an Unrelated Business Income Tax at the top corporate income tax rate (now 35%) on the income produced by that active business. This applies across the board— with one exception. That one exception is ESOPs. ESOPs, and only ESOPs, can engage in an active business and not pay a tax on its income. This, coupled with "synthetic equity" (discussed below), can produce outstanding results.

Terms Used and Their Significance

As is often the case, words used in titles are not accurately descriptive. Here, the title "Employee Stock Ownership Plan" is a misnomer. Employees do not "own" the stock. The stock is owned by a Trust--the Employee Stock Ownership Trust (ESOT), and the employees are participants in, and the beneficiaries of, that Trust. Stock that the company contributes to the ESOP is allocated among the accounts of its participants in the year it is contributed, while stock that the ESOP purchases with debt is allocated as that debt is paid. The Employee Retirement Income Security Act of 1974, as amended (ERISA) requires that every year the ESOP company must be appraised by a qualified independent appraiser and its employee-participants must be furnished with a written statement telling them how many shares have been allocated to their account and how much those shares are appraised to be worth. When the company involved is not publicly traded, the *appraised value* of the stock that has been allocated to their account (rather than the stock, itself) is the amount that is going to be due them at a designated time in the future. Contrast this with a defined benefit pension plan where the plan sponsor has a distinct obligation to pay a calculated amount that is fixed by contract. This amount is not correlated with the worth of the company. With ESOPs, however, that amount varies. If the company does well, the amount should be high, but if the company doesn't do well, then the fair value of the stock will diminish and the company isn't going to be financially crippled by its obligation to make payments to its ESOP participants. As intended, with ESOPs there is a correlation between how well the company does and how well its employees do. No "assets" of the company need to go

into the Plan. Just stock, and stock is not an asset of the company as are, for instance, receivables, inventory and equipment. This stock then serves as a "measuring device." In effect, the company gets a current tax deduction for making a commitment (i.e. incurring a liability) to pay money to its employees in the future. The value of that stock then determines how much money will to have to be paid and the plan designates when the payment must be made. Where, as is usually the case, the stock of the ESOP company is not readily traded on an established securities market, and the company is either an S corporation or substantially owned by its employees (including owner/employees) or by an ESOP, distributions will be in money (supplied by the company) in lieu of stock. The stock then either stays in the ESOP or goes back to the company. In a closely-held corporation situation, it does not "float around" amongst former participants. That's very important.

ESOP Misconceptions

Despite all of these advantages, ESOPs are not implemented as frequently as you might think, and when ESOP is mentioned advisors not adequately familiar with ESOPs have a tendency to denigrate them by inaccurately depicting them. I refer to these misrepresentations as "myths." For instance, I hear things like these: "Selling shareholders must give up control"—not so. "Employees will have access to the company's books"—not so. The law only requires that they be told how many shares are in their account, and the appraised value of those shares. They don't manage the company. They don't control the Board of Directors. And, sometimes I hear that, "If your company has an ESOP other companies will not be interested in acquiring it." Again—not so. The ESOP is just a stockholder, like any other stockholder, and can sell its company stock if it so chooses or a suitor can, instead, acquire the company's assets.

NOW, LET'S DIG DEEPER

Now that you have been exposed to the basics and have a feel for what ESOPs can do, let's delve deeper and see what they can accomplish.

ESOP – a Qualified Deferred Compensation Plan, But Much More

Initially, an ESOP is a "Qualified Deferred Compensation Plan." It is a "Defined Contribution Plan," and is governed under ERISA. But, again, much of what ESOPs do would constitute prohibited transactions but for special exceptions. For instance, stockholders can sell company stock to an ESOP, they can lend to an ESOP, and ESOPs can borrow money to buy stock. Actions such as these would be prohibited transactions, but the law provides that they are not when ESOPs are involved. Normal ERISA rules as to coverage, vesting, and anti-discrimination apply to ESOPs the same as they apply to other qualified plans. It is specifically provided, however, that in order to qualify as an ESOP the assets of the plan must be primarily invested in employer securities. That generally means, over time more than 50% of an ESOP's assets must be its sponsoring company's stock. But there is leeway. For instance, I have a client that put money in its ESOP that then used some of that money to buy company stock, but also used a lesser sum to buy stock in a newly-formed bank. The Company has done well, but the bank has done superbly well. Before long, the assets of the Trust were more than 50% invested in the bank. Accordingly, the ESOP had to sell some of that bank stock and use the proceeds to pay off participants or buy more company stock so that, over time, the primary asset of the ESOP would, again, be company stock.

C corporations can contribute to an ESOP and deduct considerably more than would otherwise be permissible if the plan was other than an ESOP. In defined contribution plans, the maximum deductible contribution is normally 25% of covered compensation. But, when ESOP is in the picture, deductible contributions can go well beyond that--up to 40% or more. This is because in ESOPs of C corporations you don't have to count against that 25% the portion of the contribution that the ESOP uses to pay

interest on stock acquisition debt. Accordingly, in the early years, when the ESOP usually has considerable stock acquisition debt, the company will be making contributions that are used by the ESOP to pay interest which will not count against that 25%. Moreover, when a C corporation's ESOP still has stock acquisition debt, a second 25% contribution should be available. Deductible contributions could then move up to, say, 70% of covered compensation.

