WEB ARTICLE

August 24, 2020

How an Employee Stock Ownership Plan (ESOP) Works

ESOPs Provide a Variety of Significant Tax Benefits for Companies and Their Owners. ESOP Rules Are Designed to Assure the Plans Benefit Employees Fairly and Broadly

Employee ownership can be accomplished in a variety of ways. Employees can buy stock directly, be given it as a bonus, can receive stock options, or obtain stock through a profit sharing plan. Some employees become owners through worker cooperatives where everyone has an equal vote. But by far the most common form of employee ownership in the U.S. is the ESOP, or employee stock ownership plan. Almost unknown until 1974, ESOPs are now widespread; as of the most recent data, 6,460 plans exist, covering 14.2 million people.

Companies can use ESOPs for a variety of purposes. Contrary to the impression one can get from media accounts, ESOPs are almost never used to save troubled companies—only at most a handful of such plans are set up each year. Instead, ESOPs are most commonly used to provide a market for the shares of departing owners of successful closely held companies, to motivate and reward employees, or to take advantage of incentives to borrow money for acquiring new assets in pretax dollars. In almost every case, ESOPs are a contribution to the employee, not an employee purchase.

ESOP Rules

An ESOP is a kind of employee benefit plan, similar in some ways to a profit-sharing plan. In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits. The 2017 tax bill limits net interest deductions for businesses to 30% of EBITDA (earnings before interest, taxes, depreciation, and amortization) for four years, at which point the limit decreases to 30% of EBIT (not EBITDA). In other words, starting in 2022, businesses will subtract depreciation and amortization from their earnings before calculating their maximum deductible interest payments.

New leveraged ESOPs where the company borrows an amount that is large relative to its EBITDA may find that their deductible expenses will be lower and, therefore, their taxable income may be higher under this change. This change will not affect 100%-ESOP owned S corporations because they don't pay tax.

Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or gradual.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues. In public companies, employees must be able to vote all issues.

Uses for ESOPs

1. *To buy the shares of a departing owner:* Owners of privately held companies can use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares (see below).
2. *To borrow money at a lower after-tax cost:* ESOPs are unique among benefit plans in their ability to borrow money. The ESOP borrows cash, which it uses to buy company shares or shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.
3. *To create an additional employee benefit:* A company can simply issue new or treasury shares to an ESOP, deducting their value (for up to 25% of covered pay) from taxable income. Or a company can contribute cash, buying shares from existing public or private owners. In public companies, which account for about 5% of the plans and about 40% of the plan participants, ESOPs are often used in conjunction with employee savings plans. Rather than matching employee savings with cash, the company will match them with stock from an ESOP, often at a higher matching level.

Major Tax Benefits

ESOPs have a number of significant tax benefits, the most important of which are:

1. *Contributions of stock are tax-deductible:* That means companies can get a current cash flow advantage by issuing new shares or treasury shares to the ESOP, albeit this means existing owners will be diluted.

2. *Cash contributions are deductible:* A company can contribute cash on a discretionary basis year-to-year and take a tax deduction for it, whether the contribution is used to buy shares from current owners or to build up a cash reserve in the ESOP for future use.

3. *Contributions used to repay a loan the ESOP takes out to buy company shares are tax-deductible:* The ESOP can borrow money to buy existing shares, new shares, or treasury shares. Regardless of the use, the contributions are deductible, meaning ESOP financing is done in pretax dollars.

4. *Sellers in a C corporation can get a tax deferral:* In C corporations, once the ESOP owns 30% of all the shares in the company, the seller can reinvest the proceeds of the sale in other securities and defer any tax on the gain.

5. *In S corporations, the percentage of ownership held by the ESOP is not subject to income tax at the federal level (and usually the state level as well):* That means, for instance, that there is no income tax on 30% of the profits of an S corporation with an ESOP holding 30% of the stock, and no income tax at all on the profits of an S corporation wholly owned by its ESOP. Note, however, that the ESOP still must get a pro-rata share of any distributions the company makes to owners.

6. *Dividends are tax-deductible:* Reasonable dividends used to repay an ESOP loan, passed through to employees, or reinvested by employees in company stock are tax-deductible.

7. *Employees pay no tax on the contributions to the ESOP, only the distribution of their accounts, and then at potentially favorable rates:* The employees can roll over their distributions in an IRA or other retirement plan or pay current tax on the distribution, with any gains accumulated over time taxed as capital gains. The income tax portion of the distributions, however, is subject to a 10% penalty if made before normal retirement age.

Note that all contribution limits are subject to certain limitations, although these rarely pose a problem for companies.

Caveats

As attractive as these tax benefits are, however, there are limits and drawbacks. The law does not allow ESOPs to be used in partnerships and most professional corporations. ESOPs can be used in S corporations, but do not qualify for the rollover treatment discussed above and have lower contribution limits. Private companies must repurchase shares of departing employees, and this can become a major expense. The cost of setting up an ESOP is also substantial—perhaps $40,000 for the simplest of plans in small companies and on up from there. Any time new shares are issued, the stock of existing owners is diluted. That dilution must be weighed against the tax and motivation benefits an ESOP can provide. Finally, ESOPs will improve corporate performance only if combined with opportunities for employees to participate in decisions affecting their work.

This article is about ESOPs in the U.S., which follow specific U.S. tax and retirement plan laws. A benefit plan in another country called an ESOP may be very different. For example, an "ESOP" in India is a stock option plan, which has nothing to do with a U.S. ESOP.

For a book-length orientation to how ESOPs work, see Understanding ESOPs.

For an infographic that visually explains ESOPs, see How an ESOP Works at ESOPinfo.org.

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ESOPs that hold privately-traded employer stock

This type of ESOP holds employer stock that is *not* traded on a national securities exchange. When an employee retires or leaves the company, employers are required to either offer distributions in the form of cash or to buy the stock that is paid out from the plan. In both cases, a "fair valuation method" must be used to determine the cash amount.

Leveraged ESOPs

A leveraged ESOP is one in which the ESOP has used a loan to buy either privately- or publicly-traded employer stock. The acquired stock is held in a separate ESOP account which then allocates shares to participant accounts as the debt is repaid through employer contributions.

ESOPs can be stand-alone plans or part of a 401(k) plan.

Common ESOP Risks

- As with 401(k) plans, it is extremely risky for ESOP participants to have too much of their overall retirement savings in any single stock, particularly employer stock. However, unlike 401(k) plans, which generally contain diversified investments, ESOPs are by definition invested solely in the employer's stock.
- A company's financial circumstances can affect the value of its stock, thus lowering the stock's value and threatening the value of employees' ESOP accounts.
- If a company with an ESOP is struggling financially and has to lay off workers, the plan must cash out those workers' shares in the ESOP, which can create even more cash-flow problems and lead to more layoffs, creating a "death spiral" that could ultimately sink the company – and the value of the employees' ESOP accounts.
- If a company's ESOP is invested in privately-traded stock, the risks listed above are even greater, because the value of the stock is not determined by the stock market but by a third party, who may or may not be unbiased.

Best practices for people with ESOPs

Because of the risks mentioned above, many experts believe that all ESOP participants should:

- Transfer ESOP balances out of employer stock into other investments, particularly when the value of the employer's stock is too large a portion of the total retirement plan investments, such as more than 10 or 20 percent.
- If an ESOP is also part of a 401(k) plan, participants are entitled to diversification rights, which include the right to transfer out of publicly-traded employer stock after three years of service.
- If the stock is privately traded or if the ESOP is not part of a 401(k) plan, participants only receive these diversification rights after reaching age 55 and participating in the ESOP for at least 10 years.

- Consider receiving any payouts in the form of cash that is directly rolled over into an IRA or 401(k) plan to avoid incurring tax penalties and so that the money can be invested in diversified funds rather than in a single stock.
- Contact a pension lawyer right away if the employer does not make a payment when it is due. Free legal assistance is available from the **Pension Counseling and Information Program**.

Special concerns and suggestions for people with ESOPs that hold privately-traded employer stock:

- If the employer's stock is privately traded, take any cash payments you may be entitled to as soon as possible. This will enable you to avoid the risk of possible investment loss that may occur if the employer encounters financial trouble and the stock value declines.

