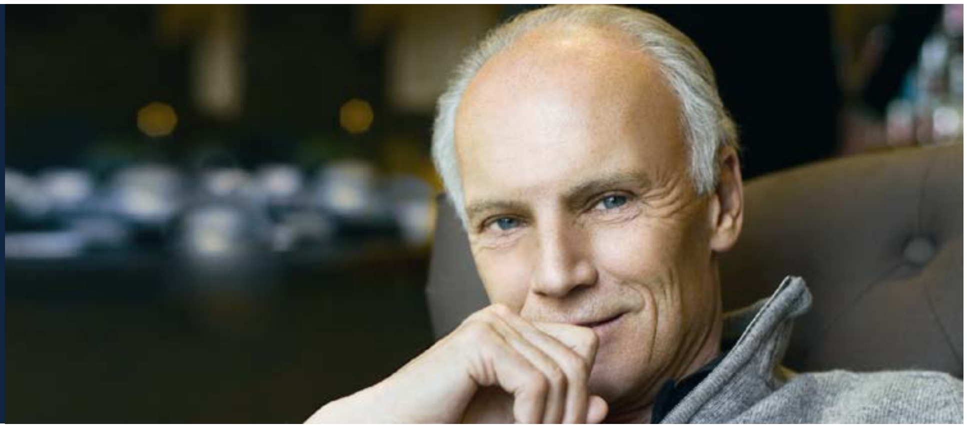

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Considering an ESOP?

Bob is 55 years old and owns a $50 million company that manufactures gears for a variety of industries. The company has been profitable, and through the years, has given Bob a nice level of income. Bob has a management team that is not quite ready to run the company themselves, but may be ready in a few years. At the same time, Bob would also like to diversify his assets, which are all tied up in the business. He wants to keep his company independent, and reward his employees for their efforts which have made the enterprise successful through the years.

Betty and her family own most of the shares in Company X, a construction materials distributor. She and her family are not actively managing the company, which is run by a seasoned executive team. Several of her family members would like to sell their minority interests, but have not been able to do so due to the lack of a market for stocks in privately held companies.

Blake is the owner of a 50-person marketing company. He realizes that his employees are what makes his company so successful, and wants to retain and motivate them. He also wants to provide an employee benefit that will give his employees some "skin in the game", without "giving away" ownership in his company.

For Bob, Betty, and Blake, an ESOP, or Employee Stock Ownership Plan, could be the answer.

What is an ESOP?

An ESOP is a company sponsored retirement benefit that allows all eligible employees to own stock in the company for which they work. As of 2014 roughly 14.1 million U.S. employees share in the ownership of over 6,700 companies through an ESOP with total plan assets exceeding $1.3 trillion according to the National Center for Employee Ownership (NCEO) [1].

[1] ESOPs by the Numbers (as of the 2014 reporting year), National Center for Employee Ownership, http://www.nceo.org/articles/esops-by-the-numbers

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More specifically, an ESOP is a defined contribution plan that primarily holds stock in the sponsoring employer. Although ESOPs can hold other assets such as cash, ESOPs are designed to give employees an ownership interest in their employer.

The attraction of employees owning stock in their employer coupled with the tax advantages for ESOP firms and selling shareholders has made ESOPs a popular ownership transition tool.

What are the Benefits of an ESOP?

Congress has provided many of the parties to an ESOP transaction with certain tax advantages in order to promote the growth of ESOPs.

The Selling Shareholder(s)

Sellers of shares to ESOPs can also enjoy great tax benefits. Congress created an incentive for shareholders to sell their stock to employees by passing Internal Revenue Code Section 1042. Section 1042 allows individuals who sell their C Corporation stock to an ESOP to defer the capital gains tax on the sale provided that they reinvest the proceeds into a qualified replacement security, and that the ESOP owns more than 30% of the company after the transaction. The selling shareholder must have owned his/her stock for at least three years before the sale. The qualified replacement securities can be debt and equity securities of U.S. operating companies.

