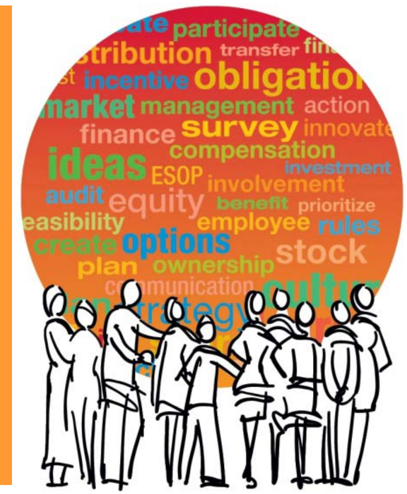
2009 NCEO/Beyster Institute Employee Ownership Conference

ESOPs in Business Succession and Estate Planning



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A Brief Recap of Ownership Transition (…or What got us to this point?)

Common Ownership Transition "Drivers"

- **Seller Desire: Many Owners Seek an Exit Strategy**
  - Retirement age may be looming…however it gets defined
  - Not all desire a quick exit, though

- **Family Protection: Is There a Need for Liquidity?**
  - How much of the business owner's wealth is tied up in the Company?

- **Management Succession: Are Capable People in Place?**
  - If not, exit strategy alternatives will be limited and may be unsatisfying
  - If there is a good group, what are their aspirations?
  - How can the company compete for talent?

Strategies for Total or Fractional Liquidity

External Sale Alternatives

- ***Sell The Entire Company***
  - *"Strategic" and "Financial" buyers*

Internal Sale Alternatives

- **Leveraged Recapitalization**
  - "LBO", "MBO", "Recap", "Stock Redemption"

And Today's Topic -

- **Employee Stock Ownership Plan**
  - Tax-favored MBO/LBO

These forms of transactions move ownership in very different ways

Business Succession Options

- Sale to Third Party
- Sale to Management
- Liquidation
- Strategic Merger
- Public Offering
- Transfer to Family
- Employee Stock Ownership Plan

Business Succession Options Analyzed

Sale to Third Party Analyzed:

Pros: Many financial buyers, relatively easy exit strategy

Cons: Potential business disruption, transaction costs, tax impact (capital gains tax)

Tax Analysis of Sale to Third Party:

Gross to Shareholders*	$30,000
Est. Federal Capital Gains Taxes	$ 4,500
Est. State Capital Gains Taxes**	$ 2,790
Net to Shareholders	$22,710

*$30,000 purchase price with $0 basis

**California Long Term Capital Gains Tax Rate of 9.3%

Business Succession Options Analyzed

Transfer to Family Analyzed:

Pros: Friendly transaction/minimal business disruption and potentially low transaction cost

Cons: Family must be willing and able to cooperate and manage business and must have cash to pay selling shareholder

Taxes: Gift taxes if transfer is gift during lifetime, estate taxes if transfer is gift after death, or capital gains taxes if transfer is a sale

Business Succession Options Analyzed

- **Sale to Management/Employees:**
  - Pros: Friendly/minimal business disruption, low job disruption, and potential gradual exit strategy
  - Cons: Management must have cash to buy and tax consequences (capital gains tax)

Tax Analysis of Sale to Management/Employees:

Gross to Shareholders*	$30,000
Est. Federal Capital Gains Taxes	$ 4,500
Est. State Capital Gains Taxes**	$ 2,790
Net to Shareholders	$22,710

*$30,000 purchase price with $0 basis

**California Long Term Capital Gains Tax Rate of 9.3%

Business Succession Options Analyzed

Sale to ESOP:

Pros:

Gradually turn over control, tax deductible acquisition debt, the ESOP will be a tax exempt entity, capital gains tax deferred in 1042 rollover

Cons:

Internal funding (company cash flow is crucial), company must be able to operate with broad based ownership, and increased business complexity (costs)

Tax Consequences of Sale to ESOP

	1042*	non 1042
Gross to Shareholders	$30,000	$30,000
Est. Federal Capital Gains Taxes	$ 0	$ 4,500
Est. State Capital Gains Taxes	$ 0	$ 2,790
Net to Shareholders	$30,000	$22,710

*If the selling corporation is a C corporation and at least 30% of the stock is sold to the ESOP, sellers may elect IRS Section 1042 treatment deferring capital gains tax.

For estate planning purposes, if the individual dies holding 1042 securities, the "stepped up" tax basis upon death will eliminate capital gains potential.

Other Benefits of ESOP Business Succession

- **ESOP Trust is separate from the company both legally and financially**
  - Files its own tax returns
  - Has its own tax ID number
- **Assets of the Trust are exempt from the claims of creditors of the company**
  - Are also not available for compromise by participants
- **Benefits are protected by ERISA**

Unique Aspects of ESOP Transactions

ESOP Transaction Basics

- **An ESOP is a Unique Combination of a "Leveraged Buyout" and an Employee Benefit Plan**
  - The can be basic or very complex transactions

- **Congress has Created Tax Incentives for:**
  - The selling shareholder – tax deferral ("Section 1042")
  - The sponsoring company – tax deductions
  - The employees – tax-deferred stock value

- **ESOPs Require the Appointment an ESOP Trustee**
  - As an advocate for the participants
  - Must review and approve the transaction
  - Trustees seek their own independent financial and legal advisors

