ESOPs in 2014 – Myths and Reality

Indiana Benefits Conference

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What Is an ESOP?

An **E**mployee **S**tock **O**wnership **P**lan (ESOP) is an employee benefit plan that is designed to invest "primarily" in the sponsoring employer's stock.

Invests “Primarily” in Employer Stock

- “Qualifying employer securities” [Code § 409(l)]
  - Stock readily tradable on an established securities market [Code § 409(l)(1)]; or
  - Stock not readily tradable on an established securities market, provided:
    - It has a combination of voting power and dividend rights at least as great as the class of common stock with the highest voting power and dividend rights. [Code § 409(l)(2)]

Invests “Primarily” in Employer Stock

- “Primarily” has generally been interpreted to mean more than 50 percent of the ESOP’s assets are invested in “qualifying employer securities”

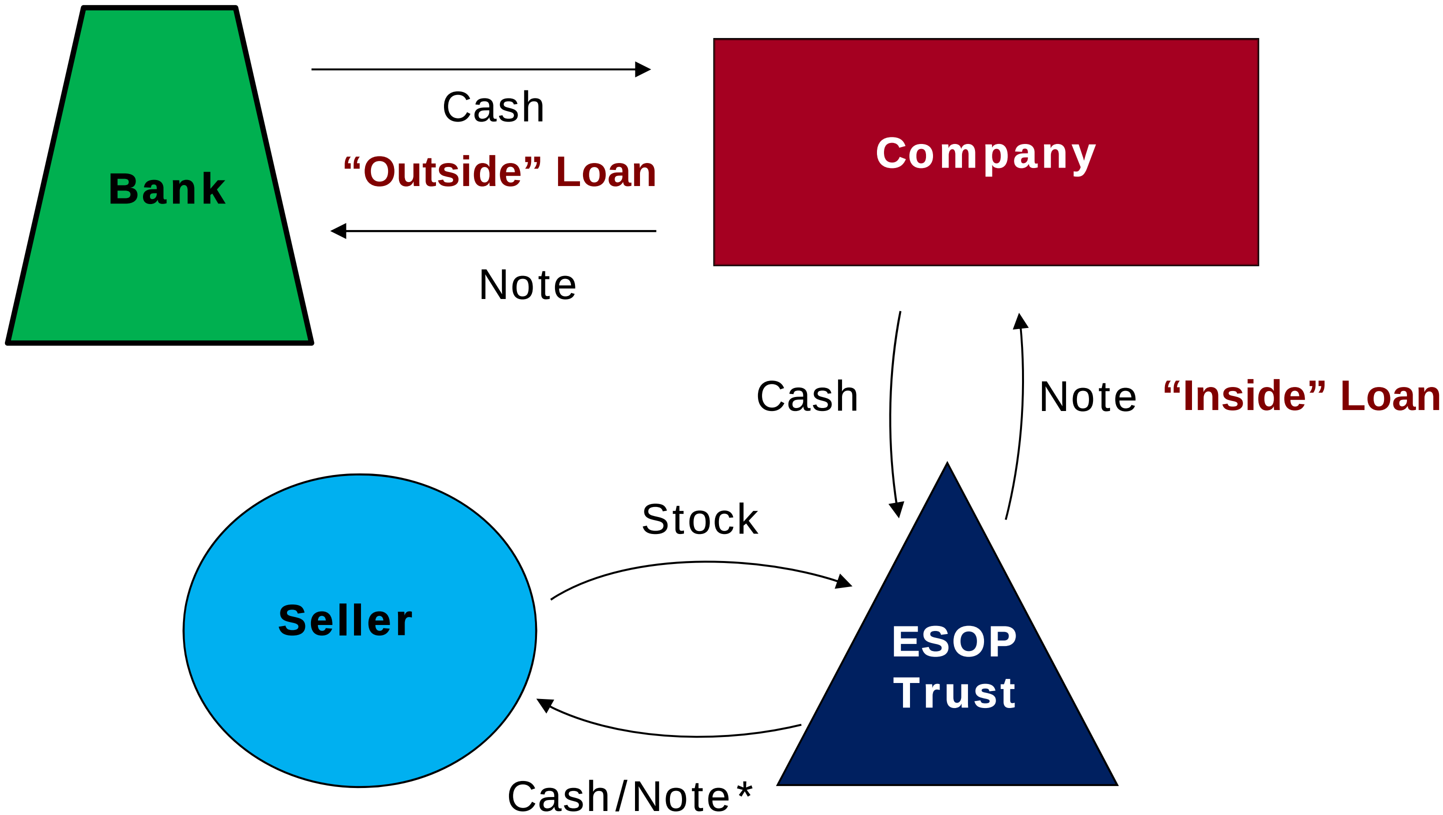
An ESOP Is Also…

- A Tool of Corporate Finance
  - ESOP can borrow $ on a tax-preferred basis from, or with guarantee of, a party in interest, including the Company or selling shareholder.

Structure of ESOP Transactions

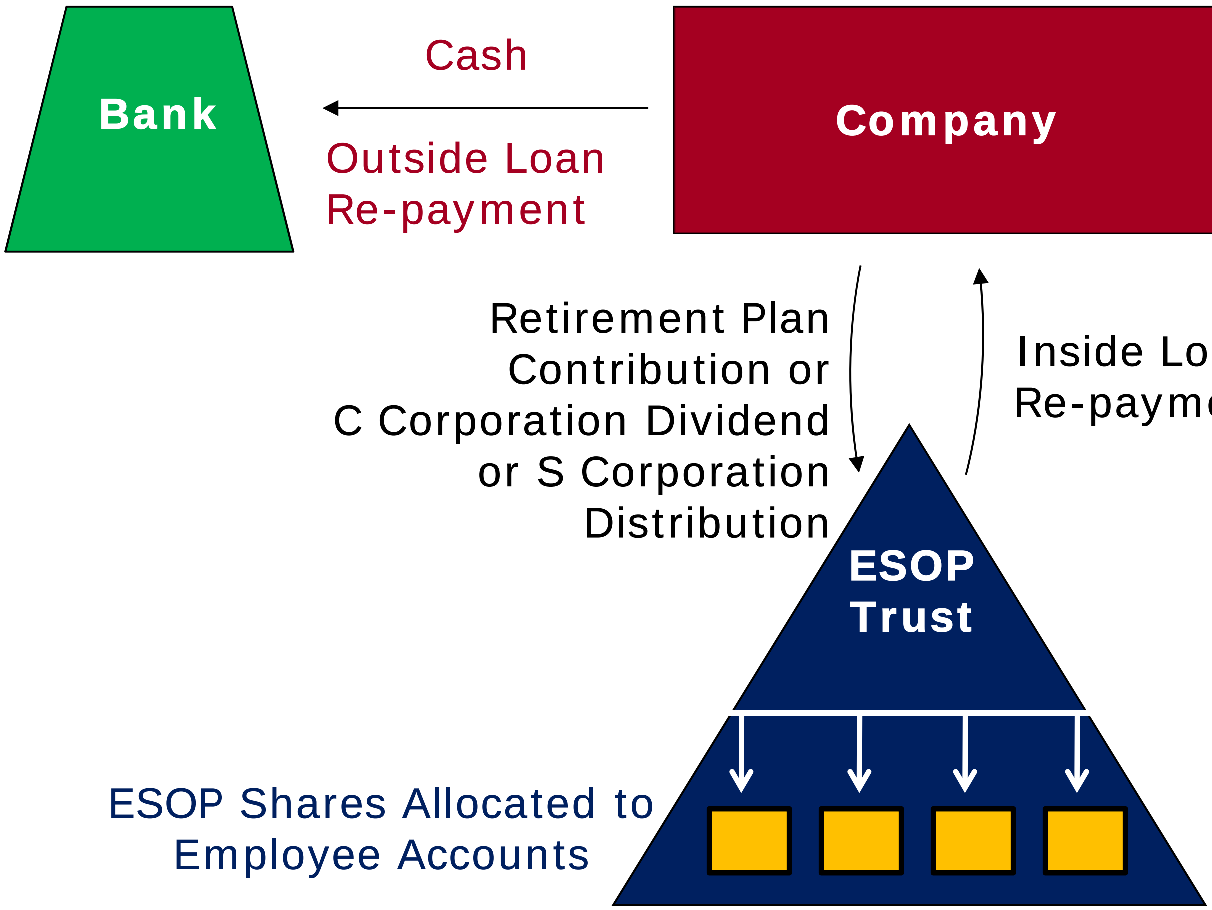
- Structure of a leveraged ESOP transaction
  - Bank borrowing or seller note financing used to acquire stock; stock allocated over time to employees' accounts
- Structure of a non-leveraged ESOP transaction
  - "Pay As You Go" ESOP: Annual cash contributions made to ESOP plan to acquire additional shares for employees
  - Rollover Contribution: Existing retirement plan assets can be "rolled over" to acquire company stock

