

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

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Butterfield Schechter♦LLP was founded in 1998 by Robert K. Butterfield and Marc S. Schechter. The attorneys at Butterfield Schechter♦LLP are dedicated to offering clients top-quality legal services in the following areas:

Employee Benefits and ERISA Compliance

Corporate, Business, and Taxation

Executive Compensation

Estate Planning

ERISA Litigation

The commitment of the Firm's attorneys to provide excellent service, together with their over 50 years of combined experience in the above-focused practice areas, continues to foster positive solutions for clients. Butterfield Schechter♦LLP's persistent effort to prevent future legal problems from occurring has also encouraged the development of long-term client relationships.

AN INTRODUCTION TO ESOPs

Whatever the nature of your business may be, or its size, there are many reasons to consider adopting an Employee Stock Ownership Plan, or ESOP.

Technically speaking, an ESOP is a tax-qualified employee benefit plan. But it is a dynamic plan--and one that offers great advantages to business owners as well as employees.

An ESOP is a method by which a business owner can qualify for significant tax benefits when the time comes to sell the business. An ESOP can also provide major benefits for employees.

What tax advantages do ESOPs offer you as a business owner?

If you'd like to sell part or all of your business, an ESOP enables you to do so without currently paying any capital gains tax.

You can also use an ESOP as a tax-advantaged method of financing your business. You benefit whether the financing is for yourself (e.g., to buy another company, purchase a retiring stockholder's interest or arrange for a son or daughter to take over the business) or for the company to buy new equipment. An ESOP can be used to significantly reduce financing costs.

In addition to the above uses, an ESOP can also:

- ❖ Provide a market for thinly traded stock;
- ❖ Create an atmosphere in which the employees want the company to succeed;
- ❖ Provide liquidity for the estate of a large stockholder;
- ❖ Let the company owner respond to demands for shared ownership, and attract, retain and reward employees without losing company control;
- ❖ Reduce the cost of corporate stock repurchases; and
- ❖ Provide for the purchase of key-person life insurance policies on a fully tax-deductible basis.

An ESOP may not ultimately be right for everyone, but it is a flexible option that should be carefully considered. This brochure is designed to provide information to business owners and advisors on how (if) an ESOP can be of benefit in your situation.

WHAT MAKES AN ESOP WORK?

An ESOP is like no other employee benefit plan.

While most employee benefit plans invest in stocks and bonds of other companies, ESOP funds may be invested primarily in your company's stock.

The advantage is that, through ESOP participation, employees literally own a part of the company--and are consequently more motivated to improve company performance because they stand to benefit directly through increases reflected in the value of company stock allocated to their ESOP accounts.

An ESOP is implemented by adopting a written plan and setting up a trust to hold your company's contributions to the plan (as you do with a standard profit sharing or pension plan). Contributions to the ESOP, either in the form of company stock or cash, are tax deductible within applicable limits. In fact, contributing company stock to the ESOP trust can provide the company much needed tax deductions, resulting in more cash available for other company needs.

Income earned by an ESOP trust is tax-exempt. ESOP participants do not have to pay tax on the amounts allocated to their accounts, or on trust fund earnings, until they withdraw their benefits from the ESOP--generally after they retire.

SELL YOUR CORPORATION AND PAY NO TAX

One important additional benefit is available to the owners of private companies in addition to the numerous tax benefits that ESOPs can provide to all companies.

Perhaps you are older, ready to retire--or younger, but with most of your wealth tied up in the value of your company stock--and you wish to diversify your portfolio, and obtain liquidity without paying taxes.

Whatever your reason, if your company's shares are not publicly traded, you can sell part or all of your company stock to an ESOP without paying any capital gains tax.

Three basic requirements must be satisfied to qualify:

1. Immediately after the sale, the ESOP must own at least 30 percent of the outstanding stock of your company;
2. Sales proceeds must be reinvested within 12 months in "qualified replacement property" (basically, stocks and bonds of domestic operating companies); and
3. Stock sold to the ESOP may not be allocated back to you or to any member of your family.

If you satisfy these requirements, no federal income tax, and in many cases no state income tax, will be currently due on the sale of your stock to the ESOP.

