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Financial Planning

Using ESOPs for Business and Retirement Planning

A powerful and flexible tool that helps a retiring shareholder sell his interest on terms favorable to him and the corporation

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One afternoon, your client, Fred Smith, calls for advice regarding a personal business exit strategy. Fred, now 60 years old, has spent the last 30 years building Fred Smith Industries, Inc., into a very successful business. Fred is the sole owner and has about 30 employees, approximately $2 million of tangible assets and annual net earnings — before payment of Fred's annual compensation of $300,000 — of $750,000.

FSI manufactures and sells a highly specialized product that is only available from a handful of other competing firms in the country. Since these companies are bitter competitors, Fred is unwilling to approach them to buy his business. However, FSI's executive vice president Joe Miller, age 40, who has been with FSI for 15 years, confided to Fred that he would be interested in taking over the business when Fred retires.

Fred has confidence in Joe, but does not think he is ready to take over FSI by himself, nor is Joe in a financial position to pay the price that Fred believes FSI is worth.

You mull over the situation for a few minutes and suddenly a possible solution comes to mind — an employee stock ownership plan. Now all you have to do is find a way to sort out the alphabet soup so Fred and Joe can understand the benefits of an ESOP and how it can meet their goals.

ESOP Basics

An ESOP is a stock bonus plan that is a qualified retirement plan under the Internal Revenue Code and is designed to invest primarily in qualifying employer securities. See section 4975(e)(7).

A "stock bonus plan" is essentially a type of profit-sharing plan in which distributions are intended to be paid in the form of employer stock. In addition, the definition of an ESOP includes a combination of a stock bonus and a money purchase plan, which was relevant under prior law to increase the deductible contribution limit from 15 percent to 25 percent; however, now that the deduction limit for profit-sharing and stock bonus plans has also been increased to 25 percent, this is no longer significant.

As a "qualified plan," similar to other types of qualified profit-sharing or pension plans, an ESOP enjoys the three principal benefits of tax qualification under the Internal Revenue Code: contributions to the plan are currently deductible by the employer when made; allocations to the participants' accounts are not taxed until actually distributed; and the assets held in trust appreciate on a tax-deferred basis.

Given these special features, payments made by a corporation to fund an ESOP's stock purchase generally will be tax deductible. In addition, an ESOP is eligible for special enhanced contribution and deduction limitations that are unavailable to other types of qualified plans. Finally, if properly structured, the ESOP purchase of Fred's shares will be exempt from certain rules that otherwise would prohibit the transaction.

As a result, an ESOP is a valuable tool not only for providing retirement benefits (to an owner and employees), but also for business and succession planning for the employer and its principals.

• *Qualifying employer securities defined*.

As noted, an ESOP must be designed to invest primarily in "qualifying employer securities." There are different statutory definitions of qualifying employer securities under Section 407(d)(5) of the Employee Retirement Income Security Act and sections 4975(e)(8) and 409(l) of the code. However, for purposes of this discussion we will focus on the more restrictive code definition, because the transaction must comply with that definition in order for the ESOP to qualify for the special tax advantages and transactional benefits described.

If the employer's stock is publicly traded, then employer securities are common stock issued by the employer (or an affiliated company which is a member of the same controlled group) that is readily tradable on an established securities market. However, where there is no readily

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tradable common stock, i.e., no publicly traded stock, then the employer securities required for ESOP purposes is that class of common stock "having a combination of voting power and dividend rights" which is at least equal to the class of common stock of the employer having the greatest voting power and dividend rights.

In certain limited circumstances, noncallable preferred stock can qualify as an employer security, which may be held by the ESOP if the stock is convertible into common stock, which meets the foregoing requirements. See section 409(l)(3).

• *Investment primarily in employer securities.*

The requirement to invest "primarily" in qualifying employer securities has not been defined by the statutes or regulations, but it is generally understood, based on an early Advisory Opinion issued by the U.S. Department of Labor, that in order to satisfy this requirement, at least a simple majority of the ESOP's assets must consist of qualifying employer securities at all times.

Although ERISA section 404(a)(2) states that the diversification and prudence standards will not be violated by the holding of qualifying employer securities, the DOL (which has regulatory authority over ERISA's fiduciary provisions) has taken the position in litigation that under certain circumstances, the holding of employer securities, or at least too large a portion of plan assets in employer securities, could be imprudent and a breach of fiduciary duty, even for an ESOP, depending on the company's financial condition, the valuation of the stock and similar factors.

