Thursday, July 9 2015 **WRM# 15-25**

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Employee Stock Ownership Plans – Tax Considerations & Planning for Repurchases.

MARKET TREND: In a high-income tax environment, ESOPs often receive a closer look in exit/succession planning based on the tax treatment provided under the Internal Revenue Code ("Code"). ESOPs combine corporate finance with an employee benefit plan and tend to be a popular vehicle among small- to medium-sized private companies interested in liquidity, succession planning, and employee retention.

SYNOPSIS: An ESOP provides a means to transfer some or all of the ownership of a company to its employees. When closely-held business owners are considering various exit strategies, an ESOP is often considered alongside third-party sales, leveraged buy-outs, and intra-family transactions. Participating employees receive a retirement benefit in the form of company stock that generally requires a cash payout upon termination of employment or retirement. While life insurance may offer a funding solution for that payout obligation in certain circumstances, it will more often play a larger role in post-transaction estate planning for the sellers.

TAKE AWAYS: ESOPs can create liquidity for private company owners while allowing them to retain operational control, provide meaningful retirement benefits to their employees, and participate in the company's future success. Sellers who do not want an immediate exit from their company and want to participate in its upside growth (usually through warrants) may find an ESOP sale attractive. ESOPs also can help attract and retain key executive talent by providing employees with an ownership stake in the company. The cost of paying-out employee ESOP retirement benefits, however, must come from future company earnings. Accordingly, an ESOP company must anticipate the funding of these future repurchase obligations when employees terminate, die, become disabled, or retire. Although life insurance can be considered as a funding vehicle in certain cases, the decisions over policy ownership, and how the proceeds are used, must be carefully considered due to resulting tax consequences, particularly as compared with the more common approach of funding repurchase obligations through current company cash-flow. Life insurance, however, can play an important role in the seller's estate and liquidity plans, post-sale.

RELATED REPORTS: 07-2; 05-5; 95-38; 92-81.

ESOPs, as qualified plans designed to hold shares of a company's stock for the benefit of company employees, can serve as an effective method to both incentivize employee retention and plan for the company's succession when it comes to cashing-out employee-participants.[1] It is important to keep in mind that an ESOP is a qualified retirement plan governed by ERISA. Thus the plan design should address and anticipate future employee distributions, and the sponsors, sellers, and ESOP trustees must pay careful attention to ERISA's fiduciary rules.[2]

WHEN TO CONSIDER ESOPs

ESOPs are often touted as a effective ownership tool for employees, which can increase employee commitment, job satisfaction, motivation, and employee productivity, leading to expected enhanced profitability.[3] Thus, ESOPs may be appealing to attain the following objectives:

1. Create a meaningful employee retirement benefit;
2. Create liquidity and value in a limited sale market;
3. Create a way for sellers to diversify their investments and equalize inheritances;
4. Enhance opportunities for charitable giving;
5. Assist with succession planning while allowing the seller/founders to retain operational control;
6. Allow sellers, key executives, and rank-and-file employees to participate in the future growth of the company; and
7. Offer unique incentives (by providing ownership opportunities) to recruit and entice executives to stay with the company as benefits accumulate over time.

ESOP OVERVIEW

ESOPs are tax-exempt, defined contribution retirement plans governed by Code § 401(a), but which have certain unique characteristics compared to other types of qualified plans. For example, ESOPs must be designed to "invest primarily in qualifying employer securities" (i.e., stock of the sponsoring corporation). Further, ESOPs can borrow money to buy qualifying stock in the sponsor ("leveraged ESOPs"), provided the loan satisfies certain requirements to qualify for an exemption to the prohibited transaction rules under Code §4975(e)(7).[4] These leveraged ESOPs are most commonly used for ownership exit or succession planning.

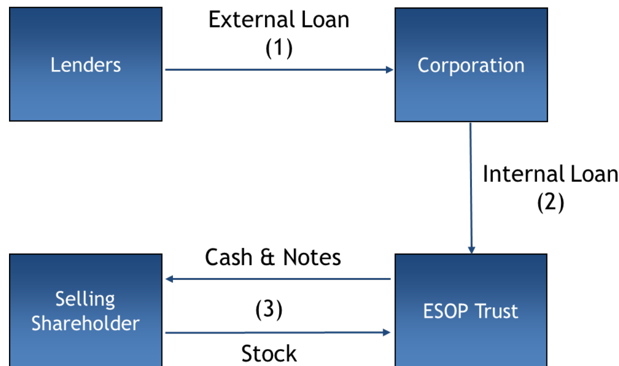
TYPICAL APPROACH – LEVERAGED ESOP

A common leveraged ESOP structure typically involves the following:

Initial Transaction

1. The corporation obtains third-party financing, such as a bank loan (the "external loan"). Larger transactions often bring in mezzanine and private equity as additional financing.
2. The corporation uses the external loan proceeds to make a loan to the ESOP (the "internal loan") based on terms negotiated with the ESOP trustee.[5]
3. The ESOP buys stock in the corporation from the selling shareholders, using cash from the internal loan proceeds, promissory notes ("seller notes"), or both.[6] Since the external loans