Income tax on this sale will be deferred until the replacement property is sold. In fact, you and your heirs can even avoid this income tax if you hold the replacement property until your death. At that point, they will only be taxed for income tax purposes on the increase in value of the stock from the date of your death to the date of sale, and not taxed at all on the stock's original value or its increase in value during your lifetime (estate taxes, however, continue to be an issue).

Some bond arrangements are also available as replacement property which can permit you to draw out in cash as much as 75 percent of the bonds' value, without creation of a taxable event.

As you near retirement, a sale of your privately held company stock to an ESOP may be the best way to provide for your retirement security by permitting you to defer or avoid capital gains taxes.

If you are younger, but with most of your wealth tied up in your company stock, you may wish to begin diversifying your portfolio. You can do so income tax-free (or tax-deferred) with an ESOP.

ESOPs AND TAX-FAVORED FINANCING

Unlike all other types of employee benefit plans, ESOPs may borrow money to purchase your company's stock.

In this manner an ESOP serves as a tax-advantaged financing tool. This is because you can deduct principal repayments as well as interest on an ESOP loan within surprisingly generous limits set by the Internal Revenue Code.

Your company obtains a tax deduction for plan contributions used to repay the loan.

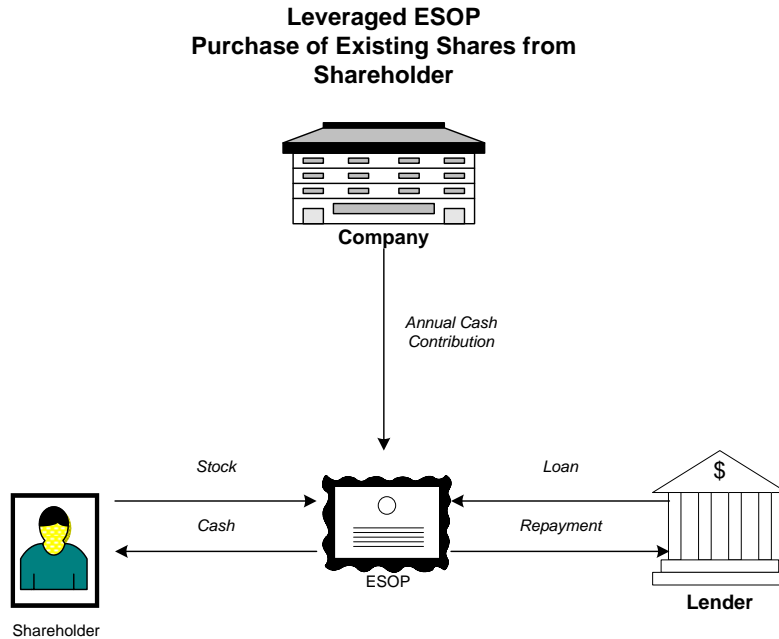
You could arrange a simple ESOP loan as follows:

1. The ESOP trustee borrows funds from a commercial lender;
2. The ESOP trustee uses the loan proceeds to purchase shares of newly issued stock from your company, which can then use the loan proceeds; and
3. Your company makes annual cash contributions to the ESOP--enough to amortize the loan--and deducts the amounts so contributed.

After the ESOP trustee purchases stock from your company, you can then use the loan proceeds for any acceptable business purpose--such as buying equipment, buying another company, taking your private company public or financing the sale of your stock--and your after-tax loan financing costs are dramatically reduced. There is

virtually no limit to the types of transactions in which you can use ESOPs to reduce financing costs.

Through the use of ESOP financing, the result is that your company pays back only (approximately) two-thirds of the loan principal. The government pays (essentially subsidizes) the remainder of the loan by providing tax deductions.



CASE STUDY: ACHIEVING SHAREHOLDER LIQUIDITY

Here's a hypothetical example of how you as the owner of a private corporation could use an ESOP to facilitate a successful transfer of ownership of your business. This case illustrates the use of an ESOP as both a way to sell without currently paying tax and a way to obtain tax-favored financing.

Say you own all your company's stock, and you're approaching an age when you'd like to retire. Several key employees have also worked at your company many years and would like to take over its management.

The value of your business that you started with a relatively small investment is about \$3,000,000.

