

ESOPs in Mergers and Acquisitions

Recently announced transactions using employee stock ownership plans (ESOPs) as a financing tool in mergers and acquisitions have highlighted the role that an ESOP can play in such transactions.

Following is general information about using ESOPs in mergers and acquisitions. ESOPs are subject to numerous legal and financial requirements and are not suitable for every corporate transaction. Therefore, this information sheet should not be considered to constitute legal advice, but we will be happy to discuss ESOPs with you in more detail.

What is an ESOP?

An ESOP is a form of qualified retirement plan, which is designed to invest primarily in employer stock. The ESOP purchases employer stock (and can borrow money in a tax-advantaged manner to do so), holds it in trust, allocates it to employees' individual accounts and then distributes the stock (or its value in cash) when employees terminate employment or retire. For more information about ESOPs in general, please see our Employee Stock Ownership Plans Fact Sheet available at www.kattenlaw.com/ESOP.

ESOPs and Corporate Transactions

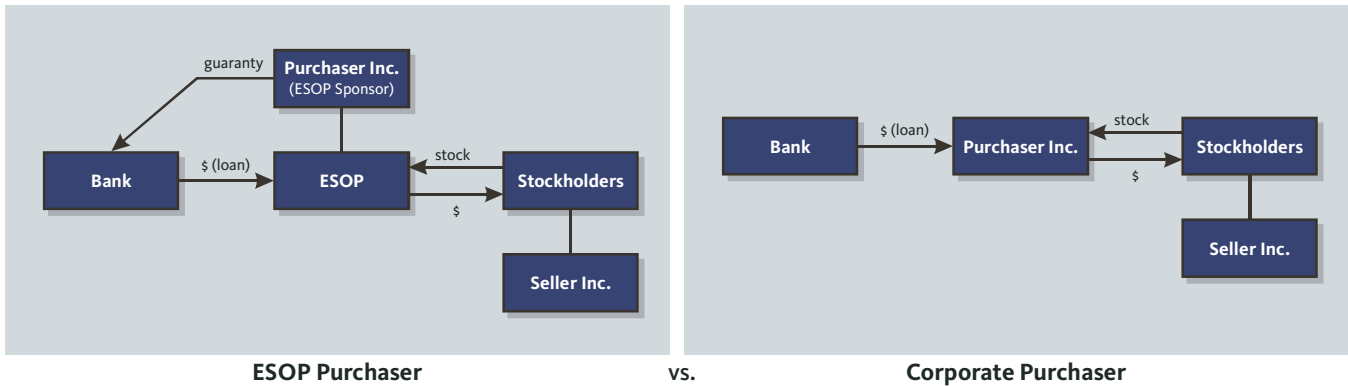
ESOPs enjoy unique tax advantages, and by using an ESOP as a party in a corporate transaction, stockholders, employees and the corporation can benefit. The following information illustrates three different benefits that can be obtained from using an ESOP in a corporate transaction.

1. Tax Advantaged Leverage for a C Corporation

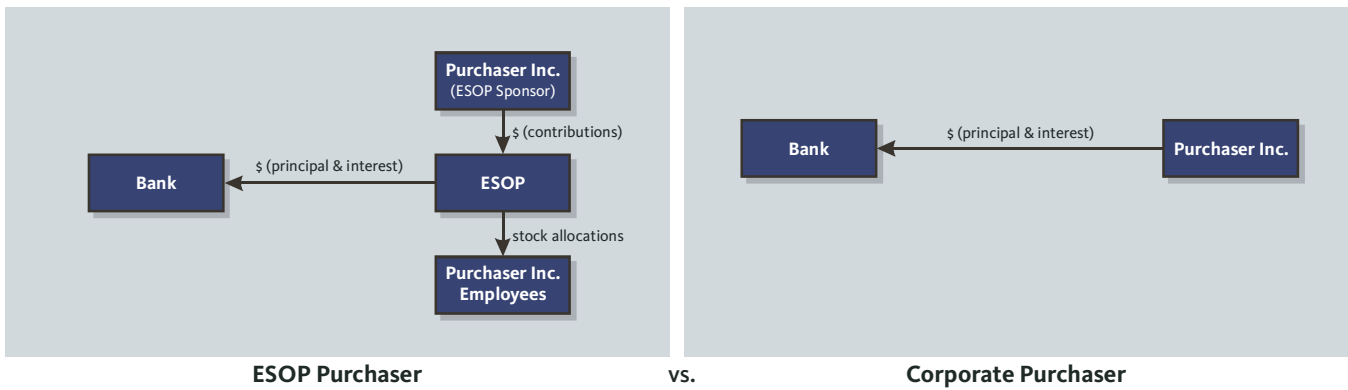
In the diagram that follows, there are two scenarios with two different buyers—a corporation and an ESOP. Both have borrowed funds from a lender to finance their purchase of Seller's stock and will have to pay back the loan principal with interest. Yet, the ESOP scenario has a distinct advantage. While the interest on the loan is deductible to both of the buyers, only in the ESOP scenario can the ESOP Purchaser deduct the principal as well.