  Most ESOPs permit lump-sum payments of participant account balances when the employee stops working for the employer. But if the employer encounters financial trouble, it can amend the plan – without notice to employees and effective immediately – to rescind this right and delay payouts for as long as seven years after termination of employment. Even then, employers are permitted to pay out participant balances in installments over five years.

- If your ESOP holds privately-traded employer stock, find out if the person who values the stock held in the ESOP is independent of the employer and has professional training and experience in valuing stock that is privately traded.

  It is difficult to determine the exact value of an employer's stock if it is not traded on a market. There is a history both of valuations being performed by a person with no professional experience or training in valuations of privately-traded stock and of valuations being manipulated to the detriment of plan participants.

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ESOP OVERVIEW

for

Denver Estate Planning Council

November 12, 2015

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1. Background on ESOPs

Historical Background on ESOPs

1950s - 1960s

- Concept developed by lawyer and investment banker Louis Kelso
- Revenue Ruling 46 of 1953 - permitted any qualified retirement plan to borrow money for the purpose of purchasing stock
- Peninsula Newspaper, Inc. – the first known leveraged ESOP

1970s - 1980s

- Regional Rail Reorganization Act of 1973 – permitting ESOPs as a vehicle to enable corporations to finance their capital requirements
- ERISA of 1974 – detailed the workings of the ESOP concept
- Tax Reduction Act of 1975 – additional tax credit for ESOP contributions

1980s - 1990s

- Small Business Development Act of 1980 – preferential loan agreement treatment for companies which ESOP owned 51%>
- Economic Recovery Tax Act of 1981 – increased allowable deductible contribution from 15% to 25% of covered payroll
- Deficit Reduction Act of 1984 - IRC §1042 provided for tax-free rollover
- Taxpayer Relief Act of 1997 – made it practical for S Corp to have ESOP

2000s

- Economic Growth and Tax Relief Reconciliation Act of 2001- broadly improved ESOPs
- Tax reduction in 2001 changed contributable amounts to ESOPs alone or in combination with other tax qualified plans

What is an ESOP?

- An ESOP is a qualified, defined contribution employee benefit plan, much like a traditional profit sharing plan that invests primarily in the sponsoring employer's stock.
  - Unique among qualified benefit plans in its ability to borrow money may be used as a technique of corporate finance
- There are approximately 10,000 ESOPs in place in the U.S., covering 11 million employees (10% of the private sector workforce)
- A majority of ESOP companies have other retirement plans, such as defined benefit pension plans or 401(k) plans, to supplement their ESOP
- Total assets owned by U.S. ESOPs is estimated to be over $1 trillion at the end of 2013
- About 800 ESOPs - 7% - are in publicly-traded companies
  - Notable publicly-traded ESOPs include (employees own more than 10%) Proctor & Gamble Company; Anheuser-Busch Companies, Inc.; Chevron Corp.; Kimberly-Clark Corporation and General Mills, Inc.

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All Parties Can Benefit from an ESOP

Seller:

- Receive Fair Market Value
- Favorable Tax Treatment on Sale
- Flexibility; can sell any % of company
- Preserve Legacy as Independent Company
- Reward Management & Employees

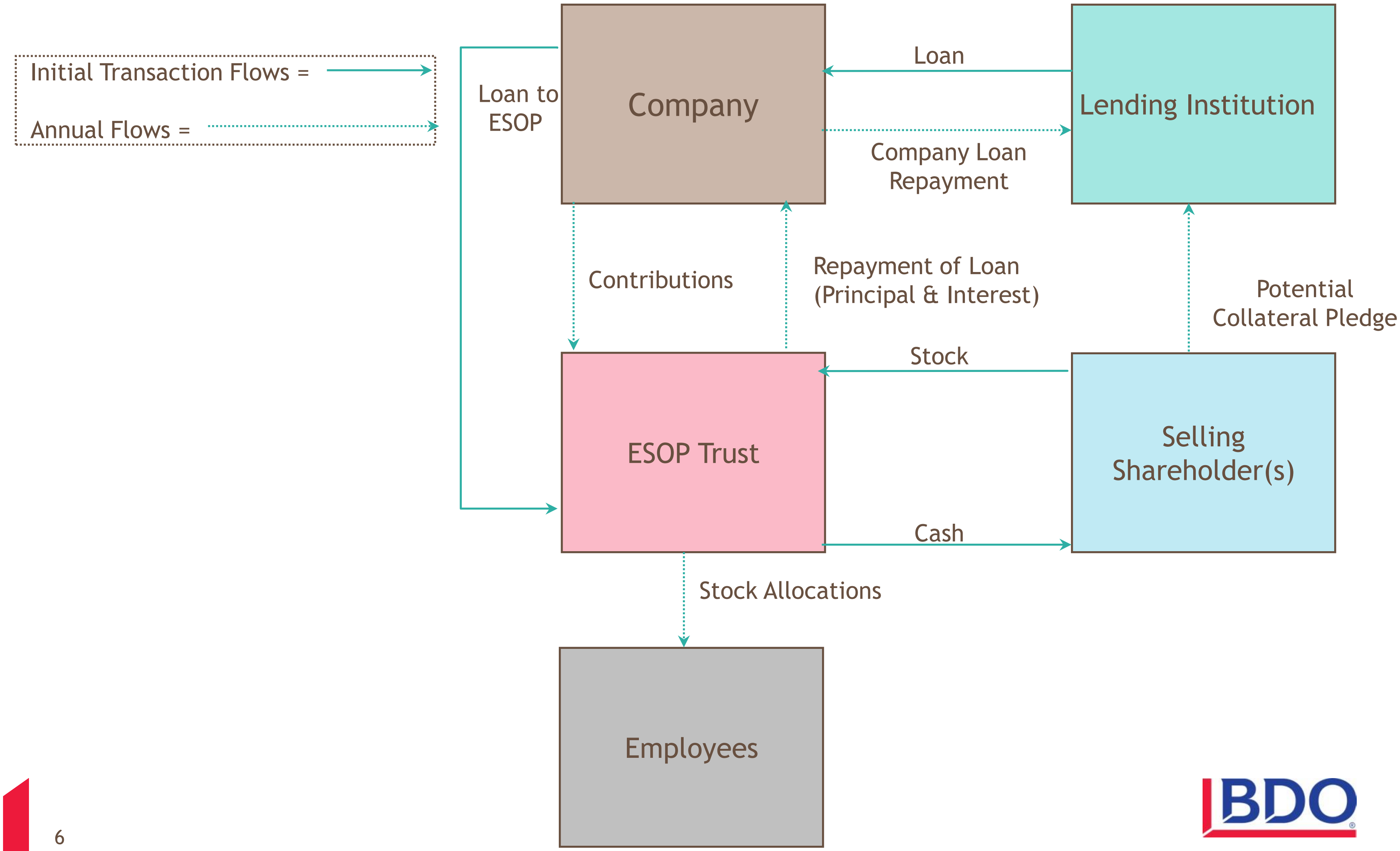
Company:

- Tax-Advantaged Financing
- Potential for Income Tax-Free Entity (100% ESOP-owned S Corporation)
- Repay Debt More Quickly with Enhanced Cash Flow
- Potential for Productivity Gains & Reduced Turnover