Your objectives are to be able to retire with an adequate and assured income, transfer control of your business to your employees over time and protect the jobs of your company's long-term employees.

You have several alternatives.

First, you could sell the business to a third party. You'd have retirement security; but by selling to outsiders, you give up the chance to pass control of the business on to your key employees, assuring them of job security. Moreover, you'd face federal and state taxes in excess of 30 percent of the sale proceeds. Assuming that you sell your stock for \$3,000,000, your total current federal and state tax liability will likely exceed \$850,000.

Second, you could have the company buy back all or a portion of your stock. Either you'd take back a note from the company, or it would borrow the money to finance the transaction. There is no tax relief either way. You pay a large capital gains tax, and the company is not entitled to any tax deductions in connection with the payments it makes to you (except for interest).

You face an additional problem: If you take back a note from the company, you still have all your eggs in one basket. If the company doesn't continue to prosper, your retirement security is in jeopardy.

A third alternative is for you to sell your stock to an ESOP. As long as you sell at least 30 percent of your company stock to the ESOP (and the other requirements mentioned on page 2 are satisfied), the sale qualifies for tax-free "rollover" treatment. For example, if you sell one-third of your stock to the ESOP for \$1,000,000, you could save about \$200,000 in federal income tax.

If the company borrows the funds to repurchase your stock through an ESOP loan, its financing costs are greatly reduced compared to borrowing for a conventional stock redemption. This is because the company will be entitled to deduct the principal repayments on the loan. Assuming it borrows the full \$1,000,000 purchase price, the company will be entitled to \$1,000,000 in federal and state income tax deductions it would not otherwise have in repaying the loan. This will result in a \$340,000 tax savings over the term of the loan (possibly more depending on your state's corporate tax rate). Combined with the \$200,000 in federal taxes that you will have deferred (plus applicable state taxes), the total tax savings can be at least \$540,000, or 54 percent of the total purchase price. Obviously, if you sold your entire interest in the company to the ESOP the savings would be proportionately greater.

To summarize, if you use an ESOP as in this hypothetical situation, you'll be able to diversify your investments on either a tax-free or tax-deferred basis and substantially increase your annual income. Over time, your key employees may be able to assume control of the business, and your employees will enjoy job security and more incentive than ever to increase their productivity.

SOUND TOO GOOD TO BE TRUE?

The many advantages ESOPs offer you are not the result of temporary tax loopholes nor is their use aggressive tax planning. Congress enacted ESOP legislation over 25

years ago as an ongoing incentive program to encourage company ownership sharing and to increase worker productivity.

Of course, ESOPs are not for everyone. Some business owners are not particularly concerned with liquidity of their wealth or contemplating retirement and may prefer to maintain sole ownership of their company. And some businesses may not be appropriate for ESOPs--such as companies that are unprofitable or that have only a short-term industry outlook. But the benefits of ESOPs are by no means limited to large companies. Most small and medium-sized businesses are well suited for ESOPs.

TEN FREQUENTLY ASKED QUESTIONS ABOUT ESOPs

1. Q: “Will I lose control of my company?”

A: Adoption of an ESOP does not normally result in a change in management. Your company’s Board of Directors selects the trustee, who generally retains the right to vote private company shares held in an ESOP.

Plan participants vote the shares allocated to their accounts only on a proposed merger, sale of the business, recapitalization or liquidation.

The trustee you select votes the shares on all routine corporate matters, such as Board of Directors’ elections.

2. Q: “How do you determine the value of stock held in an ESOP?”

A: The stock’s price when purchased by your ESOP trustee, or the tax-deductible amount your corporation claims as an employer in connection with its stock contribution to the ESOP, must not exceed the stock’s value, as determined by an independent professional appraiser who must utilize an appropriate appraisal methodology.

Stock is valued at least annually, and participants are informed annually of the value of shares allocated to their accounts.

3. Q: “Can I limit plan participation to key executives?”

A: No. As a tax-qualified plan, ESOP participation must be available to a broad cross-section of employees who meet statutory standards, not just to a select group of key executives. However, union employees may be excluded if retirement benefits are the subject of good-faith negotiations with the union.