Structure of a Leveraged ESOP Transaction



*Seller Financing often used

Structure of a Leveraged ESOP Transaction
Post-Leveraged Transaction Cash Flows



An ESOP Is Also…

- A Qualified Retirement Plan under the Internal Revenue Code
  [Code §§ 401(a) and 4975(e)(7); see Treas. Reg. § 54.4975 for additional guidance]
- Subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA)
- A long-term benefit to reward and retain employees
- Not effective as a means for short-term management compensation

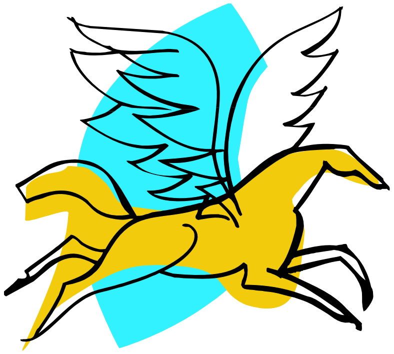
Tax-Qualified Retirement Plan

- ESOPs have may provisions similar to those in other qualified retirement plans:
  - Plan eligibility (e.g. one year from start of employment) [Code §§ 401(a) and 410(a); ERISA § 202]
  - Vesting of contributions (maximum 3 yr. cliff / 6 yr. graded) [Code §§ 411(a)(2) and 416(b); ERISA § 203(a)(2)]
  - Benefits eligible for tax-deferred rollover [Code § 402(c)(4)]
  - Subject to nondiscrimination testing [Code § 401(a)(4)]

Tax-Qualified Retirement Plan

- ESOPs also have many unique provisions not found in other qualified retirement plans:
  - ESOP exempt loan provisions [Code § 4975(d)(3); Treas. Reg. § 54.4975-7(b); DOL Reg. § 2550.408b-3]
  - Special distribution rules [Code § 411(d)(6)(c)]
  - Special rules on use of dividends [Code §§ 404(k) and 4975(f)(7)]
  - Diversification requirements [Code §§ 401(a)(28) and 401(a)(35)]
  - Employer stock voting requirements [Code §§ 409(e)(3) and 4975(e)(7)]

ESOP Myth #I



- Myth

  ESOPs are becoming less popular and there are fewer ESOPs than in prior years.

- Truth

  There is great interest in ESOPs, especially among baby-boomers who want or need to transition ownership of their businesses.

How are ESOPs used?

Common transition strategy:

- Alternative to selling to an outsider
- Gradual transition
- Tax benefits

*February 2012 National Center for Employee Ownership (www.nceo.org)

National ESOPs

Indiana ESOPs

MAC Muncie Aviation Employee Owned

KATZ SAPPER & MILLER
Our People: Your Success

HORIZON BANK

BADER Company

nasco INDUSTRIES INC

OLIVER WINERY

McFarling FOODS

RIETH-RILEY
Serving Indiana and Michigan since 1916

Opportunities for Positive Growth, Inc.

FabricServices
"Where workers own and ownership works"

SHIEL SEXTON

RMP
Rochester Metal Products

HERFF JONES

ETA Engineering, Inc.

