Bloomberg Law Reports®

November 11, 2011

Labor & Employment

Employee Benefits

Employee Stock Ownership Plans

Succession Planning for Business Owners: Are ESOPs the Secret Weapon?

Martin Chioffi LLP
COUNSELORS AT LAW

Contributed by Henry C. Blackiston, Martin Chioffi LLP

Introduction; Succession Planning Alternatives

Owners of successful businesses normally spend a great deal of time engaged in strategic planning for their businesses. As these owners approach retirement age, which is what the Baby Boomer generation is now doing, another important part of strategic planning will be figuring out how the business will run after the owners are no longer as involved, and determining who should own and operate the business in order to insure a seamless transition and future success. In many cases, owners have a great deal of equity in the business and want to monetize that investment as part of their estate plan. In other words, many such owners are facing succession planning.

Unfortunately, there is considerable data suggesting that the majority of business owners do not have a well thought-out succession plan. Those that seriously do consider succession plans usually look at three basic alternative ways of accomplishing it: going public, a management buyout, or a sale to an outside buyer.

Although each of the above alternatives has their place as a desirable approach given the right circumstances, there is another alternative that should be considered: the ESOP, or employee stock ownership plan. The purpose of this article is to give a basic summary of the tax advantages of ESOPs and how, in the right circumstances, they can be an excellent tool for succession planning.

ESOPS–Their Advantages

– Introduction

An ESOP, if properly structured, can fulfill critical elements of a succession plan by a) allowing the owners of a business to sell company stock to the ESOP without currently recognizing gain, b) allowing the ESOP to borrow from the company for the owner's stock, and having the repayment of the borrowing (principal as well as interest) be made with tax deductible company contributions to the ESOP, and c) allowing the company to take a deduction for any dividends declared on company stock held by the ESOP. This can all be done while allowing the selling owners to retain a controlling interest in the company. In short, ESOPs are a tax efficient way to have owners monetize their equity value without losing control.

An ESOP is a form of tax-qualified employee benefit plan governed by the legal requirements of ERISA and the Internal Revenue Code. However, an ESOP is different from other tax qualified plans in a number of ways. Significantly, it must be designed to

Originally published by Bloomberg Finance L.P. in the Bloomberg Law Reports. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

This document and any discussions set forth herein are for informational purposes only, and should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Review or use of the document and any discussions does not create an attorney-client relationship with the author or publisher. To the extent that this document may contain suggested provisions, they will require modification to suit a particular transaction, jurisdiction or situation. Please consult with an attorney with the appropriate level of experience if you have any questions. Any tax information contained in the document or discussions is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. Any opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content in this document or discussions and do not make any representation or warranty as to their completeness or accuracy.

© 2011 Bloomberg Finance L.P. All rights reserved.

invest "primarily" in qualified securities of the employer sponsor.[1] Therefore, unlike other qualified plans, the ESOP does not have to diversify plan assets, and up to 100 percent of the plan's assets can be invested in company stock.

– Tax Advantages of Leveraged ESOPs

According to the ESOP Association, there are over 11,000 ESOPs in the United States, covering about 10 million employees. About 97 percent of these are sponsored by private company employers. What is it that makes these plans continue to be popular and serve as a powerful tool for succession planning, among other uses? The answer is that they have a number of tax advantages which make the acquisition of stock by the sponsor's employees very tax efficient. In addition, they provide employees with an equity stake in the company and an additional valuable employee benefit.[2]

– *The Section 1042 Sale*

An ESOP is unique because owners of a privately held C corporation can pay no current tax on gain recognized in the sale of their stock to the ESOP if certain conditions are met.[3] Since it is not necessary to sell a majority of the outstanding shares to the ESOP in order to accomplish the deferral, this is a powerful motivation for the owner of a business to liquidate his holdings on a tax deferred basis, without necessarily giving up control, if this is desired. Therefore, as a succession planning device, it is tax efficient and at the same time avoids management and control issues that can arise for owners who give up equity to outside investors.

The key conditions applicable under the Code for this tax deferral to work are as follows:

- Immediately after the sale, the ESOP owns at least 30 percent or more of the Company's stock. Note that it is not necessary for the ESOP to own more than this minority stake. Preferred stock is not included in the 30 percent calculation.
- The stock being sold must have been held by the owner for at least three years, and may not include option shares or any publicly traded shares.
- The owner must rollover the sales proceeds within 12 months of the sale into a certain type of securities, called "Qualified Replacement Property." To qualify, these securities must be issued by a domestic corporation (they can be equity or debt) and the issuer must be an operating company, not a company with passive investments, like a mutual fund. Also excluded from qualification are government securities, real estate, bank CDs, or securities of the ESOP sponsor itself or its affiliates.
- The selling owner may not have any of the stock sold allocated to ESOP accounts belonging to the owner or his family, for 10 years. Otherwise, there is a 50 percent excise tax penalty.
- The ESOP must not dispose of such stock for three years, otherwise, the corporation must pay an excise tax of 10 percent.

