



The ESOP Decision

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In many respects the decision to implement the ESOP may be the most important decision ever made by the business owner next to the founding of the business itself. ESOPs can be, and often are, implemented on a limited basis where a minority block of stock will be sold to the ESOP, and the selling shareholders will remain active and continue to run the business. However, many other ESOP transactions involve the sale of a large block of stock and the immediate or eventual retirement of one or more shareholders from active involvement in the business. It is in this latter set of circumstances that the ESOP decision, always an important one, becomes so critical. In making this decision, the impact of the ESOP on (1) the selling shareholder, (2) the company, (3) other existing shareholders and (4) the employees must all be considered. This is why most thoughtful ESOP decisions eventually require a feasibility study to focus on the many questions and constituencies that need to be addressed. However, some initial consideration, or screening, can occur prior to focusing on the feasibility study.

A Candidate's Checklist

The ideal ESOP candidate is a mid-sized or larger C or S corporation with stock available for purchase, which pays or will pay corporate taxes, and expects to have long-term discretionary profits.

The following checklist should quickly give you a better idea of whether your company is a good candidate for an ESOP.

The Corporation

A business must be a C or S corporation, or be willing to become one, to have an ESOP. Partnerships or sole proprietorships cannot have ESOPs (they don't have stock), and the rules will vary from state to state as to what level of employee ownership, if any, is allowed in a professional corporation. S corporation stock can be owned by ESOP beginning in 1998. An S corporation ESOP will not be subject to federal income tax on its share of the net income of the S corporation.

"Mid-sized" or larger

A company with an annual payroll of less than \$500,000 is likely to find that the costs of establishing and operating an ESOP outweigh at least its short-term benefits. Again, there may be exceptions, but not many. Ideally the annual payroll will exceed \$1 million. This is especially important in those cases when the compensation of selling shareholders is excluded from covered payroll.

Profitable

A company does not have to show a profit every year for an ESOP to work. In fact, some of the most successful ESOPs have been created in companies undergoing periods of losses. However, a company must be profitable over the long run for an ESOP to produce meaningful results.

"Profitable" can, of course, mean different things to different people. A privately-held company may show very little net taxable profit because bonuses and other benefits were paid out to employees and shareholders to minimize taxes. When we say "profitable", we mean a company must have discretionary profits, over the long run. Then, everyone involved may find it to their advantage to have moneys formerly paid out in various forms of compensation (and taxed as ordinary income) contributed instead to an ESOP.

Contributions to the accounts of employee participants in the ESOP are not currently taxable, and employees' eventual withdrawals from the plan may be eligible for substantial tax benefits. Shareholders of a closely-held company selling stock to the ESOP may avoid paying taxes at the current capital gains tax rates. The proceeds from the sale to the ESOP will be "tax-free" (IRC 1042) provided that the sellers meet certain eligibility requirements and if they use the proceeds to acquire qualified replacement securities (the 1st ESOP "tax shield") which typically are the stocks or bonds of publicly traded U.S. corporations. If the replacement portfolio is held until death, the estate of the stockholder receives a "stepped up" basis and capital gains taxes are totally avoided. (The "tax-free" sale provisions of IRC 1042 are not available to S corporation ESOPs.)

A hefty taxpayer

This is certainly not a legal requirement. However, if for some reason a company is in a low corporate tax bracket, it will not be able to take full and immediate advantage of the fact that all contributions to the ESOP are tax deductible, (the 2nd ESOP "tax shield"). Similarly, if a corporation has tax credits to carry forward from prior bad years, then the ESOP's advantage of using tax deductible dollars to accomplish various objectives is lost for as long as those credits shelter substantial amounts of corporate income.

If the company is either in a high tax bracket or is lowering its tax bracket by transferring income to individuals who are themselves in high personal income tax brackets, then this is a strong reason to install an ESOP.

Available Stock

An ESOP exists to acquire the stock of the sponsoring company. Either existing shareholders or the company must want to convey stock to the ESOP. While in many cases large blocks of stock are available for sale immediately, the ESOP can be a gradual buyer, beginning with very modest purchases of stock. Cash can also be "warehoused" in the ESOP for several years in anticipation of the purchase of a block of stock.

