ESOP

EXPLORING OPPORTUNITIES FOR BUSINESS OWNERS

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AGENDA

- Why is an ESOP good for American business?
- How are ESOPs used in Succession Planning and Ownership Transitions?
- What is an ESOP?
- Technical Considerations – Focus Areas
- Structure and Useful Strategies
- What are the Pros and Cons of ESOPs?
- Feasibility & Valuation Process
- Unique Recordkeeping for ESOPs as Qualified Retirement Plans
- Recognizing Opportunities
- Q&A – Real Situations

History and Current Bills in Congress

- Positive ESOP legislation is put to Congress every year since 1989.
- Today: 115th Congressional session (2017-2018)- Bipartisan Bill to support ESOP awareness.
  - S.1589 and H.R. 2092, known as ***Promotion and Expansion of Private Employee Ownership Act***.
  - July 19, 2017, Introduced by Senators Pat Roberts (R-KS) and Ben Cardin (D-MD) – It has 22 sponsors. (10 Republicans and 12 Democrats)
  - Seeks to amend TRA '86 and the Small Business Job Protection Act to expand availability of ESOPs in S-Corporations, extend the deferral of capital gains taxation to qualified sellers of S-Corp shares, protect the SPA certification of companies that establish ESOP, and extend technical assistance to support sales to ESOPs.
  - The main change, if passed, is the expansion of the tax-deferred/tax free provision of IRC Section 1042 to S-Corporations. Currently, the tax deferral for gains attributed to the sale of a company to an ESOP is only available for C-Corporation owners.

To review the background and text of the bills, go to:

https://www.congress.gov/bill/115th-congress/senate-bill/1589/text

Why is an ESOP good for American Business?

- Statistics* show: **Difference in Post-ESOP to Pre-ESOP Performance**

Annual sales growth +2.4%

Annual employment growth +2.3%

Annual growth in sales per employee +2.3%

More likely to stay in business than non-ESOP companies

More likely to offer more benefits than non-ESOP companies

(The relative growth numbers might seem small at first glance, but projected out over 10 years, an ESOP company with these differentials would be a third larger than its paired non-ESOP match.)

*2000 Study by Douglas Kruse and Joseph Blasi of Rutgers University

- Job Retention vs. Job Creation

Using an ESOP for Ownership Transition

- You are a Company Owner and need an Exit Strategy.
- You are a Company Owner who desires to share the benefits of growth & success with your employees and leave a positive LEGACY vs a third-party sale of your life's work.
- Private companies need a flexible market to buy out owners.
- Family needs liquidation for the distribution of inheritance in the case of an owner's death.
- Management needs a proven way to draw and retain talent.
- Your company is PROFITABLE and needs tax saving strategies.

What is an ESOP?

- Employee Benefit – 401(a) Retirement Plan – Follows same legal requirements as any other Defined Contribution Plan (401k P/S)

- Business Succession/Ownership Transition Plan for Company Owners and Estate Planning Tool

- Personal and/or Corporate Tax Strategy
  - Selling Shareholders in C-Corporations
  - C-Corps
  - S-Corps

An ESOP has 3 Main Characteristics…

1

It's an Ownership Transition Tool

- Fractional or total ownership
- ESOP Trust is a single shareholder
- Creates ownership-minded culture

2

It's an Employee Retirement Plan

- Qualified retirement plan, non-discriminatory, tax-deferred growth
- ESOP Trustee acts as plan fiduciary, represents interests of ESOP participants
- Invests "primarily" in "employer stock"
- Company must make market for ESOP distributions (put option)

