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Employee Stock Ownership Plans

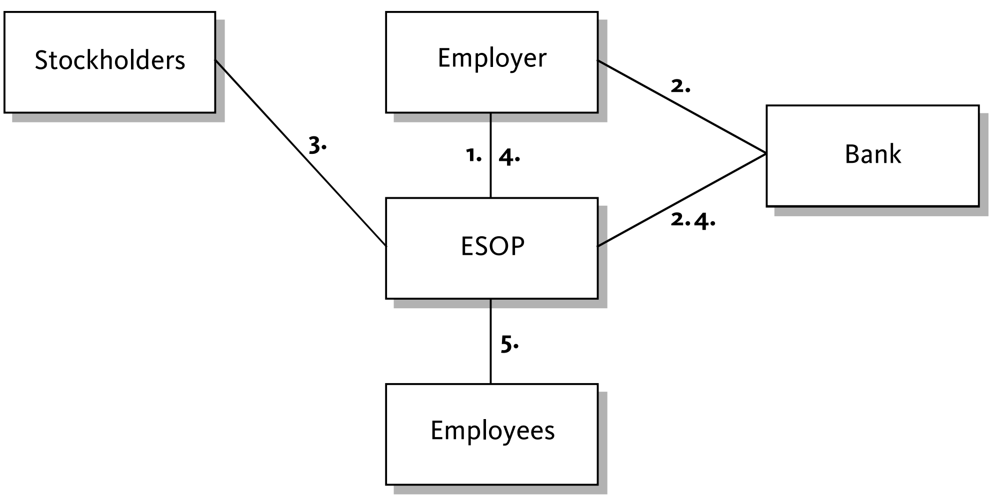
Fact Sheet

What follows is designed to be an introduction to ESOPs. Many specific facts must be considered in determining whether an ESOP is suitable for your employer. Therefore, this Fact Sheet should not be considered as legal advice.

ESOP

ESOP stands for "employee stock ownership plan." ESOPs are like profit sharing plans, but must be invested "primarily" in employer stock, and offer special tax advantages to the employer sponsor, its employees and stockholders. One major advantage is its ability to borrow money to purchase employer stock. This is called a "leveraged ESOP."

Leveraged ESOPs



1. Employer establishes ESOP plan and trust.
2. Bank loans money to ESOP, generally with Employer guaranteeing loan (or Lender loans money to Employer, which makes simultaneous "back-to-back" loan to ESOP).
3. ESOP uses loan proceeds to purchase stock from Employer or its existing stockholders. The stock may then be used as collateral for loan to ESOP. Employer or stockholders may use proceeds for any purpose.
4. Employer makes annual tax-deductible contributions to ESOP, which uses them to pay off loan.
5. As loan is repaid, a proportional amount of stock is allocated to accounts of employees. Employees receive stock (or value of stock in cash) when they retire or terminate employment.

Contact Us

Gregory K. Brown
312.902.5404
gregory.brown@kattenlaw.com

Kathleen Sheil Scheidt
312.902.5335
kathleen.scheidt@kattenlaw.com

Gary W. Howell
312.902.5610
gary.howell@kattenlaw.com

Ann M. Kim
312.902.5589
ann.kim@kattenlaw.com

Daniel B. Lange
312.902.5624
daniel.lange@kattenlaw.com

Nancy Laethem Stern
312.902.5353
nancy.stern@kattenlaw.com

ESOP Trustee

All ESOP shares are held in a trust. The ESOP trustee has the power to use ESOP funds (the ESOP loan proceeds) to purchase stock. The trustee generally votes the shares of ESOP stock held in the trust (although in some situations the vote must be passed through to participants). The ESOP can provide for the trustee to be directed by a committee, and the trustee must then follow the committee's directions (including voting directions), except where to do so would violate its duties under the law. An ESOP trustee is governed by strict fiduciary standards and must act "solely in the interest of participants and beneficiaries" of the ESOP.

