MAYNARD
COOPER GALE

GOVERNMENT SOLUTIONS WEBINAR SERIES

August 31, 2016

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EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

A. **Qualified retirement plan**
   - i. Defined contribution plan, with individual employee accounts
   - ii. Designed to invest primarily in employer stock
   - iii. Annual allocations
   - iv. Vesting schedule rewards continued employment
   - v. Distribution restrictions encourage saving for retirement
   - vi. Tax advantages

B. **ESOP as strategy for succession planning**
   - i. Vehicle for transitioning ownership of government contracting company (“GCC”)
   - ii. Leveraged financing
   - iii. Broad-based employee stake in GCC generates pride of ownership, which is an incentive toward increased profitability
   - iv. Recruiting tool
   - v. Retention tool
   - vi. Tax advantages

C. **Advantages and disadvantages of ESOP**

QUALIFIED RETIREMENT PLAN

- **Defined Contribution Plan**
  - **Employee's benefit is held in separate individual accounts**
  - **Risk of investment loss is borne by employee rather than the GCC**
  - **Employee is rewarded when GCC increases in value**
  - **"Bona fide" fringe benefit**

QUALIFIED RETIREMENT PLAN

- **Designed to invest primarily in employer stock**
  - **ESOP will invest in GCC stock**
  - **Lack of diversification**
    - **Law allows the ESOP to concentrate its investment in GCC stock**
    - **Reflects congressional support for employee ownership**

QUALIFIED RETIREMENT PLAN

- **Annual allocations**
  - ESOP can be structured to permit GCC to decide each year how much it will contribute to ESOP
    - Plan design consideration
    - Also consider terms of government contracts
  - Uniform allocation method
    - Most common method is *pro rata* % of compensation, *i.e.*, 3% or 5% of employee's annual earnings
    - Age-weighted allocation favors older workers; requires testing
    - Formula based on years of service favors long-term workers; requires testing

Qualified Retirement Plan

- **Diversification Requirement**
  - **Age 55**
  - **10 years of participation**
  - **Must offer alternative investments (i.e., mutual funds), or allow amounts to be transferred to another defined contribution plan (i.e., a 401(k) plan) with alternative investments, or distribute cash**
  - **Applies to 25% of participant's account each year; 50% at age 60**
  - **Diversification is not required until the ESOP has been in place for 10 years**

QUALIFIED RETIREMENT PLAN

- **Vesting schedule**
  - **Three-year “cliff” vesting**
  - **Six-year “graduated” vesting**
  - **Vesting must start after two years**
- **Rewards extended service**
- **Once vesting period is completed, future contributions are fully vested**

QUALIFIED RETIREMENT PLAN

- **Distribution restrictions encourage saving until retirement**
  - ESOP normally does not allow distributions before termination of employment
  - Distributions may be in stock or cash
    - Subchapter S corporation ("S Corp") can choose not to allow distribution in the form of employer stock (to avoid the limitation to 100 shareholders or less)
    - Bylaws may limit company ownership to employees (not including former employees)
    - Diversification option
  - Timing of distributions
    - Distributions may be taken within one year following death, disability or retirement
    - Other termination of employment:
      - Distributions begin within five years
      - Distributions can be spread out over five years
      - Leveraged C Corp ESOP may delay distributions until loan is repaid

QUALIFIED RETIREMENT PLAN

- **An ESOP participant who takes a distribution in employer stock can require GCC to repurchase stock distributed from the ESOP**
- **This right is called a put option**
- **Applies to closely held/thinly traded stock**
  - **“Not readily tradeable on any established market”**
- **Fair valuation formula**
  - **Independent appraiser (IRC § 401(a)(28)(c))**
- **Affects cash flow for GCC**
  - **Cash can be set aside or held in escrow to meet put obligations**
  - **GCC can purchase insurance to manage risk**

STRATEGY FOR SUCCESSION PLANNING

- **Vehicle for transitioning ownership from one owner or a few owners to broad-based employee ownership**
- **Use the ESOP to satisfy the threshhold for small business status**
- **Way to address limited market for an owner's interest in GCC without losing fair market value ("FMV")**
- **Seller has the opportunity to defer capital gains by reinvesting proceeds from sale of Subchapter C corporation ("C Corp") shares**

STRATEGY FOR SUCCESSION PLANNING

- **Ownership changes the dynamics of employer-employee relationship**
  - **Employee has a stake in GCC; GCC benefits from employees pride of ownership**
  - **Understanding the relationship between profits and increased investment value may result in increased efficiency, resulting in increased profitability**

STRATEGY FOR SUCCESSION PLANNING

- **An ESOP can be a recruiting and retention tool**
  - **Available pool of government contractor workers may already be familiar with ESOP ownership structure**
  - **Employee ownership is an attractive entrepreneurial feature to many Americans**
  - **Current workforce may prefer the long term potential for growth in an ESOP-owned GCC to a non-ESOP GCC**

