ESOPS: THE BASICS

CREATING A MARKET FOR CLOSELY HELD STOCK AND THE TRANSITION TO EMPLOYEE OWNERSHIP

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CREATING A MARKET FOR CLOSELY HELD STOCK AND THE TRANSITION TO EMPLOYEE OWNERSHIP

KEY CONSIDERATIONS

1 What is an employee stock ownership plan (ESOP)?

2 Why should your company consider implementing an ESOP?

3 How can you determine whether or not your company would benefit from an ESOP?

4 Are there tax benefits to an ESOP?

5 If you are looking at employee ownership as a business model or an exit strategy for your company, you should be asking a lot of questions.

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ALVAREZ & MARSAL TAXAND HAS THE ANSWERS.

This booklet provides an overview of ESOPs, how they work, and why they can be of great assistance to your company – strategically, financially and culturally.

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THE ESOP, EMPLOYEE BENEFITS AND CORPORATE FINANCE

TOPICS INCLUDE:

- The Structure Of The ESOP
- The Ability to Leverage is Key
- Reasons to Form an ESOP
- Key Considerations in Forming an ESOP

Generally, an employee stock ownership plan (ESOP) is a tax qualified, defined contribution employee retirement plan. Its design allows employee investment in employer stock.

An ESOP is the only employee benefit plan that can borrow money based on the employer's credit to acquire assets – i.e., employer stock. This capacity, in conjunction with several tax incentives that are unique to ESOPs, makes this plan option an attractive technique of corporate finance.

The ESOP is subject to the general rules for tax qualified plans. These rules address eligibility, nondiscrimination, vesting and deduction limitations. The ESOP has all of the advantages and disadvantages common to retirement plans. Employees do not pay tax on the benefits they accrue under an ESOP until the benefits are actually paid to them, and the company maintaining the ESOP is entitled to a tax deduction when it makes contributions to the plan.

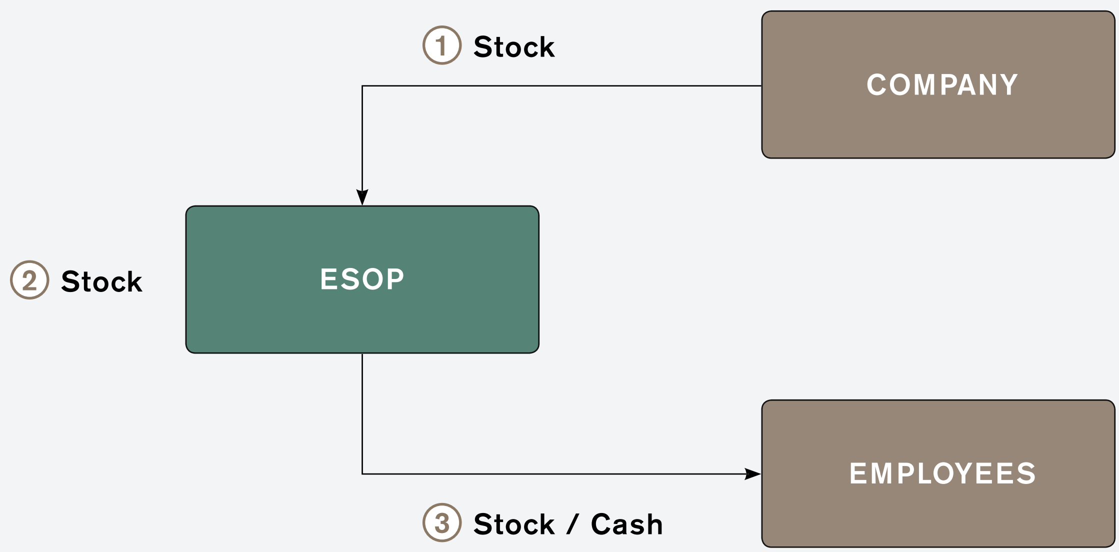
When benefits are distributed from an ESOP, other favorable tax rules may apply to participants. ESOPs must be designed and operated in a nondiscriminatory manner, which means that they must cover a relatively broad cross-section of an employer's workforce. Benefits cannot be skewed in favor of highly compensated employees.

Beyond the tax benefits to the company and the convenience of using the ESOP as a technique of corporate finance, the ESOP can be a significant means of motivating employees. When an employee owns a part of the company, he or she often takes a more active interest in how well the company performs. If contributions to the ESOP are significant, and an employee holds more than a nominal amount of shares in his or her account, the employee's outlook often becomes more like that of an owner. Much like incentive equity compensation granted to executives, which is intended to align the executive's interests with that of the shareholders, the ESOP encourages employees to adopt the commitment of ownership.

The Structure Of The ESOP

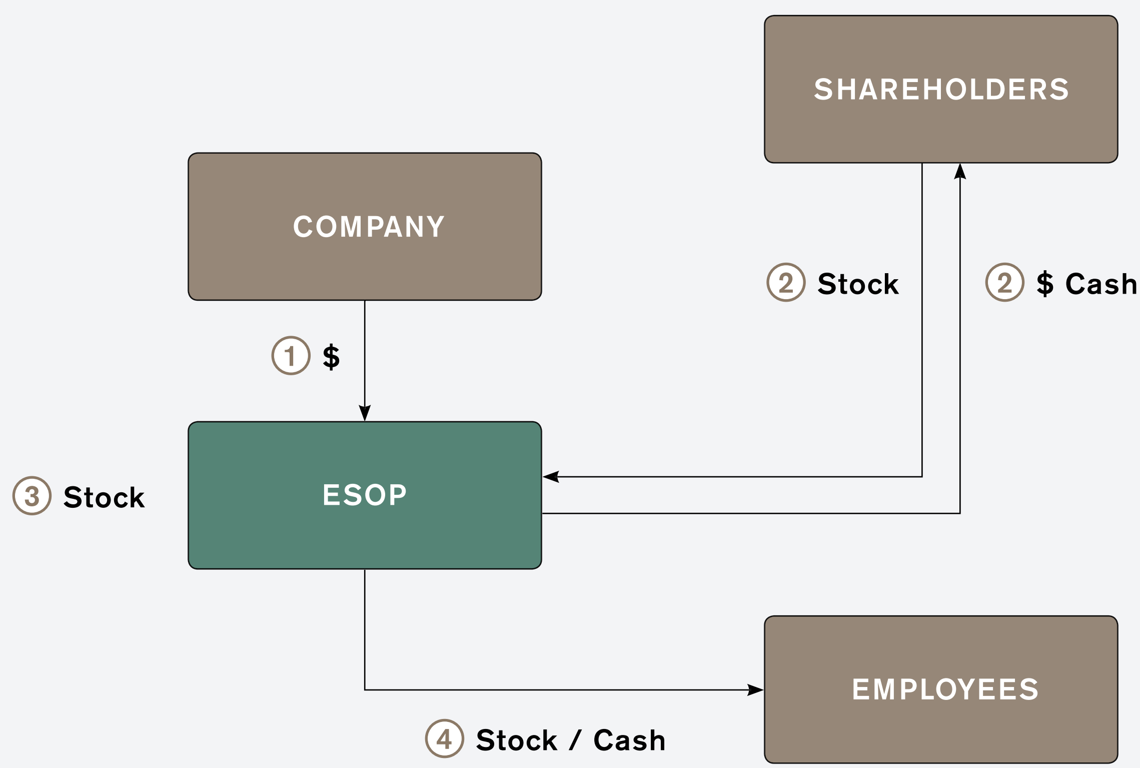
An ESOP may be structured as either leveraged or non-leveraged. In a non-leveraged ESOP, employer stock or cash is contributed to the ESOP by the employer. The leveraged ESOP uses a loan to acquire employer stock.

Non-Leveraged ESOP – Stock Contribution



1. Company contributes stock to the ESOP and receives a tax deduction equal to the fair market value of the stock contributed.
2. Contributed shares are allocated to the participants in the plan.
3. Upon retirement, employees receive a distribution of the stock held in their account or the cash equivalent.