3

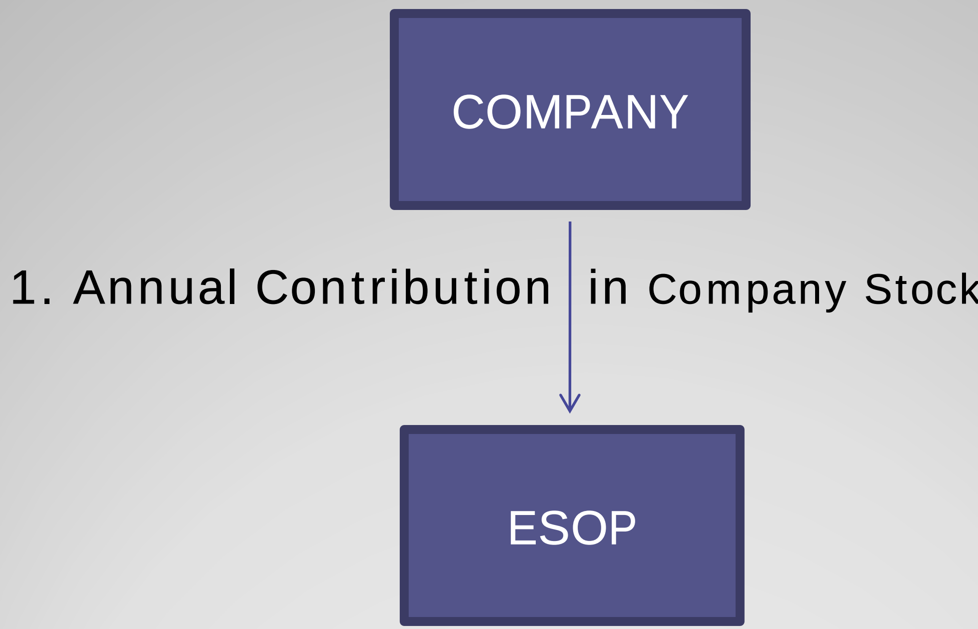
It's a Tax-efficient Leveraged Buyout Vehicle

- Tax deductibility of debt payments
- 100% S-Corp ESOP pays no taxes
- C-Corp capital gains deferral if certain conditions met

Technical Considerations – Things to KNOW ABOUT

- ✓ Making a Transition
- ✓ Appraisal
- ✓ Fiduciary Issues
- ✓ Leveraging / Sources of Capital
- ✓ Plan Design and Compliance Issues
- ✓ Developing an ESOP "Culture" – maximizing the benefits for everyone

