

**THE SALE OF STOCK IN A CLOSELY-HELD
BUSINESS TO AN "ESOP" (EMPLOYEE STOCK
OWNERSHIP PLAN): A DIVERSIFICATION AND
BUSINESS SUCCESSION STRATEGY FOR BUSINESS
OWNERS**

**Mercer County Estate Planning Council
February 8, 2012**

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What is an ESOP?

An Employee Stock Ownership Plan (“ESOP”) is:

- ▶ A form of tax-qualified defined contribution plan
- ▶ Designed to invest primarily in employer securities
- ▶ 11,500 + ESOPs covering 10.5 million employees with \$900 billion in assets (ESOP Association website, as of 2007)

An ESOP Transaction is a sale of stock by the business owner

to an ESOP for cash

ESOPs: Key Benefits

- ▶ For business owner
 - Deferral and Potential Elimination of Tax on Sale
 - Cash to Business Owner
 - Diversification
 - Retention of Control
 - Market for Privately Held Stock

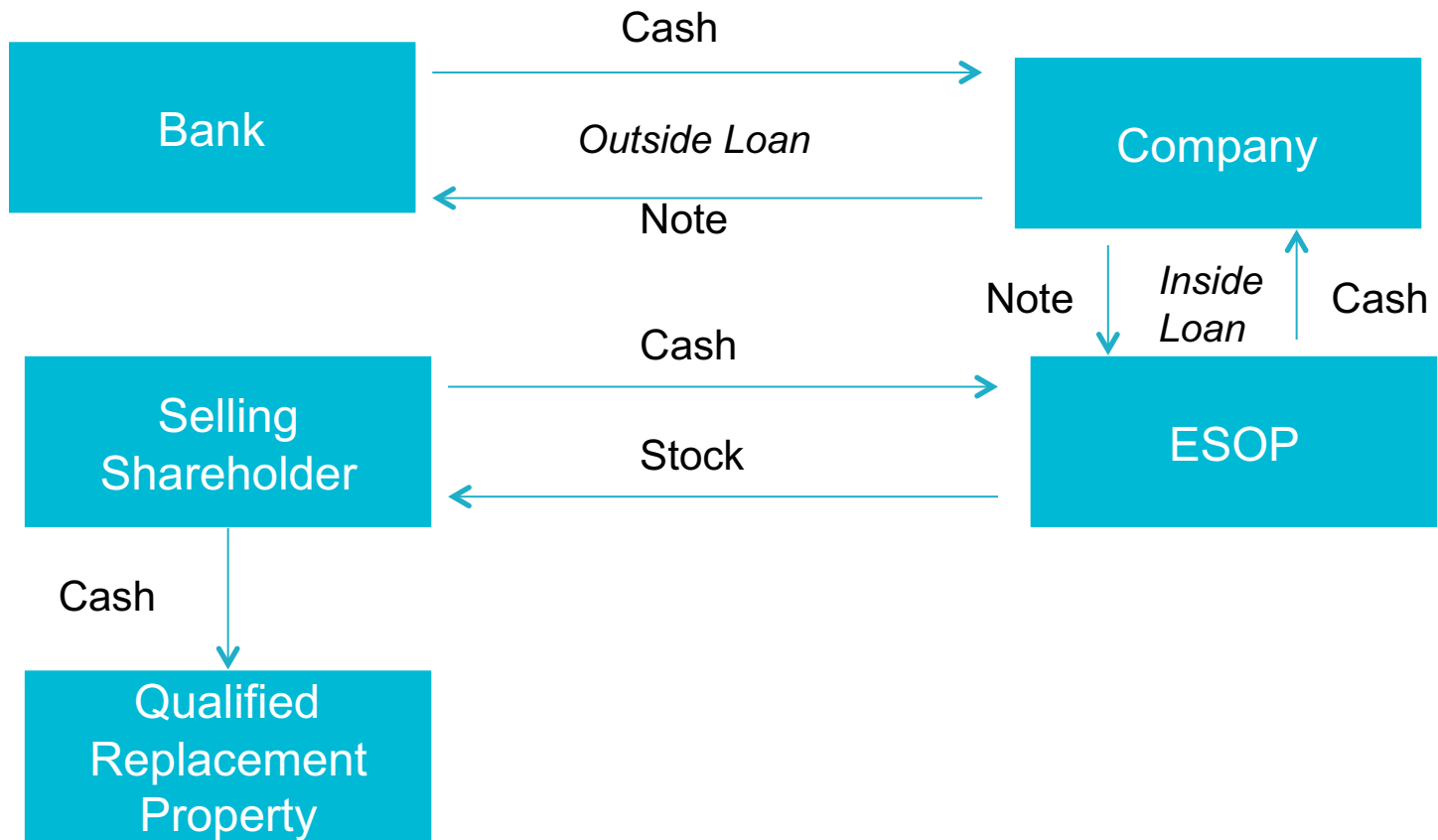
ESOPs: Key Benefits (continued)

