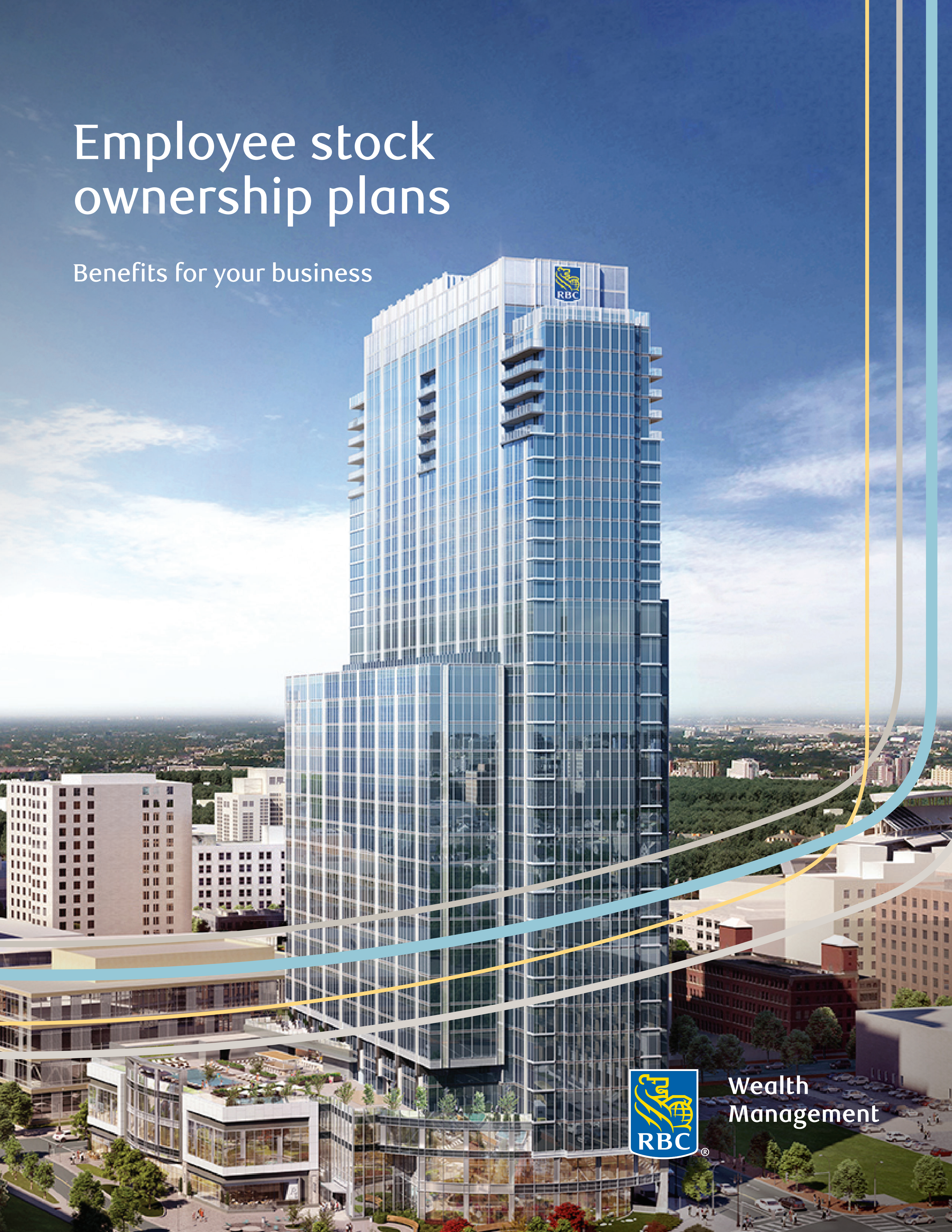
# Employee stock ownership plans

## Benefits for your business



RBC Wealth Management

# What is an ESOP?

## An employee stock ownership plan (ESOP) is a qualified retirement plan that provides tax advantages to both the employer and employees.

**Similar to a traditional profit-sharing plan, an ESOP offers many additional advantages.**

### Benefits for the employer

ESOPs provide a unique way for business owners to diversify their risk on a tax-advantaged basis. They allow business owners to cash out some or all of their equity in the company while keeping operational control. Closely held business owners can use an ESOP as an excellent estate-planning tool that generates liquidity for their shares and creates succession options for those involved in the business.

