Consider ESOPs as an Estate Plan Component for Business Owners

The sale of stock to an ESOP can be an effective strategy for ownership and management succession, as well as for estate, gift, and charitable planning.

KELLY O. FINNELL AND ANDREW T. HOLMES

The aging of the baby boom generation (i.e., those born between 1946 and 1964) is creating a burgeoning opportunity for ownership succession and estate planning for Baby Boomer Business Owners (BBBOs). There are numerous estimates of the magnitude of this opportunity. According to one study, 72% of owners of private companies plan to have a monetization event, and 62% of those owners stated that their time frame for that event is within five to six years.[1] Another survey found that 50% of business owners over the age of 55 plan to sell their companies within the next three years; however, only 10% have developed a written ownership succession plan.[2] Although BBBOs have many different objectives when developing their ownership succession plans, their top priority—by an overwhelming margin—is minimizing taxes.[3]

Most experienced advisors have an in-depth knowledge of the traditional ownership succession planning paths such as a sale to a strategic buyer, a sale to a private equity group, making lifetime gifts of ownership interests to family members, and a management buy-out, but few have much experience using an employee stock ownership plan (ESOP) in exit planning. This article provides an overview of an ESOP and its tax benefits, as well as the key issues involved in ESOP planning and how to integrate an ESOP transaction and estate and charitable planning.

ESOP background

An ESOP is a qualified retirement plan like a profit-sharing plan, stock bonus plan, and a 401(k) plan, and must thus comply with Section 401(a). However, an ESOP differs from other types of qualified retirement plans in three primary ways:

1. An ESOP must be designed to "invest primarily in" the stock of the sponsoring employer.[4]
2. An ESOP is permitted to borrow money (known as a "leveraged ESOP").[5]
3. An ESOP can engage in transactions with a party-in-interest, which means that the ESOP can purchase stock from the sponsoring company's shareholders.[6]

While an ESOP can be non-leveraged, ESOPs used in ownership succession planning typically are leveraged. The general rule is that a qualified retirement plan is not permitted to borrow money from its sponsoring employer.[7] Doing so is a "prohibited transaction" under the general law governing employ-

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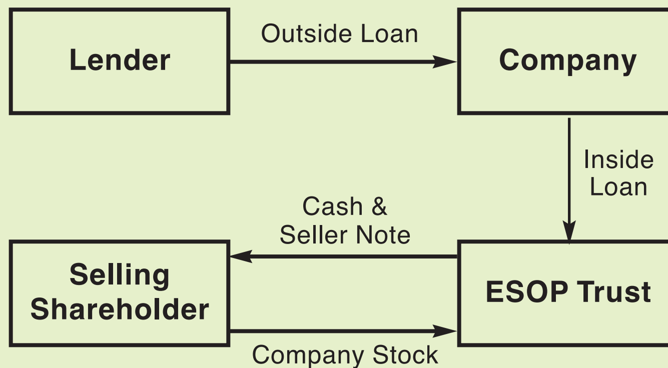
EXHIBIT 1
Typical Leveraged ESOP Transaction



ee benefit plans, the Employee Retirement Income Security Act of 1974 (ERISA), and subjects the employer to certain excise taxes.[8]

An exemption to the prohibited transaction rule exists for a loan to an ESOP, however, so long as the loan satisfies certain statutory requirements.[9] The first of these is that the ESOP itself must satisfy all of the requirements in the Code applicable to qualified retirement plans and rules set forth in ERISA.[10] In addition, the loan must be "primarily for the benefit of" the ESOP's participants and beneficiaries,[11] the interest rate on the ESOP loan must be reasonable,[12] and the ESOP may use the proceeds of the loan from its sponsoring employer only for certain purposes, including the purchase of "qualifying employer securities" (i.e., shares of company stock).[13] The Regulations list the relevant factors that the Department of Labor considers in its reasonableness determination.[14] An ESOP loan that meets these requirements is classified as an "exempt loan."

How a leveraged ESOP works

In the typical leveraged ESOP used in ownership succession planning, the employer borrows money from an outside lender, such as a bank. In ESOP parlance, this is known as the "Outside Loan." The company then loans the Outside Loan proceeds (sometimes along with additional company cash) to the ESOP, which is known as the "Inside Loan." The Inside Loan is structured to meet the requirements outlined above, and is thus exempt from the prohibited transaction rule in Section 4975(e)(7). The ESOP then uses the proceeds from the Inside Loan to purchase company stock from the selling shareholders in exchange for cash, a promissory note (a "Seller Note"), or a combination of the two.

The Seller Note is a form of loan to the ESOP; therefore, it must also meet the requirements of Section 4975(d)(3). The ESOP holds the purchased stock in its suspense account, and these shares are known as "unallocated shares." Exhibit 1 illustrates the typical leveraged ESOP transaction.

Each year, the company ensures that the ESOP has enough money to permit the ESOP to make its annual loan payments. The bank typically requires a pledge of the ESOP's unallocated stock to serve as additional security for the Outside Loan. As part of the ESOP transaction, the selling shareholder might refinance the Seller Note so that the company assumes all of the ESOP's obligations under the loan agreement between the ESOP and the selling shareholder. This refinancing transaction has no economic effect on the parties involved and generally provides the selling shareholder with a more secure debt instrument.

Exhibit 2 illustrates the following annual ESOP debt repayment process. Each year, the company makes cash contributions to the ESOP, which provide an employee benefit to the ESOP participants and a tax deduction to the company. The ESOP uses this contribution to make payments on the Inside Loan (and the Seller Note in the event the selling shareholder does not refinance the loan). In addition to making annual cash contributions, the company can pay C corporation dividends or make S corporation distributions, as applicable, to the ESOP, which it can also use to pay the Inside Loan.

