

ESOP Business Planning Group

ESOP Solutions



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CARLYLE**
OUR LAWYERS
MEAN BUSINESS

A blue logo graphic consisting of a square with a white, wavy, scalloped edge on the right side. A registered trademark symbol (®) is located to the right of the top right corner of the square.

WOMBLE CARLYLE ESOP BUSINESS PLANNING GROUP

Services to Companies

1. Provide initial feasibility analysis and transaction planning
2. Recommend ESOP professional team members
3. Negotiate and implement ESOP financing
4. Coordinate ESOP implementation process
5. Design and prepare ESOP and related documents
6. Advise regarding post-transaction ESOP administration

Services to Trustees

1. Represent internal and institutional ESOP trustees
2. Organize and conduct due diligence process for fiduciary investment decisions
3. Advise internal trustee committees regarding fiduciary issues and ESOP mechanics

Services to Financial Institutions

1. Advise regarding structure of ESOP financing
2. Design and implement leveraged ESOP lending packages
3. Conduct ESOP financial institution due diligence

INTRODUCTION

Closely-held businesses are the heart of the United States economy. Despite their importance, these businesses are subject to burdensome tax rules and regulations that create unique business succession planning issues. An ESOP is one of the few tools available to help resolve these issues. ESOPs are specifically designed to aid closely-held business owners in their efforts to pass ownership to the next family generation or a key management group. ESOPs are also a tax-efficient means of raising capital for expansion or acquisition. Finally, ESOPs may be used to create an ownership culture among the company's employees to enhance recruiting, retention and productivity.

This brochure is designed to provide owners and managers with guidance regarding when to consider an ESOP and how the tax advantages of an ESOP aid in business transition planning. The brochure also addresses some common myths and misconceptions about ESOPs.

ESOP PLANNING CONSIDERATIONS

What if your company could take a loan from a bank to finance the purchase of some or all of your stock in the company and generate a tax deduction for the loan principal repayments? What if the proceeds of the loan could be used to buy a portion of your stock and you didn't incur any tax liability or give up control of your company in the process? If these scenarios are appealing, you should probably be investigating an ESOP. The following are some of the considerations that motivate shareholders and companies to implement an ESOP.

Shareholder Motivations

- To diversify personal wealth without giving up control of the company
- To facilitate the transfer of ownership to the next generation without giving stock away
- To pass ownership to key management, who may not have the funds available to acquire the shares outright and who want a future market for their acquired shares
- To buy out a partner or facilitate a marital separation
- To implement a plan to minimize estate tax liability

Company Motivations

- To buy out the minority shareholder
- To raise pre-tax capital to expand the business
- To create an employee ownership culture that increases profitability and aids in employee recruiting and retention
- To create a 100% employee owned company that is also 100% exempt from federal (and most state) taxation
- To spin off a line of business without selling to an industry competitor

ESOP SOLUTIONS

Shareholder Tax Incentives

- **§1042 Tax Free Exchange.** ESOPs provide shareholders with the opportunity to obtain liquidity and diversify their wealth. To encourage employee ownership, Congress enacted Section 1042 of the Internal Revenue Code, which allows eligible shareholders to sell their shares to an ESOP sponsored by a Subchapter C corporation and defer (potentially forever) tax on the proceeds. As long as the selling shareholder reinvests the proceeds in qualified replacement property (debt or equity in U.S. operating companies) within the period beginning three months before and ending twelve months after the date of sale, the selling shareholder defers capital gains tax on the shares sold to the ESOP until the qualified replacement property is sold. If the transaction is properly structured, the selling shareholder can avoid taxation entirely and still have almost complete flexibility in the use of the sale proceeds.
- **Minimize Estate Tax Burden.** ESOPs also provide shareholders the opportunity to minimize their estate tax burden. The period immediately following an ESOP sale is an attractive time to implement an estate tax reduction strategy. This is because the debt incurred by the company in a leveraged ESOP transaction will temporarily reduce the value of a company's shares, thereby creating a window of opportunity to make gifts of stock to the shareholder's family. The use of a family limited partnership in conjunction with an ESOP can substantially reduce, if not eliminate, the future estate tax burden. Additionally, if the selling shareholder has a charitable intent, an ESOP combined with a charitable remainder trust is a powerful tax planning and charitable giving strategy.

Company Tax Incentives

- **Deductible Principal on ESOP Loans.** Company contributions to an ESOP are tax deductible. Consequently, a company's contribution to the ESOP to repay a loan used by the ESOP to acquire shares of the company's stock (an ESOP loan) is tax deductible within certain limits. This results in both the principal and interest on an ESOP loan being deductible, as compared with an ordinary (non-ESOP) loan where only interest is deductible.