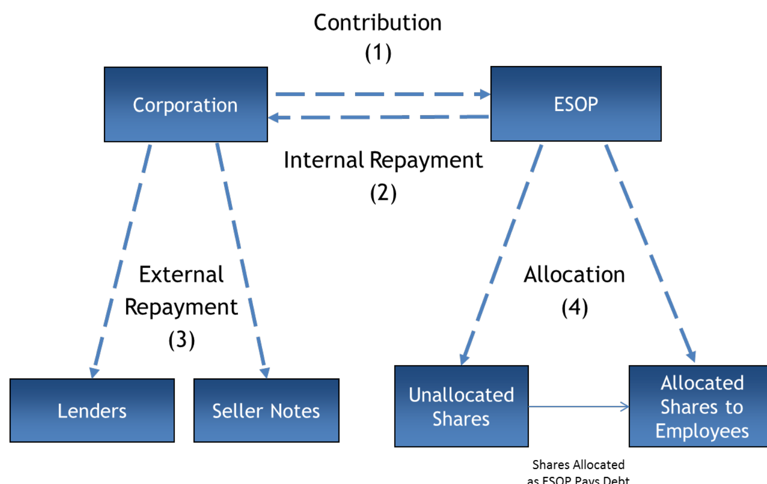
are usually for substantially shorter periods than the internal loans, ESOP transactions are often structured so that the seller notes end up running from the corporation to the sellers. This provides more security for the selling shareholders.



Post Transaction Cash Flow

Following the initial transaction, the shares purchased by the ESOP are held in a "suspense" account (the "unallocated shares") and typically pledged as additional collateral for the external loan. The following flow of funds among the ESOP, sponsor, selling shareholders and external lender(s) is designed to ensure proper debt service and the eventual release and allocation of the shares with the ESOP (to participants' accounts):

1. The corporation makes annual cash contributions to the ESOP. It can also distribute shareholder dividends (if a C corporation) or distributions (if an S corporation) to the ESOP as further funding.
2. The ESOP uses these funds to re-pay the internal loan to the corporation.
3. If the sponsor is a C corporation, the contribution to the ESOP should be tax-deductible as a qualified retirement plan contribution, and, as discussed below, with an S corporation, the earnings may be tax-free, providing for increased cash-flow to pay down the debt.As the internal loan is repaid, shares are released from the suspense account and allocated to the ESOP accounts of the plan participants (usually on the basis of compensation, similar to a profit sharing plan).
4. External loan repayments are made in accordance with their loan documents.



5. As the ESOP matures, it will have repurchase obligations to cash out the accounts of its vested participants once they meet the plan's distribution requirements, generally at a participant's retirement or within five years of termination of his or her employment. In addition, repurchase obligations arise at a participant's death or disability.

POTENTIAL TAX IMPLICATIONS

. The Code provides several provisions related to ESOPs for both corporations and individual sellers to encourage employee ownership.

- **Deductible Contributions**. The corporation receives a tax deduction for its annual ESOP contributions used to pay interest on ESOP loans and, within certain limits, for contributions applied to loan principal payments (which, outside of an ESOP structure, normally would be non-deductible).

- **C Corporation Provisions:**

    - ***Tax Deferral for Selling Shareholders***. Under Code § 1042, a shareholder selling C corporation stock to an ESOP can defer gain from the sale if, among other requirements, (i) 30% or more of the stock is owned by the ESOP after the transaction, (ii) the selling shareholder has held the stock for at least 3 years prior to the sale and (iii) the seller acquires "qualified replacement property" (i.e., typically securities in other U.S. corporations) within a 15 month period beginning 3 months before the sale date and ending 12 months after the sale date.

        - The seller will be taxed on the gain, but only when he or she sells the qualified replacement property. However, if the seller dies holding such property, it will receive a basis-step up to fair market value as of the seller's date of death, eliminating the inherent gain.

    - ***Deductions for Dividends to ESOP***. A C corporation sponsor can deduct "applicable dividends" paid on shares held in an ESOP. To qualify, the dividends must be: (1) paid directly to ESOP participants or beneficiaries or to the ESOP and distributed within 90 days after the end of the plan year in which paid, (2) based on the choice of the beneficiary, paid as described above or paid to the plan and reinvested in qualifying employer securities; or (3) used to repay an ESOP loan.

- **S Corporation Provisions.** It is quite common in an S corporation setting to see a sale of 100% of the seller's stock to an ESOP. Unlike other qualified plans that hold S corporation stock, stock of the sponsor S corporation that is held in an ESOP does not produce unrelated business taxable income, creating significant benefits. In short, an S corporation that is wholly-owned by an ESOP effectively leaves additional money available to fund (1) business operations, investments, and acquisitions, (2) payments on seller notes, and (3) repurchase obligations.

