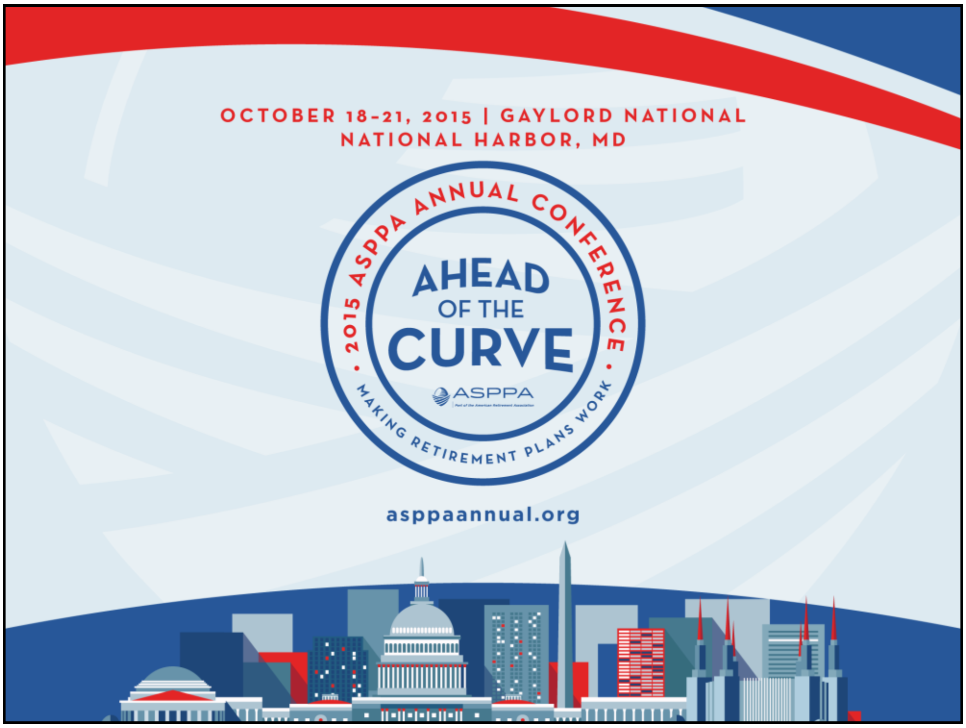

ESOPs

Workshop 20

Presented by

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INTRODUCTION

WHY HAVE AN ESOP?

- Motivate employees
  - Esprit de corps
  - “Have skin in the game”
  - Owners?
  - NOT shareholders

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WHY HAVE AN ESOP?

- Exit strategy for owners
- ESOP culture

PLAN TYPES

- Employee Stock Ownership Plan (ESOP)
- Stock Bonus Plan
- KSOP
- Profit Sharing Plan

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INVEST PRIMARILY IN EMPLOYER STOCK

- Qualifying Employer Securities
- Stock that is readily tradable
- Stock of parent company or affiliate
- Timing for initial investment

ALLOCATION AND VALUATION

- Employer contributions
  - Cash
  - Stock
- Allocated to individual accounts
- Valuation by Qualified Independent Appraiser

PLAN DESIGN AND ADMINISTRATION

- Stock and cash accounts
- Eligibility
- Vesting

PLAN DESIGN AND ADMINISTRATION

- Coverage
- Nondiscrimination
- Counting past service

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DISTRIBUTIONS

- Right to demand stock
- Exceptions
  - Readily tradable
  - S Corporation stock
  - Restricted ownership

DISTRIBUTIONS

- Timing
  - 5 year delay after termination
  - Pay in installments

DISTRIBUTIONS

- Future repurchase liability

DISTRIBUTIONS

- Cash distributions
  - Sell stock
  - Valuation/Timing
  - Reshuffle

DISTRIBUTIONS

- Stock distributions
  - Put option if stock is not readily tradable
  - Timing
  - Valuation

DIVERSIFICATION RIGHTS

- Age 55 + 10 years of service
- Portion of account
- Distribute?
- Non-stock investment options

VOTING RIGHTS

- Pass through voting
- Stock that is tradable
- Stock that is not readily tradable

LEVERAGED ESOPS

- ESOP borrows from the employer or a third-party lender to buy a block of stock
- Stock is placed in suspense while loan is outstanding as security for the loan
- Each year, the company contributes enough to make a loan payment
  - Part of loan principal is paid
  - Proportionate amount of stock is released from suspense
  - Allocated to participants' accounts

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LEVERAGED ESOPS

- Exempt loans
  - Plan borrows from bank
  - Company borrows from bank; lends to ESOP
  - Seller carries back a note

