

**ESOPs INCLUDING S CORPORATION
AND CODE SECTION 409(p) ISSUES**

**ASPPA BENEFITS COUNCIL
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I. BASICS OF AN EMPLOYEE STOCK OWNERSHIP PLAN (ESOP).

An ESOP is a qualified retirement plan with additional requirements and benefits. Key Internal Revenue Code (“Code”) Sections include 409 and 4975.

A. An ESOP Must be Established to Invest Primarily in Qualifying Employer Securities (QES).

1. Code Definition is More Restrictive than Under ERISA. QES are common stock issued by the employer, which are readily tradable on an established securities market. Alternatively, with respect to non-tradable securities, QES constitute an employer’s common stock which have a combination of voting and dividend rights which equal or exceed the common stock of the employer which has the greatest of those rights. Code §§409(l) and 4975(e)(8).
2. “Primarily” Invested in Employer’s Securities Means More Than 50%. This is a Department of Labor requirement. An ESOP, however, will not lose its qualification status because investments in QES temporarily go below 50%.
3. Special Controlled Group Rules Apply in Testing QES Definition. These rules are set forth at Code §409(l)(4), and are based upon the controlled group rules of Code §1563(a). However, with respect to a parent-subsidary, a 50% test, as opposed to an 80% test, is used.
4. ESOP Cannot Consist of Preferred Stock unless the preferred stock is at all times convertible into common stock which constitutes QES. Code §409(l)(3).

B. Certain Voting Rights Must Be Passed Through the ESOP to the Participants.

1. Publicly Traded Stock. If the QES are registration-type securities (e.g., publicly traded), a participant must be allowed to direct the plan on how to vote his allocated shares. Code §409(e)(2).
2. Closely-Held Stock. If the QES are not publicly traded, the participants need only be given the right to direct their votes on corporate matters with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business or such similar transaction. Code §409(e)(3).
3. The voting right requirement will be satisfied if the plan permits one vote to each participant with respect to each issue and the trustee votes the

shares held by the plan in the same proportion as the total participant vote. Code §409(e)(5).

C. Distribution Requirements.

1. Participants Generally Must Have the Right to Receive Their Distributions in the Form of Stock. An ESOP, however, is not precluded from making distributions in cash. Code §409(h). Also, an employer can have a right of first refusal to buy back the stock from a participant if the stock is not publicly traded and was purchased with an exempt loan. Treasury Reg. §54.4975-(b)(9).
2. Upon Disposition of QES by a Participant, an Employer or the ESOP May, but Need Not, Have a Right of First Refusal If:
 - a. The stock, which was purchased with an exempt loan, is not publicly traded (as of the time of the right of refusal).
 - b. The right is in favor of the employer or the ESOP.
 - c. The terms under the right to the participant-seller are as favorable as the greater of the stock's value based upon a good faith valuation or a good faith offer by another buyer to purchase the stock.
 - d. The right lapses 14 days after the stockholder give written notice to the holder of the right. Treasury Reg. §54.4975-7(b)(9).
3. Participants of ESOPs of Companies Whose Stock Ownership is Substantially Restricted by Law or by Charter Do Not Have to Be Given the Right to Receive Distribution in Stock. Code §409(h)(2). Additionally, if the sponsoring corporation's charter or bylaws restrict stock ownership to the ESOP or current employees, stock will not be distributed to former participants.
4. Distribution Requirements. Code §409(o)(1).
 - a. Unless an employee elects otherwise, payment of ESOP benefits must begin no later than one year after the close of the Plan Year:
 - i. In which the participant terminates employment due to retirement, disability or death; or
 - ii. Which is the fifth plan year following separation from service for any other reason (provided the participant does not return to service prior to that time).

- b. Exception – Securities acquired with the proceeds of an acquisition loan in accordance with Code §404(a)(9) do not have to begin to be paid until the close of the plan year in which the loan is repaid. However, if the participant attains normal retirement age in an earlier year, benefits must commence no later than 60 days after the year in which the participant attains normal retirement age, absent a contrary election by the participant. Code §409(o)(1)(B).
 - c. Distribution must be in substantially equal periodic payments (not less frequently than annually) and must be over a period not greater than:
 - i. Five (5) years, or
 - ii. In the case of a participant with an account balance in excess of \$885,000, five years plus one year for each \$175,000 or fraction thereof in excess of \$885,000. Code §409(o)(1)(C).
5. Forfeitures. All non-vested amounts in a participant's account are forfeited and allocated among the accounts of other participants. A forfeiture can occur within one year after the participant leaves service, or alternatively, the employer can hold on to such forfeited amounts in a suspense account for five years. The decision on whether to use the one year or five year forfeiture rule will have some impact on the amount of stock reallocated to participants and on the employer's repurchase liability.

D. Right to Demand Employer Securities; Put Option.

- 1. Put Option to Receive Cash in Lieu of Stock for Leveraged ESOP if Stock Is Not Publicly Traded. Upon a distribution, the participant has a non-terminable option against the employer to receive cash instead of stock. Although the plan may not be required to satisfy a put option, it may assume the rights and obligations of the employer at the time the put option is exercised. The option must be given twice: for a period of at least 60 days following the distribution; and for at least a 60-day period in the following plan year. Code §409(h)(4) and Treasury Reg. §54.4975-7(b)(10), (11).
- 2. Payment Upon Exercise of Put Option – Lump Sum Distribution. Code §409(h)(5) and (6) requires that in the case of a lump sum distribution of employer securities, if the employee “puts” securities to the employer, the put option price must be paid in substantially equal installments over a period not exceeding five years, and

- a. The five-year period during which the employer must purchase the securities subject to the exercised put option begins 30 days after the date of exercise of the put option, and
 - b. The employer must provide security with respect to the put option installment payments.
3. Payment Upon Exercise of Put Option – Other Than Lump Sum. In the case of a put option exercised with respect to a distribution other than a lump sum, the employer must pay the full option price to the participant within 30 days after the close of the 60-day option period.

E. Contributions.

1. Deductibility of Dividends Paid on ESOP Stock. Under Code §404(k) such dividends must be paid to the plan or paid directly in cash to the participants. If paid to the plan, dividends must be distributed to the participants within 90 days after the close of the plan year. In order for the employer to get the deduction, the dividend must be actually paid, and not just accrued. Dividends may also be deducted if used to make payments on exempt loans.
2. No Deduction Limitation on Contribution to Plan to Pay Interest on a Loan Used to Purchase QES. This only applies to C corporation ESOPs. The contribution must be made by the due date for filing the employer's tax return (including extensions). Code §404(a)(9)(B). Although the employer's deduction for principal repayment is 25% of compensation, amounts in excess can be deducted in future years. Code §404(a)(9)(A).
3. Deduction Limitation for Non-Leveraged or Leveraged ESOP is 25% of Compensation. Code §404(a)(9).

