
THE ESOP ADVANTAGE
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An ESOP (Employee Stock Ownership Plan) is not a fable -- it can be a tax-advantaged tool of finance for the owner(s) of a business operating as a "C" or "S" corporation.

Frequently, the owner of a business has a disproportionate amount of net worth tied up in the business. The owner would like to increase his or her personal cash or diversify a portion of the value of the business into marketable securities -- or perhaps into real estate. For example, the owner may want to take \$1 million out of a \$3 million business. This can be done via an ESOP on a tax-advantaged basis.

An ESOP can also be used to purchase an owner's entire interest in the business or to resolve ownership succession issues. In addition, an ESOP can be used to borrow monies at a reduced after-tax cost to pay for ordinary business expenses, for business expansion, or for selling a division.

As an important by-product, an ESOP can motivate employees with productivity incentives through the employ-

ees' stock ownership accounts under the ESOP.

WHAT IS AN ESOP?

The first thing you need to know is that an ESOP is a form of qualified retirement plan. An ESOP is similar to a profit sharing plan, except that an ESOP is required to invest primarily in "employer stock" -- instead of marketable securities or mutual funds. It allows eligible employees to gain an ownership interest inside the plan in their corporate employer on a tax-deferred basis. Because of the tax advantages that have been granted to an ESOP, it is beneficial to the owner and the company.

Commonly, an ESOP borrows from the corporate owner in the form of a promissory note to purchase employer stock from the owner. Or, the ESOP borrows money from a bank to purchase employer stock from the owner. In either case, this is called a "leveraged ESOP."

WHAT ARE THE TAX ADVANTAGES TO THE CORPORATION?

In general, a corporation can make deductible contributions to its ESOP up to 25% of eligible employee payroll each year. Fortunately for this purpose, 401(k) employee deferrals and cafeteria plan deferrals don't reduce the amount of payroll.

In a "leveraged ESOP," these deductible contributions are used to pay for the employer stock purchased from the owner. Or they are applied to repay the bank loan that was used to purchase employer stock from the owner. Moreover, a "C" corporation can make additional deductible contributions to pay the interest on an ESOP loan. When necessary, a "C" corporation can also pay deductible dividends on preferred stock to pay the principal on an ESOP loan. In a "leveraged ESOP," what this all means is greater cash flow because the ESOP loan is paid off with pre-tax dollars -- instead of after-tax dollars.

An "S" corporation that sponsors an ESOP gains an

additional cash flow advantage. Since an “S” corporation passes through tax consequences to its owners, the ESOP doesn’t pay any income tax on the distributable income from the corporation because the ESOP is a tax-exempt shareholder. Therefore, if the ESOP owns 100% of the stock, the “S” corporation is 100% nontaxable. Or, if the ESOP owns 50% of the stock, the “S” corporation is 50% nontaxable.

WHAT ARE THE TAX ADVANTAGES TO THE OWNER?

When an owner sells employer stock to an ESOP, the proceeds are taxed as long term capital gain (currently 15% tax rate), unless the owner elects tax-free rollover treatment. To qualify for tax-free rollover treatment, the ESOP must purchase at least 30% of the stock of a “C” corporation. To obtain tax-free rollover treatment, the owner must reinvest the proceeds of the stock sale in marketable stock or securities of corporations that are incorporated in the U.S. or any state thereof.

When rollover treatment is effected, the owner has converted an investment in a closely held company to publicly traded securities -- without recognizing any income tax. In addition, after the rollover treatment is effected, some “C” corporations switch to “S” corporations to improve their cash flow. Nevertheless, some owners who qualify choose to forego tax-free rollover treatment because they

prefer to invest the sales proceeds in real estate or other special investments.

Due to the fact that an “S” corporation pays no taxes, the sales proceeds that are received by the owner from the sale of employer stock to an ESOP are not eligible for tax-free rollover treatment.

WHAT ARE THE ADVANTAGES TO EMPLOYEES?

