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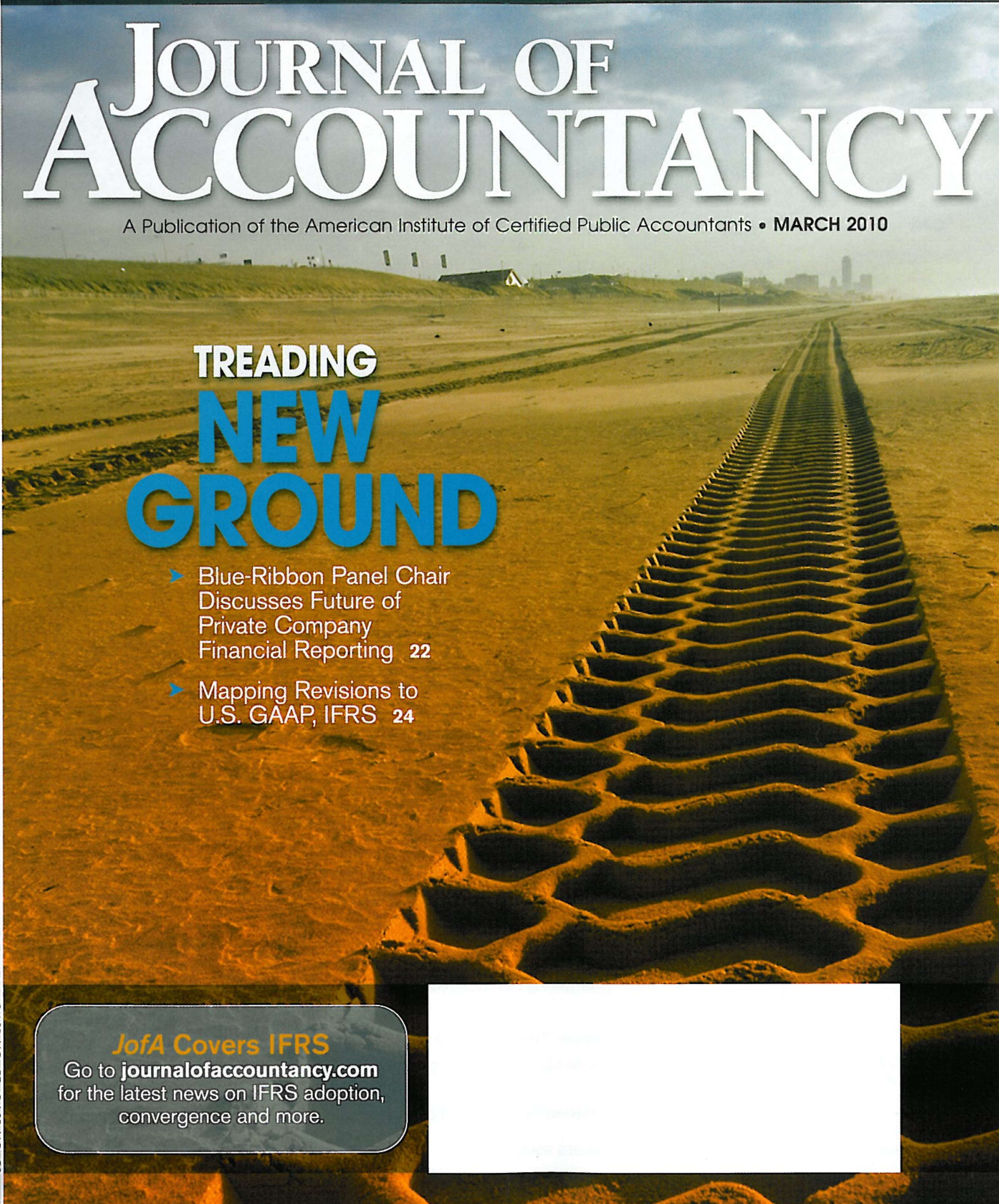
JOURNAL OF ACCOUNTANCY

A Publication of the American Institute of Certified Public Accountants • **MARCH 2010**