Non-Leveraged ESOP – Cash Contribution

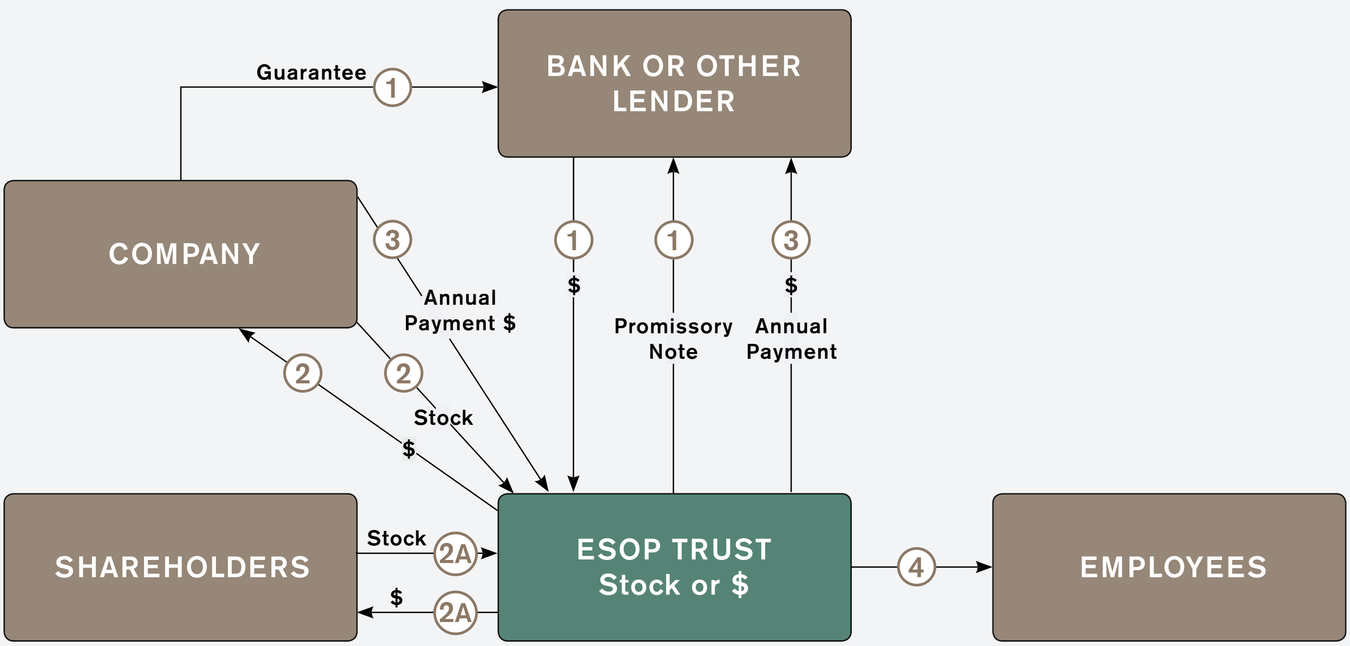


1. Company contributes cash to the ESOP and receives a tax deduction.
2. ESOP uses the cash to purchase shares from shareholders (or Company).
3. Shares are allocated to the plan participants.
4. Upon retirement, employees receive a distribution of the stock held in their account or the cash equivalent.

The Ability to Leverage is Key

In a leveraged ESOP, the ESOP borrows funds to acquire employer securities, often directly from the employer. The leveraged ESOP can be formed in one of two ways: 1) the ESOP borrows funds from the employer or a bank (with the employer's guarantee of payment) and uses the borrowed funds to purchase a block of employer stock from the employer, a shareholder, or the public, or 2) the employer borrows funds from a bank, the ESOP borrows funds from the employer, and the ESOP uses the loan proceeds to purchase employer stock from the employer, a shareholder, or the public. In either case, the ESOP loan is repaid with the employer's

Leveraged ESOP (direct loan)

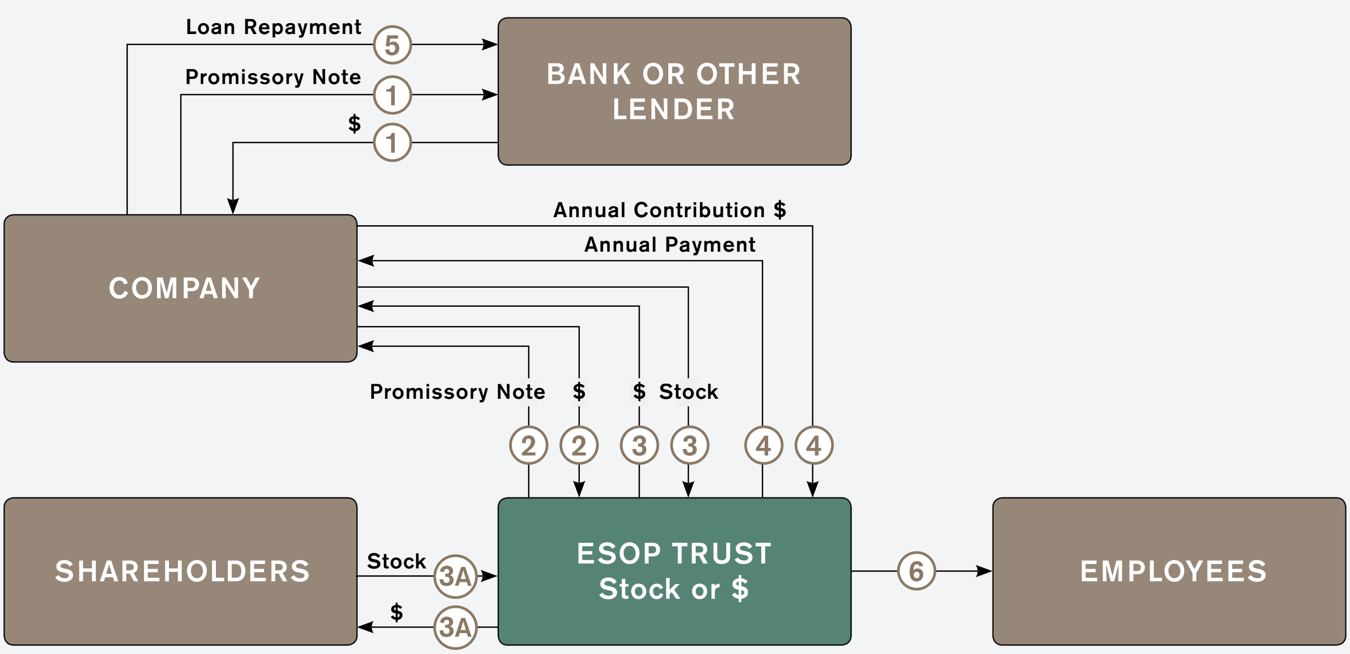


1. Bank lends money to ESOP, company guarantees loan repayment.
2. ESOP uses loan proceeds to buy stock from the employer and/or from existing shareholders.
3. Company makes annual tax deductible contributions to ESOP, which are used by the ESOP to repay the bank loan.
4. Employees receive distributions when they retire or leave the company.

deductible annual contributions to the ESOP. As the loan is repaid, shares of stock that were acquired with the proceeds of the loan are then allocated to the participants' ESOP accounts.

Alternatively, the employer may borrow funds from a bank and then loan the proceeds to the ESOP through a separate loan (i.e., a mirror loan). The ESOP will use the loan proceeds to purchase employer stock from the employer. The employer makes deductible contributions to the ESOP, which then uses the contributions to pay off the loan. These repayments to the employer, in turn, are used to pay off the employer's loan from the bank.

Leveraged ESOP (back-to-back loan)



1. Bank lends money to company.
2. Company lends money to ESOP (terms may be different than bank loan).
3. ESOP buys stock from company and/or from existing shareholders.
4. Company makes annual tax deductible contributions to ESOP and ESOP uses contributions to repay company.
5. Company repays bank.
6. Employees receive distributions when they retire or leave company.

