SIMPSON
THACHER

Fundamentals of ESOPs

May 8, 2007

Employee stock ownership plans, or "ESOPS," are tax-qualified retirement plans that must satisfy many qualification requirements. "Leveraged ESOPs" are subject to additional rules and requirements. The following is a summary of (i) ESOP qualification requirements, (ii) special rules for leveraged ESOPs, and (iii) the use of ESOPs by S corporations.

I. ESOP QUALIFICATION REQUIREMENTS

Because ESOPs are a form of tax-qualified benefit plan, they must satisfy the general qualification requirements set forth in the U.S. Internal Revenue Code of 1986 (the "Code"), including the minimum coverage and minimum vesting standards. ESOPs must be invested only in "qualifying employer securities", and are subject to special diversification and distribution requirements.

Minimum Coverage: In order for an ESOP to be deemed qualified, it must cover a sufficient number of employees to satisfy either a "ratio percentage" test or a "nondiscriminatory classification" test. The ratio percentage test generally requires that the percentage of the employer's non-highly compensated employees covered by the plan be at least 70% of the percentage of "highly compensated employees" (*i.e.*, in 2007, those earning in excess of $100,000) covered, excluding employees who fail to meet the plan's minimum age or service requirements, nonresident aliens, and union employees. If the ratio percentage test cannot be satisfied, the plan will be deemed qualified only if the IRS finds that the group of employees covered by the ESOP is not discriminatory in favor of officers, shareholders or highly compensated employees. For purposes of these tests, all affiliated companies under 80% common control are considered to be one employer. (ESOPs covering only union employees are automatically deemed to be in compliance with the non-discrimination requirements for coverage.)

Minimum Vesting: Beginning in 2007, ESOP participants are required to become vested (*i.e.,* acquire nonforfeitable rights in their accounts) according to one of two minimum vesting schedules: (1) 100% after three years of service or (2) a graded schedule requiring 20% vesting following two years of service, and 20% additional vesting over each of the next four years of service, reaching 100% at the end of six years.

Qualifying Employer Securities: An ESOP is required to invest primarily in qualifying employer securities. The Code defines "qualifying employer securities" to include common stock issued by the employer which is readily tradable on an established securities market. (Noncallable preferred stock may be used if it is readily convertible at a reasonable price into tradable common stock. Such stock is considered noncallable if, once a call is made, the holder is given a reasonable period in which to convert the stock into tradable common stock.) If the employer has no readily tradable common stock, qualifying employer securities include employer-issued common stock that has a

combination of voting power and dividend rights at least equal to both the class of common stock with the greatest voting power and the class of common stock with the greatest dividend rights.

Pass-Through Voting: If the employer's qualifying securities are registered pursuant to Section 12 of the Securities Exchange Act of 1934, each participant must be entitled to vote the shares allocated to his or her account. If the employer's shares are not registered, participants must be allowed to vote their allocated shares on any issue which by law requires approval by more than a majority of the shareholders (such as sale of all or substantially all of the shares or assets of the company). Unallocated shares which are held in the suspense account are voted by the trustee, either as an exercise of its discretion or as directed by a company committee. However, the plan may allow participants to direct the trustee as to how to vote the unallocated shares held in the suspense account, which possibly alleviates some of the potential fiduciary conflicts that may arise if the company directs the voting of those shares. Typically, the plan will also provide similar treatment of the right to tender shares (although it is not required by law to do so).

Diversification Requirements: ESOPs are generally required to permit participants who have participated in the ESOP for at least 10 years and who have attained age 55 to elect to diversify the investment of at least 25% of their plan accounts each year during a multi-year election period, with the diversification limit raised to at least 50% during the sixth, or final, year of the period. While the Pension Protection Act of 2006 generally requires that beginning in 2007, all defined contribution plans that hold publicly traded employer securities permit participants to diversify their account balances invested in such securities on a more rapid basis than described above, ESOPs that do not hold participant pre- or after-tax contributions or matching contributions, or which are separate plans from any other qualified retirement plan of the employer, are not currently subject to the accelerated diversification rules of the Pension Protection Act.

