ESOPs—A WAY TO PROVIDE LIQUIDITY FOR MINORITY SHAREHOLDERS

ESOPs can provide a closely held company with a market for its stock and resolve its shareholders' liquidity needs.

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Picture the following situation involving shareholders of a closely held corporation. Emily, Luke, and Abby each own one-third of the outstanding stock of ELA Corp., a very successful company that provides consulting services to government defense contractors. All three owners are in their fifties and have spent most of their working lives building up the company. As is the case with many closely held businesses, their stock in the business is a substantial part of their personal assets.

Luke has developed a sophisticated process that he thinks will revolutionize the gathering of intelligence information, but a significant additional capital investment by the shareholders will be needed to develop the concept further. Emily and Abby are not convinced of the viability of the project and refuse to provide any additional funding. As a result, communications among the shareholders has broken down, and there are frequent disputes. Luke wants to sever his business relations with Emily and Abby and has demanded that they purchase his stock.

Neither ELA Corp., Emily, nor Abby has the necessary funds to purchase Luke's stock. In fact, Emily and Abby would like to sell some of their stock to increase their personal liquidity. Emily would like to provide funding to assist her daughter in acquiring a minor league baseball franchise. Abby is a very successful real estate investor, but is concerned that all of her investments are illiquid, and she has no way to quickly acquire a significant amount of cash.

As with many closely held companies, there is no market for the company's shares. As a result, there is no easy way for Emily, Luke, or Abby to sell all, or a portion, of the stock they own. The company and other shareholders have no available funds, and the sale cannot be to a third-party strategic buyer (often a competitor in the same market or industry) because ELA Corp., Emily, Luke, and Abby are parties to a shareholders agreement that prevents them from selling to a third-party “strategic buyer,” wealthy investors, or private equity firm. In fact, even if there were no corporate restrictions on sales to third parties, because Emily, Luke, and Abby are each a minority shareholder, many strategic buyers, wealthy investors, or private equity firms are not interested in buying their shares, unless they can also acquire control of the company.

Unfortunately, this situation is quite common for closely held companies. Shareholders want to retire. Shareholders die or become disabled. Sometimes, a shareholder is forced to sell his or her stock for financial reasons, or because of regulatory changes, such as recent changes in ownership requirements for certain medical facilities. In a closely held corporation, however, there is usually no market for the stock.
One area in which a lack of a market for the shares is especially problematic, is shareholder disputes. Such disputes often relate to managerial issues, personal issues, or management misconduct. If the issues are not resolved, they can quickly cripple a business. Unfortunately, such disputes often are time consuming and costly not only for the company but for the affected parties as well. There needs to be a way to provide a market for the shares to help facilitate the resolution of such disputes.

**ESOP CAN PROVIDE LIQUIDITY**

For many closely held businesses, an employee stock ownership plan (ESOP) can provide the needed liquidity. As discussed below, an ESOP is a powerful innovative liquidity tool that may enable a shareholder to sell a portion or all of his or her stock in a tax-advantaged manner. An ESOP can provide tremendous flexibility to a corporation and its shareholders as well as providing significant tax benefits. The ESOP’s purchase of a selling shareholder’s stock is the only way the shares can be purchased on a pre-tax rather than an after-tax basis. The purchase of a selling shareholder’s stock by another shareholder, or redemption of such stock by the company, is always on an after-tax basis.

Occasionally, the price paid by an ESOP exceeds what a strategic or other third-party buyer will pay, thereby providing the shareholder with “top dollar” for his or her stock. For the shareholder who wants to sell his or her stock but does not want to give up control of the business, various techniques are available to enable the selling shareholder to maintain control of the company after selling a portion or all of his or her shares to the ESOP.

There is tremendous flexibility in using an ESOP to provide liquidity. The ESOP can be leveraged, which means it borrows funds to acquire a selling shareholder’s stock. Funding to acquire the stock can come from banks or other financial institutions or mezzanine lenders, and the transaction often is partly or wholly financed by the selling shareholder. The ESOP also can be non-leveraged, which means it uses its own funds and the funds of other qualified plans of the company, such as 401(k) plans to fund the purchase of stock from a selling shareholder. To encourage the use of ESOPs, Congress added provisions to the Code that have made the tax treatment of ESOPs very favorable, for both corporations and their shareholders.

