The ABCs of ESOPs – How an ESOP Can Work for Your Company

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Agenda

1. ESOP Overview & Mechanics
2. Advantages & Disadvantages
3. Tax Benefits
4. Accounting Considerations

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What is an ESOP?

- ESOP is an Employee Stock Ownership Plan
- Defined contribution employee benefit plan
- Invests primarily in stock of employer
- Tax advantages for the selling shareholder and company

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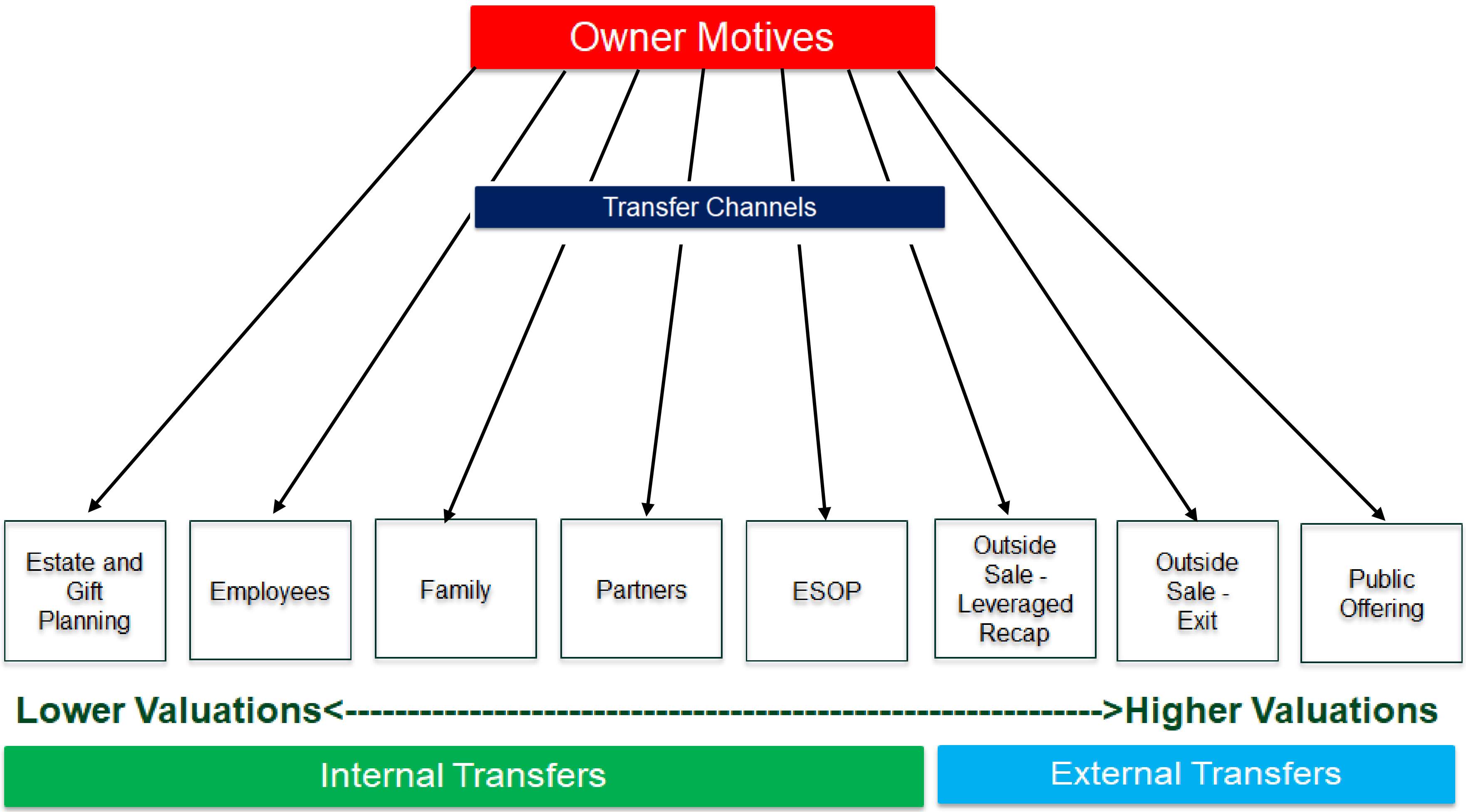
Business Transfer Spectrum



