Employee Stock Ownership Plans (ESOPs): An Exit Strategy for Entrepreneurs

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# ESOPs

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ESOPs

Introduction

An ESOP (“Employee Stock Ownership Plan”) is a “defined contribution” employee benefit plan (see Chapter 18). ESOPs are designed to benefit a broad range of employees by providing them with an ownership stake in the employer business through a deferred compensation plan. The statutes and regulations governing ESOPs provide a number of incentives to encourage their creation.

Those same incentives allow the ESOP to be used as a powerful financial tool in maximizing the value of an ongoing business enterprise in a number of ways. For an entrepreneur, an ESOP can be used to minimize the costs of taking capital out of the business, transferring the business from one generation to the next, or simply of “cashing out” when an IPO or third party sale is not available. For the corporate organization itself, an ESOP can be used to help finance an acquisition strategy or a management-led buyout of an independent operating division from the parent entity.

In this chapter we will focus on ESOPs largely in the context of their uses for the entrepreneur.

An entrepreneur’s dilemma

Our friend and client, George Sanders, owns the Sanders Snack Company, which he believes is worth $10 million. He built it from nothing, and virtually everything he has is tied up in the business. Salaries provide him and his family a comfortable lifestyle, but George is beginning to believe that it is time he stopped feeling as though the business owns him. He wants to get some of the value of his equity out of the business.

When we first met him, George wasn’t entirely sure what he should do. Since he had started with almost nothing, most of the proceeds from the sale of the business to a third party buyer would be subject to capital gains tax. With the federal long-term rate currently at 20%, Mr. Sanders would probably keep less than $8 million if he were able to get his estimated $10 million.

If George were to make a gift of the stock in the business to a charitable remainder trust, he could avoid capital gains taxes and create a stream of income for himself and his family; however, the capital would have to remain in the trust during lives of the income recipients and be distributed to a designated charity at the death of the last one.

George didn’t want to pay any taxes he could avoid. However, he also didn’t want to commit his capital to a trust. Even more important, however, he didn’t like the idea of selling

1 Although his concerns are real, our George Sanders is not a real person. Instead, he is a composite of a number of clients with whom we have worked.

2 Long-term gains on capital investments owned for longer than a year are currently subject to federal taxes that are calculated at lower rates than those applied to ordinary income (such as salary and dividends) or gains on capital investments owned for shorter periods. These gains may also be subject to state taxes, which, in some states, are calculated at the same rate as the rates used to tax ordinary income. Because state taxes are generally deductible for federal tax purposes, the net combined tax rate is generally less than the federal rate plus the state rate. For example, if the federal rate is 20% and the California rate is 8.4%, the combined effective rate is approximately 26.72%.
the business. After all, he thought, one of his sons and his daughter practically ran the place anyway; and it seemed a little unfair to put their lives and livelihoods in jeopardy just because he wanted to get his capital out. But what could he do?

How could Mr. Sanders get some or all of his value out of the business asset without destroying the business enterprise?

George Sanders’ quandary was not an unsolvable problem. We told him there was a way for him to achieve exactly the goal he had articulated. It is known as an ESOP.

Our plan for this chapter

ESOPs are subject to a variety of rules and regulations. They also involve several steps to implement. Making effective use of them as part of other strategies also requires a number of considerations. In order to make these things as clear as possible in the limited space allowed, we will begin by discussing what an ESOP is and how it is structured as an employee benefit plan. We will then take you through the steps that would be taken by a business owner who wants to use an ESOP to harvest some of the value of his or her equity in the business. Following that, we will then return briefly to the George Sanders example and provide a few of the financial details that will affect his choices if he uses an ESOP as a central tool in his own financial and estate plan. In our summary, we will provide some guidelines that can be used by a business owner or executive to determine whether an ESOP might be useful in a specific situation.

Overview: What is an ESOP?

As we just noted, an ESOP is a defined contribution employee retirement plan subject to Section 401(a) of the Internal Revenue Code (generally referred to as the “Code,” the “tax Code” or “IRC”). Like other plans covered by these provisions, an ESOP is known as a “qualified plan.” Also like many other such plans, an ESOP’s assets are held in a tax-qualified Trust and overseen by a Trustee whose job it is to protect the interests of the employees and the assets covered by the plan, i.e., to act as a fiduciary.

