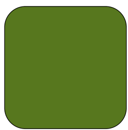

ESOPS: A DIFFERENT PURCHASING IMPLEMENTATION APPROACH FOR CONTRACTORS

ESOPs have long been used as an effective means of purchasing a retiring shareholder's ownership interest. This article focuses on how a construction company can implement an ESOP without its having a detrimental effect upon the balance sheet in a single transaction.

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The typical Employee Stock Ownership Plan ("ESOP") is leveraged through traditional financing and in some cases through seller financing and may be used to purchase a retiring shareholder's ownership interest in the company. An ESOP must invest primarily in company securities, but there has never been a legal definition of the term "primarily in company securities." Therefore, the practice of "cash warehousing" or investing cash in certificates of deposit or money markets for a reasonable period of time has been acknowledged and accepted by the Internal Revenue Service. The "reasonableness" of the period of time depends upon the facts and circumstances of each case. Since the period of time before which the cash must be invested in company securities has never been spelled out specifically, a company must use caution and consult with counsel when making this decision.

The biggest drawback of a leveraged ESOP for a construction company is the effect of the added debt on the balance sheet. This is a concern for the contractor because the balance sheet is the cornerstone of the company's bonding program and financing package with its lending institution. A lever-

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EXHIBIT 1 Balance Sheet: Pre-Leveraged ESOP

Balance Sheet: Pre-Leveraged ESOP

		Accounts Payable	$ 500,000
		Other Liabilities	$ 500,000
		Total Liabilities	$1,000,000
		Total Equity	$2,500,000
TOTAL ASSETS	$3,500,000	Total Liab. & Equity	$3,500,000

Balance Sheet: Post-Leveraged ESOP

		Accounts Payable	$ 500,000
		ESOP DEBT	$1,000,000
		Other Liabilities	$ 500,000
		Total Liabilities	$2,000,000
		Stockholders' Equity	$2,500,000
		ESOP Contra-Acct.	($1,000,000)
		Total Equity	$1,500,000
TOTAL ASSETS	$3,500,000	Total Liab. & Equity	$3,500,000

aged ESOP, by decreasing equity by the amount of the loan recorded on the balance sheet, can cut bonding capacity drastically.

It is a common misconception of uninformed ESOP candidates that seller financing is not required to be on the balance sheet. This is not true. Seller financing debt must be listed as a liability of the company.

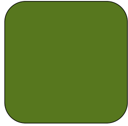
As seen from Exhibit 1, the ESOP debt decreases equity when a loan is initiated and debt is increased. The impact upon the debt-to-equity ratio is affected the most because debt is increased and equity is decreased, and this changes the ratio in a negative way. Working capital is also diminished by the amount of current debt associated with the ESOP debt.

Impact on corporation balance sheet

The technique of cash warehousing tends to lessen the blow of a leveraged ESOP on the balance sheet. When the ESOP debt is recorded on the balance sheet, an equal offsetting debit is recorded in the equity section as a contra-equity account. This contra-equity account is eliminated as the ESOP debt is paid. Exhibit 1 displays the change that a typical leveraged ESOP of $1 million will have on a company's balance sheet.

Section 1042 rollover

The driving force behind a leveraged ESOP has been and is the 1042 rollover available to C corporations under Internal Revenue Code ("IRC") 1042. (However, the capital gain rate of 15 percent, which became effective in 2001 and is set to expire for tax years beginning after December 31, 2008—at which point the rate increases to 20%—has made the 1042 rollover less attractive.) The 1042 rollover allows a shareholder of a C corporation



AN ESOP IS ALLOWED TO HOLD SHARES OF AN S CORPORATION AND NOT BE IN VIOLATION OF THE SHAREHOLDER RULES APPLICABLE TO S CORPORATIONS.

to sell his ownership interest to an ESOP (at least 30%) and defer the gain on the sale of stock. To meet the requirements of IRC 1042, the selling shareholder must purchase qualified replacement property within three months prior to the sale or 12 months after the sale. Qualified replacement property is stocks, bonds, debentures, warrants, or other debt or equity instruments issued by U.S. corporations that did not receive more than 25% of their income from passive investment. Investments such as mutual funds, U.S. government bonds, and municipal bonds do not qualify. Also, the qualified replacement property cannot be the stock of the company sponsoring the ESOP.

One item to note is that in a seller-financed transaction, the seller must purchase all replacement property within the following 12 months after the sale, even though the seller has only received one installment from the buyer. This means that the seller must have other funds available to purchase such replacement property. At some point, typically later in life, the shareholder will then sell the qualified replacement property. The shareholder, with some strategic planning, could ideally pay income tax on the sale at the lower ordinary income tax rates of 15%, thereby saving 15% or more of tax. The 1042 rollover technique for the selling shareholder, prior to 2001, was very similar to the concept of deferring money in a 401(k) plan.

The 1042 rollover has become less attractive, however, because the advantage of deferring income tax on the sale of stock for small business owners that were in personal tax brackets of 28% or higher is no longer available since 2001. The 1042 rollover still allows an owner to defer income tax, but the rate of tax for a sale of stock without the 1042 rollover is typically 15%, which is the second lowest tax bracket possible (with 10% being the lowest). This means that the shareholder is not gaining a huge income tax savings by deferring the use of those funds until later in life.

The low rate of tax on the sale of stock is important because it eliminates the advantage of selling 30% of an owner's interest in one transaction, thereby giving more flexibility to the company in purchasing the shares.

Election of S corporation status

Since the advantages available under Code Section 1042 are less attractive to the owner, the shift of focus that still makes an ESOP attractive is the ability of the company to elect S corporation status and not pay income tax on the amount of income "passed through" to the ESOP. An ESOP is allowed to hold shares of an S corporation and not be in violation of the shareholder rules applicable to S corporations. There are anti-abuse laws regarding 100% ESOP-owned S corporations that cannot be violated, but they are only intended to stop abuses in certain situations not applicable here.

The advantages of not paying tax on the income attributable to the ESOP ownership interest are self-evident: Tax savings can be used to purchase more shares of stock, additional capital improvements, or for any other needs of the company.

It is quite possible that companies will make a small business election and become an S corporation before triggering an ESOP in order to shield the taxable income of the corporation. Before a company switches from C corporation to S corporation status, adequate attention should be given to such considerations as the built-in gains tax, credit carryovers, net operating loss carryovers, contribution carryovers, etc.

Since the company no longer needs to finance the transaction to obtain the benefits under a 1042 rollover, it can purchase an owner's shares of stock as the money becomes available. This in effect "finances" the transaction over a period of time without having a negative impact on the balance sheet of the company in a single year. The decrease in equity is spread over a period of time as the shares are purchased. It is very similar to cash warehousing, but the company is actually purchasing shares of stock instead of just accumulating the cash with the idea of putting a large note in place at some future point in time. Also, unlike most cash warehousing arrangements whereby stock is not purchased for several years in conjunction with a leveraged transaction, the purchase of shares on an as-available

basis allows S corporations to realize the benefits of shielding taxable income immediately.

However, there are disadvantages in purchasing small blocks of shares since it is an inefficient means of purchasing the shares and the company is required to obtain a valuation every time the shares are purchased.

Conclusion

As the baby boom generation nears retirement, they are going to be searching for potential buyers for their closely held companies. ESOPs are definitely not the only answer to every situation, but they are an alternative to the sale of a company to a competitor and can alleviate the problem of heirs who are unable to buy out or take over these companies. The ideas discussed in this article, such as switching to S corporation status and purchasing the stock with cash as it becomes available, may shed a different light on the alternative of the ESOP that may have initially been disregarded. ■