MENKE & ASSOCIATES, INC.

ESOP ADVISORS & INVESTMENT BANKERS
FOR OVER 34 YEARS

ESOPs:
Uses, Advantages & Illustrative Case Histories

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USES OF AN ESOP

A Readily Available Market for Controlling Shareholders

Frequently, controlling shareholders desire to sell a part of their shares in order to diversity their holdings, or to provide liquidity for investment or estate planning purposes. Usually, however, there is no market for the sale of a minority interest in a closely-held company.

The adoption of an ESOP solves this problem by providing a readily available market for the purchase of shares from controlling shareholders. Moreover, the ESOP enables a shareholder to sell tax-free, provided that the ESOP acquires at least 30% of the outstanding shares.

A great deal of flexibility is available in structuring sales to the ESOP. If a shareholder desires immediate liquidity, the plan may obtain a bank loan and purchase the shares for cash. If a shareholder does not need immediate liquidity, he may defer the tax on the sale by selling his shares to the trust on an installment sale basis, or by selling only a portion of his shares to the trust on a year-by-year basis.

In most cases, it is typical for older shareholders and retiring shareholders to sell their stock to the ESOP prior to other shareholders. If, however, the shareholders do not agree to this procedure, any offers to purchase stock on behalf of an ESOP must be made on a pro rata basis to all shareholders.

A Readily Available Market for Minority Shareholders and Outside Investors

The ESOP also provides a readily available market for the minority shareholders and other "outside" investors who desire to realize their gain or to liquidate a part or all of their investment for reinvestment in other companies. If the ESOP acquires at least 30% ownership, a minority shareholder may also elect tax-free rollover treatment under §1042 of the Internal Revenue Code.

A Tax-Advantaged Alternative to Sale or Merger

Purchase of an owner's stock by an ESOP will almost always be more beneficial to the owner than sale or merger. For example, in the case of a sale, the seller will incur an income tax, will lose control, will usually lose his salary and fringe benefits, and will seldom be able to keep any retained equity. In comparison, there will be no tax to the seller if he sells stock to the ESOP under the tax-free rollover provision of the 1984 Tax Reform Act. In addition, under an ESOP, 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.

An Effective Tool for Increasing Cash Flow and Net Worth

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 annual payroll. Using this approach, a company may drastically reduce or even eliminate its corporate tax liability. The cash flow impact can be dramatic. 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.

A Superior Employee Incentive Device

An Employee Stock Ownership Plan is designed to provide employees with the incentive of a "piece of the action," and to enable employees to share in the *capital growth* of the company. Employee stock ownership gives employees a direct and vested interest in the success of their company, enables employees to share in the profits of their own labor, and creates an identity of interest between management and labor.

As an employee incentive device, the ESOP is usually superior to other incentive plans. In an ordinary profit sharing plan, for example, the funds are invested in stocks of unrelated companies, and the incentive effects are minimal. In an ESOP, on the other hand, the employees acquire an ownership interest in their own company, and the incentive element is maximized.

The ESOP is a flexible plan that can be used either in lieu of or in combination with other employee benefits plans. Because of its many advantages, the ESOP is becoming an increasingly popular form of employee benefit. The ESOP is particularly advantageous for companies whose rapid growth has required the reinvestment of profits, resulting in a shortage of cash available for employee benefits. A collateral benefit is that the ESOP often serves to diminish employee interest in unionization.

A New Way to Finance Debt Reduction with Tax-Deductible Dollars

Companies frequently find it necessary to borrow money in order to finance corporate growth. One disadvantage of debt financing is that repayment of the loan principal is not a deductible expense. An ESOP can be used to mitigate this problem by having the company issue newly issued stock or treasury stock to an ESOP. The resulting tax savings can then be applied against the principal payments so that tax-deductible dollars are used to pay part, or all, of the loan principal.

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. Consequently, an ESOP required 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 Internal Revenue Service difficulties.

The ESOP, like a profit sharing plan, must cover all nonunion employees who are at least age 21 and have one year of service. An ESOP may either include or exclude union employees. In practical effect, share ownership under the plan is usually proportionate to the relative salaries of the participants in the plan.

Employees' accounts are normally vested over a period of six years, and are normally taken out at retirement or whenever an employee incurs a five-year break in service. Upon distribution the shares may be subject to a "right of first refusal" pursuant to which the shares must first be offered back to the trust and/or the company at their fair market value before being sold to a third party.

In order to assure marketability of the stock subsequent to distribution, the employees must be given a "put" option, which enables them to require repurchase of their stock at fair market value. 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 the assets of the corporation. Contributions can be made in any amounts up to 25% of payroll if the company has unused contribution carryovers, or if the plan is combined with a money purchase pension plan which provides for a fixed annual contribution of 10% of annual payroll. In the alternative, if the plan is leveraged, the company may make annual contributions of up to 25% of eligible payroll to the extent such contributions are necessary to make principal payments on the loan.

Such principal payments must be made on or prior to the date for filing the company's tax return, including extensions. In addition, the company may make whatever contributions are necessary to pay the interest on the loan, even if these contributions result in contributions in excess of 25% of eligible payroll, provided that not more than one-third of the contribution is allocated to highly compensated employees. Contributions to another defined contribution plan or a 401(k) plan, however, count against the 15% and the 25% contribution limitations.