The ESOP is designed to invest primarily in employer securities. Every ESOP must have a “stock bonus” element. A stock bonus plan is a profit-sharing plan that distributes benefits in employer stock. An ESOP may also be a combination stock bonus and money purchase plan (a retirement plan to which the sponsoring employer commits to making a minimum annual contribution to each employee’s account). If a stock bonus feature is combined with a money purchase plan, the ESOP resembles other defined contribution pension plans, except that its benefits are payable in (or, at least, with values determined by) employer stock.

Employee protection features of an ESOP

ESOPs are structured to allow each employee certain choices regarding the assets in her

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3 Although there are special provisions that apply to ESOPs as shareholders in corporations that have elected to be “S corporations,” space will not allow us to address them here. In most cases, owners of S corporations will find that the most expedient way to achieve an efficient sale to an ESOP as discussed here is to revoke the S election on the eve of the transaction. More specific questions about S corporation ESOPs can be directed to the authors.

4 IRC §§4975(e)(7) and 4975(e)(8). Employer securities for this purpose are defined in IRC §409(l).

5 Reg. §1.401-1(a)(2)(iii), (b)(1)(iii).
own account when she terminates employment. Each plan must provide that a participant employee entitled to receive a distribution may demand that the distribution be made in employer stock. If no such demand is made, the distribution may be in cash. However, if the employer’s charter or bylaws restrict stock ownership to employees and/or to a qualified employee trust, the ESOP may distribute benefits in cash only, or it may require that employer stock distributed to employees be sold to the employer at its appraised fair market value.

In order to ensure that the employees are able to withdraw liquid assets from the plan when they retire, a “repurchase obligation” is imposed on any ESOP sponsor-employer that is a closely held corporation. Under this obligation, any stock not readily tradable on an established market (such as the New York Stock Exchange or the NASDAQ) and held in an employee-participant’s ESOP accounts at the time of the employee’s termination of employment must be paid for in cash.

Older employees may also feel it is important to protect their assets in anticipation of retirement. To facilitate that, an ESOP must currently provide “qualified” participants (those who are at least 55 years old and who have participated in the Plan for at least 10 years) an opportunity to “diversify” their Plan holdings. That is, qualified participants must be allowed to direct at least 25 percent of their ESOP accounts into stock other than the employer’s. This diversification may be accomplished during the six-year period beginning with the year the participant becomes qualified. In addition, during the last year of the six-year diversification period, qualified participants must be allowed to direct the diversification of at least 50 percent of the balance of their Plan accounts.

Contributions to an ESOP are currently deductible by the sponsoring employer and are generally subject to the contribution, deduction, and benefit limits imposed by the Code on all qualified plans. Some modifications to the limits applied to most plans have, however, been made for ESOPs to facilitate their ability to purchase employer stock (see leveraged ESOPs below). ESOPs are also subject to other qualified plan requirements, such as the minimum participation, minimum funding (in the case of a money purchase component) and non-discrimination rules. In addition, special rules apply where an employer maintains both a defined benefit plan and a defined contribution or stock bonus plan.

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6 IRC §409(h)(1)(A), (h)(2).
7 IRC §409(h)(2)(B)(i)(I).
9 IRC §401(a)(28)(A), (B). See, generally, Notice 88-56, 1989-1 C.B. 540. From the employer-sponsor’s perspective, accomplishing these diversification objectives may require the employer to repurchase its stock from the ESOP and force the employer to repurchase some stock earlier than it might have if no distributions took place before an employee’s designated retirement age (usually 65).
10 We refer in this text only to the “employer.” In doing so, we intend also to incorporate those entities generally referred to as the employer’s “affiliates.” The limits discussed here, as well as certain other tests applied to qualified plans, are generally applied to the plans of an employer company and its affiliates as a group.
11 IRC §§404(a)(3), (a)(7), (a)(9), (j).
Nonleveraged and leveraged ESOPs

An ESOP can be nonleveraged or leveraged. If the ESOP is nonleveraged, the employer simply makes regular payroll-based contributions to the Plan in cash, and the Plan buys employer stock with those proceeds. Employer contributions to ESOPs are limited under current law to 25 percent of aggregate annual employee-participants’ covered compensation, subject to a $200,000 maximum (subject to future adjustments to reflect inflation) annual covered compensation per employee.

If the ESOP is leveraged, the Plan is authorized to borrow funds to purchase any amount of employer stock. The Plan will then receive the fully deductible payroll-based contributions and, possibly, dividend payments to repay all principal and interest on the loan. Payments other than the payroll-based contributions will not be subject to the contribution limitations for leveraged ESOPs.