The Tax-Free Sale

Internal Revenue Code (IRC) Section 1042 allows a tax-free rollover of gain by a stockholder who sells stock to an ESOP sponsored by a closely-held C corporation. There are a number of requirements that must be met, but when they are, dramatic results can be achieved. Appendix 1 illustrates what can be accomplished through this provision. There a sale of $7,000,000 worth of stock to an ESOP is contrasted with the redemption of that stock by the corporation. Under the ESOP alternative, the seller sells the stock for $7,000,000 which he uses to buy Qualified Replacement Property (QRP)—stocks, bonds or notes of active U.S. corporations. (The Wall Street Journal and most major newspapers contain pages of securities issued by publicly-traded corporations, virtually all of which would qualify as QRP.) Selling to the ESOP for money provided by the company by means of contributions that, because they are deductible, cost the company only $4,200,000 (i.e. 60 cents on the dollar), while providing the seller with a tax-free $7,000,000. In the non-ESOP alternative, the seller sells and has to pay a capital gain tax, and so the $7,000,000 is reduced by taxes down to $5,600,000, while the company is out the full $7,000,000 since it cannot deduct the cost of redeeming its own stock. Add the two together, and you have an aggregate tax saving of $4,200,000 on a $7,000,000 transaction. How can that be? The simple answer is, crunch the numbers, that's where you end up.

Now turn to Appendix 2, and see how much you would have to get for your stock to end up with $7 million after tax. If the tax on capital gain is 20% (15% Federal and 5% State), in order to realize $7 million dollars you would have to sell your stock for

$8,750,000, and if the tax on capital gain goes up by 5%, which it may, then you would have to sell your stock for $9,330,000 in order to net $7 million. That's the magnitude of the benefit derivable through 1042. However, there are a number of requirements that must be met in order to effectuate a 1042 election. For instance:

- The ESOP must own at least 30% of the value of all of the employer's common stock immediately following its 1042 purchase;
- The Seller cannot be a C corporation; and
- Must make a timely 1042 election;
- The Seller, his family, and other 25% stockholders, cannot, in their capacity as ESOP participants, share in the allocation of the stock purchased from the Seller; and
- The employer must consent to:
    - a 50% penalty should such an allocation take place; and
    - a 10% tax should the ESOP dispose of that stock (other than by means of a gift, death, merger covered by IRC §368, or a subsequent 1042 sale) prior to 3 years after its purchase.

Section 1042 only applies with respect to "Qualified Employer Securities," which meet the following requirements:

- They must constitute "best common stock" (or preferred stock convertible into it);
    - Of an active (cannot have 25% or more of its gross receipts from passive sources [e.g., interest, dividends]) U.S. non-publicly traded C corporation;
    - That has been held for at least 3 years; and
    - Was not received pursuant to another tax-deferred plan (e.g., an Incentive Stock Option (ISO) Plan); and
- Must have been eligible for LTCG treatment at the time it is sold to the ESOP.

As part of the 1042 ground rules, the QRP that the seller purchases within a year from the date of the sale is subject to a basis adjustment. The gain on that sale that is not currently recognized is reflected as a reduction in the basis of the QRP. This "deferred" gain is then "triggered" in the event that the QRP is "disposed of" (e.g., sold) prior to the seller's death. The corollary here is that the gain not taxed at the time of the sale is "deferred." But this "deferred" tax can be "avoided" by having the seller hold the QRP until he dies. However, this "lock-in" precludes what could otherwise be sound investment planning and prevents the sales proceeds from being converted from the original QRP into other investments, or being used for other things such as personal expenditures (e.g., a house, a vacation or a yacht).

But even this adverse "lock-in" consequence can be alleviated by means of a process known as "monetizing" that was devised in the Avis Rent-A-Car 1042 sale. There, counsel for the sellers worked with GE Credit to create something that qualified as QRP, but was specifically designed just for this transaction. GE Credit created debt instruments analogous to bonds, which are referred to as "Floating Rate Notes" (FRNs). These FRNs were non-callable for 30 years and matured in 40 years. Their "life" was intended to extend beyond the life of the sellers who could then hold these FRNs until they die, when, by their terms, they are putable to their maker and get an increased basis in the seller's estate and can thus be cashed in without triggering an income tax. Then, in the Avis transaction, an arrangement was entered into with another lender, there Bankers Trust (which is now DeutscheBank), which lent the Sellers an amount equal to 90% of the face value of these FRNs, which were held by the bank as collateral for its loans.

To understand the effect of the monetizing transaction look at Appendix 3, which assumes a $10,000,000 sale, the proceeds of which are used to purchase $10,000,000 of FRNs (which are now issued by a group of lenders in addition to DeutscheBank) that then serve as collateral behind a $9,000,000 loan, the proceeds of which can be used as the seller sees fit, without triggering a tax on the deferred gain.

There is, however, a relatively small annual cost to carry this monetizing transaction. This is because the interest received on the FRNs generally runs at LIBOR plus, say, a half a percent, while the interest the seller pays on the 90% loan is between .5% to 1% higher. In this example, I assumed a .75% differential that must be paid annually to keep the whole transaction alive, but this payment is, in turn, deductible. So we are dealing with a minor annual cost—after deducting the interest differential, the after-tax annual cost is only $11,000 to carry this $9,000,000 transaction. Accordingly, through monetizing, that "deferred" tax will never be triggered, and will be permanently avoided.