If the owner disposes of any such "Qualified Replacement Property" at any time, then any gain that would have otherwise have been recognized at the time of the sale of the company stock to the ESOP, will be recognized on such a disposition. Note that there is an exception for death, so that the tax is avoided altogether for any such shares still held at that point.

– *The Employer Contribution Deduction.*

A second special tax benefit applicable to ESOPs, is the deductibility of certain principal payments required to amortize the loan taken out to pay for the shares. Under section 404 of the Code, employer contributions used by the ESOP to repay the principal of the company exempt loan to the ESOP will be deductible. The Code limits the deduction to 25 percent of the payroll of the employees participating in the ESOP. Employer contributions used by the ESOP to repay interest on such a loan are fully deductible without such a limit.[4] In order for this benefit to apply, the loan must qualify as an "exempt loan" as described below. Other complex IRS rules generally applicable to all qualified plans may also limit employer contributions to the ESOP in some circumstances, but the details are beyond the scope of this article.[5]

Obviously, this benefit of being able to deduct principal payments has the potential effect of significantly reducing the effective cost of the ESOP loan, depending on the corporation's tax bracket. For example, if the corporation is in a combined state and Federal tax bracket of 40 percent, a $1 Million loan to the ESOP might require only $1 million of earnings to pay principal, whereas in a non-deductible context, about $1.67 million of earnings would be required. The important point is that a leveraged ESOP requires less cash flow to amortize the loan than a normal loan.[6] The owner's equity can therefore be monetized at a reduced cost to the company.

– *The Dividend Payment Deduction*

A third special tax benefit unique to ESOPs is the dividend payment deduction. Normally, the payment of a dividend is not deductible to the corporation. Not so are dividends declared on stock held by an ESOP. These are deductible with respect to employer securities held by an ESOP in any of the following circumstances:[7]

- The dividend is paid in cash to ESOP participants and beneficiaries.
- The dividend is paid to the ESOP and distributed by the ESOP to the participants and beneficiaries within 90 days of the close of the plan year in which paid.

An ESOP is a form of tax-qualified employee benefit plan governed by the legal requirements of ERISA and the Internal Revenue Code. However, an ESOP is different from other tax qualified plans in a number of ways. Significantly, it must be designed to invest "primarily" in qualified securities of the employer sponsor.[1] Therefore, unlike other qualified plans, the ESOP does not have to diversify plan assets, and up to 100 percent of the plan's assets can be invested in company stock.

– Tax Advantages of Leveraged ESOPs

According to the ESOP Association, there are over 11,000 ESOPs in the United States, covering about 10 million employees. About 97 percent of these are sponsored by private company employers. What is it that makes these plans continue to be popular and serve as a powerful tool for succession planning, among other uses? The answer is that they have a number of tax advantages which make the acquisition of stock by the sponsor's employees very tax efficient. In addition, they provide employees with an equity stake in the company and an additional valuable employee benefit.[2]

– *The Section 1042 Sale*

An ESOP is unique because owners of a privately held C corporation can pay no current tax on gain recognized in the sale of their stock to the ESOP if certain conditions are met.[3] Since it is not necessary to sell a majority of the outstanding shares to the ESOP in order to accomplish the deferral, this is a powerful motivation for the owner of a business to liquidate his holdings on a tax deferred basis, without necessarily giving up control, if this is desired. Therefore, as a succession planning device, it is tax efficient and at the same time avoids management and control issues that can arise for owners who give up equity to outside investors.

The key conditions applicable under the Code for this tax deferral to work are as follows:

- Immediately after the sale, the ESOP owns at least 30 percent or more of the Company's stock. Note that it is not necessary for the ESOP to own more than this minority stake. Preferred stock is not included in the 30 percent calculation.
- The stock being sold must have been held by the owner for at least three years, and may not include option shares or any publicly traded shares.
- The owner must rollover the sales proceeds within 12 months of the sale into a certain type of securities, called "Qualified Replacement Property." To qualify, these securities must be issued by a domestic corporation (they can be equity or debt) and the issuer must be an operating company, not a company with passive investments, like a mutual fund. Also excluded from qualification are government securities, real estate, bank CDs, or securities of the ESOP sponsor itself or its affiliates.
- The selling owner may not have any of the stock sold allocated to ESOP accounts belonging to the owner or his family, for 10 years. Otherwise, there is a 50 percent excise tax penalty.
- The ESOP must not dispose of such stock for three years, otherwise, the corporation must pay an excise tax of 10 percent.