In a leveraged ESOP, the purchased stock is initially held by the ESOP Trustee in a “suspense account.” The Trustee then makes allocations of the purchased stock to individual employee accounts as regular employer contributions are made, and as dividends on the stock are paid, by the employer to the ESOP Trust.

Financial uses of leveraged ESOPs

As an employee retirement plan designed to invest in employer stock, an ESOP provides employees throughout the company with a significant financial stake in the company’s success. It is thus intended to provide performance incentives for the covered employees.

An ESOP, particularly a leveraged ESOP, can have ancillary uses and benefits as well. Because the repayment of loan principal (and, therefore, the payment of the full purchase price) is effectively accomplished with before-tax funds, there is a substantial financial incentive to employ a leveraged ESOP wherever the buy-out of a significant stockholding is planned.\(^{12}\)

The ESOP buys stock from whomever is willing to sell it, privately or in the open market, if the stock is publicly traded. A leveraged ESOP makes that stock purchase with borrowed funds. When it does, the seller(s) receive the entire purchase price at the time of the sale, but the company pays for the purchase over a number of years with before-tax funds.

When the ESOP’s sponsor company is closely held, the stock purchase may be undertaken before a shareholder’s death to accomplish several objectives. First, the transaction can provide the seller(s) with tax-free liquidity if the seller(s) make a timely “Section 1042 rollover” into traded securities (explained in further detail below). Because the employer corporation is significantly leveraged after a leveraged ESOP stock purchase, the equity value of each share is much decreased. Therefore, the shareholder(s) may gift any remaining stock not owned by the ESOP at much reduced values, thus lessening or eliminating both gift and estate taxes.

The sale of stock to an ESOP may also be made at the stockholder’s death to provide

\(^{12}\) A loan to any qualified plan from a disqualified person, or which is guaranteed by a disqualified person, or which is collateralized by the assets of a disqualified person, is a “prohibited transaction” subject to the Section 4975 excise tax except to the extent of the limited exemption granted to “leveraged ESOPs.” IRC §4975(c)(1)(B), (d)(3), (e)(7); Reg. §54.4975-7(b). The sponsoring employer is a “disqualified person.” IRC §4975(e)(2)(C).
liquidity to pay estate taxes. If the stock is purchased by the ESOP at the owner’s death, the value of the stock in the estate would, under current law, be stepped up to “fair market value” (FMV) at the time of the estate valuation. Capital gains on the sale would thus be largely or completely eliminated. Sale to the ESOP would also preserve the closely held status of the company.

A leveraged ESOP can also be used to facilitate the purchase of company stock (indeed, of the whole company) by other family members or by an unrelated third purchaser. For example, a pre-acquisition tax-free recapitalization could create a separate class of voting stock (such as a “super common” or a convertible preferred) to be owned by the ESOP. This restructuring would have the effect of reducing the value of the common stock, making it easier for others to acquire, while also creating a fixed and predictable stream of cash flow for the new class of stock. Family members or an unrelated third party purchaser could then buy all of the common stock at the reduced value, and the ESOP could buy the super common or the convertible preferred stock in a leveraged purchase. While this may not be a practical means to “go private,” since the value would be reduced by the creation of the super common or the preferred stock, it can facilitate transfers among family members where the company is already closely held.

**Purchase of stock by a leveraged ESOP**

The purchase of employer stock by a leveraged ESOP is accomplished as follows. A lender loans the stock purchase price to the ESOP. The lender may be the sponsoring employer, or it may be a bank or another financial institution (or institutions). If the lender is not the employer itself, the employer will normally guarantee the loan, since the loan must be nonrecourse to the ESOP.

Alternatively, in the more common scenario, the employer can borrow from the lender (the “outside loan”) and re-lend the funds to the ESOP (the “inside loan”). The ESOP then uses the funds to buy employer stock from the seller(s). The seller(s) may be the employer itself or substantial shareholders. The stock may also be purchased directly in the trading market if the stock is publicly traded.

The employer agrees to make, and makes, annual contributions to the ESOP. It also pays periodic interest on the loan, directly to the lender or to the ESOP, which would then make the payment. (If the employer is the lender, it must report the interest in gross income.) In addition, the employer pays annual dividends on the stock. Shares of employer stock are allocated to individual employee plan accounts in proportion to their covered compensation, as the ESOP loan principal is amortized.