1042 Pros vs. Cons

The principal 1042 Pro is the tax-free sale potential (see Appendices 1 and 2).

The main Cons are (1) the sellers, their family and other 25% stockholders cannot share in the allocation of that 1042-purchased stock inside the ESOP even though, otherwise, they are "participants," and (2) the 1042 "lock-in." Note: monetizing (i.e., the purchase of floating-rate notes (FRNs) and borrowing against them) provides partial, but not total, relief (e.g. the FRN-secured loan is "recourse" to the borrower and the 10% excess of the FRN over the loan it secures produces no interest income for as long as the monetizing transaction remains open). Accordingly, depending on the underlying facts (e.g., the percentage of covered compensation that is attributable to owner-employees, including family members), where the Cons exceed the Pros, instead of using 1042, a low-taxed LTCG sale to the ESOP coupled with a gift to a Charitable Remainder Trust (discussed below) might prove to be a better alternative. The answer as to which course is best can be readily determined by a feasibility study (also discussed below).

Possible Use of a Transitory ESOP in the Acquisition by an ESOP-Owned S Corporation of an S Corporation Target

Our objective here is to overcome the sale-to-an-S-corporation-ESOP 1042 exclusion. First the S Corporation Target must terminate its S status. Then the Target's

shareholders would sell their now C Corporation Target stock to a newly formed Target ESOP. This will be followed by acquisition of C Corporation Target by the ESOP-owned S Corporation and the merger of the Target ESOP into the ESOP-owned S Corporation's ESOP. (The IRS has ruled that this transaction qualifies under 1042). Then a subsequent "qualified Subchapter S (Q-Sub) election" as to Target by its ESOP-owned S Corporation parent should qualify Target's income to be tax-free. (But, don't overlook the possibility that this Q-Sub election could trigger "built-in gain" at the Target level.)

ESOPs Coupled With Charitable Remainder Trusts

Another transaction that is done from time to time by ESOP proponents counseling business owners is to couple an ESOP with a Charitable Remainder Trust (a CRT). Appendix 4 shows you what can be accomplished under this arrangement. Here a 65 year old man who owns a corporation worth \$12,000,000 contributes 1/10th of its stock— which is, after a minority discount, worth \$ 1,000,000—to a CRT and reserves a \$50,000 dollar annuity (which is the approximate yield he was getting on that \$1,000,000 worth of stock). The CRT then, in turn, sells that stock to the corporation's ESOP. Here, the first line in this example shows the \$1,000,000 worth of stock that is "invested" into the CRT. (I use the word "invested" even though it is a charitable contribution—but, under the circumstances, you will see why I use the word "invested.") Note that the stockholder who placed \$1,000,000 into the CRT retained a \$50,000 annuity from it, so he has retained a 5% yield. But, when he contributed that stock to the CRT, he got an income tax deduction that saved him \$168,000, leaving him with a net investment of \$832,000. Now his \$50,000 annuity increases his after-tax benefit yield up to 6%.

Next, consider that he has also extracted \$1,000,000 out of his taxable estate which reduces his estate tax by 35%. But, I "present valued" that saving because he has a 21 year life expectancy, so the present value of the \$350,000 of estate tax saving is

$184,000. Now, his “investment” in this transaction is down to $648,987, but he is still getting that $50,000 annuity and his yield is up to 7.7%.

But consider that when the company in which he now owns a 90% interest makes the $1,000,000 contribution to its ESOP that it uses to buy that stock from the CRT, it gets a deduction worth $400,000 (40% of $1,000,000), 90% of which ($360,000) inures to him. If the company is an S corporation, that tax benefit flows right through to him, while as a C corporation it offsets what would otherwise be tax at the corporate level. At this point, his "investment" has been reduced to a mere $288,000, but since he is still getting that $50,000 a year annuity, his yield is now up to 17.7%. To me this is intriguing. He is making a charitable contribution but increasing his yield on his original contribution from 5% up to 17.7% as a result of it.

Changing the facts a bit, assume that this fellow is married and the $50,000 annuity is joint and survivor, so that when the last of the two dies a charity gets the corpus of the trust and their heirs lose what might otherwise have been a portion of their inheritance. Under those circumstances, I suggest that the donor and his spouse set up an irrevocable life insurance trust to buy a last-to-die life insurance policy on their joint lives sufficient to restore the lost inheritance for the children at the time when the last of the two dies.

Now let’s assess what has been accomplished. When all is said and done the donor/investor will have benefited a charity, got his name “up in the lights” and basked in the notoriety of being a major contributor to, say, his university. And, in the meantime, the couple will be receiving a handsome yield on their money and, as I see it, the whole transaction makes great sense and is made possible only because an ESOP is involved.