Reasons to Form an ESOP

The U.S. Senate Finance Committee specifically identified the ESOP as a technique of corporate finance in its report on the Tax Reduction Act of 1975. The report states that leveraged ESOPs are designed: (1) to meet general financing requirements of the corporation, including capital growth and transfers in the ownership of corporate stock; (2) to build employees' beneficial ownership of stock of their employer or its affiliated corporations; and (3) to receive loans or other forms of credit to acquire stock of the employer corporation or its affiliated corporations, with such loans and credit secured primarily by a legally binding commitment from the employer, to make future payments to the trust in amounts sufficient to enable such loans to be repaid.

The U.S. Congress clearly recognizes the use of the leveraged ESOP as a corporate finance vehicle, with several advantageous results:

- Create a market for the stock of a closely held corporation
- Provide a source of capital
- Refinance outstanding debt
- Spin off a division
- Take a public company private
- Provide a source of financing for acquisitions
- Help defend against a corporate takeover

ESOPs have several advantages over traditional methods of debt financing:

- Principal and interest payments on the loan may be deductible as business expenses by the employer.
- Dividends paid on employer stock held by the ESOP may be deductible as business expenses by the employer.
- Shareholders may qualify for favorable tax treatment on gains from sales of employer stock to an ESOP.

Key Considerations in Forming an ESOP

- The price of the shares to be sold to the ESOP. When shares are not readily tradable on an established securities market, the purchase price must be determined by an independent appraisal.
- The number of shares that current shareholders are willing to sell to the plan.
- The administrative costs of implementing and maintaining the ESOP.
- The effect the ESOP will have on the employer's financial statements.
- The employer's ability to use the tax advantages associated with an ESOP.
- The employer's ability to obtain an ESOP loan in a leveraged ESOP.
- The employer's ability to service the debt on an ESOP loan.
- When employer stock is not readily tradable, the employer should forecast the potential "repurchase liability" and prepare a contingency plan that addresses how this future liability will be satisfied. Repurchase liability arises from the employees' right to require the employer to buy back employer securities that are not readily tradable on an established securities market at fair market value within a limited time after distribution.

II

IS YOUR COMPANY A GOOD CANDIDATE FOR AN ESOP?

While the ESOP holds some significant advantages over other types of qualified plans and other types of debt financing, you should not leap into an ESOP. There are a number of factors to consider; first and foremost is the size and financial health of your company.

Your company is a strong candidate for an ESOP if it:

- Is at least a medium-sized business (for small companies, the cost of setting up and operating the plan would probably more than offset any benefit from the plan, unless the ESOP is the only alternative for transfer of ownership purposes).
- Has been and will continue to be profitable.
- Can make full and immediate use of the unique tax benefits available through use of an ESOP.
- Can make shares available for sale to the ESOP.
- Is a domestic (U.S.) C corporation or an S corporation with a significant number of non-owner employees.

When using an ESOP as part of a leveraged buyout, the company should have consistent and adequate income streams, and operate in an industry that is stable and growing steadily.

III

LOANS AND PURCHASING SHARES IN AN ESOP

TOPICS INCLUDE:

- Avoid a Prohibited Transaction
- Exemptions to Prohibited Transaction Rules
- Understanding "Qualifying Employer Securities"
- Understanding Tax Incentives for Shareholders Who Sell Stock to the ESOP
- Disadvantages to Selling Shareholders

Avoid a Prohibited Transaction

The Internal Revenue Code ("Code") and the Employee Retirement Income Security Act of 1974 ("ERISA") set the rules for the ESOP prohibited transaction: *"The direct or indirect lending of money or extension of credit between a plan and a 'disqualified person' or a 'party-in-interest.'"*

An employer with employees covered by a plan is both a "disqualified person" under the Code and a "party-in-interest" under ERISA with respect to that plan.

A loan (or loan guarantee) from an employer to its plan is generally a prohibited transaction. Under the Code, disqualified persons who enter into prohibited transactions are subject to an excise tax. Under ERISA, a fiduciary of a plan, who causes the plan to engage in what he knows or should know to be a prohibited transaction, has committed a breach of fiduciary duty.

Exemptions to Prohibited Transaction Rules

There are seven requirements that, if satisfied, can help you to achieve exemption from the prohibited transaction rules.

First, the loan must primarily exist for the benefit of plan participants and beneficiaries under the following conditions:

- At the time the loan is made, the interest rate on the ESOP loan and the price of the employer stock to be acquired will not drain the plan's assets.
- The terms of the ESOP loan are at least as favorable to the ESOP as a comparable arm's length loan between independent parties.
- Within a reasonable time after receiving the loan proceeds, the ESOP uses the proceeds to acquire "qualifying employer securities," repay the loan, and/or repay a prior exempt loan.
- The loan is without recourse against the ESOP. The only assets the plan can give as collateral are (a) the employer securities acquired with the proceeds of the loan, and (b) the employer securities held by the ESOP as collateral on a prior exempt loan, which was repaid with the proceeds of the current loan. The lender cannot have any right to any assets of the plan other than the collateral pledged for the loan, cash contributions made to meet the plan's obligations under the loan, and earnings on such collateral and cash contributions.
- The ESOP's payments on the loan during a plan year do not exceed the sum of the cash contributions and earnings received during or before the current plan year, less the accumulated payments made in prior years.

Second, if the lender is a disqualified person, repayment cannot be accelerated upon default. Instead, the loan must provide for a transfer of plan assets only to the extent of the ESOP's failure to meet the payment schedule.

Third, the interest rate on the ESOP loan cannot exceed a reasonable rate.

Fourth, the ESOP loan must be a term loan as opposed to a demand loan.

Fifth, the ESOP plan must provide for the release from encumbrance of the assets (employer securities) used as collateral for the loan.

Sixth, if the ESOP holds stock of an S corporation, dividends can be used to repay the loan only to the extent that the dividends are paid on unallocated shares, or the loan will fail to satisfy the prohibited transaction exemption.

Finally, the ESOP loan must be made to a qualified plan that is an ESOP at the time of the loan. To be considered an ESOP, a qualified plan must meet the following conditions:

- The plan is formally designated as an ESOP in the plan documents.
- The plan is: (i) either a Code section 401(a) qualified stock bonus plan or qualified stock bonus and money purchase pension plan; and (ii) state that it is designed to invest primarily in qualifying employer securities.
- The plan grants (i) participants the right to demand employer securities on distribution; (ii) the right to require the employer to repurchase securities that are not readily tradable; (iii) the timing of distributions; (iv) the allocation of securities received in certain tax-deferred sales under Code section 1042; and (v) the pass through of voting rights in the case of registration-type employer securities.
- The plan does not obligate itself to acquire employer securities from a particular shareholder at an indefinite point in time in the future based on the occurrence of an event such as the holder's death. The plan cannot be bound by a buy-sell agreement.
- The plan formula for allocation of benefits (shares) is not integrated with Social Security (This is also known as *permitted disparity*.)
- All assets (*i.e.*, employer securities) that the plan acquires with the proceeds of an exempt loan are maintained in a suspense account to be allocated and withdrawn only in accordance with certain rules.
- At the end of each plan year, shares released from the suspense account are allocated to participants' accounts.

Understanding "Qualifying Employer Securities"

Qualifying employer securities generally refers to common stock issued by the employer – or by a corporation that is a member of the same controlled group – traded on an established securities market. If there is no readily tradable common stock, qualified employer securities refers to common stock issued by the employer – or by a corporation that is a member of the same controlled group – that has a combination of voting power and dividend rights at least equal to those classes of common stock of the employer or group member with the greatest voting power and the greatest dividend rights.

Non-callable preferred stock is treated as qualifying employer securities if *at all times* it is convertible into common stock of the employer that satisfies the definition of qualifying employer securities, and if the conversion price is reasonable.

In determining the members of a controlled group, special rules apply in cases in which the common parent owns 50 percent or 100 percent of the voting power of the non-voting stock of a first-tier subsidiary.