The result, for the employer, is the *fully* deductible payment of principal and interest on the loan. First, contributions to the ESOP to pay interest are fully deductible.\(^{13}\) Then, contributions to the ESOP to pay principal are deductible, under current law, up to 25 percent of employee-participants’ annual covered compensation.\(^{14}\)

\(^{13}\) IRC §404(a)(9)(B).

\(^{14}\) Contributions used to pay loan principal but in excess of the limitation may be carried over and deducted in succeeding years. The carried over amounts, when combined with the succeeding years’ contributions will be subject to the same limitation. IRC §§404(a)(3)(A)(I), (II), 401(a)(17).
And, finally, dividends paid on employer stock purchased by the ESOP with the loan proceeds are fully deductible (if reasonable in amount, a key limiting factor) by a C corporation (but not by an S corporation). These dividends must be used by the ESOP to repay the loan principal. Employer stock with a fair market value equal to the dividends must also be allocated to plan participants for the year of the dividend. Deductible dividends may also, at the election of the employee participant, be reinvested in employer stock by the ESOP.\textsuperscript{15}

Thus, if all of these conditions are met, the entire amortization for the loan that financed the initial stock purchase can be fully deductible to the employer. The size of the loan and the amortization schedule are, therefore, generally structured to match, as closely as possible, the projected payroll-based contributions and the dividends on ESOP-owned employer stock.\textsuperscript{16}

**Tax-free rollover election for a seller of the stock to an ESOP**

Under most circumstances, when stock in a business is sold for cash, the seller will incur capital gains taxes at the time of the sale.\textsuperscript{17} The taxable amount will be the difference between the stock’s sale price and its “basis” (see Chapter 19). Consequently, the seller of stock in a business of which he is the founder, or the heir to the founder, is often faced with a sizable tax bill when the sale is completed.

However, there is a special election available to a selling shareholder to defer gain on eligible sales of employer stock of a C corporation (but not of an S corporation) to the employer-sponsored ESOP.\textsuperscript{18} In a sale where at least 30 percent of either (i) each class, or (ii) the total value of all of the employer’s stock is owned by the ESOP after the sale, the realized gain may be deferred if the seller makes a timely election to “roll over” the proceeds into “qualifying replacement property.” The qualifying replacement property is broadly defined as publicly traded stock and bonds of domestic operating corporations. (Companies with primarily passive assets, such as mutual funds or REITs, do not qualify.)\textsuperscript{19} If the qualified replacement securities are held until their owner’s death, the realized gain is permanently eliminated. Sellers who make this rollover election (as well as certain “related persons”) cannot, however, be participants in the ESOP that purchased the stock.\textsuperscript{20} The “Section 1042 rollover” cannot be elected if the employer’s stock has been tradable on an established securities market within one year immediately before or immediately after its sale to the ESOP.

Even if the rollover election is not available because the stock has been traded publicly, or because the employer company has made the S election (and does not revoke it), the ESOP

\textsuperscript{15} The dividends would also be fully deductible to a C corporation employer, in the case of either a leveraged or a nonleveraged ESOP, if they are paid directly to the employee-participants for whom the stock is held by the ESOP. IRC §404(k).

\textsuperscript{16} Costs of ESOP loans are generally in line with market conditions, although they are somewhat more expensive than were during the early years of ESOP development. A former tax Code provision that allowed lending banks to exclude one-half the ESOP loan interest from their gross incomes was repealed in 1996. Former IRC §133, repealed by §1602(a) of P.L. 104-188 (1996), effective Aug. 20, 1996.

\textsuperscript{17} If a sale is structured as an installment sale, the entire tax will not be due at the close of the sale. Generally it will be assessed on the capital gain portion of each payment at the time the payment is received.

\textsuperscript{18} IRC §1042(a), (c)(1)(A).

\textsuperscript{19} IRC §1042(b).

\textsuperscript{20} IRC §409(n).
can, under current law, purchase employer stock at no taxable gain immediately after a holder’s
death, because of the basis step-up to fair market value. As we noted earlier, the post-death sale
to the ESOP would achieve liquidity for the decedent’s estate, while also preserving the closely
or non-widely held status of the company.

**Monetizing for immediate liquidity**

One possible “negative” to the 1042 rollover is that the new securities provide no
immediate liquidity to their owners. A means of achieving immediate liquidity is to make the
rollover under Section 1042 into replacement securities that are high-grade floating rate “ESOP
bonds.” These bonds, which are known as “floating rate notes” (“FRNs”), are specifically
designed to be used in Section 1042 ESOP rollovers. They are issued by AAA- or AA-rated
“Fortune 100” corporate issuers and generally have very long maturities (up to 40-60 years),
interest rates that reset every 30-90 days, and a holder “put” to the issuer, after a period of ten
years, at the principal amount. As a result of these features, the market value of the FRN is
always very close to the principal amount.