Tax Advantages of ESOPs

1. Use of a leveraged ESOP allows a corporation to borrow and then deduct both principal and interest, rather than interest only, as is the case under a conventional loan. This is because the corporation's contributions to the ESOP—which are used to pay off the ESOP debt—are deductible as contributions to a retirement plan.
2. Sale of stock in a closely held corporation to an ESOP provides liquidity for the owners. If an ESOP acquires 30% of the stock of a non-public corporation (other than an "S" corporation), the stockholder(s) who sold stock to the ESOP may roll over the proceeds, tax-deferred, into other securities. Such a rollover is a "Section 1042 transaction."
3. While dividends paid by a corporation are normally not deductible by the corporation, dividends paid on stock held in an ESOP are deductible if they are used to pay off the ESOP loan or are paid to the ESOP participants—either directly or through the ESOP. Dividends are also deductible if they are used at a participant's election to purchase additional employer stock.
4. S corporation ESOPs are not taxed on their share of corporate earnings.

The tax-advantaged borrowing potential and liquidity of ESOPs, may make them attractive to owners of closely held corporations.

Tax Deferred Requirements

1. There must be a sale of **qualified securities** to an **ESOP**. The proceeds from the sale must then be used by the seller to purchase **qualified replacement property** within the **replacement period**. Section 1042 treatment must be **elected** properly by the taxpayer within the time frame for filing the tax return for the year of the sale to the ESOP. Section 1042 is an elective provision, not an automatic or mandatory one.
2. The ESOP must own at least 30% of the corporation's stock following the sale. To reach this 30% threshold, sales from different stockholders may be treated as one sale if they are part of a single, integrated transaction under a prearranged agreement between those stockholders. Once the ESOP satisfies the 30% requirement, subsequent sales of additional amounts of stock may be made by stockholders; those stockholders may also take advantage of Section 1042. Provided that the 30% requirement is satisfied, a stockholder is not required to sell his entire interest in the corporation to the ESOP. In addition, if several stockholders are aggregated to satisfy the 30% requirement, each of them may separately elect whether or not to make a Section 1042 election.
3. The ESOP must prohibit allocations to the stockholder who sold securities and elected nonrecognition treatment in the 1042 transaction, members of that stockholder's family, and any other person who owns more than 25% of the corporation's stock. However, allocations to the stockholder or a family member may be made after the later of: (a) the date 10 years after the sale or (b) the date any ESOP loan incurred in the 1042 transaction is paid off.

"Qualified Securities"

"Qualified securities" generally refers to the common stock (and certain convertible preferred stock) of a U.S. operating corporation which has no publicly traded stock. The person who sells the qualified securities to the ESOP must have held them for at least three years. In addition, they must not have been received as a distribution from a tax-qualified retirement plan, through the exercise of a stock option, under a grant of restricted stock or under a similar arrangement.

“Qualified Replacement Property”

“Qualified Replacement Property” generally refers to any security of a “domestic operating corporation” that did not have passive investment income exceeding 25% of its gross receipts during the year preceding the Section 1042 transaction. The major exclusions are government securities and mutual funds. An operating corporation is any corporation that uses more than 50% of its assets in the active conduct of a trade or business and includes banks and insurance companies. Securities of an employer that is a member of the same controlled group of corporations as the corporation whose shares were sold to the ESOP are not “qualified replacement property.”

“Replacement Period”

The replacement period is the period beginning three months before the date of the sale to the ESOP and ending 12 months after that date. For example, if a taxpayer purchases $1 million of securities which meet the definition of qualified replacement property in September 2006 and then sells his 35% interest in a closely held corporation to that corporation’s ESOP in October 2006 for $1 million, he can designate the securities purchased in September as his replacement property and will not recognize gain on the sale to the ESOP, provided that the other requirements of a Section 1042 transaction are satisfied. He could also invest the $1 million from the ESOP over 12 months following the ESOP transaction, designating each batch of securities purchased as replacement property.