LEVERAGED ESOPS

- Suspense account
  - Share release formulas
  - Security for loan

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LEVERAGED ESOPS

- Prohibited transaction rules
  - Exemption for loans
  - Exemption for purchase/sale
  - Timing for valuation

LEVERAGED ESOPS

- Code Section 1042 – Defer gain on sale of stock
  - C Corporation
  - ESOP must own 30%
  - Must reinvest sale proceeds in Qualified Replacement Property
    - Timing for purchase of QRP
    - Holding Period
  - Non-allocation rules

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LEVERAGED ESOPS

- Contributions/Deductions

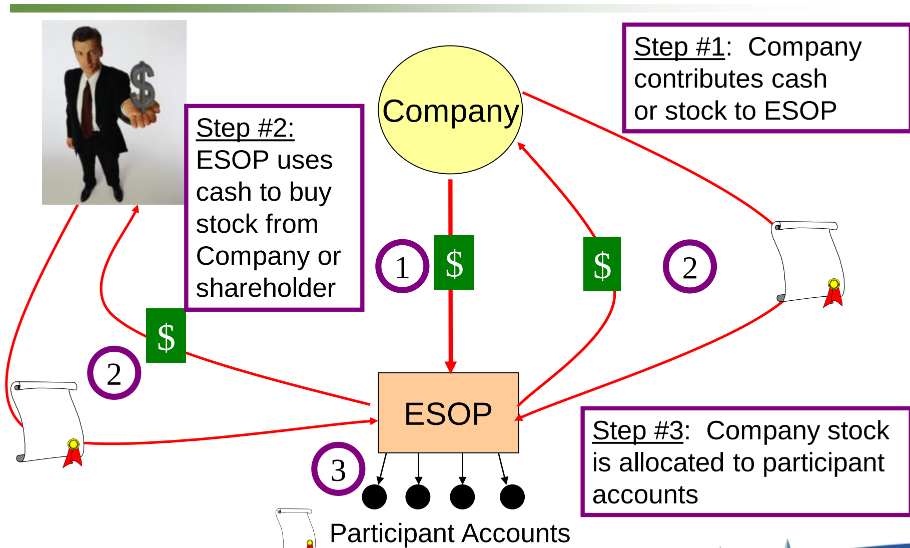
LEVERAGED ESOPS

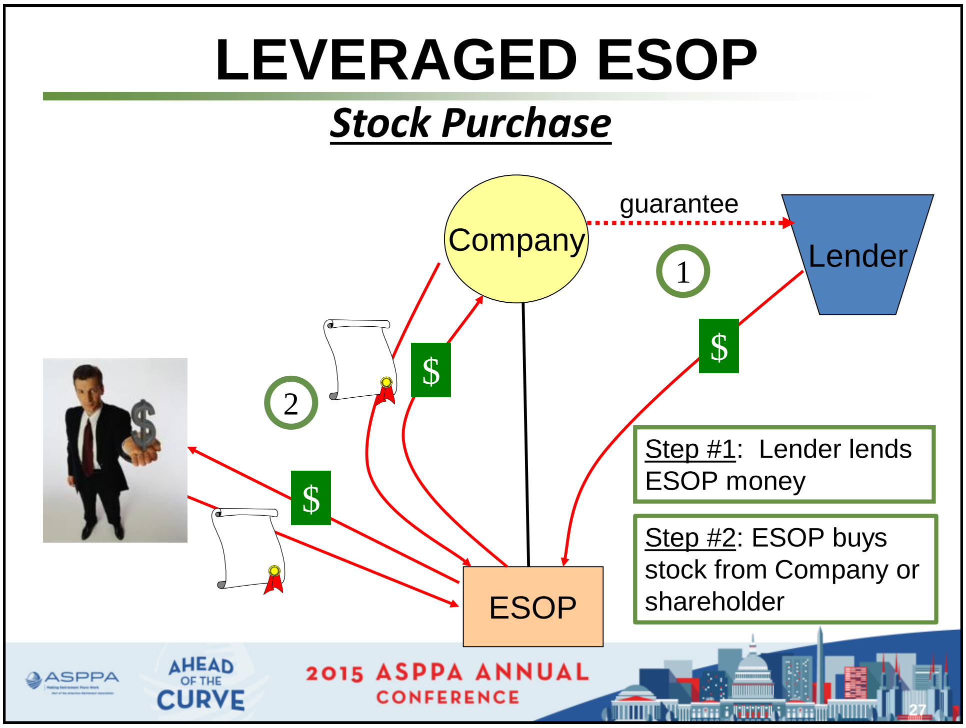
- Feasibility
  - Eligible payroll
  - Amount needed to make loan payments

LEVERAGED ESOPS

- How much stock to buy
  – All at once?
  – Buy in stages?

