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EBEC (Employee Benefits / Executive Compensation) Law Update

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ESOP Buyouts – Popular Exit Strategy for Owners of Private Companies

An increasingly popular option for owners of private companies who want to sell all or a portion of their company is to sell the shares of the company to an employee stock ownership plan. An employee stock ownership plan – an ESOP – is a tax qualified retirement plan for employees that is designed to invest primarily in employer securities.

Capital gains can be deferred on the sale of closely-held shares of a C-corporation to an ESOP if certain requirements are met, as described below. This exit strategy is particularly helpful in a slow market where it may be hard to find a buyer for the company even at fair market value. ESOP buyouts are also useful where the owner wants to exit gradually from the business but still continue in some role for a period of time.

ESOP Financing. In an ESOP buyout, an ESOP and trust are set up and financing is secured in order for the ESOP to buy some or all of the shares of the company from the owner(s). Such shares are held in the ESOP's suspense accounting to be allocated to employees' accounts as the loan is repaid. The leverage is generally in the form of a loan from the company to the ESOP with a corresponding secured bank loan to the company. Often the bank loan is only for, e.g., 50% of the company, although the seller may finance some or all of the balance with seller notes secured on the shares. Most ESOPs own less than 50% of the company. The ESOP thus serves as both a tool of corporate finance (similar to the financing in any leveraged buyout) and as an employee benefit.

Advantages of ESOP Buyouts. There are a number of advantages in doing an ESOP buyout, including:

- ability to roll over and defer gain under IRC § 1042, as described below;

- helping find a buyer in an illiquid market;
- providing for financing of the sale;
- tax free earnings for the company if it converts to an S-corporation, as discussed below;
- ability to deduct dividends paid to the ESOP;
- increased employee motivation; and
- ability of existing owners to retain a connection with the company.

Disadvantage of ESOP Buyouts. There are disadvantages to ESOP buyouts, including that:

- the company and ESOP need to undertake a significant debt obligation to be able to purchase the shares of the company;
- a mandatory buyback of ESOP participants' shares (a put to the company) on termination from employment can impose a significant cash obligation on the company (although the buyback can generally be spread over five years);
- contributions made to the ESOP each year must be sufficient to service the ESOP debt;
- an ESOP which is to be invested primarily in employer stock may be a hard sell to employees who may be wary of putting all their eggs in one basket particularly after the Enron failure in 2001; and
- there is the potential for lawsuits relating to the prudence of the ESOP's purchase of employer stock.

Tax Benefits of ESOP Buyout. The capital gains on the sale of shares of the company or part of the company to an ESOP can be deferred under IRC §1042, provided the following conditions are met:

- the company is a U.S. non-public C-corporation at the time of the sale;
- the shares have been held by the shareholder(s) for at least three years prior to the sale;
- the ESOP will own at least 30% of the shares of the corporation after the transaction;

- the proceeds are used within 6 months to buy securities (stocks or bonds) of a U.S. operating company; and

- the shares sold to the ESOP will be held by the ESOP for at least three years.

Deductions for Dividends Paid. Although dividends are normally not deductible by a company, dividends paid by a company for shares held by the ESOP will generally be deductible under IRC § 404(k) if they are paid to participants or are used to repay the ESOP loan. Principal and interest on the ESOP loan will generally be deductible by the company as contributions to a qualified retirement plan.

Use of Preferred Stock for ESOP. Often the shares held by the ESOP will be convertible preferred stock. This allows for higher dividend rates for the ESOP stock, which would be deductible under IRC § 404(k) and yet would not be treated as annual additions for purposes of Internal Revenue Code contribution limits on qualified plans.

ESOP Trustee. An ESOP trustee can be an insider. If an insider serves as trustee, he or she would be relying heavily on counsel and advisers to value of the ESOP and evaluate the deal. However, to avoid a conflict of interest, an independent trustee will typically be chosen.

S-Corporation Election to Avoid Taxes. If an ESOP-owned company elects S-corporation status, taxable earnings of the company can be avoided because the S-corporation does not pay taxes (it is a pass-through vehicle), and the shareholders are the ESOP which is a tax-exempt entity. ESOPs are also exempt from unrelated business taxable income (UBTI). To elect S-corporation status, there must be not more than 100 shareholders (with the ESOP counted as a single shareholder) and there must be only a single class of stock in the company. IRC § 1361(b). Note that if an entity converts from an S-corporation form to a C-corporation form right before the ESOP formation, it may not convert again to an S-corporation for five years. There are also a number of restrictions and limitations applicable to S-corporation ESOPs under the Internal Revenue Code in order to prevent abuse.

If you would like to learn more about ESOP buyouts or if you believe your company may be a candidate for an ESOP buyout, please contact me at 201-357-0577 or 212-380-3834.

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