# ESOPs

## *Pros & Cons*

Menke & Associates, Inc.

ESOP ADVISORS AND INVESTMENT BANKERS

# ESOPs Pros & Cons

## Table of Contents

INTRODUCTION . . . . . 2

TAX-FREE ROLLOVER . . . . . 3

Alternative to Sale . . . . . 4

Investment Diversification . . . . . 4

CAPITAL GAINS . . . . . 5

DIVIDEND DEDUCTION . . . . . 5

MECHANICS OF TAX-FREE ROLLOVER TRANSACTIONS . . . . . 6

ESOPS IN S CORPORATIONS . . . . . 7

Strategies for Existing S Corporations . . . . . 7

Strategies for Existing C Corporations . . . . . 8

Anti-Abuse Provisions . . . . . 8

Planning Pointer . . . . . 8

MECHANICS OF ESOP LOAN TRANSACTIONS . . . . . 9

CASH FLOW INCREASES . . . . . 10

MAXIMIZING EMPLOYEE INCENTIVES . . . . . 11

COMPATIBILITY WITH 401(K) PLANS . . . . . 12

DISADVANTAGES . . . . . 12

HOW THE PLAN IS DESIGNED . . . . . 14

OUR SERVICES . . . . . 16

Installation . . . . . 16

Communications . . . . . 16

Administration . . . . . 16

Rev. 3.09

# Introduction

Information in this booklet has been developed for those owners of privately-held businesses who are interested in liquefying some portion of the equity which has accumulated in their companies. We have assumed that many of our readers may be interested in accomplishing this objective without sacrificing the identity of their companies, jeopardizing the jobs of valued employees or relinquishing control of the companies they own.

An ESOP installation may provide the optimal solution for business owners hoping to achieve all of these goals. An ESOP (Employee Stock Ownership Plan) is a powerful and versatile business and financial tool which can help a business owner to accomplish the following:

- The ESOP trust establishes the fair market value of the company's privately-held stock and it also functions as the marketplace for that stock.

- ESOPs assure flexibility by allowing an owner to liquefy whatever portion of his ownership he chooses. The owner does not have to sell the entire company in order to liquefy a portion of the accumulated equity in the company.

- In situations where the company treasury does not have resources sufficient to liquefy the privately-held stock being conveyed to the ESOP, the ESOP is allowed to borrow the funds necessary to complete the transaction.

- Moreover, the company owner does not have to relinquish control of his company. Regulations governing ESOP operations allow the owner to sit on the committee which oversees the ESOP. Indeed, the owner can be the sole voting committee member on the ESOP Committee if he so chooses.

- In the case of a regular C corporation, if 30% or more of the company's outstanding stock has been sold to the ESOP at the completion of the transaction, and the proceeds are reinvested in qualified replacement securities within twelve months from the date of sale, the selling shareholder can defer payment of the capital gains tax on the sale of privately-held stock to the ESOP.

- In the case of S corporations, the ESOP creates a "tax shield" for part or all of the company's earnings, depending upon the percentage of stock held by the ESOP. This shield results from a provision of the Code that exempts from taxation that portion of the corporation's taxable income that is attributable to stock held by the ESOP. Thus, for example, in the case of a S corporation that is 100% owned by its ESOP, the company's earnings will be entirely tax exempt.

- The ESOP establishes an incentive-based retirement program for employees in the owner's company, making them beneficial stock owners in the company where they work. This incentive can produce very positive benefits for the company's bottom line profits. National studies reveal that on average ESOP companies tend to be 8% to 11% more profitable than their non-ESOP counterparts. As a direct consequence of sharing ownership with his employees, the business owner reaps the added benefit of increased profits (and increased valuation) for himself and for his company.

- A company can reduce its corporate income taxes and increase its cash flow and net worth by simply issuing treasury stock or newly issued stock to its ESOP.

The remainder of this booklet discusses and more fully explains these and other capabilities of this versatile and powerful business and financial tool.

## Tax-Free Rollover

Under §1042 of the Code, a taxpayer may defer paying any federal income taxes on the sale of closely-held stock of a C corporation to an ESOP, provided that he reinvests the proceeds in qualified replacement securities within twelve months of the date of sale.