**ESOP BASICS**

An ESOP is a special kind of qualified retirement plan designed to give employees an ownership stake in their company by investing primarily in shares of stock of the sponsoring employer (or a member of the sponsoring employer’s controlled group). It is governed by laws for private retirement savings plans, such as the Employee Retirement Income Security Act of 1974 (ERISA) and the Code and must meet most of the general participation and benefit requirements applicable to qualified retirement plans. Only corporations can sponsor an ESOP. Although partnerships and limited liability companies cannot sponsor an ESOP, there are ways to structure ESOP transactions so that non-corporate entities may participate. ESOPs have been around since the 1970s, and they currently cover more than 11 million employees.

The shares of stock of the sponsoring employer are owned by a trust that is managed by a trustee appointed by the board of directors of the sponsoring employer. The trustee may be an officer or other insider, or an external independent trustee. An external trustee should be used to negotiate the terms and execute the transaction involving the purchase of shares of stock from a selling shareholder. Once the transaction is completed, the external trustee can be replaced by an officer or other insider. Generally, the trustee has the right to vote the shares in its discretion. However, certain corporate transactions, such as mergers, reorganizations, and sales of a significant portion of the company’s assets, may require “pass-through” voting, which means the participants must be given the right to instruct the trustee with respect to voting the shares allocated to their accounts. ESOP participants do not actually own the shares, and they do not have the right to see any internal financial statements. The only information they are entitled to see is the share price and number of shares allocated to their accounts on a yearly basis.
Following the ESOP’s purchase of shares of stock from a selling shareholder, the shares are held by the trust in a “suspense account.” The shares are released from the suspense account based on relative principal, or principal and interest paid on the ESOP loan. The released shares are then allocated to participant accounts based on participant compensation. Participants will vest in the shares allocated to their account in accordance with the vesting schedule set forth in the plan documents, generally over a period of three-to-six years.

A participant is entitled to a distribution of his or her account on retirement, death, disability, or other termination of employment. Generally, commencement of payments due to a participant’s termination of employment (for reasons other than death, disability, or attainment of normal retirement age) can be delayed until the later of (1) five years or (2) the term of the ESOP loan, and then paid out over five years. (It is unclear whether an S corporation ESOP can delay payment until the ESOP loan is repaid.) Payments on account of death, disability, or attainment of normal retirement age must commence no later than the end of the plan year following death, disability, or attainment of normal retirement age, and then paid out over a five-year period.

An ESOP can be leveraged or non-leveraged:

- A leveraged ESOP uses borrowed funds to purchase company stock from a selling shareholder. Many banks are eager to finance ESOP transactions. Usually, the bank makes a loan to the company (often referred to as an “outside” loan) which, in turn, loans the funds to the ESOP (often referred to as an “inside” loan). The company then makes annual contributions to the ESOP in an amount necessary for the ESOP to make the annual payments on the “inside” loan. The ESOP then makes the payment to the company, which, in turn, makes the payment to the lending bank. Often, the terms of the outside and inside loans mirror each other. The amount a lender is willing to lend is often a multiple of the Company’s EBITDA. Company contributions to the ESOP are generally limited to 25% percent of participants’ compensation.
- A non-leveraged ESOP buys company stock using existing plan assets, assets of other qualified plans of the company, or annual company contributions. No funds are borrowed—it is a pay-as-you-go type plan.

There are special rules applicable to ESOPs that own S corporations that are intended to prevent concentration of the ownership of the S corporation among a small number of “disqualified persons.”

**STEPS IN A TYPICAL LEVERAGED ESOP TRANSACTION**

The following is a summary of the steps involved in a typical ESOP transaction in which funds are borrowed from a lender (leveraged ESOP transaction).