<u>Deduct Dividends</u>

C corporations can deduct dividends when those dividends are paid on stock that was acquired by the ESOP with stock acquisition debt and are used to (a) pay down that

debt, (b) passed through the ESOP to its participants, or (c) designated by them to be used to buy more company stock for their ESOP account. This is the only instance within our tax system where dividends can be deducted. Unfortunately, however, the IRS has ruled that these deductible dividends are subject to the Alternative Minimum Tax, and, despite the obvious fact that this was not contemplated by Congress when it enacted this provision, courts have upheld the IRS on this. Accordingly, unless the AMT is changed (as it may be), the benefit of this deduction will be reduced to only around 14% (i.e., the difference between the 34% tax rate on corporate ordinary income and the 20% Alternative Minimum Tax rate).

Participant Discretionary Diversification

In order to allow employees to "hedge their bet" and decrease their exposure to a drop in the value of their employer's stock as they near retirement age, Congress amended the law to provide that a participant who is age 55 and has 10 years of participation in the ESOP can compel diversification of up to 25% of the stock portion of his ESOP account starting in his first year of eligibility and then in the 6th year move that up to 50%.

Participant Distributions

Focusing now on ESOP distributions to existing participants, the law extends considerable flexibility. When a participant leaves because of retirement, death or disability, benefits must commence in the year following the triggering event and continue in equal increments for up to the following 4 years. But, where a participant leaves because of other than retirement, death or disability, the commencement of distributions can be delayed for up to 5 years—and then paid over the next 5 years starting in the 6th year, so that the company can actually have 11 years within which to fund its ESOP so that it can complete the payment process. But, in deference to the fact that banks don't like to see borrower monies used to redeem stock before they are paid, and to encourage banks to make ESOP loans, Congress enacted a provision allowing no payments to be made on stock that was acquired with debt until that debt has been paid in full. The IRS has, however,

(perhaps incorrectly) taken the position that this provision applies only to payments due from C corporation ESOPs.

It must be recognized that even though payments may not be required for some time, they should be planned for. I suggest that a sinking fund be set up and funded. Frequently key-man life insurance is used as a segment of this funding process.

Annual Appraisal Requirement

As previously noted, the law requires that the ESOP's company stock be appraised annually, and the worth of the stock that has been allocated to participants' accounts must then be communicated to them in writing.

Lateral Transfers

Here is a concept that does not frequently come into play, but you should know about it because, when it does, it can facilitate the realization of goals that might not otherwise be attainable. The law permits participants to transfer funds from their account in another qualified plan (including a rollover Individual Retirement Account (IRA)) into their account in an ESOP. For instance, where a company has both a 401(k) plan and an ESOP, participants can be permitted to move money from their account in that 401(k) plan into their account in the ESOP, and then direct that those funds be used to buy company stock just for their account. I have served as counsel in transactions that have used this approach. In one, most of the assets of a tax-exempt, but quite profitable, foundation controlled by a university were to be sold and the proceeds donated to the University. The foundation's management interceded and requested the opportunity to buy the business themselves. Although they did not have the financial wherewithal to accomplish such a purchase, they did, however, have ample money in their accounts in the foundation's qualified plans. The University agreed to work with those employees towards that end. A program was then instituted pursuant to which all of the foundation's employees, which, of course, included management, were given the

choice of moving their entitlements in the foundation's qualified plans laterally into their account in an ESOP adopted by a newly-formed company (Newco). Then, after full compliance with Security and Exchange Commission (SEC) and state "Blue Sky" rules notifying these employees in writing (e.g. a "prospectus") and in meetings, as to all that was involved, a number of those employees agreed to transfer $27,000,000 of the $110,000,000 of aggregate employee entitlements in foundation plans into their account in the Newco ESOP. Then, using that money as their equity and borrowing the rest, the ESOP bought the company on their behalf. That company is now a very successful government contractor. I have also designed analogous arrangements, including one for a much smaller transaction involving only around $2,000,000. While this procedure is complicated and costly, where it fits it has the potential to be quite rewarding.

Now, the Coup de Grâce – ESOP-Owned S Corporations

In order to really grasp this "be all, and end all" ESOP attribute you must open your mind, be willing to at least temporarily sublimate preconceived notions, and hone in on the bottom line. This is because courses of action that initially may seem repugnant can quite often have a very "silver lining." With this backdrop, I will delve into concepts that can be quite lucrative, and should be analyzed and explored far more than they are since they may enable you to achieve results you probably never thought possible.

To reiterate—when an ESOP owns stock in an S corporation, its share of that company's earnings are not taxed. Again, this is the only instance within our whole tax ensemble where such a result can be attained. Let's delve further into this precept—within our tax system, with very few exceptions, all active income is currently taxed. This includes even active income generated by otherwise tax-exempt entities that is not incident to their tax-exempt purpose. This applies across the board— for instance, to churches, trade associations and labor unions. As applied to otherwise tax-exempt entities, this tax is denominated as the Unrelated Business Income Tax and was enacted to

prevent tax exempt entities from engaging in active businesses that are not related to their tax-exempt purpose and competing with other active taxable businesses. There is only one exception to this rule, to wit—ESOPs. ESOPs are exempted from the Unrelated Business Income Tax. This means that where an ESOP owns stock in an S corporation (which it now can) the ESOP's share of that income is not taxed. And, when an ESOP owns all of the stock of that S corporation, it is simply not taxed at all. This paves the way for earnings that remain in the company because tax was not paid upon them to, first, be used to pay "stock acquisition debt," to wit, debt that was incurred by the ESOP to buy the S corporation's stock. Then, after that has been accomplished, retain them to finance growth.