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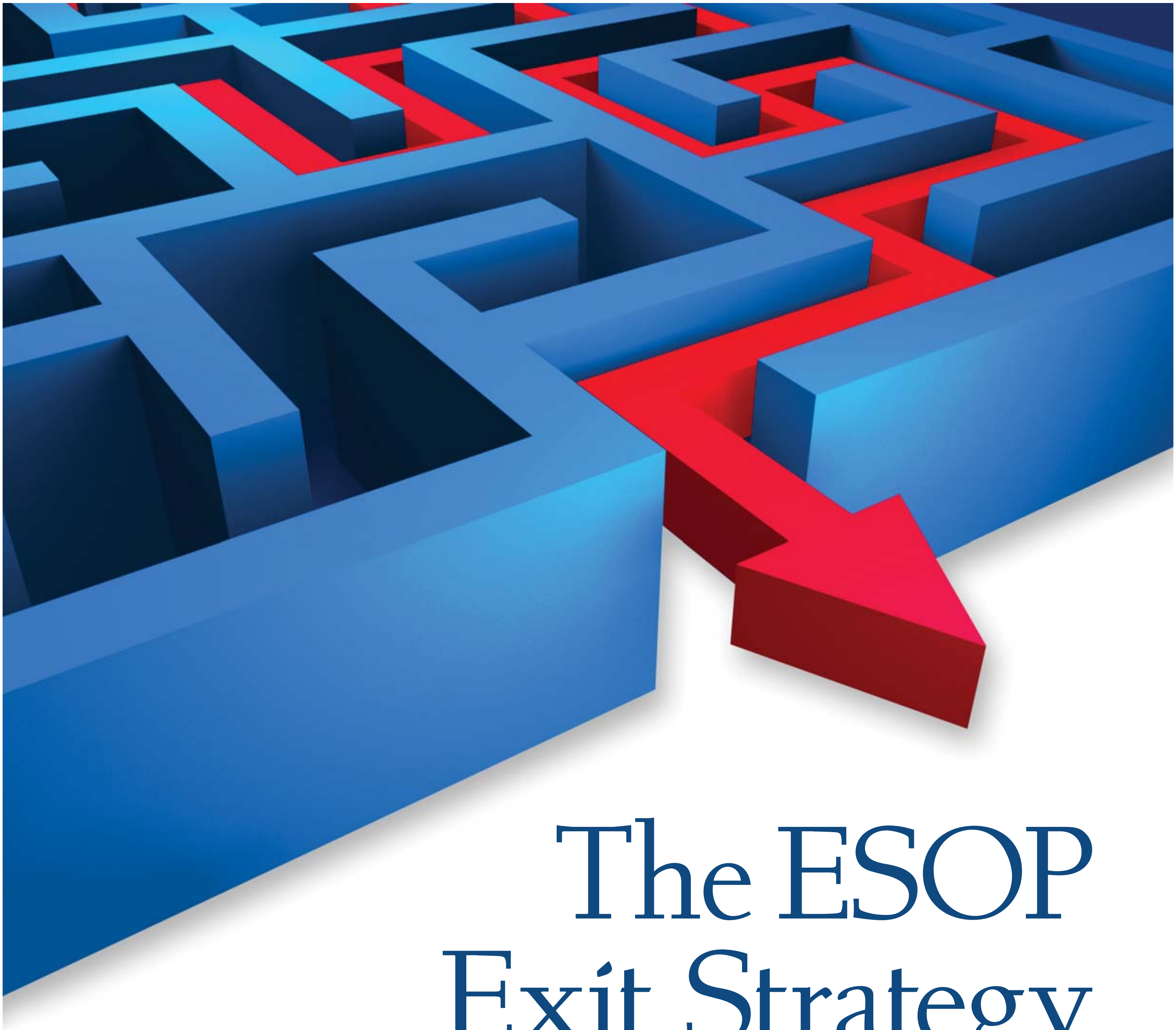

The ESOP Exit Strategy

Explore the advantages of this popular tool for succession planning.

by Scott D. Miller, CPA/ABV

The scenario is all too common. A majority partner wants to retire, but the remaining partners can't afford to buy him or her out, or they want out themselves. Key employees eye the door as rumors swirl that the company may be sold to a larger competitor that is sure to clean out any "redundancies." And other interested parties—key customers, suppliers and lenders—begin to ask about the owners' succession plan.

The confluence of 35 years of progressive employee stock ownership plan (ESOP) financial successes, S corporation tax attributes, potentially higher taxes on the horizon and an aging baby-boomer generation combine to make ESOPs an attractive option that private company CFOs—and the CPAs who advise them—should consider.