ESOP Landscape

- ESOP/Employee-Owned Company Metrics
  - Approximately 6,000 in the U.S.
  - Approximately 300 in PA
  - Approximately 60 – 70 in Southeastern PA
  - KM – currently serving approximately 30 companies
- ESOPs Growing in interest as a transition strategy
  - Age demographics
  - PEG “exhaustion and damage fear”
  - Many “exit planning experts” popping up

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ESOP Mechanics

Up Front Transaction

1. Company establishes an ESOP Trust
2. ESOP Trust purchases company stock from shareholders or company
3. Financing provided by bank or Bank or seller note

Ongoing Operation

1. Company pays contributions or dividends to ESOP
2. ESOP uses company contributions or dividends to repay debt
3. Company or ESOP repurchases shares from employees after separation of employment

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Typical ESOP Transaction Structures

C Corp

- One or more Section 1042 ESOP transactions to transfer most or all stock ownership to ESOP
- Common and Preferred stock typically part of structure
- Synthetic equity (stock appreciation rights or phantom stock) granted to key management to allow key executives to own eventually 15-30% of economic value of entity outside ESOP
- S Corporation ESOP election

S Corp

- S Corporation redemption of all of the stock held by current shareholders for cash and subordinated notes
- Common stock part of structure
- Synthetic equity (usually stock appreciation rights or phantom stock) granted to key management to allow key executives to own eventually 15-30% of economic value of entity outside ESOP
- Company uses S Corp tax-free operation to accelerate debt reduction