- The company establishes an ESOP plan and trust and appoints an ESOP trustee.
- The ESOP trustee negotiates with a selling shareholder to establish the terms of the sale of stock to the ESOP.
- The company borrows a part or all of the funds necessary for the ESOP to purchase the stock from the selling shareholder from a third-party lender (outside loan). The lender evaluates the ESOP company in the same way other potential borrowers are evaluated. The company’s ability to collateralize and repay the loans. Loans are based on the credit markets.
- The company loans the funds to the ESOP (inside loan). The terms of the loan are based on the credit markets.
- The ESOP uses the funds borrowed from the company to purchase the stock from the selling shareholder. To the extent of available funds, the selling shareholder would receive cash and take back a note for the balance (subordinated note).
- The company makes annual tax-deductible cash contributions to the ESOP.
- The ESOP uses the cash contributions received from the company to repay the inside loan.
• The company uses the payment received from the ESOP to make payments on the outside loans.

**COMPANIES THAT ARE GOOD ESOP CANDIDATES**

Good ESOP candidates generally have (1) solid operating performances, (2) stable or predictable cash flows, (3) a good senior management team, and (4) payroll sufficient to support the contributions necessary to fund the repayment of the ESOP loan. As mentioned previously, only corporations can adopt an ESOP.

A feasibility study should be done to confirm that a company is a good ESOP candidate. Generally, the feasibility study is performed by an outside consultant and includes:

• A preliminary valuation of the company to determine the approximate price the ESOP could or might pay to acquire the company’s stock. Generally, ESOP valuations must be performed by an independent appraiser, and the company’s value is determined in accordance with regulations adopted by the IRS and Department of Labor. The standard of value is fair market value, which takes into account adjustments for special ESOP-related issues, such as repurchase liability.
• An analysis of the effects of the proposed ESOP on the other shareholders and the financial statements of the company.
• An analysis of various plan designs and financing strategies.
• An analysis of the company’s liquidity to determine the company’s ability to repurchase the stock allocated to the accounts of ESOP participants on the participant’s retirement, death, or other termination of employment.

Even if a company is not a good ESOP candidate, the company may still benefit from having an ESOP if the ESOP acquires the stock in a non-leveraged transaction, or in a transaction that is seller financed.

**SHAREHOLDER TAX SAVINGS**

An ESOP is especially beneficial for shareholders of C corporations because it provides the selling shareholder an alternative to the “double taxation” that sometimes occurs when the business is sold to a strategic buyer. It also provides a shareholder with a way to defer (sometimes permanently) the gain on the sale of his or her stock to the ESOP.

**NO DOUBLE TAXATION FOR C CORPORATION SHAREHOLDERS.**

When a corporation is sold to a strategic buyer, the transaction can be structured either as a stock sale or an asset sale. However, strategic buyers often require that the transaction be structured as a sale of assets because they do not want to assume any unanticipated liabilities of the selling corporation. For shareholders of C corporations, this can be catastrophic because a sale of assets often can result in a “double tax,” with taxes being imposed at both the corporate and shareholder levels. However, an ESOP can buy stock only, so a sale to an ESOP must be structured as a stock sale. For this reason, many times, even if the price offered for the business by the ESOP is less than the price offered by the strategic buyer, it makes sense for shareholders to sell to the ESOP.

*Example:* Emily, Luke, and Abby own 100% of the stock of ELA Corp. which is taxed as a C corporation. Assuming they sell all of their shares for $30 million and their tax basis is zero, their taxable gain is $30 million. Further assume that the corporate tax rate is 40%, and the individual capital gains rate is 20%. In an asset sale by ELA Corp., ELA Corp. would pay tax of $12 million ($30 million × 40%) and Emily, Luke, and Abby would pay taxes of $3.6 million (($30 million − 12 million) × 20%), netting them $14.4 million. In a stock sale, ELA Corp. would pay no taxes and Emily, Luke, and Abby would pay $6 million in
taxes ($30 million × 20%), netting them $24 million. Emily, Luke, and Abby’s sale of stock to the ESOP would result in an additional $9.6 million in their pockets. This means that they could sell their stock to an ESOP at any price above $18 million and still have more money in their pockets (after taxes) than from a sale of assets for $30 million to a strategic buyer.