Liquidity and diversification may then be obtained by borrowing against the FRNs. A
bank will typically lend 80-90 percent of the FRNs’ principal amount, so that the income on the
FRNs should be sufficient to pay all the loan interest. The owner of the FRNs can then invest the
loan proceeds in any type of investment without regard to the Section 1042 replacement property
constraints. Thus the investor can purchase real estate, foreign or domestic stock, mutual funds,
venture capital partnerships, or even company stock. The only limits on this investment plan
would be those imposed by any security interest required by a lender.

At the death of the FRN’s owner, under current law the tax basis of the securities is
stepped up to their fair market value (which should also be their principal amount). These
holdings will be subject to the estate tax, but the decedent’s estate will not be subject to any
capital gains taxes when the FRNs are then sold at their estate tax value. The proceeds from that
sale can be used by the estate and heirs to pay off the loan (which reduces the value of the net
taxable estate) while they retain the diversified investments that had been purchased with the
loan. Under current law, those other investments would also be stepped up, so estate taxes
would be levied on, and the heirs would assume as the basis in the holdings, their fair market
value at the date of the decedent’s death.

**Charitable contribution opportunities**

If the rollover election is made, the qualified replacement securities may be donated to
family members or to charities without triggering “recapture” of the deferred gain. While intra-
family gifts may be subject to the federal gift and generation skipping transfer taxes, a gift to
charity is exempt from those transfer taxes. It also results in a current income tax deduction and
removes the donated asset from the donor’s gross estate.

A common planning technique following an ESOP rollover election is to donate some or
all of the replacement securities to a charitable remainder trust (“CRT”). A CRT typically leaves
the donor with a retained lifetime annuity (minimum of five percent of the initial value, or five
percent of the value of the assets in the trust, as determined annually). At death, the assets
remaining in the trust pass to the designated charity.21

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21 IRC §664(d).
The donor receives a charitable contribution income tax deduction for the year of the gift equal to the present value of the gift that will eventually go to the charity. The amount of the deduction is computed by subtracting the actuarially computed present value of the donor’s retained annuity from the contributed assets’ current value. The income tax deduction is subject to the annual deduction limits that apply to all contributions of long-term capital gain property. Any excess deduction may be carried forward to be deducted, subject to the same limitations, in each of the succeeding five years.\textsuperscript{22}

George Sanders’ ESOP sale and exit strategy

Let’s return to the case of George Sanders. He has decided that he will sell some or all of his stock to an ESOP. This section will outline the steps George will have to take and show how a leveraged ESOP can help him to get immediate cash liquidity without giving up effective control of the Company.

Steps George takes

When George has received a professional valuation of The Sanders Snack Company, he will make sure he has a commitment for the “outside” loan to the Company. Not all financial institutions are familiar with (or willing to make) ESOP loans, so he will have to find one and negotiate terms with it.

The Sanders Snack Company must also establish an ESOP. Because the Company has previously had no retirement plan, this process probably will not be complex. However, since the ESOP is a tax-qualified plan, it must follow very specific rules and will be subject to scrutiny by both the Internal Revenue Service and the Department of Labor.

Once the Company has received its loan from the bank, it will make a loan to the ESOP. The ESOP will use the proceeds of the “inside loan” to purchase the Company stock from George, who will be selling at least 51% of the Company stock to it. This 51% is the minimum that he must sell to the ESOP in order to preserve the control premium in the price. If the ESOP were to buy less than 51% of the stock (i.e., less than the controlling share of the stock), its Trustees might claim that they were entitled to a discount for lack of control.