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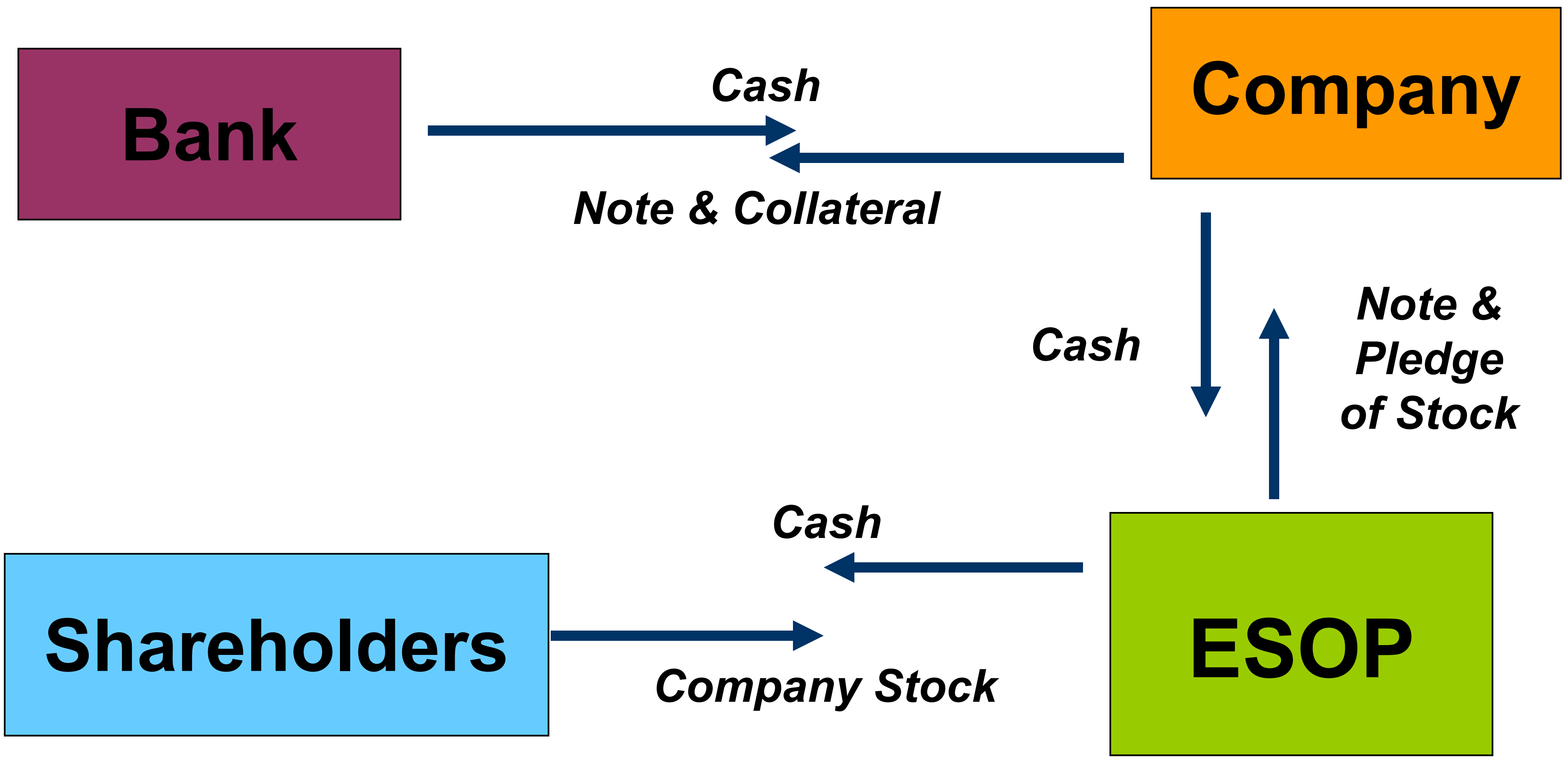