This article examines why ESOPs are more appealing to both selling shareholders and ESOP participants now than in years past, defines issues that must be fully considered before installing an ESOP, and highlights common attributes of successful installations.

The Growth of ESOPs for S Corps

Employee Stock Ownership Plans and Trusts (ESOP) became available under the Employee Retirement Income Security Act of 1974 (ERISA) as qualified retirement plans. In the intervening years ESOPs have evolved into a powerful and comprehensive exit planning option for many business owners.

An ESOP is a tax-qualified defined contribution employee benefit program intended to primarily invest in the stock of the plan sponsor company. Significantly, the ESOP is primarily invested in employer stock; it's generally understood that more than half the plan assets are employer stock. The ESOP owns the stock for the beneficial interests of the employees, with the stock allocated to the accounts of the employees and not other legal entities such as a partnership or LLC. More significantly, at the higher employee ownership percentages, the ESOP is the controlling shareholder.

From the earliest days until 1996 the number of C corporation ESOP installations grew steadily. Such installations enjoyed certain tax advantages but were still subject to C corporation income taxes and had the repurchase obligation, which requires the sponsoring company to make a market for the stock allocated to the ESOP accounts of departing employees. Together these formed an onerous financial obligation. But following a legislative change in 1996 that opened ESOPs to S corporations, it is now estimated that 70% to 80% of ESOP installations since then have been in S corporations. Exhibit 1 indicates the growth in ESOPs and other equivalent plans as estimated by the National Center for Employee Ownership (NCEO) after eliminating sham plans from the early 2000s.

Exhibit 1 Growth of ESOPs

Year	Number of Plans	Participants
1980	4,000	3,100,000
1990	8,100	5,000,000
2000	10,000	7,510,000
2009	11,400	13,700,000

Source: The National Center for Employee Ownership, **nceo.org**.

Transition Planning Options

Theoretically, business owners enjoy a wide range of exit options. These include sale to a strategic buyer (often a competitor or other player in the same market or industry) who sees synergies with existing business interests; sale to investors such as private equity firms and wealthy individuals; or an initial public offering (IPO). Practically, however, many business owners have far fewer suitable exit options.

In mature markets or economic down cycles, strategic buyers may not be available or may be unwilling to pay what a long-term owner believes the business is worth. In addition, the synergies that make a purchase attractive to many strategic buyers generally involve consolidation, which frequently includes facility closings, discontinuation of product lines or services, layoffs, name changes and other transitional moves that operating owners find incompatible with their loyalty to other shareholders, employees, customers and communities where they operate.

A cash sale to a nonoperating investor such as a private equity firm or wealthy individual may be the most appealing exit for owners. But such investors have rigorous acquisition criteria for growth and profits that most companies cannot meet. IPOs require similarly rigorous criteria, with the burden of greater regulatory requirements.

EXECUTIVE SUMMARY

■ **S corporation tax attributes make ESOPs** very attractive. More companies installing ESOPs are arriving at an employee-owned company often with 100% of the stock.

■ **S corporation and C corporation attributes** (including the IRC § 1042 tax-free rollover) may be combined to forge a flexible succession plan meeting the goals of sellers, senior management and ESOP participants.

■ **The potential for future tax increases magnifies** the tax incentives enjoyed by ESOPs.

■ **An aging population increases** the demand for succession alternatives, including ESOPs.

■ **Optimal financial results are obtained** when the ESOP is combined with ongoing communications to educate employees about the responsibilities and obligations of ownership.

■ **ESOPs are practical for both** business owners and CPA firms.

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In addition, owners typically find it necessary to continue to hold significant blocks of stock, the value of which is subject to market factors outside the seller's control or influence.

THE ESOP EXIT OPTION

For owners who have not found the previous exit options suitable, an ESOP is often a good alternative. This may be especially true of owners who want their employees to enjoy the financial benefits of owning the company they helped build. In 2009 the ESOP Association estimated that of the 11,400 companies that had ESOPs, 2,500 (22% of the total) were 100% employee owned, and 4,000 were majority employee owned. Virtually all 100% employee-owned companies were S corporations. Only about 4% of all ESOPs were in public companies.

Because selling shareholders almost always provide financing or guarantee bank debt, they retain a tangible interest in the ongoing financial success of the business so that seller financing is repaid faster and guarantees lifted sooner.