ESOP ADVANTAGES

For Stockholders	For the Company	For Employees
Creates liquidity at fair market value	Provides the company with an employee incentive plan & an employee retirement plan	Allows employees to share in the *capital growth* of company
Allows *tax-free* sales	Provides for *continuity of corporation* & operating management	Accumulated values are funded by employer contributions only: *no diminution of employee take-home pay*
Allows shareholders to *retain voting control*	Corporate income taxes may be reduced substantially	Growth of employee's interest is *not subject to tax until distribution*
Establishes *definite valuation* of shares for estate tax purposes	*Cash flow and net flow* may be increased substantially	Employees can realize *tax-favored* income
	Allows use of *pretax dollars to refinance repayment*	*Builds employee loyalty* & concern for corporation progress and profitability
	Avoids the cost of making after-tax stock redemptions	Creates identity of interest between labor & management

A Stock Redemption May Be Several Times As Costly as an ESOP Purchase

ESOP VS. STOCK REDEMPTION

ASSUMPTIONS:

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

COMPUTATION — ONE YEAR ONLY:

	No plan	With 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**

ILLUSTRATIVE CASE HISTORIES

Providing Liquidity for Controlling Shareholders

Problem: Company "A" was a Texas apparel manufacturer whose earnings had been increasing at a compound growth rate of almost 25% per year. The stock of the company was owned by a stockholder in his early '50's. The stockholder desired to raise $1.2 million in order to diversify his investments. The owner considered a corporate stock redemption, but discovered that a redemption would be nondeductible.

Solution: The company adopted an ESOP, and the ESOP obtained a $1.2 million bank loan, which was guaranteed by the company. The ESOP then purchased 30% of the owner's stock in exchange for an aggregate purchase price of $1.2 million. Thereafter, the company made annual tax-deductible contributions to the plan, which were used to amortize the bank loan. The owner elected tax-free rollover treatment under §1042 of the Code. As a consequence, he was able to obtain $1.2 million of the funds entirely tax-free.

Providing a Market for Minority Shareholders and Outside Investors

Problem: Company "B" was a privately owned manufacturer of electrical and chemical products. For its most recent fiscal year, the company had sales of approximately $20 million. Approximately 20% of the company was owned by a minority shareholder who wanted to retire from the business. The company was concerned that a redemption of the 20% interest would strain working capital, which was needed for corporate growth.

Solution: The company adopted an ESOP, and the plan obtained a bank loan and purchase the 20% interest from the minority shareholder. Thereafter, the company made annual tax-deductible contributions to the plan, which were used to amortize the bank loan. As a consequence, the 20% interest was repurchased out of pretax earnings, thereby reducing the cost substantially.

Providing an Alternative to Sale or Merger

Problem: Company "C" was a New York advertising agency that was 100% owned by the company's founder. The founder was in his early '60's, and desired to retire from the business to pursue other interests. Although the company had been highly profitable, the founder had been unable to find a buyer who would pay the cash asking price. The company had an existing profit sharing plan with accumulated assets of approximately $600,000, half of which was invested in cash and liquid investments.

Solution: The company suspended and replaced the existing profit sharing plan with an ESOP. The plan obtained a $2,500,000 bank loan, which was guaranteed by the company. The plan used these funds plus the $300,000 from the profit sharing plan to purchase outstanding shares owned by the founder. In order to minimize fiduciary concerns, the founder guaranteed the profit sharing plan against any loss that might result from the use of the prior profit sharing funds. An additional $200,000 worth of stock was purchase by key employees outside of the plan.

Thereafter, the company made annual tax-deductible contributions to the plan, which were used to amortize the bank loan. The founder elected tax-free rollover treatment. As a consequence, the founder received his cash asking price tax-free. Had the founder sold to an outsider, the entire amount of the gain would have been taxable. The employees also benefited in that they were able to acquire complete ownership of the business at little or no cost to them. Moreover, except for the shares purchased outside of the plan, the purchase price was deductible from the company's pretax earnings.

How an ESOP May Be Used to Dramatically Increase Cash Flow

	No plan	With Profit Sharing	With ESOP
Pretax earnings	$500,000	$500,000	$500,000
Contribution (15% X $2 million)	- 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	$300,000
Cash flow & net worth increase	**$ 68,000**	**$ 12,000**	**$112,000**

Providing Employee Benefits and Increased Cash Flow

Problem: Company "D" was a large Midwestern manufacturer of photographic equipment. The company's sales had more than doubled during the last three years. This rapid growth in sales had required that profits be reinvested in plant expansion, thus severely restricting working capital. The company was in the full 44% tax bracket (based on combined federal and state income tax rates) and had a relatively large payroll. The company did not have an existing employee benefit plan and had been plagued by continual employee turnover. The company was considering adopting a profit sharing plan, but felt that it could not afford the additional cash expense at a time when additional working capital was needed to support corporate growth.

Solution: The company adopted an ESOP. An independent valuation of the company's stock determined that the stock should be valued at a price/earnings ratio of approximately 10. The company then contributed company stock to the plan in an amount sufficient to utilize the maximum deductible contribution of 15% of qualified payroll. As a result, pretax income for tax purposes was reduced from $500,000 to $200,000, and taxes were reduced from $220,000 to $88,000. Hence, the plan increased cash flow and net worth by $132,000, and the employees were provided with the incentives and the benefits of "a piece of the action."

Financing Debt Repayment with Pretax Dollars

Problem: Company "E" was a West Coast manufacturer of sawmill equipment. Company E was similar in size and growth to Company D, except that Company E had an existing profit sharing plan. The profit sharing plan had been in effect for several years, but there had not been any significant increase in employee motivation and productivity. Moreover, the company had borrowed $3 million to purchase equipment and was finding it difficult to repay the loan with after-tax dollars.

Solution: The company suspended the existing profit sharing plan and replaced it with an ESOP, contributing $300,000 of newly issued stock to the ESOP each year rather than $300,000 of cash to the profit sharing plan. As a result, the company's cash flow was increased by $300,000 per annum, which was used to make the annual $300,000 principal payments on the bank loan.