In essence, the ESOP acts as a vehicle for diversification, permitting the selling shareholder to exchange his/her interest in the sponsoring employer for shares in the broader security market. Unfortunately, at this point, this benefit is not available to shareholders of S corporations.

If the shareholder requires use of the funds immediately, he or she can obtain a floating rate loan using the qualified replacement securities as collateral. As long as the shareholder can pay the interest on the loan, the shareholder can use the cash proceeds as he or she sees fit.

If the shareholder passes away while the proceeds are still held in qualified replacement securities, the value of the shares are "stepped up" to current market values. So, the value of the proceeds from the sale of a company can be transferred tax-free to the shareholder's descendants.

ESOP purchases of shares are based on stock transactions, not asset transactions. This provides a seller with capital gains tax treatment, which is more favorable than ordinary income tax treatment.

Other advantages include:

- An ESOP can provide liquidity for minority interest positions. Even if a seller decides to sell a minority stake, he or she can utilize an ESOP to provide liquidity for an otherwise illiquid interest.
- An ESOP can help to diversify the shareholder's investments prior to retirement and allow shareholders with management responsibility to sell over time and ease away from business.

The Company

Contributions by the company to pay both principal and interest payments on ESOP debt are tax-deductible within certain limits. Further cash dividends on ESOP stock used to repay ESOP debt may also be tax-deductible. So, the ESOP is purchasing stock using pretax dollars.

In a special circumstance, 100 percent owned ESOP companies that convert to S corporation do not pay current income tax. Profits of S corporations are taxed at the shareholder level, and since the ESOP is a tax-exempt entity (income is not taxed when earned, but is taxed when participants take a distribution), ESOPs do not pay federal corporate income tax on their pro-rata share of an S corporation's profits. If the ESOP owns 100 percent of the company, no federal income taxes are due. The money that would otherwise be distributed or used to pay taxes can be re-invested in the company-–a great advantage over competitors.

In addition to reaping tax advantages, many ESOP companies find their financial and operational performance improves due to better employee morale, productivity, and participation in the company. Since the employees share in ownership of the company, they have a vested interest in the company's financial performance.

The Employees

Employees "own" shares in the company they work for, without making personal contributions to purchase those shares. The employees receive a put option along with their allocation of shares that entitles them to sell the shares upon death, disability, retirement, or termination. Much like a 401(k), income taxes are deferred until the shares are redeemed and the employee withdraws the proceeds.

The ESOP gives employees the opportunity to enjoy capital growth. In a healthy and especially growing company, an ESOP could potentially be the most financially lucrative benefit plan a company could set up for its employees. However, since ESOPs result in a sharing of both the risks and rewards of ownership, ESOPs involve a somewhat higher degree of risk than other plans. For this reason, provisions are made for participant diversification at certain ages.

How Does an ESOP Work?

There are two types of ESOPs: leveraged and unleveraged. A leveraged ESOP is the only employee benefit plan authorized by ERISA to finance the purchase of company stock through corporate debt. An unleveraged ESOP is an employee benefit plan that receives employer stock through contributions made by the sponsoring company. Since most business owners do not wish to dilute their ownership interests by issuing shares to an ESOP, unleveraged ESOPs are not common. The remainder of this section will deal with how a leveraged ESOP works.