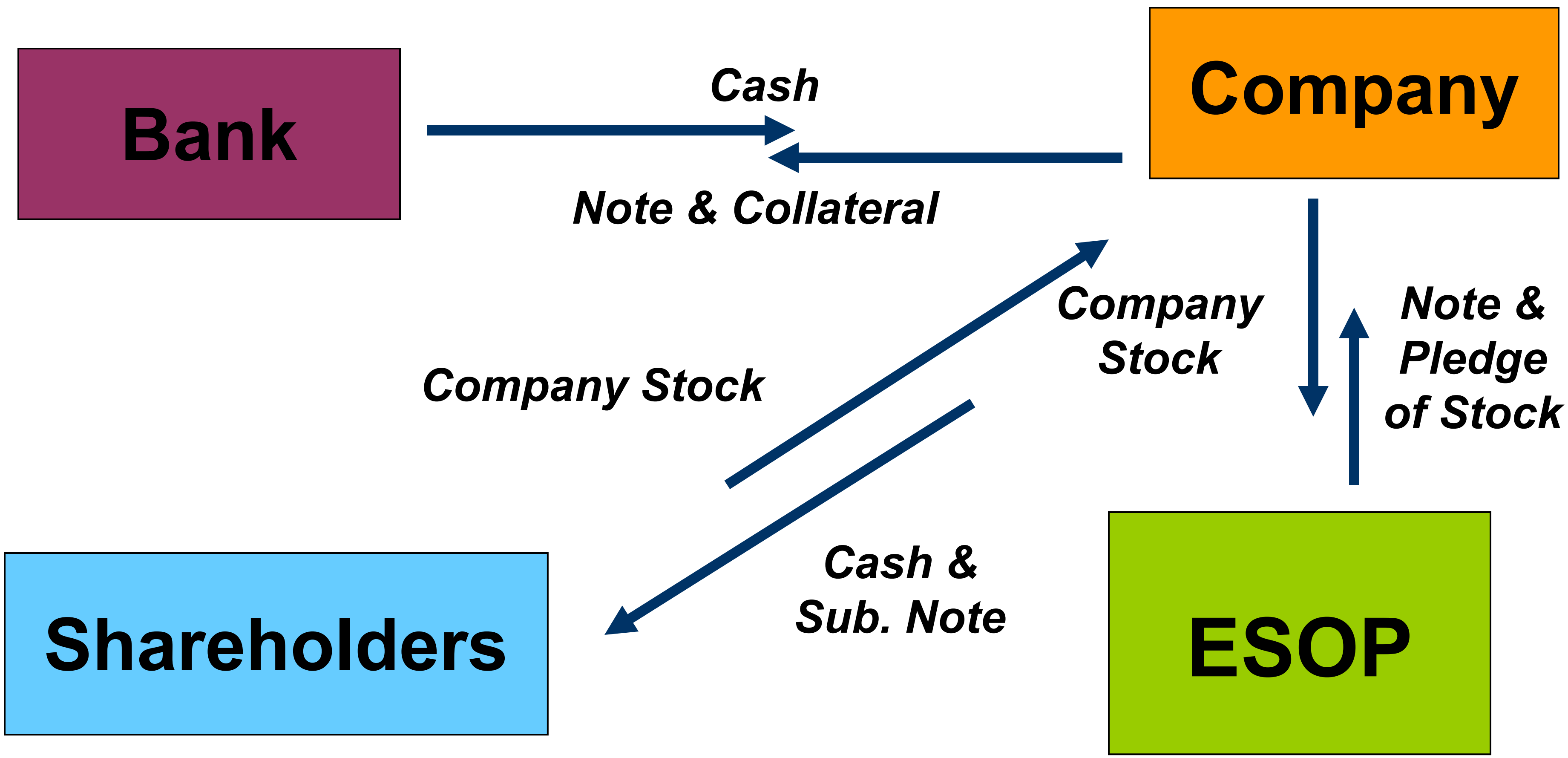
Initial C Corporation ESOP Transaction