This circular flow of funds from the company to the ESOP and back

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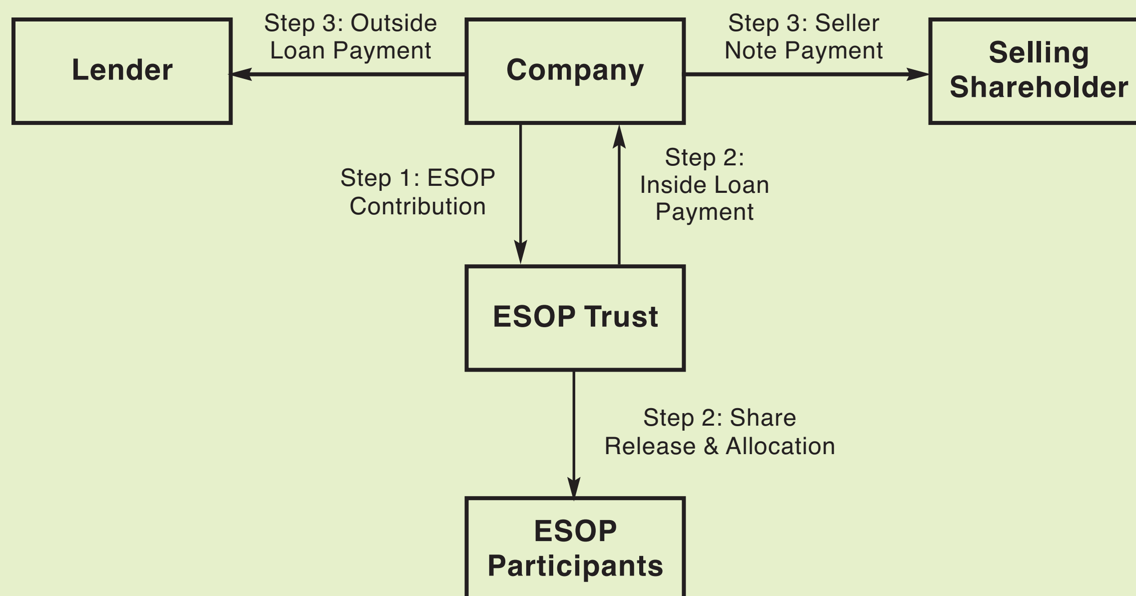
1 PricewaterhouseCoopers, *Trendsetter Barometer™* (4/7/2010).
2 Bain Surveying, 9/11/2008.
3 White Horse Advisors, *Survey of Closely-Held Business Owners* (2008).
4 Section 4975(e)(7)(A).
5 Section 4975(d)(3).
6 Section 4975(c)(1)(A).
7 Employment Retirement Income Security Act (ERISA) of 1974, 29 U.S.C. section 1106(a)(1)(B).
8 Sections 4975(a) and (b).
9 Section 4975(a).
10 Section 4975(e)(7).
11 Section 4975(d)(3)(A).
12 Section 4975(d)(3)(B).
13 Reg. 54.4975-7(b)(4).
14 Reg. 54.4975-7(b)(7).
15 Section 415(c).
16 For a more detailed discussion on the formulas that ESOP companies use to calculate the number of shares that a leveraged ESOP releases from its suspense account each year, see Finnell, *The ESOP Coach: Using ESOPs in Ownership Succession Planning*, 82-83 (2010).
17 See generally Section 404(a)(3) (The limit on a company's deductible contributions is 25% of eligible compensation).

EXHIBIT 2
ESOP Debt Repayment Process



to the company is "cash-neutral" to the company because all of the contributions are immediately paid back to the company in satisfaction of the Inside Loan obligation. However, money should actually change hands as opposed to the parties merely making journal entries. The company uses the Inside Loan payment from the ESOP and other operating cash, if necessary, to make payments on the Outside Loan and the Seller Note (in the event the selling shareholder refinances the loan).

As the ESOP makes payments on the Inside Loan using the company's contributions, the ESOP releases a proportionate number of unallocated shares from its suspense account and allocates them to the accounts of eligible ESOP participants (i.e., employees who have satisfied the plan's eligibility requirements) based on the participants' respective compensation up to certain limits (allocations of shares released that are attributable to Inside Loan payments made from dividends or distributions, as applicable, are based on the participants' respective account balances).[15] The ESOP document will specify whether the ESOP will release unallocated shares under the "principal only" method or the "principal and interest" method; provided, however, that if the term of the Inside Loan is longer than ten years, the ESOP must release shares under the "principal and interest" method.[16]

ESOP tax benefits

An ESOP provides tax benefits for the company (which may vary depending on its status as either a C corporation or an S corporation) and the selling shareholder. First, an ESOP provides a company with a tax deduction equal to the annual contributions it makes to the ESOP. Second, an ESOP provides a C corporation with the ability to deduct dividends it pays on ESOP shares. Third, Section 1042 provides a shareholder who sells C corporation stock to an ESOP the ability to reinvest the proceeds received from the ESOP sale in "qualified replacement property" without immediately paying income tax on those proceeds. Finally, an ESOP provides a method by which a 100% ESOP-owned S corporation can essentially operate as a tax-exempt entity.

Tax-deductible contributions. An ESOP is a qualified retirement plan, so its sponsoring employer receives a tax deduction for its annual contribution to the plan, up to certain limitations imposed by the Code.[17] Because an ESOP company can use tax-deductible dollars (as a result of the "cash-neutral" circular flow of funds described above) to make payments on the Outside Loan, the company effectively converts some or all of what is normally a nondeductible loan principal payment into a tax-deductible contribution to a qualified retirement plan. Therefore, a leveraged ESOP allows the sponsoring company to repay the entire loan—both interest *and* principal—on a tax-deductible basis.

Tax-deductible dividends. Suppose that a company's annual debt service would exceed its 25%-of-pay limitation under the Code. For example, assume that a company's principal payment on its Outside Loan is $300,000 and its eligible payroll is $1 million. The company would like to take full advantage of the tax benefit discussed above, but the company's deduction is limited to $250,000 which is $50,000 less than the company's Outside Loan payment.[18] If the company is a C corporation, it can make a tax-deductible dividend payment on the ESOP-owned shares and the ESOP would use that dividend to pay a portion of the Inside Loan.