With proper planning, this course of action can enable the owners of closely held C corporations to sell their stock to an ESOP and be paid on a tax-free (1042) basis with money that would otherwise have been consumed by taxes paid to governments (federal and state) and then elect S status effective as of the beginning of the following taxable year. Or, where the corporation involved is already S, (1) terminate that status and revert to C, (2) sell stock to the ESOP under 1042, (3) wait for five taxable years during which the company involved makes expanded deductible contributions that can serve to offset otherwise taxable income, then (4) re-elect S and regain its tax-exempt status. Or, once again, forego 1042, pay LTCG (15%) tax (on the installment method where the sale includes take-back debt) and, in their capacity as participants, share in the allocation of the stock they sold to the ESOP.

But, frequently, when I inform stockholders of the potential inherent in a 100% ESOP-owned S corporation, they retort—"but I don't want to sell my company. It's a good company, and I want to participate in its future growth." Well, within clearly delineated parameters, successful business owners can "get the best of both worlds." This can be accomplished through the use of something known as "Synthetic Equity." Synthetic Equity is a contractual entitlement that falls short of actual stock ownership, but is, in context, still equity—thus the official name (as used in the Internal Revenue

Code) —"Synthetic Equity." Included in this category are stock options, warrants, and appreciation rights, and phantom stock. The aggregation of rights that inure to this category of entitlement is not deemed to be "stock," as such, and, accordingly, is not allocated any of the S corporation's income and therefore does not trigger a current income tax. Congress recognized that the existence of synthetic equity in ESOP-owned S corporations could, if not constrained, result in abuse, and insightfully placed limits upon that status. These limits are embodied in Internal Revenue Code Section 409(p), which imposes dire penalties when fifty percent, or more, of the ESOP's S corporation stock is owned by "disqualified persons" (i.e. persons who own (or, including synthetic equity, are "deemed to own") a ten percent or more interest in the ESOP).

As you can, no doubt, surmise, this is quite complicated. It is, nevertheless, manageable, and, fortunately, the Treasury Department and the Internal Revenue Service in Regulations and rulings have provided us with "safe harbors" that enable us to plan our way through this maze. But, as I see it, this penalty—though severe—is actually a benefit in that it delineates what we can and cannot do. And, so as long as persons, including existing and former stockholders, who constitute "disqualified persons," do not, in the aggregate, own, or are deemed to own, 50% or more of the ESOP's actual or deemed owned stock, they can still maintain a very significant continuing equity interest in the company.

Now, to carry this line of reasoning to its logical end, you must keep in mind that this ESOP-owned S corporation is, or can be, completely ***tax-exempt***. This is crucial. To better understand the concept here at hand, consider the following—a continuing 42% equity interest in a tax-exempt company is equivalent to a 70% interest in a taxable one (a 70% interest reduced by a 40% income tax burden equals a net 42%), while a 48% (still less than the 50% limit) equity interest in a tax-exempt company is equivalent to an 80% interest in a taxable one. Appendix 5 illustrates that an annual realization of $1,000,000 of net income per year by a tax-exempt ESOP-owned corporation compounded at a before tax 15% for 15 years will grow to $8,137,000, while that same

income production by a taxable C corporation produces, after tax, only a 9% (15% less a 40% tax) yield and will accumulate to less than $2,185,000 over that same 15 period.

Similarly, let's now assess an ESOP-related stock sale for $10,000,000 consisting of cash of $2,000,000 and a take-back note of $8,000,000 that is secured only by the unpaid portion of the purchased stock, subordinate to banks, cannot be accelerated upon default, and carries less than the going rate of interest for that type of loan. Assume further that a qualified appraiser calculates that note to be worth sixty cents on the dollar. This means that the seller would then be behind by forty percent of that $8,000,000, or $3,200,000. The appraiser is then asked "how many warrants to purchase authorized but unissued company stock at its then fair market value should the seller get in order to bring him up to equipoise." Assume that the appraiser's answer is 42%, so that, having received $2,000,000 in cash, an $8,000,000 note worth $4,800,000 and warrants worth $3,200,000, this seller will have been paid in full, and still have a major equity interest in that tax-exempt company. So at that point this seller will be in the position to ultimately collect $10,000,000 in cash and still own the equivalent of a 70% income interest in a company that can be expected to continue its exponential growth taking into account the fact that it will not be burdened by ongoing taxation.

<u>ESOPs AS A TOOL IN BUSINESS SUCCESSION PLANNING</u>

With all of the tax-saving avenues discussed above, ESOPs are ideally suited to be used in the design of a business succession plan. For instance, the ability to sell tax-free using 1042 coupled with monetizing, and the facility to combine ESOP with Subchapter S, thereby creating a tax-exempt entity, constitute luscious : "food for thought" to a tax planner who knows, or has access to, the intricacies of ESOP.

