

Outline: ESOPs for CPA Firms
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ESOP Overview

- Started in 1974
- 11,000 companies in 2008; 13 million employees
- \$800 billion in assets (estimated 2008)
- Used for
 - ✓ Succession Planning
 - ✓ Financing Growth
 - ✓ Employee Rewards
 - ✓ Matching 401(k) Deferrals
- Tax Benefits for
 - ✓ Selling Shareholders
 - ✓ Company
 - ✓ Employees

Common Myths About ESOPs

• Too complex and costly	• Not more complex and are both less costly and more flexible than selling to third party
• Employees must end up with control	• Board appoints trustee to vote the shares
• Only for C corporations	• C or S corporations qualify
• Best for certain kinds of businesses	• ESOPs are found in every kind of business
• ESOPs usually don't work	• ESOPs are found in every kind of business

Why an ESOP?

- Creates a way for owners of closely held companies to provide for ownership transition in the most tax effective way available.
- Allows companies to be transferred to employees using corporate profits, not employee after-tax dollars, on a schedule comfortable to the owner(s).
- ESOPs can buy some or all of the stock, from one owner or more
- Properly structured ESOPs can improve competitiveness.
- S ESOP companies can avoid taxation on profits attributable to the ESOP's ownership percentage.

ESOP Basics

- Defined contribution plan under ERISA
- Company sponsored and paid; employees very rarely buy shares
- Funded instead by company contributions to an ESOP trust; contributions allocated among plan participants based on relative pay or more level formula
- All full-time employees are usually covered by the plan, subject to service and vesting rules
- Paid out in flexible terms on termination

How an ESOP Buys Out an Owner

- Company sets up an employee benefit trust
- Contributes cash to buy shares or
- Borrows money through the plan to buy shares
- Employees do not buy the stock.
- Contributions are tax deductible, even when used to repay a loan (principal and interest), up to 25% of eligible pay.

How Much Will the ESOP Pay?

- Price must not be higher than fair market value on a financial basis as determined by an independent, outside appraisal firm.
- Negotiations over sale terms can only be to produce a better price than that set by the appraiser.

- The ESOP cannot pay synergistic value.
- Minority ownership sales are valued at less per share than control sales.

Elements of Valuation

- Most important is some multiple of future free cash flow or, similarly, discounted future cash flow over an appropriate number of years.
- Comparable company sale data and, if applicable, public company comparison data will be factored in.
- Asset value is usually the least important factor, but valuable non-performing assets may add to value.

Benefits to Seller

- If ESOP owns 30% or more of the company after the sale in a C corporation, seller can defer tax on gain on the sale if reinvested in qualifying stocks and bonds. If this is not possible, sale still qualifies as capital gain.
- If the company is an S corporation, deferral is not possible, but capital gains deferral is not available, but other tax benefits are.
- ESOP can buy some stock now, some later.
- Sale accomplished in pre-tax dollars

Rules for Owners in Section 1042

- Stock must have been held for at least three years to be eligible.
- Only privately held C corporations qualify.
- 30% rule means ESOP must own 30% of all the stock after the transaction; synthetic equity (such as options) is considered as outstanding stock in making this calculation.
- Direct family members, sellers, and 25% owners cannot get an allocation of shares in the ESOP subject to the deferral of taxation. They can, however, if the seller opts not to take the deferral.

Eligible Investments

- Sellers have 12 months after the sale to reinvest in “qualified replacement property” (QRP).
- QRP must be securities of domestic operating companies not making more than 25% of their income from passive investment (no mutual funds, government bonds, for instance).
- Gain on sale of any QRP is taxed using original basis of stock in company with the ESOP.

Sales in an S Corporation

- The tax deferral is not available.
- The profits attributable to the ESOP, however, are not subject to federal, and usually state, income tax.
- Subject to the anti-abuse rules discussed later, the seller, 25% owners, and family members can get ESOP allocations.
- Distributions made to other owners must be made pro-rata to the ESOP, but can be used to buy additional shares.