Courtesy of Jim Steiker – SES Advisors

Initial S Corporation ESOP Transaction



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Advantages of an ESOP

Seller	Company	Employees
• Receive fair market value • Flexible exit strategy • Beneficial tax treatment • Preserve legacy of company	• Tax advantaged financing • Potential for income tax free entity • Potential to enhance employee morale, increase productivity and reduce turnover	• Non-contributory retirement account • Incentive for employees • Ability to impact value of company and therefore, value of accounts

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Disadvantages of an ESOP

Seller	Company	Employees
• Seller gets price closer to a financial buyer rather than a strategic buyer • Seller typically does not fully cash out • Requires active role in training employees to be owners	• Complexity • Financial leverage is usually high • Repurchase obligation • Highly regulated • Ongoing administration	• Non-diversified retirement plan risk • May not have 100% liquidity upon exit

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Benefits to the Company

- National Center for Employee Ownership ("NCEO") tracks benefits of ESOPS and published various findings:
  - Better corporate performance – ESOP companies grew 2.5% per year faster in sales, employment and productivity after their ESOP was setup vs. expectations pre-ESOP
  - Better pay and benefits – employee-owners earned 5-12% more then median wages compared to employees in similar non-ESOP companies, 2.5 times more in retirement savings and 20% more in financial assets overall
  - Longer business life and less likely to lay people off in a recession – ESOP companies were only have as likely as non-ESOP firms to go bankrupt or close
  - Provide greater opportunity for young workers – a recent survey that compared people age 28 to 35 with ESOP benefits to their peers without found that those ESOP employees enjoyed 92% higher median household wealth, 33% higher income from wages and 53% longer median job tenure.
- Company can increase cash flow due to tax-free status