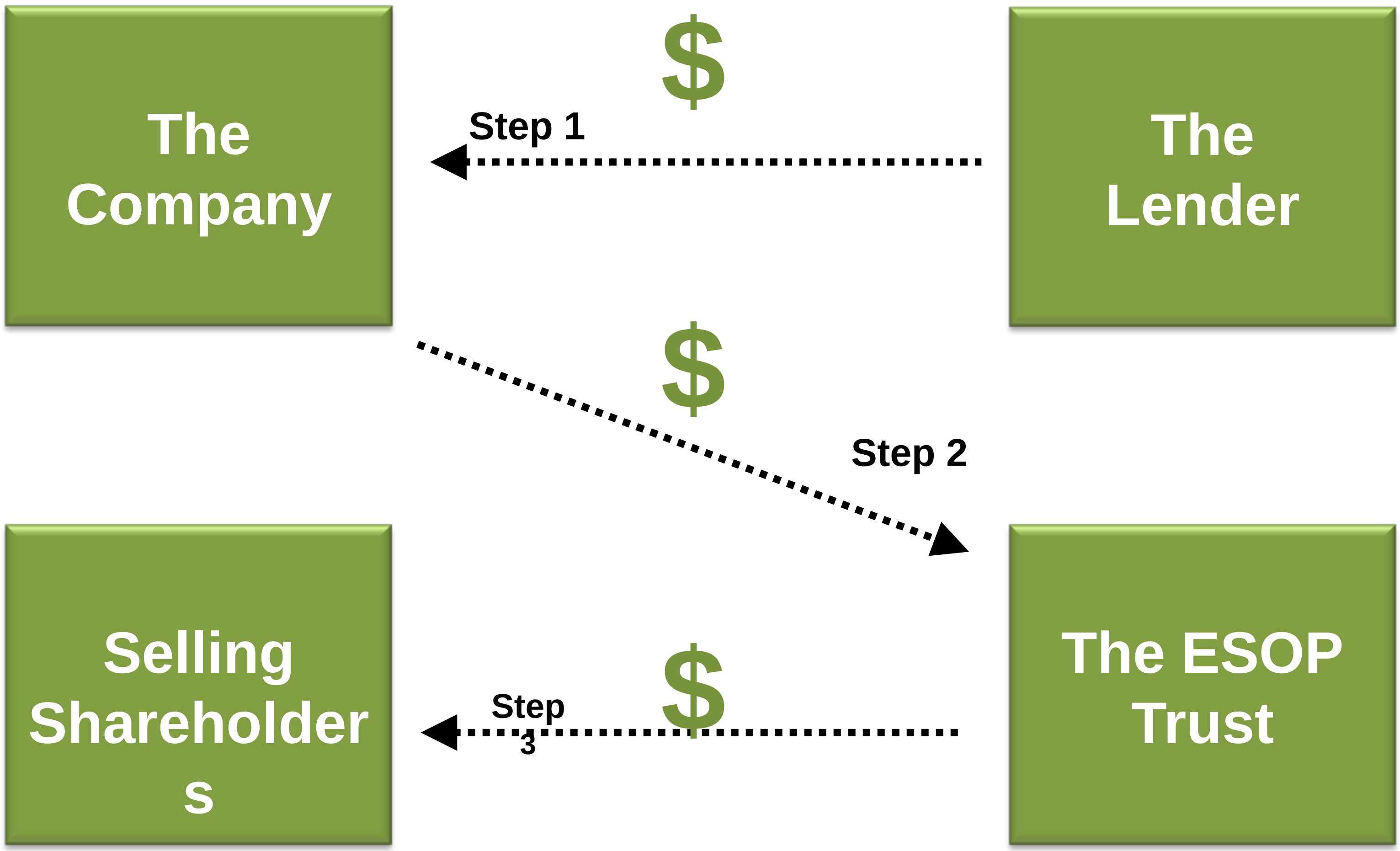
There Are a Few ESOP "Quirks"

- **ESOPs are Qualified Defined Contribution Plans With Assets Held in Trust**
  - Regulated by the IRS
  - And also regulated by the Department of Labor under ERISA
  - Why?: to monitor the fair treatment of participants