- ▶ Allows for Gradual Sale of Company
- ▶ Incentivizes Employees
- ▶ Provides Tax Benefits

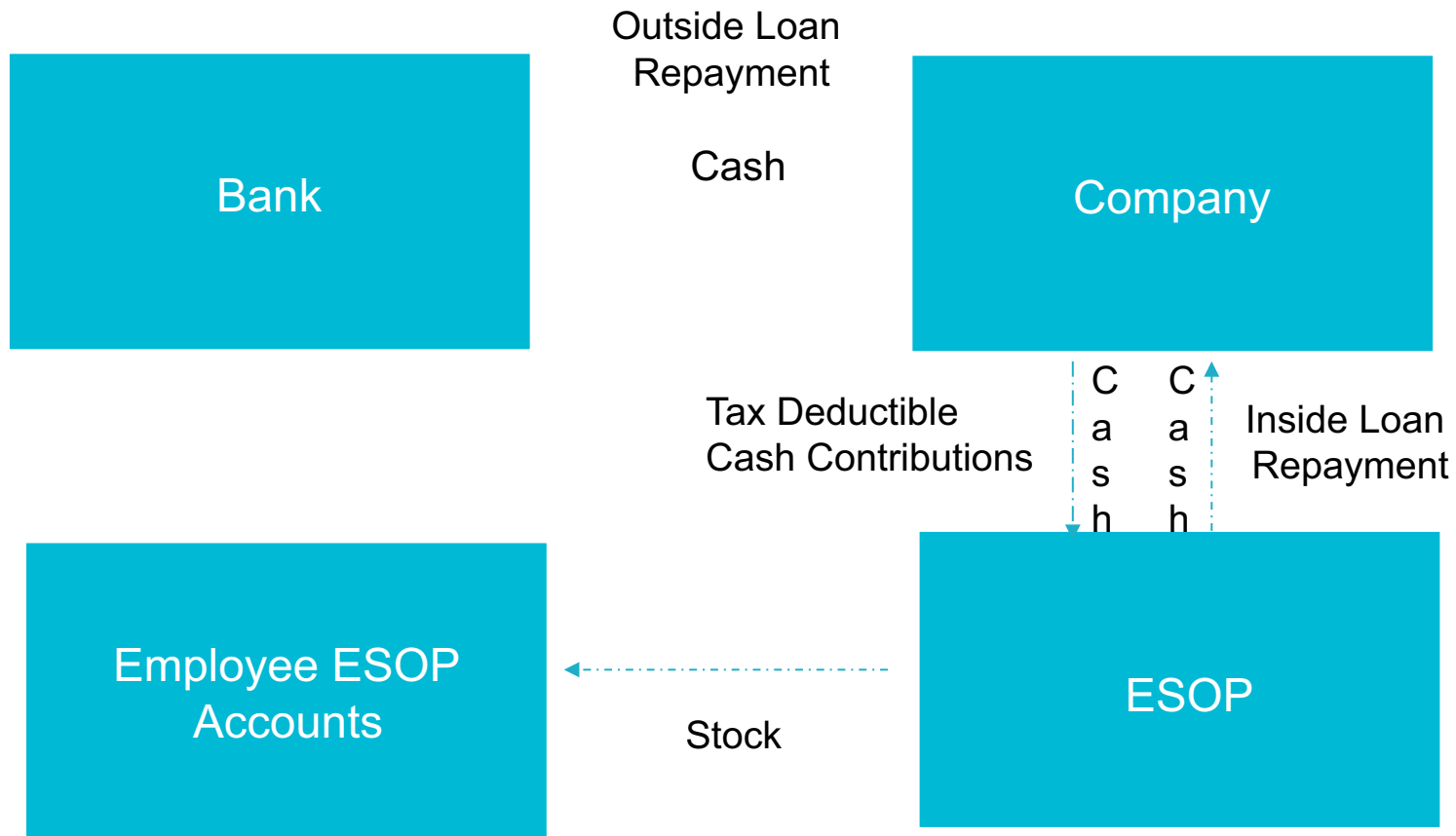
ESOP Example:

