ESOPs

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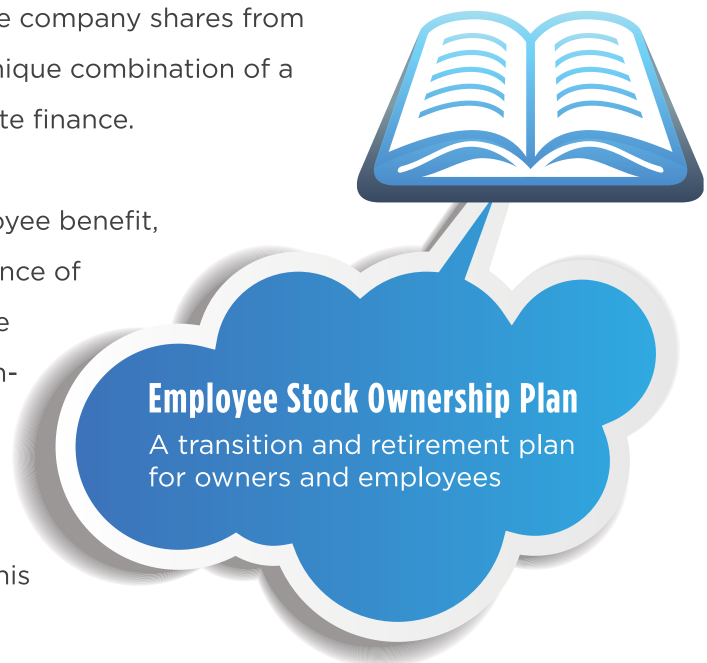
Contents

Define ESOP

At its core, an Employee Stock Ownership Plan (ESOP) is a qualified retirement plan. However, the practical use of this strategy is to provide an ownership transition and retirement plan for owners of privately owned businesses. An owner can sell part or all of his shares to the ESOP at fair market value. ESOPs stand out from other benefit plans because they allow the company to borrow money from an outside source, such as a bank, in order to purchase the company shares from the owners. As such, they are a unique combination of a benefit plan and a tool of corporate finance.

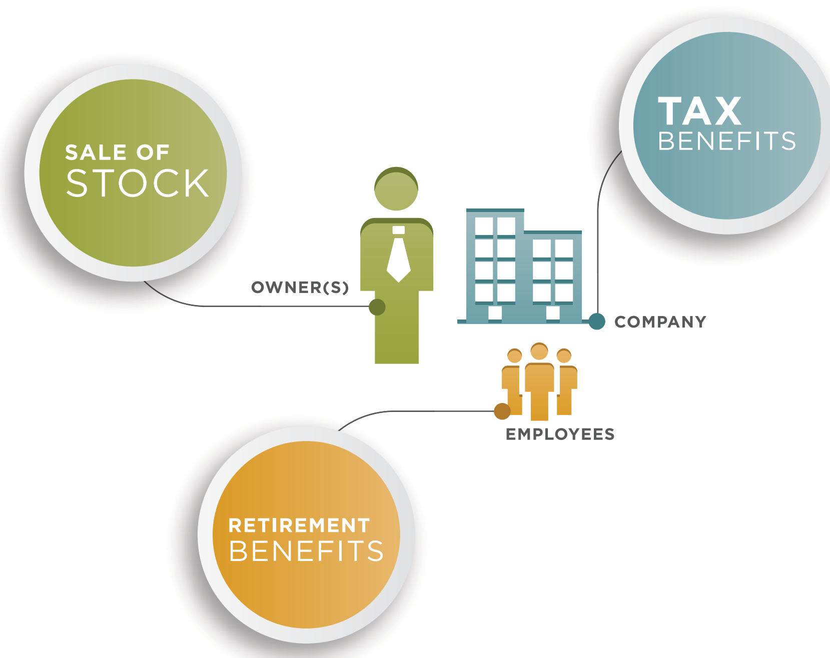


The value of the plan, as an employee benefit, is directly related to the performance of the company, creating an effective incentive for management and employees to perform well. The tax advantages that ESOPs provide a company are extensive and are covered in greater detail later in this document.

Because the rules have been updated and continue to be modified since the inception of the ESOP in 1974, this document is based upon current regulations.

ESOP Advantages

The advantages of an ESOP are significant, and they apply to the owners, employees and company as a whole. Congress has encouraged employee ownership by offering unique incentives to companies that implement an ESOP. When structured correctly, ESOPs can work successfully for the selling shareholders, employee participants and the company. The shareholders (owners) of a company are able to sell company stock without placing the jobs of their employees at risk, as may occur when selling to a third party. Employees earn generous retirement benefits if the company performs well through their holdings of the company's stock, which is repurchased from their accounts, generally upon retirement. The company itself is eligible for major tax benefits.