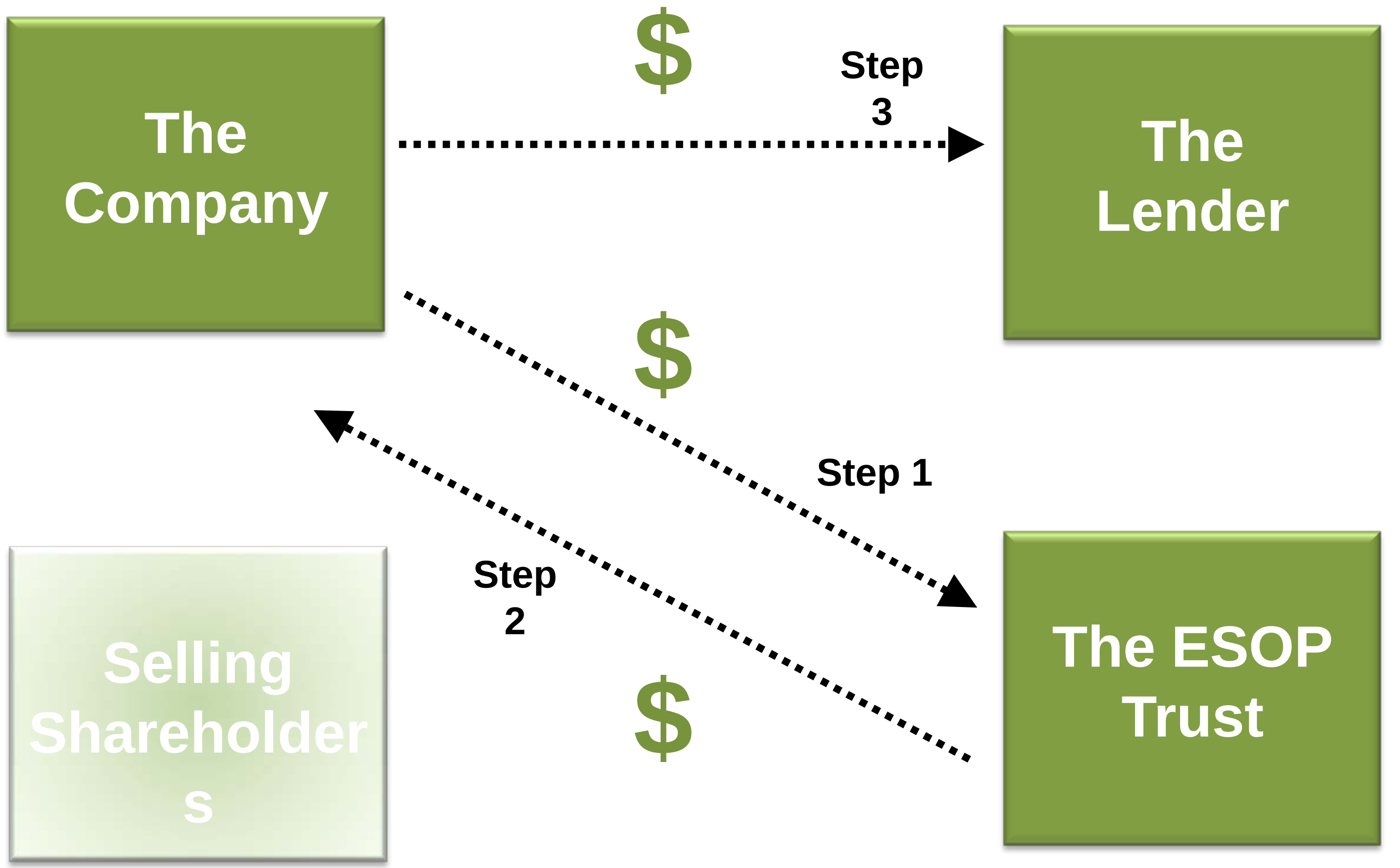
- **Regulations Allow a Lot of Structural Flexibility**
  - In meeting corporate ownership objectives and timing expectations
  - Knowledge of structural limits is critical in implementing an ESOP

- **The Company Must Provide Funding to Cash-Out Participants**
  - Referred to as "Repurchase Obligation"
  - This is an off-balance sheet item, but is required by law

How an ESOP Works
The Money in Motion… at Closing



How an ESOP Works
The Money in Motion… Over Time



Determining Value *in the ESOP World*

- **Valuation is at the core of all succession planning decisions…including ESOPs**
  - Value and value "trajectory" are both relevant

- **An ESOP trustee reviews initial transaction and sets the value annually**
  - Trustees can be a company employee or outsiders

- **Independent valuations in the ESOP world require specialization**
  - The basic valuation approaches are the same
  - But there are some unique issues that can impact value
  - Tax-deductibility of financing, the ESOP "Put" right, etc.0

Valuing Businesses *in General*

Businesses are usually valued using variants of two generalized approaches

- ***Looking INSIDE*** **- The Income approach**
  - Discounted cash flow modeling
  - Expected revenues, expenses, capital expenditures, etc.
  - Riskiness of the cash flows needs to be assessed
  - *Potential weakness: Are the projections reasonable?*

- ***Looking OUTSIDE*** **- The Market Approach**
  - Multiples are extracted from market data
  - Public companies or private transactions
  - Assess how our company stacks up
  - Adjust the multiples for comparability differences
  - *Potential weakness: Are the comparables truly comparable?*

Some *ESOP-Specific* Valuation Issues

- **Tax treatment of ESOP leverage**
  - Internal ESOP loan is typically funded by ESOP Contributions
  - Contributions are tax deductible
  - This creates an ESOP "tax shield"

- **ESOP stock marketability**
  - Statutory "Put" creates a better market than in most closely-held company settings
  - Enhanced marketability enhances value
  - The Discount for Lack of Marketability is typically lower
  - Prairie's view

- **The ESOP Repurchase Obligation**
  - An issue whose time has come

ESOP Tax Considerations

- **As an inducement to the business owner, Congress has created some interesting tax incentives**
  - Tax benefits to the company – Tax deductibility of the entire payment to service transaction debt
  - Tax benefits to the employees – A non-contributory, tax-deferred retirement account
  - Tax benefits to the selling shareholders – deferral of capital gain on sale to the ESOP Trust

- **If the transaction qualifies, a capital gain tax deferral is provided under section 1042 of the Internal Revenue Code.**
  - Shares sold must have been held by the seller for at least 3 years
  - The ESOP Trust must own at least 30 % of the stock of the company after the transaction
  - The company must be a C-Corporation at the time of the transaction

ESOP Tax Benefits to the Seller

- **Reinvestment ("Rollover") of proceeds of the sale**
  - Must fully be reinvested within 12 months after closing

- **Qualified Replacement Property ("QRP")**
  - ***Stocks*** and ***bonds*** of ***domestic operating corporations***
  - **Stocks and Bonds** – any equity or debt instrument (i.e. must be a security)
  - **Domestic –** Must be a U.S. controlled corporation (i.e. foreign controlled firms fail test)
  - **Operating** – Must not have too much passive income (i.e. REITS and mutual funds fail)
  - **Corporations -** Government entities fail, partnership interests fail, etc.