F. Valuation of Stock and Independent Appraiser.

1. Allocating the Stock of a Closely-Held Corporation or Stock Which is Not Traded on the Open Market.
 - a. In order to determine the fair market value of the stock of a corporation that is not publicly traded, an independent appraisal is necessary. Code §401(a)(28)(C). The appraisal of the stock directly coincides with the company's contributions and deductions.

- b. Although such appraisals can be costly and the contributing shareholders desire the appraisal to be as favorable as possible, it is important to remember that the appraisal must be able to withstand IRS and DOL scrutiny.

- c. Department of Labor proposed regulations at §2510.3-18 define “adequate consideration” for purposes of valuing plan assets for which there exists no generally recognized market. The regulations list several factors to be reviewed by the independent appraiser performing the valuation including:
 - i. The nature of the business and the history of the company from its inception;
 - ii. The economic outlook in general and outlook of the specific industry in particular;
 - iii. The book value of the company and the financial condition of the business;
 - iv. The earning capacity of the company;
 - v. The dividend-paying capacity of the company;
 - vi. Whether or not the company has goodwill or other intangible value;
 - vii. The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;
 - viii. The marketability, or lack thereof, of the securities;
 - ix. Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued.

- d. Since the IRS has not issued regulations on valuing the stock of a closely-held corporation, the guidelines set forth in Revenue Ruling 59-60 (which pertains to valuing such stock for estate and gift tax purposes) are often looked to for guidance on these issues. That Revenue Ruling looks to the following factors:

- i. The type of business and its entire history;
 - ii. The general economic outlook as well as the outlook for the specific industry;
 - iii. The stock's book value and the business' financial condition;
 - iv. The company's earnings ability;
 - v. The company's ability to pay dividends;
 - vi. Whether the company has good will or other important non-capital assets;
 - vii. Previous stock sales; and
 - viii. The market value of the stock of similar companies whose stocks are traded on a stock market.
- e. For companies whose stocks are traded on a stock market, their stock value is easily determined. Code §41(c)(7) refers to the average closing prices over the 20-day consecutive trading period which immediately precedes the date the stock was contributed to the plan.

G. Investment Diversification Rules. Code §§401(a)(28)(B) and 409(h)(7).

1. **Participants Eligible to Diversify.** Any employee who has completed at least 10 years of participation under the plan and has attained age 55 is considered a "qualified participant" and is eligible to diversify a certain percentage of his or her account balance over a six-year period. Code §§409(h)(7) and 401(a)(28)(B).
2. **Election Period.** Each "qualified participant" has the option to elect within 90 days after the close of each plan year to direct the plan as to the investment of at least 25% of the participant's account in the plan for the first five plan years after becoming a qualified participant. Election in the sixth and final year may be made up to 50% of his account balance less any amounts which were previously diversified. Code §401(a)(28)(B)(i).
3. **Method of Diversification.** The plan can satisfy the diversification requirements in one of three ways:

- a. Distribution to IRA. That portion of the participant's account to be diversified may be distributed within 90 days after the period during which the election may be made. Such amounts are eligible to be rolled over tax free into an Individual Retirement Account. Code §401(a)(28)(B)(ii)(I).
 - b. Investment Options. The plan may offer at least three investment options to each participant and transfer amounts to such investments within 90 days after the expiration of the election period. Code §401(a)(28)(B)(ii)(II).
 - c. Direct Transfer to Another Qualified Plan. The plan could transfer the portion of the participant's account that is eligible to be diversified, to another qualified plan that allows for participant-directed investment and contains at least three investment options. IRS Notice 88-56, Q & A-13.
4. De Minimis Amounts. Participants with an account balance of \$500 or less need not be given the diversification election. IRS Notice 88-56, Q & A-7.

H. ESOP Loan Exemption.

The leveraged ESOP assets must be held in a suspense account. As the ESOP loan is repaid, assets from the suspense account are proportionally allocated to the participant's account pursuant to one of two described formulas. Treasury Reg. §54.4975-7(b)(8).

II. FIDUCIARY DUTY ISSUES.

A fiduciary such as a trustee is subject to numerous obligations.

Duty of Loyalty. Fiduciaries must discharge their duties with respect to a plan solely in the interest of participants and beneficiaries.

Duty Regarding Exclusive Purpose. Fiduciaries must act for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan.

Duty of Prudence. Fiduciaries must act with the care, skill, prudence and diligence under the circumstances then prevailing that a "prudent man" acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

Duty of Diversification. The fiduciary is also under a duty to diversify plan investments unless, under the circumstances, it is clearly prudent not to do so.

Duty to Follow Documents. Fiduciaries must act in accordance with the documents and instruments governing the plan as long as those documents and instruments are consistent with ERISA.

Duty to Avoid Prohibited Transactions. In addition to adhering to the above affirmative fiduciary obligations under ERISA (and subject to the availability of statutory, administrative class or administrative individual exemptions), fiduciaries shall not engage in or cause a plan to engage in certain prohibited transactions. Furthermore, a fiduciary should not violate ERISA provisions which protect a plan against fiduciary self-dealing and conflict of interest.

Dual Loyalties. When ERISA fiduciaries hold corporate offices, they are obligated to act, on one hand, for the plan's participants and beneficiaries so as to secure and make certain that plan benefits will be available at the time of distribution and, on the other hand, for the company so as to safeguard the company's profits. A company's decision to create, adopt, modify, amend or terminate retirement plans is not subject to fiduciary obligations. For example, if the ESOP is deciding whether to sell employer securities, the interest of the company and its officers and stockholders may conflict with the interest of the ESOP participants and beneficiaries. In this and other similar situations, the question inevitably arises as to whether the fiduciary can continue to act as the fiduciary on behalf of the ESOP, whether heightened standards of conduct apply and whether an independent fiduciary should or must be appointed.