Section 404(k)(2)(A) provides four instances in which a C corporation can deduct a dividend it pays on shares held by its ESOP. For most ESOP companies, the most useful of these instances is that a C corporation can deduct dividends paid on ESOP shares to the extent the ESOP uses the dividend to make payments on the Inside Loan (which the company will then use to make Outside Loan payments).[19] This provision is the only place in the Code where a company can receive a deduction for dividends paid.

Returning to the example above, the company can make an ESOP contribution in the amount of $250,000 and pay dividends on the ESOP shares in the amount of $50,000. The ESOP will make an Inside Loan payment in the amount of $300,000, the company will make payments on the Outside Loan (and Seller Note, if applicable) in that same amount, and the company will receive an income tax deduction of $300,000.

Section 1042 tax-deferred reinvestment. Section 1042 provides that a selling shareholder can elect not to recognize his or her gain on a sale of stock to an ESOP if certain requirements are satisfied.[20] The threshold requirements of this nonrecognition provision are that the selling shareholder must have held the stock for at least three years prior to the sale to the ESOP and he or she cannot have received the stock under a compensatory stock arrangement, such as a stock option plan.[21]

This circular flow of funds from the company to the ESOP and back to the company is "cash-neutral" to the company.

An additional requirement of the tax-deferred reinvestment concerns the type of securities that the ESOP purchases. The ESOP must purchase "qualified securities" under Section 1042(c)(1), and the central requirement of this definition is that the shareholder must sell C corporation stock to the ESOP.[22] Therefore, this nonrecognition treatment is not available to shareholders of S corporations.

Another requirement is known as the "30% Ownership Test," and requires that immediately after the sale, the ESOP must own at least 30% of each class of the company's outstanding stock, or at least 30% of the total value of all of the company's outstanding shares.[23] This test looks only at the ESOP's ownership following the sale; so long as the ESOP owns 30% of the company's stock immediately after the sale, each of the selling shareholders can elect nonrecognition treatment on his or her individual sales proceeds, even though he or she did not individually sell at least 30% of his stock.

Another requirement for tax-favored treatment under Section 1042 is that the selling shareholder must reinvest his or her sales proceeds in "qualified replacement property" (QRP) within a 15-month period beginning three months before the date of the sale and ending 12 months after the sale.[24] The Code defines QRP to mean "securities" (as defined in Section 165(g)(2)) that are issued by a domestic operating corporation other than the corporation that issued the stock involved in the transaction.[25] Generally, QRP includes:

- Common and preferred stock.
- Corporate fixed rate bonds.
- Corporate floating rate notes.

The following investments do not constitute QRP: certificates of deposit, mutual funds, municipal bonds, U.S. government bonds, and foreign securities.

The 15-month replacement period is measured from the date of the transaction, not the date the selling shareholder receives his or her sales proceeds. Thus, if a portion of the ESOP transaction is financed with a Seller Note, the selling shareholder may need to purchase QRP prior to receiving all of his or her payments on the Seller Note. For this reason, installment sellers often purchase corporate floating rate notes on margin to satisfy the QRP replacement period requirement.

For example, assume a shareholder sells $10 million of company stock to an ESOP, financed with a $4 million Outside Loan,

[18] Section 404(a)(3).
[19] Section 404(k)(2)(A)(iv).
[20] A full discussion of Section1042 and its requirements is beyond the scope of this article. For a more in-depth discussion of Section 1042 of the Code, see Kaplan, Brown, and Granados, "Basic Requirements of an ESOP," 354 Tax Mgmt. Port. (BNA) ESOPs A-23 (2010).
[21] Sections 1042(b)(4) and (c)(1)(B).
[22] Section 1042(c)(7).
[23] Section 1042(b)(2).
[24] Section 1042(c)(3).
[25] Section 1042(c)(4).
[26] Section 1042(e)(1).
[27] ERISA, 29 U.S.C. section 1002(18).
[28] ERISA, 29 U.S.C. section 1002(18)(B).

$2 million company cash, and a $4 million Seller Note. The selling shareholder receives $6 million in cash at closing, and he or she can purchase $10 million of floating rate notes as QRP with the cash plus $4 million of margin debt. He or she can pledge a portion of his QRP as collateral against the $4 million borrowed. Banks often will lend up to 90% of the value of a high-quality portfolio of floating rate notes.

If all of the requirements of Section 1042 are satisfied, the selling shareholder will not be taxed on his or her ESOP sales proceeds, and his or her tax basis in the stock sold to the ESOP is transferred to the QRP. Thus, Section 1042 actually provides the selling shareholder with a deferral of tax, not a forgiveness. The selling shareholder will recognize gain in the year he or she sells or disposes of the QRP.[26] However, many selling shareholders attempt to structure their QRP portfolio so that they hold their QRP until death; at that time, the QRP will receive a stepped-up basis under Section 1014, effectively converting their tax-deferred sale to the ESOP into a tax-free sale.

Exhibit 3 illustrates the federal tax *savings* of a leveraged ESOP sale coupled with an election under Section 1042 compared to the *cost* of a traditional leveraged redemption. A shareholder who sells $10 million of C corporation stock to an ESOP and elects to defer taxes on the sales proceeds saves $2,380,000 of federal taxes (assuming a federal capital gains rate of 20% plus a net investment income tax rate of 3.8%). The ESOP also saves the company an additional $3,400,000 in taxes as a result of the tax-deductible ESOP contributions (assuming a corporate income tax rate of 34%). These ESOP tax savings provide the company with a federal tax subsidy equal to 57.8% of the $10 million transaction.