STRATEGY FOR SUCCESSON PLANNING

- **For an S Corp ESOP, the following tax rules apply:**
  - S Corp distributions to the ESOP are not taxed
  - Dividends may be used to repay an exempt loan only to the extent the dividends are paid on unallocated shares
  - S Corp ESOP places specific limitations on non-ESOP owners who are “disqualified persons”
    - “Disqualified persons” cannot receive a “prohibited allocation” during a “non-allocation year”
    - A “non-allocation year" is any ESOP plan year where, at any time during the year, "disqualified persons" own directly or through attribution, 50% of the number of outstanding shares of the S Corp
    - For purposes of the 50% test, the “deemed-owned shares” held in the ESOP are treated as held by the individual that is deemed to own them

STRATEGY FOR SUCCESSION PLANNING
(S CORP ESOP cont'd.)

- A "prohibited allocation" is one that violates the requirement that, during a "non-allocation year," no portion of the assets of the ESOP may accrue or be allocated (directly or indirectly) for the benefit of any "disqualified person"
- A "disqualified person" is one who is either a member of a "deemed 20% shareholder group", or a "deemed 10% shareholder"
- A person is a member of a "deemed 20% shareholder group" if the number of "deemed-owned shares" of the person and the person's family is at least 20% of the total S Corp shares held by the ESOP
- A person is a "deemed 10% shareholder" if the person is not a member of a "deemed 20% shareholder group" and the number of the person's "deemed- owned shares" is at least 10% of the total S Corp shares held by the ESOP

STRATEGY FOR SUCCESSION PLANNING

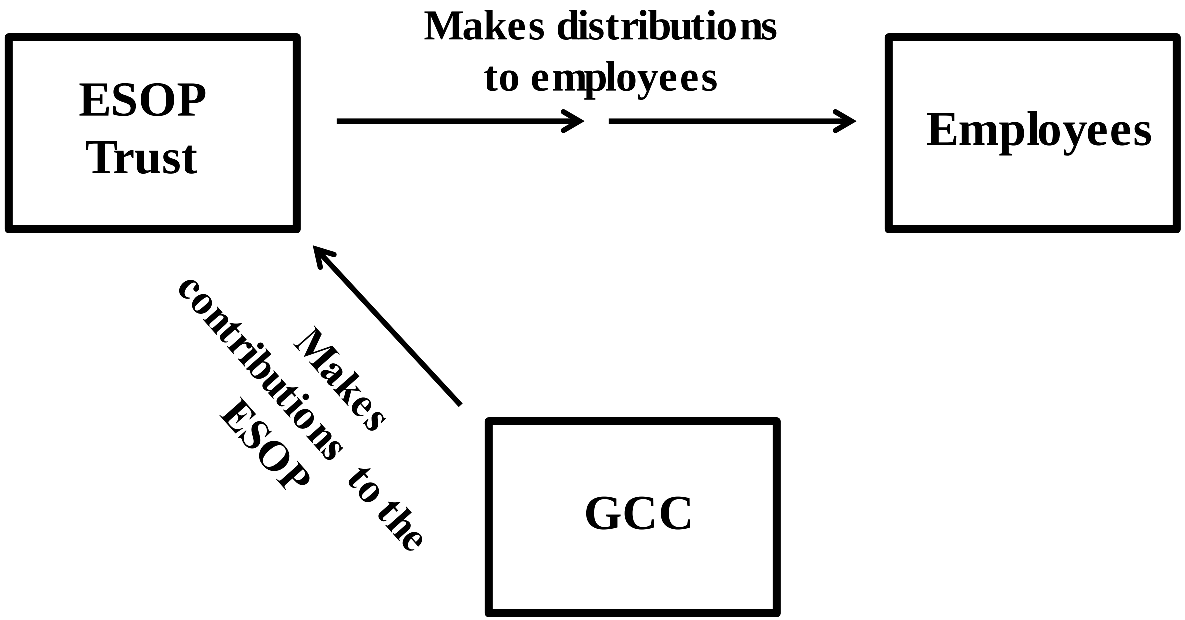
- **Non-leveraged ESOP**
  - GCC creates ESOP and contributes stock to ESOP trust, or contributes cash to the trust, which is used to purchase shares of stock
  - Operates much like a discretionary profit sharing plan
  - Doesn’t lend itself to a stock acquisition arrangement unless the GCC has excess cash