- **Tax Reporting Requirements**
  - Statement of consent, statement of election, statement of purchase

ESOP Financing: Where Does the Money Come From?

- **Most ESOP transactions are leveraged**
  - Externally though independent sources of financing
  - Internally using cash on the Company's books
  - Using seller financing
  - These can work independently or in combination

- **Financing categories**
  - Senior bank financing is the least expensive "slice"
    - Cash flow loans
    - Asset-based loans
  - Subordinated ("Mezzanine") debt can get quite expensive
  - Seller financing can be structured as either senior or subordinated

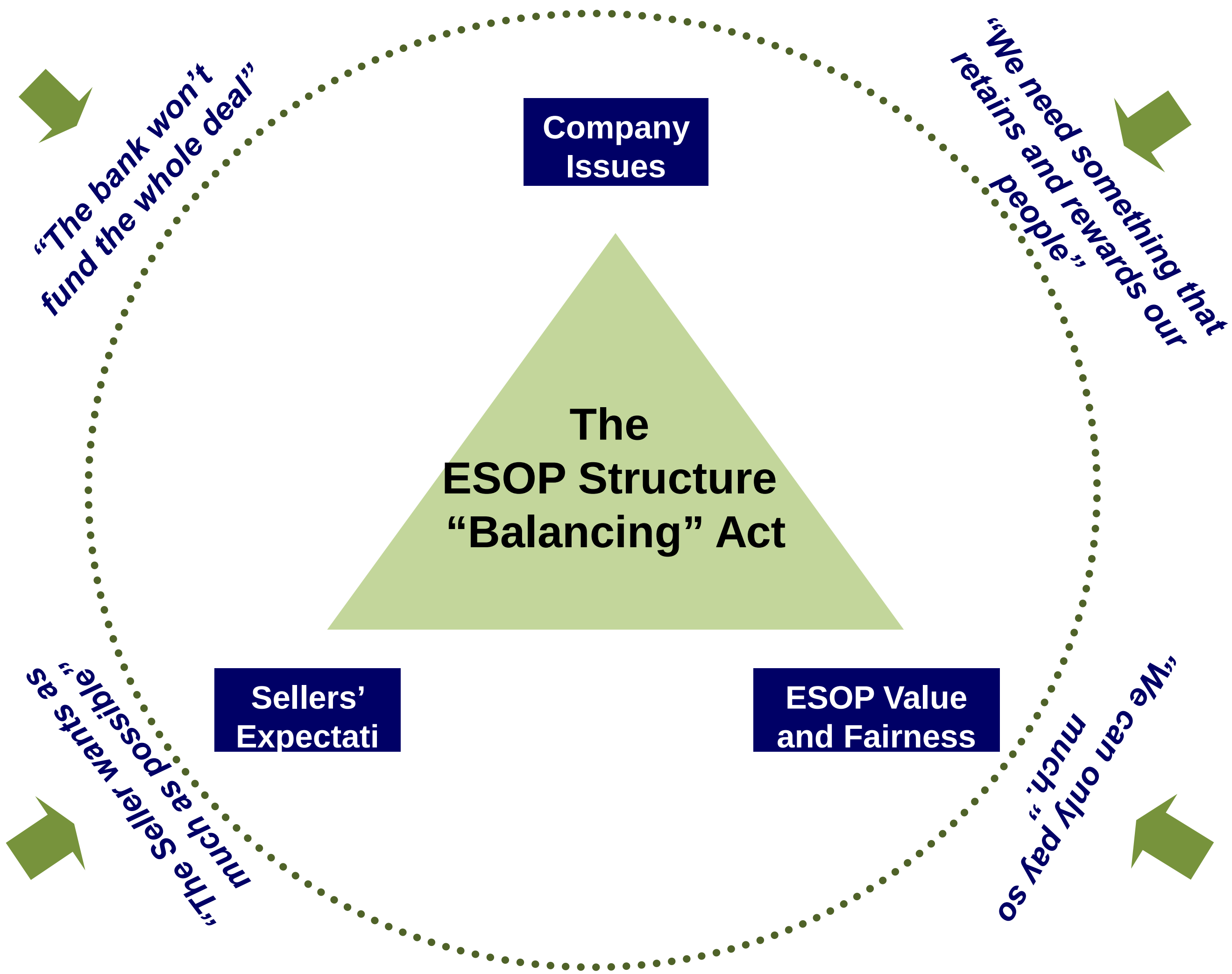
- **How much each category depends on the situation**

Financing a "Larger" ESOP Transaction

- **If the objective is to complete a large transaction, some questions come to mind:**

1. Is there a borrowing base shortfall that our bank won't fill?
2. Do the managers have any funds to fill the gap?
3. Are there benefit plan balances that can be used?
4. If we need high-yield capital (sub-debt, equity, etc.) what will it cost?
5. If we borrow enough to fund the entire deal, do we have sufficient capital reserves?
6. Is the seller willing to take back notes for all or a portion of the purchase?

