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May 21, 2009

Use of ESOPs for Business Succession and Estate Planning

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A. Selling stock to an ESOP

1. If a selling shareholder sells company stock to an ESOP, and immediately thereafter, the ESOP owns 30% or more of the company, the selling shareholder can defer the gain under Code Section 1042.

2. Company must be a regular, C-corporation to get the tax deferral.

3. Subject to tax planning, you can revoke an S-corporation election just prior to closing.

4. To get this treatment, the selling shareholder must invest the sales proceeds in “qualified replacement property” or “QRP.”

5. QRP is comprised of stocks or bonds of domestic operating companies, like Home Depot.

6. QRP would not include mutual fund shares, REITS or government securities, or companies dominated by their international business.

7. The selling shareholder’s low tax basis in his company stock carries over and becomes his basis in the QRP (but we can show how to get around that).

8. If Section 1042 is not used, capital gain recognition is available.

B. How does the ESOP get the money to buy the stock?

1. The company borrows money from a lender and turns around and lends it to the ESOP.

   a. Selling shareholder can be the lender.

   b. Seller financing easily done where Code Section 1042 <u>not</u> an issue, because no need to buy QRP.

   c. If selling shareholder is the lender and wants Code Section 1042 treatment, he will need other assets to purchase QRP.

2. The terms of the bank (or other lender) loan to the company and the company loan to the ESOP need not match up.

3. The lender will require collateral from the company, and may ask for a pledge of the stock owned by the ESOP. May ask for inventory, equipment, A/Rs, etc.

4. If the company does not have sufficient borrowing base, the selling shareholder may need to guarantee the outside loan and possibly pledge some or all of the QRP from a Code Section 1042 transaction.

5. As the loan is repaid, the company stock and the QRP are released from the pledge to the outside lender. DOL has required collateral release rules.

6. ESOP loans tend to be in the 5 to 15 year amortization time period.

C. How does the ESOP repay the loan to the Company?

1. Company makes <u>tax deductible</u> contributions to ESOP. Also can pay dividends or S corporation distributions to the ESOP.

2. Company can contribute and deduct an amount up to 25% of compensation of eligible participants, plus for C corporations, the interest amount on the loan and reasonable dividends.

3. ESOP turns around and gives the money back to the company to pay the promissory note (and the company then repays the lender - <u>meaning the company repaid the lender with tax deducted monies</u>).

D. How do the Employees benefit?

1. By law, as the ESOP loan is repaid, a ratable number of shares of company stock must be released from the collateral or pledge.

2. Those released shares are allocated to the eligible participants based on relative compensation - - much like a profit sharing contribution.

3. Typically, eligible participants are employees who have been with the company for at least 1 year, and are over age 21.

4. Typically, to receive an allocation for a year, an employee must work 1,000 hours of service and be employed on the last day of the plan year.

5. When the shares are released and allocated, they are then <u>beneficially</u> owned by the participant, and become his/her retirement account.

6. An ESOP account is like a profit sharing account, but it is invested in shares of company stock. The value of the company stock largely determines the value of the account.

7. In order to keep the employees in service, the employer can impose a vesting schedule. Typical schedules:

Years of Service	"Graded" % Vested
Less than 2	20 %
3	40 %
4	60 %
5	80 %
6 or more	100 %

Years of Service	"Cliff" % Vested
Less than 3	0 %
3 or more	100%

8. Also, for C corporations, no distributions have to be made while the ESOP loan is outstanding. Thus, it can be years before the company has to make any distributions.

9. When the employee leaves, retires or dies, the company can be required to buy the stock back at the then fair market value. This is called a "put option." Does not apply to public companies.

10. Repurchase obligation can be funded with insurance contracts.

11. Employees have a right to diversification at age 55 with 10 years of service (25%/50%).

E. Who controls the ESOP?

1. The selling/controlling shareholder can be the trustee and vote the stock. Typically done until all QRP or other collateral given by the selling shareholder is released from pledge to lender.

2. Mechanically, selling shareholder is the controlling director at outset. He votes himself as trustee. As trustee, he votes the stock the ESOP buys for him to be the director. The circle continues.

3. Trustee must act in the best interest of the participants, but still has the right to make reasonable business decisions and pay himself reasonable compensation.

F. What does selling shareholder do with the proceeds?

1. If Code Section 1042 treatment desired, must purchase QRP, which takes on the tax basis of the company stock that was sold.

2. Often times, the lender requires the selling shareholder to pledge the QRP and then releases it as the outside loan is paid back.

3. In larger transactions (over $1 million), the QRP often takes the form of floating rate debentures of quality companies.

4. If the QRP is not pledged, or as it is released, it often is used as collateral for a loan (at 90% of value), and those proceeds are used to buy a diversified portfolio of securities.

5. These securities, unlike the QRP, have a fair market value tax basis, so if the owner wants to sell them later, he has a higher tax basis and lower capital gain.

G. Players in the ESOP transaction.

1. Dean Mead, as lawyers, draft the plan documents and review the loan and related documents for the company.

2. Appraiser. DOL requires the sale to be at FMV. There is an ongoing appraisal too - annually.

3. Independent Trustee. Used to make sure the terms of purchase and sale of stock are fair to the participants. One shot deal.

4. Bank /Lender - lending to the Company. Has own counsel.

5. Deal analysis professional, like Berman, Hopkins, Wright & LaHam. Early on, will run the numbers to show the feasibility of

the transaction. Determines how much can be deducted each year, which determines the loan amortization amount, that determines the maximum loan amount, that determines the percentage of the company to be sold.

6. Third party administrator, like Blue Ridge ESOP Associates. Does the plan recordkeeping, participant statements each year, and annual Form 5500 for the ESOP.

7. Financial Advisor. Assists the seller with the purchase of the QRP. If floating rate debentures used, there can be 2 layers of QRP. Also could help fund repurchase obligation.