When the sale of stock to the ESOP has been completed, the ESOP will own 51% of the Company, and George will have received $5.1 million in cash on which no U.S. taxes will be payable if he elects the 1042 rollover. However, George (and his family) will still exercise effective control over all decisions relating to the Company and its business because the ESOP will have what is known as a “directed Trustee.” The “directed Trustee” of the ESOP will be required by the Trust instrument to follow the instructions of the ESOP’s administrative committee, which will be composed of Company employees appointed by the Company’s Board of Directors. Any vote by the Trustee will be directed by the administrative committee which will be acting as the “named fiduciary” of the ESOP. The Trustee will refuse to follow an instruction of the committee only if to follow it would cause the Trustee to violate its fiduciary duty to act in the exclusive interest of the ESOP employee-participants.\textsuperscript{23}

\textsuperscript{22} IRC §§664(e), 170(b), (d); Reg. §1.170A-6(b)(2). \textit{See, generally,} Louis Diamond, “CRT Plus ESOP – A Win/Win Combination,” ONLINEMAG (Dec. 4, 2001) (www.fed.org/onlinemag/dec01/tips.htm).

\textsuperscript{23} The Board or the administrative committee would be considered not to be acting toward the ESOP in the exclusive interest of the employee-participants only in the unlikely event of fraudulent activity toward the ESOP or
The ESOP will be structured so that no Sanders Snack Company stock will ever be held by a participant or former participant in the ESOP. The ESOP will pay out benefits only in cash. As a consequence, the Company will be obligated to purchase for cash the Company stock in departing participants’ accounts to fund ESOP cash distributions to participants.\textsuperscript{24}

As explained above, the ESOP will pay debt service on the inside loan to the Company using tax-deductible contributions made to the ESOP by the Company. The Company will then pay the debt service on the outside loan with funds provided by the inside loan debt service payments. Thus, all principal and interest on the third-party outside loan will be fully tax-deductible. At a combined federal and state (income) tax rate of 40%, every $100 of loan principal will be repaid with only $60, after tax.

**Financial results of George Sanders’ ESOP transaction**

As we noted earlier, George built the Sanders Snack Company from nothing. Therefore, let’s assume that he has essentially a zero tax basis in his Company stock. Let’s also assume that his $10 million estimate of the Company’s value as going concern is confirmed by an independent professional appraisal. With this figure in mind, now consider two alternative transactions: George could sell 51 percent of his Sanders Snack Company’s stock to an ESOP in a leveraged transaction for $5.1 million (leaving him with 49% of the Company’s stock). Alternatively, he could sell the entire company (100 percent of the stock) to an independent third party for $10 million.

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<th>ESOP Sale of 51 Percent by George</th>
<th>Sale of 100 Percent to 3rd Party</th>
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<tr>
<td>Cash received</td>
<td>$5,100,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Less: Capital Gains Tax</td>
<td>$0</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Net proceeds to seller</td>
<td>$5,100,000</td>
<td>$8,000,000</td>
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As indicated above, assuming the proceeds of the 100% sale to an independent third party are subject only to federal capital gains taxes, George’s total net after-tax proceeds would be $8,000,000. While he and his children might be hired or retained as consultants by the new owners, none of them would have any significant operating control of the business after the transaction.

If George sells to the ESOP, however, he will receive proceeds of $5,100,000 from the mismanagement of the ESOP or its investments (i.e. the Company) or a corporate transaction in which the trustee deems the price and/or the terms to be inadequate.

\textsuperscript{24} George Sanders, or any other member of his family who also does not participate in the ESOP, will be able to purchase the Company stock held by the ESOP to fund that obligation.
51% ESOP sale. If he elects the 1042 rollover and is thus able to avoid personal capital gains taxes, his net after-tax proceeds will also be $5,100,000. He and the directed trustee of the ESOP will also retain control of the business. Part or all of the holding George retains after the sale can be sold to the ESOP at a later date, when the Company’s value has increased because the inside loan has been repaid and also, hopefully, because the company has grown. The gain on such a sale would again be without any tax liability if George elected to do the Section 1042 rollover. Alternatively, all or part of the holding not sold as part of this initial transaction can be (i) retained, (ii) gifted to his children or grandchildren, and/or (iii) donated to a charitable remainder trust.

Revaluation of the Company’s equity

Let’s assume that George decides to sells 51% of his position to the ESOP. Since the ESOP in this example will acquire more than 50 percent of the outstanding stock of the Company, George’s sale of the stock to it will be completed at a price that includes a premium for control value. However, if George undertakes this transaction as a “leveraged ESOP,” debt will be recorded as a liability on the company’s balance sheet, and the value of the company’s equity will decline as a result.

When the Sanders Snack Company incurs a $5.1 million debt to finance the ESOP’s purchase of 51% of the stock, the total $10 million pre-transaction equity value will decline to a value somewhat less than $7.0 million, on a post-transaction basis. The decrease in a company’s post-transaction equity value is typically somewhat less than the amount of the ESOP transaction debt for two reasons. First, debt financing typically has a lower cost of capital than equity financing. Second, as explained above, the ESOP transaction debt receives preferential income tax treatment in that its principal, as well as its interest, is generally fully tax deductible.