If the owner disposes of any such "Qualified Replacement Property" at any time, then any gain that would have otherwise have been recognized at the time of the sale of the company stock to the ESOP, will be recognized on such a disposition. Note that there is an exception for death, so that the tax is avoided altogether for any such shares still held at that point.

– *The Employer Contribution Deduction.*

A second special tax benefit applicable to ESOPs, is the deductibility of certain principal payments required to amortize the loan taken out to pay for the shares. Under section 404 of the Code, employer contributions used by the ESOP to repay the principal of the company exempt loan to the ESOP will be deductible. The Code limits the deduction to 25 percent of the payroll of the employees participating in the ESOP. Employer contributions used by the ESOP to repay interest on such a loan are fully deductible without such a limit.[4] In order for this benefit to apply, the loan must qualify as an "exempt loan" as described below. Other complex IRS rules generally applicable to all qualified plans may also limit employer contributions to the ESOP in some circumstances, but the details are beyond the scope of this article.[5]

Obviously, this benefit of being able to deduct principal payments has the potential effect of significantly reducing the effective cost of the ESOP loan, depending on the corporation's tax bracket. For example, if the corporation is in a combined state and Federal tax bracket of 40 percent, a $1 Million loan to the ESOP might require only $1 million of earnings to pay principal, whereas in a non-deductible context, about $1.67 million of earnings would be required. The important point is that a leveraged ESOP requires less cash flow to amortize the loan than a normal loan.[6] The owner's equity can therefore be monetized at a reduced cost to the company.

– *The Dividend Payment Deduction*

A third special tax benefit unique to ESOPs is the dividend payment deduction. Normally, the payment of a dividend is not deductible to the corporation. Not so are dividends declared on stock held by an ESOP. These are deductible with respect to employer securities held by an ESOP in any of the following circumstances:[7]

- The dividend is paid in cash to ESOP participants and beneficiaries.

- The dividend is paid to the ESOP and distributed by the ESOP to the participants and beneficiaries within 90 days of the close of the plan year in which paid.
- The dividend is payable, at the election of the participants or beneficiaries, as follows: as provided in either of the first two circumstances above, or paid to the ESOP and reinvested in company stock.
- The dividend is used to make payments on the ESOP loan, and the loan proceeds are used to acquire employer securities held by the ESOP.

Other Leveraged ESOP Rules

– *The Exempt Loan Requirement*

In order for an ESOP to work efficiently as a succession planning device, it is necessary for it to have funds in order for it to purchase the company stock from an owner. These funds must usually come from borrowing since an ESOP established for this purpose usually has no independent resources. In order for such a borrowing to avoid the ERISA and Internal Revenue Code prohibitions applicable to borrowings by other employee benefit plans, and in order for the repayment of principal to be tax deductible, the funding must qualify as an "exempt loan." The following are the key requirements for such a loan: [8]

- The purpose of the loan must be "primarily" for the benefit of plan participants and beneficiaries. A well run, permanently established ESOP which applies to all employees in a non discriminatory manner, will almost always meet this test, even if it incidentally benefits the owners as a tax efficient tool of succession planning.
- The rate of interest on the loan must be reasonable, taking into account all factors. A variable interest rate may be reasonable.
- The term of the loan must be fixed, and payments may not be accelerated upon default. In certain circumstances, depending on how shares are released from the ESOP trust upon repayment, the term may not exceed 10 years.
- The loan proceeds must be used within a reasonable time of receipt to either purchase the employer securities held by the ESOP, or to repay an outstanding ESOP loan.
- The only assets the ESOP may pledge as collateral for the exempt loan are the employer securities acquired with the loan proceeds.
- The terms of the loan must be at least as favorable to the ESOP as a loan resulting from arm's length negotiations between independent parties.
- The ESOP's payments must not exceed its liquid assets, and payments cannot be funded through the sale of pledged securities.