Recently, the DOL argued this position in its amicus curiae brief filed in the Enron ERISA litigation on the long-standing premise that ERISA's prudence rules apply to the acquisition, holding and sale of employer securities. See Amended Brief of the Secretary of Labor Opposing the Motions to Dismiss, Aug. 30, 2002, *Tittle et al. v. Enron Corp. et al.*, Civil Action 14-01-3913 and Consolidated Cases (S.D. Tex).

• *Other requirements.*

As a qualified plan, an ESOP must satisfy most of the same rules that apply to profit-sharing plans, such as the minimum coverage and vesting requirements, nondiscrimination in contributions and benefits, compliance with the top-heavy plan rules, etc.

A detailed discussion of these general qualification rules is beyond the scope of this article, although it is worth noting that an ESOP generally may not be aggregated with other plans of the employer for purposes of demonstrating compliance with the coverage and nondiscrimination rules — although an existing plan can be converted to an ESOP. However, there are also several additional requirements applicable only to ESOPs:

• *Stock distributions.*

Participants can demand a distribution from the ESOP in the form of employer securities instead of cash and, in the case of securities that are not readily tradable, may require the employer to repurchase them. An ESOP is usually designed to allow distribution to occur at retirement age, disability or termination of employment.

However, if the corporate charter or bylaws restrict stock ownership to employees or to a qualified retirement plan — even if the restriction is only implemented when the ESOP is adopted — or if the employer is an S corporation, the ESOP may distribute benefits only in cash. See section 409(h).

This may be particularly important for S corporations, so that the S election is not defeated by the corporation exceeding the number of permitted shareholders. Note that distributions, whether in stock or cash, create a "repurchase liability," which creates some additional planning opportunities. If shares are distributed and the corporation buys them, it will not be able to deduct such an expense. If instead, the ESOP repurchases the shares, the repurchase will be funded with a (deductible) contribution.

On the other hand, if the ESOP repurchases the shares, these shares will be reallocated within the ESOP, with the effect that they will be repeatedly repurchased. Part of a study of the economic feasibility of an ESOP is an analysis of projected repurchase liability.

• *Pass-through voting.*

An ESOP established by an employer with registered securities must include a provision allowing participants to vote their ESOP shares.

If the employer securities are not registered, then the ESOP must provide pass-through voting to participants only on certain significant corporate matters which require shareholder approval, such as a corporate merger, liquidation or sale of substantially all of the corporation's assets. See section 409(e). Most important, the right to elect directors is not required to be passed-through.

• *Diversification.*

Participants who have reached age 55 and completed 10 years of participation must be given the right to elect, over a six-year period, to diversify a portion of their ESOP accounts in up to three investment options other than employer securities. This allows participants nearing retirement age to create a diversified, and potentially less risky, portfolio.

This can be accomplished by adding other investments to the ESOP (such as a money market account and mutual funds) or by distributing assets to the participant. See section 401(a)(28)(B). The requirement may also be satisfied by allowing a participant to transfer the amount eligible for diversification to another plan maintained by his employer, which allows investment direction.

• *S Corporation ESOPs.*

An S corporation can sponsor an ESOP, effectively reducing (or eliminating) the shareholders' current pass-through income tax liability (the liability is shifted to participants and deferred).

However, there are additional rules applicable to S corporation ESOPs that limit the allocation of stock to the accounts of certain "disqualified persons." See section 409(p). Also, as noted below, certain special ESOP benefits are not available for an ESOP sponsored by an S corporation.

Valuable Tool

An ESOP has special characteristics under the code and ERISA that distinguish it from other qualified plans, making it a uniquely valuable tool to use when structuring a redemption or buy-out of corporate stock in a tax-advantaged manner.

• *Deferral of gain recognition.*

An individual who sells stock in a C corporation to an ESOP may be able to defer recognizing gain on the sale under section 1042 if he invests the proceeds from the sale of the stock in "qualified replacement property" — generally securities of a domestic corporation other than the employer that is engaged in the active conduct of a trade or business — within the 15-month period ending one year after the securities are sold to the ESOP, provided certain other conditions are satisfied, as discussed below.