In order to qualify for this deferral, the shareholder must sell closely-held domestic company stock that he has held for three or more years. Also, stock that the shareholder originally acquired as §83 stock, as restricted stock, as bargain stock, or as stock under a stock option plan or as a distribution from a qualified plan, does not qualify for this deferral. Secondly, after the transaction is complete, the ESOP must own at least 30% of the total value of all outstanding company stock (other than non-voting preferred stock). For purposes of this rule, any stock options are treated as though the optioned stock is already outstanding. Thirdly, the employer company must file a consent to the tax-free rollover transaction. Fourthly, the funds must be reinvested in qualified replacement securities within the period beginning three months before the sale and ending twelve months after the sale. Lastly, the company must be a regular C corporation.

"Qualified replacement securities" means any securities issued by a U.S. corporation which did not, in the year preceding purchase by the taxpayer, have passive investment income (rents, royalties, dividends, interest, etc.) in excess of 25% of the gross receipts of such corporation. Accordingly, the proceeds may be reinvested in corporate stocks and/or corporate bonds of either publicly-traded or privately-held corporations. On the other hand, the proceeds may not be reinvested in government securities, in mutual funds, or in real estate.

The ESOP is required to hold the employer securities which it has purchased for at least three years after the acquisition date. If the ESOP disposes of part or all of these securities (other than by means of a normal distribution to a terminated or retired participant), then the company will be liable for a 10% penalty tax, based on the value of the employer securities sold by the ESOP.

The seller must carry over his basis from the old securities to the new securities. Thus, if the seller subsequently sells the replacement securities, he will then incur a capital gains tax based upon the difference between the fair market value of the securities at the time of sale and his original basis.

Some of the ways in which the tax-free rollover provision may be especially useful to corporate owners are as follows:

1. **Alternative to Sale.** Purchase of an owner's stock by an ESOP will almost always be more beneficial to the owner than a sale or merger. For example, in the case of a sale to a third party, the seller will incur a capital gains tax, will lose control, will typically lose his salary and fringe benefits, and will usually not be able to keep any retained equity. In comparison, there will be no federal capital gains tax (and usually no state income tax) to the seller if he sells stock to an ESOP under the tax-free rollover provisions of §1042 of the Code. In addition, the seller can keep control, can continue to receive his salary and fringe benefits, and can keep as much or as little of the stock as he desires. Of course, the seller will be subsequently taxed if he later sells the replacement securities. However, in most cases it will be advisable for the seller to defer the tax. By taking advantage of the tax-free rollover provision, for example, a shareholder can sell $1 million worth of his closely-held stock to an ESOP and subsequently acquire $1 million worth of corporate stocks and/or bonds. By electing the tax-free rollover provision, he would save $200,000 in federal and state income taxes (assuming his basis in the stock is zero and assuming a combined tax rate of 20%). This will enable him to receive dividends and interest on $1 million worth of securities rather than on only $800,000 worth of securities. Further, if the shareholder holds these securities until his death, he will escape the income tax altogether. One caveat should be mentioned with respect to the purchase of corporate bonds. A bond is deemed to be sold or exchanged when it matures. Thus, if a bond matures prior to the owner's death, the capital gains tax will then be incurred. Accordingly, any shareholder who purchases corporate bonds as replacement securities should be careful to purchase long-term bonds.

2. **Investment Diversification.** Previously, the only way in which an owner of a closely-held company could achieve investment diversification without incurring an immediate income tax was to engage in a tax-free merger with a public company. In order to qualify for a tax-free merger, however, an owner must transfer 80% or more of his stock in exchange for public company stock. In effect, the owner has to give up control. Moreover, he still has no investment diversification and, worse still, no control over the new investment.

   Under the ESOP rollover provision, these problems are avoided. In order to get tax-free treatment, the ESOP need only acquire 30% ownership, and the replacement securities can be fully diversified into as many securities as the seller desires.

   The ESOP rollover provision also solves the problem of the locked-in shareholder. Under present law, if a shareholder holds his stock until death, the stock will receive a step-up in basis in his estate, and the income tax will be avoided. If, on the other hand, the shareholder sells part or all of his stock prior to his death, he will incur both a capital gains tax and an estate tax. As a consequence, many shareholders have been locked into their existing investments. Now, with the tax-free rollover provision, these shareholders can sell part or all of their closely-held stock and purchase marketable securities without incurring any federal capital gains taxes.

## Capital Gains

An ESOP can also be used to lock in the capital gains tax rate. If, for example, a shareholder wishes to sell less than 30% of his stock, or wishes to invest the proceeds in investments other than qualified replacement securities, he may sell part or all of his stock to the ESOP and elect capital gains treatment. As a result, he will be taxed at the capital gains tax rate, even if he retains significant stock ownership. This is in contrast to a partial stock redemption, which is usually taxed at ordinary income tax rates.