EXHIBIT 3
Tax Savings of a Leveraged ESOP

	Leveraged Redemption	ESOP	ESOP Tax Savings
Net Proceeds to Shareholders	$7.62M	$10.0M	$2.38M
Net Cost to Company	$10.0M	$6.6M	$3.4M
			$5.78M (57.8%)

S corporation ESOP tax benefits. The final tax benefit that is unique to ESOP companies is available only to S corporations that sponsor ESOPs. To the extent of the ESOP's ownership of S corporation stock, the company's earnings will not be subject to federal income tax. Thus, the income produced by a 100% ESOP-owned S corporation will not be subject to tax because it is a "flow-through" entity whose income flows through to its sole shareholder, the ESOP trust, which is a tax-exempt entity. This is a very powerful tax incentive that essentially allows for-profit corporations to operate on a tax-exempt basis.

Key ESOP issues

A business owner who is considering an ESOP typically wants to address three key issues very early in the process:

1. Valuation.
2. Financing.
3. Control.

The owner wants to know how his or her stock will be valued, how the ESOP will pay for the stock it purchases, and who will control the company after the ESOP transaction closes.

Valuation. One of the most critical issues regarding valuation is the concept of adequate consideration. The ESOP trustee cannot pay more than "adequate consideration" for the stock it purchases.[27] In the context of an ESOP, ERISA defines adequate consideration as the stock's "fair market value ... as determined in good faith by the trustee...."[28] The proposed Department of Labor regulations define "fair market value" as the "price at which [the stock] would change hands between a willing buyer and a willing seller when the former is not under any com-

pulsion to buy and the latter is not under any compulsion to sell....”[29] The regulations go on to say that the fair market value must be determined “as of the date of the transaction” and must be reflected “in written documentation of valuation.”[30]

In order to establish fair market value for the stock of a company whose securities are not readily tradable on an established securities market, the trustee must—by law—hire an “independent appraiser.”[31] In the context of an ESOP, an independent appraiser is someone who does not perform any other services for a party whose interest may be adverse to the ESOP, including the selling shareholders, and who meets an objective standard of impartiality.[32] More simply, the trustee should select an appraiser who has no other business relationship with the company or its shareholders.[33]

In order to determine fair market value for the stock that the trustee is purchasing from the company’s shareholders on behalf of the ESOP, the independent appraiser engages in a thorough due diligence process in which he or she collects and reviews company documents and information such as:

- Historical financial statements and projections.
- Material contracts and lease agreements.
- Corporate legal documents, such as articles of incorporation, bylaws, and buy-sell agreements.
- Descriptions of past transactions involving company stock.
- Any relevant environmental or industry information.

The appraiser also meets with company management and conducts on-site inspections and interviews. After the appraiser completes the due diligence, he or she reports a range of fair market value of the company’s stock *only* to the trustee and its legal counsel. The trustee negotiates the purchase price and the other terms of the transaction with the selling shareholders, and the final purchase price cannot exceed the top end of the range of value.[34] It is important to note that the standard of value is the amount a “financial buyer” would pay, which in certain situations, may be less than the amount a strategic buyer is willing to pay. The trustee is legally prohibited from paying more than fair market value for the stock on behalf of the ESOP. The adequate consideration requirement places a great deal of scrutiny on the advantages that the non-ESOP parties (such as the selling shareholders and the company’s key employees) could gain as a result of the ESOP transaction.[35] In addition to the requirement that the ESOP cannot pay more than fair market value for its investment, the adequate consideration standard also requires that the ESOP transaction be “fair” to the ESOP relative to the other parties to the transaction.[36]

The trustee can establish that he or she acted in “good faith” in determining fair market value if the trustee relies on the report of a qualified independent appraiser.[37] A qualified independent appraiser is one who (1) holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis and is qualified to make appraisals of the type of property being appraised; and (2) is independent with respect to the company and the other parties to the ESOP transaction other than the ESOP itself.[38] The proposed regulations provide that the appraiser must apply “sound business principles of evaluation” and “conduct a prudent investigation of the circumstances prevailing at the time of the valuation.”[39] The “sound business principles of evaluation” requirement includes the application of the generally accepted approaches to valuation, which are the income approach, the market approach, and the asset-based approach, along with the accompanying methodologies to the various approaches.[40]

Under the proposed regulations, the “written documentation of valuation” must be signed and dated by the appraiser, and include the following information:

- A summary of the appraiser’s qualifications.
- A statement of the value of the stock that the ESOP trustee is purchasing and the methods the appraiser used in determining value.
- A full description of the stock that is the subject of the valuation.
- All of the factors the appraiser considered in making his or her determination of fair market value.
- The purpose of the valuation.

[29] DOL Prop. Reg. 2510.3-18(b)(2)(i).

[30] DOL Prop. Regs. 2510.3-18(b)(2)(ii) and (iii).

[31] Section 401(a)(28)(C).

[32] Kaplan, Brown, and Granados, “Basic Requirements of an ESOP,” 354 Tax Mgmt. Port. (BNA) ESOPs A-14 (2010).

[33] Rosen, “Understanding ESOP Valuation,” in *Leveraged ESOPs and Employee Buyouts, Sixth Edition* 31, 33 (Gordy, Hawkins, Josephs, Merten, Miller, Rodrick, Rosen, and Solimine, eds., 2013).

[34] ERISA, 29 U.S.C. section 1002(18) (2012); DOL Prop. Reg. section 2510.3-18(b)(2).

[35] Mueller and Gehr, “Valuation Issues in Multi-Investor ESOP LBOs,” in *ESOP Valuation, Third Edition* 25, 27 (Rodrick ed., 2005).

[36] *Id.*

[37] DOL Prop. Reg. 2510.3-18(b)(3)(ii).

[38] Murphy and Murphy, “An Introduction to ESOP Valuation,” in ESOP Valuation, Third Edition 1, 20 (Rodrick ed., 2005).

[39] DOL Prop. Reg. 2510.3-18(b)(3)(ii)(A).

[40] A discussion of valuation is beyond the scope of this article. For more in-depth discussions regarding valuation and the various methods of valuation, see Murphy and Murphy, *supra* note 38; and Rosen, *supra* note 33.