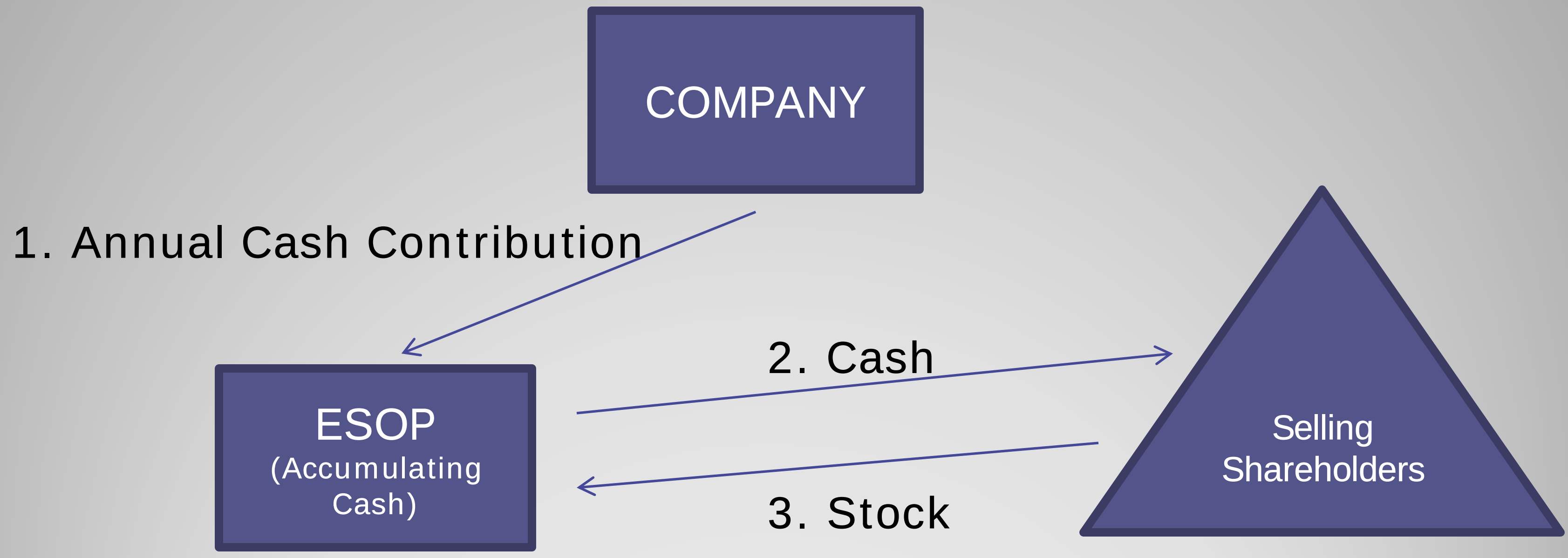
Cash Flow ESOP



Strategy: Increase CASH FLOW through TAX SAVINGS

1. Company issues new stock to ESOP (dilution considerations)
2. Company gets tax deductible contributions for FMV of the stock

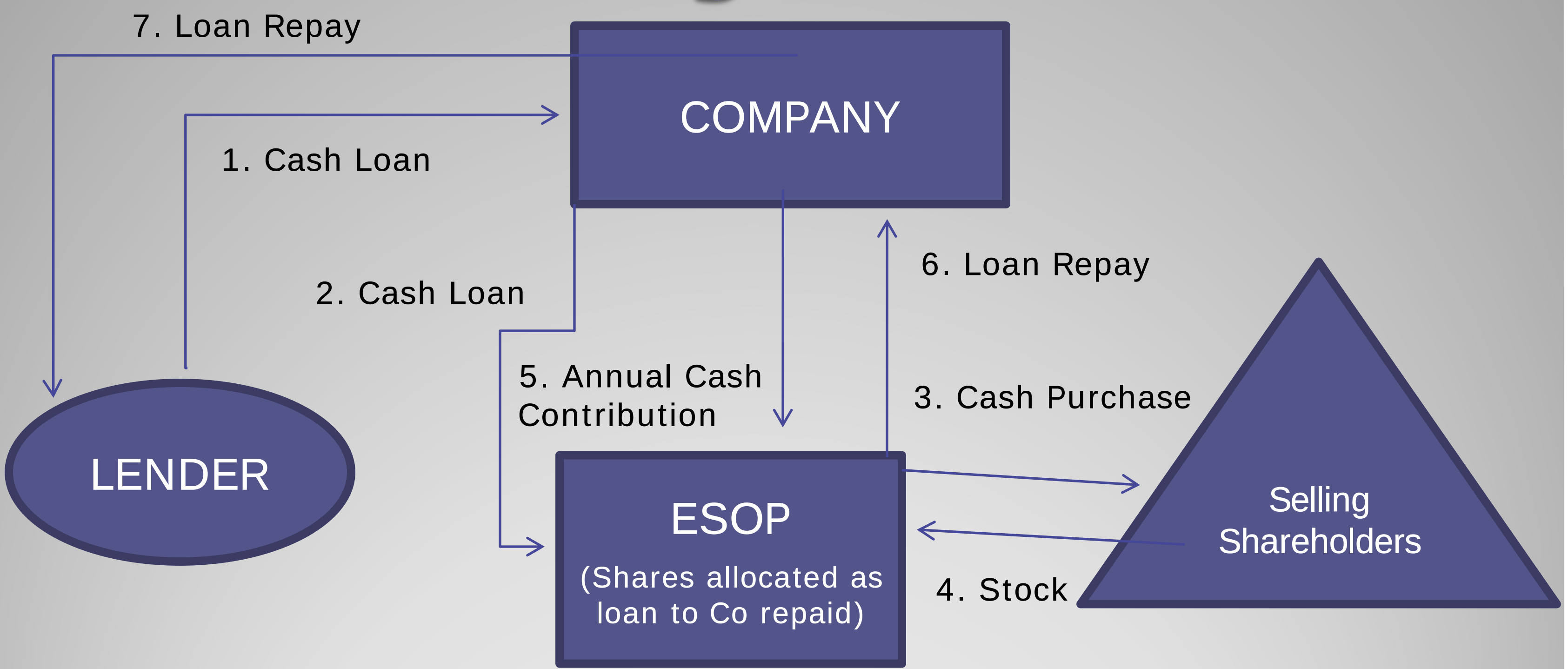
Step Transaction / Prefunding (Non-Leveraged ESOP)