**DEFERRAL OF GAIN FOR C CORPORATION SHAREHOLDERS.**

The owner of a C corporation can defer capital gains on the sale of stock to an ESOP if certain technical requirements of Section 1042 are met and (1) after the sale, the ESOP owns 30% or more of the outstanding stock of the company, and (2) the seller reinvests the sales proceeds into “qualified replacement property” (QRP) during the period beginning three months prior to the sale and ending 12 months following the sale. QRP includes stocks, bonds, or other securities of operating companies incorporated in the U.S. It does not include government bonds, mutual funds, real estate investment trusts (REITs), or ownership through means other than a security, such as interests in a partnership or limited liability company.

If the QRP is sold before the death of the holder, a taxable event occurs. However, if the QRP is held until the holder’s death, and if a “step up in basis” is permitted under the estate tax laws at the time of the selling shareholder’s death, the selling shareholder and his or her estate may be able to permanently avoid paying taxes on the gain on the sale of stock to the ESOP. As a practical matter, because current capital gains taxes are relatively low, many selling shareholders have decided to pay the income taxes at current capital gains rates and not make the Section 1042 election to defer the taxes. It is expected that tax rates will increase in future years, so it is also likely that the elections under Section 1042 will increase.

Occasionally, the selling shareholders get tripped up by failing to comply with Section 1042’s technical requirements (especially the reporting requirements) and get hit with an unexpected tax liability. Another possible problem with a Section 1042 ESOP is a liquidity issue. To qualify for Section 1042, the selling shareholder must purchase QRP. However, if the selling shareholder takes back a note as part of the proceeds from the sale, the selling shareholder may not have the funds necessary to purchase the QRP. In this case, the selling shareholder may have to borrow funds or use other personal funds to acquire the QRP.

**Example:** Assume the same facts as in the example above. Instead of paying taxes on the $30 million gain on the sale of stock, Emily, Luke, and Abby each elect to defer the gain by timely making a Section 1042 election and purchasing QRP. As a result, Emily, Luke, and Abby would pay no income taxes currently (thereby saving $6 million in taxes) and if, at the time of their death, the estate tax rules permit a “step up in basis,” this $6 million in income taxes will be deferred permanently. If at some point they need a portion of the $30 million received on the sale, they can sell a portion of the QRP and pay taxes only on the portion sold.

**CORPORATE TAX SAVINGS**

In addition to shareholder tax savings, an ESOP can provide tax savings to the corporation. The most significant tax savings for corporations relate to (1) the deductibility of contributions to the ESOP used by the ESOP to purchase the shares of a selling shareholder; and (2) the fact that the ESOP pays no taxes on its share of the earnings of an S corporation.

**TAX DEDUCTION FOR CONTRIBUTIONS TO THE ESOP.**

Generally, an ESOP transaction is structured so that the corporation makes tax-deductible contributions to an ESOP, and the ESOP uses the contributions to make payments of principal and interest on the loan used to acquire stock from the selling shareholder. This means that, if the corporation’s income is taxed...
at 40%, the corporation will have tax savings equal to 40% of the costs of acquiring the selling shareholder's stock. Only a shareholder's sale of stock to an ESOP will provide a tax deduction to the company. A shareholder's sale of stock to a strategic buyer or a redemption of stock by the corporation does not generate any deductions for the corporation. This means that the cost of a corporation using an ESOP to acquire a selling shareholder's stock is significantly less than if the corporation redeems the selling shareholder's stock.

Example: Assuming a 40% corporate tax rate, if ELA Corp. redeems Luke's stock for $10 million, it will have no deduction for the amounts paid to redeem the stock. However, if ELA Corp. establishes an ESOP and makes contributions aggregating $10 million to the ESOP, which are used to purchase Luke's stock, the corporation will get a tax deduction for the $10 million in contributions, resulting in tax savings of $4 million to the corporation (or its shareholders, if an S corporation). The net after-tax cost of acquiring Luke's stock by using the ESOP is only $6 million, as opposed to $10 million if the stock is redeemed by the corporation.