Understanding Tax Incentives for Shareholders Who Sell Stock to the ESOP

A taxpayer who sells "qualified securities" to an ESOP can elect, in certain cases, to defer the part of the gain that would have been long-term capital gain to the extent that the taxpayer reinvests the proceeds in "qualified replacement property" during the "replacement period." This is a significant tax incentive for shareholders to sell employer stock to an ESOP. The requirements for tax deferral include:

- Immediately after the sale, the ESOP must own at least 30 percent of each class of the corporation's outstanding stock, or at least 30 percent of the total value of all the corporation's outstanding stock.

  The outstanding stock does not include preferred stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights that do not exceed the stock's issue price (except for a reasonable redemption or liquidation premium), and is not convertible into another class of stock.
- The selling shareholder must have held the shares for at least three (3) years.
- The shares sold by the shareholder must consist of qualified securities. This means:
  - The shares must be "employer securities" under Code section 409(1);
  - The shares must be issued by a domestic corporation that has no outstanding stock readily tradable on an established securities market; and
  - The selling shareholder must not have received the shares in a distribution from a qualified plan or as a result of exercising a stock option.
- The selling shareholder must replace the shares sold to the ESOP with qualified replacement property. The replacement property must consist of securities of a domestic "operating" corporation whose passive income for the taxable year preceding the replacement year did not exceed 25 percent of its gross receipts for that year. Stock issued by banks, certain financial institutions and insurance companies may also be used as qualified replacement property.
- The replacement property cannot consist of securities of the same corporation that issued the securities being replaced, or of any member of that corporation's controlled group. In applying the rules relating to qualified replacement property, the corporation issuing the replacement property and any other corporations that the issuing company controls, or is controlled by, are treated as a single corporation.

- The selling shareholder must buy the qualified replacement property during the 15-month period beginning three (3) months before the date of the sale to the ESOP and ending 12 months after the date of that sale.
- The selling shareholder must specifically elect to have the tax deferral rules apply. This election must be made no later than the due date (including extensions) of the shareholder's tax return for the year in which the sale occurs.
- The shareholder also must file with the IRS a certified written statement in which the employer consents to be liable for: (1) any excise tax under Code section 4978, should there be an early disposition of shares the ESOP acquired in the tax-deferred sale; and (2) the excise tax under Code section 4979A, should there be a "prohibited allocation" of shares the ESOP acquired in the tax-deferred sale.
- The IRS has ruled that a Code section 1042 election to defer gain on a sale of employer stock to an ESOP must be made with respect to the entire amount realized on the sale, even if the gain is reported under the installment method.
- The selling shareholder cannot be a C corporation

Disadvantages to Selling Shareholders

A disadvantage to a selling shareholder in an ESOP non-recognition transaction is that neither he nor any of his family members (brothers, sisters, spouse, parents, etc.) or any other person who directly or indirectly owns more than 25 percent of the company stock may participate in the ESOP. The lineal descendants (children, grandchildren) of a selling shareholder electing non-recognition treatment may participate only to the extent that the aggregate shares allocated to all such descendants does not exceed five (5) percent of the total number of shares originally acquired by the ESOP. Since the company may contribute up to 25 percent of eligible compensation to the plan on an annual basis, plus interest and dividends on ESOP stock, the selling shareholders who elect non-recognition treatment may have to forego a significant annual contribution that they may otherwise have been eligible to receive.

Code Section 4978 Excise Tax on Early Dispositions. An excise tax is imposed on the employer if the ESOP disposes of any qualified securities within three (3) years after the date on which it acquired qualified securities in a tax-deferred sale, and either the total number of shares the ESOP holds after the disposition is less than the total number it held immediately after the tax-deferred sale, or the value of the qualified securities the ESOP holds after the disposition is less than 30 percent of the total value of all employer securities at the time of disposition. The excise tax is equal to 10 percent of the amount realized on the disposition.

The excise tax does not apply with respect to any distribution or sale of securities made by reason of an employee's death, retirement after age 59½, disability, or separation from service resulting in a one-year break in service; in the case of an exchange of stock in a corporate reorganization under Code section 368(a)(1); or in the case of a distribution made to meet the ESOP diversification requirements under Code section 401(a)(28).

Code Section 4979A Excise Tax on Prohibited Allocations. A different excise tax is imposed on the employer if the ESOP makes a prohibited allocation of qualified employer securities. The tax is equal to 50 percent of the amount involved. Prohibited allocations include allocations of qualified employer securities acquired in a tax-deferred sale to certain persons in violation of the restrictions of Code section 409(n), and any benefits accruing to any person in violation of Code section 409(n).

Basis in Qualified Replacement Property. The selling shareholder's basis in qualified replacement property is reduced by the amount of any unrecognized gain. Disposition of the qualified replacement property may trigger recapture (and taxation) of the unrecognized gain.

IV

CONTRIBUTIONS AND ALLOCATIONS IN AN ESOP

TOPICS INCLUDE:

- The Suspense Account
- The Allocation to Participants' Accounts
- The Limits on Annual Additions
- Special Allocation Rules for S Corporations
- Employer Deduction
- Discrimination, Coverage, Integration and Anti-Cutback

To understand how ESOP mechanics work, it is important to first understand the difference between a contribution and an allocation.

A contribution occurs when the employer puts cash or stock into the plan. The stock (or cash) is then held by the plan for the benefit of the participants in what is called a suspense account.

An allocation occurs when specific amounts are credited to the accounts of specific participants. Cash or stock is allocated to each participant's account based on a specified formula. When this occurs, shares (or cash) are released from the suspense account and moved over to the accounts of the participants.

The Suspense Account

When an ESOP acquires any qualified employer securities with an exempt loan, the plan must credit the acquisition to a suspense account and maintain it there. For each plan year for the duration of the loan, the ESOP generally must allocate from the suspense account (i.e., release from encumbrance) the number of securities (or shares) determined under this formula.

$$\text{Total Number (Shares) of Encumbered Securities} \times \frac{\text{Principal and Interest Paid for the Year}}{\text{Principal and Interest Paid for the Year and For Future Years}}$$

It is also possible to determine the number of securities the ESOP must release from encumbrance solely on the basis of the amount of exempt loan principal repaid, as opposed to principal and interest, subject to three additional rules:

1. The ESOP loan must provide for annual payments of principal and interest at a cumulative rate that is no lower than level annual payments over 10 years.
2. The interest portion of any ESOP loan payment is disregarded only to the extent it would be considered interest under standard loan amortization tables.
3. The ESOP cannot use this exception to the extent that, due to a renewal, extension, or refinancing, the sum of the expired duration of the loan, the renewal period, the extension period, and the duration of a new exempt ESOP loan exceeds 10 years.

The IRS closely scrutinizes any ESOP that releases encumbered securities in varying amounts, particularly those that provide for deferred or balloon ESOP loan payments. This may indicate the employer's failure to make substantial and recurring contributions to the ESOP.

The Allocation to Participants' Accounts

As with contributions to a profit-sharing plan or a stock bonus plan, contributions to an ESOP must be allocated among the plan participants using a definite, predetermined, non-discriminatory formula.