There are no specific requirements under ERISA's fiduciary responsibility rules that there be independent trustees, investment advisors, investment bankers, legal counsel or appraisal firms representing an ESOP. However, the courts have held that where interests of fiduciaries irreconcilably conflict with the interests of the ESOP participants and beneficiaries, such ESOP fiduciaries should obtain the benefit of independent legal, financial and investment counsel. Moreover, the court decisions have suggested that even where fiduciaries obtain the benefit of independent advisors, it would be desirable for fiduciaries with conflicts of interest to resign and be replaced by independent fiduciaries. If the fiduciaries with conflicts of interest do not resign, such fiduciaries have an extremely difficult burden of establishing that they complied with the ERISA fiduciary requirements and consequently must meet a higher standard of conduct.

Recent court decisions show that procedural due diligence is critical to insulate a fiduciary's decision from being overturned. In one court case where there was evidence that the fiduciary satisfied his duty to investigate, the court did not second-guess the fiduciary's decision. However, in another court case, where the fiduciary had a conflict of interest and did not investigate his options, the court found that he had breached his fiduciary duties. These decisions indicate that a court finds it easier to conclude that a fiduciary breached his duty when he breached his duty to investigate, but is less likely to second-guess a fiduciary's decision when the fiduciary has investigated all options and obtained the advice of expert legal and financial advisors.

The relationship of ESOP fiduciaries to the ongoing management of the company involves the need for a delicate balancing of interests of the company and those of the ESOP participants and beneficiaries. A balance is particularly difficult to achieve if the ESOP holds all or a majority block of the stock and thus has the power to elect a majority or all of the board of directors. Management's initial perspective in most instances will be that the ESOP is a creature of the company and thus should operate in accordance with the company's desires and interests. However, the ERISA fiduciary responsibility rules require that fiduciaries conduct themselves with an undivided loyalty to participants and beneficiaries in the ESOP in accordance with the prudent man standard. They are required to ignore any ESOP provisions or other directions from the company or fiduciaries which are inconsistent with those primary fiduciary duties. The ESOP as a stockholder need not involve itself ordinarily in the day-to-day management affairs of the company. So long as the company is generally being properly managed, the ESOP trustee's main concern is to assure itself that proper management continues. However, if the company is not being properly managed, the ESOP fiduciaries have an overriding fiduciary responsibility to take whatever action a stockholder in the position of the ESOP might take to protect its stockholder interest, which action might include appropriate litigation and removal of inappropriate members of the board of directors and/or management. In other words, as long as the company is doing well, the burden upon ESOP fiduciaries to manage the company is almost non-existent; but as the fortunes of the company worsen, the burdens of the ESOP fiduciaries become greater.

Fiduciary Protective Measures. In acting prudently, trustees or other fiduciaries should also act defensively, building a record to defend their actions. Fiduciaries should, for example: (1) keep detailed records of the actions taken and the factors that went into the decisions; (2) make sure these records describe in detail the relevant circumstances prevailing at the time—that is, outline the conditions under which the action was taken; and (3) make sure all reasonable steps have been taken to acquire the information needed to make informed decisions.

Measure of Damages for Breaches of Fiduciary Duty. If a fiduciary breaches his duties under ERISA, then he or she may be personally liable for damages and may be removed as a fiduciary of the plan. A fiduciary may also be liable for the breach of another fiduciary in which he participates or has knowledge of but does not take reasonable steps to prevent. A fiduciary participating in the fiduciary breach will be subject to an automatic civil penalty of 20% of the applicable recovery amounts, which includes any amount which is recovered from the fiduciary or other person.

III. DEFERRING TAXES FROM THE SALE OF STOCK TO AN ESOP BY PURCHASING QUALIFIED REPLACEMENT SECURITIES. Code §1042.

This is currently only available to C corporations.

- A. Code §1042 Requires an Election to Be Made. Seller must file an election by the due date (including extensions) of the income tax return corresponding to the year of the sale. The seller must be an individual, trust, estate, partnership or S corporation. The seller cannot be a C corporation.

B. Rollover Must Be from the Sale of Qualified Securities and the Purchase of Qualified Replacement Property.

1. “Qualified Securities” are defined at Code §1042(c)(1). They are:
 - a. Issued by a domestic corporation that has no stock outstanding that is readily tradable on an established securities market (i.e., not publicly traded).
 - b. Neither attributable to a distribution from a qualified plan nor pursuant to the exercise of a compensatory stock option.
 - c. Securities that have been held by the seller for at least three years prior to the sales of the ESOP.
2. Qualified Replacement Property is Defined at Code §1042(c)(4). It is:
 - a. Stock which the seller purchased within the replacement period. This time period commences three months before the date of the sale to the ESOP and ends 12 months after the date of the sale. Code §1042(c)(3).
 - b. Stock issued by a domestic corporation which does not, for the taxable year in which such stock is issued, have passive investment income exceeding 25% of its gross receipts. Private Letter Ruling 8724009 provides that shares of stock in a mutual fund do not constitute qualified replacement property.
 - i. Qualified Replacement Property can include: common stock, preferred stock, corporate bonds and notes and convertible bonds.
 - ii. Qualified Replacement Property does not include: U.S. government securities, municipal bonds, foreign securities, mutual funds or limited partnerships.

C. ESOP Must Meet Certain Requirements for Code §1042 Treatment to Apply:

1. Immediately after the sale, the ESOP must own at least 30% of the total value of the employer securities outstanding. Code §1042(b)(2). Thus, the seller need not sell all of his stock to qualify for Code §1042 treatment. For example, if the selling shareholder owns 81% of the company stock, he could sell 30% to the ESOP and still maintain control of the company.

2. The seller must specifically elect non-recognition treatment not later than the due date (plus extensions) for filing the seller's income tax return for the taxable year in which the sale occurs. Code §1042(a)(1), (c)(6).
3. The seller must receive from the employer, and file with the IRS, a statement consenting to an excise tax (equal to 10% of the amount realized on the sale of the stock) if there is a disposition of stock (for reasons other than participants retiring or separating from service) within the three year period after the sale to which Code §1042 applied which causes the employer stock held by an ESOP to fall below 30% of the total value of all employer securities. Code §4978(a).
4. The seller, a member of his family (determined under Code §267(b)) or any person who owns more than 25% (attribution rules of Code §318 apply) of any of the employer's outstanding securities may not participate in the ESOP to the extent of the securities purchased by the ESOP or any assets attributable thereto. Code §409(n). The non-allocation period begins on the date of the sale of the qualified securities and ends on the later of (i) 10 years after the date of the sale, or (ii) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale. Code §409(n)(3)(C). Stock allocated to the employer's account under the ESOP is included in the determination of whether the employee is a 25% shareholder. Code §409(n)(1)(B). Allocations are permitted, however, if the individual is a lineal descendent of the taxpayer selling the securities and the total allocation to all such lineal descendants during the non-allocation period does not exceed 5% of the total securities held by the plan which are attributable to the sale. Code §409(n)(3).