Strategy: Step Buyout (gradual) or Diversification for shareholder(s)

1. Company issues tax deductible cash contribution to ESOP
2. ESOP accumulates enough cash to buy stock
3. ESOP buys stock from shareholder(s) at current FMV

Leveraged ESOP



Strategy: Faster Ownership Transition or IRC 1042 (C-Corps)

1. Lender loans cash to Company / 2. Company loans the cash to ESOP
3. ESOP buys stock from shareholder(s) at current FMV – pays cash to shareholder
4. Stock transferred to ESOP Suspense account – "Owner" = ESOP Trust
5. Company makes tax deductible ER Contribution TO ESOP (sufficient to pay P&I)
6. ESOP repays P&I ON COMPANY LOAN – shares allocated to participant accounts
7. Company repays LENDER (loan terms do NOT have to be the same)

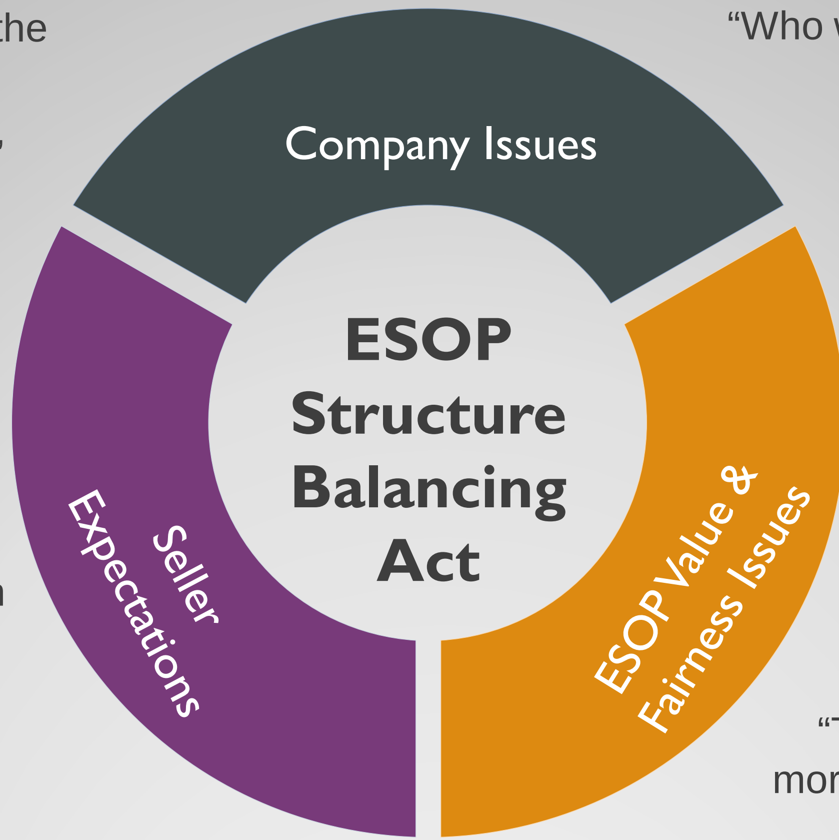
Success Begins with an ESOP Structure that "Works"

"The bank won't fund the whole deal"

"Unproductive debt"

"Who will run the company after the transaction"

"Board composition"



"The seller wants cash upfront"

"The seller wants top dollar"

"The Trustee will be concerned with dilution"

"The ESOP cannot pay more than fair market value"

Items to Consider When Structuring a Transaction

The financial advisor to the seller provides structural options tailored to a seller’s goals.

1 **Size of the Transaction** – Minority v. Control. May do partial sale as diversifying liquidity event.

2 **Financing** – Senior debt vs. mezzanine debt vs. seller debt.