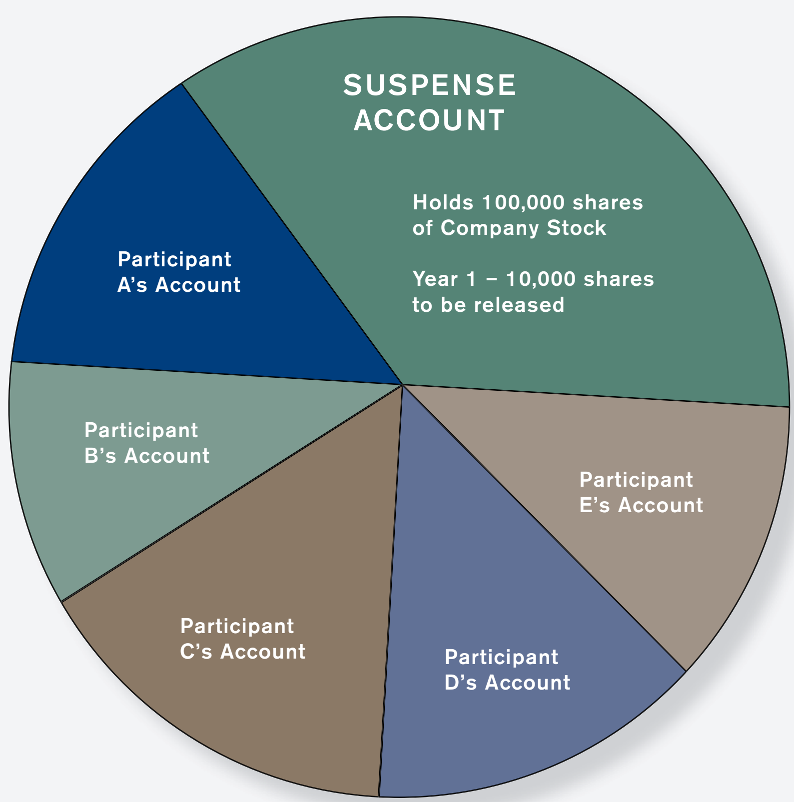
At the end of each plan year, the ESOP must consistently allocate to the participants' accounts non-monetary units representing their interests in assets withdrawn from the suspense account (i.e., shares of employer stock).

Income from securities held in the suspense account must be allocated as income of the plan, unless the ESOP provides that the interest is to be used to repay the loan.

Forfeitures. When a portion of a participant's account is forfeited, qualifying employer securities that were allocated from the suspense account must be forfeited only after all other assets in the participant's account have been forfeited. If the participant's account has been allocated more than one class of qualifying employer securities, the participant is treated as forfeiting the same proportion of each class of qualifying securities.

Example of the Release of Shares from a Suspense Account

Assume that 100,000 shares are purchased by the ESOP with the proceeds of a loan and, in Year 1, 10,000 shares are released.



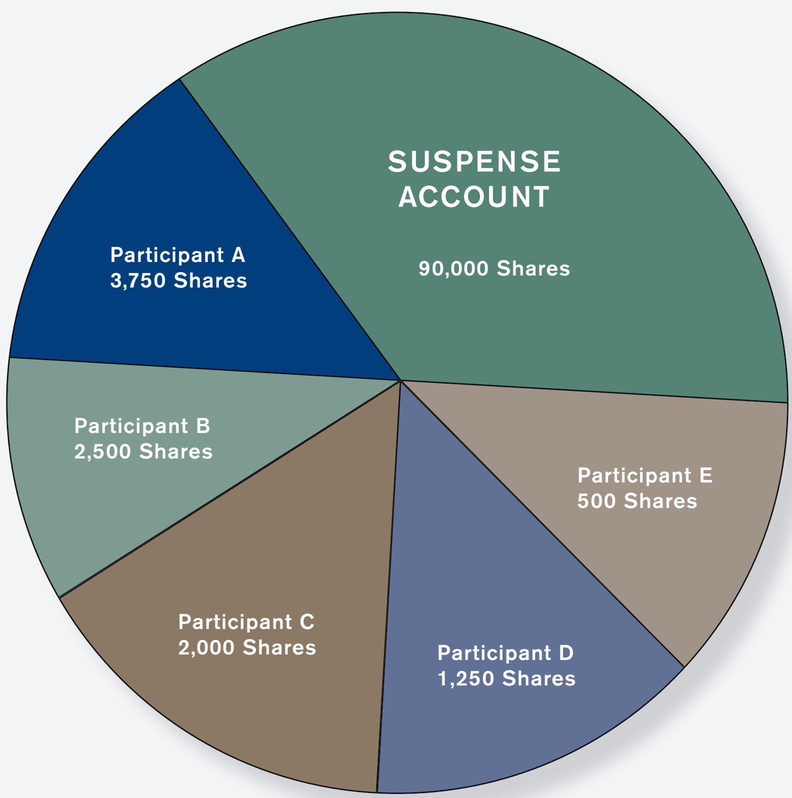
Example of Allocation to Partcipants' Accounts

Continuing with the previous example, how do the 10,000 shares get allocated to Participants A, B, C, D and E?

Assume that the allocation formula is based on the percentage derived from compensation for each participant as compared to the total compensation for all participants (also known as the compensation-to-compensation formula). The shares will be allocated in accordance with these percentages.

Calculation of Shares to be Allocated:

Participant	Participant Compensation (Annual)	Participant Compensation Divided by Total Participant Compensation	Number of Shares to be Allocated to Participant's Account
A	$150,000	37.5%	3,750
B	100,000	25%	2,500
C	80,000	20%	2,000
D	50,000	12.5%	1,250
E	20,000	5%	500
Total	$400,000	100%	10,000



The Limits on Annual Additions

ESOPs are generally subject to the same limitations on annual additions found in Code section 415 as other defined contribution plans.

Annual additions to a participant's account cannot exceed the lesser of 100 percent of compensation (up to $230,000 of compensation for 2008) or $46,000 (as adjusted by the Service).

If no more than one-third of the employer's deductible contributions to the ESOP for the year are allocated to accounts of highly compensated employees, then (a) forfeitures of employer securities acquired through an ESOP loan and (b) loan interest that the employer is allowed to deduct as a plan contribution are disregarded in applying the limit on annual additions for each plan participant.

Special Allocation Rules for S Corporations

Earnings on S corporation stock (dividends and pass through income) held by an ESOP are not taxable until distributed.

Congress and the IRS became concerned that companies were using ESOPs maintained by S corporations to inappropriately defer or avoid taxation. To address this situation, Code section 409(p) was enacted. Code section 409(p) limits the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees and not just highly compensated employees and historical owners.

Code section 409(p) provides that certain disqualified persons who participate in an ESOP maintained by an S corporation are prohibited from receiving allocations of assets attributable to qualifying employer securities if such allocations are made during a nonallocation year. A disqualified person is an individual who owns more than 10 percent of the deemed-owned shares or whose family unit (expansive definition) owns more than 20 percent of the deemed-owned shares.

Deemed-owned shares include: (i) shares allocated to a participant's account under the ESOP; (ii) a participant's proportionate share of the stock held in the ESOP suspense account; and (iii) synthetic equity, which includes stock options, warrants, phantom stock, stock appreciation rights, and certain other forms of deferred compensation. A non-allocation plan year occurs when disqualified persons own or are deemed to own at least 50 percent of the S corporation shares on any day in the plan year.

In the event a non-allocation year occurs, there are severe consequences:

- The S corporation is subject to an excise tax equal to 50 percent of the value of the shares held by the plan on behalf of disqualified persons during the non-allocation year (including any shares that were previously allocated in prior years or are allocated in the current year).
- The S corporation is subject to an excise tax equal to 50 percent of the value of any synthetic equity held by disqualified persons.
- The disqualified persons are treated as though they have received a taxable distribution from the plan of any shares held in their accounts during the non-allocation year

Other serious consequences, including the ESOP's loss of qualified status, could result as well.

Employer Deduction

Deduction for Contributions. A sponsoring employer's maximum deduction for a taxable year for ESOP contributions that go toward repaying principal on an exempt ESOP loan is 25 percent of the total of participants' compensation (not in excess of $230,000 per employee for 2008) for the taxable year. Contributions in excess of that limit can be carried over and deducted in succeeding years, subject to the 25 percent limit in effect for those years. Contributions that go toward payment of interest on an exempt loan are fully deductible in any amount for a C corporation.

An S corporation can only deduct interest to the extent that the 25 percent of compensation deductible limitation has not been satisfied.