[41] DOL Prop. Regs. 2510.3-18(b)(4)(i)(A) through (H).

[42] Rev. Rul. 80-155, 1980-1 CB 84.

EXHIBIT 4
Borrowing Capacity Based on Cash Flow

EBITDA	$ 300,000
Non-Recurring Expenses	200,000
Owner Compensation Adjustment	1,000,000
AEBITDA	$1,500,000
at 2x	$3,000,000
at 3.5x	$5,250,000

- The relevance or weight the appraiser gave to the valuation methodologies used.
- The effective date of the valuation, which is the closing date of the ESOP sale.[41]

Although not legally required, it is prudent that the trustee have the appraiser issue a fairness opinion as of the date of the ESOP transaction which states that the price and other financial terms of the transaction are fair to the ESOP participants. The ESOP is also required to have its stock appraised as of the last day of each plan year and on the occurrence of certain activities.[42]

Financing. Business owners often ask how much of the ESOP purchase price they should anticipate being able to finance with bank debt. The answer to this question depends on numerous factors, but the primary factors—known as the "Three Cs of Credit"—are cash flow, collateral, and character.

A bank wants to make sure that the company has enough cash flow to service the loan facility requested in connection with the ESOP transaction as well as the company's other debt obligations. Typically, a company can borrow between two and three and one-half times its annual cash flow from a senior lender (e.g., a bank). "Cash flow" is generally defined as a company's earnings before interest, taxes, depreciation, and amortization (EBITDA), adjusted for certain items such as non-recurring expenses and expense savings that the company will realize after the ESOP transaction, such as reductions in the owners' compensation, benefits, and perquisites ("adjusted EBITDA" or "AEBITDA"). Exhibit 4 provides an example of an AEBITDA calculation, which could support bank financing between $3 million and $5.25 million.

Collateral, the second "C of Credit," refers to company assets, or those of a third-party guarantor, such as a selling shareholder, that may be pledged to protect the senior lender in the event the com-

EXHIBIT 5
Effect of ESOP Debt on Company's Equity Value

Enterprise Value	$10,000,000
Plus: Excess Cash	1,000,000
Less: Long-Term Debt	–1,000,000
Less: ESOP Debt Balance	–10,000,000
Plus: Present Value of ESOP Tax Benefit	2,007,507
Equity Value	$ 2,007,507
Number of Shares	1,000,000
Price Per Share	$2.01

EXHIBIT 6
Calculation of Value of Warrants

	Year 1	Year 10
Enterprise Value	$10,000,000	$16,288,946
Plus: Excess Cash	1,000,000	1,000,000
Less: Long-Term Debt	–1,000,000	–1,000,000
Less: ESOP Debt Balance	–10,000,000	0
Plus: Present Value of ESOP Tax Benefit	2,007,507	0
Equity Value	$ 2,007,507	$16,288,946
Number of Shares	1,000,000	1,000,000
Price Per Share	$2.01	$16.29

(Year 10 Price Share – Year 1 Strike Price) × Number of Warrents = Value of Warrants

($16.29 – $2.01) × 100,000 = $1,228,000

pany defaults on its obligations. A bank would view a company with sufficient assets to cover a loan obligation as a safer credit than a comparable company with limited asset support.[43] The bank will look at the company's balance sheet assets and will apply applicable advance rates against those assets to determine the company's "borrowing base," which is a calculation that determines its asset coverage.[44]

If the company's asset coverage is insufficient to secure the full amount of the requested loan facility, which is common for service companies, the bank might extend the remaining amount of the loan as an "airball," which is an uncollateralized portion of a loan.[45] If the desired loan exceeds the company's borrowing base and the airball the bank is willing to extend, the selling shareholder could offer a limited personal guarantee or offer to pledge a portion of his or her personal assets, such as the investments he or she purchases with ESOP sales proceeds, to secure the remainder of the loan facility.

Assume that the company whose cash flow is illustrated in Exhibit 4 is a service company whose only asset is its accounts receivable, which are pledged to secure its line of credit. A bank might loan the company $4 million to finance the ESOP transaction, but will likely require a pledge of the selling shareholder's assets as collateral to secure its position. Because banks calculate collateral requirements based on the advance rates on particular asset classes, the bank might require assets, such as floating rate notes, having an equity value of approximately $4.5 million (assuming an advance rate of 90%) as collateral for the $4 million ESOP loan.

Banks also consider the "character" of the borrower, including the company itself as well as its senior management team. Especially if the selling shareholder is the founder of the company who is selling out or transitioning away from the company, the bank will want to be confident that the successor management team can continue to generate the earnings level that the bank is underwriting, as well as understand management's experience with debt and achieving quarterly covenants.[46] Additionally, the bank will want to understand the impact of any key employees who might be leaving the company in connection with the ESOP transaction, as they might retain valuable information or key relationships that could affect business going forward.[47] Any management risk the bank perceives could be decreased by the trustee requiring key employees to execute employment agreements as part of the ESOP sale, which is common practice.[48]

As part of its consideration of the company's character, the bank will determine whether the company has a concentration issue with respect to its customers or suppli-

[43] Josephs and Hawkins, "ESOP Underwriting Considerations," in *Leveraged ESOPs and Employee Buyouts, Sixth Edition*, *supra* note 33 at 121, 123.

[44] *Id.*

[45] *Id.*

[46] *Id.* at 133.

[47] *Id.*

[48] *Id.*

[49] Josephs and Hawkins, *supra* note 43 at 179, 181.

[50] *Id.* at 182.

[51] *Id.* at 184.

[52] *Id.*

[53] *Id.*

[54] *Id.* at 188.

