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together

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Employee Stock Ownership Plan (ESOP)
Is it a good idea?

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- Counseled public and private corporations, ESOP fiduciaries, lenders, management groups, and private equity firms on the use of ESOPs
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- **Blue Ridge ESOP Associates** was founded in 1988 and delivers the highest quality ESOP and 401(k) Administration services in the industry. We exceed client expectations through personal attention, a proactive, team-oriented approach, and a focus on timeliness and technological innovation.

- We serve clients in a diverse spectrum of industries and with plans ranging in size from 15 to over 20,000 employees.

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Since its founding in 1935, Morgan Stanley and its people have helped redefine the meaning of financial services. The firm has continually broken new ground in advising our clients on strategic transactions, in pioneering the global expansion of finance and capital markets, and in providing new opportunities for individual and institutional investors.

Why Bother with an ESOP?

- ***Because*** the Owner(s) benefit
- ***Because*** the Shareholders benefit
- ***Because*** the Employees benefit
- ***Because*** the Company benefits

A **win-win** situation…

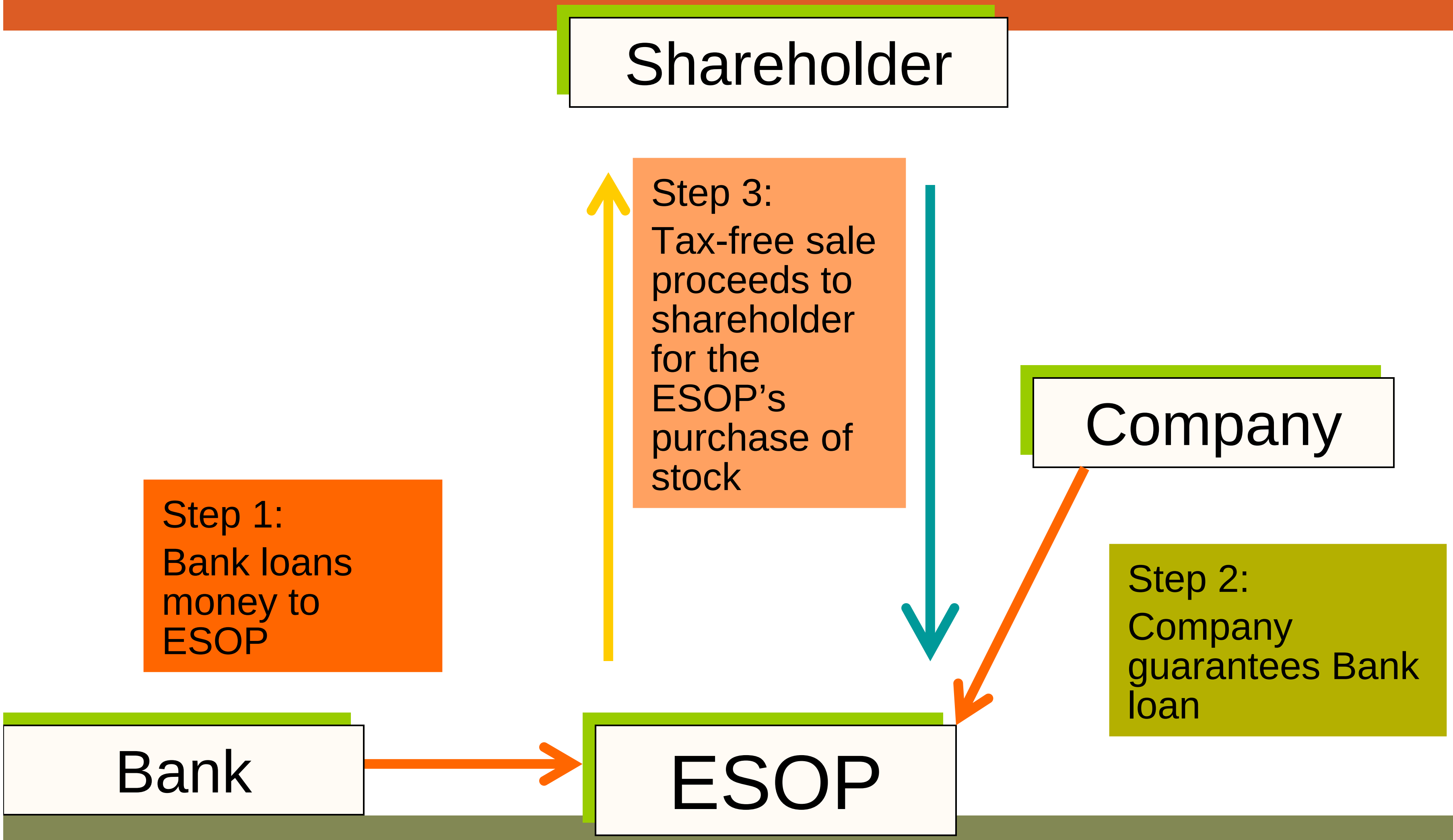
…for EVERYONE

What Is an ESOP?