Creating an ESOP

ESOPs are unique in that they can be funded by loans (a leveraged ESOP) or they can be funded over time by the company's own contributions (an unleveraged ESOP). In a leveraged ESOP, the company borrows money from its bank and/or other capital providers via an "outside loan" then passes it on to the ESOP via an "inside loan." The ESOP then uses the proceeds of the inside loan to purchase company stock. Once the ESOP trust uses the inside loan to purchase company stock from the shareholder(s), the shares purchased are kept in a "suspense account." To repay the inside loan, the company makes annual payments to the ESOP trust that are then used to repay the loan. Because the contributions are tax-deductible contributions to a qualified benefit plan, the company is, in effect, repaying the loan with pre-tax dollars. This is more relevant with a C-Corporation ESOP or a less than 100% S-Corp ESOP. With a 100% S-Corp ESOP, the business is exempt from Federal income tax as the pass-through tax entity, the ESOP trust, is exempt from Federal income tax.

As the inside loan is repaid, shares are released from the suspense account and allocated to employee accounts. In order to participate in the ESOP, an employee must generally be at least 21 years of age, have worked at least one year at the company and have contributed at least 1,000 hours of service in a year.

ESOP Tax Advantages

Company tax benefits are a great incentive to implement an ESOP. Here are some of the ways an ESOP provides a company with tax advantages:

- When the company contributes to the ESOP annually, contributions to the plan used to repay debt are tax-deductible.
- Dividend payments used to repay the ESOP debt are tax-deductible (but may be subject to AMT).
- Employees are exempt from paying taxes on contributions. When they leave the company, employees must pay taxes on the distribution. Employees can, however, roll over their account balances into an IRA or other retirement plan, thereby further deferring the tax liability.
- Stock contributions are tax deductible. If a company decides to allocate new shares to the ESOP, it can do so without paying taxes on the value of the contribution.
- In certain circumstances, capital-gains taxes on the proceeds from the sale of the company’s stock to the ESOP can be deferred or eliminated under the provisions of Section 1042 of the Internal Revenue Code.

ESOP Laws

Because they provide such extraordinary tax benefits, ESOPs must follow a myriad of strict regulations. The Employee Retirement Income Security Act of 1974, as amended (ERISA) is the law that oversees retirement plans, and it provides the guidelines that companies must fulfill in order for a retirement plan to qualify for certain tax benefits. If an ESOP is neither arranged correctly nor executed according to ERISA's requirements, the company involved can incur penalties.

While ERISA's requirements can be extensive, here is a list of core requirements for an ESOP to be considered a qualified retirement plan:

1. Generally speaking, every employee over 21 who has worked for at least one year and 1,000 hours within the year is eligible to be included in the plan.

2. Once the eligibility requirements are met, an employee must participate in the ESOP no later than the first day of the new "plan year" or within six months of meeting the requirements (whichever of these two scenarios comes first). The "plan year" refers to the ESOP's 12-month accounting period.

3. Employees subject to a collective bargaining agreement are generally excluded from participation due to the multi-employer plans to which they generally belong.

4. ESOP participation cannot be offered to employees who work as independent contractors (1099 Employees).

There are additional regulations applicable to ESOPs and other qualified benefit plans, such as vesting schedule rules.

ESOP Rollover (Section 1042)

Planning for the future of a business can be extremely challenging for the owner(s) of a company. Selling to an outsider buyer is not always the best route. Even if the owner and the potential buyer settle on a price, there are often other significant issues to be dealt with that can impact employees' futures. Headcount reductions are generally a major concern of employees when an ownership change occurs. Also, many privately owned businesses are located in non-metropolitan areas that could be adversely affected if a core employer is relocated or shut down after the acquisition.

To provide an incentive for owners to sell to an ESOP, and therefore preserve jobs and the economic sustainability of communities, the tax regulations provide for a deferral or elimination of capital gains taxes for C-Corporation owners selling to an ESOP.

Internal Revenue Code Section 1042 covers the ways owners can utilize a rollover feature to defer taxation, in some cases permanently. There are, of course, strict guidelines that must be met. First, the ESOP must own at least 30% of the value of the company post-sale. This doesn't necessarily mean that one owner must sell 30%; if two owners each sold 15% of the company's shares to the ESOP, then they would qualify for the Section 1042 rollover benefits. The sellers, however, must have owned that stock for at least three years. Second, the owners must reinvest the earnings into Qualified Replacement Property "(QRP") over a 15-month period beginning three months prior to the sale and ending 12 months following the sale.

The funds rolled over into QRP (debt or equity securities of domestic operating companies) do not need to be the proceeds from the sale. They can instead be an equivalent amount of money. Additionally, the full amount need not be allocated to a qualified replacement property, but the remaining sum will be subject to capital gains taxes. Many times, sellers will receive both cash and seller debt in a transaction. There are many ways a seller can maximize the tax effectiveness of the proceeds by carefully managing both 1042 tax treatment and installment sale treatment.