ESOP Myth #II

- Myth

  An ESOP is too expensive. It adds an extra expense on top of our 401(k) plan and it would be less costly to just have the company redeem the shares from the selling shareholder(s) or sell my company to a third party.

- Truth
  - Redemption is typically much more costly than an ESOP purchase of shares because shares are purchased with after-tax $
  - Sale to a third party is also much more costly due to investment banker fees of 10% to 20% of purchase price

ESOP Myth #II

- Truth (cont.)
  - Additional cost may not be as great as anticipated because all or a portion of match or profit sharing contribution can be made to the ESOP to be used to pay the ESOP loan (shares released from suspense account and allocated as match)
    - Reduces cost of ESOP
    - Rewards employees who save for retirement with 401(k) deferrals

Tool of Corporate Finance

Comparison of Costs of ESOP Borrowing vs. Conventional Borrowing

	REPAYMENT PERIOD	
	10 Years	15 Years
Assumptions For Comparison		

- $5,000,000 principal
- Interest rate of 6.00%
- Annual payments
- Marginal income tax rate of 40% (combined federal and state)
- Loan term of 10 years or 15 years

	10 Years	15 Years
Total net cost of repaying $5,000,000:		
Conventional borrowing at 6.00% as adjusted for tax savings	6,076,039	6,633,324
Total net cost of repaying $5,000,000		
ESOP borrowing at 6.00% as adjusted for tax savings	4,076,039	4,633,324
Total Potential Savings	2,000,000	2,000,000

ESOP Myth #III

- Myth

  The ESOP has to own at least 30% of the company's stock

- Truth

  The ESOP may own from 0% to 100%

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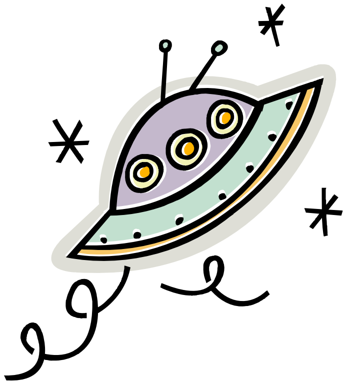
The "1042 ESOP Rollover"

- 30% ESOP ownership is required if the selling shareholder(s) elects gain deferral
- The business owner can elect to defer the recognition of long-term capital gain on the sale of C corporation stock to an ESOP if certain requirements are satisfied:
  - Owner must sell "qualified securities" – "best common stock" of a non-publicly traded C corporation
  - Holding period must be at least three years at time of sale

The “1042 ESOP Rollover”

- Immediately after sale, ESOP must own at least:
  - 30% of the total number of shares of each class of stock; or
  - 30% of the value of all outstanding stock of the corporation
- Selling shareholder, members of family and 25% or greater shareholders cannot receive allocations on shares on which gain is deferred

ESOP Myth #IV



- Myth

  The tax benefits for ESOPs are being eliminated by Congress.

- Truth

  ESOPs have many unique tax benefits and it will be difficult to eliminate them due to the large number of ESOP companies.

Tax Incentives for C Corporations

- If certain requirements in Code § 1042 are met, selling shareholder(s) can defer (or even eliminate) taxable gain on sale
- All contributions to an ESOP (including those used to repay the ESOP loan) are tax deductible [Code § 404(a)(3)]
- Cash dividends used by ESOP to repay loan or distributed to participants or on which participants get an election are tax deductible [Code § 404(k)]

Tax Incentives for C Corporations

- Allocations to participants' accounts are tax deferred; distributions eligible for tax-free rollover [Code §§ 501(a) and 402(c)(4)]
- Special deferral of tax on net unrealized appreciation (NUA) on distribution of stock until the stock is sold or death, and taxed as capital gain [Code § 402(e)(4)]

Tax Incentives for S Corporations

- ESOP's share of "S Corp distributions" can be used to repay loan, satisfy repurchase liability or pay plan expenses [Code § 4975(f)(7)]
- Allocations to participants' accounts are tax deferred; distributions are eligible for tax-free rollover [Code §§ 501(a) and 402(c)(4)]
- Special deferral on NUA on distribution of stock until the stock is sold or death and taxed as capital gain [Code § 402(e)(4)]
- ESOP enables up to 100% of company's earnings to be income tax-free (federal and state)