## Dividend Deduction

In the case of a regular C corporation, §404 of the Code provides for the deductibility of dividends used to make payments on an ESOP loan. The deduction is allowed in the taxable year of the corporation in which the dividend is used to make loan payments. The dividend is deductible, however, only on the stock that is purchased with the loan proceeds.

This provision is particularly useful in cases where a contribution of 25% of eligible payroll (the maximum allowed under §404(a)(9) of the Code) is not sufficient to repay the annual principal payment to the lender. In such cases, the solution may be to pay a deductible dividend, and use the dividend to make up the difference between the contribution amount and the required principal payment. The dividend rate must, however, be "reasonable."

§404 of the Code also provides for the deductibility of cash dividends paid to an ESOP, provided that the dividends are passed through in cash to plan participants within ninety days of the end of the tax year. In the alternative, the dividends may be paid directly to the participants without first being paid to the plan.

The purpose of the dividend pass-through provision is to provide greater employee incentives by enabling the participants to realize current income from the plan. In many cases, the payment of a cash dividend has had a dramatic effect on employee motivation and incentive.

Participants are fully taxable on these payments, and are not eligible for the $100 exclusion of dividend income. The dividend is deductible to the corporation in the taxable year in which the dividend is distributed to the participants. The dividend is deductible, however, only with respect to shares that have been allocated to the plan participants.

One disadvantage of both types of dividend payments is that a dividend must be paid to all holders of the same class of stock. Thus, if the founder still holds 70% of the outstanding stock, only the portion of the dividend that is paid to ESOP will be deductible. The solution to this problem is to have all the shareholders, other than the ESOP, waive the dividend prior to the date that the dividend is declared. Similarly, if the ESOP holds stock that was not purchased with the proceeds of a loan, only the dividends paid on the ESOP stock bought with loan proceeds will be deductible. A solution to this problem is to recapitalize the corporation so that the ESOP purchases a separate class of dividend paying stock.

Regulation §l.56(g)-1(d)(3)(iii)(E) provides that deductible dividends must be added back to the calculation of adjusted current earnings for the purposes of calculating Alternative Minimum Taxable Income. Thus, to the extent that the company becomes liable for the Alternative Minimum Tax, the company will not enjoy the full tax benefit of deducting the dividend payments.

## Mechanics of Tax-Free Rollover Transactions

Election of tax-free rollover treatment is optional with the seller. The seller may, if he wishes, elect to be taxed on part or all of the proceeds. Assume, for example, that the ESOP purchases 30% of the outstanding stock from shareholder A for $1 million, and that shareholder A desires to invest $600,000 in stocks and bonds and $400,000 in real estate. In this case (assuming his basis in the stock is zero), $400,000 of the gain will be taxable, and the remaining $600,000 will be tax-free.

By the same token, it is not necessary for the ESOP to acquire 30% ownership if the seller does not desire tax-free rollover treatment. If the seller is willing to pay the tax, he may sell any amount of stock to the ESOP whether more or less than 30%. To the extent that any sale of stock to an ESOP does not qualify for tax-free rollover treatment, the seller will be taxed at favorable capital gains rates. This is a distinct advantage as compared to a partial stock redemption. A partial stock redemption is usually taxed as a dividend. Under current tax law, dividend distributions to shareholders are taxed at the same rate as capital gains are taxed. However, such distributions are not tax-deductible by the company.

In certain instances a shareholder may wish to take advantage of tax-free rollover treatment, but may not own the requisite 30%, or may not want to sell 30% by himself. In such cases, it is permissible to aggregate sales from two or more sellers so that the ESOP acquires the requisite 30% ownership. Any aggregate sales, however, must occur simultaneously in order to qualify. If, for example, shareholder A sells a 20% interest on January 1st and shareholder B sells a 10% interest on January 2nd, shareholder B will be eligible for tax-free rollover, but shareholder A will not.

If shareholder B does not wish to sell any shares, shareholder A could still qualify for tax-free rollover treatment by selling a 20% interest and by having the ESOP simultaneously purchase enough treasury stock or newly issued stock to result in 30% ownership of outstanding shares by the ESOP.

It should also be noted that once the ESOP acquires 30% ownership, any subsequent sale of stock to the ESOP will automatically qualify for tax-free rollover treatment.