Concern for Employees

In addition to being a mid-sized or larger C corporation with stock available for purchase, which pays or will pay corporate taxes, and expects to have long-term discretionary profits, a company must have concern for its employees, who are to acquire some or all of the equity of the corporation. Selling shareholders and the company are certainly justified in trying to maximize the tax benefits available to them through an ESOP. These tax benefits are so substantial, that everyone involved -- the employees, the existing owners, the company, and the country -- can win with a properly designed and administered ESOP. If management implements an ESOP in a miserly spirit, grudgingly giving rights and benefits to the employees only as the law requires, the ESOP might work, but not nearly to its full potential. Employees usually recognize when they've been patronized; a cynical work force cannot be expected to provide superior performance. One of the reasons that ESOPs have worked so well is that management, in most ESOP companies, has demonstrated sincere concern for the benefit of all employees.

Other Desirable Factors

ESOPs provide shareholder and/or corporate liquidity to assist individual stockholders in estate planning. A stock purchase contract with the corporation, which can be executed by the ESOP, can also insure that the estate will have a market for its stock, providing liquidity with corporate tax deductible dollars. Life insurance can be used to provide the necessary funds if corporate contributions or loan proceeds are deemed insufficient.

ESOPs can make acquisitions and divestitures easier. A company can make acquisitions with tax deductible dollars, or readily divest a division or subsidiary to an ESOP, sometimes with local management or outside investors as buying partners.

Companies defending against unfriendly takeovers have used ESOPs, although this use of an ESOP is controversial and subject to ever-changing rules and regulations. After a hostile takeover bid is launched, it may be too late to use an ESOP as part of a defense. However, when implemented prior to the beginning of a takeover attempt, the ESOP can be an extremely effective tool to defend against takeovers.

Owners can make gifts to charity in conjunction with an ESOP. The donor receives substantial income and estate tax benefits, the charity receives cash, and the employees of the donor's company receive stock allocated to their ESOP accounts, purchased with tax deductible corporate dollars. For owners of privately-held companies this is without question the most tax-effective method of making a charitable contribution.

ESOPs can enable the corporation to recapture prior years corporate income tax. A company can make contributions of stock to the ESOP even in years when it makes no profits. The corporation then may recapture taxes paid in the last three years by utilizing the net loss carry back rules. Although issuing new stock to the ESOP dilutes the holdings of existing shareholders, the business receives a cash infusion at a crucial time.

Once the candidate's checklist has been completed, and an ESOP appears preliminarily to be a viable option, the next step that is undertaken is typically a feasibility study.

The basic components of the feasibility study are normally the (1) preliminary appraisal, (2) design study, (3) financial analysis, and (4) repurchase liability study.

1. Preliminary Appraisal

Appraise the company's fair market value and develop valuation standards and criteria.

Whether individual stockholders or the company are selling stock to the ESOP, no one will sell unless he feels the price is fair and reasonable.

Yet the ESOP can pay no more than fair market value for stock as determined by an independent appraisal. It seems only logical then that for a privately-held company, or a public company without a generally recognized market, the place to begin is with a preliminary appraisal. Unless and until shareholders agree that the per share value or range of values determined by the appraiser is reasonable, there is normally no reason to proceed with the ESOP. Of course, if the company is actively publicly traded, this appraisal step can be omitted.

It's important to examine what are the appropriate tests to determine whether an appraisal firm is "independent", since the appraisal used for the purposes of the ESOP transaction must be performed by an independent appraiser. Unfortunately, the 1986 Tax Reform Act which established this requirement, gives little guidance. While it is clear that the person or firm performing the appraisal should be in the business of performing appraisals on a regular basis, it is not clear what establishes "independence". A reasonable approach would be to require that the individual or firm performing the appraisal service have no other consulting relationship or perform no other consulting service for the company or selling shareholders. It is possible that the IRS will issue regulations which prohibit any other relationship. Should such regulations be issued and had an appraisal been performed by a person or firm deemed not to be independent, it would jeopardize both the qualification of the ESOP itself and any "tax-free" treatment that may have been elected by selling shareholders. Therefore, until such clarifying regulations are issued it seems difficult to justify taking this risk, however slight, since there are a number of appraisal firms experienced in the ESOP appraisal area and thus create no potential conflict.

2. Design Study

Along with the substantial incentives offered to selling shareholders there are also a number of restrictions which are oftentimes overlooked in assessing the desirability of implementing an ESOP. Chief among these restrictions are the exclusion of certain shareholders from receiving ESOP allocations under certain conditions, and the ability of a corporation to contribute 25% of covered payroll plus interest to repay ESOP debt when certain allocation tests are met.