Deductions for Dividends Paid. A sponsoring employer also is allowed a deduction for the amount of cash dividends it pays on certain employer securities held by the ESOP. First, all cash dividends paid by the employer to the ESOP are deductible if they are paid (credited) to the plan participants no later than 90 days following the end of the plan year in which the ESOP receives the dividends. Typically, the employer pays a cash dividend to the ESOP. Then, the ESOP pays (credits) to participants the amount of the cash dividend their account was entitled to receive. Occasionally, the cash dividend is paid directly to each participant, bypassing the ESOP altogether. Second, the employer cash dividend paid by the employer to the ESOP will be deductible if plan participants are given an election between having their dividend paid through to themselves or having their dividend reinvested in the ESOP. Finally, cash dividends used to make payments on an exempt ESOP loan are deductible. To be deductible, however, the proceeds of the loan being repaid must have been used to buy the securities on which the dividend is being paid. The dividend used to make payments on an ESOP loan are only deductible if employer securities with a fair market value at least equal to the dividend received are allocated to participants for the year in which the dividend itself would have been allocated.

An S corporation is not allowed to take a deduction for cash dividends paid on employer securities held by an ESOP. However, S corporation income allocable to stock held by an ESOP is not subject to regular or unrelated business income tax.

Discrimination, Coverage, Integration and Anti-Cutback

Discrimination. Generally, an ESOP cannot be aggregated with a non-ESOP plan in testing whether the ESOP or the non-ESOP satisfies the non-discrimination requirements of Code section 401(a)(4). An ESOP can satisfy the non-discrimination requirement only on the basis of contributions – it cannot satisfy that requirement on the basis of benefits.

Coverage. The Code requires that qualified plans provide benefits to a non-discriminatory group of employees. This means that a plan cannot operate such that the employees eligible to participate in the plan do not include enough non-highly compensated employees. Generally, this means that the ESOP must include a broad spectrum of the company's workforce.

Integration – Permitted Disparity. An ESOP cannot be integrated directly or indirectly with Social Security; the permitted disparity rules of Code sections 401(a)(5)(C) and 401(l) do not apply. In determining whether an ESOP is non-discriminatory under Code section 401(a)(4), the permitted disparity rules do not allow any disparity in the allocation rates to be disregarded.

Accrued Benefits and Plan Amendments. ESOPs are subject to the Code section 411(d)(6) anti-cutback rules, which prohibit a decrease in a participant's accrued benefit, including an optional form of benefit. However, the Code specifically states that an ESOP is not treated as violating the anti-cutback rules merely because it modifies distribution options in a non-discriminatory manner.

Further, the regulations specifically state that an ESOP will not violate the anti-cutback rules merely because the employer eliminates or has the discretion to eliminate, for all employees, any of the following optional forms of benefit:

- A single-sum payment option or an installment payment option, for benefits that are subject to the Code section 409(h)(1)(B) put option requirement.
- When an employer becomes substantially employee-owned, substitution of cash distributions for distributions of employer stock, for benefits that are subject to the Code section 409(h) rules relating to the right to demand employer stock and the right to a put option – but only if the employer otherwise satisfies the section 409(h)(2) requirements relating to restrictions on the ownership of outstanding employer stock.
- Cases in which the employer securities become readily tradable, optional forms of benefit by substituting distributions of employer stock for distributions of cash, for benefits subject to the Code section 409(h) rules.
- Substitution of cash distributions for distributions of employer stock, for benefits subject to the Code section 409(h) rules if (1) the stock ceases being readily tradable, or (2) the stock is still readily tradable, but there is a sale of substantially all the employer's stock or of substantially all the assets of a trade or business of the employer, and the purchasing employer continues maintaining the plan.

ESOP benefits are eligible for any of these anti-cutback exceptions only if the benefits have been held in the ESOP subject to Code section 409(h) for the shorter of (1) the five-year period before the amendment or exercise of discretion, or (2) the entire period of their existence before the amendment or exercise of discretion. If the benefits held by an ESOP are transferred to another plan that also is an ESOP at the time of the transfer, the ESOP periods can be aggregated in applying the five-year rule.

V SPECIAL OPERATING REQUIREMENTS

TOPICS INCLUDE:

- Pass-Through Of Voting Rights
- The Diversification Requirement
- The Independent Appraiser

Pass-Through Of Voting Rights

If the employer has a class of "registration-type" stock, an employee participating in an ESOP must tell the ESOP's trustee how to vote any voting shares allocated to the participant's account in the plan.

Registration-type stock consists of securities that must be registered under section 12 of the Securities Exchange Act of 1934 ("SEC"), and securities that would have had to be registered under SEC section 12, were it not for the exemption under SEC section 12(g)(2)(H).

If the employer does not have a class of registration-type stock, participants tell the trustee how to vote any voting shares allocated to their accounts on any corporate matter requiring a shareholder vote in connection with the approval or disapproval of a corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all the assets of a trade or business or similar transaction.

Voting on a one-participant, one-vote basis is acceptable in the case of an employer that does not have registration-type stock. For this purpose, voting on a one-participant, one-vote basis means that the plan must permit each participant one vote on each issue, and the plan's trustee must vote the total shares held by the ESOP in the proportion determined by the total of the participants' individual votes.

The Diversification Requirement

An employee who has completed at least 10 years of participation under an ESOP and has attained age 55 may elect, within 90 days after the close of each plan year in the "qualified election period," to direct the investment of a portion of the employee's post-1986 account balance totaling, in the aggregate, 25 percent (50 percent for the final year in the qualified election period) of that balance. An ESOP can satisfy this diversification requirement in any of three ways:

1. The ESOP can distribute the amount covered by the employee's election within 90 days after the last day on which an election can be made. You meet the requirements of this method if the ESOP gives the employee the opportunity to receive a distribution, regardless of whether the employee actually elects to receive the distribution.
2. The ESOP can offer the employee at least three distinct investment options for the employee's post-1986 account balance; any option the employee elects must be implemented within 90 days after the period for making the election.
3. The ESOP can offer the option of transferring the portion that is subject to the election to another qualified defined employer contribution plan that offers at least three investment options. The transfer must be made within 90 days after the period for making the election.

The qualified election period is the six-year period beginning with the first plan year in which the employee became a "qualified participant" (age 55, 10 years of participation).

If the fair market value of the post-1986 securities allocated to a participant's account is $500 or less, those securities are not subject to the diversification requirement. In applying this rule, called the de minimis rule, fair market value is determined at the plan valuation date immediately preceding the first day on which the participant is eligible to make a diversification election. Employer securities in all ESOPs maintained by the employer and the employer's controlled group are aggregated.

The Independent Appraiser

Fair market value of employer securities that are not readily tradable on an established securities market must be determined by an "independent appraiser." Generally, an independent appraiser is one who satisfies the following requirements, with a few narrow exceptions: (i) the individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis; (ii) the appraiser is qualified to make appraisals of the type of property being valued; and (iii) the appraiser understands that an intentionally false and fraudulent overstatement of the value of the property may subject him or her to civil penalties.

Stock must be valued at least once per year.

VI MAKING ESOP DISTRIBUTIONS

TOPICS INCLUDE:

- The Right to Demand Employer Securities
- The Put Option Requirement
- The After Separation from Service Requirement – Special

The Right to Demand Employer Securities

An ESOP can make distributions in the form of either cash or securities. However, a participant who is entitled to a distribution from an ESOP has the right to demand that his benefits be distributed in the form of employer securities.

If the employer's charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees and qualified plans, participants do not have the right to demand securities as long as the plan gives them the right to receive cash.

ESOPs maintained by S corporations may require distributions to be in cash only. This preserves the S corporation status by restricting the number of shareholders, since an S corporation must limit ownership to 100 shareholders.

The Put Option Requirement

If the ESOP distributes employer securities, and those securities are not readily tradable on an established securities market, a participant who is entitled to a distribution has the right to require the employer to repurchase the employer securities (a "put option") under a fair market valuation formula. The put option is available for a period of at least 60 days following the date of the distribution. If the participant does not exercise the option within that 60-day period, the option remains available for an additional 60-day period in the following plan year.