Technical Rules for Reinvestment

1. The basis of the property is its cost, minus a proportionate share of the gain that was not recognized as a result of the application of Section 1042. Upon the subsequent death of a person who has engaged in a Section 1042 transaction, the basis of the qualified replacement property is “stepped up” to its fair market value on the date of death. This results in avoidance of any tax on the gain that was not recognized in the Section 1042 transaction.
2. The holding period of the property includes the period in which the taxpayer held the stock he sold to the ESOP.
3. Upon the subsequent sale of any qualified replacement property, the gain that was not recognized as a result of Section 1042 is recaptured. Therefore, turnover should be minimized in the portfolio of securities that are purchased with the proceeds of a Section 1042 sale to an ESOP and designated as the replacement property.

Financing Source

A corporation can fund an ESOP internally by making a loan to the ESOP in return for the ESOP’s note if it had sufficient funds. Otherwise, a Section 1042 transaction will generally involve a loan by a third-party bank to the ESOP, usually guaranteed by the corporation; with the ESOP then using the loan proceeds to purchase the stock, as described earlier.

Sizing the ESOP Loan

The Internal Revenue Code sets the upper limit on the deductible annual payments that a corporation can make to fund an ESOP loan. These upper limits can be determined for the corporation, then compared to its cash flow projections. These projections of amounts necessary to fund the proposed loan (whether it is from the corporation or from an outside bank), versus the amounts that will be available over the term of the proposed loan, are integral to the corporation’s “ESOP feasibility study.”

A 100% ESOP buyout may be difficult to finance. Banks want to see the seller taking back some debt, or purchases of stock by others besides the ESOP (such as managers). A bank may seek to have the selling stockholder pledge his replacement property as additional security for the ESOP loan. These issues may be negotiated.

Value Determined

A sale to an ESOP must be for “adequate consideration.” An independent third-party appraiser must determine this value in the case of a closely held company in accordance with U.S. Department of Labor regulations. The appraiser’s report is a key element in the ESOP trustee’s decision to purchase stock from a selling stockholder. Any non-public corporation that maintains an ESOP is required to obtain an annual valuation of its stock for purposes of plan accounting and repurchases.

Other Potential Financial Liabilities

Stock of a non-public corporation that is purchased with the proceeds of an ESOP loan may, but need not, be subject to a right of first refusal in favor of the ESOP or the corporation. In addition, stock of a non-public corporation in an ESOP must be subject to a "put" at fair market value (determined by the annual appraisal described above) when it is distributed to a participant upon retirement, termination of employment, etc. Therefore, a corporation must project its ESOP repurchase liability. This involves a projection of how much stock will be distributed to participants in future years at retirement, termination of employment, etc., and will be a function of factors such as age, mortality and turnover for that employee group. The corporation must consider whether it will have sufficient current funds or must create a reserve to satisfy these future repurchase obligations once these projections are made.

Tax Deferred Candidates

Stockholders of a closely held corporation might consider a Section 1042 transaction under several circumstances. If, for example, the corporation has one or more stockholders who, together, own at least 30% of the corporation's stock, and those stockholders want to terminate or reduce their investments in the corporation but do not intend to transfer their stock to family members, a Section 1042 sale may be useful. Or, a 100% stockholder may wish to make part of his investment more liquid by selling some stock to an ESOP and rolling over the proceeds while still retaining control. If an ESOP feasibility study suggests that, the corporation could support an ESOP of a size sufficient to purchase the stock of those stockholders, then a Section 1042 transaction may be appropriate.