Distribution Requirements and Put-Options: Distributions from an ESOP generally must begin not later than one year after the end of the plan year in which the participant retires, dies or becomes disabled, or by the fifth plan year following the plan year in which the individual otherwise terminates employment. The distribution must be made in substantially equal periodic payments over no more than a five year period, although if the participant's account exceeds $800,000, the distribution period may be extended one year for each $160,000 in excess of $800,000. There is an exception for such portion of an individual's account balance containing employer securities acquired with the proceeds of an ESOP loan, which are not required to be distributed until the loan has been repaid in full, except in the event of death or retirement. However, it is not clear whether an S corporation ESOP can take advantage of this exception. Generally, distributions are made by the ESOP in employer securities, although the ESOP can provide for cash distributions subject to a participant's right to demand that his or her distribution be made in stock. If the employer's corporate charter or bylaws restrict the ownership of substantially all employer securities to employees or to the ESOP, the ESOP may preclude a participant from obtaining a distribution of employer securities.

If the securities distributed by the ESOP are not readily tradable on an established market, the ESOP participants must be a given an option to put the employer securities back to the company for their

fair market value. The put option must last for a period of at least 60 days following the date of distribution. If the option is not exercised, the participant must be given a second 60 day period to sell the securities back to the employer during the following plan year. In addition, either the ESOP or the employer may be given a right of first refusal if the participant seeks to sell the securities to a third party.

Independent Appraiser. ERISA requires that all acquisitions and dispositions of shares by an ESOP be for "adequate consideration" (generally, fair market value as of the date of the transaction). Dispositions include distributions of shares (or the value of shares) by the ESOP to a terminating participant or beneficiary. An ESOP that holds securities which are not readily tradable on an established securities market must have all valuations of the securities it holds made by an appraiser independent of the issuer.

II. SPECIAL RULES FOR LEVERAGED ESOPS

Typically, a leveraged ESOP borrows money from the employer or a bank or other lending institution in order to purchase qualifying securities of the employer. The annual contributions made by the employer to the ESOP's trust are applied by the trustee to repay the ESOP loan. Subject to certain limitations described below, corporations (other than S corporations) receive a tax deduction for the contributions made to the ESOP which are used to repay the ESOP loan. (However, the value of such deduction to an S corporation fully owned by an ESOP would be limited, since no matter what the level of the S corporation's income, that income is passed through to a tax-exempt entity.) The securities purchased by the ESOP are placed in a suspense account, to be allocated to participants' plan accounts annually in accordance with a formula described below. Because the annual contributions to the ESOP are based on payroll, capital-intensive companies – as opposed to labor-intensive companies – may not have enough payroll expense to take full advantage of the deduction limits. In addition, high growth companies may not be good candidates for leveraged ESOPs because debt requirements will increase as the number of participants grows.

Suspense Account. The qualifying securities acquired by a leveraged ESOP with loan proceeds must be placed in a suspense account until allocated to participants' individual accounts. The shares held in the suspense account are allocated from that account to participants' accounts as the ESOP loan is repaid. Income from the securities held in the suspense account is allocated to participants' accounts, unless the ESOP provides for the use of such income to repay the loan. Securities are released from the suspense account based on the ratio of the amount of principal and interest paid on the loan for that year to the total principal and interest payable over the remaining term of the loan. Securities released from the suspense account are then allocated to participants based upon a participant's pro-rata share of the total compensation of all participating employees, subject to annual limitations.

Special ESOP Contribution and Deduction Limitations for C corporations. Generally, the annual deduction limit for contributions to an ESOP is 25% of all compensation otherwise paid or accrued during the year to the participants under the plan. However, there is a special provision for leveraged ESOPs maintained by C corporations: where the contribution is used to repay an ESOP

loan, the 25%-of-compensation limit is just for the amount used to pay the principal on the loan, and all amounts applied to the payment of interest are deductible in addition to those amounts used to pay the principal. In addition, dividends paid on employer securities held by an ESOP are also deductible if, among other things, they are used to make payments on an ESOP loan. *Note,* however, that these special provisions are *not* applicable to S corporations, which are not able to deduct ESOP contributions or dividends used to repay an ESOP loan.

