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ISSUE BRIEF #6

The Advantages of ESOP Financing

Introduction

An Employee Stock Ownership Plan (ESOP) is a tax-qualified plan under Sections 401(a) and 4975(e)(7) of the Internal Revenue Code. More specifically, it is a specialized type of defined contribution plan with two distinguishing features:

1.) It can invest exclusively in the sponsoring employer's stock, and;
2.) It can borrow money.

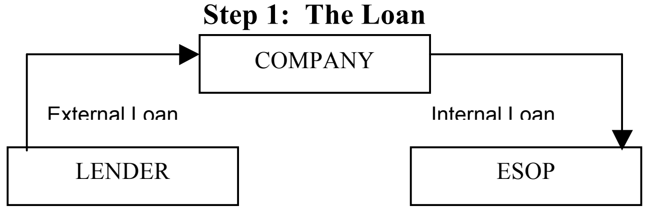
Very few companies are in a financial position to pay cash to buy out an owner or major shareholder. Therefore, the prudent use of debt can be an extremely attractive alternative to accomplish the owner's succession strategy. Using an ESOP in conjunction with debt financing has so many unique characteristics that it is called "ESOP financing." In this issue brief, some of the basic characteristics of ESOP financing are discussed and compared with conventional debt financing.

Like any traditional loan, a bank will base an ESOP lending decision on the character, cash flow, collateral and capital of the borrower. Under current tax law, an ESOP loan must be primarily for the benefit of the participants; it must have a reasonable interest rate; and the only collateral the ESOP can offer is the qualifying employer securities purchased with the loan proceeds.

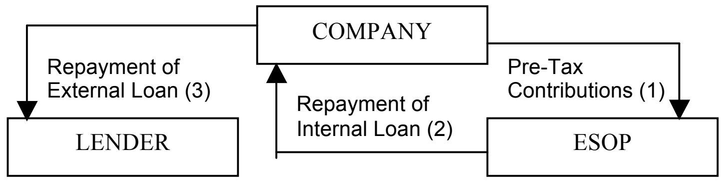
Repaying the Loan within IRC Section 415/404 Limitations

Typically, a loan is made from the lender to the company and is referred to as the "outside loan." The company re-lends the money to the ESOP (the "inside loan"). The terms of the two loans **need not** be identical. The illustration below summarizes the steps.

The Leveraged ESOP Transaction
Step 1: The Loan



The Leveraged ESOP Transaction
Step 2: The Repayment



The corporation makes tax-deductible contributions (subject to IRC 415/404 limitations) to the ESOP, thereby providing the cash necessary to make loan payments to the bank. In addition, dividends paid on shares of company stock acquired with the ESOP loan can be used to make payments on that loan. The maximum amount that a non-leveraged C corporation or an S corporation (leveraged or non-leveraged) may contribute annually to an ESOP is generally limited to 15% of the compensation paid to all employees participating in the plan for the tax year. The maximum deductible amount is increased to 25% of compensation for C corporations for amounts used to repay an ESOP loan incurred to purchase ESOP stock. These important limitations are summarized in the table below.

	Leveraged		Non-leveraged	
	C Corp	S Corp	C Corp	S Corp
Contribution Limits (1)	25% of eligible payroll; does not include interest on the loan (2)	15% of eligible payroll including interest on the loan (3)	15% of eligible payroll (3)	15% of eligible payroll (3)

1.) The contribution limits must be reduced by the amount of employee and employer contributions to other tax-qualified retirement plans. IRC 415 limits contributions to any individual to the lesser of $30,000 or 25% of compensation.
2.) Interest is included in the 25% limit if not more than one-third of the contributions are allocated to the accounts of highly compensated employees. Individual compensation amounts exceeding $170,000 (for year 2000 indexed for inflation) are not included in the eligible payroll calculation.
3.) If the ESOP includes a money purchase pension plan in which the employer commits to contribute a set percentage of covered payroll in cash or stock, the 15% limit can be increased by the percentage contribution up to a maximum of 25% of covered payroll.

Other ESOP loan structures are possible. Two common alternatives include:

1. The bank may simply accept a note from the ESOP for the loan proceeds. This note usually is accompanied by a guarantee from the employer that it will make contributions to the ESOP sufficient to enable it to amortize the loan. The note may be secured by a pledge of the ESOP's newly acquired shares, or, if the lender requires it, a pledge of the corporation's assets.

2. In the third alternative, the company makes a loan to the ESOP, and the ESOP uses the proceeds of the loan to purchase shares from a shareholder. The shareholder (instead of a third party lender) makes a loan to the company, and the company issues a note to the shareholder. The shareholder will receive repayment of his or her loan in fixed periodic payments to reinvest over time. This arrangement works well in situations where the company would otherwise have a difficult time securing financing from a third party, or the shareholder would rather collect the interest than pay it to a third party.

All three of these financing alternatives share the cash flow benefits of ESOP financing that are described on the next page.

The Cash Flow Benefits of ESOP Financing

The most fundamental characteristic of ESOP financing is that it increases the total cost of borrowing but significantly decreases the cash cost of borrowing compared to traditional financing. This results from the fact that principal payments as well as interest payments are deductible when repaying an ESOP loan, and that ESOP financing involves transferring employer stock to the ESOP.