3 **ESOP Features –** Size and length of ESOP (“internal”) loan, vesting requirements, amount of benefit to be delivered over time.

4 **Other Transaction Features –** Equity-based incentive plans for key employees and warrants to selling shareholders who provide financing.

5 **Tax Treatment -** S-Corporation v. C-Corporation, “1042 election”.

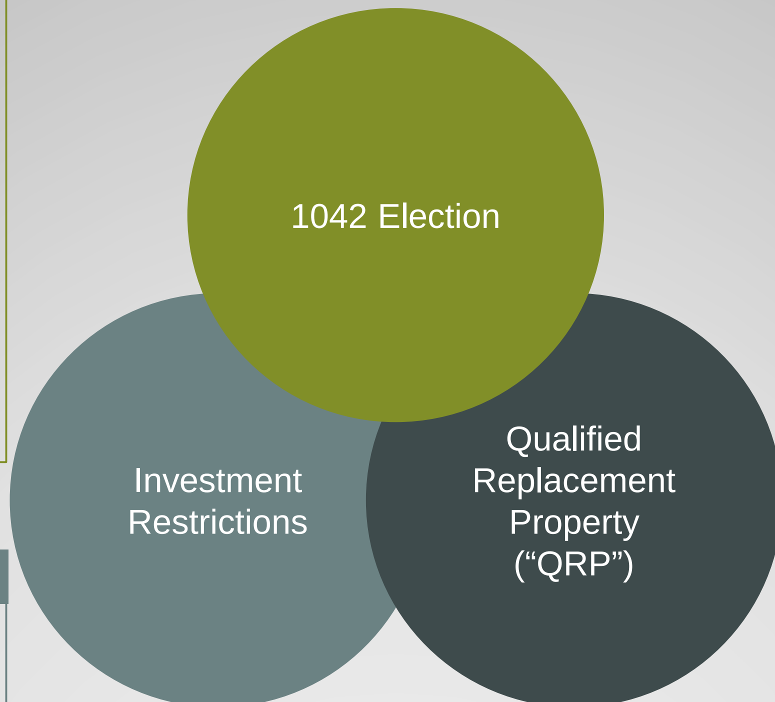
Benefits of C-Corporation ESOP Structure

Seller 1042 Election

- Capital gains tax deferral
- 30% or greater sold to ESOP
- Seller must own stock for at least 3 years
- Must be C-corp. at time of deal
- Seller (or any lineal descendants) cannot receive ESOP allocation of “1042 shares” if 1042 is elected
- Opportunity to create employee ownership culture

Investment Restrictions

- Proceeds received by seller have certain restrictions
- Seller has up to a year to invest proceeds in qualified replacement property after closing



QRP Characteristics

- Stock and bonds of domestic operating corporations
- Must be a security (i.e. equity or debt instrument)
- Must be US controlled corporation
- No passive income generating corporations (i.e. REITS, mutual funds)
- No government entity or partnership interests
- Tax basis of shares sold become tax basis of QRP
- Tax is deferred as long as QRP is held
- Seller can time triggering of capital gains
- Permanent tax deferral (upon death, portfolio moves to estate on a stepped-up basis)
- Cash dividends and interest earned on QRP are taxable

Benefits of S-Corporation ESOP Structure

S-Corporation Structure

Motivating Factors
▪ Sales proceeds taxed at lower capital gains rate
▪ No capital gains tax deferral to sellers
▪ No investment restrictions on sales proceeds
▪ Transaction debt (principal and interest) to fund ESOP purchase can be repaid with pre-tax earnings
▪ Sellers can participate in newly established ESOP
▪ **S-Corporation ESOP company does not pay income taxes to the extent of the ESOP's ownership percentage (ESOP trust is a tax exempt entity)**
▪ If ESOP owns less than 100%, its share of tax dividends can be used to pay loan, pay ESOP expense and retained to fund future repurchase liability
▪ ESOP counts as one shareholder
▪ Opportunity to create ownership culture