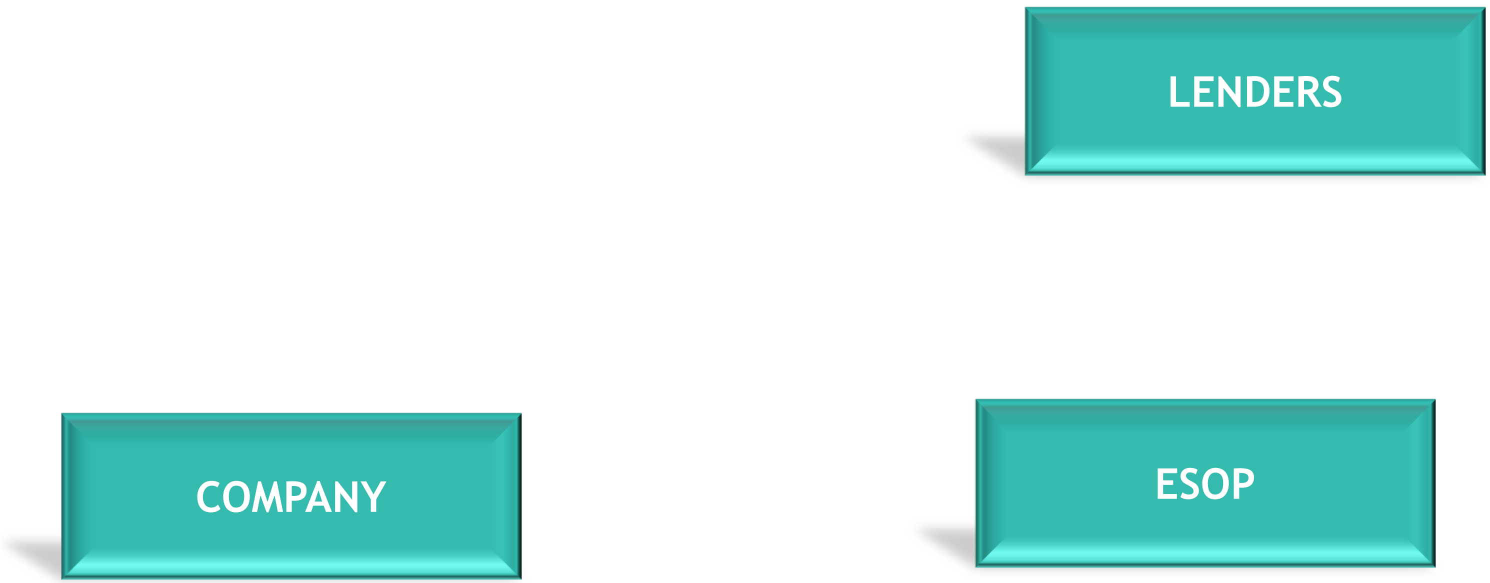
Employees:

- Valuable Retirement Benefit
- Ability to Participate in Value they Help Create
- Continued Employment
- Rewarding & Motivational
- Incentive for Management

Traditional “C” Corp ESOP Transaction Scenario



“S” Corp Transaction Example - 100% ESOP



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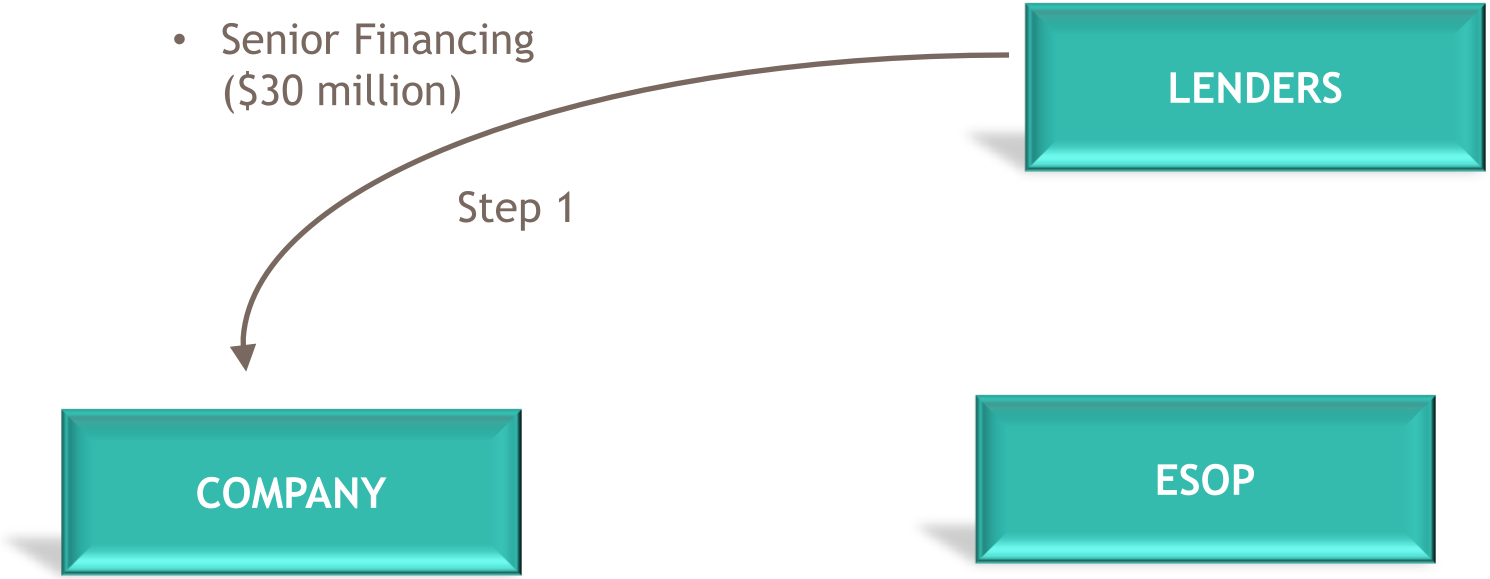

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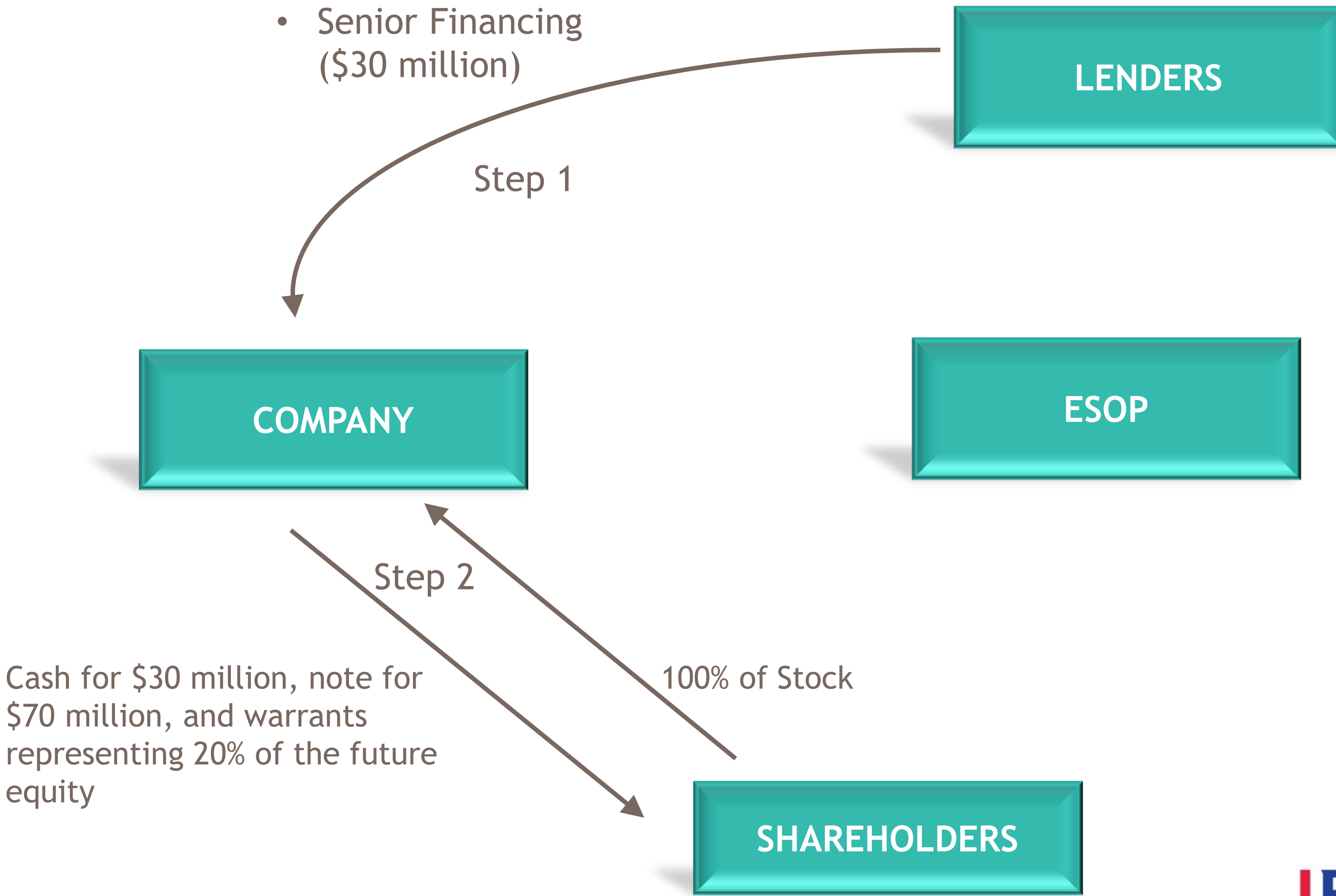