1. Owners of business sell 30% of stock of company worth \$50 million to ESOP for \$15 million
2. Sale is financed by \$15 million bank loan
3. Owners use \$15 million proceeds to purchase domestic stocks and bonds
4. Owners retain control of business

Leveraged ESOP: How It Works



Bank Loan Repaid with Tax-Deductible Dollars



ESOPs: Significant Tax Benefits

- ▶ Seller defers gain – Section 1042 capital gains deferral provision
- ▶ Company deducts –
 - Loan interest and principal payments
 - Dividends paid to ESOP
- ▶ Tax exemption for S Corporation earnings
- ▶ Tax-deferred employee benefits

Section 1042 Tax Rollover Requirements

- ▶ ESOP must own 30% of the stock
 - 30% of each class of outstanding stock of the corporation or 30% of total value of outstanding stock of corporation
 - Test determined immediately after the sale so once ESOP has achieved 30% ownership, every sale thereafter satisfies the requirement
 - Multiple sellers in a single transaction can be aggregated

Section 1042 Tax Rollover Requirements (continued)

- ▶ Employer establishing ESOP must be:
 - Non–publicly traded company
 - C [but *not* S] corporation (see conversion discussion below)
- Stock sold to ESOP must be employer securities, i.e., issued by a domestic C corporation which sponsors the ESOP or a member of the controlled group of corporations which includes the corporation sponsoring the ESOP

Section 1042 Tax Rollover Requirements (continued)

- ▶ Seller, his family members and 25% shareholders cannot participate in ESOP
 - Violation of this rule results in employer excise tax, income inclusion to participants who receive impermissible allocations and potential plan disqualification

Section 1042 Tax Rollover Requirements (continued)

- ▶ Seller files with his tax return for year of sale election to take advantage of Section 1042 and statement of company consenting to imposition of excise tax if QRP is disposed of by ESOP within three years or if qualified securities are allocated to persons prohibited from receiving them

Section 1042 Tax Rollover Requirements (continued)

- ▶ Seller must have owned stock for three years
 - Tacking of holding periods applies, e.g., gifted stock, stock acquired pursuant to tax-free organization, stock acquired in Section 351 transaction
- ▶ Seller may not be a C corporation
 - Partnership can take advantage of 1042 provided partnership purchases qualified replacement securities

Section 1042 Tax Rollover Requirements (continued)

- ▶ Within 15 month replacement period, seller must reinvest proceeds in “qualified replacement securities (QRP)”
 - No tracking requirement
 - U.S. operating corporations’ stocks and bonds
 - *Not* mutual funds or Treasuries

Section 1042 Tax Rollover Requirements (continued)

- ▶ Disposition of QRP triggers gain except for transfers in a tax-free reorganization, by reason of death, gifts or contributions to a charitable remainder trust
- ▶ Carry over basis – Basis of stock sold to ESOP carries over to basis of QRP
- ▶ QRP gets stepped-up basis at death