If the ESOP allocates assets to a person in violation of the Code §409(n) restrictions, the amount allocated is a deemed distribution to that person under Code §409(n)(2)(a). Additionally, an excise tax equal to 50% of the prohibited allocation and any other improperly accrued benefit is imposed on the employer sponsoring the plan.

D. Miscellaneous Requirements.

1. The seller's basis in qualified replacement property is reduced by the amount of gain not recognized under §1042. Also, Code §1042(d) has an allocation formula if the seller has more than one item of qualified replacement property.
2. No rollover treatment is permitted to sellers of securities to an ESOP to the extent that they were acquired by an underwriter in the ordinary course of his trade or business. Code §1042(c)(5).

3. Non-recapture events. Code §1042(e)(3) provides that the transfer of replacement property on account of the following events is not a disposition that would trigger recapture of gain deferred on the sale of stock to an ESOP:
 - a. The death of the electing shareholder.
 - b. A gift.
 - c. Another Code §1042 transaction.
 - d. A reorganization under Code §368 (e.g., a merger), except in certain situations where the electing shareholder controls the acquired or acquiring corporation.

Under Code §§1014 and 2031 et seq., replacement property passing at death receives a stepped-up basis to fair market value at the date of death or the alternate valuation date, as applicable.

IV. S CORPORATION ESOPs.

A. ESOPs and S Corporations. Effective for tax years commencing after December 31, 1997, Code §1361(c)(7) permits an ESOP (as well as other tax-qualified retirement plans) to be a shareholder in an S corporation. To avoid the 100-shareholder limit applicable to S corporations, the legislative history provides that for purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder.

1. Code §512(e)(3) states that an S corporation's income or loss generated by employer securities held by an ESOP will not be unrelated business taxable income (UBTI) for the ESOP. Thus, the ESOP will not pay tax on the net income and gains attributable to its investment in the S corporation; the tax is deferred until distributions are made.

For example, an S corporation is 100% owned by an ESOP. The corporation will pay no tax on its earnings because it is an S corporation, the ESOP will pay no income tax on its 100% share of the corporation's taxable earnings because it is a tax-exempt entity, and it will pay no unrelated business income tax because of the 1997 repeal of that tax for ESOPs. Therefore, no one will pay any tax on the S corporation income when it is earned. Ultimately, that income will be reflected either in the increased value for the stock held in participant accounts or in distributions of S corporation income to those accounts, which will be taxed when participants receive their ESOP distributions. The date of that tax payment could be many years off, however, because participants have the right to roll their ESOP distribution directly into an IRA.

2. The ESOP is not required to give participants the right to demand employer securities upon distribution as long as participants are entitled to receive their distribution in cash equal to the stock's fair market value. Code §409(h)(2)(B). Without this restriction, any distribution to an ineligible shareholder would void the S election.

B. Some Differences Between an S Corporation and a C Corporation ESOP.

1. The non-recognition of gain provision of Code §1042 is not available with respect to the sale of S corporation stock to an ESOP.
2. Contributions by a C corporation used to pay interest on an ESOP loan are fully deductible in addition to contributions used to pay the principal amount of the ESOP loan. However, contributions by an S corporation used to pay interest on an ESOP loan will count against the 25% limit along with the contributions used to pay the principal amount of the ESOP loan. Code §404(a)(9)(C).
3. S corporation distributions paid to the ESOP are not deductible, while C corporation dividends paid to the ESOP are deductible. Code §404(k).

C. Professional Corporations. Although ERISA and the Code do not preclude a professional corporation from establishing an ESOP, there could be an issue under state law as to whether legal title to the stock is held by someone other than a member of the applicable profession. If the trustee is deemed by the applicable state to hold legal title to the stock held in the ESOP, there should not be a problem with the applicable state's corporate law if the trustee is a member of the class of professionals covered under the professional corporation. The ESOP would be required to contain a provision prohibiting the distribution of stock to former employees/participants of the professional corporation. Ohio Attorney General Opinion 85-065 permits shares of stock in a professional corporation to be held in trust for the benefit of non-professionals if legal title is held by a trustee who is duly licensed or otherwise legally authorized to render the professional service.

D. Tax Treatment of S Corporation.

1. Income flows through to the shareholder and is taxed at the shareholder level. Code §1366. There is no corporate level tax. Code §1363(a).
2. Since the ESOP is a tax-exempt trust, the income flows through to the ESOP and is tax-exempt.

E. S Corporation Requirements.

1. Single class of stock.

An S corporation must have only one class of stock issued and outstanding. Code §1361(b)(1)(D). A corporation is treated as having only one class of stock if all the outstanding shares confer identical rights to distribution and liquidation proceeds. Treasury Reg. §1.1361-1(l). In many S corporations where the ESOP is not the 100% owner, the corporation will make substantial distributions of earnings to its owners to enable them to pay tax on their proportionate share of the S corporation's taxable earnings. In such a case, the ESOP must receive an S corporation distribution in an amount per share equal to distribution made to the other shareholders in order to maintain compliance with the single class of stock requirement. Although the distributions paid to an ESOP are not tax deductible under Code §404(k), distributions paid on the unallocated shares may still be used to make payments on an ESOP loan and will not count against the contribution or annual addition limitations.

2. 100 shareholder limit.

An S corporation cannot have more than 100 shareholders. Code §1361(b)(1)(A). Before December 31, 2004, the limit was 75 shareholders.

3. Eligible Shareholders.

An S corporation can have as shareholders only the following: individuals, estates, certain trusts and, for tax years beginning after 1997, certain tax-exempt organizations including qualified plan trusts. Non-resident aliens cannot be S corporation shareholders. Code §1361(b)(1)(B), (C). Normally, an IRA may not be an eligible S corporation shareholder. However, the IRS has ruled that if the distribution of S corporation stock is made directly to an IRA and, under the terms of the plan (as permitted under Code §409(h)(2)) the shares are immediately repurchased by the corporation, then the corporation's subchapter S status will not be treated as terminated. Private Letter Ruling 200122034. Revenue Procedure 2004-14 extended this exception to an ESOP repurchase.