• *Exemption from prohibited transaction rules.*

Generally, the fiduciary of a qualified plan is not permitted to cause the plan to buy or sell assets or engage in a loan transaction with a "disqualified person." Both the employer that maintains the plan and a majority shareholder of the employer are disqualified persons.

However, special statutory exemptions allow an ESOP to engage in such transactions, in particular a loan transaction, provided it is "primarily for the benefit" of plan participants, is made at a "reasonable rate of interest" and satisfies the collateral restrictions mentioned below. See sections 4975(d)(3) and (13). This also allows a company to obtain a bank loan and then lend the proceeds to the ESOP.

• *Increased deduction limit.*

The maximum deductible contribution to a defined contribution plan is generally 25 percent of the annual compensation of the participants. However, in the case of a leveraged ESOP, the 25 percent limitation applies to principal payments only.

There is an additional deduction for the full amount of interest on indebtedness incurred by the ESOP to acquire qualifying employer securities. See section 404(a)(9)(B). The additional deduction for interest does not apply to an ESOP sponsored by an S corporation.

The deductibility of payments to an ESOP reduces the effective cost of the stock purchase. For example, assuming a corporation has a 40 percent effective tax rate, it must have $1.67 of pretax earnings to make a one-dollar nondeductible stock redemption payment, but only one dollar of pretax earnings to make the same deductible payment to the ESOP.

• *Increased annual addition limit.*

The maximum "annual addition" to a participant's account in a defined contribution plan is the lesser of $41,000 or 100 percent of a participant's compensation.

However, if no more than one-third of the employer contributions to an ESOP are allocated to highly compensated employees (this can be expressly addressed in the ESOP document), the normal annual addition limits will not apply either to: (1) forfeitures — the non-vested portion of a participant's account forfeited upon termination of employment — allocated to other participants if the employer securities being allocated were acquired with the proceeds of an exempt ESOP loan; or (2) any interest paid on the ESOP loan which is deductible under section 404(a)(9)(B), as described above. See section 415(c)(6). As will be illustrated below, this provision allows higher than ordinary allocations and may be necessary for the ESOP transaction to work.

• *Dividend deduction.*

If the employer declares a dividend that is either distributed to participants or used to repay an ESOP loan, the dividend may be deductible, even if it exceeds the normal ESOP deduction limit described above.

However, dividends used to repay an ESOP loan only are deductible if the dividends are paid with respect to the shares acquired with the loan being repaid and are used to repay the exempt loan, resulting in a further allocation of shares to participants' accounts. See section 404(k). It is worth noting that this is the only instance in which corporate dividends are deductible to the issuing corporation.

Structuring Fred's Buy-Out With an ESOP

For Fred to understand how these rules work, it is best to present a specific example to demonstrate how his buy-out may be structured using an ESOP.

First, you confirm some basic facts and assumptions.

Given the current total of 30 employees, and the turnover history, Fred estimates that if the ESOP requires completion of one year of service and attainment of age 21 for participation, there will be an average of 25 participants, with total compensation of $1,250,000. Therefore, the 25 percent deduction limit will be $312,500, although Fred tells you that FSI expects to have sufficient available cash to fund an annual contribution of up to $350,000.

There will be a total of three "highly compensated employees" participating in the ESOP, including Joe (earning $200,000) and two other executives of FSI, each earning $100,000. None of Fred's family members works for FSI. Accordingly, the amount allocable to highly compensated employees should be less than one-third, and the ESOP should be eligible for the increased annual addition limit under section 415(c)(6), as described above.

FSI has only one class of stock, so by definition all of its shares are qualifying employer securities. There are 10,000 authorized shares, of which 1,000 (all issued to Fred) are outstanding. FSI is not an S corporation.

The company's appraised fair market value is $4,250,000. (In the case of an employer whose stock is not publicly traded, section 401(a)(28)(C) requires all valuations of employer securities for plan purposes to be determined by an independent appraiser.) Since Fred is the only stockholder, this amount is the total buy-out price for Fred's shares.

As noted above, Fred is not yet ready to retire and he does not think Joe is ready to run the business by himself. Fred agrees to your suggestion of a five-year transition period, during which the ESOP can begin buying Fred's stock and Joe can gradually be given more executive authority.