As you know, there is now a wealth of outstanding professionals who engage in "cutting edge" estate planning that, for instance, removes high-worth assets from taxable estates,

minimizes the value assigned to gifted assets—including interests in businesses (usually by making them minority, illiquid and non-marketable). Nevertheless, quite frequently, those cutting edges can be made considerably sharper by coupling them with planning using ESOPs. To illustrate, let's focus on a few common business succession planning problems facing many, if not most, family business owners:

- **Situation 1:** A father has a profitable, but illiquid company and two adult children; a son who works in the business and a daughter who does not.

  First dilemma — How can the father treat both children equally knowing that leaving each 50 percent of the business will result in acrimony?

  Second dilemma — How can the father turn the business over to his son, yet still extract money to fund retirement for himself and his wife, while equalizing the share given to their daughter?

  Some suggestions:

  1. Recapitalize by having the father exchange half of his common stock for "super common stock"(common stock with a limited dividend preference) to offset an unwanted discount. Sell the super common stock to the ESOP in exchange for take-back debt, elect 1042 and monetize, continue to run the business, and live off of the income from it and the interest on debt while preserving proceeds of the take-back note for the daughter. The business can then deduct the cost of repaying the debt by channeling it through to the ESOP in the form of deductible contributions.
  2. Place the remaining common stock into a limited partnership or LLC and start making discounted gifts of minority interests to the son.

- **Situation 2:** What if there are no children in the business, nor will there ever be? Here are three options:

  1. The father sells his business to an ESOP—30 percent (the 1042 minimum) to start, then more after take-back debt has been paid and value restored.
  2. The father sells 100 percent of the business to an ESOP and elects 1042, but maintains control at least until his take-back debt has been paid.

3. After the ESOP becomes owner of the business, it elects S corporation status effective for its fiscal year beginning after the sale and becomes tax-deferred (or avoided, by either retaining QRP until death or monetizing). The business then uses its untaxed earnings to pay the father's take-back debt.

- **Situation 3:** A father has management that wants equity, and a young son who works in the business.
  1. The business adopts an ESOP and extends employees the right to transfer funds from a 401(k) plan to the ESOP to purchase some stock from the father (experience discloses that, even though it is made available to them, few employees beyond management choose to go this route).
  2. Where needed, provide selected managers "incentive stock options" to purchase stock from either the father or the corporation that owns the business, at an appropriate price.
  3. The father and management train the son to guide the business in the future.

THE NEED FOR A FEASIBILITY STUDY

As you have, no doubt, surmised, this thought process is complicated, and should usually be supported by the preparation of a "feasibility study." Stockholders contemplating a sale of stock to an ESOP should not be left to wonder whether they are buying a "pig in a poke." They should know what their alternatives are and just what the dollars crunch out to be. Accordingly, I almost always recommend doing a feasibility study. This is especially so when the company involved is already an S corporation and is thus not eligible for 1042, which is available only to owners of C corporation stock. Under those circumstances, a number of alternatives should be considered. The sellers can have their corporation retain its S status, make a long-term capital gain sale of stock to the ESOP, and then, in their capacity as "employees," actually be participants in the ESOP and share in the allocation of the stock that was purchased from them. Alternatively, they can cause the corporation to renounce its

S status, activate 1042, then by means of large contributions to its ESOP that are used to amortize the stock acquisition debt incurred to finance the sale, "zero-out" its taxable income for the five taxable years until it can re-elect S. By means of the feasibility study, I can prevent their eyes from "glazing over" and the way may well be cleared to make intelligent choices, including use of an ESOP.

PUTTING THE PIECES TOGETHER

Let's now look at Appendix 6. This is a real deal that appears to be a morass, but was anything but. Here a father who owned a very successful company died and left its stock to his three children—a son who ran the business and two uninvolved daughters. Animosity ensued because the daughters, who got neither salary nor dividends, felt cheated and wanted the company to be sold—something that their brother refused to do. Instead he asked them, "how much do you want for your stock?" and they each said $40,000,000. Well $80,000,000 would break the bank. So this is what he did. He said, "Well, I'll tell you what I'll do. I'll put in an ESOP, and you sell to the ESOP, make a 1042 election, and I will pay you what you would have had left if you had made a taxable sale for $80,000,000." The sisters agreed. This dropped the total price down to $66,000,000, which was doable. He then asked the company's employees, who had $90,000,000 in the company's 401(k) plan, if they would be interested in laterally transferring some of that money into their account in the ESOP and using it to buy some of the sisters' stock. The employees then came up with $10,000,000, which, when added to borrowed money, made the deal feasible. The company borrowed most of the purchase price from its bank and lent it to the ESOP, but was still $10,000,000 short, which it borrowed from a "venture capitalist," then closed on the deal and later elected to be taxed under Subchapter S. This complicated transaction involved lateral transfers, 1042 elections, bank and mezzanine-type loans, and much more. But it worked out well and was later written up in the Wall Street Journal.

CONCLUSION

Now, let's take a critical look at ESOPs. First, do they have a "down-side?" Then, do they meet the objectives of all concerned—stockholders, employees, companies, lenders, and even the USA. Are they worth the trouble and the cost?

The "Down-Side"

Special Limitations and Requirements--ESOPs are subject to special limitations and requirements that may appear to present unsolvable problems, but in actuality, rarely do.