EXHIBIT 7
Post-Transaction Drop-in-Value

Enterprise Value	$10,000,000
Plus: Excess Cash	1,000,000
Less: Long-Term Debt	–1,000,000
Less: ESOP Debt Balance	–5,000,000
Plus: Present Value of ESOP Tax Benefit	1,340,862
Equity Value	$ 6,340,862
Number of Shares	1,000,000
Price Per Share	$6.34

ers. The bank may be concerned if more than 20% of the company's revenue is attributed to one customer or if the company is dependent on one supplier for more than 20% of its raw materials or other assets used in its products or services. The bank will also want to be comfortable with the stability of the company's historical earnings and with the degree of predictability of its projected earnings. Therefore, highly cyclical companies generally cannot borrow as much as companies whose earnings are more stable.

Many companies use a combination of excess company cash, senior bank debt, and subordinated Seller Notes to finance an ESOP transaction. Seller Notes must meet appropriate tests to be classified as debt instead of equity, including an interest rate at least equal to the applicable federal rate (AFR), a date certain of maturity, and other terms and conditions that reflect "commercial reasonableness."[49] Often, business owners initially object to the suggestion of seller financing. However, after learning more about how the seller financing may provide better risk-adjusted rates of return relative to a more typical market investment, business owners begin to embrace the idea.

Generally, in order for the subordinated seller debt to satisfy the requirement of commercial reasonableness, its terms must not exceed the terms one would anticipate in an arm's-length transaction with a commercial subordinated debt lender such as a mezzanine lender ("mezz lender"). Currently, mezz lenders generally require an all-in return of 12% to 18%, which is justified due to the increased risk associated with being a junior subordinated lender.

For a subordinated note holder, the all-in return may come from two separate components: interest payments and warrants.[50] A warrant is a security that is similar to an option that allows the holder to buy company stock at a fixed exercise price for a specified period. A company usually issues warrants in conjunction with a debt instrument. Debt holders require compensation for the risk of lending, and for traditional lenders, this compensation is interest expense.[51] Subordinated debt is more risky due to its subordination to senior bank debt; therefore, traditional interest-only compensation might not be sufficient to justify the risk.[52] Warrants provide a way for holders of ESOP Seller Notes to enhance their return commensurate with the risk.[53] Typical subordinated debt terms might be a loan interest rate of 8% plus warrants whose value results in an additional return of 7% over the term of the warrants.

Once business owners understand that their seller debt may be entitled to the same return that a mezz lender receives, they often are willing to help finance a portion of the transaction. Their return on the subordinated debt might actually exceed their anticipated return if they received cash at closing and reinvested it in a more traditional manner. A Seller Note with warrants provides a selling shareholder a continued opportunity to participate in the equity appreciation of the company after the ESOP transaction; it provides the company with less stringent terms and covenants than commercial subordinated lenders; it helps to reduce the burden of interest payments to the company; and it provides a way for the warrant holder to be taxed at capital gains rates when he or she exercises warrants in the future, instead of paying ordinary income tax on current interest payments.[54]

Control. A common misconception about ESOPs is that the owner of a company will lose control of his or her company if all or a portion of his or her stock is sold to the ESOP. While control is certainly an issue that a selling shareholder should consider, ESOP trustees are typically passive financial investors (as opposed to active operating investors). The selling shareholder often continues to operate the company for the benefit of its new owners (effectively, its employees) after the sale; therefore, an owner can retain operational control after the sale, even though the trustee has exclusive authority and discretion over the plan's assets.

It is prudent to engage an independent institutional trustee that will use its own judgment in making decisions related to the terms of the ESOP transaction, including the price to be paid and the terms of the stock purchase agreement;

EXHIBIT 8
Calculation of Value of Gift

ABC Equity Value	$10,000,000
Less: ABC ESOP Debt	–5,100,000
ABC Post-Transaction Equity Value	$ 4,900,000
49% of ABC Post-Transaction Equity Value	2,401,000
Less: 25% Valuation Discount	–600,250
Value of Gift to Active Child	$ 1,800,750

however, after the transaction closes, that same institutional trustee can operate as a directed ESOP trustee on an ongoing basis. Explicitly authorized by the law, a directed trustee is a trustee who is subject to the direction of another named fiduciary in the plan.[55] That other "named fiduciary" is typically the company's board of directors (or a subcommittee of the board). The board directs the trustee as to how to vote the ESOP stock, and the trustee must determine that those directions are proper, are made in accordance with the terms of the plan, and are not contrary to the provisions of ERISA.[56]

The ESOP participants and beneficiaries must be given the right to direct the voting of allocated shares only in the following situations: any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, a sale of substantially all of the company's assets, or other similar transactions that the Treasury Department prescribes by regulations.[57] Note that the participants have the right to direct the ESOP trustee in voting their allocated shares, not to vote them directly; the ESOP trustee actually votes the shares held by the ESOP.[58]

ESOPs and estate planning

Implementing a leveraged ESOP transaction creates gift, estate, and charitable planning opportunities. The valuation effect that a leveraged ESOP produces—the "post-transaction drop-in-value"—provides a business owner with a unique opportunity to make lifetime gifts of interests in his or her company (shares of stock or warrants) at a deeply discounted value. An ESOP also presents the opportunity for equitable estate planning (treating active and inactive children fairly) as well as various charitable planning strategies for the philanthropic business owner.

Gift tax leverage. One of the principal goals of gift and estate tax planning is to make lifetime gifts of assets whose values are temporarily deflated, but that will appreciate rapidly in the hands of the donee. The concept of the ESOP "post-transaction drop-in-value" presents an opportunity for a business owner to make a gift of this type of asset (a "leveraged gift"). In order to fully understand how this opportunity arises in connection with an ESOP transaction, it is imperative to understand the concepts of enterprise value and equity value.

The appraiser will determine enterprise value using one or more of the generally accepted valuation approaches mentioned above. However, calculating enterprise value is only the first step in valuation, because a company does not sell for its enterprise value. Rather, a company sells for its equity value, which is its enterprise value less long-term debt plus excess cash and other non-operating assets. If a company with an enterprise value of $10 million has $1 million of long-term debt and $1 million of excess cash, then its equity value is equal to its enterprise value of $10 million. The selling shareholders would receive $10 million for a sale of 100% of their stock to an ESOP.