In order to elect tax-free rollover treatment, a seller must attach a Statement of Election and an Employer Consent form to his personal income tax return. The seller must also execute and have notarized a Statement of Purchase form within thirty days of the purchase of each replacement security. To the extent he has purchased replacement securities prior to filing his personal income tax return for the prior year, he must also attach these Statement of Purchase forms to his income tax returns. To the extent he has not purchased replacement securities by the time of filing of his income tax return, he must attach such Statement of Purchase forms to his next year's income tax return.

A seller may buy and sell securities during the twelve month election period. However, once a seller uses part or all of the sale proceeds to purchase replacement securities, he cannot later change his mind and designate other securities as the replacement securities.

One additional requirement of the tax-free rollover provision is the requirement that none of the stock acquired by the ESOP in a tax-free rollover transaction may be allocated to the seller (or his family), or to anyone who owns (together with his family) more than 25% of the outstanding stock of the company.

*It should be especially noted that any loss of plan benefits by the seller or by a more than 25% shareholder, or by any related parties, can be "made up" by adopting a Supplementary Executive Retirement Plan ("SERP") for the affected parties.*

For purposes of the non-allocation rule, the seller's family includes his spouse, brothers, sisters, ancestors and lineal descendants. In the case of a more than 25% shareholder, the family includes only his spouse, and his children, grandchildren and parents. Any stock allocated to a participant's account under the ESOP is also counted in determining whether such individual is a more than 25% shareholder.

If a seller elects tax-free rollover treatment with respect to part or all of the sale proceeds, then he (and his family) is not counted as part of the eligible payroll, and is not eligible to receive allocations under the ESOP. By the same token, if a shareholder (and his family) owns more than 25% of the outstanding stock at the time of the transaction, or subsequently becomes a more than 25% shareholder (by virtue of his participation in the ESOP or otherwise), then he (and his family) is no longer eligible to receive allocations under the ESOP.

There is an exception, however, for lineal descendants of the seller. Under this exception, the lineal descendants as a group may receive allocations of up to 5% of the stock purchased from the seller. This exception does not apply to a lineal descendant, however, if the lineal descendant is a more than 25% shareholder, either directly or by virtue of attribution of ownership from related parties.

Under a SERP, the company simply sets aside each year a number of shares equal to the number of shares the affected individual would have gotten under the ESOP. The company then distributes the cash value of these shares to the affected individual at the same time and in the same manner as he would have otherwise received it under the ESOP.

## ESOPs in S Corporations

**Strategies for Existing S Corporations.** The great majority of existing S corporations that adopt ESOPs elect to continue their S status so that the corporation can take advantage of the ESOP "tax shield" that applies to the portion of the corporation's taxable income that is attributable to stock held by the ESOP. However, stock acquired by an ESOP adopted by an S corporation will not be eligible for tax-free rollover treatment under §1042 of the Code. Accordingly, if shareholders want to take advantage of tax-free rollover treatment under §1042 of the Code, they should terminate the S election prior to making the sale of stock to the ESOP. In this regard it should be noted that the sale of company stock of an S corporation to an ESOP will no longer automatically terminate the S election. Accordingly, if the shareholders want to terminate the S election, they must take affirmative action to revoke the S election before selling company stock to the ESOP.

**Strategies for Existing C Corporations.** The ESOP tax shield is not available to C corporations. Conversely, the tax-free rollover provisions of §1042 are not available to S corporations. However, in the case of existing C corporations, it is possible to have the best of both worlds. This can be accomplished by having the shareholders consummate one or more tax-free rollover transactions and then subsequently elect S corporation status. Thus, the selling shareholders will get the benefit of the tax-free rollover and, after the S election is made, the portion of the company's earnings attributable to the shares held by the ESOP will be tax exempt.

**Anti-Abuse Provisions.** In order to prevent abuse of these new S corporation provisions by small ESOPs which benefit only a small group of key employees and family members, EGTRRA imposes a 50% excise tax on any S corporation with respect to the amount of any prohibited allocation to a disqualified person. In addition, the amount of the prohibited allocation is also taxed as ordinary income to the disqualified person, even though this amount has not been distributed to the disqualified person. A prohibited allocation occurs if, at any time during a plan year, disqualified persons own at least 50% of the S corporation's outstanding shares. A person is a disqualified person if the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20% of the total number of deemed-owned shares of the company, or if the number of deemed-owned shares of such person himself or herself is at least 10% of the total number of deemed-owned shares of the company.

"Deemed-owned shares" include (1) shares allocated to a participant's ESOP account, (2) the participant's proportion of the shares in any unallocated loan suspense account (assuming that all such shares become allocated in the same proportion as the most recent annual stock allocation under the plan), and (3) any synthetic equity (stock options, warrants, restricted stock, stock appreciation rights, phantom stock units, deferred compensation or similar rights) owned by the participant. Deemed-owned shares do not include shares held outright by an individual outside of the plan.