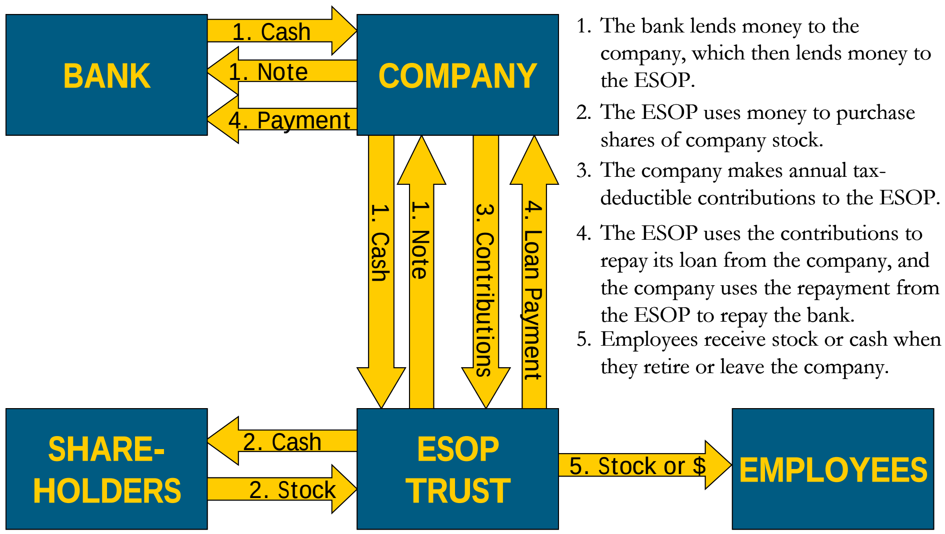
A company that wants to set up an ESOP creates a trust. The trust is the entity that purchases the shares and holds these shares for the benefit of the employee-participants.

The ESOP will borrow to finance its purchase of stock from a selling shareholder. Since the ESOP initially has no assets of its own, the ESOP must borrow from the company itself to purchase its stock. To fund the ESOP borrowing, the sponsoring company will use its assets as collateral, and borrow the transaction amount from a bank or other third-party lender. It will then lend that amount, usually with the same repayment terms (although not required to be the same), to the ESOP in a "mirror loan" transaction. The ESOP will, in turn, pledge the shares it acquires as collateral.

Each year, the company makes tax-deductible contributions to the ESOP as part of the company's compensation expense. The ESOP uses these contributions to repay its loan from the company, and the company repays its loan from the bank. The end result is that the debt used to fund the purchase of ESOP shares can be repaid in pretax rather than aftertax dollars.

As the loan is repaid, a portion of the shares are released from the collateral pool and allocated to the employee-participants' accounts within the ESOP trust. Usually, the shares are allocated in proportion to each participant's compensation.

The illustration below illustrates the mechanics of a leveraged ESOP:



1. The bank lends money to the company, which then lends money to the ESOP.
2. The ESOP uses money to purchase shares of company stock.
3. The company makes annual tax-deductible contributions to the ESOP.
4. The ESOP uses the contributions to repay its loan from the company, and the company uses the repayment from the ESOP to repay the bank.
5. Employees receive stock or cash when they retire or leave the company.

ESOP contributions are fully tax-deductible to a certain extent. Companies organized as C corporations can make tax-deductible contributions of up to 25 percent of covered payroll annually to repay the principal on an ESOP loan. Interest payments on ESOP loans and dividends used to pay an ESOP loan are also tax-deductible. Neither ESOP interest payments nor ESOP dividends count toward the 25 percent contribution limit.

For More Information

Two excellent ESOP websites are those sponsored by the National Center for Employee Ownership (NCEO) at (www.nceo.org) and the ESOP Association (www.esopassociation.org). Both organizations offer a wealth of information to firms considering ESOPs, as well as educational opportunities through annual conferences and periodic seminars for those firms with ESOPs.

ComStock Advisors

Know your value

ComStock Advisors is a premier national financial advisory firm that delivers expert, objective, and defensible valuation opinions, primarily in relation to privately held companies. Working closely with boards of directors, shareholders, management, and their advisors, we develop an in-depth understanding of both the financial considerations and the underlying business drivers of each business with which we work.

We address each client's specific requirements by leveraging our expertise/experience in these practice areas:

- Estate, Gift & Tax
- Trust Special Asset Services
- ESOP & Employee Benefits
- Litigation Support
- Corporate Transactions
- Financial Reporting