Immediately following the ESOP sale, the company will have a different—and usually much lower—equity value, which is attributed to the debt the company incurred to finance the transaction. The result of this debt is known as the "post-transaction drop-in-value."

Example. A business owner wishes to sell 100% of the stock in his closely held company for $10 million. The company borrows $6 million from a bank, and lends that amount to the ESOP. The ESOP pays the business owner $6 million in cash and issues a Seller Note paying 6% interest annually with 100,000 detachable warrants for the remaining $4 million. This company has an enterprise value of $10 million, but also has $10 million in debt.

Ending the calculation there produces an equity value of $0. The leveraged ESOP transaction that created the debt, however, also produces a substantial tax benefit in the form of tax-deductible annual ESOP contributions.

Valuing this tax benefit requires calculating the net present value of the corporate tax deduction produced by the annual ESOP contributions at a discount rate equal to the company's weighted average cost of capital. In this case, the net present value of the ESOP tax benefit is calculated to be $2,007,507. The company's one million shares of stock now have a value of $2.01 per

[55] ERISA, 29 U.S.C. section 1103(a)(1).

[56] *Id.*

[57] Ackerman, *Questions and Answers on the Duties of ESOP Fiduciaries* 70 (The National Center for Employee Ownership ed., 2008).

[58] *Id.*

share, which will also be the strike price of each warrant. Exhibit 5 demonstrates the effect of the ESOP transaction debt on the company's equity value immediately following the transaction.

Suppose that after the ESOP transaction closes, the business owner makes a gift of the warrants he received in connection with his Seller Note. For gift tax purposes, the value of the warrants is calculated using the Black-Scholes model, which is the most widely used option valuation model. It is based on assumptions specific to the issuing company. Under this model, the value of the warrants will be substantially less than the value of the stock prior to the transaction, creating an opportunity for the business owner to make a highly leveraged gift. As the company grows and pays its ESOP debt, the warrants produce a leveraged growth rate exponentially higher than the company's organic growth rate. Here, at the end of ten years, the total value of the warrants in the hands of the donee is $1,428,144, which represents a leveraged growth rate of 21.68% (as is calculated in Exhibit 6).

Suppose now that the business owner sold only 49% of his stock. Exhibit 7 illustrates the reduction of equity value that the post-transaction drop-in-value produces on the owner's 51% equity interest. The business owner could make a gift of the 51% ownership interest in the company outright to his children; he could transfer the 51% interest to a family limited partnership (FLP) and make lifetime gifts of the heavily discounted limited partnership units to the children; or the business owner could make a gift to a grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT) meeting the requirements of Section 2702, and retain an income stream.

Active child vs. inactive child challenge. A business owner can also use an ESOP sale to address the "active child vs. inactive child" planning challenge that many BBBOs face. Many BBBOs own closely held companies with a child (or children) who are active in the business and a child (or children) who are not active in the business. The challenges that this situation presents are fairly evident; however, using an ESOP to solve this dilemma requires some explanation.

Example. The owner ("Owner") of a private company, ABC, Inc., a Subchapter C corporation, has two children. One child is active in the business ("Active Child") and the other is not active in the business ("Inactive Child"). Owner is 65 years old and would like to achieve some liquidity from the company while ensuring that Active Child remains with the company and has an opportunity to succeed Owner at ABC. Another of his goals is to treat Inactive Child fairly.

Selling ABC to a third party would provide Owner with some liquidity, but that liquidity comes with a significant tax liability and would likely make Active Child unable to succeed his father as president of ABC. Instead of selling ABC to a third party, Owner can sell a part of his company to an ESOP to obtain some liquidity—without paying taxes—and potentially allow Active Child to succeed him as the president of the company.

ABC establishes an ESOP which purchases 51% of Owner's stock in a leveraged transaction. ABC is able to borrow $5.1 million from its bank (Outside Loan), and then loans this amount to the ESOP (Inside Loan). The ESOP uses the

proceeds of the Inside Loan to pay Owner $5.1 million in cash for 51% of his stock in ABC. Because ABC is a Subchapter C corporation, Owner defers $1,213,800 in capital gains taxes by electing the tax deferral provided by Section 1042, and he receives income from the reinvestment of his QRP on the full amount of his ESOP sales proceeds.

Owner has accomplished his goal of achieving some liquidity, but how does an ESOP allow him to provide for Active Child? After the transaction, Owner makes a gift to Active Child of the remaining 49% of ABC stock. This gift results in Active Child receiving a significant equity interest in the company and the opportunity to succeed Owner as the president of the company.

In addition, this gift is very tax-efficient as a result of the post-transaction drop-in-value. The value of Owner's gift to Active Child is not $4.9 million (49% of $10 million). The company's $10 million enterprise value is reduced after the transaction by the $5.1 million of ESOP debt resulting in an equity value of the entire company of $4.9 million. The value of Owner's 49% retained interest is $2,401,000 (49% of $4.9 million). Assuming the gift tax appraiser applies a minority interest discount of 25%, the value of the gift to Active Child is $1,800,750 which is within Owner's unified credit amount. (Exhibit 8 shows this calculation.) Therefore, the ESOP sale coupled with Owner's election of tax-favored treatment under Section 1042, along with the avoidance of gift tax liability, enables Owner to transfer an asset worth $10 million without paying taxes.

An ESOP sale also presents strategies Owner can use to provide for Inactive Child. Assuming that Owner receives a high enough annual return on his qualified replacement property to live comfortably, Owner could pass his entire investment portfolio at his death to Inactive Child. Because Owner held his qualified replacement property until his death, Inactive Child receives a stepped-up basis in the inherited property equal to the fair market value of the securities on the date of Owner's death.[59] The result is that no income tax will ever be paid on Owner's qualified replacement property.[60]

The income produced by a 100% ESOP-owned S corporation will not be subject to tax because it is a "flow-through" entity whose income flows through to its sole shareholder, which is a tax-exempt entity.