**Planning Pointer.** In many cases it is possible to avoid violating the prohibited allocation rule by building a fail-safe clause into the ESOP document. Under the provisions of the fail-safe clause, allocations to persons who are, or who would be, disqualified persons can be limited to the extent necessary to prevent such persons from owning, during any nonallocation year, 50% or more of the total number of outstanding shares of the company (including shares held outright, deemed-owned shares and synthetic equity shares).

# Mechanics of ESOP Loan Transactions

Under prior law, it was necessary for the lender to lend directly to the ESOP. The loan would then be guaranteed and/or collateralized by the company. This type of loan structure frequently complicated the loan documentation. Under current law, this structure is no longer necessary; the lender may now simply make the loan directly to the company. The company can then loan the money to the ESOP, provided that the ESOP uses the money to acquire common stock or convertible preferred stock of the company. The advantage of this approach is that the lender can use the standard form of loan agreements and collateral agreements that it would use in the case of any corporate loan. It should be noted that the term of the loan from the company to the ESOP can be different from the term of the loan from the bank to the company. If, for example, the company wishes to allocate the shares over a longer period of time than the term of the bank loan, or the maximum deductible contribution amount is not sufficient to amortize the ESOP loan over the term of the bank loan, then the term of the company loan to the ESOP should be for a longer number of years than the term of the bank loan to the company.

It should also be noted that it is not always necessary to use an outside lender. If, for example, the company has accumulated funds under a profit sharing plan, these funds may be rolled over into an ESOP (subject to fiduciary considerations) and used to purchase company stock. In addition, if the company has excess funds, the company may itself be the lender. By using one or more of these sources of internal cash, the company may be able to reduce or eliminate the necessity of borrowing from an outside lender.

# Cash Flow Increases

As indicated by the following chart, a company can reduce its corporate income taxes and increase its cash flow and net worth by simply issuing treasury stock or newly issued stock to an ESOP in any amount up to 25% of eligible payroll. Using this approach, a company may substantially reduce or even eliminate its corporate tax liability. If the contribution to the ESOP is made in lieu of cash contributions to a profit sharing plan, the cash flow savings are even more dramatic. Of course, the owners must consider that these contributions of stock will result in some dilution of their ownership interest.

## HOW AN ESOP MAY BE USED TO INCREASE CASH FLOW

### Assumptions

Qualified payroll = $2,000,000
Pretax earnings = $500,000
Profit Sharing Contributions = $300,000 cash
ESOP Contributions = $300,000 of newly issued company stock

### Computation — One Year Only

| | *No Plan* | *Profit Sharing* | *With ESOP* |
|---|---|---|---|
| Pretax earnings | $500,000 | $500,000 | $500,000 |
| Contribution (15% x $2,000,000) | - 0 - | $300,000 | $300,000 |
| Adjusted pretax earnings | $500,000 | $200,000 | $200,000 |
| Federal & state taxes (44%) | $220,000 | $88,000 | $88,000 |
| After tax earnings | $280,000 | $112,000 | $112,000 |
| Add back non-cash contribution | - 0 - | - 0 - | $300,000 |
| Cash flow & net worth increase | $280,000 | $112,000 | $412,000 |

An ESOP can also be used to generate cash flow savings if the company is contemplating a stock redemption. Stock redemptions are non-deductible. By using an ESOP instead, the stock repurchase can be made with deductible dollars, Moreover, as shown by the following chart, if the ESOP replaces a profit sharing plan, the cash contributions that would have been made to the profit sharing plan can be made to the ESOP instead, thereby enabling the plan to purchase the stock without any additional cash flow expense to the company whatsoever.

### A STOCK REDEMPTION MAY BE SEVERAL TIMES AS COSTLY AS AN ESOP PURCHASE

#### Assumptions

Profit sharing contributions = $100,000 cash - invested in stock market
ESOP contributions = $100,000 cash - used to purchase company stock
Stock redemption = $100,000 per year

#### Computation — One Year Only

| | *No Plan* | *Profit Sharing* | *With ESOP* |
|---|---|---|---|
| Pretax earnings | $300,000 | $300,000 | $300,000 |
| Contribution | - 0 - | $100,000 | $100,000 |
| Adjusted pretax earnings | $300,000 | $200,000 | $200,000 |
| Federal & state taxes (44%) | $132,000 | $88,000 | $88,000 |
| After tax earnings | $168,000 | $112,000 | $112,000 |
| Stock redemption | $100,000 | $100,000 | - 0 - |
| Cash flow | $68,000 | $12,000 | $112,000 |

