

Structuring a Sale of Your Business  
to an  
Employee Stock Ownership Plan

Ohio Employee Ownership Center  
Succession Planning Webinar Series  
May 27, 2009

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ESOPs

▪ **LEVERAGED ESOP**

- Outline of Leveraged ESOP Transaction
  - Leveraged ESOP Transaction. Although it is not necessary to undertake the acquisition of employer securities through a "leveraged" transaction, it is frequently done so as a technique to facilitate the financing of the acquisition.

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ESOPs

- Outline of Transaction. The basic leveraged transaction operates as follows:
  - The employer establishes an ESOP;
  - The ESOP borrows from a lender (the employer or some other entity or institution);
  - The ESOP uses the proceeds of the loan to purchase employer securities;
  - The acquired securities are held in a suspense account in the ESOP as security for the loan;

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## ESOPs

- The employer makes tax-deductible contributions to the ESOP which the ESOP uses to repay the loan; and
- As the loan is paid off, the securities held in the suspense account are allocated to the individual accounts of the participants based on the ESOP's allocation formula.

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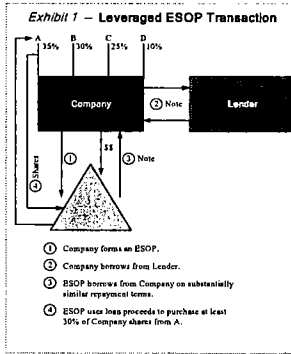


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## ESOPs




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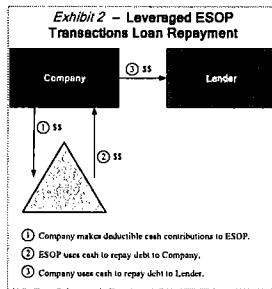


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## ESOPs




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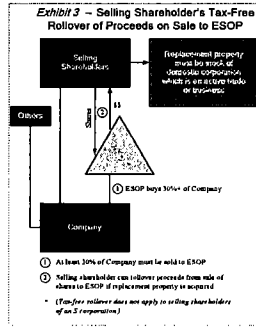


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## ESOPs



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## ESOPs

### ▪ ADVANTAGES IN USING LEVERAGED TRANSACTION

– Repayment of Both Principal and Interest is Deductible. The company funds the repayment of the leveraged ESOP loan by means of its annual contribution to the ESOP. A C-Corporation may contribute and deduct:

- The entire amount used by the ESOP to pay the interest due on the ESOP loan; and
- An amount equal to 25% of the compensation of all participants in the ESOP used by the ESOP to repay the principal on the ESOP loan.

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## ESOPs

- Note - Not available for S-Corporation ESOPs
- Certain Dividend Payments May Be Deductible. In addition, a C- Corporation can pay dividends on its stock, use the dividend paid on the stock held in the ESOP to repay the principal and interest on the loan, and deduct the amount of the dividends so used.
  - The IRS is empowered to deny the deduction if the IRS determines the dividend constitutes in substance or “avoidance or evasion” of taxation.

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## ESOPs

- The legislative history indicates that the IRS has the authority to disallow the deduction for dividends used to repay ESOP loans if it determines the dividend is "unreasonable." For publicly traded companies, all dividends are reasonable. For non-publicly traded companies, the reasonableness of a dividend is to be determined by comparing the dividend rate on the ESOP company with the dividend rate on comparable publicly traded companies.

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## ESOPs

- Because the appraisers routinely describe comparable companies in their valuation reports, we will need to watch those companies' dividend rates carefully. Especially if dividends will be an integral part of the debt service. The company will also receive a deduction if participants can elect to have the dividend paid into the plan and invested in company stock.
- The company can also receive a deduction if the participant elects to have the company pay the dividend to the ESOP and have it reinvested in company stock.

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## ESOPs

### ▪ SECTION 1042 TRANSACTION

- Deferring the Recognition of Gain. A shareholder who sells his or her C-Corporation stock to an ESOP can delay the recognition of gain on that sale if:
  - The shareholder purchases "qualified replacement property" within a fixed replacement period commencing three months before the sale to the ESOP and ending 12 months after; and
  - The ESOP holds at least 30% of the outstanding stock of the company after the transaction.

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## ESOPs

- Qualified Replacement Property. The rules defining qualified replacement property are complex, but, in general terms, the stock of most publicly traded large corporate entities will generally meet the requirements. Note: Mutual funds and tax exempt bonds are not qualified replacement property.

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## ESOPs

- Restrictions on Benefit Accruals for Certain Individuals
  - Restricted Accruals. If an ESOP acquires stock from a shareholder who wishes to defer the recognition of gain on the sale, certain individuals are prohibited from accruing a benefit under the ESOP (or any other retirement plan maintained by the company) attributable to the stock acquired in the transaction.

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## ESOPs

- Restricted Individuals. The restricted individuals are:
  - 25% shareholders of the company;
  - selling shareholder;
  - selling shareholder's spouse, brothers, sisters, ancestors or lineal descendants.

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**ESOPs**

- Period Benefit of Accrual Restriction. Prohibition on benefit accruals is permanent for 25% shareholders. The prohibition lasts only ten years for selling shareholders and the above listed relatives of shareholder. Lineal descendants may be able to accrue minimal benefit amounts.

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**ESOPs**

▪ **REPURCHASE LIABILITY**

- Put-Option and Diversification. As indicated above, the participants in the ESOP are entitled to receive their benefit in stock and the company is required to purchase that stock during certain put-option periods. Also, certain ESOP participants are eligible to diversify the account balances.
- Cash Needed. Because of these requirements, the company will need a source of cash to fund the repurchase of distributed stock and the diversification of the account balances.

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**ESOPs**

- Costs of Establishing and Maintaining an ESOP
  - Establishment and Maintenance Cost. The establishment and maintenance of the ESOP will be an additional expense for the company.
  - Independent Appraiser. It will be necessary for an independent appraiser to value the stock for the initial purchase and for the ESOP's annual valuations.

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## ESOPs

### ▪ SITUATIONS WHERE AN ESOP MIGHT BE USED

- Stock Held by Surviving Spouse and Children. A common situation is one in which the founder of company had died and surviving spouse and children have no desire to actively manage company. An ESOP could be used to buy out these heirs.

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## ESOPs

- Founder is Retired or Preparing for Retirement. An ESOP could also be used when founder of the company has retired or is preparing to retire and wishes to liquidate some or all of his or her holdings in the company. The ESOP provides the founder with a purchaser for the stock. The purchase can be structured in order to permit founder to retain control over company.

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## ESOPs

- Restructure Ownership. In a situation where multiple shareholders own a company, an ESOP could be used to facilitate a majority shareholder buy-out of the minority shareholders and a restructuring of the ownership of a company.

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