4. Calendar Year.

The taxable year of an S corporation must be the calendar year unless the corporation can establish, to the satisfaction of the IRS, a business purpose for using a different fiscal year. Code §§1378, 444.

V. 409(p) ISSUES.

- A. The Law. Code §409(p) states that no portion of the assets of the ESOP attributable to (or allocable in lieu of) the stock in an S corporation may, during a non-allocation year accrue (or be allocated directly or indirectly under any qualified plan) for the benefit of any disqualified person.

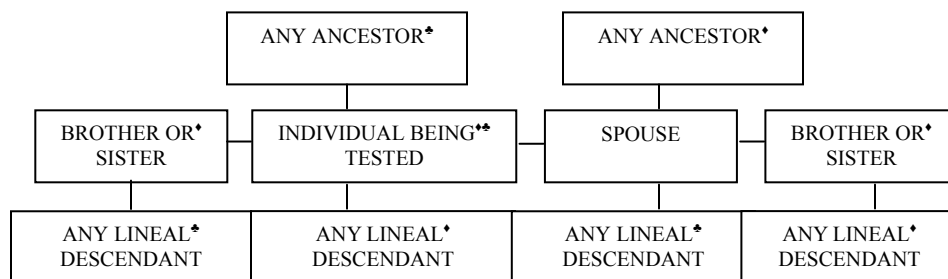
The purpose for the law is to limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners. Congress was concerned with two potential types of abuse:

1. A highly paid professional puts his business into the corporation, which establishes an ESOP to acquire all of its shares and employ the professional as its sole employee and sole ESOP participant. The corporation and the individual will now be free of federal income tax, except to the extent that the individual takes money from the corporation or the ESOP for living expenses.
 2. The owner of an S corporation with 1,000 outstanding shares sells 10 of them to the ESOP and converts the remaining 990 shares into warrants or some other form of synthetic equity. The corporation can now grow rapidly on a tax-free basis. Shortly before the corporation is sold many years from now, the owner exercises his warrants and captures 99% of the value of the corporation's tax-free growth.
- B. Effective Dates. The rules of §409(p) apply to plan years beginning on or after January 1, 2005, unless any of the following apply: (1) the ESOP was established after March 14, 2001, then §409(p) applies as of the date of the establishment of the ESOP; or (2) the corporation is a C corporation with an ESOP and elects S corporation status on or after March 14, 2001, then §409(p) applies as of the effective date of the S corporation election; or (3) the S corporation ESOP first owns S corporation shares on or after March 14, 2001, then §409(p) applies as of the date of ownership.
- C. Consequences of Violation of Code §409(p).
1. Penalties to Disqualified Person.
 - a. Prohibited allocations are deemed to be currently distributed to the disqualified person, but no rollover treatment is available. Code §409(p)(2).
 - b. Ten percent (10%) excise tax on premature distributions if the disqualified person is under age 59½. Code §72(t).

2. Penalties to Corporation.
 - a. Fifty percent (50%) excise tax on fair market value of prohibited allocations. Code §4979A(a).
 - b. Fifty percent (50%) excise tax on fair market value of synthetic equity of disqualified persons. Code §4979A(a)(4).
 - c. Special first allocation year rule of 50% excise tax on the fair market value of all deemed owned shares held by disqualified persons. Code §4979A(e)(2)(C).
3. Plan Ceases to be an ESOP.
 - a. Any exempt loan being repaid by the ESOP loses its prohibited transaction exemption and becomes a prohibited transaction. Code §4975(d)(3).
 - b. The plan becomes subject to the tax on unrelated business taxable income. Code §512.
4. Plan may be considered as having lost its tax-qualified status. Code § 4975(e)(7).

D. Definitions. To understand Code §409(p), there are several definitions to know:

1. Disqualified Person. Code §409(p)(4).
 - a. Is a member of a family that owns 20% or more of deemed-owned shares of the corporation, including only their synthetic equity in the denominator (not all synthetic equity outstanding), or
 - b. Owns 10% or more of deemed-owned shares of the corporation, including only his synthetic equity in the denominator (not all synthetic equity outstanding).
2. Family Members of an Individual Are: Code §409(p)(4)(D).
 - a. Spouse of an individual.
 - b. Ancestor or lineal descendant of the individual or individual's spouse.
 - c. Brother or sister of the individual or the individual's spouse and any lineal descendant of the brother or sister.
 - d. Spouse of any individual in b or c, above.
 - e. Step-siblings or cousins may be included in the family of an individual through a person who has no involvement with the ESOP or its sponsor.
 - f. See the following chart:



♣ SPOUSE OF THIS PERSON

♣ ♦ GENERALLY A PARTICIPANT OR PERSON HAVING SYNTHETIC EQUITY

3. Non-allocation Year. Code §409(p)(3).
 - a. Disqualified persons own 50% or more of the stock in the S corporation and the ESOP holds S corporation stock.
 - b. Ownership includes deemed-owned shares (including synthetic equity) and shares outside the ESOP actually owned or by attribution.
4. Deemed-Owned Shares: Code §409(p)(4); Treasury Reg. §1.409(p)-1T(e).
 - a. Allocated ESOP shares.
 - b. Pro rata portion of shares in ESOP loan suspense account.
 - c. Synthetic equity. Code §409(p)(5).
5. Synthetic Equity Includes: Code §409(p)(6); Treasury Reg. §1.409(p)-1T(f)(2).
 - a. Stock options.
 - b. Warrants.
 - c. Restricted stock.
 - d. Deferred issuance stock rights.
 - e. Similar interest or right that gives holder the right to acquire or receive stock.
 - f. Stock appreciation rights.
 - g. Phantom stock.
 - h. Similar right to future cash payment based on value of stock or appreciation in value.
 - i. Right to acquire stock or assets of a related entity.
 - j. Non-qualified deferred compensation.
 - k. Split-dollar life insurance.
 - l. Synthetic equity can only be used to make an individual a disqualified person or a non-allocation year. Synthetic equity

cannot be used to avoid a person becoming a disqualified person or avoiding a non-allocation year.

- m. For disqualified persons, synthetic equity counts as shares in determining ownership for purposes of the 10% individual test and the 20% family test.
- n. Non-allocation year synthetic equity counts as shares in determining whether a disqualified person owns at 50% of the “stock” of the company.