ESOPs and charitable planning opportunities

Suppose Owner has a favorite charity he would like to benefit as part of his ownership succession and estate plan. Continuing with the same fact pattern, instead of holding all of his QRP until death, Owner contributes $2 million of his QRP to a charitable remainder trust (CRT), which allows him to take an income tax deduction for the value of the gift without giving up future income on the QRP. Establishing the CRT as a charitable remainder unitrust (CRUT) provides Owner with an annual payment from the CRUT, which is a fixed percentage of the annual fair market value of the CRUT's assets.[61]

Generally, Section 1042(e)(1) provides that Owner's gift of his QRP to the CRUT is a "disposition" that triggers a recapture of the gain with respect to the $2 million of QRP. However, the IRS has issued a series of private letter rulings in which it takes the position that if the CRUT complies with the Code and other IRS guidance, then Owner will not realize any gain on his transfer of QRP to the CRUT.[62] Owner receives an income tax deduction in the amount of the present value of the remainder interest,[63] which passes to Owner's favorite charity at the end of the unitrust term.

Another option for Owner is to contribute ABC stock directly to the CRUT, and then have the trust sell the stock to the ABC ESOP. Owner receives an income tax deduction for the value of the gift and avoids recognizing gain on the sale of the stock by the CRUT to the ESOP. The charity will invest the ESOP sales proceeds, and pay Owner an income on the investment proceeds until sometime in the future, at which point the charity may use the principal investment. This charitable planning technique is useful if Owner does not want to worry about satisfying the reinvestment requirements of Section 1042. Section 409(n) contains a prohibited allocation rule which says that family members of a selling shareholder who elects to take advantage of the tax deferral under Section 1042 cannot receive allocations of stock from the ESOP. Therefore, this technique is useful if Owner has family members at ABC and he wants to benefit them through the ESOP.

The simplest charitable planning opportunity is for Owner to contribute all or a portion of his ABC stock directly to a charitable organization, which allows Owner to take

[59] Section 1014(a)(1).
[60] Section 1042(e)(3)(B).
[61] Section 664(d)(2)(A).
[62] Ltr. Rul. 9234023, Ltr. Rul. 943012, and Ltr. Rul. 9438021.
[63] Section 170(f)(2)(A).

an income tax deduction for the appraised value of his stock, after factoring any applicable minority interest discounts. The charity can then sell the stock that Owner contributed to the ABC ESOP.

It should be noted that charitable organizations described in Section 501(c)(3) and exempt from tax under Section 501(a) are qualified S corporation shareholders. However, a charitable remainder trust does not qualify. A charitable lead trust may qualify if it is a grantor trust for income tax purposes.

Characteristics of ESOP candidates

Financial characteristics of companies that are strong ESOP candidates include high levels of profitability and low levels of debt. Because a company will typically use a leveraged ESOP in connection with the business owner's succession plan, unused debt capacity is necessary so that the company is able to borrow the money needed to finance the ESOP transaction. It is also helpful for a company to have steady cash flows throughout its fiscal year and not operate in a declining industry.

In terms of transaction amount (the value of the stock to be sold to the ESOP), the minimum amount necessary to produce an attractive cost-benefit result is generally $3 million. Typically, ESOP transactions range from $6 million to $100 million, indicating that the company has at least $1 million of adjusted cash flow represented by AEBITDA or earnings before owners' compensation (EBOC). In addition, the tax benefits that an ESOP provides to its sponsoring company make it very attractive, so a company that pays a significant amount of corporate tax is usually a prime ESOP candidate.

Because an ESOP is essentially a sale to insiders, a company considering an ESOP needs to have a management team in place that can successfully run the company following the departure of the business owner, or at least have identified the individuals who will comprise that management team. An ESOP often works best for a company that has started to develop a management succession plan and whose owner has started to transition away from operating responsibilities.

A key planning objective of many ESOP candidates includes protecting employees' jobs and perpetuating the company's legacy. The owners of these companies are concerned that a third-party sale will result in the company being absorbed into a much larger entity that will not retain its key employees. "Using an ESOP can be an ideal succession strategy in these circumstances as it also enables [business owners] to reward their employees and the management team that helped them develop and grow the business."[64]

Conclusion

Many BBBOs have thought about ownership succession and estate planning for years, and might have even discussed it with their professional advisors and management team. However, most BBBOs have not developed a written succession plan or formalized a methodology for valuing their company.[65] This uncertainty can create stress for the business owner and may make it difficult for him or her to retain the key employees desired to manage the company as the owner "slows down" towards retirement.

A partial ESOP transaction provides a BBBO with the liquidity needed to mitigate the risk of having a majority of his or her net worth invested in the equity of his or her company, while providing the management team a strong incentive to remain with the company and to continue to contribute to its growth. A partial ESOP transaction also allows the business owner to remain involved in the company and maintain the flexibility to later sell the remainder of his or her stock to the ESOP or directly to key employees, or to sell the entire company to a third party.

A 100% ESOP transaction maximizes a business owner's liquidity and a company's tax benefits. Almost every 100% ESOP-owned company operates as an S corporation, allowing the company to operate as a tax-exempt entity which provides it with a tremendous competitive advantage over non-ESOP-owned companies.

An ESOP is a very effective strategy for ownership and management succession as well as estate, gift, and charitable planning. Given a business owner with a desire to sell to insiders, an ESOP can operate, as described above, as a fully tax-deductible leveraged buyout while providing the selling shareholders with additional tax benefits and a company's employees with very generous retirement benefits. An ESOP is an appropriate planning strategy for many BBBOs and an attractive alternative to traditional ownership succession strategies. ■

[64] Interview by financierworldwide.com with Maria Pencheva, Managing Director, Innovative Shareholder Strategies, LLC, in "TalkingPoint: Outlook for ESOP Structures in 2014" (April 2014).

[65] Bain Surveying, *supra* note 2.