The After Separation from Service Requirement – Special

Under an ESOP, if a participant leaves the company due to retirement, disability or death, and if the participant elects (and, if necessary, the participant's spouse consents), the distribution of the participant's account balance begins no later than one year after the close of the plan year in which the participant separates from service – or no later than one year after the close of the fifth plan year following the plan year in which the employee separates from service for any other reason, provided the participant is not reemployed by the employer before that time.

The ESOP provides that, unless the participant elects otherwise, the distribution of his account balance will be in substantially equal periodic payments (not less frequently than annually) over a period no longer than five years.

In the case of a participant with an account balance of more than $500,000, the distribution period is increased by one year (up to a maximum of five additional years) for each $100,000 or fraction of $100,000 by which the balance exceeds $500,000. These dollar amounts are subject to indexing. For 2008, the distribution period is increased by one year for each $185,000 by which the account balance exceeds $935,000.

VII OTHER POINTS TO CONSIDER

TOPICS INCLUDE:

- Coordinating 401(k) Plans with an ESOP
- Offering Long-Term Incentives to Key Management Employees
- Accounting Treatment

Coordinating 401(k) Plans with an ESOP

If your company already sponsors a 401(k) plan, you can consider forming a 401(k)/ESOP combination, known as a KSOP.

Instead of making a match in cash to the 401(k) plan, the match would be made in the form of ESOP shares that are released and available for allocation, thereby funding the debt payment obligations on a leveraged ESOP. This is an attractive arrangement from the company's point of view, since it allows you to pay for ESOP shares using the matching contribution that you would otherwise make under the 401(k) plan.

As in a traditional 401(k) plan, the employees' salary deferrals in a KSOP are invested in a variety of investment fund options, including an employer stock fund. Another advantage of this plan design is dividends paid on the shares held in the employer stock fund can be deductible to the employer. The company that sponsors a 401(k) plan does not have this advantage.

Additionally, dividends paid on stock held by an ESOP are generally deductible for the corporation if used to repay an ESOP loan, if passed through to the employees, or if voluntarily reinvested by employees in company stock within the ESOP. If the plan were just a 401(k) with a company stock fund, you would not be able to deduct any dividends paid on that stock.

Finally, the 401(k) portion of the plan is a convenient way to transfer investments in company stock in the ESOP portion of the plan that are subject to the diversification rules to the mutual funds in the 401(k) portion of the plan.

Offering Long-Term Incentives to Key Management Employees

When you evaluate your plan options, you should consider the effect an ESOP would have on current executive compensation programs.

Think about establishing a stock option plan or other similar program for key executives to ensure their loyalty and provide for continuity of management.

You also should consider succession planning to facilitate an intentional and successful transition of your business to the next generation of owners and management.

Accounting Treatment

Non-leveraged ESOPs. A non-leveraged ESOP involves periodic contributions by the sponsor employer to the plan in the form of cash or stock. These contributions traditionally are made annually. When cash is contributed, it is used by the plan to buy shares on the open market or from private sales. The board of directors usually determines the amount of the contribution, but the amount may be tied to specific financial performance criteria.

The amount contributed (or owed) to an ESOP for a particular year must be reported as a cost for that year. If stock is contributed, the amount recorded as an expense will be equal to the fair market value of the stock on the date of transfer.

Leveraged ESOPs. You must record any ESOP debt as a liability in the financial statements, whether or not you guarantee the debt.

The offsetting debit to the liability you record is counted as a reduction in shareholder equity. This is accomplished through a contra-equity account. The contra-equity account must be reduced by the historical cost value of the shares that are released from the unallocated stock account as a result of your company's contributions.

The company charges a compensation expense equal to the fair market value of the shares that are allocated to the accounts of employees, even though this amount may not equal the amount of the principal reduction on the ESOP debt or the reduction of the contra-equity account. Any difference that occurs between the historical cost value of the allocated shares and the compensation expense is charged to or credited to paid-in capital. The interest paid with the employer contribution will be treated as an interest expense.

The company treats shares of stock allocated to employees' accounts as outstanding for purposes of determining the amount of earnings per share. However, shares held in the unallocated account are not treated as outstanding for this purpose.

Dividends paid on stock, whether allocated or unallocated, which are used to service the ESOP loan will reduce the amount of the loan but will not have a corresponding effect on either the compensation or interest expenses. However, if there are dividends on unallocated shares that are distributed to participants, these amounts will be treated as a compensation expense.

VIII

PREPARING TO IMPLEMENT AN ESOP

TOPICS INCLUDE:

- Appoint a Team Leader
- Clarify Objectives
- Who Plays a Role in the Transition?
- Identify Risks and Concerns
- Perform a Preliminary Assessment of Your Company's Readiness
- Perform a Feasibility Study

Appoint a Team Leader

Your company needs someone to coordinate the transition effort, and very often, the best resource is a consultant experienced in charting and navigating the process. The team leader assembles the internal players and manages everything from the preliminary assessment to the closing of the transaction and its implementation.

The advantage of using an experienced consultant is that you are less likely to make common mistakes, duplicate effort or duplicate cost. If you decide to take the consultant path, look for a resource with experience in every aspect of creating the ESOP.

Clarify Objectives

If your company opts to implement an ESOP, make sure the decision is clearly understood. Then, use the key objectives to drive subsequent decisions. Your company can elect to implement an ESOP for any one of the following reasons or a combination of them:

- Creating a market for the stock of your closely held corporation
- Buying out existing shareholders of your closely held corporation
- Providing a source of capital
- Refinancing existing debt
- Spinning off a division
- Taking your public company private
- Motivating employees through a tax-favored benefit that gives them an ownership interest in the company
- Providing a source of financing for acquisitions
- Helping defend your company against a takeover

Articulating the exact reasons for the creation of the ESOP not only helps to clearly communicate why the company is doing it, but also to decide the plan's structure, outline the number of shares and determine the required financing.

Who Plays a Role in the Transition?

Depending upon the culture and style of your organization, involving representatives from the board of directors, management, major shareholders, attorneys, accountants, lenders, investment bankers and an independent stock appraiser is generally a good idea.

Identify Risks and Concerns

ESOPs, by their very nature, often engender special concerns among the interested parties. Issues can include: the cost of setting up and maintaining an ESOP, the dilution of the ownership interest of existing shareholders, repurchase liability and fiduciary issues.

Cost. The initial cost of implementing an ESOP is generally higher than for most other qualified plans, owing largely to the need to conduct a feasibility study before implementation. Once implemented, the ongoing cost of maintaining an ESOP is only slightly higher than the cost of maintaining a regular profit-sharing plan, except for the additional cost of independent appraisals.

Dilution. Existing shareholders – or the prospective buyers in the case of a leveraged buyout – may be concerned about how an ESOP will dilute their ownership interests in the company. However, two factors should serve to mitigate this concern. First, the amount of newly issued shares may represent a relatively small percentage of the total outstanding shares. Second, in a closely held corporation, the creation of a market for that stock as a result of the ESOP's adoption will likely increase the value of the existing shareholders' stock. Of course, if the ESOP is intended as a vehicle to buy the interest of one or more existing shareholders, dilution is not an issue.

Repurchase Liability. In a closely held corporation, the issue of repurchase liability may be the biggest concern relating to the adoption of an ESOP. Repurchase liability is the obligation on the part of a closely held corporation (i.e., a corporation whose shares are not readily tradable) to offer to buy back the securities (shares) distributed to ESOP participants.

Fiduciary Issues. In the post-Enron era there are important fiduciary concerns that should be addressed, especially when employer stock is held by a qualified plan. Fiduciaries are held to the standard of a reasonable prudent person. A fiduciary must ensure that caution is taken, prudence is exerted and that the interests of the plan's participants and beneficiaries are foremost in their mind in the operation of the ESOP.

