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## ESOPs and Hybrid ESOP Buyouts

by Robert Willens •  
Lehman Brothers, New York  
and Robert W. Wood • San Francisco

In some cases, it can be appropriate to effect a buyout by using an employee stock ownership plan ("ESOP"), or a combination of an ESOP and a more conventional purchase. While an ESOP transaction can certainly involve only the ESOP, it may also involve another company (perhaps formed by new investors) to buy part of the stock of the target, with the ESOP buying the remainder. The ESOP transaction is perhaps the most classic leveraged buyout, since the ESOP mechanism contemplates the use of borrowed funds from a "qualified lender."

### ESOP Advantages

To the uninitiated, the ESOP is truly remarkable from a federal income tax perspective. An ESOP stock purchase typically involves a loan directly to the ESOP. In some cases, the loan is made to the plan sponsor (who then relends the funds to the ESOP in what amounts to a back-to-back loan). The loan proceeds, of course, are used to acquire the stock of the employer. The loan is repaid via contributions to the ESOP made by the employer.

The tax advantages of this arrangement are legion. First, the employer is entitled to a deduction for contributions to the plan that are used to repay interest on the loan. But there is more. A limited deduction for contributions

that go to pay principal is also available. Contributions to the plan that are intended to repay loan principal are deductible by the employer to the extent they do not exceed 25% of the compensation that is paid to participating employees.

Lenders have a particular incentive to engage in ESOP transactions as opposed to more garden variety loans. Money lenders (banks, insurance companies and corporations actively engaged in the trade or business of lending money) have a particular incentive to make ESOP loans because of a partial exclusion from the bank's own income. Such institutions can exclude from their own income 50% of the interest they receive on the ESOP loan if

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## ESOP BUYOUTS

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certain conditions are met.

In essence, this interest exclusion has to be taken into account when the financial institution computes its effective return from a loan. Although the interest rate is therefore not equivalent to a tax-free rate, it is at least half as good as that. The conditions that must be met in order for the 50% interest exclusion to apply include:

- The term of the loan cannot exceed 15 years.
- The plan must provide for full pass-through of voting rights on the stock allocated to participants.
- The ESOP must own more than 50% of the stock, either by class or by value.

### Other Advantages

Quite apart from the advantages accorded to lenders, there are actually deductible dividends (seemingly an oxymoron) allowed to the paying company. To qualify for a deduction, dividends must be distributed by the ESOP participants (and this must occur within 90 days after the close of the plan year in which the dividends were paid). Alternatively, the dividends will be deductible if they are used to make payments on the ESOP loan.

Thus, a company can pay out a deductible dividend that is used to funnel through the ESOP to the lender. In this case, the plan must provide that the

employer secure these with a value equal to the dividends, and they must be allocated to participants. Dividends used for debt repayment may be paid in addition to those paid under the 25% payroll limitation for principal payments (mentioned above).

### Seller's Benefits

Perhaps the most dramatic benefits—and certainly the tax benefits of greatest interest to the seller who owns the target corporation—relate to the rollover of gain. Under Section 1042 of the Internal Revenue Code, a deferral of gain is allowed to the extent a seller of “qualified securities” reinvests the sales proceeds in qualified replacement property. The gain on sale protection applies for a period of three months before the sale, and continues for twelve months thereafter. Stated differently, the reinvestment must occur within this 15-month timeframe. That allows enormous flexibility, and should be distinguished from the much less generous rollover provisions that prevail in other areas of the law.

In order for this advantage to be available, for at least one year before the sale, no stock of the target (or any of its affiliates) can have been readily tradeable on an established securities market. Plus, the seller of the stock must have held it for at least three years before the sale, and must not have received the stock from a qualified retirement plan or pursuant to certain stock options.

Finally, for the seller to qualify for rollover of gain, the ESOP must own, immediately after the sale, at least 30% of each class of outstanding stock (or at least 30% of the total value of all outstanding stock). It is this 30% rule that makes it quite possible for an ESOP to purchase only part of the stock in a company, with the remainder continuing to be owned by the seller, or the remainder being purchased by other buyers. Thus, it can represent another type of leverage. And, given the tax benefits to the business owner who sells stock to an ESOP, the presence of an ESOP side to a transaction can be helpful for the seller's tax position.

The permissible reinvestment is quite broad. A qualified security that is eligible for reinvestment

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generally includes any security issued by domestic corporation that qualifies as an "operating corporation" and that meets certain income tests. The operating corporation portion of the definition requires that the corporation have more than 50% of its assets devoted to the active conduct of a trade or business. What the rules are trying to prevent here is the purchase of securities in a holding company that does not conduct an active business.

As to the income tests that the corporation must meet, the corporation that issues the securities cannot have more than 25% of its gross receipts from the previous taxable year attributable to passive investment income. Here again, the rules are designed to prevent investing in a mere holding company that produces primarily dividends, interest, and similar types of passive income.

Various technical rules apply to insure that securities issued by a corporation that appears to be an operating company are not really holding company securities in disguise. For example, in applying the active business assets test and the income test referred to above, groups of controlled corporations are aggregated. They are all looked at together in order to determine whether more than 50% of their assets are used in the active conduct of a trade or business, and in order to determine whether more than 25% of their gross receipts are from passive investment income.

### Real World Benefits

These technicalities aside, the qualified replacement property rule allows the seller of stock to an ESOP to go into the marketplace and purchase a portfolio of securities, thus shielding the gain on the ESOP sale. Most publicly traded companies will satisfy both the operating assets test and the non-investment income test, so these limitations should not be a problem in the ordinary case.

Moreover, there is even a special exception under which the 50% active business assets rule does not apply to financial institutions. Thus, in addition to buying stock in public companies, the seller of stock to an ESOP can purchase stock in banks, savings and loan associations, and life insurance companies. All in all, the ESOP reinvestment rules are extremely favorable and certainly serve as an

incentive to make an ESOP sale.

There is an old adage that dying is the best tax planning. For someone who sells stock to an ESOP and then rolls the gain on sale into qualifying securities, this adage is quite true. The gain that is deferred from the sale of stock in the target company to the ESOP will result in a low basis in the replacement securities. If these replacement securities are held with that low basis until death, there will be a step up in basis for income tax purposes, so that the gain is never subject to income tax.

There can be estate tax consequences, of course, but the ability to make what amounts to a taxable sale of the shares of stock in the target to an ESOP, followed by having public company securities that are held until death can be of enormous estate planning advantages as well.

### Last Word

As anyone who has been involved in an ESOP transaction can attest, there are complexities and difficulties that have always made these transactions somewhat cumbersome. And there are various fiduciary issues that arise by virtue of the ESOP being designed to be for the benefit of employees and constituting a statutory ERISA plan. Nonetheless, in appropriate circumstances the benefits of an ESOP transaction can be truly extraordinary. And, they can be coupled with more traditional forms of acquisitions, too. ■

### NEW PUBLICATION!

#### TAXATION OF INTANGIBLE ASSETS

by Mark A. Muntean

This book fills an important void in tax literature concerning a complicated and controversial issue. Covering many topics from the general principles of intangible treatment, alternative minimum tax and intangibles, research and development expenditures to a thorough and straightforward discussion of covenants not to compete. Compression bound, \$99 (plus \$10 shipping and handling and \$8.42 California sales tax on California orders).



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