- A qualified retirement plan designed to invest in company stock
- Benefits employees and, indirectly, customers
- 9,500 ESOPs in the U.S. covering 10 million employees and controlling $600 billion in assets*

***Source: www.nceo.org**

The Players – A Leveraged ESOP



The ESOP’s Repayment of Debt

Employees

Company

Step 4:
Employees receive company stock or cash from ESOP

Step 1:
Company makes deductible contributions and dividends to ESOP

ESOP

Step 3:
As debt is repaid, stock is allocated to employee ESOP accounts

Step 2:
ESOP repays stock acquisition loan from Bank

Bank

Shareholder Benefit

- Tax-free sale of proceeds for sale of stock to an ESOP
- Retain control of company regardless of amount of stock sold to ESOP
- Tie employee compensation to company performance, leading to a more productive workforce
- Effectively transfer ownership of the company to employees, if desired

Employee Benefits

- Shared ownership of a company provides employees with an incentive to improve both individual and company performance
- Employee receives a retirement benefit equal to the value of company stock in his/her ESOP account
- Employee receives tax-deferred growth until his/her benefit is distributed
- Gains in employee stock value are taxed as capital gains, not as ordinary income

Company Benefits

- Company pays down the debt with pre-tax dollars because annual contributions and dividends are tax deductible
- Company can increase working capital through significant reduction of tax liability. This effect is compounded with an S corporation as income flows through to a tax-exempt trust
- If a company is an S corporation and owned 100% by its ESOP, the company can operate tax free

Return to diagram

How Does It Work?

- Company creates a trust to which it makes contributions
- Contributions are allocated to individual employee accounts based on compensation (up to $225,000) within the trust
- The shares of company stock and other plan assets allocated to employees’ accounts vest
- Employees receive vested portions of their accounts at termination or retirement

How Is an ESOP Stock Sale Financed?

- Traditional bank loan
- Seller financing
- Mezzanine lenders
- Private equity
- Employees’ monies from other qualified plans

1042 Tax-Free Sale

- Advantages of 1042
  - *Seller of stock to a C corporation's ESOP pays no income tax on sale proceeds that are reinvested in Qualified Replacement Property (QRP) (note that this need not be just a deferral if coupled with monetizing)*
  - *Corporation deducts the cost of paying the seller*
  - *Example of tax-saving potential --*

Sale to ESOP at $7,000,000
vs.
Sale to Company at $7,000,000

	After-Tax Benefits to Seller	After-Tax Cost to Company
ESOP Alternative	**$7,000,000**	**$4,200,000**
Non-ESOP Alternative	**$5,600,000**	**$7,000,000**
Differential	**$1,400,000**	**$2,800,000**
Total Tax Savings Using ESOP		**$4,200,000**

1042

- Only ESOPs sponsored by C Corporations can consummate a 1042 Election
- Only “Qualified Securities” can be sold
  - *Best common or convertible preferred*
  - *Domestic corporation*
  - *3-year holding period*
  - *Not received pursuant to "another plan"*
  - *Sale otherwise eligible for LTCG*