Through their ESOP accounts, employees become part owners of the business. The value of their stock interest is tied directly to the future performance of the business. Therefore, an ESOP has proven to be a considerable incentive to motivate employees, both individually and collectively, to work efficiently with a view toward the bottom line.

When an employee retires, dies, or becomes disabled, the value of the former employee’s ESOP account becomes payable under the payment policies of the ESOP. In closely held companies, the distribution of the account is generally made in cash instead of employer stock to preserve the closely held nature of the business. In the case of an “S” corporation, the distribution must be paid in cash. The payment usually is made in annual installments over a five-year period. If an employee quits or is discharged, the installment payments are typically delayed until the sixth year after employment termination, or if

later, until the end of the year in which an ESOP loan is repaid in full. The distributions are taxable to the former employee when received, unless tax-free rollover treatment is elected -- similar to a 401(k) or profit sharing plan distribution.

ANTI-ABUSE RULES FOR “S” CORPORATION ESOP

An S corporation may have only a few shareholder-employees, or it may also have hundreds or thousands of rank and file employees, as well as highly compensated employees.

Therefore, because the “S” corporation income allocable to the stock owned by an ESOP is not taxable, there are anti-abuse rules in place. These rules effectively discourage the establishment of an “S” corporation ESOP that benefits only a small group of shareholder-employees and their family members.

In general, the anti-abuse regulations accomplish this purpose by prohibiting the allocation of stock in an “S” corporation ESOP to disqualified persons who together own at least 50% of the corporation’s stock. A disqualified person includes a person whose number of deemed-owned ESOP shares is at least 10% of the number of the deemed-owned ESOP shares of the “S” corporation.

If an established “S” corporation ESOP violates the prohibition against the alloca-

tion of stock, then there are harsh taxes imposed on a disqualified person. In addition, there may be excise taxes imposed on the "S" corporation, the corporation may lose its "S" status, and the ESOP may lose its status as a qualified plan.

In summary, an "S" corporation ESOP cannot be used as a tax shelter for only one or a few shareholder-employees.

SETTING UP AN ESOP

An ESOP is by no means appropriate for all businesses. The most appropriate business, particularly in the case of a "leveraged ESOP," is one that has a sound cash flow and is expected to be financially strong for at least the next eight to ten years, and hopefully longer.

Setting up an ESOP should follow a methodical step-by-step process. An experienced ESOP attorney should work with the company's accountant from the very beginning of the process. The potential ESOP should be

evaluated in view of the owner's personal objectives, the company's objectives, the employee benefit objectives, the company's payroll, the financing alternatives, the company's cash flow, and the valuation of the company. An appraisal of the company early on may make or kill the ESOP program. This process will not only determine the feasibility of an ESOP, it will demonstrate fiduciary due diligence and save considerable time and expense.

If at any point in the process it is determined that the ESOP is not feasible, be prepared to abandon it entirely -- or the repercussions will be regrettable. With this in mind, avoid relying on companies or consultants that market ESOPs as an off-the-shelf product to be sold.

If an ESOP is feasible, the ESOP attorney can recommend and coordinate the services of others as needed, including an independent appraiser, an ESOP transaction trustee, a bank lender, and a third party administrator. He or she can

also prepare the documents for the ESOP, the associated trust, and transaction related documents that are tailored to fit the needs of the owner, the company, and the ESOP program. Importantly, the ESOP attorney can provide tax and legal advice on essential fiduciary matters not only in connection with the setting up of the ESOP, but also with respect to the ESOP's ongoing operation.

CONCLUSION

At best, setting up an ESOP is a detailed and time consuming process. The process can take 90 to 180 days from start to finish, depending on the complexity of the transaction and the parties needed. Shortcuts are taboo because they necessarily create excessive legal and tax risks to the owner, the company, and the ESOP transaction trustee.

If an ESOP is feasible and properly set up, the ESOP will deliver economic and tax advantages to the owner, the company, and the company's employees that exceed those of any other program.

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