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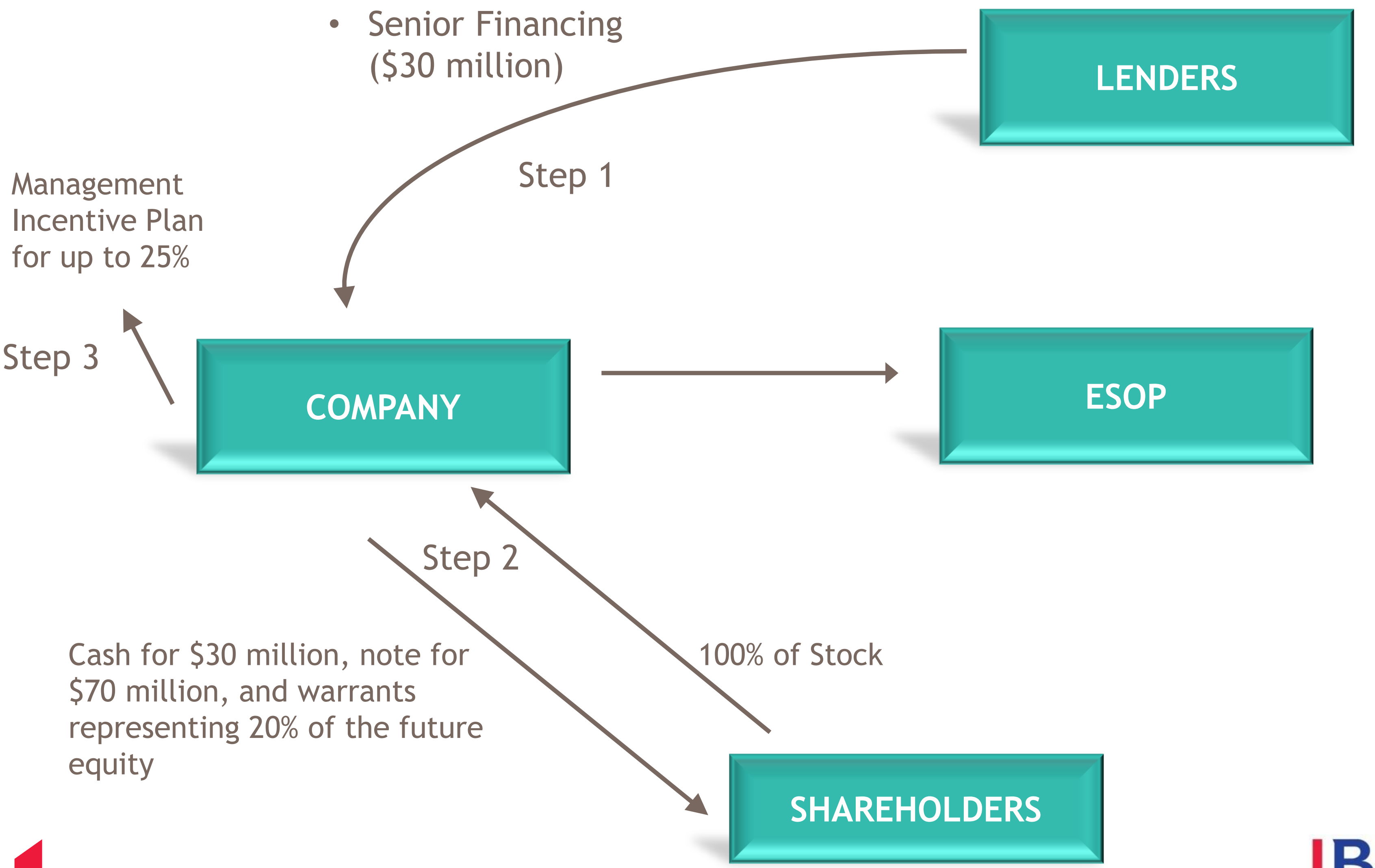

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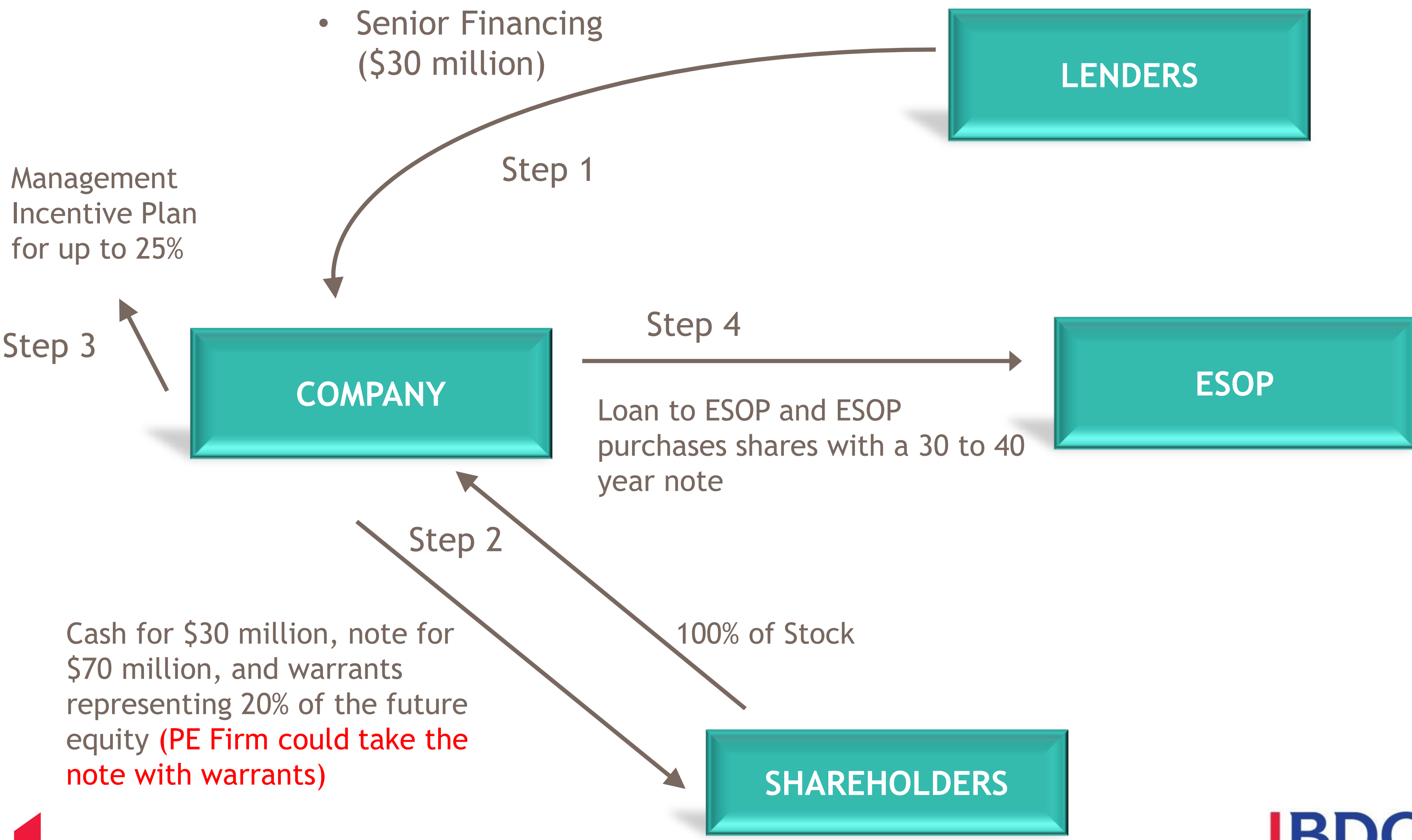