STRATEGY FOR SUCCESSION PLANNING

Leveraged ESOP

- GCC or ESOP borrows money from lender (i.e., a bank) to finance the purchase of shares
- If the GCC borrows the money, the ESOP then borrows money from the GCC to buy the shares
- ESOP trustee then uses the loan proceeds to purchase stock
- Purchased stock is placed in a suspense account and used as collateral on the loan
- Employer contributions (tax deductible) to the ESOP are used by the ESOP to pay off the principal and interest on the loan
- As the loan is paid off, shares are released from the suspense account and allocated to participant accounts

Diagram of Non-Leveraged ESOP

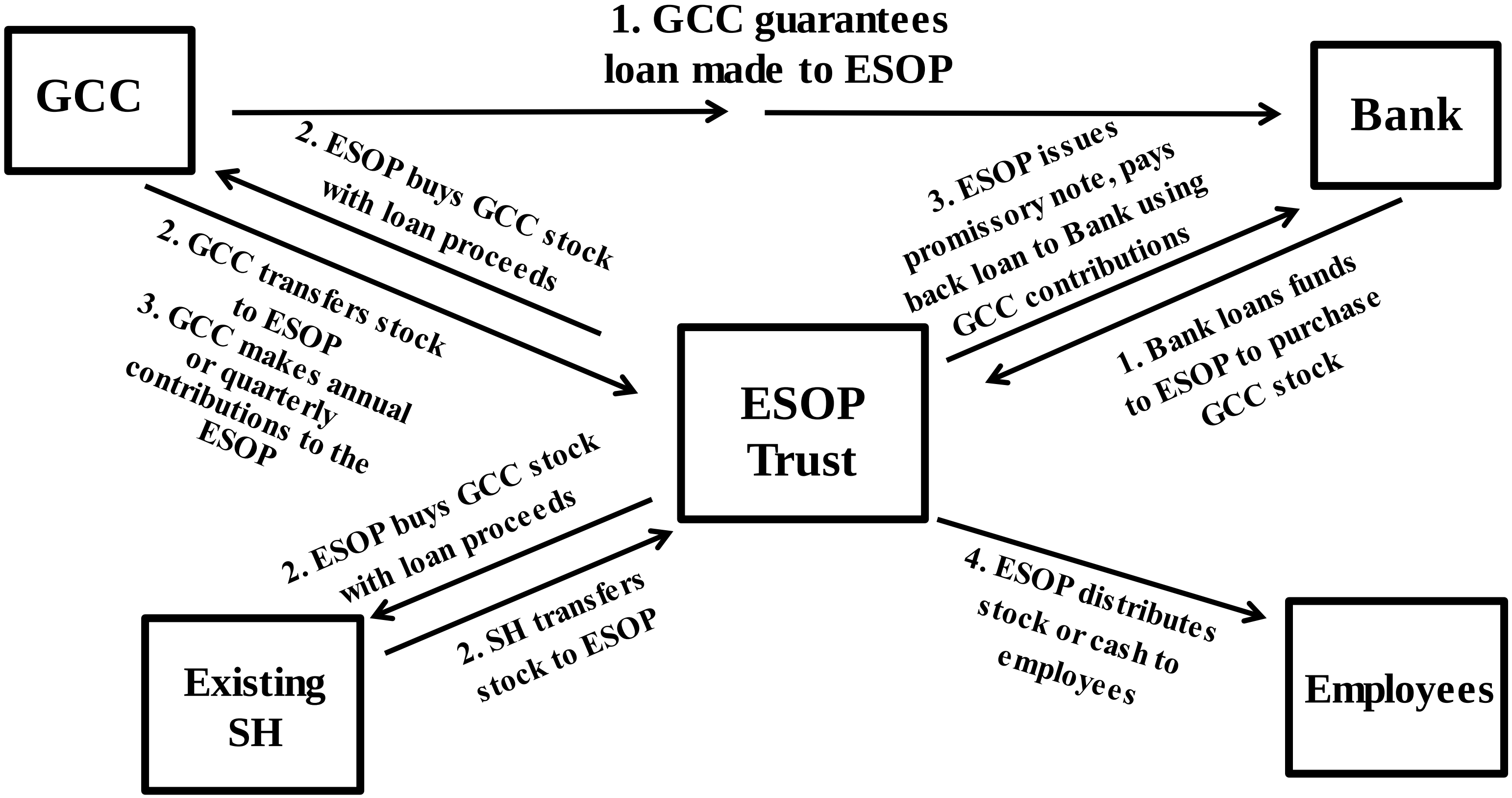


Explanation of diagram

Each year GCC contributes either stock or cash to the ESOP, which holds the stock. The stock is then allocated to each participant's account, based on the formula in the plan.

GCC must notify the participants how much stock they own and how much the stock is worth. Employees receive distributions in stock or cash when they leave GCC or retire, in accordance with the plan's vesting schedule.