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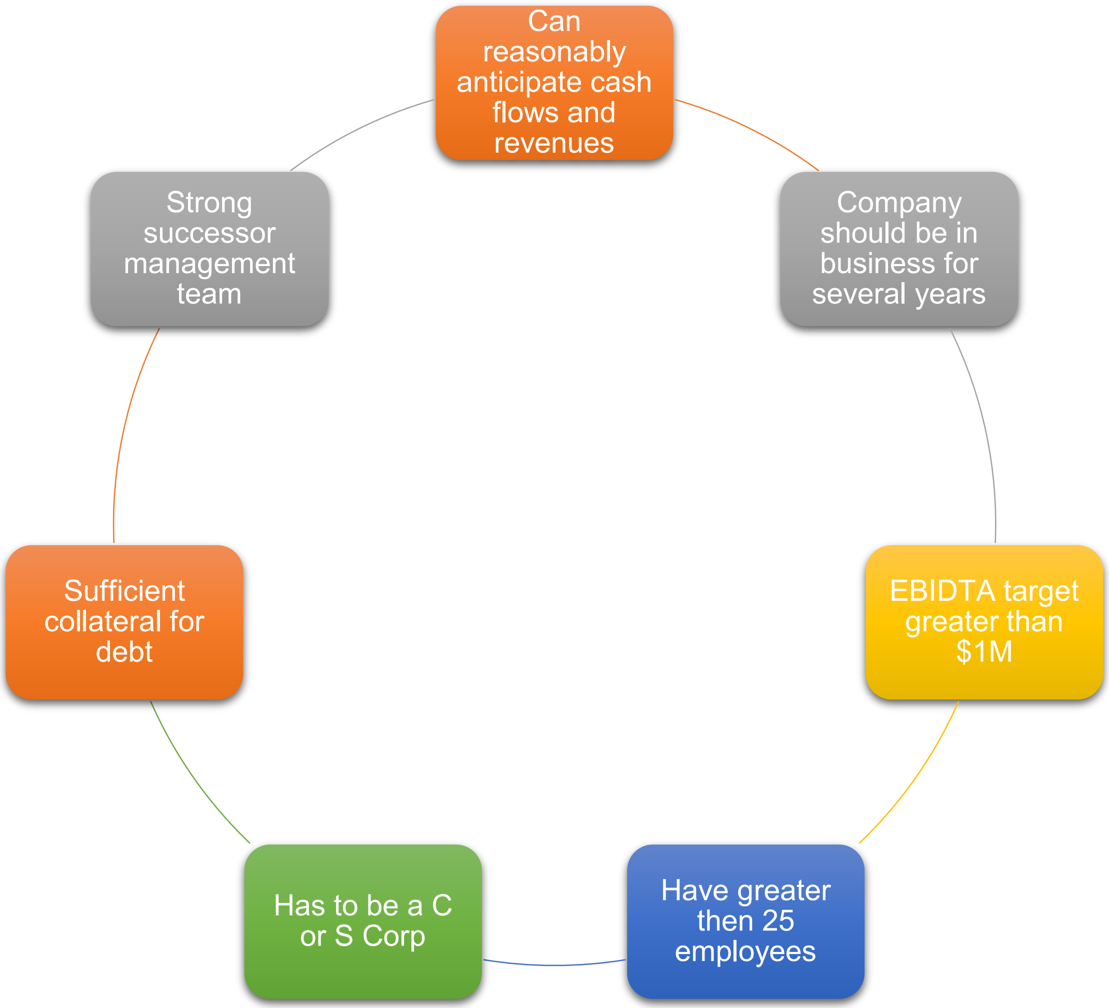
Is an ESOP a Good Fit for Your Company?



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Third Party Communications

- Typical advisors involved:
  - Accountants
  - Bankers
  - Valuators
  - External trustee
  - ESOP TPAs
  - Lawyers
  - Other advisors

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Third Party Communications

- Important for all parties to be working together to provide high service to the company
    - Proper tax planning
    - Proper share release
    - Communication of matters affecting the valuation
    - Bank deadlines
    - Bank covenants

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Initial Transaction Timeline

- Initial Transaction usually takes at least 6 months
  - Feasibility study
  - Financing
  - Valuation
  - Plan Design
  - Legal Documents
  - Closing
  - IRS Determination Letter

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Annual ESOP Timeline (Ongoing)

A Typical Annual ESOP Timeline

January / February	Company Audit Preparation Payroll Analysis
February / March	Financial Audit
March / April	Stock Valuation
May	Plan Accounting Completed Participant Statements Issued
June	Diversification and Distribution Notices
July	ESOP Audit Form 5500 Filing
August / September	Funding Analysis and Distributions
October / December	Consider Plan Amendments and Administrative Matters

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Tax Benefits

- S Corporations owned by an ESOP are tax-free for federal and most state tax purposes
- Selling shareholder may be able to defer their tax gain by purchasing qualified replacement property with the proceeds from the sale (could be permanent deferral)
- Step-up in cost basis to selling shareholders estate
- Deductibility of dividends paid
- Employees pay no tax on the contributions to the ESOP, only distributions from the ESOP

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Section 1042 – Benefits to Selling Shareholder

