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EMPLOYEE OWNERSHIP

S Corporation ESOPs:
Legal Issues

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What is an S Corporation?

- "Pass-Through Entity"
  - Corporation's income, losses, deductions and credits are passed through to shareholders for tax purposes. STEVE
- Up to 100 shareholders (ESOP = 1 shareholder).
- Shareholders must be U.S. citizens or residents, certain trusts, estates.
- Only one class of stock. Voting & non-voting, but no preferred
- Certain businesses (banking, insurance, DISCs) ineligible.
- Calendar year.
  - Exception: with IRS approval, for a valid business purpose. STEVE

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S Corporation ESOP v. C Corporation ESOP

Differences Between S and C Corporation ESOPs		
Description	**C Corporation**	**S Corporation**
Ownership	Unlimited # of Shareholders.	100 SH limit (ESOP = 1 SH). SHs must be U.S. citizens or residents, certain trusts, estates. (Special case: QSSS.)
Income taxes	Corporation pays taxes on its income.	Generally, corporation passes through corporate income, losses, deductions, and credits for tax purposes. Shareholders pay taxes on their pro-rata share of Corporation's income. However ESOP, as a shareholder, is exempt from federal (and most States) taxes.
Dividends - C Corporations	Must be "reasonable." Different classes of stock may have different dividend rights. Generally, taxable to SH; no deduction to corporation ("double taxation"). However dividends paid to ESOP may be deductible.	Not Applicable
Distributions - S Corporations	Not Applicable	No "reasonableness" limitation. Must be pro-rata to all shareholders including ESOP. Typical S corp.s distribute at least enough to fund shareholders' tax liability. Not taxable to SH; no deduction to corporation.
Compliance Testing	Discrimination testing, Contribution Limits, Allocation Limits	Discrimination testing, Contribution Limits, Allocation Limits + 409(p)
IRC §1042 tax deferral	Applies only to C corporation. 3 year holding period; 30% test; invest in QRP w/i 12 mths.	Not Applicable
Transaction strategies	Sell at least 30% to ESOP for IRC §1042 eligibility; Elect S-status after transaction.	Sell any %, often with eventual goal of creating 100% ESOP ownership.

S Corporation Advantage

- 100% ESOP owned S Corporation: **No federal (and most States) income tax at corporate or shareholder level** increased cash flow to pay leveraged financing, fund expansion, etc.
  - Less than 100% ESOP owned S Corporation: Non-ESOP SHs must pay taxes on their pro-rata share of corporate income. Typically, corporation pays distributions to SHs to fund this tax liability. Distributions <u>must</u> be pro-rata to all SHs (including ESOP).
  - To the extent that the ESOP can use its share of S corporation distributions to pay leveraged financing or ESOP benefits, S corporation distributions paid to the ESOP may reduce the need for contributions and for funding repurchase obligation.

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S Corporation Drawbacks

- Partial ESOP ownership. 30%
- Cash buildup & repurchase obligation. 100%
- LTIPs for executives & equity dilution. 100%
- Decreased limit for tax deduction for contributions to leveraged ESOP when used to pay interest on exempt loan (partial ownership ESOPs). Partial
- No tax deduction for cash dividends paid on stock held by ESOP that is used to pay principal or interest.
- No delay of distributions until payment of ESOP loan (majority interpretation).

S Corporation ESOP Testing: Section 409(p)

- 409(p) intended to prevent concentration of benefits of 100% ESOP owned S corporation, among a small group of participants.
- May limit allocations to key employees, especially if total number of participants is small.
- May limit use of synthetic equity (e.g., warrants, stock appreciation rights).
- Family attribution rules apply.
- Violations carry potentially severe penalties.

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Use of S Distributions to pay ESOP leveraged financing

- HOWEVER Only the S distributions on shares acquired with an ESOP loan can be applied to the payments made on such loan.
- Distributions on shares allocated to a participant's account may be used to pay ESOP leveraged financing, only if the value of shares allocated as a result of such payment is at least equal to the amount of the distribution. VALUE TEST
  - Any drop in the value of the shares – whether due to the impact of transaction debt on post transaction value, company specific performance, or general economic conditions – can make this difficult to accomplish.

*Note: these rules also apply to C corporation dividends.

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C to S Conversion ESOPs

- 100% shareholder approval required.
- IRC §1042 Rollover.
  - Elect 1042 “tax-free” rollover in a C corporation transaction, then elect S corporation status.
- File Form 2553. Some States require a separate state filing.
- BIG tax:
  - Five years after conversion.
  - Built-in gains tax on the sale of appreciated assets as well as impact of recognition of deferred income.
  - Liability could affect business value.
- LIFO recapture:
  - LIFO recapture rule under Sec. 1363(d) accelerates income related to the taxpayer’s LIFO inventory.
  - LIFO method affects the timing of recognition of additional built-in gain related to inventory.