- **Deductible Corporate Dividends.** If either used to pay down an existing ESOP loan or passed through to participants, the dividends attributable to stock held by the ESOP are tax deductible.

A note on S Corporation ESOP Tax Planning. ESOPs are particularly effective when combined with a Subchapter S corporation (or simply an “S corporation”). Together, they create a powerful tool for income tax deferral and capital accumulation within a business. S corporations are “pass through” entities, meaning their income is not subject to a corporate level income tax under the Internal Revenue Code and the tax laws of most states. Instead, income is passed through to the company’s shareholders, who individually pay tax on the income. Since an ESOP is a tax-exempt entity, to the extent that income from the S corporation is passed through to an ESOP as a shareholder, that income escapes current income taxation at both the corporate and individual levels. If an ESOP owns 100% of an S corporation, no income tax will be paid on the corporation’s current income (i.e., because the income is allocated to the ESOP, which is a tax-exempt shareholder), thereby allowing funds that otherwise would be used to pay taxes to be retained for corporate purposes.

DISPELLING ESOP MYTHS AND MISCONCEPTIONS

Many business owners find that their business advisors react negatively to the suggestion of an ESOP. Although ESOP transactions can add tremendous value, they can be complicated to implement and administer. The universe of experienced ESOP professionals is small; few can implement an ESOP transaction in a timely and cost effective manner. Many excellent business advisors find ESOPs overwhelming in their complexity and, unfortunately, react negatively to their clients. Over the years, this type of reaction has created a variety of ESOP “Myths and Misconceptions,” such as the following:

ESOPs are overly complicated.

Without an experienced ESOP team, an ESOP transaction can quickly become so complicated and inefficient that the owners/managers

begin to wonder why they ever got themselves into the transaction. This is a disappointing reality because, when properly structured, ESOPs are a powerful tax savings tool.

ESOPs are too expensive.

Once again, unless properly designed, implemented and administered, an ESOP can become extremely costly. However, businesses can manage this expense by keeping an open line of communication and asking for hard estimates up front. Many times a company will start a transaction with an inexperienced ESOP team that fails to give the client a realistic estimate. An experienced ESOP professional should be able to give the company a reliable estimate of the total implementation expense and stick to it.

If I implement an ESOP, I have to give up control to my employees.

For a privately held company, the board of directors selects the ESOP trustee. In most cases, the ESOP trustee votes the shares, not the individual employees. Only in special circumstances (merger, sale of the business, recapitalization or liquidation) do the employees have the right to vote the shares allocated to their ESOP accounts.

If I implement an ESOP, I will be forced to provide detailed financial information to employees.

As a general rule, there is no requirement to reveal confidential financial information to employees as the ESOP Trustee is the legal owner of shares of company stock. However, many employers find it useful to educate their employees on the economics of the business.

WHAT IS AN ESOP?

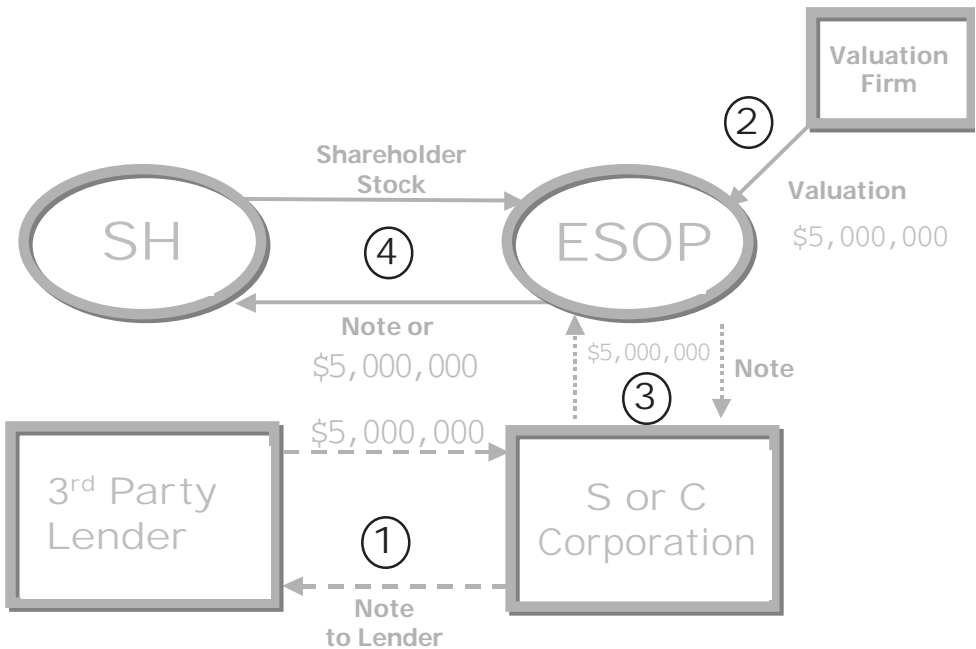
An ESOP is a tax-qualified retirement program that owns stock of the sponsoring company for the benefit of the company's employees. Although ESOPs have been around for over 30 years, most have been implemented since 1985. Because an ESOP is a tax-qualified retirement plan, it is subject to many of the same rules and restrictions that apply to more well-known tax-qualified retirement programs, such as 401(k) plans and pension plans. But an ESOP is perhaps better viewed as a tool of corporate finance, and this additional function can produce some confusion. The two major differences between ESOPs and other retirement plans are (i) an ESOP can borrow money to purchase its sponsoring company's stock, and (ii) Congress has established significant tax incentives to encourage employee ownership of companies through ESOPs.