Although even the most diligent fiduciary can be sued, it is possible to reduce exposure in several ways:

- Outsource as many functions as possible to carefully chosen, closely monitored, independent, expert third parties.
- Surround yourself with a team of competent advisers, including an attorney, an accountant and a financial adviser.
- Buy fiduciary insurance to cover general breaches of fiduciary duty, such as theft, and consider extending the coverage to violations of fiduciary responsibilities and obligations imposed by ERISA, federal and state laws.

Perform a Preliminary Assessment of Your Company's Readiness

Take another look at the ESOP option in light of your clarified objectives and the risks. Review all your options, for achieving these objectives, determine what risks are associated with each option, then perform a cost-benefit analysis taking into account your specific situation. If the ESOP comes out on top, then your company is ready to move on to the next step in the process: the feasibility study.

Perform a Feasibility Study

A feasibility study examines the financial information upon which the ultimate decision on whether or not to implement an ESOP rests. This step also prepares the material required when using a lender in forming the plan. The study includes several sub-studies:

- A preliminary stock valuation
- A repurchase liability or liquidity study
- A shareholders' equity study
- A study of the financial accounting impact on the company
- A plan design study
- In a leveraged ESOP, a study on whether the participants' compensation can service the debt

After you perform these sub-studies, your company's board of directors can review the results and decide whether to go forward with implementing the ESOP.

Preliminary Stock Valuation. The preliminary stock valuation is often a threshold in deciding whether to adopt an ESOP. This is especially true in cases when the ESOP will purchase shares from existing shareholders. This preliminary appraisal, which should be conducted by an independent appraiser with experience in valuing shares of stock for ESOP purposes, may establish a value, for example, $x, plus or minus y percent of $x instead of one specific dollar value.

Although there is no plan at this point – and although the valuation is not necessarily the formal appraisal used to determine the share price the ESOP will actually have to pay for shares of the employer's stock – a preliminary stock valuation is essential in proving compliance with ERISA's prudent investor standard and its provisions relating to adequate consideration in arriving at a preliminary share value.

Among other things, the prudent investor standard demands that the fiduciary of an ESOP not allow the plan to pay more than adequate consideration for employer stock. When the employer stock is a security for which there is a generally recognized market, adequate consideration means either the price of the security prevailing on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 or, if the security is not traded on such an exchange, a price not less favorable to the ESOP than the offering price as established by the current bid and asked prices quoted by persons independent of the issuer and / or any party in interest.

In the case of employer stock for which there is no generally recognized market, proposed regulations provide that adequate consideration refers to a "good-faith determination" of "fair market value," as those terms are defined in the proposed regulations.

Fair market value is the price at which an asset would change hands between a willing and able buyer and a willing and able seller, neither of whom is under a compulsion to buy or sell, neither of whom is related to the other, and both of whom are well informed about the asset and the market for the asset. The good-faith standard requires, in part, that the determination of fair market value be made either by a fiduciary, who is independent of all parties to the transaction other than the ESOP, or by an independent appraiser.

Moreover, the Code requires, as a condition of plan qualification, that all valuations of employer securities not readily tradable on an established securities market be conducted by an independent appraiser.

Plan Design Study. With ESOPs, form follows function. The purpose of a plan design study is to determine the mix of design alternatives that will best achieve the objectives that the interested parties are trying to achieve with the ESOP. A design study addresses a variety of issues:

- Coverage and participation
- Eligibility requirements
- Past service credits
- Vesting schedules
- Treatment of forfeitures
- Voting rights
- Distribution alternatives
- Restrictions on stock transferability and ownership
- Early retirement options
- The conversion of an existing plan to an ESOP
- The basic plan structure (stock bonus plan, combination stock bonus and money purchase plan, KSOP)

Repurchase Liability Study. "Repurchase liability" refers primarily to the obligation on the part of a closely held corporation to give participants a put option – that is, to offer to buy back the shares distributed to ESOP participants. It also encompasses the Code section 401(a)(28)(B) requirement that certain participants be allowed to diversify a percentage of their Post-1986 account balance in an ESOP.

A repurchase liability study projects the company's future (10-to-15-year) obligations to repurchase shares from participants as a result of the mandatory put option and diversification requirements. It determines whether the ESOP, as proposed, could create a corporate cash shortage in the future.

A repurchase liability study also is an actuarial study. It takes into account the various factors that could affect a company's repurchase liability:

- The ESOP's vesting schedule
- Participant mortality rates
- Participant disability rates
- Employee turnover
- Growth in the number of employees
- Growth or decline in the fair market value of the employer's stock
- The ESOP's normal and early retirement age
- The size of annual contributions
- Seniority
- Salary increases and participant's investment diversification elections
- The ESOP's mix of corporate stock and other investment
- The extent to which the ESOP is leveraged and the repayment period on the ESOP loan
- The distribution and allocation methods
- Eligibility to participate
- The manner of repurchase

In addition to being a factor in determining the feasibility of a proposed ESOP transaction, the repurchase liability study can be used in determining the distribution methods to be offered under the ESOP. For example, the study may show that an ESOP with a lump-sum distribution option would create more significant liquidity problems than an ESOP without such an option.

Possible solutions to an anticipated repurchase liability problem include: establishing a sinking fund outside the ESOP specifically to fund this liability; contributing cash to the ESOP; using the proceeds of key employee life insurance (COLI) to buy a participant's shares; obtaining loans; and taking the company public.

Shareholders' Equity Study. This study addresses issues of concern to existing shareholders, which include whether the ESOP will dilute their ownership interests and how it will affect the corporation's profitability and cash flow and the value of the corporation's stock.

IX

MAKING THE DECISION: ALVAREZ & MARSAL TAXAND CAN HELP TO SEAMLESSLY EXECUTE AN ESOP

Alvarez & Marsal Taxand professionals help your team to develop and implement processes required to make a seamless transition to employee ownership.

1

Preliminary Assessment: The first step in determining whether a company is a candidate for an ESOP is to conduct a preliminary assessment. Alvarez & Marsal Taxand assists companies in analyzing the objectives to be achieved by use of an ESOP and determines whether an ESOP is the appropriate vehicle for achieving those objectives.

2

ESOP Feasibility and Design Study: Our professionals assist companies in putting together all of the components of a feasibility study and analyzing the plan design most appropriate for its circumstances.

3

Implementation Process: When a company has determined that an ESOP is the right decision, Alvarez & Marsal Taxand assists with the entire implementation process, including the coordination of all outside parties required to conduct the transaction.

X | ABOUT ALVAREZ & MARSAL TAXAND, LLC

Alvarez & Marsal Taxand, an affiliate of Alvarez & Marsal (A&M), a leading global professional services firm, is an independent tax group made up of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend A&M's commitment to offering clients a choice in advisers who are free from audit-based conflicts of interest, and bring an unyielding commitment to delivering responsive client service. A&M Taxand has offices in major metropolitan markets throughout the U.S., and serves the U.K. from its base in London, England.

Alvarez & Marsal Taxand is a founding member of Taxand, the first global network of independent tax advisers that provides multinational companies with the premier alternative to Big Four audit firms. Formed in 2005 by a small group of highly respected tax firms, Taxand has grown to more than 2,000 tax professionals, including 300 international partners based in more than 40 countries.

Alvarez & Marsal Taxand's Compensation and Benefits Practice – Specialists In All Forms Of Ownership Plans

The Compensation and Benefits practice of Alvarez & Marsal Taxand assists tax, finance, and human resource departments in designing compensation and benefits plans, evaluating and enhancing existing plans, benchmarking compensation, and reviewing programs for compliance with changing laws and regulations. Our objective is to minimize the tax, financial, and regulatory burdens related to such plans. We help clients lower costs, improve performance, boost the bottom line and attract and retain strong performers.

Alvarez & Marsal's Compensation and Benefits practice offers:

- Executive Compensation Advisory Consulting
- Bankruptcy Compensation Consulting
- Risk Management Consulting
- Pre- and Post-Merger and Acquisition Advisory Services
- Benefit Plan Evaluation, Design and Implementation
- ESOP Feasibility, Design and Implementation Services
- Global Incentive Compensation Advisory Services

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