6. Examples.

a. Example No. 1:

- o ESOP owns 100% of the S corporation’s shares
- o All ESOP shares are allocated
- o No synthetic equity
- o Four employees have 14%, 12%, 10%, and 5%, respectively, of total deemed-owned shares
- o No employees are related
- o No non-allocation year—three disqualified persons, but in the aggregate they own less than 50% of all S corporation shares

b. Example No. 2:

- o ESOP owns 40% of the S corporation’s shares
- o Three unrelated employees each have 4% of S corporation’s shares allocated to them in the ESOP (i.e., 10% of ESOP’s shares each)
- o Same three employees also directly own 15% each of the S corporation’s issued and outstanding stock
- o There is a non-allocation year—
 - a) three employees are disqualified persons (each has 10% of deemed-owned shares, the ESOP shares).
 - b) three disqualified persons in the aggregate own at least 50% of all S corporation shares (12% in ESOP + 45% outside the ESOP).

7. IRS Temporary Regulations. Treasury Reg. §1.409(p)-1T.

a. IRS Temporary Regulations.

- i. Issued July 18, 2003; modified December 16, 2004.
- ii. Temporary regulations as amended are generally effective for plan years beginning on or after January 1, 2005.

b. Additional Definition: Prohibited Allocation.

- i. A prohibited allocation occurs if, during a non-allocation year, there is an impermissible accrual or an impermissible allocation. Treasury Reg. §1.409(p)-1T(b)(2)(iii).

- ii. Impermissible accrual – exists to the extent (and only to the extent) that shares of stock of an S corporation (or assets attributable thereto) are held under the ESOP for the benefit of a disqualified persons during a non-allocation year. Treasury Reg. §1.409(p)-1T(b)(2)(ii).
 - iii. Impermissible allocation means any allocation, direct or indirect, for the benefit of a disqualified person during a non-allocation year.
 - c. Synthetic Equity.
 - i. Related Entity. Any right to acquire stock or assets of a related entity, to the extent of the S corporation’s ownership in the entity, now constitutes synthetic equity. Treasury Reg. §1.409(p)-1T(f)(3); (f)(4)(ii).
 - ii. Super voting stock. A right to acquire stock with greater voting rights than the stock owned by the ESOP is considered as owning shares of synthetic equity equal to the number of shares with the same number of voting rights if such shares had the same per-share voting rights as the ESOP shares. This rule is effective as of January 1, 2005. Treasury Reg. §1.409(p)-1T(f)(4)(v).
 - d. Valuing Synthetic Equity.
 - i. Pro-rata Rule. If the ESOP owns less than 100% of the S corporation, the value of synthetic equity as otherwise determined is reduced by the same percentage of the Company not owned by the ESOP (provided the other owners are taxable). Treasury Reg. §1.409(p)-1T(f)(4)(iv).
 - ii. This rule is retroactively effective to March 14, 2001.
 - iii. Example: ESOP owns 35% of the Company; CEO owns options to purchase 100 shares; CEO is considered as owning 35 shares of synthetic equity.
 - e. When Is Synthetic Equity Valued. Treasury Reg. §1.409(p)-1T(f)(4)(iii)(B).
 - i. Synthetic equity can be valued as of any determination date during the year, if representative, and in some cases that value can be fixed until the third anniversary of the determination date (with new grants valued as of the next date that is an anniversary of the determination date).
 - ii. Tri-annual valuation is allowed for synthetic equity which is cash based non-qualified deferred compensation (not based on shares of stock in S corporation or related entity).
 - a) If used, must be applied to all similar synthetic equity.
 - b) Provision for tri-annual valuations must be included in the ESOP plan document.

- f. Valuing Synthetic Equity—Stock-Based Synthetic Equity. Treasury Reg. §1.409(p)-1T(f)(i).
 - i. Determination of number of shares of stock-based synthetic equity (options, warrants, etc.).
 - ii. The person who is entitled to the synthetic equity is treated as owning the number of shares of stock deliverable pursuant to the synthetic equity.
 Example: If there is an option to purchase 100 shares of the S corporation stock at a fixed price in the future, the holder of the option is deemed to own 100 shares.
 - iii. Example—Stock Options and 409(p).
 100% ESOP owned S corporation (1,000 shares outstanding).
 - a) ESOP aggregate allocations are limited to 9.9% of stock owned by ESOP (99 shares) and A, B and C each have that amount allocated.
 - b) A, B and C each have options to purchase 150 shares.
 - c) 409(p) analysis: A, B and C are each a disqualified person because of the options. Disqualified persons analysis: 99 ESOP shares + 150 option shares = 249 deemed-owned shares. $249/1150 = 21.6\%$, a disqualified person. Non-allocation year analysis: $(249 + 249 + 249)/1450 = 51.5\%$.
 - d) There is a non-allocation year.
 - e) If the ESOP owns less than 100% of the S corporation the calculation will be different.
- g. Valuing Synthetic Equity—Referenced by Stock But Paid in Cash. Treasury Reg. §1.409(p)-1T(f)(iii). If synthetic equity is in reference to S corporation stock, but payment is to be made in cash or other property (e.g., SAR, phantom stock):
 - i. Holder is treated as owning the number of shares having a fair market value equal to the cash/property entitlement on the measurement date.
 - ii. Example: An SAR is granted with regard to 100 shares of S corporation stock. The shares the holder is deemed to own equals the number of shares having a value equal to the appreciation at the time of measurement (without regard to lapse restrictions).
- h. Valuing Synthetic Equity—Nonqualified Deferred Compensation. Treasury Reg. §1.409(p)-1T(f)(iii). For purposes of §409(p) testing, nonqualified deferred compensation (NQDC) is converted to a number of shares equal to the number of shares having a fair market value equal to the present value of the NQDC.

- i. Attribution Rules
For purposes of determining whether there is a non-allocation year, ownership of stock is generally attributed under the rules of Code §318, except that:
 - i. The family attribution rule is modified to include certain other family members, as described above with respect to disqualified persons;
 - ii. Option attribution does not apply (but, instead special rules relating to synthetic equity described above apply); and
 - iii. Deemed-owned shares held by the ESOP are treated as held by the individual with respect to whom they are deemed to be owned. Code §409(p)(4)(D); Treasury Reg. §1.409(p)-1T(c)(2).