ESOP Result

- ESOP owns 100% of the Company for Tax Purposes
- Seller will have contractual rights as long as the seller note is outstanding, and an equity kicker (e.g., warrants of 20% of post-ESOP value increase). Interest rate on notes and number of warrants vary based on structure. For example:
  - Interest on notes – 5% **(PE firm or hedge fund replaces seller, rate could be higher)**
  - 20% warrants
    - Pre-ESOP value of Company $100 million
    - Post-ESOP value of Company $20 million
    - 20% of increase value above $20 million
  - Seller gets $30 million cash up front, $70 million over time with interest, and 20% upside over Post-ESOP value ($16 million if Company value gets to $100 million) **(PE Firm or hedge fund could replace seller on the note)**
- Post-Transaction S Corporation and thus, Tax-Exempt Entity so more cash to service debt and fund company growth - $6 million a year tax savings if EBITDA is $15 million
- Governance will be implemented to stabilize the ESOP structure
- Management Incentive Plan (MIP) implemented to attract and retain key management to run the company

Hypothetical ESOP Transaction Timeline (post-feasibility analysis)

Project Phase	Time Required (in weeks)	Responsibility	Week: 1	2	3	4	5	6	7	8	9	10	11	Comments
Organization and Internal Process														
Execute Engagement Letter	1 week	C												
Engage Legal Counsel	1 week	BDO, C , A												
Prepare Timeline and Responsibilities	1- 2 Weeks	BDO, C												
Prepare Summary Memo of Transaction Structure	1- 2 Weeks	BDO, C												
Preliminary Discussions with Counsel & Trustee	2- 3 Weeks	BDO, C												
Identify Potential Transaction Issues	1 week	BDO												
Refine Transaction Structure	1 week	BDO, C , A												
Refine Summary Memo of Transaction Structure	1 week	BDO, C												
Preparation of Information Memorandum														
Begin Drafting Transaction Memo (for Trustee/Lender)	1 - 4 Weeks	BDO												
Review and Revise Draft	1 week	BDO, C												
Approval of Final Draft	1 week	C												
Early Execution Activities														
Initial Contact with Potential Lenders	2 weeks	BDO, C , A												
Legal Due Diligence Begins	2 + Weeks	BDO, C , A												
Engage ESOP Trustee	1 week	BDO, C , A												
Circulate Transaction Memorandum (for Trustee/Lender)	1 week	BDO, C , A												

Legend: Stated Time Required   Possible Additional Duration   C = Company   BDO=BDO LLP and Capital Advisors   A = Attorney

Hypothetical ESOP Transaction Timeline (post-feasibility analysis)

	Project Phase	Time Required (in weeks)	Responsibility	Comments
Financing Activities	**Execution**			
	Lender Due Diligence	1 week	BDO, C , A	Assume Due Diligence Commenced in Week 7
	Management Presentations to Lender	TBD	BDO, C	
	First Draft of Stock Purchase Agreements	TBD	BDO, C , A	
	Finalize Lending Agreements	TBD	BDO, C , A	
	Finalize Stock Purchase Agreements	TBD	BDO, C , A	
	Confirmatory Due Diligence	TBD	BDO, C , A	
ESOP Activities	**Plan Documentation**			
	Prepare Outline of Plan Provisions	1 week	C	Assume Preparation Commenced in Week 4
	First Draft of ESOP Plan Documents	5 weeks	BDO, A	
	Review Draft of ESOP Plan Documents	2 weeks	BDO, C , A	
	Employee Communications			
	Prepare Employee Announcement Materials	2 weeks	C, A	
	Prepare Employee Meeting Materials	2 weeks	C, A	
	Conduct Employee Meetings	3 weeks	C	
	Trustee Related			
	Trustee Due Diligence and Analysis	1 week	BDO, C	Assume Due Diligence Commenced in Week 7
	Management Presentations to Trustee	TBD	BDO, C	
	Finalize Negotiations with Trustee	TBD	BDO, C , A	
	Trustee Receives Fairness Opinion	TBD	BDO, C , A	
	Closing Meeting and Document Execution	1 week	BDO, C , A	

Week: 12 13 14 15 16 17 18 19 20 21 22

Legend: Stated Time Required | Possible Additional Duration | C = Company | BDO=BDO LLP and Capital Advisors | A = Attorney

ESOP Tax Advantages

Deductibility of Principal and Interest Payments

- Principal and interest payments of an ESOP loan are considered contributions to a tax-qualified employee benefit plan and thus are tax deductible
- For a C corporation, principal payments are deductible up to 25% of covered eligible payroll. Interest payments are deductible in full and may exceed the 25% of covered eligible payroll limit
- For an S corporation, the maximum deductible amount is 25% of covered eligible payroll and unlike a C corporation, both principal and interest are included in the 25% limit. However, an ESOP is a non-tax paying shareholder, so an S corporation that is owned 100% by an ESOP does not pay any tax.

Deductibility of Dividends

- In a C corporation, dividends paid on stock held by the ESOP are tax deductible to the corporation if they are distributed to ESOP participants and do not count towards the 25% limit
- Furthermore, these deductible dividends may be used to pay principal and interest on the loan
- Dividends are not deductible for S corporation ESOPs

ESOP Rollover

- Shareholders selling to a C corporation leveraged ESOP qualify to defer federal income taxes on the gain from the sale by purchasing “qualified replacement securities” with the proceeds from the sale

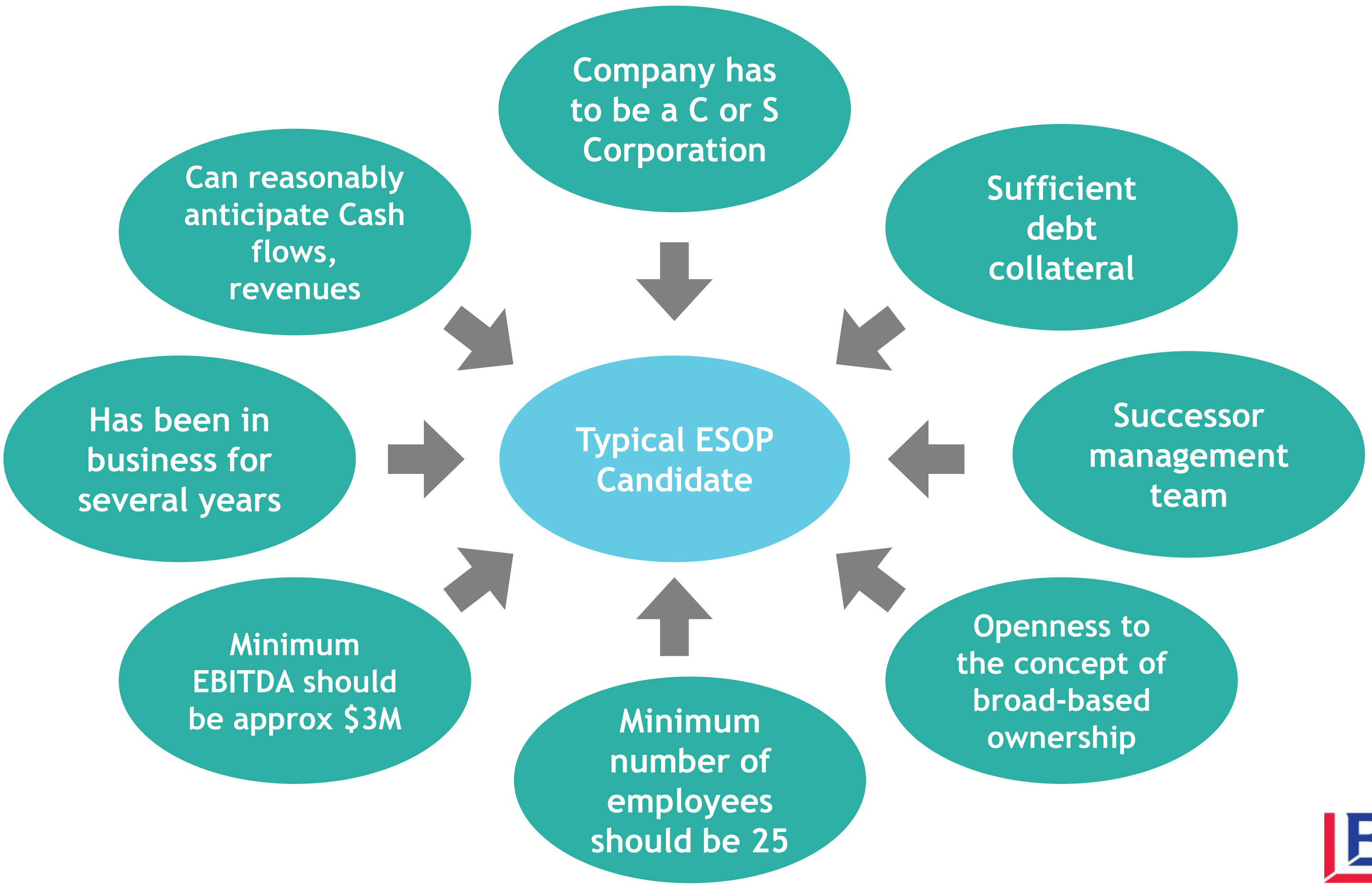
Step-Up in Cost Basis to Seller’s Estate