Allocation Restrictions

If one or more selling shareholders elects the so-called "tax-free rollover", then certain people are limited or prohibited from receiving ESOP allocations until the block of stock which generated the special tax treatment has been fully allocated. The "restricted" list includes electing and 25% shareholders, and immediate family members. While a special rule does allow for lineal descendants to receive allocations up to a maximum of 5% of the total annual allocation, it is overridden by the 25% shareholder rule, due to attribution rules, thus totally prohibiting most family members from receiving an ESOP allocation. To further complicate matters, all stock in a shareholder's ESOP account must be considered when applying the 25% test, as well as stock owned within a certain period prior to a stock sale to the ESOP. Thus a shareholder who might otherwise own less than 25% of a company's shares could also be prohibited from participating in the ESOP.

The good news is that a company can "make up" the benefits that excluded employees would otherwise have accumulated in the ESOP by the establishment of a non-qualified deferred compensation plan, since a non-qualified plan can be selectively applied to key employees. Essentially, the company promises to pay the key employee a certain sum of money at a fixed date in the future and can deduct all of the payments when made to the employee. [The company may or may not choose to fund the deferred compensation plan.] While the assets of a deferred compensation plan can not be as well protected as an ESOP's assets, it can be argued that in the event of bankruptcy the stock in the ESOP would have little real value, as would a deferred compensation agreement.

Unlimited Interest Deduction

The ESOP provisions allow that C-corporations may contribute up to 25% of covered payroll plus interest to repay an ESOP loan provided that no more than 1/3 of each year's ESOP allocation go to the "highly compensated" employee group. Interest is not excluded from the 25% limit in S-corporations, but S Distributions are excluded. This can be a critical factor in determining the feasibility of an ESOP to repay an existing debt and should be carefully reviewed.

Additional Consideration

Other major issues that should be addressed in a design study include vesting, past service credit for vesting, policies for delaying distributions for up to five years for employees who either quit or are terminated, as well as the possible combination of other qualified plans, such as the 401(k) plan, with the ESOP.

Combining a 401(k) plan and the ESOP should be considered in any situation where the company has or anticipates adopting a 401(k) plan, assuming of course that there is a need for an ESOP. The combination plan can allow the corporation to make a "no cost" match of company stock in the 401(k) plan, perhaps provide a larger matching contribution which will in turn encourage more participation, at the same time allow the employees to "earn" additional equity through 401(k) contributions. However, contribution and allocation limits may make the addition of a 401(k) impractical, since all employee and company contributions must be taken into account. In most cases, a maximum of 25% of covered payroll can be contributed by the corporation to all defined contribution plans. To further complicate the matter, the employee contributions to the 401(k) reduce covered payroll. Thus, while 401(k)-ESOPs aren't for everyone, when they work they work very well.

3. Financial Analysis

This part of the study will address several of the critical questions usually asked by major shareholders when considering an ESOP. Typically, major shareholders want to know how the ESOP will affect the value of their stock, how it will affect the company's cash flow and profitability, and what dilutive effects the ESOP will have. When the company has an existing profit sharing plan, the analysis will also show the effects of the ESOP compared to those of the profit sharing plan.

This study uses the company's own projections, and a number of "what ifs" and pro formas, to project a clear picture of the effect of different contribution levels and mixes. Both a summary and individual schedules are typically provided. Contribution mixes occur because an ESOP can purchase stock from the company and from the existing shareholders. The Plan can also have a portion of its assets in investments other than company stock, (normally less than 50%) which are assumed to be cash.

The stock values projected in this study will become the basis for the buy-back obligations projected by a repurchase liability study. These stock values should also be used to project buy-back obligations under buy-sell agreements. Once the ESOP is installed, buy-sell agreements are usually re-written to recognize the ESOP price as the base price for any other transactions (with discounts or premiums possibly applied to the base price for individual transactions outside of the ESOP).

4. Repurchase Obligation Study

The purpose of the repurchase Obligation study is to predict the repurchase obligations that the company will incur over a period, often to fifteen years, because of ESOP distributions to participants and their beneficiaries due to death, disability, retirement and termination of service. There is no legal requirement to provide funding for this "emerging liability" of the ESOP. However, ignoring this need would be foolish and irresponsible.

Employees are anticipating that their stock will be converted to cash when they retire, become disabled, or leave the company. Upon reaching age 55, participants with 10 years of service have the right to diversify 25% (50% at age 60) of their ESOP accounts attributable to ESOP stock. Failing to fund the emerging repurchase obligations arising from employees' rightful expectations is much like installing a defined benefit pension plan, guaranteeing the benefit, and then failing to make current contributions. The latter is no longer legal, because some companies with defined benefit plans practiced such abuses, which resulted in the passage of ERISA. Recent laws place still more restrictions on defined benefit plans and as a result administration and insurance, defined benefit plans are becoming more and more costly.