LIFE INSURANCE

Funding Repurchase Obligations. As employees receive increased allocations of stock, and that stock appreciates, the company must ultimately plan to fund this (stock) repurchase liability. Companies determine their repurchase obligations by engaging specialists to conduct actuarial studies. The most popular funding method is to fund from current cash-flow, particularly given that the method supports increased future cash-flow. Other companies will pre-fund the liability

by making additional contributions to the ESOP (if permitted within the Code's deductibility limits) or creating a sinking fund.

While the use of corporate-owned life insurance ("COLI") has often been discussed as a funding device for repurchase obligations, due to tax and product issues, it is not commonly used. If, however, an employee dies and the corporation has purchased a life insurance policy on that employee, then the proceeds could help fund the ESOP's repurchase of the employee's shares. If the corporation holds a cash value product, the policy's cash value also can be accessed to finance the repurchase during the employee's life.

Possible Tax Implications. The tax consequences arising from life insurance policies in connection with ESOPs depend upon which entity owns the policy. Having the ESOP own the insurance policies offers some short-term benefits that are generally outweighed by significant downsides, including the inability to use the proceeds to pay down the ESOP debt due to the possibility of causing prohibited transactions under ERISA. Having the life insurance owned at the company level as COLI may be more favorable because of the growth potential and freedom in using proceeds. However, with S corporation ESOPs, the anti-abuse rules under Code § 409(p) must be carefully reviewed before purchasing any life insurance by the plan or the corporation.

Other Insurance Considerations. While life insurance may not be the most practical solution to funding ESOP repurchase obligations, there is still a role for life insurance in ESOP transactions. Given the importance of the founders/sellers to the on-going company, key-man insurance is considered a good approach to providing both key-man protection and a source of funds to pay-off seller notes in the event of a pre-mature death of a seller. Also, as the seller's available liquidity after an ESOP sale may vary depending on the use of seller notes and/or warrants, the acquisition of life insurance by the family or a family trust after the ESOP transaction is often part of the post-ESOP estate plan for the sellers. Given the scope of this topic, estate planning for ESOP sellers and the potential uses of life insurance will be covered in a follow-up *WRMarketplace* report.

TAKE AWAYS

ESOPs can create liquidity for private company owners while allowing them to retain operational control, provide meaningful retirement benefits to their employees, and participate in the company's future success. Sellers who do not want an immediate exit from their company and want to participate in its upside growth (usually through warrants) may find an ESOP sale attractive. ESOPs also can help attract and retain key executive talent by providing employees with an ownership stake in the company. The cost of paying-out employee ESOP retirement benefits, however, must come from future company earnings. Accordingly, an ESOP company must anticipate the funding of these future repurchase obligations when employees terminate, die, become disabled, or retire. Although life insurance can be considered as a funding vehicle in certain cases, the decisions over policy ownership, and how the proceeds are used, must be carefully considered due to the current tax regime, particularly as compared with the more common approach of funding repurchase obligations through current company cash-flow. Life insurance, however, can play an important role in the seller's estate and liquidity plans, post-sale.

NOTES

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[1] For a more detailed review of various ESOP issues, *see* Kelly O. Finnell & Andrew T. Holmes, "Consider ESOPs as an Estate Plan Component for Business Owners," *Estate Planning Journal*, Vol. 41, No. 9, September 2014.

Jeffrey M. Bauer, "Points to Remember – Unique Tax Advantages of ESOPs," *ABA Section of Taxation News Quarterly*, Summer 2014. Bryan, Pendleton, Swats & McAllister, LLC (BPS&M) for Wells Fargo Institutional Retirement & Trust Group, *A Look at the Good, the Bad, and the Ugly of an Employee Stock Ownership Plan*, Wells Fargo Bank, N.A. (2013).

[2] ERISA § 3(2)(A).

[3] *See e.g.*, the study of ESOP-performance in closely-held companies conducted by Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University, as funded in part by the Employee Ownership Foundation. The study compared 1,100 ESOP companies with 1,100 comparable non-ESOP companies and followed the businesses for over a decade. This study reported that ESOPs appear to increase sales, employment, and sales/employee by approximately 2.5% over what would have been anticipated, absent an ESOP. In addition, Drs. Blasi and Kruse found that 77.9% of the ESOP companies followed in the survey survived, as compared to 62.3% of the comparable non-ESOP companies.

[4] *See* Finnell & Holmes, "Consider ESOPs as an Estate Plan Component for Business Owners," at Note 1, providing that these statutory requirements include: "the ESOP itself must satisfy all of the requirements in the Code applicable to qualified retirement plans and rules set forth in ERISA. In addition, the loan must be "primarily for the benefit of" the ESOP's participants and beneficiaries, the interest rate on the ESOP loan must be reasonable, and the ESOP may use the proceeds of the loan from its sponsoring employer only for certain purposes, including the purchase of "qualifying employer securities" (i.e., shares of company stock)."

[5] These loans also must be structured to qualify for an exemption to the prohibited transactions rules under Code § 4975(e)(7).

[6] As the seller notes are technically loans, they also must qualify for the PT exemption.

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