## Maximizing Employee Incentives

From an employee standpoint, the ESOP is almost always a better incentive plan than a profit sharing plan. The philosophy of a profit sharing plan is that if the company makes a profit, a portion of this profit will be shared with the employees, and the employees will thereby have an incentive to maximize company profits. In theory this sounds workable. In practice it is not. In practice, most companies report that little or no employee incentive or motivation is generated as a result of profit sharing contributions. The difficulty is that profit sharing plans are not tangible, and there is no direct link between employee productivity and employee benefits under such a plan.

An ESOP is frequently superior to a profit sharing plan in the following respects:

1. The ESOP creates a direct link between employee benefits and employee productivity. As a consequence, the ESOP is frequently a better employee incentive plan than is a profit sharing plan.

2. In many cases, the employees are not interested in stock market investments, but are interested in owning stock of their own company.

3. In many cases, the company's own stock is a better investment than investing in the stock market, since smaller firms frequently can maintain a better growth rate than larger firms.

In the ideal case, the ESOP can provide a better employee incentive plan, a better investment result for the employees and also, simultaneously, provide a market for the shareholders of the company.

## Compatibility With 401(k) Plans

A 401(k) plan is fully compatible with an ESOP since 401(k) plans and ESOPs are both defined contribution plans.

If the company has a separate 401(k) plan, we recommend that the plan be continued as a separate plan. However, the company may want to consider having future matching contributions go to the ESOP rather than to the 401(k) plan.

## Disadvantages

The principal disadvantages and possible problem areas that should be evaluated in considering an ESOP are as follows:

1. **Dilution.** If the ESOP is used to finance the company's growth, the cash flow benefits must be weighed against the rate of dilution.

2. **Availability of Financing.** One potential disadvantage of a sale to an ESOP versus a sale to a third party is that a sale to an ESOP depends upon the ability of the company to obtain the necessary financing. If the transaction is financed with a bank loan, the company must have the ability to obtain the necessary bank loan, based upon having sufficient cash flow to service the loan and sufficient assets to collateralize the loan. If the company does not have sufficient collateral, the seller may have to give a personal guaranty or may have to pledge a portion of the qualified replacement securities. On the other hand, a seller can always self-finance the sale in whole or in part if sufficient bank financing is not available.

3. **Balance Sheet Impact.** If the company borrows money and lends this money to the ESOP to enable the ESOP to make a leveraged purchase of company stock, the accounting regulations require that the bank loan be recorded as a liability, and that a like amount be debited to a contra equity account. The net effect is to reduce the company's net worth by the amount of the bank debt. In most cases, the reduction should have little or no impact on the company's operations. If, however, the company is involved in the

construction industry, the reduction in the company's net worth may affect the company's ability to obtain construction bonding.

4. **Disclosure.** Participants receive an annual benefit statement from the plan, similar to the statements they receive from a profit sharing or 401(k) plan. Since they are not direct shareholders, they are not entitled to receive company financial statements or attend shareholder meetings.

5. **Valuation.** The stock must be valued annually in order to establish the value of the stock for purposes of purchasing the stock, allocating the stock, and distributing the stock. If the valuation is prepared by a qualified third party, the valuation should be immune from subsequent adjustment. If, however, the stock is overvalued, the consequence depends upon whether the stock was contributed or purchased.

   If the stock was contributed by the company at an excessive valuation price, the penalty would be a reduction of the deduction that the company had taken for the contribution. If the stock was purchased by the ESOP, the deduction would not be affected, but the seller would be required to pay back the excess purchase price. In addition, under ERISA, the seller is subjected to a 15% penalty tax for each year that the stock was overvalued.

6. **Liquidity.** If the value of the stock appreciates substantially, the ESOP and/or the company may not have sufficient funds to repurchase stock upon employees' retirement. In most cases, very little liquidity will be needed in the first five years of the plan, since most employees who terminate in the early years are only partially vested.

   After the first five years, the ESOP should keep a portion of the fund in liquid investments in order to provide liquidity for retiring or terminating employees.

7. **Fiduciary Liability.** The plan committee members who administer the plan are deemed to be fiduciaries and can be held liable if they knowingly participate in improper transactions.