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S to C Conversion ESOPs

- Can occur unintentionally due to ineligible SH or second class of stock.
- Recent tax reform and new corporate tax rates for C corporations.
- Five-year wait for conversion back to S corporation status.
- Considerations:
  - Cash flow for income tax payments; and
  - Maximize contributions to minimize taxes, or eliminate C corporation taxes altogether.

LLC to C Corp to S Corp Conversion ESOPs

- LLC can convert to C corporation.
- C corporation can take advantage of 1042.
- Convert to S corporation with no waiting period.
- S corporation can take advantage of 100% ESOP owned S corporation benefit.

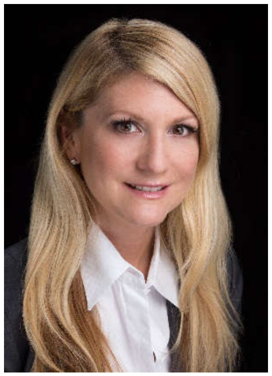
Valuation of S Corporations v. C Corporations

- Valued using the same methodologies and valuation discounts.
- Valuation methodologies:
  - Discounted Cash Flow Method – predominantly used.
  - Capitalization of Economic Income Method – less common, occasionally used (no ability to forecast cash flows).
  - Adjusted Book Value Method – rarely used in specific circumstances (company heavily invested in tangible assets and equipment).
  - Guideline Public Company Method – typically used as a sanity check.
  - Guideline Transaction Method – typically used as a sanity check.
- S corporation cash flows are tax affected at C corporate rates, for valuation purposes.
- Fair market value with application of valuation discounts:
  - Discount for Lack of Marketability; and
  - Discount for Lack of Control (Minority Interest Discount).

Take Aways

- S Corporations
  - Limitations on shareholders;
  - No second class of stock;
  - No 1042 benefit;
  - 409(p) Testing is a concern;
  - Conversion issues;
  - . . . but, 100% ESOP ownership tax benefit;
  - Valuation of S and C Corps are similar;
  - Various valuation methodologies, however some are more commonly used than others; and
  - Valuation discounts are applicable and appropriate.

Questions?



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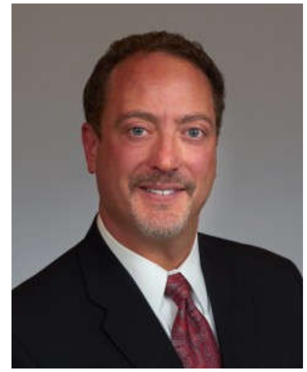

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Erin D. Hollis, ASA, CDBV, is a Director at Marshall & Stevens Incorporated. She works within the financial practice group and with ESOP clients on financial analysis and consulting services needs.

Experience – Since 2000, Ms. Hollis has worked with advisors and closely-held business owners for valuation needs, and has experience providing valuation advisory and economic analysis services in the areas of litigation, taxation, transactional, and planning purposes. Erin has provided professional services in industries, such as manufacturing, construction, transportation, agricultural, distribution, retail, wholesale, and a wide range of service industries.

She is a qualified expert witness, and has testified for various marital and corporate litigation matters. She is a prolific author on the subject of business valuation, and has written for several industry trade publications and as a contributing author for professional organizations. Erin sits on the Business Valuation Committee of the American Society of Appraisers (ASA) and is a past ASA Chicago Chapter President. She is also a member of The ESOP Association's Valuation Advisory Committee and the Interdisciplinary Advisory Committee on Fiduciary Issues, and the (NCEO) National Center for Employee Ownership.

Education – Erin received a B.A. and B.S. from Michigan State University. She is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers, and Certified in Distressed Business Valuation (CDBV) with the Association of Insolvency & Restructuring Advisors (AIRA).

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- Partner at Steiker, Greenapple & Fusco, P.C., a nationally recognized law firm focusing on ESOPs and ESOP transactions.
- Principal at SES ESOP Strategies, a financial advisory firm focusing on ESOP design and financing.
- 28 years of experience representing ESOP plan sponsors, shareholders, and trustees.
- Has served as expert witness in litigation relating to ESOPs, in federal and State courts.
- Member of, and a frequent speaker for, the National Center for Employee Ownership and The ESOP Association.
- Recent Chair of The ESOP Association's Legislative and Regulatory Committee.
- Trustee of The Employee Ownership Foundation.
- Admitted to practice in New Jersey, New York and Pennsylvania.
- Bachelor of Science from Cornell University; and J.D. from Cornell Law School.
- Martindale-Hubbell's highest "AV" rating.

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