A significant amount of research and empirical data shows that ESOP companies generally outperform their non-ESOP closely held counterparts. The studies reinforce what is already generally known among business authors and consultants: that open sharing of information is a superior organizational structure that typically contributes to longer-term financial success.

In a comprehensive review of employee ownership, Steven Freeman, a faculty member in the Organizational Dynamics Graduate Program at the University of Pennsylvania, authored the Organizational Dynamics Working Paper *Effects of ESOP Adoption and Employee Ownership: Thirty years of Research and Experience*. This analysis led him to the conclusion that there is a clearly established link between financial performance and employee ownership. According to Freeman, "evidence suggests that combining employee ownership with increased employee participation may generate astounding returns on investment."

Research supported by The Employee Ownership Foundation and provided by professors Joseph Blasi and Douglas Kruse, both with the School of Management and Labor Relations at Rutgers University, reports overwhelmingly positive results over a 10-year period indicating that ESOPs appear to increase sales and employment, and that ESOP companies tend to be more stable and offer greater retirement benefits than non-ESOP companies. "Employee ownership is one of the few issues on which the political left and right can agree, and is thereby capable of attracting strong support across the U.S. political spectrum," notes Freeman. Federal legislation has been highly favorable to establishing ESOPs and encouraging increased employee ownership.

TAX INCENTIVES

ESOP transactions have been legislatively designed to embrace certain tax incentives for both sellers and buyers (the ESOP) to encourage more employee ownership (see Exhibit 2). Accordingly, the likelihood of higher federal and state tax rates makes the tax incentives look more attractive. CPAs in particular are in an excellent position to assist employers (or clients) in gaining an understanding of ESOPs because the plans enjoy significant tax incentives. The technical compliance associated with those incentives is an exacting discipline well suited to experienced CPAs.

Seller tax advantages. The gain on the sale of stock to a C corporation ESOP may be deferred (or eliminated) under an IRC § 1042 tax-free rollover. The tax deferral applies to sales proceeds invested in qualified replacement property (QRP). If the QRP is subsequently sold before the death of the holder, a taxable event occurs. However, if the QRP is held until the death of the holder, the QRP passes to the holder's estate and would, in years after 2010 (unless the estate tax repeal is made permanent), receive a stepped-up basis, subject to estate tax regulations. Thus, the deferred gain would escape taxation.

ESOPs and Employee Ownership in CPA Firms

Such professional service organizations as CPA and engineering firms may find that an ESOP can be both a succession and staff retention tool.

Professional services firms interested in establishing an ESOP must examine state law to determine whether a traditional ESOP may be a shareholder in the firm. In most cases, an ESOP may be a shareholder with minor modifications to conform to state law.

For Norman, Jones, Enlow & Co. CPAs in Columbus, Ohio, an ESOP turned out to be the best succession option for selling shareholders when it was first funded in 2005, according to Andy Coen, the firm's president. Several larger shareholders were all approximately the same age, and the next generation of managers would have faced a daunting financial challenge to acquire the practice in a traditional manner.

The firm examined Ohio law and received a determination letter, permitting it to adopt the ESOP. All participants in the ESOP must have the potential to become CPAs, whether or not they ultimately become CPAs. A few clerical and administrative associates did not meet CPA educational requirements, and the firm received a waiver for them. "The ESOP has been a wonderful exit vehicle for the selling shareholders. It allows all our associates to build a financial stake in the firm. Employee ownership is a strong recruiting tool as well," Coen says.

Exhibit 2 Technical & Tax Update[1]

Description	C Corporation	S Corporation
Annual employer payroll contribution limits	25% qualifying payroll for all qualified plans	25% qualifying payroll for all qualified plans
Self-directed employee contributions to qualified plans	Does not count against employer 25%	Does not count against employer 25%
Maximum eligible individual payroll	$245,000, indexed for inflation	$245,000, indexed for inflation
Annual additions limit to all qualified plans	$49,000, indexed for inflation	$49,000, indexed for inflation
Tax status of sale of stock to ESOP	Capital gain	Capital gain
IRC § 1042 tax deferral	Applies only to C corporation 30% test and invest in QRP	Does not apply
Dividends – C corporations	May be deductible, must be reasonable, does not count against 25% test, subject to corporate alternative minimum tax	Does not apply
Distributions – S corporations	Does not apply	May be paid directly to all shareholders, unlimited, does not count against 25%
Income taxes	Subject to C corporation income taxes	ESOP not subject to income taxes, outside shareholders pay prorated taxes
Anti-abuse provisions	Does not apply	Possible severe penalties
Transaction strategies	Sell minimum 30% for IRC § 1042 eligibility, migrate to S corporation over time	Sell any percentage, often with eventual goal of 100%