Here's how it works: The Purchaser makes contributions to the ESOP, which are deductible as contributions to a qualified employee benefit plan. Then, the ESOP uses these cash contributions to make the loan repayments. This results in a significant tax savings for the ESOP Purchaser over conventional borrowing.

Transaction

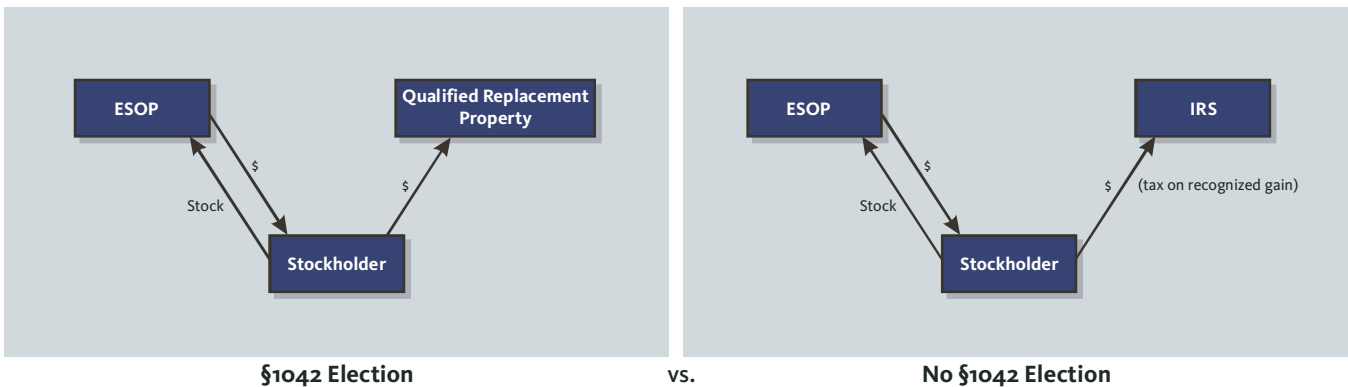


Post-Transaction



2. Tax Advantages for Selling Stockholders of a C Corporation

Shareholders of C corporations may be able to make a "Section 1042 election" under the Internal Revenue Code in connection with a sale of stock to an ESOP. If a seller is qualified to make such an election and reinvests the proceeds from the sale in "qualified replacement securities," that seller can defer recognition of gain from the sale. The seller can enhance the benefit of the Section 1042 deferral with careful estate planning. Without a Section 1042 deferral, the selling stockholder would recognize gain at the time of sale and pay tax on the excess of the sales proceeds over the basis in the stock.



3. Tax Advantages for S Corporation ESOPs

Another application involves use of an ESOP to transform from a C corporation into an S corporation. After the transformation, the corporation pays no tax on its earnings because of its S corporation status. Likewise, the ESOP, as a tax-exempt entity, does not have to pay any federal income tax on its share of the corporation's earnings. These savings can be used to grow the corporation (ESOP buys more stock from corporation; corporation uses proceeds for business purpose). Thus, S Corporation ESOPs provide tax benefits to all parties, which results in a substantial competitive advantage for the corporation, since the ESOP's share of earnings is not taxed. Numerous corporations have become 100% ESOP owned S corporations to maximize these tax benefits.

Conclusion

ESOPs can serve as a useful tool in reducing the tax consequences of corporate transactions and can be used to benefit multiple parties. If you would be interested in learning more about the ideas described here or how Katten Muchin Rosenman LLP can help you with an ESOP and/or corporate transaction, please contact one of the attorneys listed below.

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