- Section 1042
  - Allows a selling shareholder a deferral of the capital gains tax on the sale of their stock to an ESOP if:
    - The Company is a C Corporation at the time of the sale; AND
    - The ESOP owns at least 30% of the Company's stock post-transaction; AND
    - The selling shareholders reinvest the proceeds in "Qualified Replacement Property" within 12 months
- What is Qualified Replacement Property ("QRP")?
  - Stocks and bonds of U.S. corporations, public or private, that derive no more than 25% of their gross income from passive sources
    - Floating rate notes
    - NOT mutual funds
    - NOT government bonds
- Opportunity for permanent tax deferral under current tax law

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Section 1042 – Example

- Sales price = $10,000,000
- Shareholder stock basis = $2,500,000
- Ignore state tax implications for simplicity

	Biden Tax Law	*Current Tax Law*	
	Sell to 3rd party	**Sell to 3rd party**	**Sell to ESOP w/ 1042 Election**
Sales Price	$ 10,000,000	$ 10,000,000	$ 10,000,000
Tax Basis	$ 2,500,000	$ 2,500,000	$ 2,500,000
Gain on sale	$ 7,500,000	$ 7,500,000	$ 7,500,000
Federal Tax Due	$ 2,385,000	$ 1,785,000	$ -
Net Proceeds Available	$ 7,615,000	$ 8,215,000	$ 10,000,000

*Assumes tax rate of:

- Biden tax law: 31.8% (25% capital gains + 3.8% NIIT + 3% Surcharge)
- Current tax law: 23.8% (20% capital gains + 3.8% NIIT)

** Pennsylvania does not currently recognize Section 1042

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Impact of Biden Tax Proposals

- Biden tax proposals make Section 1042 much more attractive. As tax rates increase so does the value of a tax deferral.
- Tax deferral may allow selling shareholder to unwind QRP in more favorable capital gain environment or in tranches.
- Charitable giving of qualified replacement property is more valuable.
- No current proposals to remove section 1042 deferral.

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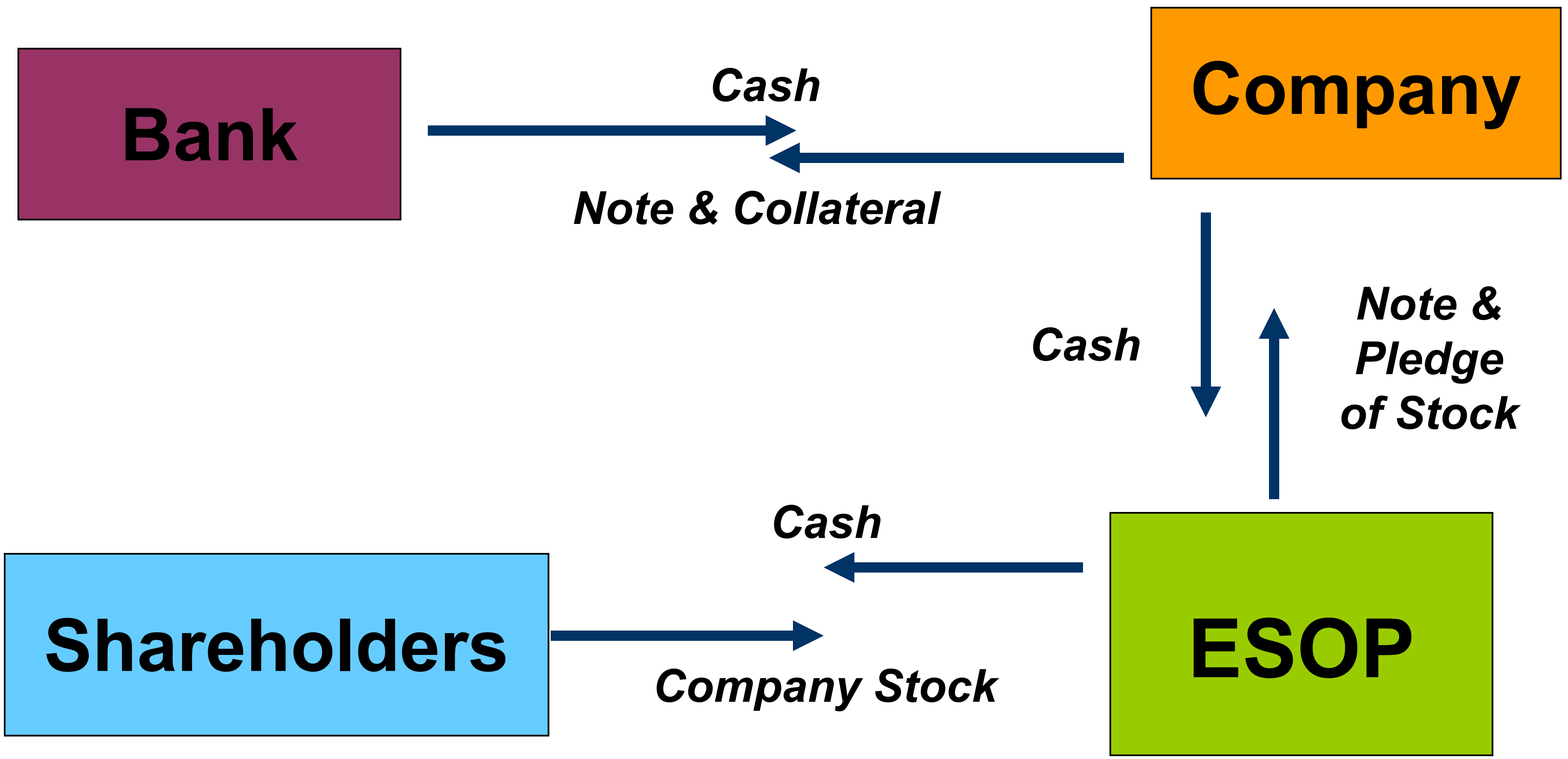
Structure Overview (Again)