1. Tax data is effective for 2009; 2010 data was not available at time of publication.

However, as of this writing, as a result of the estate tax repeal at the end of 2009, a step-up in basis for some or all of the qualified replacement property may not be available if the holder dies in 2010 (for an examination of current issues with the federal estate tax, see "In the Twilight of the EGTRRA," **journalofaccountancy.com/Web/20102479.htm**).

With some advance planning, it is also relatively easy for S corporation owners (sellers) to re-elect the C corporation status to qualify for the IRC § 1042 election.

All ESOP transactions are stock sales, which qualify for favorable capital gain treatment to the sellers even if the IRC § 1042 election is not available (in the case of S corporations) or not elected. This is an important advantage to using the ESOP exit strategy because many other sales of closely held companies are asset-based transactions that often produce less favorable tax results for the sellers.

Buyer (owner) tax advantages. C corporation dividends paid on ESOP stock may be deductible (IRC § 404(k)). C corporations can deduct dividends paid on ESOP stock by applying dividends directly to loan principal or by paying the dividend directly to the ESOP participants. This may also be a tax advantage to exiting owners (sellers) who have retained a stock or financing interest in the business.

ESOP participants (and their beneficiaries) have the option under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) of electing to have their dividends paid to the plan and reinvested in additional qualifying employer securities. This option is likely to be used only by larger and financially sophisticated companies that have registered securities.

Employee contributions into the ESOP are tax deductible within statutory limits. This is a significant tax incentive, particularly when the ESOP borrows funds to purchase stock from a selling shareholder, since debt principal payments are otherwise not typically deductible for federal income tax purposes.

Finally, S corporations can make distributions to the ESOP that may be used to repay ESOP-related debt.

Issues to Be Considered

While ESOPs have many benefits, a number of key issues must also be addressed.

One important aspect of a company's ESOP installation is that current shareholders control the transition process. They determine the full range of transaction attributes including whether the ESOP will be installed, when the transaction will take place, how much stock will be sold, and the financing details.

In a post-ESOP transaction environment, particularly when control is passing from the former majority shareholder to the ESOP, issues of corporate governance are important to review. The duties of the shareholders, board of directors and corporate officers should be understood. In many closely held corporations, often the same individuals have multiple roles such as director, officer and ESOP trustee. That may cause conflicts of interest. It is important to identify potential conflicts and to ensure they are minimized or eliminated. As discussed below, using an independent trustee is an excellent first step in minimizing conflicts. Serving as an adviser on such issues as corporate governance, strategic thinking and best internal control practices are other venues for CPAs to provide services to ESOP clients.

> CPAs are often strong candidates to serve as ESOP trustees where there are no real or perceived conflicts of interest.

The standard of value for an ESOP valuation must consider regulatory requirements of the IRS and the Department of Labor. Generally, the standard of value is fair market value with a specific understanding of ESOP-related issues, such as the repurchase obligation imposed by federal regulations. The stock valuation must be completed by an independent professional. In most cases, the CPA firm of record to the company is not independent for the purposes of providing an ESOP valuation. Appearances of independence are also critical, and the CPA firm has typically established a trusted relationship with the selling shareholders and the company, casting a shadow on their independence from the standpoint of the ESOP trustee.

While CPA firms are typically not independent of their clients for the purposes of providing ESOP valuations, CPAs individually are often strong candidates to serve as ESOP trustees where there are no real or perceived conflicts of interest. By the nature of their training and familiarity with accounting, finance, corporate governance and regulatory literacy, CPAs often possess the skills required of ESOP trustees.

Transactions today often reflect the acquisition of all the stock by the ESOP. Such transactions typically encompass the full range of merger-and-acquisition issues, including employment contracts and long-term incentive and retention programs for successor management, long-term leases on facilities, financing terms in the case of seller financing, board membership and ongoing duties.