The same fate need not befall the ESOP. If companies that install ESOPs make proper contributions for funding the emerging obligation, the ESOP can retain its current funding flexibility. Of more immediate interest to most companies is that an effective ESOP funding program may increase the value of the company's stock, and enhance the motivational effectiveness of the ESOP. The individuals responsible for the plan can point out to appraisers and employees that they have attempted to identify and plan intelligently for the emerging obligation of the ESOP.

The repurchase obligations determined by a repurchase obligation study can also solve possible "excess earnings" problems. When accumulated earnings are identified as needed for the redemption of stock for ESOP distributions, these accumulations are justified and should not incur penalty taxes. A few companies have been motivated to install ESOPs out of concern about their accumulated earnings, that of "guaranteeing" that participants in the ESOP receive the benefits the company and the ESOP have promised them. The IRS has never successfully argued that accumulated earnings were not properly set aside for ESOP redemptions, to the extent that these earnings were justified by a comprehensive repurchase obligation study.

The repurchase obligation study does not answer the question, "How do we provide the money for the redemption of ESOP stock?" It quantifies the question of "How much cash is needed and when?" so that a funding program can be implemented to insure that needed cash will be available. While the appropriate funding vehicle for each company can differ greatly due to many variables, a tax sheltered sinking fund can be very effective.

Implementation

Making the ESOP decision requires a clear understanding of the objectives that the company and shareholders desire to accomplish, how the ESOP can assist them in accomplishing these, and the ramifications of ESOP implementation to the company, shareholders, and participating employees. The objective of the feasibility study is to provide a **decision package** that will allow

all of the pros and cons of an ESOP to be weighed prior to making a decision to implement the plan.

A key part of making the ESOP decision is selecting the implementation team. The watchword should be experience. Experience is essential in drafting ESOP legal documents, in doing ESOP-related appraisal, communications, feasibility studies, repurchase liability funding, coordinating qualified or non-qualified plans with ESOPs, etc. Three excellent sources of ESOP information, including a listing of ESOP practitioners, are:

The National Center for Employee Ownership (NCEO),
1736 Franklin Street, 8th Floor,
Oakland, CA 94612
Telephone: (510)208-1300
e-mail: nceo@nceo.org
web: www.nceo.org.

The ESOP Association
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e-mail: esop@the-esop-emplowner.org
web: www.esopassociation.org

Foundation for Enterprise Development
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If you're considering retaining an individual to do ESOP work, inquire if they belong to the NCEO and The ESOP Association.

Some Conclusions

There are many good companies which might derive great benefits from an ESOP. Many hundreds of thousands of corporations probably meet all of the ESOP eligibility criteria just listed, but don't have an ESOP because they don't understand the ESOP concept.

Companies that have established ESOPs generally have owners, managers, or professional advisers, who made an effort to understand the ESOP, were open-minded on the subject and were willing to learn. Often they knew of companies in their community or industry that were pleased with the results of an ESOP they had established. Finally, they looked for and found experienced advisers who helped explain and design their ESOP, and whom they trusted to properly implement the ESOP.

One early ESOP pioneer, and Past-Chairman of The ESOP Association is Warren Braun. Braun rejected the advice of all of his professional advisers when they initially opposed an ESOP in his company, ComSonics, in 1976. He listened carefully to all the reasons not to go forward, then decided to do so. "Gentlemen", he announced, "we will have an ESOP."

Professional advisers today are unlikely to oppose ESOPs as a matter of course, now that ESOPs have a track record, and a very good one. However, they still often don't introduce their clients to ESOPs, but instead respond to clients' requests for information or advice regarding ESOPs. There seem to be two common reasons why professional advisers are reluctant to introduce their clients to ESOPs and make recommendations. First, advisers often lack a full understanding of how ESOPs work, and have little experience with them. It takes years to learn how employee ownership really works and to give knowledgeable advice. Second, they may fear that their clients suffer from misconceptions about ESOPs, as many business executives still do. This need not be the case.

Making the ESOP decision requires thorough analysis, hard work, the expenditure of some corporate funds, and a clear understanding of the objectives that the ESOP is to accomplish. Over 10,000 companies in the United States have made that decision.

For more information please visit us at www.esopservices.com