1042 Treatment

Since Fred will still work (and receive substantial compensation) for at least the next five years, he wants to defer recognition of the gain on the sale of his stock until he retires (if not longer). In order to do this, the transaction must meet the requirements of sections 1042 and 409(n). As noted, within the year following the stock sale, the proceeds must be invested in qualified replacement property.

Immediately after the sale, the ESOP must hold at least 30 percent of FSI's outstanding stock (i.e., 300 shares) and generally cannot dispose of such shares for three years. Perhaps most significant, for 10 years after the completion of the sale of Fred's stock, no portion of the ESOP's assets can be allocated to Fred (or certain members of his family) or to anyone who owns more than 25 percent of the FSI stock (including stock allocated to him under the ESOP). [For this purpose, "synthetic equity," such as stock options, is counted, thus limiting FSI's ability to provide Fred, and possibly Joe, with various forms of equity-based compensation.]

In order to qualify under section 1042, the ESOP must exclude Fred from participation. Moreover, assuming that Joe will be a participant in the ESOP, he must not exceed the 25 percent stock ownership limit. Finally, Fred must receive total payment for the shares within 12 months after the sale so he can invest the proceeds in qualified replacement property within the required time. This probably will require the corporation to borrow a substantial portion of the $1,275,000 sale price for the 300 shares.

However, for future sales of Fred's shares, this will no longer be an issue since the ESOP will have already met the 30 percent stock ownership requirement. So, he can sell his stock in smaller increments each year, invest the proceeds from each sale as they are received and defer recognition of the gain. These future purchases can be made using current profits that FSI contributes to the ESOP.

Joe's Management/Ownership Role

Although the ESOP will buy most of Fred's shares, in a typical transaction of this type, Joe also would acquire some FSI stock personally so he will feel more invested in the business. In addition, Fred may permit Joe to become a director, although there may be control issues to consider, especially during the transition period.

Also, now that there are multiple shareholders, a shareholders' agreement (between Joe and Fred) is probably warranted. Once Fred retires, he may seek to contractually impose some typical financial and operating restrictions on the management of FSI in order to protect the payment of the remainder of his buy-out.

Even after Fred retires, he may choose to remain involved in FSI's management by serving as an ESOP trustee.

Except for matters requiring pass-through voting, the ESOP trustees will generally vote the FSI shares held by the plan without direction from participants. While it is assumed that Joe and Fred will both be trustees of the ESOP, as trustees, they are required to vote the ESOP shares solely in the best interests of the plan participants. Accordingly, trustees who have dual relationships with the corporation (e.g., as officers or directors) must remain sensitive to possible conflicts of interest that could lead to a breach of their fiduciary responsibility. Of course, it is permissible to hire a trust company or bank to perform these functions.

There may be unusual or extraordinary circumstances that create difficult fiduciary issues given the fiduciaries' dual capacities, for example, unwanted tender offers. Addressing these situations is beyond the scope of this article, but practitioners are advised to bear in mind that the ESOP is a separate entity from the corporation, which may have divergent interests, and the trustees are fiduciaries whose conduct must conform to ERISA's fiduciary standards. Great care is warranted in these special circumstances.

Illustration

Fred initially will sell 300 shares of FSI stock to the ESOP for $1,275,000 and an additional 50 shares to Joe for $212,500. This represents 35 percent of FSI's stock. Fred wants the loan financing this first purchase fully paid within five years, so that when he reaches age 65 and retires, he can sell his remaining stock (600 shares to the ESOP and an additional 50 shares to Joe), and FSI no longer will be burdened with funding the debt service for the initial stock purchase. The FSI stock must be re-appraised to fix the purchase price based on its fair market value annually, as well as at the time of the second sale, if the transaction is not timed to coincide with the regular annual valuation.

In the first year, FSI will contribute $255,000 to the ESOP and either FSI or the ESOP (with a guaranty from FSI) will borrow the remaining $1,020,000 needed to pay Fred for the first 300 shares of stock. Assuming that the loan terms will require equal annual payments of principal, plus interest on the outstanding balance at six percent, the annual principal payments will be $255,000, which is less than the 25 percent annual deduction limit ($312,500). [Although most commercial loans would provide for level amortization, we have used equal principal payments in this illustration for simplicity.]