PROS

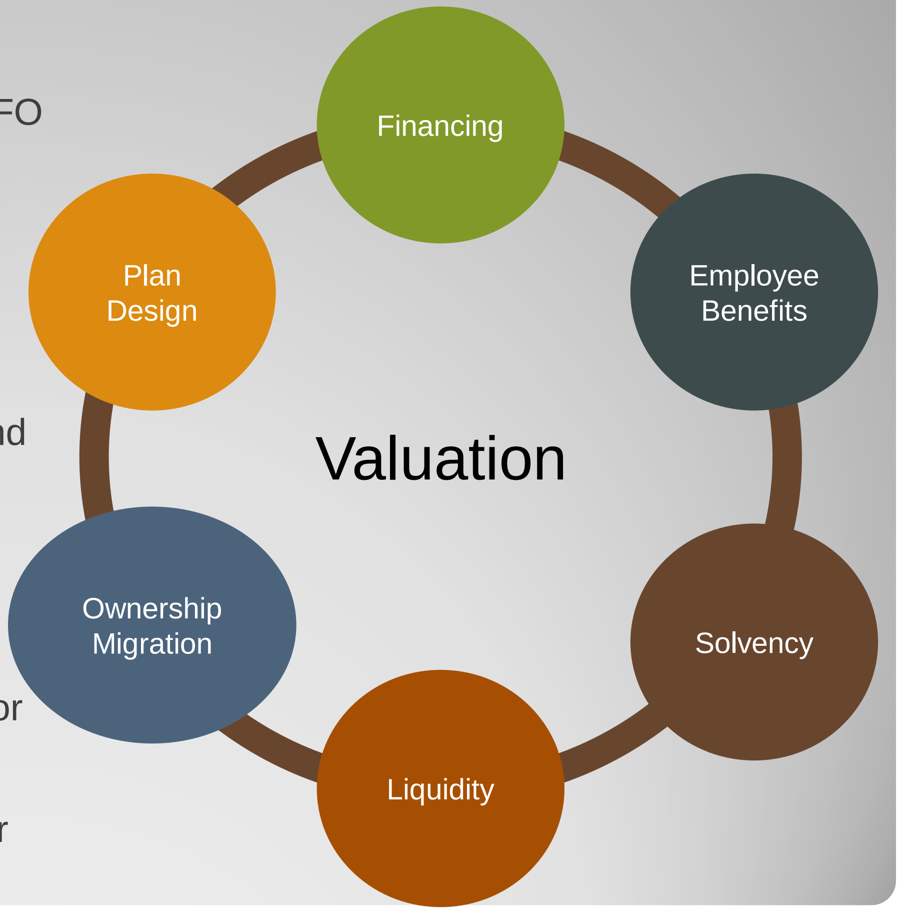
- FLEXIBILITY: Designed completely around Shareholder Timeframe. The ability to borrow capital allows transition to be gradual or immediate.
- Creates an on-going internal market in private companies for multiple ownership transitions.
- Rewards loyal employees with retirement incentives AND a stake in the growth of the company while preserving founder's legacy.
- Tax Advantages – Personal and Corporate:
  - Deferred Capital Gains Tax to Seller under IRC 1042 in C-Corporations.
  - Allows buyout with fully tax deductible dollars.
  - Increased Tax Deductions for C-corporations under IRC 404 if leveraged.
  - Deductible dividends paid on company stock in C-Corporations.
  - 100% Tax shield on ESOP ownership percentage in S-Corporation.
- Company owner may still maintain control of the company.
- Often less expensive than 3rd party sales.