The Right to Demand Distribution of Company Stock—First, ERISA provides that ESOP participants have the right to demand that ESOP distributions be in company stock. Few closely-held companies would be pleased with such a requirement since having stock "floating around" among passive minority stockholders, especially former employees, could present problems. Fortunately, however, this same law makes this problem either disappear when the ESOP is an S corporation, or avoidable when that corporation's charter or by-laws restrict ownership of "substantially all" (i.e., 80% or more) of its stock to "active employees" (which includes owner-employees) and qualified plans (which, of course, includes ESOPs). This, in turn, entitles the company, and, through it, its ESOP, to either distribute cash rather than stock, or distribute stock subject to the requirement that it be immediately sold back to either the corporation or its ESOP (which is frequently done in order to entitle departing employees to realize LTCG, rather than ordinary income, to the extent that the stock involved has NUA (i.e., value in excess of the ESOP's basis in that stock)).

The Right to a Pass Through Vote—ERISA provides that when the ESOP company is publicly traded, or when the matter to be voted on involves major actions such as mergers, consolidations, recapitalizations, reclassifications, liquidations, dissolutions, or sales of substantially all of the corporation's operating assets, the vote on all allocated ESOP stock must be passed through to the plan participants. Note, however,

that this requirement only applies to allocated stock—the ESOP trustee votes the unallocated stock (and stock as to which the plan participants have declined to exercise their right to vote), and, more often than not, matters such as mergers and acquisitions are accomplished through subsidiaries where the stock to be voted is owned by parent corporations rather than the ESOP itself. And, by its terms, the law does not extend to "tender offers."

Annual Appraisal —The law requires that the company stock held by the ESOP be appraised annually by a qualified independent appraiser, and that the appraised value of the stock allocated to participant accounts be communicated in writing to them each year. Jurisdiction over this requirement has been relegated to the Department of Labor (DOL) which, in 1988, issued proposed regulations which, although never finalized, should be followed. Transactions involving an ESOP purchase or sale of company stock must take place at "fair market value." And, the IRS also has long-standing guidelines as to factors that should be taken into account during the course of these appraisals. This requirement is arduous and expensive, but it would have to be adhered to in any event. Peoples' rights are involved. All of the parties -- the company, the ESOP and its participants must be treated fairly. And appraisals such as those here required are standard and appropriate in any event. They should not be viewed as a negative but, instead, as being inherently necessary under the circumstances inherent in the whole ESOP process.

Complexity—ESOPs are complex and understood by few. Here, however, complexity is the corollary of the exceptional benefits they can provide. Congress favors ESOPs, but only when they are not abused and the interests of employees are safeguarded. Moreover, ESOPs are entwined into the Internal Revenue Code where almost everything is complicated. Nevertheless, they are understandable and manageable when implemented and overseen by people who understand them and know how they work. Accordingly, where the aggregation of ESOP-generated benefits is adequately enticing,

as it frequently is, the complexity that accompanies them should not present anything like an impenetrable barrier.

Cost—Complexity, coupled with many and varied benefits, generates cost. ESOPs are not cheap. Fees in the forty to sixty thousand dollar range are common and, depending upon alternatives being utilized (e.g., lateral transfers) can go well above that. But those costs must be far offset by the benefits to be derived in order to justify moving forward with implementation. For this reason, as empathized above, I almost always recommend that a "feasibility study" be undertaken before an ESOP is implemented. Then an ESOP should only be implemented when the feasibility study supports that course of action.

On the Positive Side

Existing Stockholders—As detailed above, benefits attainable by business owners through ESOP cannot be matched anywhere else within our tax system—a company's income can be made to be tax-exempt; stock can be sold without a tax on realized gain; different forms of "Synthetic Equity" can be designed to enable a stock sale to be coupled with a continuing equity interest in company growth; and so much more. You will see that where the business involved is profitable and worth considerable money, an ESOP can be quite lucrative. Moreover, ESOPs are flexible and can be tailored to meet varying goals—including the advantageous treatment of heirs whether or not they maintain a continuing active interest in the business.

Employees—ESOPs couple well with other types of employee retirement vehicles such as 401(k) and profit-sharing plans. They serve the purpose of supplementing retirement benefits and correlating employee wealth with the success of their employer. That's where "employee ownership" comes into play and incentivizes employees to enhance their performance for the good of all concerned.

The Company—Companies prosper when their employees are enthused and incentivized, and tax benefits (e.g., being tax-exempt) inure to them as well as to their stockholders.

Lenders—Incurring stock-acquisition debt is a major factor in most ESOP transactions. Banks and other prime lenders recognize that ESOP companies are usually good credit risks. Remember that ESOPs are really only logical for profitable companies that have a high net worth and Congress has helped by enacting into law provisions specifically designed to encourage banks to make ESOP loans.

Our Government—I started out by saying that Congress is enthused about ESOPs. Starting with Senator Russell Long, for many years the chair of the Senate Finance Committee, who led the effort, Congress infused into ERISA incentives intended to encourage U.S. corporations to adopt ESOPs. Periodically, Congress holds hearings to further consider the desirability of continuing this line of thought. Expert testimony has been elicited and evidence in the form of in-depth studies comparing results achieved by ESOP companies with their non-ESOP contemporaries discloses that the former are more productive and profitable than the latter. Universities and organizations such as The ESOP Association, The National Center for Employee Ownership, and the Employee Benefits Research Institute have engaged in this kind of research and analysis and compiled convincing evidence in support of this conclusion. Carried to its logical end, making U.S. private industry more productive makes the USA more competitive internationally—which, in turn, fosters a continuing affinity between Congress and ESOPs.