   In general, the fiduciary liability under an ESOP is less than the fiduciary liability under a profit sharing plan, since the ESOP is primarily invested in employer stock. Under a profit sharing plan, the fiduciary has a wide range of choice of investments. The fiduciary must, therefore, diversify the investments, and all investments must meet the fair rate of return requirement. An ESOP, on the other hand, is exempt from the diversification and fair rate of return requirements, since the ESOP is designed to invest in employer stock.

8. **Stock Performance.** If the value of the company does not increase, the employees may feel that the ESOP is less attractive than a profit sharing plan. In an extreme case, if the company fails, the employees will lose their benefits to the extent that the ESOP is not diversified in other investments.

9. **Pro Rata Offers.** Any offers to purchase stock on behalf of an ESOP must be made on a pro rata basis to all shareholders. Thus, unless the remaining shareholders agree otherwise, a retiring shareholder, for example, cannot sell his stock without offering other shareholders the opportunity to also sell stock on a pro rata basis. This is the same requirement that applies to corporate stock redemptions.

## How the Plan is Designed

An ESOP is a plan qualified by the Internal Revenue Service as an equity-based deferred compensation plan. As such, it is in the same family as profit sharing plans and stock bonus plans. An ESOP however, differs from a profit sharing plan in that an ESOP is required to invest primarily in employer securities, while a profit sharing plan is usually prohibited from investing primarily in employer securities. An ESOP also differs from profit sharing plans and from stock bonus plans in that an ESOP is permitted and authorized to engage in leveraged purchases of company stock. As a consequence, an ESOP requires different accounting procedures and a different method of allocating stocks and other investments among the employees than other types of plans. For this reason the plan should be designed by an ESOP specialist in order to avoid IRS difficulties.

Under an ESOP, the Company can make tax-deductible contributions of up to 25% of eligible payroll. However, if the company makes contributions to a profit sharing plan or matching contributions to a 401(k) plan, the company will not be able to make a full 25% contribution to the ESOP. Conversely, employee elective deferrals to a 401(k) plan do not count against the 25% limit on deductible contributions. It should also be noted that in the case of a C corporation, interest on an ESOP loan is deductible over and above the 25% limit on contributions.

In the case of an ESOP maintained by an S corporation, the contribution limitation is also 25%. However, in the case of an S corporation, interest **is** counted against the contribution limitation.

In the case of C corporation ESOPs, if contributions of 25% of payroll are not sufficient to pay back the ESOP loan principal within a reasonable period of time, the company is permitted to pay deductible dividends on the stock held by the ESOP, and the ESOP can use these dividends (in addition to its deductible contributions) to repay the loan principal.

In the case of S corporation ESOPs, if contributions of 25% of payroll are not sufficient to pay back the ESOP loan principal and interest within a reasonable period of time, the company is permitted to pay out S corporation distributions to all of its shareholders, and the ESOP can use its share of these distribution (in addition to its deductible contributions) to repay the loan principal and interest.

All contributions to an ESOP must be made not later than the due date for filing the corporate tax return, including extensions.

As with other types of qualified plans, there are allocation limitations as well as contribution limitations. The allocation limitation that applies to all qualified plans, for plan years ending in 2009, is that the maximum amount of contributions and forfeitures that can be allocated to any participant in any given year is limited to 100% of his or her compensation or $49,000 (as adjusted each year for the inflation rate), whichever is lesser. All salary deferrals, matching contributions, discretionary employer contributions, participant forfeitures and ESOP contributions count against this limit. If, however, not more than one-third of the employer contributions are allocated to highly compensated employees, then forfeitures of shares purchased in a leveraged transaction do not count against this limit.

The ESOP, like a profit sharing plan, must cover all full-time non-union employees who are at least age twenty-one and have one year of service. An ESOP may either include or exclude union employees. Contributions to an ESOP are usually allocated in proportion to the relative salaries of the participants in the plan. In some cases contributions are allocated on a formula that includes both compensation and years of service.

Employer contributions must vest at least as rapidly as one or the other of the following vesting schedules:

| | | | |
|---|---|---|---|
| Year 1 - | 0 | Year 1 - | 0 |
| Year 2 - | 20 | Year 2 - | 0 |
| Year 3 - | 40 | Year 3 - | 100 |
| Year 4 - | 60 | | |
| Year 5 - | 80 | | |
| Year 6 - | 100 | | |

An employee is entitled to commence receiving his plan benefit once he has incurred a five year break in service. Such distribution may, at the option of the company, be paid in a lump sum or in five equal annual installments. Except in the case of death, disability or retirement, if the plan has incurred a loan, distribution need not commence until the loan has been repaid in full.