Structuring an ESOP Transaction that "Works"



ESOPs in
Estate Planning

Estate Planning Challenges

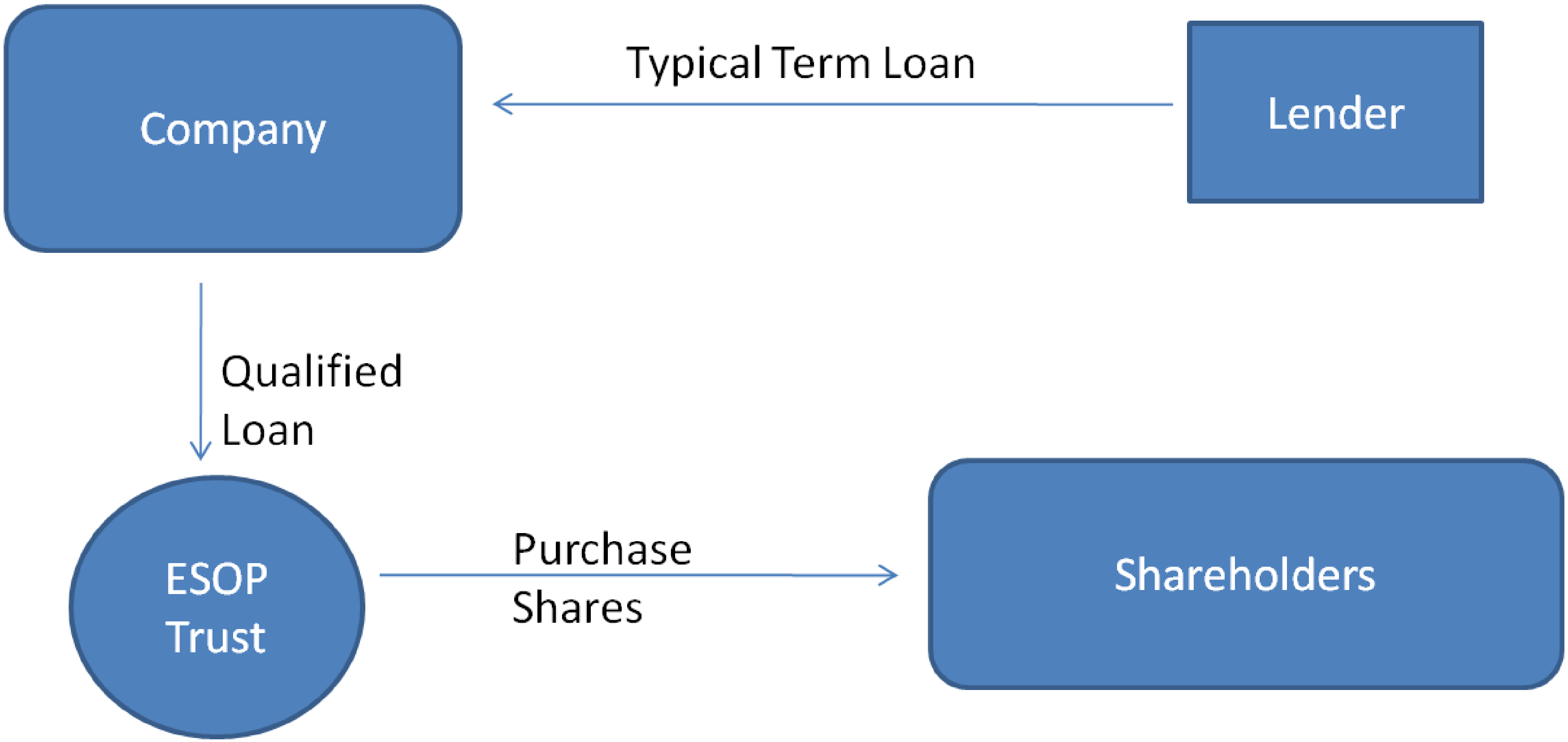
- The vast majority of the wealth in the United States is not in a liquid form
- Illiquid assets are often hard to value and hard to access
- Effective estate planning requires fair value liquidity
- Employee Stock Ownership Plans may be appropriate to solve these estate planning challenges

Estate Planning Goals

- **Self and Spouse –** Create an income stream for life after retirement and retire early enough to enjoy it
- **Children and heirs –** Provide income for heirs within the business and outside of it and minimize estate and gift tax
- **Business Continuation –** Provide business succession without risking the stability of the company
- **Employees –** Protect employees from an unplanned transition