How a leveraged ESOP works



Explanation of Diagram

1. Bank loans money to ESOP by promissory note, which is guaranteed by GCC.
2. ESOP uses the proceeds from the loan to buy stock from (i) GCC, or (ii) existing shareholders.
3. GCC makes contributions to ESOP trust to repay the loan. ESOP trustees repay loan to Bank according to loan schedule.
4. Participants receive stock or cash when they retire or leave GCC.

STRATEGY FOR SUCCESSION PLANNING

- **Valuation requirements for GCC stock**
  - **Independent appraisal**
  - **ESOP must not pay more than adequate consideration:**
    - **FMV as determined by the trustee or named fiduciary**
    - **FMV is the price at which GCC would change hands between a willing buyer and a willing seller, each with reasonable knowledge of all relevant facts, with no compulsion to act by either and with fairness to both**
  - **The appraisal is for the benefit of the ESOP**

STRATEGY FOR SUCCESSION PLANNING

- **Fiduciary considerations when ESOP purchases stock**
  - **Fair Market Value**
    - Independent Appraisal for initial transaction
    - Annual valuation
  - **GCC must appoint a Trustee for the ESOP**
    - May be an officer of GCC
    - Independent Trustee (i.e., bank, trust company)
  - **Trustee Obligations**
    - Select qualified independent business valuation appraiser
    - Document qualifications of appraiser
    - Confirm the appraiser receives complete, current and accurate information to value the stock
    - Verify appraiser is independent
    - Reasonable reliance on advice
      - Assess financial projections
      - Trustee must take into account repurchase liability, effect of company debt, valuation methodology
      - Trustee must act solely in the interests of plan participants, not in GCC's best interest

STRATEGY FOR SUCCESSION PLANNING

- **Additional fiduciary considerations when ESOP purchases stock**
  - **Transaction fairness opinion**
    - Issued by an independent financial advisor in relation to the purchase of employer stock
    - Protects the ESOP and the fiduciaries
    - Independent expert who analyzes the fairness of the transaction to the ESOP
  - **Repurchase obligations**
    - Retirement
    - Death and disability
    - Terminated vested employees
    - Diversification (10 years)
    - Required minimum distributions
  - **Voting rights: For closely held GCC, passthrough voting only required for corporate mergers, consolidations, sale of substantially all assets, recapitalization, reclassification, liquidation, dissolution**

STRATEGY FOR SUCCESSION PLANNING

Tax Advantages of an ESOP

- **Tax deductible contributions for GCC up to 25% of participants' compensation**
- **Additional deduction for C Corp for contributions used to repay interest on exempt loan**
- **Additional deduction for C Corp for dividends on stock held by ESOP if paid in cash to participants or used to repay an ESOP loan**
  - The deduction is still available even if participants can elect to take the dividend in cash or leave it in the plan
- **Section 1042 exchange opportunity with C Corp shares**
  - If proceeds from sale of stock are reinvested in qualifying replacement property, the Seller can defer capital gain tax
  - Owned stock for 3 years
  - ESOP must own at least 30% of each class of noncallable stock or 30% of total value
  - Must purchase replacement property within 15 month period ending 1 year after sale
- **For S Corp, use pretax distributions to repay ESOP debt**

GCC CONSIDERATIONS

- How are government receivables counted in a GCC's borrowing base for collateral capacity with a leveraged ESOP?
- 8(a)/woman-owned/SDVO status – consequence of ESOP ownership in excess of 49%
- Change in controlling interest triggers notice, not novation of the contract
- Impact of ESOP costs on flexibly-priced contracts
- How to project reimbursable ESOP cost?

ADVANTAGES OF AN ESOP

- **Leveraged acquisition vehicle**
- **Opportunity to instill a culture of ownership for employees**
- **1042 exchange opportunity for C Corp shares**
- **Allows transition period if primary owner is not immediately ready to retire**
- **Estate planning opportunities for individual shareholder with partial sale**
  - Liquidity for heirs not involved in the business, and retained shares for heirs who are in the business
  - Reduced share value immediately after the sale of shares to the ESOP allows transfer of shares at a reduced value
- **Alternative to inactive M&A market**
- **For S Corp, dividends paid on ESOP-owned stock are not taxed**
  - Significant restrictions to avoid excessive benefit to highly paid employees
  - Requires broad-based employee participation

DISADVANTAGES OF AN ESOP

- **Fiduciary risk from valuation for purposes of sale**
  - Ongoing viability of company
  - Engage independent fiduciary to transfer this risk
- **Initial Expense**
  - Financial advice
  - Legal counsel
  - Valuation expense
  - Fairness opinion
- **Ongoing administrative expenses**
  - ESOP TPA
  - Annual appraisal
- **Liquidity**
  - Loan repayment
  - Stock repurchase obligations
  - Diversification in 10 years
- **Lack of Economic Diversification for Workforce**

THANK YOU!