- Should a selling shareholder “rollover” her assets in a IRC §1042 transaction, her estate receives a step-up in cost basis on the qualified replacement securities at death, thus eliminating the capital gains tax liability

2. ESOP Candidate Characteristics

ESOP Candidate Characteristics

Although views differ on what exactly makes a good ESOP candidate, several characteristics reveal themselves as essential qualifiers. The list below is not exclusive, but can be used as a guideline



Market Opportunity

There are several present dynamics that make an ESOP offering a highly-strategic move

Sizeable Market	• It is estimated that within the next 10 years, baby boomer business owners will consummate approximately $6 trillion in business interest transfers • According to OneSource there are over 500,000 companies that fit the typical ESOP profile – Privately held company with over 25 employees and $10 million in revenues
Business Model	• There are many types of businesses that are not "classic" M&A candidates, but that can receive the benefits through an ESOP • Quicker execution than M&A transaction – Closing timeline is 3-6 months, considerably less than a M&A engagement • Employees view ESOPs far more favorably than M&A
Macro Market	• Lending environment is very receptive – Access to affordable debt combined with active lenders who support ESOP concept • Strong backing in the legislative community

Benefits to Selling Shareholder (IRC §1042)

The selling shareholders can defer the capital gains taxes on the sale of stock to the ESOP provided that:

- The Company is a "C-Corporation" at the time of the sale
- The ESOP owns at least 30% of the Company's stock post-transaction
- The selling shareholders reinvest the proceeds in "Qualified Replacement Property" within 12 months

What is Qualified Replacement Property?

- Stocks and Bonds of U.S. Corporations, public or private, that derive no more than 25% of their gross income from passive sources
- U.S. Government & Municipal bonds do not qualify as QRP
- Mutual Funds do not qualify as QRP
- Limited Partnerships do not qualify as QRP

Tax Savings of Sale to an ESOP

	Taxable Sale	ESOP Sale
Sale Price	$30,000,000	$30,000,000
Basis	5,000,000	5,000,000
Appreciation	$25,000,000	$25,000,000
Federal Tax	$5,950,000	$0
Net Proceeds	**$24,050,000**	**$30,000,000**

Further Advantages to Owner(s)

- An ESOP is a very flexible exit strategy – can be a partial or total liquidity vehicle
- Owner can sell out at fair market value without the disruption of an M&A process
- Selling more than 50 percent of the equity does not mean relinquishing operating control. The ESOP trustee, who oversees the plan, is not a manager. This is in contrast to a sale or a minority recap
- ESOP vesting provisions prevent employee defections; unvested shares revert to the plan; vested shares are purchased from the employee at fair market value with longer-term payouts, often greater than 5 years
- A management incentive plan that rewards only selected team members can exist alongside an ESOP. The ESOP cannot be discriminatory but the incentive plan can be

Benefits to the Company

Dividends and contributions to the ESOP are tax deductible resulting in a tax shelter equivalent to the value of the transaction

- A $30 million ESOP Loan paid over five years leads to an additional annual deduction (principal) of $6 million, which equates to $2.4 million in annual tax savings
- Over the five year life this is a total tax savings of $12 million
- The additional tax savings increases the cash flow available for debt service

Key Assumptions

- $30 million sale to ESOP
- ESOP Loan Principal Amount = $30M
- ESOP Loan = Company Loan
- 5.0% Interest (Senior and subordinate blended) and 5 Year Amortization Loans
- 40% Tax Rate

Company Tax Savings of 30% Sale to an ESOP

	ESOP Sale	Taxable Sale
EBIT	$20,000,000	$20,000,000
Interest Expense	1,500,000	1,500,000
Pre-Contribution Income	$18,500,000	$18,500,000
ESOP Contribution	$6,000,000	$0
Pre-Tax Income	$12,500,000	$18,500,000
Taxes	$5,000,000	$7,400,000
Net Income	$7,500,000	$11,100,000
Plus: ESOP Contribution	$6,000,000	$0
Cash for Debt Services	**$13,500,000**	**$11,100,000**

Frequently Asked Questions

Question	Answer
An ESOP would allow my employees to see details of the company's financials	The ESOP is only required to disclose minimal financial information on an annual basis. Confidential financial information is not required to be released.
An ESOP won't pay me as much as an outright sale	An ESOP pays 100% fair market value for company shares. A strategic/industry buyer **may** be able to pay a premium, but only if it can realize synergies.
I don't want the employees running the company	The employees do not actively participate in the management of the company. They are much like shareholders in a publicly-traded company. The owner/management team continues to run the company as it had before.
I don't like debt	The ESOP transaction allows the owner to get liquidity for their personal investment by having the company collateralize the loan, thereby protecting their personal wealth. While taking on outside company debt is usually the most beneficial to an owner, it is not a requirement. An ESOP can be completed by placing the owner as a lender, or by having the company buy shares of the owner out over time without the need for debt.
What if I want to sell the company after an ESOP is in place	The ESOP is not an impediment to a sale of the company. If the ESOP does not own a controlling block of stock, it cannot unilaterally block a transaction. If the ESOP does own a controlling block of stock, it just needs to make sure that it is receiving "fair value" for its shares.
Since my company is an S-corp, I can't take advantage of all of the tax benefits	The company can revert to C-corp status at any time and enjoy all of the available tax benefits. In order to keep the 1042 rollover benefit, it must stay a C-corp for at least 5 years after the transaction.
I don't want to stay at the company after I sell it	In any transaction, ESOP or otherwise, it is commonly expected that the owner will stay onboard for a certain period of time. If the company has a strong management team underneath the owner, the commitment to the company after the sale will be much shorter.

3. ESOP Transaction Considerations

Valuation Considerations – Value Standard

- Fair Market Value Standard
  - Per ERISA, the ESOP cannot pay more than adequate consideration (fair market value) for the stock of the Company
  - *Fair Market Value* is defined as the price at which an asset would change hands between a willing buyer and a willing seller where the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset
  - The ESOP Trustee will hire a financial advisor to render an opinion that the ESOP is not paying more than fair market value
- Fair Market Value may be less than the value that could be attained if the Company were sold to a strategic buyer (but elimination of taxes in ESOP sale evens playing field)

ESOP Transaction Considerations - Financing

- One of the most critical elements to implementing an ESOP is the ability to obtain debt financing for the transaction
- There are several potential sources of debt financing
  - Senior Lenders – Asset Based
  - Senior Lenders – Cash Flow Based
  - Mezzanine Funds
  - Seller Financing
- General Lender Considerations
  - Collateral Base (real estate, inventory, receivables, etc.)
  - Cash Flow
  - Character
- Additional Considerations for ESOP Transactions
  - ESOP transaction is a highly leveraged transaction
  - Unlike debt financing for operations, the proceeds of the loan “leave the company”
  - Enhanced cash flow available for debt service from ESOP tax benefits

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4. Company Advisor’s Role

What is the Role of the Investment Banker

- Perform a feasibility analysis and ESOP transaction design – optimal capital structure, possible need for “seller paper”
- Work with company’s tax advisor and legal counsel to draft ESOP documents
- Recommend an ESOP trustee and “sell” the valuation to the trustee and trustee’s valuation advisor
- Conduct due diligence to determine and negotiate the best possible terms with lending institutions and create a working structure for the transaction
- Work with an Investment Advisor in the rollover of proceeds to QRP if such an election is made

Steps to Setting Up an ESOP

Pre-Transaction

- Client introduction
- Assess whether owners are amenable
- NDA signed and financials received
- Engaged