Designed to invest mainly in the stock of the employer, an ESOP can be a stock bonus plan or a combination stock bonus plan and money purchase pension plan. The Internal Revenue Code (IRC) gives tax incentives to employers who sell their company stock to the ESOP. Companies can benefit from tax savings in many ways using this unique corporate financing strategy.

### Benefits for the employee

A unique aspect of ESOPs is that benefits are paid to participating employees in the form of company stock. A trust fiduciary sets up individual accounts within the trust for each participating employee. The employer then contributes either cash or shares of company stock to the trust on behalf of participating employees. If employers make cash contributions, the trust uses that money to purchase shares of company stock either from shareholders or from the company itself.

An ESOP is an excellent way to reward employees with retirement benefits at no cost to them while inspiring them to participate in the growth and success of the company. Because ESOPs have many tax advantages, employees do not pay tax on the stock allocation to their accounts until distributions are taken, usually after retirement.

# Why business owners choose ESOPs

## These three key reasons are why business owners choose ESOPs as their financing strategy of choice.

### Tax advantages

The tax code gives sellers the potential to defer capital gains tax while giving the company tax deductions of the transaction price over time, which can enhance cash flow and improve credit metrics. ESOPs are tax exempt and pay no tax on their pro-rata share of company earnings. In addition, only 30 percent of the business needs to be sold to the ESOP to obtain these tax benefits and the business owner can continue to actively participate in and receive compensation from the business.

The tax benefits of an ESOP produce financial rewards not just for the company but also for the owner and the employees. As the employer sponsoring an ESOP for your employees, your contributions to the plan, whether in the form of company stock or cash that is used to purchase company stock, are generally tax deductible on your federal income return for the year in which you make those contributions. However, to be eligible for this employer tax benefit, your plan must remain a "qualified" plan.

### Exit strategies

Baby boomers are retiring rapidly these days and over the next decade, approximately 30 to 40 percent of businesses in the U.S. will be changing ownership as a result.* ESOPs offer important benefits to help company owners make this transition. These benefits make ESOPs an excellent alternative to other exit strategies. They can facilitate family business succession planning and estate planning through the transfer of different types of assets to family members with different levels of involvement. And because ESOPs can be structured as a series of transactions, they can be either an intermediate or long-term exit strategy.

### Building company value

ESOPs give sellers the ability to profit from building value in the company over many years and to gain liquidity to diversify wealth or buy other assets. ESOPs can also be strong motivators in service industries by adding to the benefits of employees owning stock and aligning shareholder interests with those who drive shareholder value—employees. ESOPs can also help circumvent a poor buyer's market, help in the transition of franchisee ownership, be structured to take advantage of foreign tax treaty provisions, use other qualified plan investments, facilitate a going-private transaction, and more.

*National Center for Employee Ownership (NCEO).

# How ESOPs may financially benefit a business transition

### Business transition example

The tax basis in the business owner's company is $200k. The owner is considering either an outright sale or an ESOP, both of which have been valued at $10 million, meaning the business appreciated $9.8 million. Under the sale scenario, the business owner will pay the 23.8 percent long-term capital gains tax on the appreciated value, or $2.33 million, reducing net proceeds to $7.5 million. Under the ESOP, the business owner can defer the capital gains tax and receive the full net proceeds of $10 million under the following circumstances:

- The owner owned the stock for at least three years and did not receive it as part of a compensatory transaction
- Post-transaction, the ESOP will own at least 30 percent of the company
- The company is organized as a C corporation at the time of the ESOP
- Qualified Replacement Properties (QRPs) must be purchased within the 15-month period ending 12 months after the sale to the ESOP

Other requirements apply, including the filing of certain documentation with the IRS, so you should always consult your tax and legal advisors.

| | Sale not using IRC 1042 | Sale using IRC 1042 |
|---|---|---|
| Sale Price | $10,000,000 | $10,000,000 |
| Less Federal Capital Gain (23.8%) | $2,330,000 | $0 |
| Less State Capital Gain (Avg. 6%) | $600,000 | $0 |
| After Tax Dollars | $7,020,000 | $10,000,000 |
| Difference | | $2,980,000 |

Example illustrates the use of electing Section 1042, see next page for more details.

# IRC Section 1042 Exchange

## IRC Section 1042 allows an owner of a closely held C-corporation to indefinitely defer capital gains tax on stock that is sold to an ESOP (Employee Stock Ownership Plan).