Other Benefits of ESOP Business Succession

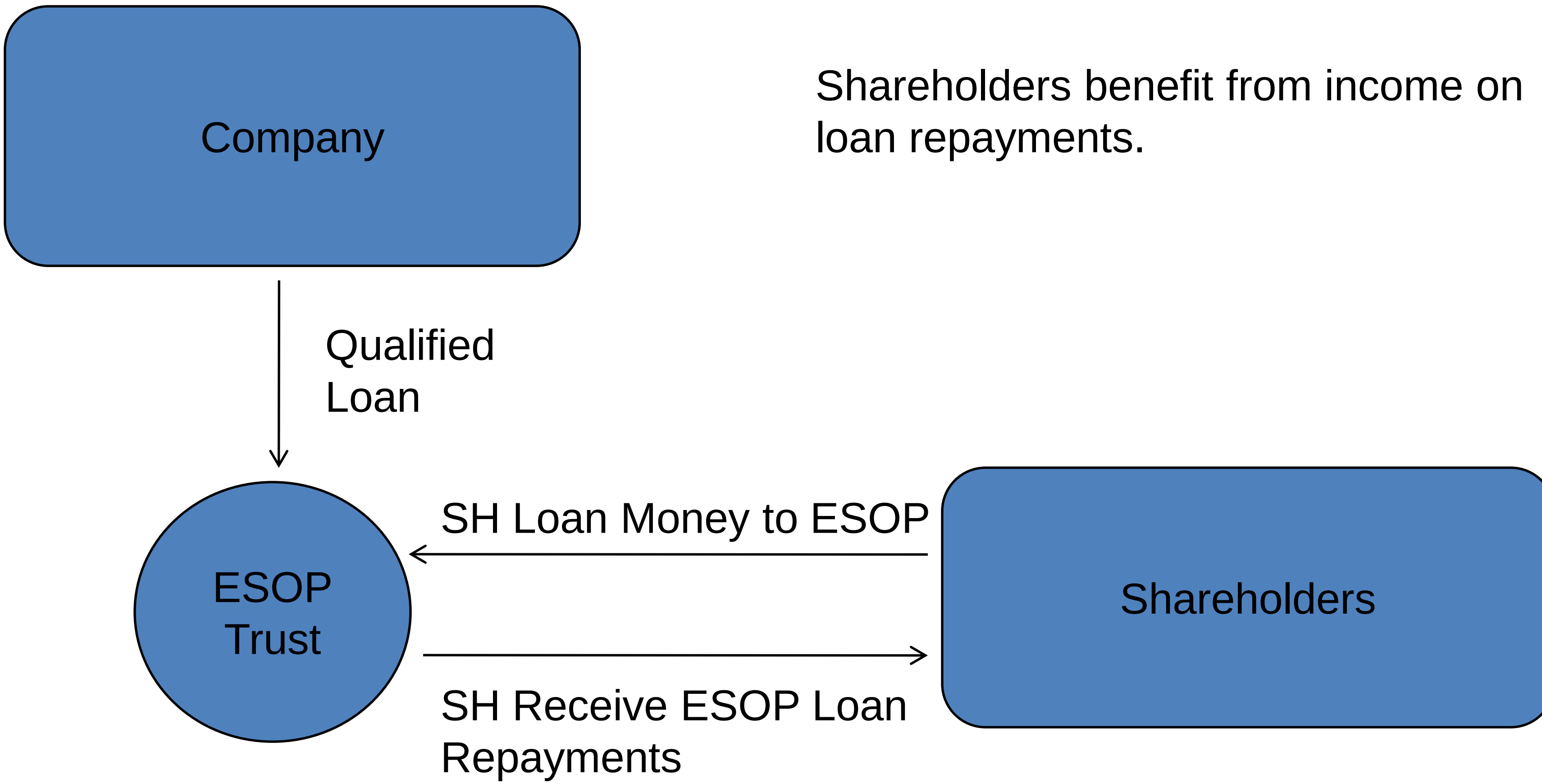
Leveraged ESOP financed by Lender



Other Benefits of ESOP Business Succession

Leveraged ESOP financed by Selling Shareholders

Shareholders benefit from income on loan repayments.



Leveraged ESOP Cont.

- Amortization is 100% pre-tax
- Contributions to the ESOP are fully tax deductible
- Loan payments are made by the ESOP to the Company using ESOP contributions to the company
- Flexibility in repayment of ESOP Loan
- Shares are added to Participant Accounts as the ESOP loan is repaid

Summary of ESOP Benefits

- **Tax-Free Stock Sale at independently determined fair market value (Section 1042)**

  - Selling shareholder may elect to reinvest proceeds and defer (or eliminate) capital gains tax on the transaction
  - Fully tax deductible financing (leveraged ESOP)
  - Significant Improvement in:
    - Employee morale and productivity
    - Retirement benefits
    - Company cash flow
  - Tax free corporate income (in the case of S-Corporation ESOP)

Challenges of Using ESOP in Estate Planning

- Family controlled corporations which have been in the family for several generations have expectations and motivations
- Family and management compensation may be too high
- Management conflicts amongst family members
- Difficult market conditions may value the business too low for stock sale
- Pre-ESOP compensation agreements for family members that survive the transition
- Balancing non-managerial family member interests with the ESOP and other family members
- Governing issues involving the Trustee and independent board members