Distributions from an ESOP may be rolled over or transferred into an IRA. If the distribution is in company stock, and the stock is “put” to the plan in exchange for a promissory note (payable in five equal annual installments of principal), the note can be rolled over into an IRA. If, however, the stock is sold in exchange for a note, the company must post “adequate security” for the note.

Once a participant reaches age fifty-five he may elect to diversify up to 25% of his plan benefit. Once he reaches age sixty he may elect to diversify an additional 25% of his plan benefit. The plan must offer at least three investment options. In the alternative, the plan may simply distribute the requisite amount and the participant may then roll over this amount into an IRA. If the participant has not attained age fifty-nine and one-half and does not roll over his distribution into an IRA, he will be subject to a 10% penalty tax in addition to ordinary income taxation.

Distributions from the plan are normally made in cash, unless the participant specifically requests that the distribution be made in stock. In the case of S corporations and corporations which amend their bylaws to restrict ownership to active employees, the option to take the distribution in stock may be eliminated entirely. If the participant has received the distribution in stock, he must be given a "put" option to the company and to the trust (which guarantees the marketability of the stock for a period of fifteen months) and a "right of first refusal" (which prohibits him from selling the stock or gifting the stock to any third party without first offering to sell the stock to the company or to the ESOP).

The plan is administered by a committee established by the directors of the company. *All voting rights are normally exercised by the committee.* However, employees are allowed to vote on any matters involving liquidation, dissolution, recapitalization, merger, or sale of all or substantially all of the assets of the corporation. Thus, voting control of the ESOP may be maintained by the initial shareholders, even after they no longer own 51% or more of the company stock. That is, if the original shareholders control the committee, they will be able to control not only the stock they still own, but also the stock owned by the ESOP. So long as the shareholders are careful in appointing the committee members, there need never be a loss of voting control.

## Our Services

**Installation.** Menke & Associates, Inc. is the most active firm in the country in the design and installation of ESOPs. The firm, founded in 1974, is also one of the oldest in the industry, and has installed over 2,500 ESOPs since beginning in business. In addition, the firm's principal, John D. Menke, has been involved in the design and installation of ESOPs since 1968.

Menke & Associates provides all services in-house. As a result, the total fees charged by Menke & Associates are often substantially less than the fees charged by other firms which subcontract for each of the requisite services.

**Communications.** It is important that the plan be properly and effectively communicated to participants if the plan is to have the desired effect on motivation and productivity. Menke & Associates has over thirty years of experience in the preparation of employee communications programs. In addition to the preparation of employee booklets, we conduct PowerPoint presentations which are presented to employees in small groups. These PowerPoint presentations have been developed over a number of years and are tailored to your particular plan provisions.

**Administration.** The annual administration of an ESOP is somewhat more complex than a pension or profit sharing plan. Accordingly, Menke & Associates administers all ESOPs on our own in-house computers, utilizing our own internally developed software. Consequently, we are able to administer any type of ESOP, regardless of how unique or unusual it may be. Menke & Associates administers more ESOPs than any other firm in the country.

# Menke & Associates, Inc.

OFFICES:

**SAN FRANCISCO, CA**
255 California Street, 10th Floor
San Francisco, California 94111-4916
(415) 362-5200 Fax: (415) 398-2260

**LOS ANGELES, CA**
12121 Wilshire Blvd., Suite 310
Los Angeles, California 90025-1123
(310) 207-8776 Fax: (310) 207-3556

**WILMINGTON, DE**
One Commerce Center
1201 N. Orange Street, Suite 783
Wilmington, DE 19801-1155
(917) 750-6178 Fax: (917) 591-3408

**NAPLES, FL**
3091 Santorini Court
Naples, Florida 34119-7708
(239) 598-2013 Fax: (239) 598-2053

**ATLANTA, GA**
1000 Holcomb Woods Parkway, Suite 428
Roswell, Georgia 30076-2585
(770) 518-4401 Fax: (770) 518-1044

**CHICAGO, IL**
85 W. Algonquin Road, Suite 560
Arlington Height, Illinois 60005-4459
(847) 290-1515 Fax: (847) 427-8578

**CHESAPEAKE CITY, MD**
1605 Town Point Road
Chesapeake City, Maryland 21915-1723
(410) 885-2531 Fax: (410) 885-2782

**LAS VEGAS, NV**
4670 S. Ft. Apache Road, Suite 100
Las Vegas, Nevada 89147-7940
(702) 982-7811 Fax: (702) 478-9859

**www.menke.com**