Using a conservative lack of control discount of 20 percent, as well as a discount for lack of marketability of another 15 percent, the post-transaction fair market value of the Company stock that George retains can be estimated as follows:

25 George could, of course, also sell a larger portion of his stock to the ESOP. As long as he makes a timely Section 1042 rollover with his proceeds, he still would not owe any federal capital gains taxes. If George were to sell 100% to the ESOP, he would not have any stock remaining with which to make gifts.

26 In certain cases, an ESOP may be justified in paying a control premium when it purchases only a minority ownership interest. This situation is possible if, as part of the transaction, the ESOP receives the legal right to acquire (at its option) sufficient shares at a later date (but at fair market value) which would then provide the ESOP with a controlling ownership interest in the Company.

27 The deduction of principal is available to the extent the Company has taxable income, and without regard to the alternative minimum tax.

28 In our empirical experience, control premiums tend to fluctuate (with significant variation) around 35 percent. That is approximately equivalent to a 25 percent minority interest discount for lack of control. We use the more conservative 20 percent in this context to illustrate the fact the value of the transaction even with a much smaller control premium.
Market value of business enterprise w/ Private Control $10,000,000

Less: After-tax cost of ESOP loan $3,060,000

Post-transactions market value of equity w/ Private Control $6,940,000

Less: lack of control valuation discount (20%) $1,388,000

 Marketable minority ownership value of equity $5,552,000

Minority ownership value of George's remaining 49% $2,720,480

Less: lack of marketability valuation discount (15%) $408,072

Fair market value of the equity for gifting purposes $2,312,408

George's financial and estate planning after the sale to the ESOP

Once the sale has been completed, and George has sold 51 percent of his Sanders Snack Company to the ESOP for $5.1 million, he takes the cash he received and makes a timely Section 1042 rollover by investing the funds in the Floating Rate Notes (FNRs) we described earlier. He then borrows against the qualified investments and reinvests the cash in a broadly diversified portfolio. In addition to his proceeds from the sale to the ESOP, George also has a 49 percent minority ownership position in the Sanders Snack Company. Because he wants to minimize the value of his estate, he will also use the occasion of the sale to the ESOP, and its valuation effects, to do some estate planning.²⁹

Based on the calculation we showed above, the fair market value of George’s remaining 49% holding of the Company’s stock would be $2,312,408 – less than 1/2 of the pre-transaction value of that position.³⁰ As a minority holder of stock in a Company with a reduced valuation, George is in an excellent position to gift all or a portion of his remaining interest in the Company. If George and his wife have made no previous taxable gifts and split the gifts (see Chapter 19), they can gift most of the remaining holding ($2 million, under current law) free of any gift or estate taxes. That stock, and all of its future growth, would thereby be removed from George’s estate. If George wants to continue to remove his Company stock from his estate in order to further reduce his potential estate taxes, he could make additional gifts of stock in the amount of $11,000 (as adjusted for inflation; $22,000 if his wife agreed to split the annual gifts) each year to each child, until all of the stock has been distributed.

In this example, then, George is (1) able to liquidate 51 percent of his ownership interest in the Company for $5.1 million cash, after tax, giving him a substantial measure of personal financial security for his retirement years; and (2) transfer a substantial ownership interest in the

²⁹ If George were to sell his holdings to a third party buyer, he could, of course, make gifts to his children from the cash proceeds of the sale. In that case, however, he would not be able to use any valuation discounts, and he could generally expect to pay gift taxes on most cash gifts above the exemption equivalent amount of $1 million. Where businesses are sold to third party buyers for cash, estate and gift planning should generally be undertaken in anticipation of the sale if their effectiveness is to be maximized.

³⁰ This remains true even though George continues as an executive of the Company and retains effective control.
family business to his children with no (or low) gift tax cost and no estate tax cost.\(^{31}\)

It is more difficult to manage the potential estate tax costs associated with the proceeds from the sale of the stock to the ESOP. If George dies before or after 2010 (the one year, under current tax law, the estate tax is fully repealed) and before selling the qualified replacement securities received in the sale to the ESOP, his estate will receive the securities (and any accumulated appreciation or depreciation) on a “stepped-up” basis under current law. The estate will, thereby, permanently avoid any capital gains tax. However, the securities will be subject to estate taxes whenever they pass to the children\(^ {32}\) (unless Congress has by then extended the repeal of the estate tax).