Case Study –

Integrating and ESOP Into the Estate Plan

ESOP Estate Plan Case Study

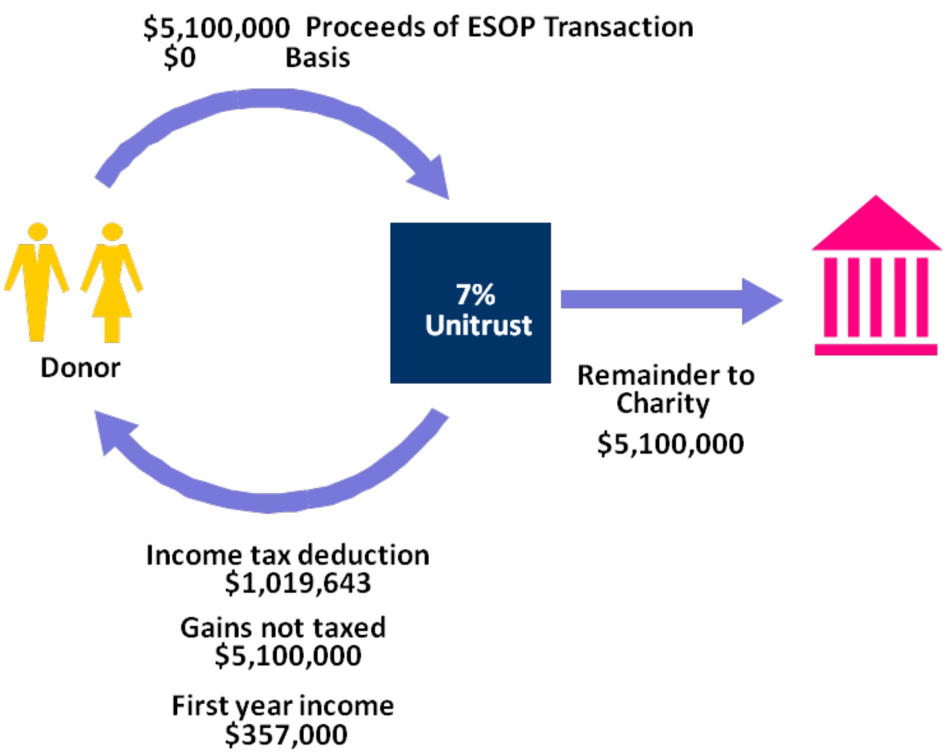
- Joe & Mary Jones, Owners of JMJ Inc. (C-Corp)
- Joe is 62 and Mary is 60
- JMJ Inc. (illiquid asset) is valued at $10,000,000
- They are looking to gradually phase out of the business and turn it over to their son, Joe Jr. (don't want to sell)
- They want to assure they have enough income to maintain their lifestyle; this requires $250,000 annually
- They have three grown children: two are professionals not involved in the business (Johnny and Suzie) and the third (Joe Jr.) works as the GM of JMJ Inc.
- There are five grandchildren and one will need lifelong care
- They want to be fair to all the kids and grandkids
- They are charitably inclined and want to leave a legacy
- So far, they have done very little planning

Case Study Cont.

- Implement an ESOP to buy 51% of JMJ using $5.1 million of tax advantaged debt
- This solves the liquidity issue and produces a better price
- Elect IRC Section 1042 and roll over proceeds into QRP, deferring capital gains tax on sale
- Use QRP to fund a Charitable Remainder Trust to meet the income needs of Joe and Mary
- Use the excess income generated by Charitable Trust and gift it into an Irrevocable Life Insurance Trust (ILIT); this will enable them to equalize their estate.
- Make one of the beneficiaries a Special Needs Trust to take care of the sick grandchild
- Set up a Family Limited Partnership to arrange for control of the remaining 49% of JMJ Inc. and facilitate a transfer to Joe Jr., either as a gift or sale

7% Charitable Remainder Unitrust

Prepared for: **Mr. and Mrs. Jones**



Benefits

Immediate

- save up to $407,587.
- $765,000.

Annual

- First year income of $357,000. Income will vary in future.
- Projected total income of $9,282,000 over 26 years.

Future

- Charity projected to receive $5,100,000 in 28 years.
- Reduced estate taxes and costs.

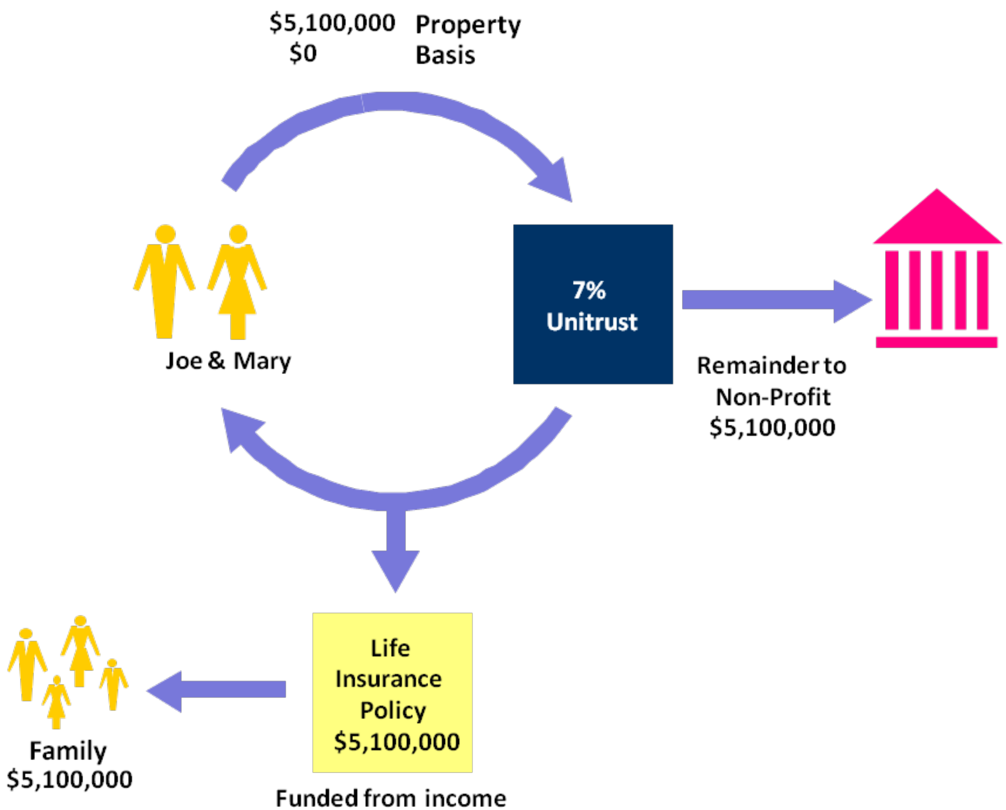
7% Charitable Remainder Unitrust, cont.