**ESOP PAYS NO TAX ON ITS SHARE OF S CORPORATION INCOME.**

If the corporation is an S corporation, its income is “passed through” and taxed to its shareholders. If the S corporation is partly or wholly owned by an ESOP (which is a tax-exempt trust), the ESOP pays no income tax on the portion of the corporation's income that is allocated to the ESOP. This is a tremendously attractive benefit to the corporation. In fact, many times, a selling shareholder will sell his or her stock to the ESOP in two or three stages so that the company becomes 100% owned by the ESOP. Because of the tax savings, ESOP ownership can be a powerful tool that enables the company to increase its cash flow by more than 60%. This enables the ESOP to pay down its ESOP loan more quickly or makes funds available to fund repurchase obligations or acquire more stock.

Example: Assume ELA Corp. has elected to be taxed as an S corporation, it has formed an ESOP, and the ESOP has purchased Luke's stock. The ESOP now owns one-third of ELA Corp. Further assume that ELA Corp.'s earnings for the year (after ESOP contributions) are $3 million. The ESOP's share of ELA Corp.'s earnings is $1 million. The ESOP pays no tax on its share of ELA Corp.'s income. Assuming a 40% shareholder tax rate, there is a $400,000 per year tax saving for the ESOP.

**DEDUCTIBLE DIVIDENDS.**

Often, C corporations are restructured prior to adopting an ESOP so that the ESOP purchases and holds dividend-paying preferred stock. Dividends are then paid on the preferred stock. The C corporation will get a deduction for dividends (1) paid in cash to employees within 90 days after the close of the plan year, (2) used to pay the debt incurred to acquire the stock for the ESOP, or (3) voluntarily reinvested by the plan participant back to the ESOP for more stock. Use of tax-deductible dividends can be especially beneficial if the corporation's payroll is not sufficient to support the level of company contributions needed to make payments on the ESOP note.

Example: Assume ELA Corp. is a C corporation and its capital ownership has been restructured, converting Luke's one-third interest to preferred stock paying a 6% dividend. Further assume that the preferred stock has been purchased by the ESOP. ELA Corp. will receive a deduction both for contributions to the ESOP and dividends paid on the preferred stock owned by the ESOP and used by the ESOP to make payments on the ESOP note.

**TAX SAVINGS ILLUSTRATION**

The following assumptions are made concerning this illustration:

- Emily, Luke, and Abby each own one third of ELA Corp.
The fair market value of ELA Corp. is $30 million. ELA Corp. has elected to be taxed as an S corporation. ELA Corp.'s annual net income is $5 million, and it makes annual tax distributions to its shareholders in the amount of $2 million to cover taxes on income earned by ELA Corp.

Luke decides to sell a portion of his stock to an ESOP:

- **The transaction.** The sales price of $10 million, would be “seller financed” by Luke, with interest at 6% per annum for a period of six years. Annual payments of principal and interest would be $2 million, for total payments over the six-year period of approximately $12 million.
- **ELA Corp. will receive a tax deduction for contributions to the ESOP.** ELA Corp.'s annual taxable income of $5 million will be reduced by the amount of the annual contributions (principal and interest) to the ESOP ($2 million). This will result in a tax savings of $800,000 per year, and ELA Corp.'s annual tax distributions will be reduced by $800,000 (from $2 million to $1.2 million). Over the six-year payment period, the total tax savings will be $4.8 million ($800,000 per year times six years).
- **The ESOP will pay no taxes on its share of the company’s income.** The ESOP will own one-third of the stock of ELA Corp., and its share of income (after the deduction for the ESOP contribution) will be $1 million (1/3 × $3 million). Assuming a 40% tax rate, the annual tax savings are $400,000. Since the ESOP will receive $400,000 as its share of the tax distribution but will not have any tax liability, this amount can be used to accelerate its payments to Luke for the purchase of his stock or used to buy stock from Emily or Abby. Over the six-year period, the ESOP's tax savings ($400,000 per year) will be approximately $2.4 million. (Note, after the ESOP loan is paid and there are not any deductions for contributions to the ESOP, this annual tax savings increases to $667,000.)