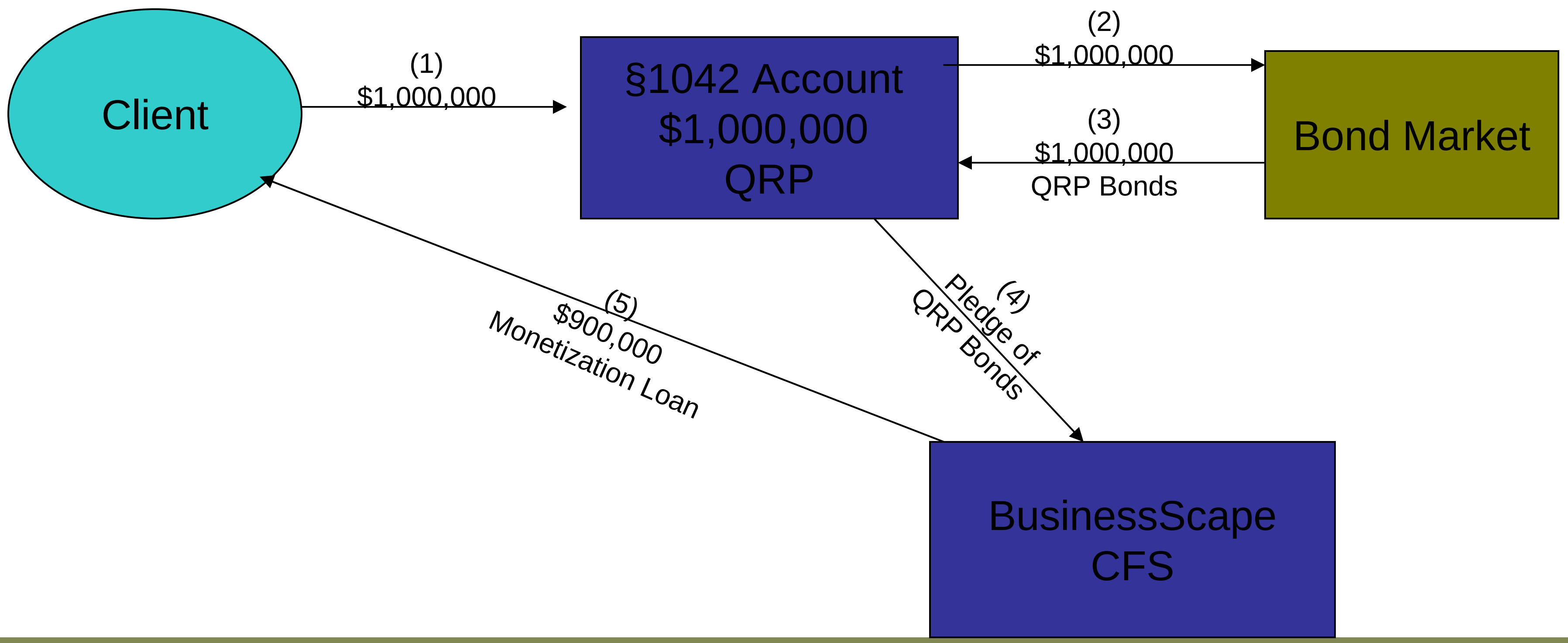
1042

- Qualified Replacement Property (QRP) must be:
  - *Stocks, bonds or notes of an --*
  - *Active U.S. corporation*
    - *That is not the employer, or*
    - *A member of a controlled group with it*
  - *Purchased within a 15-month period starting three months prior to the sale and ending 12 months after it*
  - *Rollover of Basis*

1042

- Tax on dispositions of QRP
  - *Triggers LTCG that was initially avoided*
  - *Exceptions - no tax where disposition is due to*
    - *368 reorganization*
    - *Death of seller*
    - *Subsequent 1042 sale*
    - *Gift*

1042-Monetizing to break the QRP lock-in effect



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Cost of Creating an ESOP

- Initial setup fees
- Annual valuation costs
    - *Initial cost: $10,000 - $25,000*
    - *Annual fee: $7,000 - $10,000*
- Annual administration costs
    - *Flat fee + per-employee fee*
        - *Ex.: If 100 employees - $6,500*
          If 1,000 employees - $25,000
- Repurchase liability
    - *Insurance and/or sinking fund setup possible*

A Good Idea!

An ESOP can…

let owners **cash out tax free** while **retaining control** and **resolving transitional issues**

Characteristics of an Ideal ESOP Candidate

- **Characteristics to look for in companies with possible succession issues:**
  - *Closely held business with owner/management nearing retirement age*
  - *Business owner wants to sell business, but has no prospective buyers*
  - *Business owner looking to take chips off the table and sell portion of business*
  - *Shareholder disputes, where one or more shareholders want to be cashed out*
  - *Owner seeking to gain liquidity while maintaining control*
  - *Owner seeking to reduce taxable income while maintaining overall take*

Characteristics of an Ideal ESOP Candidate

- Characteristics where the ESOP could serve corporate finance purposes**:**
  - *By routing debt through an ESOP, all payments (interest and principal) are deductible*
  - *Annual contributions (based on 25% of covered compensation), dividends paid on stock owned by the ESOP, and interest on stock purchase indebtedness can be deducted so as to greatly reduce the taxable income of a company*

Characteristics of an Ideal ESOP Candidate

- Essential Corporate Characteristics:
  - *Mid- to larger-size company that shows a profit, pays a corporate tax, and expects long-term profitability*
  - *Company should have enough employees (10 or more) and an approximate annual payroll that exceeds $1 million.*

Some Other ESOP Advantages

- Motivates employees because they feel they are getting "a piece of the rock"
- Costs for Government Contractors are subject to reimbursement on a "cost plus" basis
- Can be used as a vehicle for corporate acquisitions or divestitures
- Can enable a public company to "go private"
- An effective tool for estate planning
- ESOPs, in conjunction with a 401(k), allow for matching contributions in company stock
- The Ultimate - a 100% ESOP-owned S corporation -- a tax-exempt entity

Some Disadvantages

- Cost of annual valuations
- Initial setup costs for ESOP implementation
- Introduction of fiduciary responsibility
- The Repurchase Obligation

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