Feasibility Study

- Preliminary valuation
- Design study
- Financial analysis
- Repurchase obligation study

Funding

- Contact potential lenders/Investors
- Disseminate private financing memorandum
- Draft ESOP plan document IRS "letter of determination"
- Execute NDAs
- Prepare management
- Initial management meetings with lenders and investors
- Assemble due diligence data room

Negotiations

- Lender and investor due diligence
- More management meetings
- Assist in negotiating shareholder and loan agreement, including final terms
- Structure the ESOP

Closing

- Select ESOP committee, trustees
- Closing

3-6 Months

ESOP Transaction Considerations - Players

The Company

- Company Financial Advisors
  - ESOP Feasibility Analysis
  - ESOP Transaction Design
  - Manage ESOP Implementation Process
  - Debt Placement
- Tax Advisor
- Corporate Legal Counsel
  - Prepare required corporate documents for ESOP implementation
- ERISA Legal Counsel
  - Assist in ESOP Transaction Design
  - Draft ESOP Documents

The ESOP

- ESOP Trustee
- ESOP Trustee’s Valuation Advisor
  - Valuation & Fairness Opinion to Trustee
- ESOP Trustee’s Legal Advisor

Selling Shareholders

- Financial Advisor
  - Assist in 1042 Rollover Process
- Legal Counsel
  - Review Transaction Documents

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Key Tax Benefits

	ESOPs	Profit Sharing	Stock Bonus Plans
Deductibility of employer contributions to the plan	Deductible up to 25% of eligible compensation. In C corporations, contributions made to pay interest on an ESOP loan generally do not count toward this limit.	Deductible up to 25% of eligible compensation (profit sharing plans cannot borrow money from the company or using its credit to buy company stock, so the interest exclusion does not apply).	Deductible up to 25% of eligible compensation (profit sharing plans cannot borrow money from the company or using its credit to buy company stock, so the interest exclusion does not apply).
Deductibility of dividends	Dividends are deductible if used to repay an ESOP loan, are passed through to participants, or are voluntarily reinvested in company stock by employees.	Dividends paid on shares are not deductible.	Dividends paid on shares are not deductible.
Tax benefits to owners	Seller can defer taxation of gains from a sale to an ESOP in a C corporation that owns at least 30% of company stock after the sale.	No tax benefits to sellers to the plan trust.	No tax benefits to sellers to the plan trust.
Taxation of ownership by plan in S corporation	Allocation of corporate income to the ESOP based on ESOP ownership is not subject to current taxation on the ESOP.	Plan trusts must pay unrelated business income tax on their attributed corporate income based on ownership.	Plan trusts must pay unrelated business income tax on their attributed corporate income based on ownership.

Employee taxation	Taxed in the same way as other defined contribution plans based on distributions from the plan not otherwise rolled over to another qualified plan or an IRA.	Taxed in the same way as other defined contribution plans based on distributions from the plan not otherwise rolled over to another qualified plan or an IRA.	Taxed in the same way as other defined contribution plans based on distributions from the plan not otherwise rolled over to another qualified plan or an IRA.

Rules

	ESOPs	**Profit Sharing**	**Stock Bonus Plans**
Borrowing money	Can borrow money from the company or using its credit to buy employer stock.	Cannot borrow money from the company or using its credit to buy employer stock.	Cannot borrow money from the company or using its credit to buy employer stock.
Governance	Trust is governed by a plan trustee who must operate the plan for the exclusive benefit of plan participants.	Trust is governed by a plan trustee who must operate the plan for the exclusive benefit of plan participants.	Trust is governed by a plan trustee who must operate the plan for the exclusive benefit of plan participants.
Voting	Plan participants must be able to direct the trustee as to the voting of the shares on a limited number of issues, most significantly the sale of all or substantially all the assets of the employer.	No voting requirements.	Same voting requirements as for ESOPs if more than 10% of plan assets are in company stock; otherwise no voting requirements.

Distribution timing	Generally, must offer distribution commencing within six years after end of plan year for termination unless termination is for death, disability or retirement, in which case distribution must begin not later than one year after the end of the plan year after termination.	Must begin by normal retirement age but it is rare for plans to wait that long.	Generally, must offer distribution commencing within six years after end of plan year for termination unless termination is for death, disability or retirement, in which case distribution must begin not later than one year after the end of the plan year after
Form of distribution	Employee must have the right to demand distributions in the form of company stock unless company is an S corporation or has bylaws requiring that all or substantially all the shares be held by employees.	Can be in stock or cash.	Employee must have the right to demand distributions in the form of company stock unless company is an S corporation or has bylaws requiring that all or substantially all the shares be held by employees.
Eligibility and vesting rules	Rules are generally the same as for other defined contribution plans.	Rules are generally the same as for other defined contribution plans.	Rules are generally the same as for other defined contribution plans.
Allocation	Generally must allocate based on relative compensation or a more level formula; permitted disparity (integration with Social Security) and cross-testing (age weighting or comparability testing based on	In addition to allocation rules that apply to ESOPs, companies can use permitted disparity (integration with Social Security) and cross-testing (age weighting or comparability	In addition to allocation rules that apply to ESOPs, companies can use permitted disparity (integration with Social Security) and cross-testing (age weighting or comparability

	projected future benefits) *not* allowed.	testing based on projected future benefits).	testing based on projected future benefits).
Put option	Employees must have a put option on shares distributed to them.	Not applicable	Employees must have a put option on shares distributed to them.
Required investment in company stock	Plan must be primarily invested in company stock with the highest combination of voting and dividend rights.	No minimum requirement; plan can hold any class of shares.	No minimum requirement; plan can hold any class of shares.
Valuation	Required annually by statute.	Not required by statute, but strongly advised for fiduciary protection	Not required by statute, but strongly advised for fiduciary protection
Fiduciary Concerns	Subject to close scrutiny by DOL with respect to valuation and prohibited transaction rules.	Subject to close scrutiny by DOL with respect to valuation and prohibited transaction rules; also subject to scrutiny relative to prudence and diversification.	Subject to close scrutiny by DOL with respect to valuation and prohibited transaction rules.
Diversification out of company stock	*Private companies, and standalone ESOPs in public companies:* Participants aged 55 and with 10 years in the plan must be allowed to diversify a total of 50% of company stock over six years. *Public company ESOPs combined with a*	*Private companies:* No diversification requirement. *Public companies:** All participants have can diversify out of all company stock, except that a precondition of three years of service can be	*Private companies:* No diversification requirement. *Public companies:** All participants have can diversify out of all company stock, except that a precondition of three years of service can be

*401(k) plan:** All participants have can diversify out of all company stock, except that a precondition of three years of service can be imposed on diversifying out of company stock from employer contributions.**	imposed on diversifying out of company stock from employer contributions.**	imposed on diversifying out of company stock from employer contributions.**

WEB ARTICLE

February 7, 2018

ESOP Tax Incentives and Contribution Limits

Congress has enacted tax incentives for employee stock ownership plans (ESOPs) that provide advantages for not only the sponsoring company but also the employees, the lender to an ESOP, and selling shareholders in closely held companies. Many states have laws that automatically track these provisions, thus magnifying the tax incentives.

Tax Incentives

Deductibility of ESOP Contributions

Employer contributions to the ESOP generally are tax-deductible up to a limit of 25% of covered payroll (this limit also includes employer contributions to other defined contribution plans). For a C corporation with a leveraged ESOP, the 25% limit does not include contributions to pay interest on the loan. The law appears to allow a C corporation to also contribute up to an additional 25% that is not used for payments on an ESOP loan (discussed below).

The contribution and deduction limits for an S corporation ESOP are the same as for a nonleveraged C corporation ESOP. However, even if the S corporation ESOP is leveraged, the company is not entitled to exclude the loan's interest expense from the 25% limit.

The 2017 bill limits net interest deductions for businesses to 30% of EBITDA (earnings before interest, taxes, depreciation, and amortization) for four years, at which point the limit decreases to 30% of EBIT (not EBITDA). In other words, starting in 2022, businesses will subtract depreciation and amortization from their earnings before calculating their maximum deductible interest payments.