### IRC Section 1042 and qualified replacement property

A 1042 ESOP Exchange allows a shareholder to exchange his or her interest in a private company for a portfolio of qualified replacement property without paying any capital gains taxes on the transaction.

Capital gains tax is deferred as long as the qualified replacement property is held. Through the use of IRC Section 1042, the Qualified Replacement Property (QRP) is assigned the basis of the original investment.

Investments that qualify for QRP:

- Common stock
- Preferred stock
- Convertible bonds
- Corporate fixed rate notes
- Corporate floating rate notes (FRNs)

If a U.S. corporation uses 50 percent or more of its assets in an active trade or business and does not receive greater than 25 percent of its gross receipts from passive income, the securities can be used as QRP.

These strategies let the business owner sell their business and defer the tax until the securities mature, are called by the issuer, or sold. Thus, a business owner might be able to defer or eliminate capital gains on the sale of their business.

### Wealth management and ESOPs

Business owners can generate income from their qualified replacement property by investing in high-dividend stocks or long-term fixed income securities. This approach allows them to generate income without triggering tax consequences.

Another option is for business owners to invest in long term floating-rate notes, because they are designed specifically for ESOP sales. These securities are issued by major corporations, which have maturities of 30 to 40 years or more and offer a variable interest rate based on a short-term market index. The rate is typically monthly or quarterly, depending on the security.

The highly rated floating-rate notes are marginable for up to 90 percent. As a result, business owners can monetize them by borrowing a substantial portion of their market value and then reinvesting borrowed funds in a diversified portfolio of stocks, bonds and other assets. In addition, the notes have a put feature for liquidity purposes.

The investment portfolio can then be actively managed without triggering tax on the deferred capital gains resulting from the ESOP sale. Business owners will have to pay interest on their margin loan, but the rate will be relatively low and the interest paid may be partially or fully offset by the interest earned on floating-rate ESOP notes.

Reinvesting the proceeds from an ESOP is complex and requires the assistance of a professional who is well-versed in ESOPs and qualified replacement properties. Business owners do not want to find themselves liable for taxes they thought they had deferred or unable to withdraw assets for the fear of triggering tax consequences.

# Other advantages of ESOPs

## An ESOP may ease concerns an owner may have around a strategic sale or a sale to a private equity (PE) firm.

In these types of sales, it's always a possibility that the new owner or company will leverage the business and break apart its operational components purely for profit, disrupting the business and potentially threatening the job security of its workforce. An ESOP is an option for owners focused on preserving the business and supporting the employees after ownership transition.

### An ESOP may boost employee morale and productivity

Along with its tax benefits, an ESOP may offer additional benefits for both you and your employees, making it an attractive form of stock-based employee compensation. One of the main advantages of an ESOP is that it provides participating employees a stake or ownership interest in your company. This is primarily because plan benefits are in the form of your company's employer stock, and shares of stock represent a "piece" of the company.

Having an ownership interest may boost company morale and give your employees an incentive to perform better, resulting in greater overall productivity. From your perspective as the employer, increased productivity may improve your business's bottom line over the long term. In addition, employees who feel well rewarded are more likely to stay with your company, allowing you to retain quality workers and reduce your employee turnover rate.

### An ESOP is relatively cost effective

With most types of employer-sponsored retirement plans, employer contributions to the plan are made in the form of cash. This is not the case, however, with an ESOP in which the employer may contribute shares of company stock to the plan. An ESOP that is funded in this manner is often seen as more cost effective than other types of plans, because there is minimal cash outlay required on the employer's part. This is something to consider if you would rather use your business's cash flow for purposes other than funding employees' retirement accounts.