ESOP benefits cannot unduly favor officers, shareholders, or highly compensated employees--however, you may allocate benefits in proportion to the relative compensation of participating employees, and you may take their years of service into account for vesting of benefits.

4. **Q: “May an existing pension plan or a profit sharing plan be converted into an ESOP?”**

A: Any qualified plan may be converted into or replaced with an ESOP, although different procedures apply to different types of plans.

In the case of converting an existing qualified plan to an ESOP, it is not generally advisable to use the funds of the prior plan to purchase or acquire securities of your company for the ESOP without obtaining the consent of the participants. In some cases, it may be prohibitively expensive to let participants decide whether or not to invest existing funds in securities of your company due to the requirement of complying with federal and state securities laws.

5. **Q: “What are the typical sources of ESOP financing?”**

A: Sources of ESOP financing generally include regional commercial banks, insurance companies, credit and finance companies, and private investors. Your existing lending relationship may also be a potential source for ESOP financing. An experienced ESOP legal advisor has knowledge of ESOP lending sources and can identify and negotiate appropriate loan terms.

Most lenders see the ESOP and the sponsor-corporation as better credit risks because repayment of the loan principal can be made with tax deductible dollars, giving the borrower a significant advantage over most other companies who borrow funds.

6. **Q: “What limits apply to an ESOP’s ability to borrow money to purchase employer securities?”**

A: No requirements specifically limit an ESOP’s ability to borrow, but practical constraints on the company’s ability to make deductible ESOP contributions sufficient to repay ESOP debt control the amount an ESOP may borrow. The law limits annual deductible employer contributions used to repay an ESOP loan to interest on the loan, plus 25 percent of the total compensation of all employees participating in the ESOP.

The Internal Revenue Code also permits ESOPs of C corporations to repay acquisition debt with dividends paid on stock held by the ESOP. Like company ESOP contributions, dividends paid on the ESOP stock are deductible by the company if they are used to repay acquisition debt, but they do not count towards the 25 percent of covered compensation limit described above. C corporations which do not have sufficient covered payroll to repay acquisition indebtedness may use deductible dividends as an additional source of debt repayment funds. Dividends on ESOP stock are also fully deductible if they are paid directly to or passed through the ESOP to the participants.

7. **Q: “What happens when a participant terminates or retires?”**

A: Unless your corporate charter or bylaws restrict stock ownership to employees (a typical provision often added when an ESOP is implemented), a retiring

or terminated participant may elect to take his or her benefits in company stock. Otherwise, benefits may be paid in cash.

If company stock is distributed, your company may retain the right of first refusal. Retired or terminated participants who receive company stock from your ESOP have the option to sell those shares back to your company at a fair valuation. The company then has at least five years to pay the purchase price.

8. **Q: “How are benefits paid?”**

A: Distribution of benefits must commence within one year of a participant’s normal retirement, disability, or death--or within five years after a separation from service for any other reason.

However, if your company stock was acquired with a loan, you may delay the distribution of benefits to a terminated employee until after the loan is repaid.

9. **Q: “Can my company be an S corporation?”**

A: Yes, beginning in 1998, S corporations have been permitted to maintain ESOPs as a result of the Small Business Job Protection Act. S corporation ESOPs can offer unique and significant planning opportunities in the optimum situation. Special rules apply to S corporations--so careful analysis is needed as to whether an ESOP will meet Internal Revenue Code ownership diversification rules for S corporation ESOPs.

10. **Q: “How do I get started?”**

A: Consult with an experienced ESOP legal advisor. ESOPs must comply with highly technical provisions of tax and employee benefits laws. ESOPs are complicated to design. A legal advisor familiar with such laws can save you time as well as money.

WHAT DO WE OFFER?

Butterfield Schechter♦LLP is the largest San Diego-based law firm with a major focus on employee benefits and ERISA matters. Our broad-based clientele includes corporations, individuals, partnerships, LLCs, joint ventures, qualified retirement plans, and nonprofit organizations and government agencies.