However, adding in the first interest payment of $61,200 will result in a total contribution of $316,200. Fortunately, the excess interest payment also will be fully deductible and within FSI's budgeted annual contribution limit of $350,000. In addition, since Joe earns 16 percent of the total participant compensation, if his stock allocation in the ESOP is proportional to the full contribution of principal plus interest ($316,200 X 16 percent = $50,592), it will exceed the $41,000 annual addition limit. However, since $9,792 of this amount is attributable to interest, it would be a permissible annual addition under the special ESOP rule.

The code and regulations provide that an ESOP loan must be nonrecourse to the ESOP and can be secured only by a pledge of the stock being acquired with the loan. However, FSI can guarantee the loan and, if necessary, can also pledge collateral to secure the obligation.

Since the payment for Joe's stock will be paid with after-tax dollars, the payments can be more flexible to make the purchase obligation less onerous for him. The purchase obligation can be secured by a pledge of the stock or other collateral, as the parties may agree.

If Fred reinvests the sale proceeds properly, he will have converted over $1,000,000 in FSI stock into a diversified liquid investment portfolio in a tax-free transaction, permitting him to defer taxation on the gain.

If the transition period has gone well, beginning in year six, Fred will sell the remainder of his stock to the ESOP (600 shares) and to Joe (50 shares). If Fred retires at this time, then FSI should have additional cash available to fund the stock payments since it no longer has to pay Fred's salary.

Conversely, if the transition has not proceeded as well as expected, Fred now has the opportunity to reconsider the sale. He still owns 65 percent of FSI's stock and can even remain a trustee of the ESOP to exert greater control over corporate governance (subject, of course, to his fiduciary responsibility to the participants). Therefore, he should have sufficient effective control to proceed in a different direction regarding the sale of the business, if necessary.

Assuming that Fred proceeds with

the second stage stock sale to the ESOP, the key issue at this time will be whether or not this sale also should be structured to qualify under section 1042. Although the acquisition of the first 30 percent by the ESOP should not have caused Joe to be a 25 percent stockholder, he may well exceed the 25 percent limit before the final purchase is completed. If the nonallocation rule is violated, the amount so allocated is taxable as a distribution to the 25 percent shareholder and the corporation is liable for a 50 percent excise tax. Accordingly, in the later years of the buyout, Joe may not be able to receive any more ESOP stock allocations.

If Fred wants to continue to qualify for nonrecognition of gain under section 1042, then he needs to sell his remaining stock in a series of annual sales so that he will continue to meet the requirement that the proceeds be invested in qualified replacement property within 12 months after the date of sale. However, this will require the stock to be re-valued annually, so if the stock value declines, Fred will be selling for less.

In the alternative, if the sale does not qualify under section 1042, the stock can be sold immediately, based on its sale date valuations, with payments in installments over a term to be negotiated between FSI and Fred. The installment payments can even be structured to effectively provide Fred with retirement income over an extended period (e.g., his life expectancy). In addition, unlike normal retirement plan distributions or deferred compensation payments, the portion of the payments attributable to the principal payments for the sale of Fred's stock will be taxable at the more favorable long-term capital gain rate.

As the illustration shows, the use of an ESOP enabled Fred to sell his stock in FSI to Joe on a tax-deductible basis, making the payments far more affordable for the corporation. In addition, Fred was able to diversify his investments as part of his retirement planning in a tax-advantaged manner.

Although in this example, the ESOP eventually acquired 90 percent of FSI's stock, it is also possible to use an ESOP as a smaller part of the sale transaction; for example, if the new owner wanted a larger personal interest in the company, if the company were being acquired by several new owners or if the selling shareholder is not the company's sole shareholder.

In addition, even with the enhanced contribution and deduction limits, it may not be possible for the ESOP contributions to cover the total cost of the stock sale on payment terms satisfactory to the seller as conveniently as they did in our illustration. In that case, a greater portion of the stock may have to be purchased by others (or redeemed by the corporation). [In addition, if the employer already maintains a qualified plan, which is converted to an ESOP, it may be possible to use those assets to fund a portion of the stock purchase.]

As should be evident, a financial feasibility study is needed to determine the financial effect of the ESOP transaction on the corporation under various scenarios in order to properly structure the transaction. Moreover, because an ESOP stock purchase involves additional complexities when compared to a simple stock sale, there are additional transactional and administrative costs that should also be considered.

However, in the right circumstances and with proper planning, an ESOP can be a powerful and flexible tool to help a retiring shareholder sell his interest on terms that are favorable both to him and to the corporation. ■