– *Release of Securities from ESOP Suspense Account*

When an ESOP borrows funds under an exempt loan to purchase employer securities, an outside lender will normally want the employer securities so purchased to be pledged as security for the loan. Again, in order to avoid otherwise applicable prohibited transaction rules under ERISA and the Code, the pledge can only occur if the securities are held in a suspense account under the ESOP and are released and allocated to individual accounts as the loan is paid off, following certain rules. Although the details of these rules are beyond the scope of this article, the general idea is that the normal compliant way is to release the securities in the suspense account based upon the amount of loan principal and interest paid. [9]

Typical ESOP Example

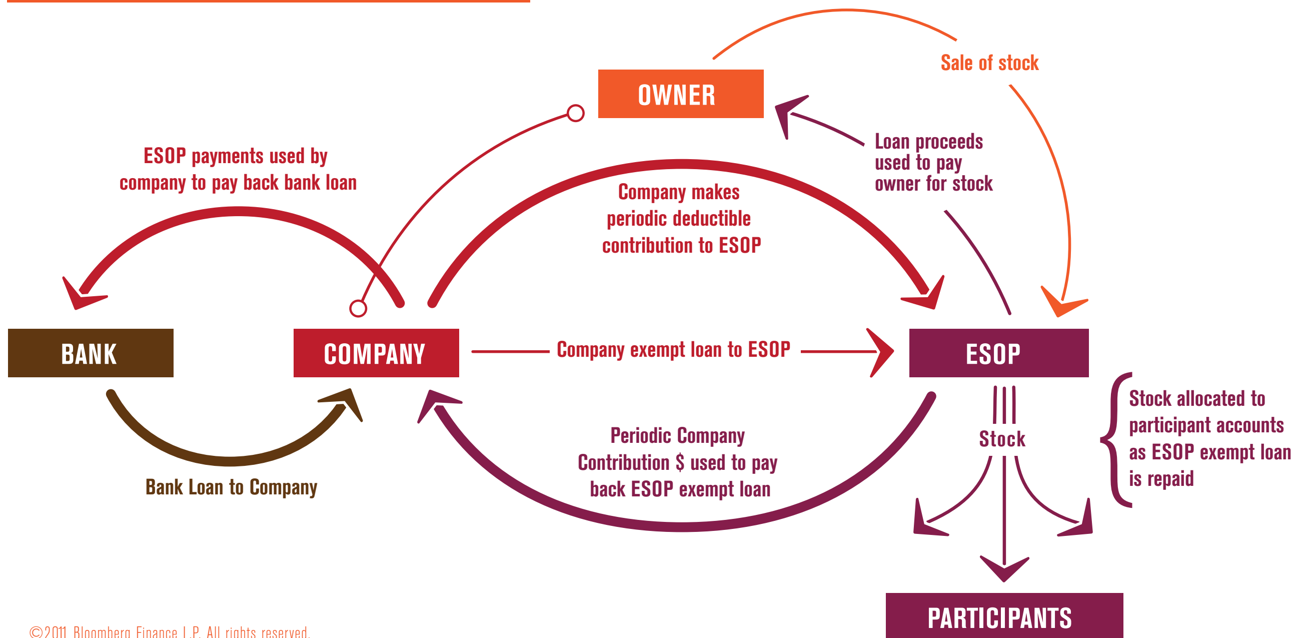
The previous discussion outlines the basic ERISA and Internal Revenue Code requirements for taking advantage of a leveraged ESOP. Clearly, there are tax efficiencies associated with using such a plan to allow an owner to monetize his stockholdings while still placing the stock in friendly hands (i.e.: the employees). The mechanics of a leveraged ESOP used in this way can be described as follows:

- The owner sells at least 30 percent of his company shares to the ESOP and defers tax on the sale, as long as he meets the requirements of section 1042 of the Code described earlier.
- The company typically borrows the purchase price from a bank (banks are normally reluctant to loan directly to an ESOP), and the loan is secured by a pledge of the employer stock to be held by the ESOP.
- The company then lends funds borrowed from the bank to the ESOP under an "exempt loan" meeting the requirements described earlier. The ESOP uses the loan proceeds to purchase employer stock from the company, and the stock will be allocated over time to the participants as the loan is paid off.
- The ESOP repays the company exempt loan through the tax-deductible contributions made over time by the company to the ESOP. As the loan is paid off, shares are released from the ESOP suspense account and allocated to the participants and beneficiaries.
- The company repays its loan from the bank with the loan repayments made by the ESOP to the company.

A diagram of how this process works is shown below:

SUCCESSION PLANNING FOR BUSINESS OWNERS

Contributed by Henry C. Blackiston, Martin Chioffi LLP



As a result of such a transaction, the owner can defer tax on his sale, the owner can retain up to 70 percent of his shares, and the debt incurred to finance the purchase will be repayable in a tax efficient manner that has a better impact on cash flow than a normal loan incurred in a non-ESOP transaction. In addition, employees will participate in an equity-based employee benefit plan that should increase their productivity and their company loyalty by giving them a stake in the business.

Is an ESOP for Everyone?