# The potential ESOP candidate

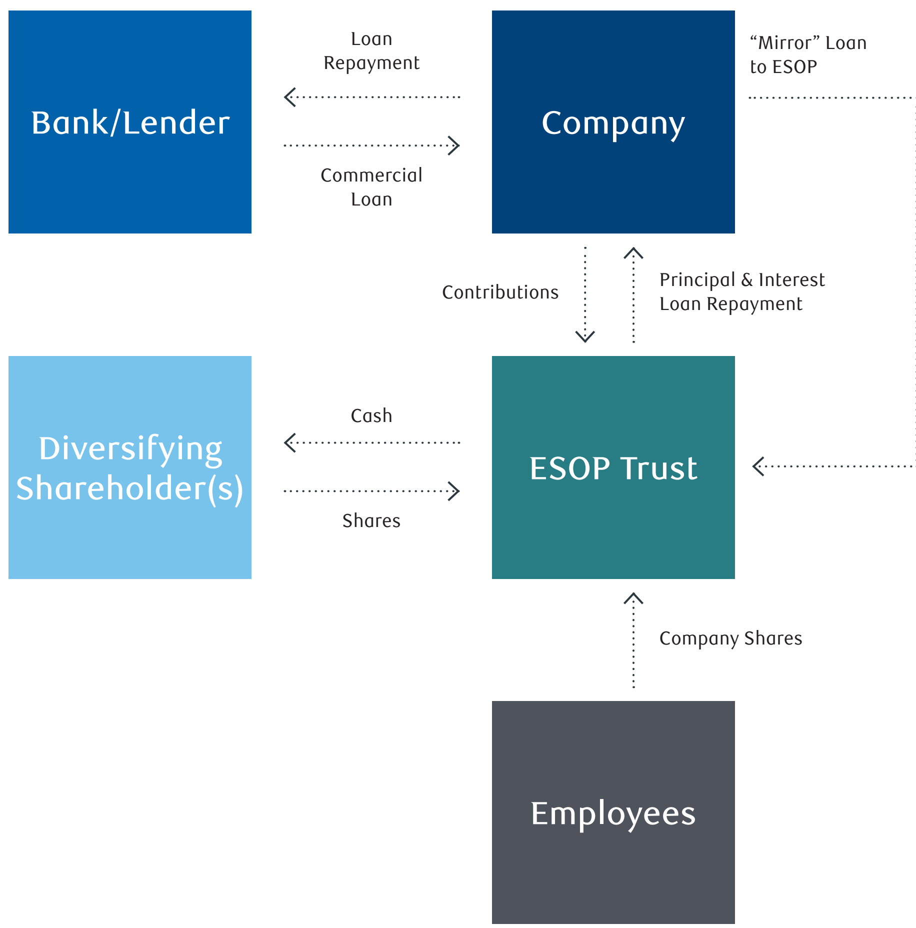
While each situation is different, here are some characteristics of a possible ESOP candidate:

- The company must currently be a C corporation, or a Sub S, or the business owner must be willing to convert.
- The company must have sufficient collateral or cash flow to support funded debt.
- A successor management team should be in place or developed over time.
- The company should have been in business for several years and be experiencing steady and controlled growth.
- The company should have had strong earnings and cash flow over the previous two years and be able to reasonably predict future revenue and cash flows (probably more important than having hard assets to support the loan).
- The selling shareholders should want to participate in the future growth of the company after the sale.

# How ESOPs work

## The following steps illustrate the way most companies establish an ESOP.

1. A company borrows money to finance the purchase of stock from current shareholders.
2. The company then lends these funds to the ESOP.
3. A trust is created to buy stock of the company on behalf of the ESOP plan.
4. The company makes annual cash contributions from its operating profits to the trust (which are tax deductible).
5. The trust uses the cash to pay down the ESOP loan while a trust fiduciary releases and allocates shares of the company's stock to the accounts of plan participants (employees) according to a pre-established formula.
6. After time, employees are vested based on years of service for the shares in their account.
7. When employees retire or leave the company, they receive a distribution of their vested benefits in the form of cash or company stock. If in stock, the employee can choose to either hold the stock or sell it back to the company at fair market value. If the stock is not publicly traded, the employee must have the right to sell the stock to the company at fair market value.



# ESOPs may not be for everyone

Although ESOPs can help business owners achieve liquidity and diversification, offer many tax advantages, and inspire employees through stock ownership, they can present some drawbacks as well.

First, ESOPs may not be used in partnership structures or in most professional corporations. Although ESOPs can be used in S corporations as well as C corporations, restrictions and lower contribution limits can apply.

Second, a conflict of interest under ERISA could result (if not handled properly). An ESOP is both a corporate finance and retirement savings strategy—especially in smaller companies where an ESOP's fiduciaries might also serve as officers or directors. Situations like this might require the help of independent legal, investment and financial professionals.

In addition, the company may be required to repurchase vested shares of departing employees. The funding of this repurchase must be managed carefully. Also, the equity value of existing owners is diluted any time a company assumes debt to finance a transaction without reducing the number of shares outstanding.

Careful consideration of some of these issues should be weighed against an ESOP's potential tax and other advantages.

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