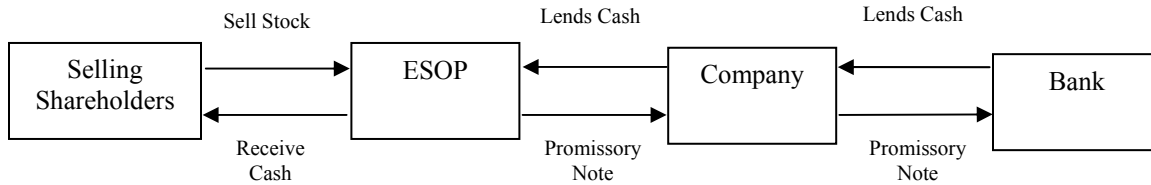
VI. CASE STUDY – INITIAL ESOP FEASIBILITY.

One of the most common uses of an ESOP is to buy the stock of an owner in a closely held company. An ESOP can provide a market for the equity of a shareholder of a closely held company and provide a benefit and job security for employees in the process. Owners of closely held companies may incur no taxable gain on a sale of stock to an ESOP, provided that the ESOP owns at least 30% of the company immediately after the sale and that the sale's proceeds are reinvested in qualified securities within a fifteen month period beginning 3 months before the date of the sale.

In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust, which will enable the trust to amortize the loan or schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. The leveraging will be used to buy out the stock of the former owners and the ESOP will acquire those shares. Two tax incentives make borrowing through an ESOP extremely attractive to companies. First, since ESOP contributions are tax deductible, a corporation which repays an ESOP loan in effect gets to deduct principal as well as interest from taxes. This can cut the cost of financing to the company significantly, by reducing the number of pre-tax dollars needed to repay the principal by as much as 34%, depending on the company's tax bracket. Second, dividends paid on ESOP stock of a C corporation passed through to employees, or reinvested by employees for more company stock, or used to repay the ESOP loan are tax deductible. This provision of federal tax law may increase the amount of cash available to a company compared to one utilizing conventional financing.

ESOP Feasibility Study

For purposes of this analysis, we have assumed the company's value to be \$3 Million and outside financing can be obtain for 15 years with an 8% interest rate. There are two equal shareholders of the company. We based the analysis on the provided employee census. We assumed that the sale structure would be as follows:



First, the company would make plan contributions to the ESOP. Second, the ESOP pays on the promissory note to company. When the shares are paid, they are allocated in the ESOP to the plan participants. Third, the company pays on the promissory note to the bank.

In the year following the sale, the company would elect S status, which would then make the company federal income tax free (with certain exception for built-in gains, LIFO recapture and excess net passive income). This will enhance the company’s cash flow and ability to grow.

In reviewing the ESOP feasibility, the following issues must be addressed:

1. Can the ESOP buy the shares based on cash flow?

For 2006, it is projected that the Company will have income of \$400,000. Based upon the assumptions (15 year loan with 8% interest rate), the annual payments to finance the ESOP are \$356,934.

2. How does the “tax-free” rollover work for the selling shareholder?

A shareholder who sells qualified securities¹ to an ESOP incurs no taxable gain on the sale if two conditions are met. First, immediately after the sale the ESOP must hold either 30% of each class of outstanding stock of the corporation or 30% of the total value of all classes of outstanding stock issued by the corporation. Second, within a 15-month period beginning three months prior to the date of sale, the seller or sellers must purchase qualified replacement property².

The rollover must be elected in writing on a timely filed tax return for the taxable year of the sale. Treasury Regulation §1.1042-1T sets forth the procedure for making the statement of election of tax-free treatment and statement of purchase of the new securities.

¹ Qualified securities are defined as common stock of a C corporation with voting and dividend rights equal to the classes of common stock having the greatest voting and dividend rights. The securities must have been owned by the seller for at least three years and cannot have been received by the seller in a distribution from a qualified retirement plan or a transfer under a stock option granted by the company.

² Qualified replacement property is defined as any security issued by a domestic (or U.S.) operating corporation that is not the corporation that issued the qualified securities that were sold to the ESOP (or a member of the same controlled group of corporations), and which does not receive more than 25% of its gross receipts during the taxable year in which it is purchased from passive investment (this requirement disqualifies mutual funds). Government securities and securities acquired by an underwriter do not qualify. An operating corporation is one whose assets are used in the active conduct of a trade or business. Passive income has the same meaning as under the S corporation rules.

The seller's basis in the new securities will be adjusted by the amount of gain not recognized as a result of the election. Also, the holding period of the employer securities is "tacked on" to the holding period of the replacement securities. Thus, the ESOP rollover allows a selling shareholder to defer, not eliminate, taxes on the sale, enabling the seller to invest and earn with money that would have been taxed away. If the replacement property should go into the seller's estate, however, then its basis will be "stepped up" to the property's current value, and the tax on the sale will effectively have been eliminated.

No portion of the assets attributable to qualified securities sold to an ESOP through a tax-free rollover may be allocated to the taxpayer seeking tax-free rollover treatment, any person who is related to that taxpayer, or any other person who owns more than 25% of the value of any class of qualified securities of the issuing corporation. If the ESOP disposes of the acquired securities within three years after acquiring them, a 10% excise tax is imposed on the employer. The excise tax applies if the total number of shares held by the ESOP is less than before the disposition, or if the value of the ESOP's share of the company ceases to meet the 30% requirement.

Utilizing the assumptions, let's review three possible scenarios:

1. No ABC Co. shareholder elects tax-free rollovers.

Step One: The company obtains bank financing for \$3 Million with a term of 15 years, interest at 8%.

Step Two: The company makes a mirror loan to the ESOP of the \$3 Million with a term of 15 years, interest at 8%.

Step Three: All shareholders sell their shares to the ESOP for \$3 Million.

Step Four: The shareholders pay capital gains tax rate (15%) on the sales price (less stock basis).

Step Five: All of the shareholders are eligible for participation in the ESOP.

Attached chart 1 demonstrates a shareholder's account value after 5 and 10 years assuming the net sales proceeds of \$1.5 Million each are invested at 8% (with a 15% capital gains tax applied each year on the earnings) and participation in the S corporation ESOP at 9% participation rate (avoid Disqualified Person status) with the company growing at an annual rate of 3% (company's growth value on Chart 3).

2. All of the shareholders elect tax-free rollovers.

Step One: The company obtains bank financing for \$3 Million with a term of 15 years, interest at 8%.

Step Two: The company makes a mirror loan to the ESOP of the \$3 Million with a term of 15 years, interest at 8%.

Step Three: All shareholders sell their shares to the ESOP for \$3 Million, as noted above.

