



ESOP & Succession Planning Volume 3

ESOP As A Corporate Financing Mechanism

Three key factors make ESOPs a unique, flexible, and low-cost option for financing buyouts of company founders and other majority shareholders, as well as financing other corporate initiatives.

- ESOPs can and must invest primarily in the stock of the sponsoring company;
- ESOPs can borrow money to finance the purchase of company stock
- Tax incentives encourage companies to utilize ESOP.

Because of their unique structure and tax advantages, ESOPs can substantially reduce a company's borrowing costs and improve cash flow, and because ESOPs make employees beneficial owners of the company, employers can experience productivity increases driven by employees who are more motivated.

Leveraged ESOPs

Leveraged ESOPs are those that borrow to finance the purchase of their sponsoring company's stock. Private companies typically use leveraged ESOPs to buy out company founders and other shareholders. When an ESOP finances the purchase of company stock, the shares it purchases are pledged as collateral for the loan and are held in a special "suspense account" by the ESOP trust. Shares are released from the suspense account based on loan payments made in any given year and are allocated to participants' accounts, generally based on the compensation of eligible participants.

Lenders can loan funds directly to an ESOP. In such cases, the lenders require the sponsoring company to guarantee that it will make contributions to the ESOP in amounts sufficient to enable loan repayment. Generally, however, loans are made to the company, which then loans the funds to the ESOP. An ESOP must be used to purchase company stock, must not be payable on demand (except in case of default) and must be properly documented.

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C corporations sponsoring a leveraged ESOP can generally deduct:

- Contributions to the ESOP used to pay the loan principal, up to 25 percent of the eligible participants' aggregate payroll
- All contributions used to repay loan interest, without limit
- Cash dividends paid on ESOP stock, to the extent that those dividends are used to repay the loan passed-through to the participants; or, at the participants' election, either passed-through or reinvested in company stock

While many ESOPs are leveraged, some are not. A nonleveraged ESOP is an ESOP that receives contributions of company stock or that buys company stock using money that has been contributed, not borrowed. Company contributions to this sort of plan are discretionary and can be deducted by the company, as long as they do not exceed 25 percent of participants' annual payroll.

S corporations sponsoring either a leveraged or nonleveraged ESOP, on the other hand, can generally deduct contributions to the ESOP, up to 25 percent of the eligible participants' aggregate payroll.

The Section 1042 Rollover

A powerful ESOP tax incentive is the Section 1042 rollover. IRC section 1042 gives certain shareholders of closely-held C corporations the ability to sell their stock to an ESOP and defer (or possibly avoid) taxes on any capital gain arising from the sale. While ESOP rollover transaction must follow IRS regulations and be carefully documented, a properly constructed rollover can provide significant benefits to the selling shareholder, the company, and its employees.

Normally, retiring owners or other majority shareholders in a privately-held company have the following options for selling all or part of their interest in the company. Each of these options typically give rise to taxable income:

- Selling shares back to the company, if such a transaction is feasible
- Selling shares or assets to another company or individual, if a will buyer can be found

Under the authority of IRS Section 1042, however, shareholders selling to an ESOP will defer capital gains taxes indefinitely. Additionally, unlike most other transactions involving the sale of a privately-held company, departing owners selling to an ESOP are not required to sell all of their shares at once but can withdraw from the business gradually by selling their shares in a series of transactions.

Generally, for a sale to an ESOP to qualify for the Section 1042 tax deferral:

- The stock being sold must meet certain requirements, such as having been owned by seller for at least 3 years, having been issued by a domestic C corporation that has no outstanding stock that is tradable on an established securities market, and qualify for long-term capital gains treatment.
- The ESOP must own at least 30 percent of the company's stock immediately after the sale.
- The selling shareholder must reinvest the proceeds from the sale in "qualified replacement property" within a 15-month period.
- The seller, certain relatives of the seller, and other shareholders who individually own 25 percent or more of outstanding company shares are prohibited from receiving allocations of the stock acquired by the ESOP in the Section 1042 rollover transaction.

If the conditions are met, the seller's gain on the sale of the stock to the ESOP is deferred by adjusting the seller's basis in the qualified replacement property up to an amount equal to the basis in the employer stock sold to the ESOP. If qualified replacement property is sold, gain may be recognized at that time. Alternatively, if the replacement securities are held until the taxpayer's death, the basis of the securities is stepped-up and, under current tax law, the taxpayer's beneficiaries will be able to entirely avoid the recognition of such gain.

ESOP and Succession Process

As attractive as an ESOP may seem, it may not be the right program for you and your company. For this reason, DZH Phillips LLP developed a thorough ESOP and succession process that can determine if your business would benefit from an ESOP structure. To obtain more information on ESOPs and other succession opportunities, please contact Dan Heller at 415-624-2212 or dheller@dzhphillips.com.

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