ESOP Valuation

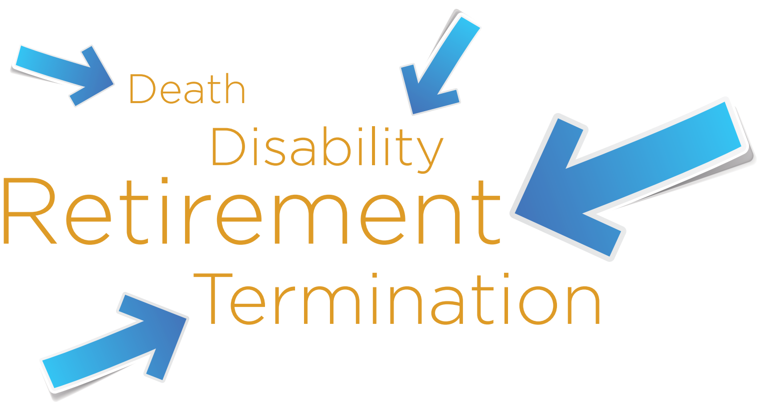
As part of the ESOP implementation process, a company is legally obligated to undergo a valuation process through an independent professional retained by the ESOP trustee. As a rule, the “independent” factor implies that the company has no previous relationship with the valuation consultant, as this could skew the validity of the assessment. By “professional,” the law implies that the corporation or individual providing the valuation must routinely perform this service and must have the acknowledged credentials to do so. This valuation process is critical in that the ESOP trust can pay no more than fair market value for the company’s stock, and this process ensures that will be the case.

An appraiser who is both independent and professional will consider many factors when determining the value of a company. Included in this list are current profit, projected cash flow, market conditions, existing debt, assets and more. Because this is a vital step in ESOP implementation, the process is extensive and can require financial records from the past five years, projected financial statements and just about any other documentation that might impact the value of the company. Not following the valuation procedures carefully can result in legal action against the corporation, such as lawsuits filed by the government, participants or both.

In order for the determined value to be relevant, the ESOP’s purchase of shares must be performed soon after valuation.

ESOP Distribution

Employee participants in the ESOP are eligible to receive the benefits when they leave the company. The list of circumstances related to employee departures includes death, disability, retirement and termination of employment. The timing and amount of the payout can vary according to the circumstances of the departure. At the time of an ESOP's inception, the owners of the company should discuss the impact that the distribution process will have on the organization. This foresight will encourage the company to carefully plan for what is referred to as Repurchase Liability. The distribution of funds in employee ESOP accounts can represent a major cash use for the company and should be planned for in advance to avoid any negative impact to the business. For departures related to death, retirement or disability, the ESOP plan will generally start distributions during the plan year succeeding the event. However, if the participant's employment is terminated, the company has up to six years before the ESOP account is required to be distributed. In this case, the distributions can then be made over time, with the payment of reasonable interest on the undistributed balance. Payments may also be deferred as long as there is debt outstanding related to the funding of the ESOP transaction.



Repurchase Obligation

Once an employee leaves the company, he or she is generally required to sell the stock in their ESOP account back to the company for cash. This is the Repurchase Liability referred to earlier. Due to the significant impact of this Repurchase Liability, if not planned for, it is highly recommended that companies involved in an ESOP consult with an experienced advisor beforehand to discuss this topic and various ways of planning/funding the obligation.

Disadvantages of an ESOP

Unfortunately, ESOPs can add financial risk if not implemented carefully and with the guidance of a qualified counsel.

One of the primary costs of setting up an ESOP is the process of assembling the right team. There are costs for the company's and shareholders' qualified counsel, legal fees, trustee fees and fees for the trustee's independent financial advisor who performs the upfront and annual valuations.

Leveraged ESOPs, while common, add debt to the company's balance sheet and may have an impact on how others view the creditworthiness of the business. Because company shares are purchased with borrowed funds in a leveraged ESOP, a corporation may find it difficult to service the additional debt if business declines. **The good news for Mosaic portfolio companies is that it provides flexible and patient capital to fund ESOP transactions.**

When employees leave the company for retirement or other reasons, the company generally repurchases those employees' shares, and plans generally give the employee participants the right to do so. This Repurchase Liability can be costly to a company that has not planned for it.

Associations

There are several groups nationwide that are known for their focus on and expertise in ESOPs. The National Center for Employee Ownership has an extensive library of resources and literature that is available for purchase. The ESOP Association is another membership-based group that offers educational services to its members.

References

http://www.nceo.org/

http://www.esopassociation.org/