A brief example will illustrate the cash flow benefits of ESOP financing. Suppose a company, taxed at the 42% rate, wants to borrow $1 million. The firm arranges conventional financing at 9.50% interest and makes equal annual principal payments over five years. In exchange for $1 million, the corporation assumes debt repayment obligations that look like this:

Conventional Debt

Year	Principal Payment	Beg. Yr. Loan Balance	Interest	Deduction (Interest Only)	A/T Cash Outflow
1	$ 200,000	$ 1,000,000	$ 95,000	$ 39,900	$ 255,100
2	$ 200,000	$ 800,000	$ 76,000	$ 31,920	$ 244,080
3	$ 200,000	$ 600,000	$ 57,000	$ 23,940	$ 233,060
4	$ 200,000	$ 400,000	$ 38,000	$ 15,960	$ 222,040
5	$ 200,000	$ 200,000	$ 19,000	$ 7,980	$ 211,020
Total	$1,000,000		$ 285,000	$ 119,700	**$1,165,300**

ESOP Financing

Year	Principal Payment	Beg. Yr. Loan Balance	Interest	Deduction (Prin. + Int.)	A/T Cash Outflow
1	$ 200,000	$ 1,000,000	$ 95,000	$ 123,900	$ 171,100
2	$ 200,000	$ 800,000	$ 76,000	$ 115,920	$ 160,080
3	$ 200,000	$ 600,000	$ 57,000	$ 107,940	$ 149,060
4	$ 200,000	$ 400,000	$ 38,000	$ 99,960	$ 138,040
5	$ 200,000	$ 200,000	$ 19,000	$ 91,980	$ 127,020
Total	$1,000,000		$ 285,000	$ 539,700	**$ 745,300**

The after-tax cash outflow from the corporation to finance the ESOP is $745,300, which is less than the original loan principal. However, in the ESOP financing case the company incurs the additional cost of allocating $1 million of stock in the ESOP. Thus, the total after-tax cash outflow of the ESOP financing is $1,745,300 as opposed to $1,165,300 for the conventional debt, but the after-tax cash outflow for the ESOP financing is only $745,300 versus $1,165,300 for the conventional debt.

From a lender's perspective, the ESOP financing generates $420,000 in pre-tax dollars the company does not have to earn to repay the loan. In other words, ESOP financing makes a company a better risk for a lender, because the loan is amortized entirely with pre-tax dollars, which considerably enhances the company's ability to repay the debt.

Loan Underwriting Criteria

Banks underwrite ESOP loans in much the same way that they underwrite conventional loans, but they pay particular attention to the eligible payroll of the company in relation to the 415 limitations and cash flow and collateral of the company to service the debt. As part of the bank's standard due diligence, they will request the following information from the company:

1. Three to five years of financials
2. Business plan
3. Financial projections
4. Industry outlook
5. Succession management plan

Financing Feasibility – Step 1:

The following quick calculation can help establish the potential feasibility of a leveraged ESOP. The company's fair market value is the most important factor affecting the feasibility of any given ESOP financing situation. The next most important factor is the company's eligible payroll. The payroll of ineligible employees is deducted from the company's total payroll to arrive at the eligible payroll. In addition, compensation of any individual exceeding $170,000 (for year 2000 indexed for inflation) is not included in the eligible payroll calculation. Most banks will amortize an ESOP loan over five to seven years. The following two simple cases involving C corporations illustrate the way to calculate the potential size of a given leveraged ESOP transaction.

Case #1

Company fair market value:	$10 million
Eligible payroll	$1 million
Loan term	Seven years

The maximum annual contribution to the ESOP for principal payments in this case (assuming that the company has no other qualified plans) is equal to 25 percent of the eligible payroll, or $250,000. Multiplying $250,000 by seven years equals **$1,750,000,** which is the maximum ESOP transaction that this company could implement without extending the term of the loan or paying a special dividend on the stock in the ESOP.

Case #2

Company fair market value:	$10 million
Eligible payroll	$4 million
Loan term	Seven years

Here the maximum annual contribution to the ESOP for principal payments (assuming that the company has no other qualified plans) is equal to 25 percent of the eligible payroll or $1,000,000. Multiplying $1,000,000 by seven years equals **$7,000,000,** the maximum ESOP transaction that this company could implement without extending the term of the loan or paying a special dividend on the stock in the ESOP.

Conclusion

An ESOP enables a business owner to sell some or all of his or her company at fair-market value and defer or eliminate the capital gain tax that would otherwise be due on the sale by using IRC-1042 (limited to C corporations; see Issue Brief #4 for more information). Commercial and academic research studies show that ESOPs improve company profitability by facilitating an "ownership culture" within the sponsoring company. Most companies do not have sufficient financial resources to implement a significant ESOP transaction without negatively impacting the company's operations. ESOP debt will lower net earnings and net profits during the period of loan amortization because the cost of interest plus principal plus the ESOP contribution will exceed the interest and principal payments of conventional financing. However, cash flow is greater than it would have been with conventional debt financing, and therefore an ESOP loan enhances a company's debt servicing ability.

ESOP Advisors Group provides one stop ESOP design formation and implementation services. Visit the ESOP Advisors Group website at ***www.esopadvisorsgroup.com.*** *Or call Mel Duffey (650) 468-5465.*