Tax Incentives for S Corporations

Example of Benefit of "S" Corporation Status

Net Income of $5,000,000 with No ESOP

Corporate Tax : -0-

Individual Shareholders' Taxes: on $5,000,000 @ 40% = $2,000,000

Total "Tax Dividend" = $2,000,000

Net Income of $5,000,000 with 50% ESOP

Corporate Tax : -0-

Individual Shareholders' Taxes: on $2,500,000 @ 40% = $1,000,000

ESOP Shareholder Tax on $2,500,000 = $0
ESOP's Share of Tax Dividend = $1,000,000

Net Income of $5,000,000 with 100% ESOP

Corporate Tax: -0-

ESOP Shareholders' Taxes on $5,000,000 = $0

ESOP's "Share" of Historic Tax Dividends = $2,000,000 or the Corporation doesn't have to pay a tax dividend and may retain the entire $2,000,000

ESOP Participant Tax Benefits

- Participants defer paying tax on the value of their ESOP account until they take a distribution [Code § 501(a)]
- Distributions from ESOP accounts are eligible to be "rolled over" to an IRA or another rollover eligible retirement plan [Code § 402(c)(4)]
- Special deferral of tax on net unrealized appreciation on distribution of stock until the stock is sold or death, and taxed as capital gain [Code § 402(e)(4)]

ESOP Myth #V

- Myth

  ESOPs are not good for employees.

- Truth
  - Numerous studies have shown ESOP companies out-perform their peers.
  - ESOPs have higher rates of return than 401(k) plans and are also less volatile.

ESOP Myth #V(cont.)

- Truth (cont.)
  - ESOP companies are 20% more likely to offer a second DC plan than non-ESOP companies are to offer any DC plan at all
  - ESOP companies lay people off less than conventional companies (ESOP participants are 1/3 to 1/4 as likely to be laid off as non-participants)

Impact of Employee Ownership on Company

- Broad-Based Stock Options and Company Performance: What the Research Tells Us
  - Joseph Blasi, Douglas Kruse, James Sesil and Maya Kromouva; Working Paper Series in Human Resource Management, Center for HR Strategy, Rutgers University (http://chrs.rutgers.edu/pub_documents/Article%2060%20Blasi%20(2).pdf)
- Key Studies on Employee Ownership and Corporate Performance
  - National Center for Employee Ownership (http://www.nceo.org/main/article.php/id/54/)

ESOP Myth #VI

- Myth

  Management structure will change; the ESOP will become involved in management

- Truth

  ESOP does not replace management's responsibility for day-to-day decision making

ESOP Myth #VII

- Myth

  Compensation and/or corporation’s financial statements must be disclosed to employees

- Truth
  - Company can choose to only provide annual ESOP plan statement to participants
  - Some ESOPs have developed “open book management” systems, by choice

ESOP Myth #VIII

- Myth

  Employees or Trustee must have seat on Board

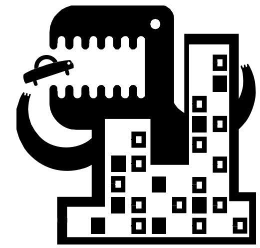
- Truth
  - ESOP will expect to be treated as fairly as any other shareholder
  - Having Trustee serving on Board is not recommended (conflict of interest)

ESOP Myth #IX

- Myth

  "Control" of corporation will be lost
- Truth
  - ESOP does not replace management's responsibility for day-to-day decision making
  - ESOP participants are beneficial shareholders, only have "pass through" vote on certain actions

ESOP Myth #X



- Myth

  Corporation will be less attractive to potential buyers

- Truth
  - Academic research supports the link between employee ownership and corporate performance
  - ESOP companies remain attractive candidates to both purchasers and potential employees

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- *Pursuant to Circular 230 promulgated by the Internal Revenue Service, please be advised that these slides were not intended or written to be used, and that they cannot be used, for the purposes of avoiding federal tax penalties unless otherwise expressly indicated.*

Questions?

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