New leveraged ESOPs where the company borrows an amount that is large relative to its EBITDA may find that their deductible expenses will be lower and, therefore, their taxable income may be higher under this change. This change will not affect 100%-ESOP owned S corporations because they don't pay tax.

Deductibility of Dividends Paid on ESOP-Held Stock

Companies that sponsor ESOPs can deduct dividends paid on ESOP-held stock primarily in three ways. First, dividends may be paid in cash to ESOP participants, either directly or as payments to the ESOP that are distributed to participants within 90 days after the close of the plan year. Second, dividends may be applied to a leveraged ESOP's loan payments (but only dividends on the shares bought with the loan can be used to make such payments). Third, dividends voluntarily reinvested in company stock in the ESOP by employees are deductible to the company.

Dividend deductions are not subject to the 25% limits described above for ESOP contributions. To be deductible, dividends must be "reasonable."

S corporation distributions (the equivalent of dividends) are not tax-deductible, but they can be used to repay an ESOP loan.

Deferring Taxation Using the Section 1042 "Rollover"

Providing for business continuity is one of the most difficult challenges for closely held companies. Even if buyers can be found, the terms of their offers may not be acceptable, either financially or personally. For example, a buyer may want to shut down the company or eliminate valued employees. As hard as it is to sell a business outright, it is even harder to sell it in stages, allowing for a gradual withdrawal by the owner; or partially, allowing heirs, key managers, or others to have a partial ownership interest.

An ESOP provides a way to accomplish these goals in a tax-advantaged manner and to manage the sale process more effectively. First, as described above, the ESOP allows the company to use pretax dollars to buy out the owners. This can be done under whatever schedule is practical. Second, the seller(s) can defer capital gains taxation on the sale proceeds.

Under section 1042 of the Internal Revenue Code (the "Code"), an owner of a closely held C corporation (but not an S corporation) can defer capital gains taxation on stock he or she sells to an ESOP if (1) the ESOP owns 30% or more of each class of outstanding stock or of the total value of all outstanding stock, excluding nonconvertible, nonvoting preferred stock; and (2) the seller reinvests ("rolls over") the sale proceeds into qualified replacement property (stocks or bonds of domestic operating companies) during the period from three months before to twelve months after the sale. As explained below, the price an ESOP pays in such transactions is based on a valuation by a qualified, independent appraiser.

The money "rolled over" into replacement property need not be the actual proceeds from the sale, but rather can be an equivalent amount of money from another source. Any or all of the proceeds can be rolled over; the seller(s) will simply pay taxes on the rest. Two or more owners may combine their sales to meet the 30% requirement if the sales are part of a single, integrated transaction. It has become increasingly common in section 1042 transactions for sellers to facilitate the sale by pledging part or all of their replacement property as collateral for the loan, especially in companies with limited assets or with substantial debt.

None of the shares sold to the ESOP in a transaction to which section 1042 applies may be allocated to ESOP accounts of the seller, certain relatives of the seller (ancestors, siblings, the spouse, or lineal descendants), non-selling shareholders holding more than 25% of company stock, or family members of the more-than-25% shareholders if they own stock by attribution (e.g., spouses). (This restriction does not apply to ESOP stock not purchased in the rollover transaction.) There is one exception: lineal descendants of the selling shareholder(s) may be allocated a total of 5% of the stock, provided that the lineal descendants are not treated as more-than-25% shareholders by attribution.

There are other requirements for the section 1042 rollover; for example, the selling shareholder(s) must have held the stock for at least three years before the sale and cannot have received the stock through exercising stock options or certain employee stock arrangements under section 83 of the Code. If the ESOP disposes of the shares within three years after the sale, the employer generally must pay a 10% excise tax on the proceeds from the disposition.

Sellers using the section 1042 rollover often avoid taxation completely by retaining the replacement property until death, at which time the property transfers to their heirs with a stepped-up basis.

S Corporation Benefits

Since January 1, 1998, S corporations have been able to have ESOPs as owners. These ESOPs do not qualify the seller for section 1042 treatment, do not allow for the deductibility of dividends, and must count interest payments on an ESOP loan toward contribution limits. Forfeitures of unvested shares count toward the limits on how much can be added annually to a participant's account (they do not in C corporation

ESOPs, provided that not more than one-third of the ESOP benefits go to highly compensated employees). On the other hand, the ESOP is not taxable on its share of corporate earnings.

Tax Treatment of ESOP Benefits

Employees pay no tax on stock allocated to their ESOP accounts until they receive distributions; at that point, they are taxed on the distributions. If they are younger than age 59 1/2 (or age 55 if they have terminated employment), they, like employees in qualified plans generally, are subject not only to applicable taxes but also to an additional 10% excise tax unless they roll the money over into an IRA or a successor plan in another company (or unless the participant terminated employment due to death or disability). Certain lump-sum distributions from an ESOP may be eligible for favorable income averaging and/or capital gains tax treatment.

If the money is rolled over into a traditional IRA or a successor plan, the employee pays no tax until the money is withdrawn, at which point it is taxed as ordinary income. Rollovers from ESOP distributions to IRAs are available for distributions of stock or cash over periods of less than 10 years. (Amounts rolled over into a Roth IRA are taxable, although the 10% early distribution excise tax mentioned above does not apply.)

When dividends are directly paid to plan participants on the stock allocated to their ESOP accounts, such dividends are fully taxable, although they are exempt from income tax withholding and are not subject to the excise tax that applies to early distributions.

Contribution Limits

Company Contribution Limits

In general, companies can deduct up to 25% of eligible pay to defined contribution plans (ESOPs, 401(k), profit sharing, money purchase, and stock bonus plans). This is a combined limit that aggregates contributions to all these plans. However, recent (2004 onward) private letter rulings from the IRS indicate that in a C corporation with a leveraged ESOP, there are separate 25% limits for (1) employer contributions to repay the principal on an ESOP loan and (2) employer contributions to other defined contribution plans or to a nonleveraged component of the ESOP itself (i.e., payments to the ESOP that are not used to pay either principal or interest on an ESOP loan). Thus, a C corporation with a leveraged ESOP has a total 50% contribution limit available to it.

Eligible pay is defined as the pay of all the participants in the plan up to $275,000 in 2018 dollars (this is indexed for inflation, rounded to $5,000 increments). Employee deferrals into 401(k) plans or cafeteria plans no longer reduce the eligible pay against which this 25% is computed. In C corporations, the interest on payments on an ESOP loan does not count towards the 25% limit; in S corporations, it does.

Limits on Annual Additions to Employee Accounts

The combination of employer contributions and employee deferrals into defined contribution plans (ESOPs, 401(k) plans, etc.) cannot exceed 100% of of any plan participant's eligible pay in any one year. This limit is constrained, however, by a second limit, which provided that not more than $55,000 can be added (as of 2018; this is indexed for inflation).

Special Rules for Leveraged ESOPs

Reasonable dividends paid on ESOP shares can be used to pay off an ESOP loan. In a C corporation, but not an S corporation, these dividends do not count toward the contribution limits. In S corporations, however, company distributions (which are not technically dividends and are not tax-deductible) do not count as contributions and are not covered by the 25% of pay limit. These S corporation distributions, when made to either allocated or unallocated shares, can be used to repay an ESOP loan without limit.

S Corporation Issues

Special rules for S corporations are incorporated in the text above, but can be simply reiterated here. The limit on tax-deductible employer contributions is 25% of pay, whether the ESOP is leveraged or not. Contributions to 401(k), profit sharing, money purchase, and stock bonus plans count towards this limit, as do interest payments on an ESOP loan. Distributions on shares in the ESOP, for whatever purpose they are used, do not count as contributions. Annual addition rules for plan participants are the same as in C corporations.

How Much Is Enough?

Employers often ask not "how much can we contribute," but "how much should we contribute to make plans meaningful to employees." The average corporate contribution to all retirement-oriented plans combined is only about 4% of pay (this does not count employee contributions). The average ESOP contribution, according to various surveys, is about 6%-10% of pay. More than 80% of all ESOP participants also are in another company-sponsored plan, often a 401(k) plan. How much is enough to make employees fell like owners, unfortunately, cannot be answered, but research does show the higher the contribution, the more employees feel like owners.

Whether calculating legal limits or practical guidelines, it is important to get qualified, ongoing advice. The penalties for violating the limits are both severe and, with planning, easily avoided.