THE BOTTOM LINE

An ESOP is not always the right answer. It may be that it doesn't fit the goals at hand. But unless this planning alternative has been at least considered, it is hard to justify that an adequate study has been done.

APPENDIX 1

SALE TO ESOP AT $7,000,000
VS. SALE TO COMPANY AT $7,000,000

	After-Tax Benefits to Seller	After-Tax Cost to Company
ESOP Alternative	$7,000,000[1]	$4,200,000[2]
Non-ESOP Alternative	$5,600,000[3]	$7,000,000[4]
Differential	$1,400,000	$2,800,000
Total Tax Savings Using ESOP	**$4,200,000**	

[1] The full sale price not reduced by taxes because of §1042.

[2] $7,000,000 contributed to its ESOP and deducted by the Company reduced by the worth of a 40% (federal at 34% and state at 6%) tax deduction.

[3] $7,000,000 sales proceeds reduced by a 20% long-term capital gain tax (federal at 15% and state at 5%)

[4] Non-deductible money paid by the Company to purchase this stock.

APPENDIX 2

NON-ESOP TAX EQUIVALENT SALE

TO NET $7,000,000

	20% combined Tax Rate	25% combined Tax Rate
Sales Price to Net $7,000,000 After Paying Combined Federal and State Tax	$8,750,000	$9,330,000
	x 80%	x 80%
	$7,000,000	$7,000,000

APPENDIX 3

FLOATING RATE NOTE MONETIZATION STRATEGY

Collateralized Account

Purchase $10,000,000 Floating Rate
40-Year Notes as Qualified
Replacement Property

Principal amount:	$10,000,000	
Current Yield:	4.45%	
Annual Income:		$445,000
Monetized Floaters		
Monetization Percentage:	90%	
Monetized Amount:	9,000,000	
Monetized Interest:	5.15%	
Monetized Expense:		(463,500)
Net Interest Income (expense):		$(18,500)
Reduced by tax deduction at 40%:		7,400
Annual monetization expense as % of principal amount:	(0.11%)	$(11,100)

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APPENDIX 4

CHANNELING A STOCK SALE THROUGH A CRT

See how it works

In our example, let's say a 65-year-old man contributes 10 percent of stock in his 100 percent-owned company with an appraised value of $1 million to a charitable remainder trust (CRT), subject to a retained annuity of $50,000 per year. The CRT then sells that stock for $1 million to the company's employee stock ownership plan (ESOP).*

What Happens	Tax Savings	Net Investment Contribution Reduced by Tax Saving	Retained Annuity	Yield
The seller contributes company stock worth $1,000,000		**$1,000,000**	**$50,000**	**5.0%**
This transaction produces income tax deductions for the seller of $403,180, which saves tax of 40% (federal 35%; state 5%) = $161,272	**$161,272**	**$832,728**	**$50,000**	**6.0%**
It also excludes from his taxable estate $1,000,000, producing estate tax savings of $350,000, the present value of which assuming life expectancy of 21 years is $184,000	**$183,747**	**$648,981**	**$50,000**	**7.7%**
Meanwhile, the company deducts ESOP contribution of $1,000,000 × 90% (100% - 10%) × 40% federal and state tax, which saves the grantor $360,000	**$360,000**	**$288,981**	**$50,000**	**17.7%**

* These calculations, and other contained in this article, were derived with the computerized help of Number Cruncher, created by Leimberg & LeClair, Inc., leimberg@mindspring.com.

APPENDIX 5

TAX ADVANTAGE INHERENT IN A 100% S-ESOP-OWNED CORPORATION

	C Corp	S-ESOP-owned S Corp
One year's Net Income before taxes	$ 1,000,000	$ 1,000,000
Income tax (Fed. 34%/State 6%)	(400,000)	- 0 -[5]
Net inuring to the benefit of shareholders	$ 600,000	$ 1,000,000
15% (before-tax) Yield[6] for 15 years		$ 8,137,000
9% (after-tax) Yield for 15 years	$ 2,185,000	
Total taxable upon distribution	$ 2,185,000	$ 8,137,000
Less tax on distribution @ 20% LTCG	(437,000)[8]	
Less tax on distribution @ 40% ordinary income[7]		(3,256,800)
	$ 1,748,000	$ 4,880,200
After-tax differential benefit to S-ESOP participants	**$3,132,200**	

5. This assumes that the State involved follows Federal law and exempts S corporations from a corporate level tax.

6. This equates to a 9% after-tax yield, which would be modest for even a reasonably successful closely held business.

7. While the difference between the fair market value and the ESOP's basis in distributed ESOP stock, being "net unrealized appreciation" (NUA), is taxed as LTCG, here this increase is represented by deferred tax on S corporation income, not NUA, is taxed as ordinary income.

8. This assumes that this distribution is either a 20% taxed (15% federal and 5% state) dividend, or one eligible for LTCG (also taxed at a combined 20%).

APPENDIX 6