Funding Options

- Banks can loan money to the company, which re-loans to the ESOP, which uses the cash to buy the owner's shares.
- Sellers can finance the transaction with a note, but can only get a tax deferral on what they reinvest in first 12 months (see more in next slide).
- Company can contribute cash each year to the plan, either to buy shares that year or to build a cash reserve to make a larger purchase later on, perhaps in combination with debt.
- In limited circumstances, some portion of funds in existing defined contribution plans may be used to help fund the ESOP (but fiduciary issues arise).

Seller Financed Sale to Employees

- Seller takes a note for the shares with multiple employees.
- Employees repay the loans individually according to the note's terms.
- Interest payments are deductible, but not principal.
- Interest rates and terms must be arms length or difference is taxable.

Leveraged ESOPs

- Plan can borrow money to buy existing shares or new shares to fund growth.
- Company contributes cash to the ESOP to repay the loan and takes a tax deduction.
- Shares go into a “suspense account” and as they are paid for get released to employee accounts.

Key Points to Remember

- The company, not the employees, fund the plan.
- The acquisition of shares is a non-productive expense, so the company must have the earnings to absorb it.

- ESOPs are the only way a company can use pre-tax dollars to buy out an owner.

Contribution Limits

- Generally, 25% of compensation of employees covered by the plan
- If there is an ESOP loan, in a C corporation, interest payments and dividends don't count towards this limit; in a S corporation, they do.
- Not more than 100% of pay or \$45,000 (in 2007) can be added to an employee's account each year from all defined contribution plans.

Participation, Vesting, and Allocation

- Employees have individual accounts.
- Company contributes cash to buy stock, contributes stock, or has plan borrow to buy shares.
- Accounts are subject to vesting over not more than 6 years.
- Generally, at least all-full-time employees with 1,000 hours in a year must be included in the plan.
- Allocations can be based on relative pay or a more level formula. They cannot be discretionary or merit based.

Distribution

- Employees get distributions not later than one year after death disability, or retirement, or
- Five years after the end of the plan year for other terminations.
- Can be paid out in installments up to five years.
- Employees with 10 years in the plan who are 55 or older can diversify part of their stock accounts.

Distribution Payments

- Company must assure employees get fair market value for the stock, but can put cash into the plan to do this.
- Employees have a put right for shares distributed to them.
- Distributions are taxed the same way that other distributions from defined contribution plans are taxed.

Governance

- Limited employee voting rights
- Plans governed by a trustee appointed by the board
- Often an ESOP committee to assist in the process.

Costs

- First year costs typically \$40,000 and up.
- Ongoing costs can be as low as \$15,000 or so, depending on size of the company, changes in the law, and other factors.
- ESOPs more expensive than other plans, but much less expensive than selling a business in other ways.

S Corporation Issues

- The ESOP's share of taxable income is not subject to federal and, usually, state income taxes. 100% S ESOPs pay no federal and, often state income tax.
- ESOP is one shareholder.
- Sales to an ESOP do not qualify for tax deferral.
- Contributions limits can be somewhat lower because interest, as well as principal payments on the loan count towards the limits.

Anti-Abuse Rules

- "Anti-abuse" rules make it impossible to use ESOPs to benefit just a few employees. One effect of these rules is that ESOPs are impractical in S companies with fewer than about 12-15 employees.
- Generally, individual employees who have more than 10%, or families that own more than 20%, of the "deemed-owned" ESOP shares (a measure that includes any synthetic equity they hold, such as options) cannot own more than 50% of the total equity in the company.

Other Plan Applications

- As an additional benefit
- Buying out an owner in a closely held company
- Acquiring new capital
- Selling or buying divisions of companies

Selling Directly to Employees Instead

- Employees can purchase shares at a negotiated value.
- Purchase is done in after-tax dollars.

- Company can pay taxable bonuses to employees to help pay for the purchase.
- Company can make non-recourse arms-length interest rate loans to help fund purchase.
- Seller pays capital gains tax on the sale.

Getting Equity to Employees Outside the ESOP

- Employees can individually be granted equity rights.
- Stock options
- Phantom stock and stock appreciation rights
- Restricted stock.
- Bonus shares.

Who Is a Good ESOP Candidate?

- Generally at least 15-20 employees
- Adequate free cash-flow to take on costs of buying out the shares
- Management willing to share information and work-level decisions with employee owners
- If buyer has synergistic seller options, is the buyer willing to accept somewhat lower price