Courtesy of Jim Steiker – SES Advisors

ESOP Balance Sheet Example

Assets	$	10,000,000	Liabilities	$	5,000,000
			ESOP debt, senior		2,000,000
			ESOP debt, subordinated		5,000,000
					12,000,000
			Equity		5,000,000
			Unearned ESOP shares		(7,000,000)
					(2,000,000)
Total	$	10,000,000	Total	$	10,000,000

Unadjusted Debt:Equity	(6.00)
Adjusted Debt:Equity	2.40

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Balance Sheet Impact

- ESOP Note Receivable:
  - Not reflected as an asset on the Balance Sheet
  - Included as a component of Stockholders' Equity
  - **May not actually equal the note balance**
  - Typically referred to as "Unearned ESOP Shares"
- Since it is not considered an asset under GAAP:
  - Interest is not recorded to the income statement
  - Cash received for interest is recorded directly to APIC

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Balance Sheet Impact

- ESOP Note Receivable:
  - Don’t think of the Unearned ESOP shares as the Note Receivable – instead think of it as treasury stock.
  - Accounting is similar to treasury stock:
    - Recorded at historical cost
    - Balance represents remaining restricted/unallocated shares at the initial transaction share price
    - Shares are released from “treasury” as the company contributes them to the ESOP

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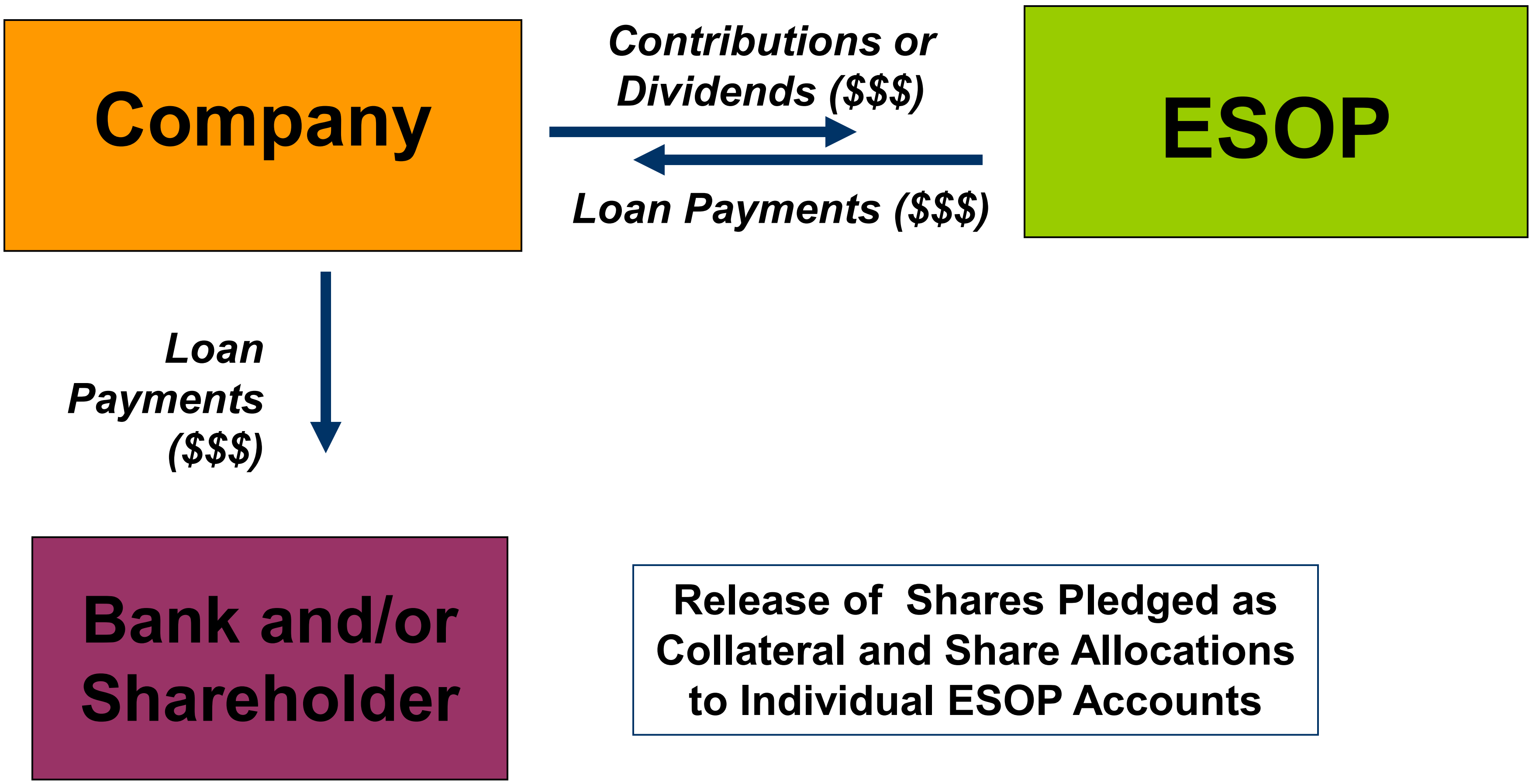
ESOP Loan Repayment



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Income Statement Impact

- ESOP Compensation Expense:
  - Shares released through inside loan – recorded at fair market value of the Company's stock
  - Dividends on unallocated shares – recorded in the income statement
  - Cash contributions – may be needed during leveraged stage to pay exiting participants
- Expense can vary significantly year over year

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3 Key Takeaways

- Is your company and owner a good fit?
- Tax advantages
- Ongoing operations and administration

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Questions

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Contact the Presenter

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Andrew provides a variety of practical tax strategies & services including tax compliance, tax planning and tax research for corporations, multi-state companies, partnerships, trusts and high-net-worth individuals. Andrew has a diversified range of experience providing tax services to a variety of real estate, distribution, manufacturing and professional services industries. He also is actively involved with the firm's Employee Stock Ownership Plan (ESOP) Group.

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Contact the Presenter

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Steve has a wide range of experience providing traditional audit and accounting services to a variety of businesses, including manufacturers, not-for-profits, distributors, and professional services organizations. Steve has also provided business advisory services such as accounting department assessments and due diligence services for his clients.

Steve serves on Kreischer Miller's Manufacturing Industry Group and Not-for-Profit Industry Group, and he is a member of the ESOP specialty area. As an ESOP specialist, Steve has presented at a number of industry events, including those sponsored by the ESOP Association and the National Center for Employee Ownership. He is also an instructor for several of Kreischer Miller's in-house professional training seminars and has delivered presentations on various accounting issues, focusing on ESOPs, inventory, and industry updates for manufacturing and not-for-profit clients.

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