We are dedicated to employee ownership, as evidenced by our active involvement and leadership in such professional associations as The ESOP Association, the National Center for Employee Ownership (NCEO), and the Beyster Institute for Entrepreneurial Employee Ownership. When you come to us for ESOP services, you get an influential legal counsel who stands beside you to help you stay informed, in compliance, and abreast of the latest developments—all to help you realize your plan goals as fully and effectively as possible.

We are among the most experienced ESOP attorneys in the country, with Marc Schechter and Robert Butterfield having worked in the ESOP field an aggregate of over 50 years. We have assembled an experienced ESOP Team, comprised of lawyers with substantial experience in the various legal disciplines ESOP transactions call into play.

Members of our ESOP Department have extensive experience in federal and state taxation, employee benefits, corporate law, ESOP financing matters and various aspects of employee benefit litigation. The attorneys have counseled both large and small corporations on the use of ESOPs in various transactions, including leveraged buyouts, corporate stock repurchases and ownership succession transactions.

ESOP RELATED SERVICES

For clients who wish to implement ESOPs, we:

- ❖ Counsel on plan feasibility and design;
- ❖ Prepare the ESOP plan and trust agreement;
- ❖ Assist with finding financing, including contacting lenders and reviewing and negotiating the bank loan agreement and related security documents;
- ❖ Prepare legal opinions for lenders on compliance with applicable laws (including the Internal Revenue Code and ERISA);
- ❖ Obtain official IRS approval for your ESOP document, including preparing and filing a tax-ruling request with the Internal Revenue Service; and
- ❖ Help you communicate changes and explain ESOP advantages to your employees, including preparation of a plan summary designed to explain the ESOP to employees.

In addition to representing companies that sponsor ESOPs, we also represent ESOP trustees and lenders to ESOPs and advise on their fiduciary responsibilities generally. On behalf of lenders, we:

- ❖ Counsel on compliance with legal requirements;
- ❖ Draft loan documents and related security agreements;
- ❖ Review ESOP documents to assure that they are legally prepared and implemented; and
- ❖ Assist with any litigation that may arise respecting an ESOP.

MARC S. SCHECHTER, head of our ESOP Department, is a member of The ESOP Association and the National Center for Employee Ownership. He actively participates

in the activities of these national organizations, and in related educational and lobbying efforts.

Mr. Schechter has written comprehensive articles on ESOPs, and he speaks regularly at ESOP seminars and at legal and tax seminars on the subject of ESOPs.

ROBERT K. BUTTERFIELD, an ESOP Team member, has worked with ESOPs since 1976 and has extensive experience in all areas of employee benefit planning. He speaks regularly at seminars on employee benefit topics.

Mr. Schechter and Mr. Butterfield are ready and willing to meet with you to discuss your ESOP options.

SUMMARY OF TAX INCENTIVES FOR ESOPs

1. The company's contributions to an ESOP are tax-deductible (within applicable limits) and tax-free to ESOP participants until they receive their distribution.
2. The income of an ESOP trust fund is exempt from federal and California income tax.
3. Special IRA "rollover" provisions and special tax treatment of appreciated company stock with ESOPs can defer the tax on distributions from ESOPs to employee-beneficiaries.
4. You may sell stock of your closely held corporation to an ESOP on a tax-deferred (potentially income tax-free basis), if (a) the ESOP owns at least 30 percent of your company's stock immediately after the sale, and (b) you reinvest the sales proceeds in securities of other domestic operating corporations.
5. Purchase of a company can be leveraged through use of ESOP borrowed funds to purchase most of the outstanding stock.
6. If your company uses an ESOP to obtain a loan, the company is entitled to income tax deductions for both loan interest and principal payments, instead of on interest payments only (as in an ordinary corporate loan).
7. Interest rates on loans to ESOPs sometimes are less than rates for other commercial loans.
8. Cash dividends on shares held by an ESOP of a C corporation are deductible if passed along to ESOP participants--or if used to pay off a loan used to finance the purchase of company stock.
9. Premiums for key-person insurance owned by the ESOP are fully deductible.
10. Cashless deductions are available through contribution of the company's own stock to the ESOP, freeing up dollars for other company needs.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

For more information . . . please call Marc Schechter or Robert Butterfield at (858) 444-2300. Our other contact points are listed on the next page.

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This publication is not intended to provide legal advice on specific matters.

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