HOW AN ESOP WORKS




LEVERAGED ESOP
Stock Purchase
Company
guarantee
Lender
1
$
2
$
$
Step #1: Lender lends ESOP money
Step #2: ESOP buys stock from Company or shareholder
ESOP
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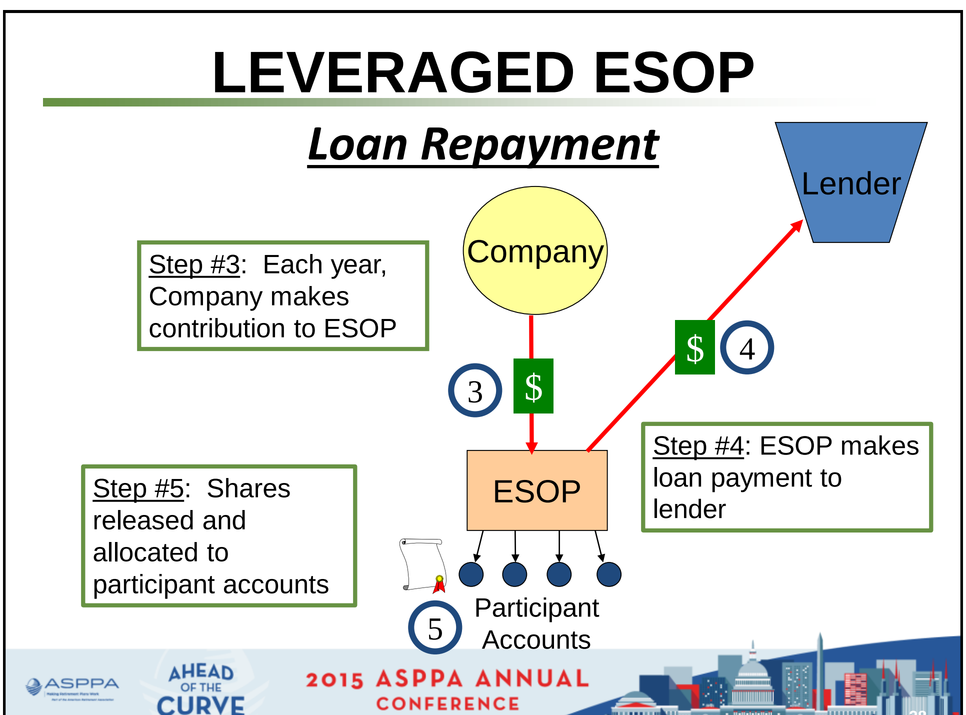
LEVERAGED ESOP
Loan Repayment
Lender
Company
Step #3: Each year, Company makes contribution to ESOP
3
$
$
4
Step #4: ESOP makes loan payment to lender
ESOP
Step #5: Shares released and allocated to participant accounts
5
Participant Accounts
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S CORPORATION ESOPS

- Tax advantages
- Code section 409(p)
  - No allocation/accrual for Disqualified Person
  - DQP
    - Member of 20% shareholder group
    - 10% shareholder
    - Family member

S CORPORATION ESOPS

- Code section 409(p) [Cont.]
  - Violation
    - Not treated as “ESOP”
    - PT exemptions don’t apply; excise taxes
    - S Corporation election may terminate
    - Excise tax on prohibited allocations

FIDUCIARY ISSUES

- Who wears which hats?

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FIDUCIARY ISSUES

- Conflicts and self-dealing
  - Purchase/sale
  - Valuation
  - Owner/Officer compensation and benefits
  - Other issues

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FIDUCIARY ISSUES

- Avoiding prohibited transactions

FIDUCIARY ISSUES

- Potential Solutions
  - Independent trustee
    - Cost
    - Availability
  - Committee
  - Employee involvement
    - Pros
    - Cons

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IRS/TAX QUALIFICATION

- Scrutiny
- No pre-approved documents – advisable to get individual determination letter

DOL SCRUTINY

- Fiduciary issues
- Fees
- Acts by Company Directors, Officers and Shareholders

LITIGATION

- Couturier
- Moench
- Participant claims

ADVANTAGES TO ESOPS

- If company is a C corporation, dividends paid to the ESOP may be tax deductible
- ESOPs transfers ownership to employees
  - Encourages their productivity
- Creates a market for privately held shares
- Tax-deductible manner to finance company growth or expansion
- May contain 401(k) feature (generally called a "KSOP")

QUESTIONS?

Presenters

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