Step Four: The shareholders decide to make the “tax-free” election and take the steps necessary to effect the election.

Step Five: None of the former shareholders (and any family member) are eligible for participation in the ESOP.

Step Six: A deferred compensation arrangement may be instituted to make the former shareholders whole, due to their inability to participate in the S corporation ESOP.

Attached chart 2 demonstrates a shareholder’s account value after 5 and 10 years assuming an 8% annual tax-deferred growth and a 15% capital gains tax at the end of the 5 and 10 years.

3. Do nothing and sell the stock to an outside buyer 10 years from now using the company value on chart 3.

| | |
|----------------------------------|---------------------|
| Stock sale price | \$4,031,749.00 |
| Less 15% cap gain | <u>- 604,762.00</u> |
| Net sale price (total) | \$3,426,987.00 |
| Net sale price (per shareholder) | \$1,713,493.50 |

If this ESOP feasibility analysis phase continues, an independent appraisal is required along with the appointment of designated fiduciaries to represent the ESOP interests.

VII. S CORPORATION ESOP AS AN ACQUISITION TOOL.

- A. In a typical acquisition, generally the buyer wants to buy assets so that it obtains a depreciation deduction for the increase in the tax basis of the assets. Moreover, an asset sale limits the buyer’s liability. The seller would rather have a stock sale to achieve capital gain tax versus the double corporate tax for a C corporation. Also in a traditional stock sale, all the liabilities are transferred to the buyer. The buyer’s only protection is to obtain meaningful representations and warranties and an indemnification from the seller.

- B. From the seller’s point of view, if the seller sells stock, then the seller pays long-term capital gain tax on the sale (less the stock basis). However, if the seller sells the assets, then the seller has a double tax. For a C corporation, the double tax rate will be approximately 52% and if the seller is an S corporation as low as 20% as long as there is no unrelated business taxable income, or certain assets

(depreciation recapture, appreciated inventory, accounts receivable for a cash-method taxpayer or built-in gains tax).

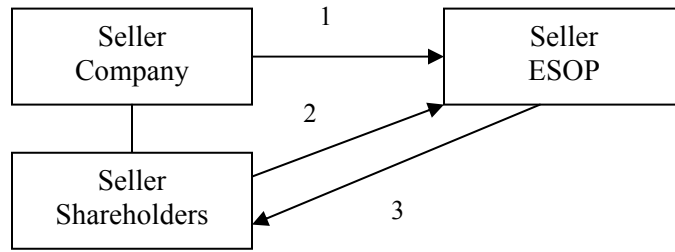
- C. However, if the ESOP is the buyer, it prefers to buy stock. For a 100% ESOP, the tax deductions are irrelevant since it pays no tax. If a seller sells its stock to the ESOP buyer, the seller may be able to take advantage of Code §1042. Thus, the ESOP may be able to reduce the price paid to the seller yet the seller's proceeds will be higher than a sale to a non-ESOP buyer wanting to buy assets. The ESOP can out bid other buyers that cannot provide these tax advantages.
- D. Consider the following comparison to this seller's net proceeds amongst an asset sale, a stock sale and a 1042 sale.

| | <u>C Corporation Asset Sale</u> | <u>Stock Sale or Asset Sale by an S Corporation</u> | <u>1042 Sale</u> |
|---------------------------------------|-------------------------------------|---|------------------|
| Gross Sale Price | 5,000,000 | 5,000,000 | 5,000,000 |
| Taxes Due – (40%) Corporate Level | 2,000,000 | 0 | 0 |
| Taxes Due – (22%) Individual Level | 660,000 | 1,100,000 | 0 |
| Net Proceeds | 2,340,000 | 3,900,000 | 5,000,000 |

- E. The ESOP buyer should consider the treatment to be afforded to the seller's employees. For example, will they be included in the ESOP and how will that affect the buyer's current employees?
- F. Structuring the ESOP purchase. The owners of the selling company are interested in selling. The buyer ESOP and certain other non-ESOP companies want to acquire the seller and are competing to do so. The buyer ESOP can out bid competitors due to the fact that the buyer does not need to deduct acquisition costs because being an S corporation ESOP, it is not subject to income tax and the buyer can provide owners of the selling company with the opportunity to make a §1042 election. The following are the mechanics of the structure:

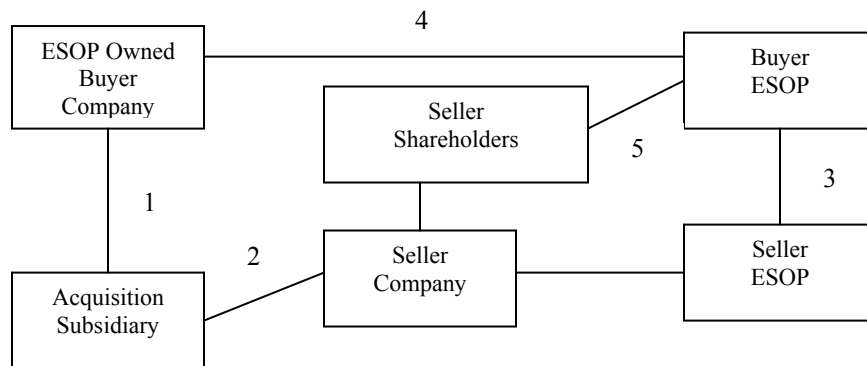
First Stage:

1. Seller company adopts ESOP.
2. Seller shareholders sell stock to ESOP.
3. Seller shareholders receive a note for purchase price.

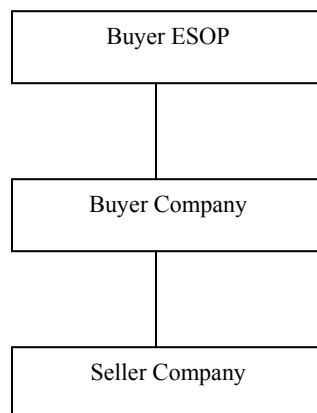


Second Stage:

1. Buyer company forms an acquisition subsidiary.
2. Acquisition subsidiary merges into seller company.
3. Seller ESOP merges into buyer ESOP, which assumes seller's shareholder's debt.
4. Buyer company borrows from bank using seller company's assets as collateral and lends to Buyer ESOP.
5. Buyer ESOP pays seller's shareholder's notes.



End result:



As you can see, the S corporation ESOP is a tax-efficient buyer with a competitive advantage over its taxable competitors.

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