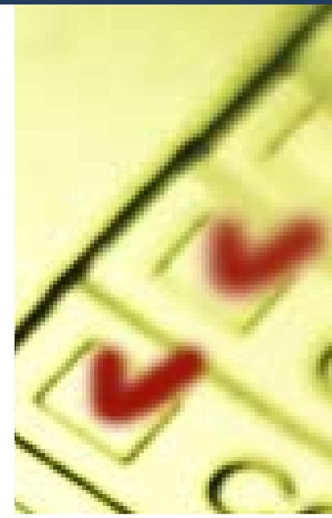
S Corporation ESOPs

"S" corporations may establish ESOPs. An "S" corporation ESOP may not take advantage of certain ESOP incentives, such as Section 1042. However, "S" corporation ESOPs can utilize the special tax advantages of leveraged ESOP financing, which creates a tax deduction for both principal and interest on a loan used to acquire employer securities. This allows the "S" corporation ESOP to become a tax-advantaged purchaser of shares of other "S" corporation stockholders, or of newly issued shares of the "S" corporation.

Furthermore, there is no tax paid by the ESOP on its proportionate share of "S" corporation taxable income because the ESOP is a tax-exempt stockholder.

It may be possible to change from "S" to "C" corporation status without adverse tax consequences if a corporation wants to take advantage of all the ESOP advantages. However, the corporation's advisers must thoroughly analyze the impact of changing its status and weigh this against the benefits of an ESOP.

Recent legislation places restrictions on ESOP transactions involving "S" corporations to prevent unintended use of ESOPs. Anyone considering the use of an ESOP by an "S" corporation should consult with legal counsel to obtain an up-to-date analysis.



ESOP Candidate Checklist

YES **NO**

___ ___ 1. The employer is a corporation in the normal manner. Please check type of corporation.

“C” Corp. ___ “S” Corp. ___ Professional Corp. ___ Other ___

___ ___ 2. The employer is closely held, or publicly traded with significant ownership in a few hands.

___ ___ 3. The employer has sales and payroll adequate to support an ESOP; current and projected payroll as a percentage of sales is 20% or greater.

___ ___ 4. The employer has a strong earnings or cash flow record over the previous five years.

___ ___ 5. The employer expects to pay substantial federal income taxes over the next few years.

___ ___ 6. The employer has paid substantial federal income taxes during the past three years.

___ ___ 7. At least some stockholders have a reason why they might be interested in selling some stock; e.g., planning for retirement, liquidating an estate, entering a new business venture, children not involved in business, etc.

___ ___ 8. If one or more principal executives will be departing in connection with the sale, there is strong management available to take their place(s).

___ ___ 9. The employer customarily makes payments to a profit sharing or other employee benefit plan that could in the future be diverted to an ESOP.

___ ___ 10. The owners are psychologically willing to share ownership with their employees, assuming an attractive deal can be arranged. (Difficult to assess in advance, but critical.)

No mechanical approach can be perfect, but this list is a good start. An employer with six or more “Yes” answers is a good candidate.

ESOPs as Financial Tools

An ESOP, or Employee Stock Ownership Plan invests primarily in employee stock. Assuming for comparison purposes that each individual stockholder and the corporation have an effective combined income tax rate of 40% of their taxable income, following are several different objectives that stockholders of a privately held corporation might have which can be achieved through use of an ESOP and the comparative income tax cost of using an ESOP as opposed to a more common method of achieving the same objective. Interest was ignored because under either alternative, interest would be owed.

	GOAL	COMPARISON OF ALTERNATIVE SOLUTIONS	
1	Secure funds to buy out one of two equal stockholders of a corporation with a value of $12,000,000 for $6,000,000.	**Cost to Redeem Stock by Corporation**	
		Before-Tax Dollars Needed to Repay $6M Loan	$10,000,000
		Taxes (40%)	4,000,000
		After-Tax Dollars Needed to Repay $6M Loan	6,000,000
		Total Cost (Purchase Price Plus Taxes)	**$10,000,000**
		Use of ESOP	
		Dollars Needed to Repay $6M Loan	$6,000,000
		Total Cost (Purchase Price)	**$6,000,000**
		Total Savings from ESOP	**$4,000,000**
2	Sale of stock of corporation by father to children active in business to provide $4,000,000 of funds to give or bequeath children who are inactive in business. Stock owned: $8,000,000 Stock to be sold: $4,000,000	**Cost of Sale of Stock to Children Who Are Active in Business**	
		Sale Price	$4,000,000
		State and Federal Capital Gain Tax on Sale (20%)	800,000[1]
		Income Children Must Earn to Pay for Stock	6,666,666
		Total Cost to Children and Father	**$7,466,666**
		Use of ESOP	
		Contribution of Stock to ESOP	$4,000,000
		Tax Deduction (40%)	(1,600,000)
		Net Cost	2,400,000
		Tax Savings from ESOP	**$5,066,666**