The selling shareholders may elect to sell any amount of their stock from a small block to 100%. This means that the transaction is scalable. Selling a smaller block of stock may mean the transaction is more easily financed from existing lines of credit, reducing the company's risk of default if events suddenly turn negative. If a piecemeal approach is adopted, the shareholders may structure the transaction so that control remains with the sellers until the controlling block of stock is sold to the ESOP. This popular strategy helps ensure the company's survival by avoiding excessive leverage.

Under an ESOP purchase arrangement, the company is literally buying itself through cash flows on behalf of the ESOP, so starting the transition process as soon as practicable and planning on a long installation time frame is advised. Owners wishing to sell in a shorter time horizon should anticipate assisting the ESOP, often financially, to facilitate the transaction.

Compliance Requirements

ESOPs are subject to a host of federal regulations, but the regulations have been written to allow great flexibility in plan design and installation. CPAs who work for or advise a company that has an ESOP should take an active role in ensuring the plan balances the needs of sellers and buyers, and complies with relevant regulations (see sidebar "ESOPs and Employee Ownership in CPA Firms").

What is most noteworthy is that the ESOP is a willing buyer with an interest in owning all or part of the company at the election of the current shareholders. The current shareholders do not have to negotiate with a third-party buyer that is often unknown, unpredictable and may back out of the transaction following the exchange of confidential information. As a candidate buyer, the ESOP is a known party that will purchase stock in the company subject to applicable regulations.

The ESOP is a qualified retirement vehicle that is actually a trust, and as such, must have a trustee that is accountable for upholding fiduciary responsibilities. ERISA-based fiduciary obligations are among the most-stringent conduct regulations in the business community. These regulations exist to protect plan participants, and they are effective in meeting that goal. In the world of ESOP transactions it is a recommended practice, but not a requirement, to engage an independent trustee to negotiate on behalf of and represent the interests of the ESOP participants in stock transactions. This election to use an independent trustee is a way to help ensure compliance with applicable federal fiduciary regulations. If an independent trustee is considered for ESOP-related duties, it is appropriate to identify candidates with extensive transaction experience.

Due to unintended consequences of S corporation legislation, there were a number of abusive installations in the early 2000s resulting in the concentration of financial benefits into the hands of a few. Legislation was passed to correct those S corporation abuses. The legislation is complex, but generally it relates to the number of eligible employees in the plan and the percentage of financial ownership they have. The more employees in the S corporation, the better are the chances of full compliance with regulations.

The first level of anti-abuse testing relates to the concentration of stock allocated to the accounts of individual employees. A concentration greater than 10% of the total ESOP stock allocated into the account of a single employee is the first red flag marking that employee as a "disqualified person." The second level of anti-abuse testing examines the total equity ownership of all disqualified persons. If more than 50% of the total equity of the company is owned by the disqualified persons, then substantial financial penalties will be imposed. The best defense is to limit the ability of any employee to become a disqualified person. Practically speaking, S corporation ESOPs with fewer than 15 employees after the installation will have significant compliance issues with the anti-abuse statutes.

Keys to Success

There are a number of established best practices in identifying ESOP candidates. The candidate should be financially successful with a track record of reasonably predictable profitability and cash flow. Stable and well-established firms are a plus since their track record will help service acquisition-related obligations and secure the support of lending institutions. ESOPs are often not suitable for startup organizations, failing industries or companies with a history of exceedingly volatile earnings. A capable successor management team is also important as it will be required to facilitate the repayment of the debt. Companies with established communications with their employees are excellent candidates because rapport and trust is already established. ❖

AICPA RESOURCES

Articles

■ "Tax Reform Alters ESOP Landscape," *JofA*, June 02, page 37
■ "A Piece of the Action," *JofA*, Aug. 96, page 52
■ "Employers' Accounting for Employee Stock Ownership Plans," *JofA*, Feb. 93, page 53
■ "Identifying Good ESOP Candidates," *The Practicing CPA*, Oct. 05, **tinyurl.com/y8skxqb**

Use **journalofaccountancy.com** to find past *JofA* articles. In the search box, click "Open Advanced Search" and then search by title.

Publication

Financial Valuation of Employee Stock Ownership Plan Shares (#WI678473)

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OTHER RESOURCES

Web sites

■ The ESOP Association, **esopassociation.org**
■ The Employee Ownership Foundation, **employeeownershipfoundation.org**
■ The National Center for Employee Ownership, **nceo.org**
■ Employee-Owned S Corporations of America, **esca.us**
■ Ohio Employee Ownership Center, **oeockent.org**

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