Contributions, Dividends and Allocation Limits

- ▶ Loan repayment – tax deductions
 - Company payroll contributions to ESOP
 - Limits based on payroll – Code Section 404
 - 25% of eligible payroll plus unlimited interest payments if a C Corporation
 - Unless more than one third of ESOP Contributions are allocated to accounts of highly compensation employees
 - 25% of eligible payroll including interest if an S Corporation

Contributions, Dividends and Allocation Limits (continued)

- In the case of leveraged ESOP sponsored by a C Corporation, 25% limit is in addition to 25% limit for all other defined contribution plans – Code Section 404(a)(9)(A)
- Section 404 limits amount deductible but if company contributes more than it can deduct there is a 10% excise tax on the excess
- Dividends on ESOP stock
 - Deductible if used to pay ESOP loan used to buy shares on which dividend is paid

Contributions, Dividends and Allocation Limits (continued)

- Limits based on comparable transactions and reasonability (for C Corporations) – not an avoidance or evasion of taxation
- Dividends deductible in C Corporation's taxable year in which they are used to repay the ESOP loan
- Dividends not deductible for AMT purposes
- Annual Addition Limit
 - Code Section 415 limits yearly amount that can be allocated to all the plan accounts of any particular participant to lesser of 100% of payroll or \$50,000

Contributions, Dividends and Allocation Limits (continued)

- For C Corporations, forfeitures and interest are not included in annual additions limit, provided not more than one-third of contributions are allocated to HCEs
- Penalty for exceeding 415 limits is plan disqualification

S Corporation ESOP Tax Benefits

- ▶ S corporation shareholders are responsible for paying their pro rata share of the company's tax liability
 - ESOP may be S corporation shareholder and as of 1/1/98, the S corporation's share of the ESOP's income is not subject to the unrelated business income tax
- ▶ As an S corporation shareholder, the ESOP is not required to pay income tax on its pro rata share of the company's earnings

S Corporation ESOP Tax Benefits (continued)

- Company owned 100% by ESOP is therefore a tax free entity (except for New York City which doesn't recognize S corps)
- ▶ ESOP can use distributions it receives to pay down inside loan
- ▶ Code Section 409(p) – Prohibited allocation rules limit the establishment of ESOP's by S corporations to those that provide broad – based employee coverage and that benefit rank and file employees as well as highly compensated employees and owners

S Corporation ESOP Tax Benefits (continued)

- S converting to C to take advantage of 1042
Pros:
- Deferral of gain on sale to ESOP
 - 15% federal capital gains rate probably increasing in 2013
 - State tax on capital gains
- C corporation can have multiple classes of stock
- Enhanced contribution and deduction limits for leveraged ESOPs

S Corporation ESOP Tax Benefits (continued)

- Potential double taxation but the contributions the company makes to repay the ESOP loan very often eliminate the corporate level tax
- ▶ Conversion Issues
 - LIFO recapture
 - Built-in gains tax

ESOPs and Estate Planning

- ▶ Liquidity created by ESOP transaction:
 - Provides business owner with liquidity to equalize inheritances
 - Can be used to pay estate taxes without having to engage in forced sale to raise funds
- ▶ Post – ESOP transaction company value is depressed by leverage incurred to purchase stock

ESOPs and Estate Planning (continued)

- Opportunity for business owner to make gifts of retained interest to family members either outright or in trust through use of grantor retained annuity trust
- ▶ Business owner can contribute stock to charitable remainder trust (“CRT”) which pays lifetime annuity to owner and his spouse and then CRT sells stock to ESOP
 - Owner receives income tax charitable contribution deduction

ESOPs and Estate Planning (continued)

- Section 1042 limitations are obviated
- CRT pays no tax on sale to ESOP
- Stock is removed from business owner's estate

ESOPs are a Good Choice for:

- ▶ Businesses with --
 - Consistent Annual Profits (including Owner Compensation) of \$1.5 million or more
 - 15+ employees
 - Solid management in place
 - Non highly leveraged balance sheet

Thank you

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A Diversification and Business Succession Strategy for
Business Owners

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