[1] Assumed no cost basis in stock sold

	GOAL	COMPARISON OF ALTERNATIVE SOLUTIONS	
3	Acquisition of new business (privately held) for $3,000,000. Use of ESOP would permit selling stockholders of corporation to own new business by investing funds from sale.	**Corporation Buys Business with $3,000,000 Loan**	
		Before-Tax Dollars Needed to Repay $3M Loan	$51,000,000
		Taxes (40%)	2,000,000
		After-Tax Dollars Needed to Repay $3M Loan	3,000,000
		Total Cost (Purchase Price Plus Taxes)	**$5,000,000**
		Use of ESOP	
		Dollars Needed to Purchase Business	$3,000,000
		Total Cost (Purchase Price)	**$3,000,000**
		Total Savings from ESOP	**$2,000,000**
4	To obtain $6,000,000 from corporation by stockholders to use for diversification of investments.	**Borrow $9,000,000 from Corporation to Diversify**	
		Before-Tax Dollars Needed to Repay $9M Loan	$15,000,000
		Taxes (40%)	6,000,000
		After-Tax Dollars Needed to Repay $9M Loan	9,000,000
		Total Cost (Loan Plus Taxes on Funds to Repay Loan)	**$15,000,000**
		Use of ESOP	
		Dollars Needed to Purchase Business	$9,000,000
		Total Cost (Purchase Price)	**$9,000,000**
		Total Savings from ESOP	**$6,000,000**

About the Firm

Katten Muchin Rosenman LLP is a full-service law firm with offices in the nation's largest centers of business, government, finance and technology and an associated entity in London, England. Our 600 attorneys in more than 40 practice areas provide timely and cost-effective counsel to clients in numerous industries. We are business advisors and advocates for a wide range of public and private companies – from entrepreneurial, emerging-growth, and middle market firms to global Fortune 100 corporations – as well as government entities and major universities, museums and other charitable and cultural organizations.

Based on a survey of corporate counsel at Fortune 1000 companies, we have been placed on BTI Consulting's Client Service A Team. Our leading practices and attorneys have been recognized in *Chambers & Partners Guides, Who's Who Legal, Leading Lawyers Network, Corporate Counsel*, and the *Expert Guides* published by Euromoney Institutional Investor PLC. In addition, *Corporate Board Member* has recognized the Firm based on its survey of CEOs and directors of major public companies.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

401 S. Tryon Street
Suite 2600
Charlotte, NC 28202-1935
704.444.2000 tel
704.444.2050 fax

525 W. Monroe Street
Chicago, IL 60661-3693
312.902.5200 tel
312.902.1061 fax

5215 N. O'Connor Boulevard
Suite 200
Irving, TX 75039-3732
972.868.9058 tel
972.868.9068 fax

1-3 Frederick's Place
Old Jewry
London EC2R 8AE
+44.20.7776.7620 tel
+44.20.7776.7621 fax

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel
310.788.4471 fax

575 Madison Avenue
New York, NY 10022-2585
212.940.8800 tel
212.940.8776 fax

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
650.330.3652 tel
650.321.4746 fax

1025 Thomas Jefferson Street, NW
East Lobby, Suite 700
Washington, DC 20007-5201
202.625.3500 tel
202.298.7570 fax