ESOPs allow employees to participate in the ownership of a company in two ways. First, the company can simply make annual contributions of stock to the ESOP as an additional employee benefit. This type of arrangement is commonly referred to as a "nonleveraged ESOP." Second, by borrowing funds from either an outside lender or the company to purchase company stock, the ESOP can be a tool of corporate finance. This second type of arrangement is commonly referred to as a "leveraged ESOP." In either case, the shares of stock acquired by the ESOP are held in a trust where the shares are allocated to an account for each eligible employee. The stock is then held in this account until the employee retires or otherwise becomes eligible to receive a distribution.

Typical Leveraged ESOP Transaction Structure

The following diagram illustrates a typical leveraged ESOP transaction structure:

1. Corporation borrows \$5,000,000 from a financial institution. (Note: It may be desirable, under certain circumstances, to use “seller” financing.)
2. The trustee of the ESOP engages an independent valuation firm to provide a valuation opinion regarding adequate consideration for the proposed stock purchase.
3. The Corporation lends the \$5,000,000 to the ESOP.
4. ESOP purchases stock from shareholders for \$5,000,000.



How does the Womble Carlyle ESOP Business Planning Group help?

The ESOP Business Practice Group at Womble Carlyle appreciates that an ESOP transaction is one of the most important transactions in the lifecycle of a company and, therefore, we treat our ESOP clients with special respect. With an integrated group of ERISA, corporate, securities and banking attorneys located in nine offices, Womble Carlyle has one of the largest and most experienced ESOP planning groups in the country. Based in the Southeast and mid-Atlantic, our ESOP attorneys have been involved in ESOP transactions throughout the country. We pride ourselves on designing and implementing ESOP transactions that provide maximum flexibility and financial benefit while retaining respect for the economics of the transaction.

What is the first step in investigating the use of an ESOP for your company? The simple answer is... contact us. Because we have some of the most experienced ESOP attorneys in the business, we can usually give you a pretty good idea of whether an ESOP transaction may be of value to your company by simply having a short conversation. We are happy to provide you with some initial guidance and do not generally charge for this service. If you decide that you want to investigate an ESOP more fully, we will help guide you through an initial feasibility study to determine if you are a viable candidate. We will do this as cost effectively as possible. The last thing we want is for you to make a significant investment of your time and money investigating a transaction that does not make sense for your situation.

About Womble Carlyle Sandridge & Rice, PLLC

With more than 500 lawyers in nine offices, Womble Carlyle Sandridge & Rice, PLLC is one of the oldest and largest law firms in the Southeast and mid-Atlantic region of the U.S., as well as one of the country's most technologically advanced firms.

For more information about ESOPs and their application to your situation, please contact James Daniel at 704-331-4931, or Bill Whitehurst at 336-721-3653, or visit our website at www.esopsolutions.com.

Services Provided by the ESOP Business Planning Group

- Screening and Feasibility
- Transaction Structuring
- Financing Memorandum Preparation
- Financing Representation:
 - Senior Debt
 - Mezzanine Debt
- ESOP Design and Implementation
- Repurchase Obligation Analysis
- Employee Communication and Education
- Mergers & Acquisitions Advisory Services

To learn more about the uses for an ESOP, please contact:

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