Tax savings of $7.2 million will be achieved as a result of the transaction:

- $4.8 million of tax savings as a result of the deduction for ESOP contributions ($800,000 per year times six years).
- $2.4 million of tax savings because the ESOP pays no taxes on its share of the company earnings ($400,000 per year times six years).

If Luke sells his stock to the ESOP for $10 million (plus $2 million interest), the tax savings will benefit Emily and Abby as the remaining shareholders of ELA Corp. ELA Corp. has additional deductions of $12 million as contributions to the ESOP, of which Emily's and Abby's share (as shareholders of an S corporation) will be $4 million each, or (assuming a 40% tax rate) $1.6 million each in tax savings. These additional tax savings may help provide the additional funds needed by Emily and Abby. In addition, the ESOP will have funds that can be used to purchase a portion of Emily’s and Abby’s stock, if they so desire.

The stock purchase by the ESOP in this example was seller-financed, with interest computed at 6% per annum. There is a great deal of flexibility in structuring the type and terms of an ESOP transaction. The transaction might involve having an outside lender provide financing instead of the selling shareholder. It may also involve the selling shareholder receiving cash from the ESOP for his or her stock and loaning the company a portion of the cash received from the ESOP for the sale of the stock. The interest rate frequently is the subject of negotiations between the parties. It is often a function of the financial condition of the company, and the priority of the notes with respect to company creditors. It is not unusual to see notes structured in a way that yields an effective rate of return to the selling shareholder of 15% or more, especially if the notes are subordinated to other loans. Sometimes the notes are supplemented by warrants that give the note holder a chance to participate in future increases in value of the business. This can be a very attractive rate of return to a seller who is willing to finance a part or all of the sale of his or her stock.
In addition to the tax benefits discussed previously, there are many non-tax reasons for using an ESOP to provide liquidity for shareholders of a closely held corporation. A sale to an ESOP may:

- Provide financing sources and alternatives, not available to a third-party buyer, such as providing financing to a selling shareholder and using funds in other qualified plans of the company.
- Enable a shareholder to obtain top value for his or her stock. Many times the amount paid by the ESOP will provide the selling shareholder with a better after-tax return than the amount paid by a strategic buyer.
- Enable the shareholder to maintain control of the business following the sale. If the selling shareholder had control of the business before the sale, there are ways to continue control of the company following the sale of a portion or all of his or her stock.
- Maximize the shareholder's after-tax proceeds and provide him or her with unique estate planning and tax-saving opportunities. There are many estate planning tools that can be used in conjunction with an ESOP transaction to provide tax and estate planning opportunities to the selling shareholder.
- Provide more favorable terms and conditions of sale. Often, the terms and conditions (and the necessary warranties and representations) of a sale to an ESOP are less onerous than if the sale were to a strategic buyer.
- Allow easier negotiations, less due diligence and an earlier closing date. Because an ESOP is familiar with the business of the company, significantly less due diligence is required, and the closing can take place much sooner than would be possible if the sale was made to a strategic buyer.
- Reward employees for their loyalty and allow them to participate in the growth of the company. This is one of the most important non-tax benefits of an ESOP and often increases employee productivity and makes the company more profitable.

**CONCLUSION**

An ESOP is an incredible tool that may provide a closely held company with a market for its stock and facilitate the liquidity needs of its shareholders. The many tax and non-tax advantages of an ESOP and the flexibility to structure transactions to fit the needs of the company and the selling shareholder make an ESOP an attractive and effective device that should be considered seriously when analyzing the liquidity needs of a closely held corporation and its shareholders.

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1. A mezzanine lender provides financing which makes up the difference between available conventional financing and the purchase price. It is commonly structured as subordinated debt and may include equity kickers. The debt ranks behind senior debt but before equity in terms of creditor standing.

2. Section 401(a).


4. Section 409(e)(3).

5. Regs. 54.4975-11(c) and (d).


7. Section 404(a)(3).

8. Section 409(p).