CONS

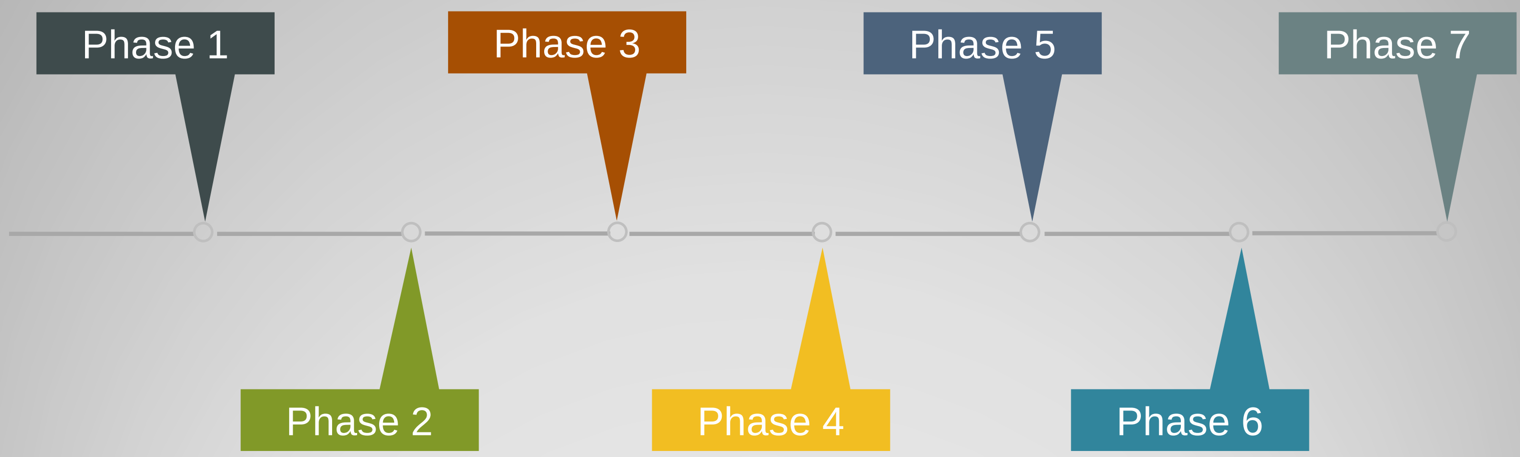
- Costs to small companies.
- S-Corporation Anti-Abuse Rules -IRC 409(p).
- Availability of Financing.
- Effect of Debt on Company Financial Statements.
- Valuation – Fiduciary responsibility of Trustee to see fair market value of the company stock.
- Liquidity and Repurchase Obligation.

What is a "Feasibility" Study?

- Begins once preliminary valuation is complete and shareholder(s) approve
- Can be prepared by Company accountants, CFO or financial advisor to Committee or Trustee
- Layering in transaction "effects"
- Does the proposed structure "work"?
- Tax Planning (S vs. C, BIG tax, tax issues to selling shareholders, structure of seller debt and warrants form a tax standpoint, etc.)
- Scenario testing and structural changes
- Determines ESOP stock allocations
- Presented to ESOP formation committee and/or ESOP Trustee
- Considers all retirement plans benefit levels for reasonability and sustainability



What Exactly Occurs During the Preliminary Valuation Process?



Phase 1
Engagement

Phase 2
Data Collection

Phase 3
Due Diligence

Phase 4
Build Valuation Models

Phase 5
Review Projections/ Comparables with Management

Phase 6
Prepare Reports/ Deliverables

Phase 7
Present Value Conclusions to ESOP Committee or Trustee

Internal Sale to Management vs. ESOP – Pros & Cons

Ownership Transition Alternatives

Pros

ESOP

- Tax-advantaged buyout (debt funded with pre-tax $s)
- Partial or total stock purchase
- Controllable transaction
- Structural flexibility
- Ability to continue leading and managing the business
- Employee-ownership culture
- Maintain legacy
- Transfer of wealth to employees

Management Buyout (MBO)

- Business continuity
- Maintain legacy
- Opportunity for management to achieve wealth

Cons

ESOP

- Purchase price not based on “strategic” pricing
- Normally only partial liquidity at close
- Annual administration costs
- Non-productive debt
- Regulatory compliance and oversight
- Need capable management team
- ESOP “repurchase obligation”

Management Buyout (MBO)

- No tax advantages to company or buyers
- Lack of equity capital by management team
- Negotiations can be adversarial/emotional
- Management motivations may change
- Need capable management team
- Non-productive debt

BASIC ACCOUNTING ENTRIES FOR LEVERAGED ESOP

- **ESOP Debt Recorded as a Liability**

Regardless of whether the sponsoring company has guaranteed an ESOP's debt, the debt must be recorded as a liability in the company's financial statements.