George can, however, use a charitable trust to attain some liquidity as well as a charitable deduction, while also removing some additional assets from his estate. After the sale to the ESOP and the tax-deferred Section 1042 rollover, George can donate some or all of the qualified replacement securities to a charitable remainder trust (CRT). The requirement to pay out a certain percentage of the CRT’s assets as annual income will provide him significant retirement funds. If George wants to “replace” the gift to the CRT, he can use some of the annuity income to purchase life insurance that will benefit his heirs at his death.\(^ {33}\)

Thus, the combination of an ESOP transaction with a carefully structured gifting program enables a greater transfer of wealth after taxes to the younger generation than simply gifting the Company, selling or liquidating the company, or doing nothing.

**Conclusion: is an ESOP the right choice?**

Over the course of this chapter we have provided an introduction to ESOPs, albeit one without an assessment of whether an ESOP is the best solution in a particular case. Every situation is different, although there are several questions that an individual business owner can use to help determine whether he or she should consider a sale to an ESOP.

As we indicated in our introduction, the most important question is, “Is there a desire (or need) to monetize a large portion of the firm’s equity without disturbing the business enterprise?” If the answer to this question is “yes,” the ESOP option should be seriously explored. Other questions that might offer some guidance to owners of a closely (or not widely held) business include:

- Does a significant shareholder of the company have a desire to “cash out” that position without incurring a large capital gains tax?

\(^{31}\) George could also increase his future security and reduce the need to have an ongoing annual gifting program by increasing the amount of stock he sold to the ESOP in the first place. However small George’s remaining position might be, it would be subject to the minority and lack of liquidity discounts discussed above.

George might also decide to use a family limited partnership (often called a “FLP”) for the transfer of his interest. This approach could avert future disagreements about the management of the remaining stake in the company as well as further reduce George’s potential total gift and estate tax liability.

\(^{32}\) Assets would not be subject to capital gains tax if they passed from George to his wife.

\(^{33}\) He could ensure that these “replacement funds” are also excluded from his taxable estate by creating an irrevocable life insurance trust (“ILIT”) with an independent trustee to purchase and own the policy. Payments to the trust would be counted as gifts to the beneficiaries of the ILIT. If the beneficiaries were George’s children, these payments would reduce George’s ability to transfer his remaining stock to them using the $11,000 annual gift exclusion.
- Does a significant owner of the company want to withdraw his or her own investment in the company without changing the closely (or not widely) held status of the company?

- Does a significant owner of the company want to find a way to transfer some of his or her stock to other members of the family (or ownership) group at a reduced price?

If the answer to two or more of these questions are yes, and the company has value as an ongoing enterprise of about $10 million or more (in today’s environment), the company or its owners should explore the value of an ESOP for their situation.34

Although we believe that ESOPs can be very useful in accomplishing a variety of goals, we do not believe they are panaceas or offer solutions to every problem. An ESOP is a very particular structure, subject to several sets of stringent rules and regulations, and should be used only where owners and executives are prepared to observe the ESOP’s requirements.

Nevertheless, ESOPs present an exciting opportunity for many businesses and business owners. Although we can’t provide any more than general guidelines to help managers consider the possibilities presented by ESOPs for their own businesses, we encourage each of them to give this arrangement serious consideration.

34 Because an ESOP will have both individual and corporate implications, these discussions should ultimately include both the owner(s) who would sell shares to the ESOP and the company’s CFO and senior human resources officer, who will both be involved in the structuring and financing of the ESOP.

Where the company is more widely held, the questions that should be asked by the executive contemplating an ESOP are similar, but should focus on the advantages to the company overall:

- Will the employees of the company benefit from having some economic investment in its performance? Are there tax advantages to be achieved for the business by using an ESOP? Is there a need for low-cost financing to further one or more of the business’s strategic goals (such as an acquisition or a management buy-out)?

Initial creation of a leveraged ESOP that allows sellers to qualify for the Section 1042 rollover will also require that the company find shareholders willing to sell at least 30% of the company’s stock to the plan. If there is a single, large shareholder (either a founder or a parent company) that can sell the whole block, the deal may be fairly straightforward. If, however, a consortium of sellers has to be created, the deal can become far more complex, and will generally require the involvement of an advisor whose role it is to help manage the human issues that often arise during complex, multi-party transactions.
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