– Negative Aspects

Although the tax and other benefits of ESOPs described above have obvious advantages to a business owner interested in succession planning alternatives, an ESOP is not for everyone. The following are some of the negative effects of a leveraged ESOP transaction in this context:

- The ESOP must comply with the complex ERISA and Internal Revenue Code rules, and such compliance has hidden costs in terms of ongoing administration and compliance.
- ESOP trustees and fiduciaries are subject to US Department of Labor audit or review to insure that their actions are always taken solely in the interests of plan participants and beneficiaries, and there are civil liabilities arising from non-compliance. Often, this means engaging independent valuation firms, counsel and accountants on a regular basis to insure compliance, which gives rise to administrative costs.
- The company's balance sheet will be negatively affected by the ESOP debt.
- Using an ESOP requires that some of the company's equity be owned by the ESOP, and ultimately by the employees, and this dilutes the equity interest of the owners, which is sometimes undesirable.
- The company faces a cash drain when it is required to satisfy the put option that must be given to ESOP participants once the ESOP distributes shares to them.

Given these concerns, a leveraged ESOP would not be a good choice for a company that has a poor earnings record or poor earnings prospects, or volatile earnings.

In addition, companies without an adequate payroll could not make use of the tax advantage arising from the deductibility of employer contributions to repay principal of the ESOP debt,

because the limitations on these contributions are tied to the size of the company's payroll. The smaller the payroll, the less the amount of debt that could be retired in this way.

Most importantly, owners who do not want to have stock ownership outside of the family would be poor candidates to set up such an ESOP because under IRS rules, an ESOP must be available to all employees in a non-discriminatory manner, and company stock must be eventually distributed to them, although a controlling interest need not be.

Finally, ESOPs are not good choices for owners of business in their early growth stages where dynamic growth is anticipated, since the dilutive effect of an ESOP would have a particularly negative effect on family wealth in this context. In any event, such businesses are often established as LLCs, and LLCs are not eligible to set up ESOPs. (However, employees of LLCs could participate in an ESOP set up by a parent corporation which is a C corporation.)

– Positive Aspects

The positive aspects of using a leveraged ESOP have been described above. What type of business is particularly suited to using such an ESOP as a tool of succession planning for the owners? The following characteristics would suggest that the ESOP could be a valuable device for such purposes:

- The company is a mature business with stable earnings and good cash flow and profitability.
- The company has a sufficiently large payroll of full time employees to support the large IRS deductions that would be available which are based on a percentage of payroll.
- The owners are willing to dilute some of their equity ownership and give that amount to employees through the ESOP, although it is not necessary to give away control.
- The owners are anxious to have a tax advantaged way of providing liquidity in their estate planning process.

Conclusion

Although leveraged ESOPs are not for everyone, the unique tax advantages associated with establishing one for mature, profitable businesses suggest that they should be seriously considered by any owner of such a business interested in succession planning and monetizing the owner's equity interest. In addition, they have the advantage of potentially increasing the productivity of employees who are ESOP participants, by providing those employees with equity in the company with no cash outlay on their part (or on the owner's part), and at the same time significantly improving their employee benefit package.

Mr. Blackiston is a partner at Martin Chioffi LLP in Stamford, Ct., and was previously a partner and Senior Counsel at Seyfarth Shaw LLP. Before that, he was a partner at Shearman & Sterling, where he practiced for 37 years and founded the Compensation & Benefits practice group. His practice includes employee benefits, executive compensation and employment law, and he has written and spoken frequently on these topics. His client base includes Fortune 500 companies, privately owned businesses, family offices and individual executives. He is a graduate of the University of Virginia Law School and Princeton University.

[1] 26 C.F.R. § 54.4975-11(b).

[2] For a full discussion of these benefits and other ESOP attributes see *ESOP– The Ultimate Instrument in Succession Planning*, by Robert A. Frisch (John Wiley & Sons 2001).

[3] 26 U.S.C. § 1042.

[4] 26 U.S.C. § 404(a)(9).

[5] 26 U.S.C. § 415(c)(6).

[6] *See* Note 2 above, page 137.

[7] 26 U.S.C. § 404(k)(2).

[8] 26 C.F.R. § 54.4975-7(b); 26 U.S.C. § 4975(d)(3)(B). For a general discussion of this and other aspects of leveraged ESOPs, see *ESOPS- What They Are and How They Work*, by Henry C. Blackiston III, Linda E. Rappaport, and Lawrence A. Pasini, The Business Lawyer, Vol. 45, No. 1, November 1989. Note that some of the tax benefits described in that article have been repealed since its publication.

[9] 26 C.F.R. § 54.4975-11(d).