If they just gave all that money to charity, what about the kids?

Let’s add an Irrevocable Life Insurance Trust (ILIT) to the plan and see what that looks like.

7% Charitable Remainder Unitrust

Prepared for: **Mr. and Mrs. Jones**



Benefits

Immediate

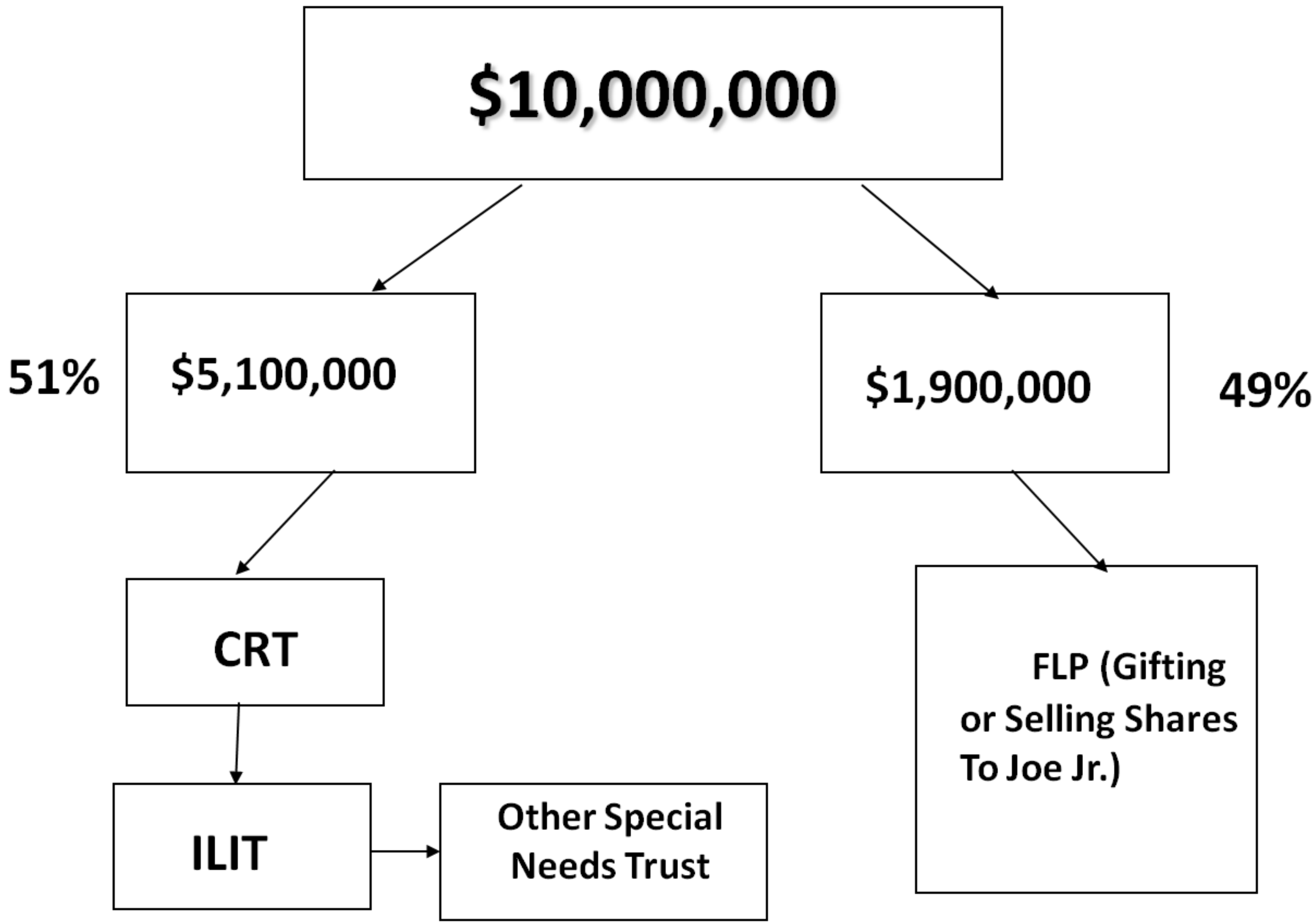
- Income tax deduction of $1,019,643 May save up to $407,857
- Pay no capital gains tax. May save up to $765,000.

Annual

- First year income of $357,000 Income will vary in future.
- Projected total income of $9,282,000 over 26 years.

Future

- Non-Profit projected to receive $5,100,000 in 26 years.
- Insurance proceeds pass to family tax free.


$10,000,000
51%
$5,100,000
$1,900,000
49%
CRT
ILIT
Other Special Needs Trust
FLP (Gifting or Selling Shares To Joe Jr.)

For Questions or Additional Information, Contact:

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Thank You!

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