- **Released Shares Recorded as Compensation Expense**

The fair value of shares released to individual employees is generally charged to compensation expense. The interest accrued on the note payable is treated as interest expense.

- **Treatment of Dividends**

Dividends on unallocated shares used for ESOP debt service will reduce the ESOP debt or accrued interest. Dividends on unallocated shares paid to participants, on the other hand, are treated as compensation expense. Dividends on allocated shares should be charged to retained earnings.

BASIC ESOP RECORDKEEPING

- ESOPs have special Limitations on
  - Deductible contributions
    - C-Corp
    - S-Corp
  - Allocations and Benefits

    Maximum Addition Limits
    – Market Value or Employer Contribution
    – C-Corp 1/3 testing
  - 1042 – Prohibited Allocations
  - S-Corp Anti-Abuse Testing (409(p))
  - Compliance Testing for Multiple Plans

MAXIMUM DEDUCTIBLE CONTRIBUTION COMPANY LIMITS

- Code Section 404(a)(3)
  - 25% of eligible compensation
    (limited to $270,000 for 2017)

  - **Includes:** All Employer Contributions to DC plans

  - Examples:
    - ESOP Cash Contribution
    - ESOP Stock Contribution at fair market value
    - 401(k) Safe Harbor Contributions
    - 401(m) Employer Discretionary Match
    - 401(k) Employer Discretionary Profit Sharing Contribution

  - **Does NOT include:** Employee deferrals or S-Distribution Earnings

MAXIMUM DEDUCTIBLE CONTRIBUTION COMPANY LIMITS

Additional ESOP limits (for C-Corps only)

- **Code Section 404(a)(9)**
  - Principal used to repay ESOP loan – limited to 25% of eligible compensation
  - Interest used to repay ESOP loan
- **Code Section 404(k)**
  - Dividends paid on Employer Securities (subject to conditions)

CONTRIBUTION
COLLATERAL SHARE RELEASE

- Principal-only Method

  Current Principal Payment X Shares in Suspense
  Current + Future Principal Payments

- Principal-and-Interest Method

  Current P&I Payments X Shares in Suspense
  Current + Future P&I Payment

- $150,000 / $1,500,000 * 60,000 = 6,000 shares released

- Participant would receive 60 shares based on $40,000 wages (1% of release)

IT TAKES A VILLAGE: ESOP TEAM MEMBERS

- Company – Plan Sponsor
- Financial Advisor/Planner
- Company Accountant
- ERISA attorney
- Plan Trustee
- Valuation Firm
- Plan Auditor
- Plan recordkeeper (TPA)

Deal Team

Transaction Roles & Responsibilities

Corporate Team

- Manage transaction process
- Produce requested information
- Provide access to key company personnel
- Raise external financing
- Structure transaction
- Make initial offer to ESOP
- Produce legal documentation
- Continue to operate business

ESOP Team

- Due diligence
- Conduct initial valuation
- Conduct (or review) feasibility analysis
- Review / negotiate offer and deal terms
- Review legal documentation
- Fairness opinion
- Post-deal implementation / communication
- Annual ESOP valuation

Recognizing ESOP Opportunities

1. ESOP can only be used in C & S-Corporations. Company must have enough employees to pass IRC 409(p) Test.

2. Profitable companies that might need tax saving strategies.

2. Private companies that need a flexible market to buy out owners.

3. Business Owners who need an Exit Strategy or a flexible transitioning of ownership among family members or employees.

4. Company needs a Management Succession Plan – use ESOP as a funding vehicle to transition ownership.

5. Owner desires to share benefits of growth & success with employees and leave a legacy.

ESOP

EXPLORING OPPORTUNITIES FOR BUSINESS OWNERS

Conclusion

In summary, although there are some concerns that must be addressed, when an ESOP is a good fit for a company, the benefits typically far outweigh the costs. Over time, the return on the ESOP as an investment of the company can be celebrated as a WIN-WIN-WIN for all.

Q & A

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