Notwithstanding the deduction limitations described above, the Code provides that the maximum annual dollar amount that can be allocated to any one participant's accounts under all defined contribution plans maintained by the employer (which would include an ESOP) is the lesser of $40,000 (as adjusted for COLA to $45,000 in 2007) or 100% of the participant's applicable plan compensation. For these purposes, a participant's applicable plan compensation is limited to no more than $200,000 a year (as adjusted for COLA to $225,000 in 2007). In calculating a participant's annual allocation, the shares to be allocated to his or her account are valued based on the shares' original purchase price by the ESOP. However, if no more than one third of the employer's contributions for the year are allocated to "highly compensated employees" (those earning in excess of $100,000 in 2007), contributions applied to pay interest on the loan, as well as forfeitures of ESOP stock acquired through a loan, are disregarded for purposes of computing the annual addition. Because the annual allocation limitations apply to <u>all</u> defined contribution plans maintained by an employer, an employer may have to freeze or suspend contributions to its 401(k) or profit sharing plans (even employee deferrals) to the extent that the maximum allocation limitation is needed to service the debt on the ESOP loan.

"1042 Transactions". Code Section 1042 provides that no gain will be recognized on certain sales of stock to an ESOP if the selling shareholder reinvests an amount equal to the proceeds in "qualified replacement property." The seller must have held the securities for at least three years prior to the sale to the ESOP, and following the transaction, the ESOP must own at least 30% of each class of securities of the issuing corporation, or at least 30% of the total value of all outstanding stock of the corporation immediately after the sale, including options. The seller's basis of his stock sold to the ESOP carries over to the qualified replacement property. Tax on the gain is deferred until the seller ultimately disposes of the qualified replacement property, and the ESOP must pay a 10% excise tax if it disposes of the acquired shares within three years after the acquisition date. "Qualified replacement property" is generally defined as publicly traded securities of a domestic operating company unrelated to the company whose shares were sold to the ESOP in the 1042 transaction.

Employer stock sold to the ESOP must be qualifying employer securities issued by a domestic C corporation, where neither the issuing corporation nor any member of its controlled group has any stock that is readily tradable on an established securities market for a year prior to and following the sale. It is not possible for an ESOP to acquire shares of an unrelated company in a 1042 transaction since the acquired securities must have been issued by a member of ESOP's sponsor's controlled group. The seller of securities in a 1042 transaction can be any person, partnership, estate or trust, but cannot be a C corporation. If the seller is a partnership, it is the partnership (and not the individual partners) that must make the 1042 election and purchase the qualified replacement property. Generally, 1042 transactions have been utilized primarily by founding shareholders of

small private companies as an estate planning tool, since it permits them to transfer equity of their company, retain control through use of the ESOP, diversify the proceeds, and defer taxation on the gain over their initial investment in their company until the replacement property is sold.

III. ESOPS AND S CORPORATIONS

Generally, the same basic rules apply to S corporation ESOPs as outlined above for C corporations. However, there are some special rules applicable to ESOPs established or maintained by S corporations:

Income Taxation and Unrelated Business Taxable Income ("UBTI"). As noted earlier, because in general, an S corporation is a pass-through entity and an ESOP is exempt from taxation, the proportionate share of an S corporation's income passed through to the ESOP is essentially free from income tax. (Note, however, that S corporations that were converted from regular corporations remain taxable as C corporations for up to ten years with respect to profits that were realized but not recognized when the corporation operated as a C corporation, such as on uncollected accounts receivable or appreciated real estate.) While normally, qualified plans are subject to tax on UBTI, the Code was amended in 1998 to provide that where an ESOP is a shareholder in an S corporation, the ESOP's proportionate share of the S corporation's income is not considered in computing the ESOP's UBTI. In addition, gain realized from the sale by the ESOP of S corporation employer securities is exempt from UBTI.

Dividends. Unlike regular corporations, an S corporation cannot deduct dividends it pays on employer securities held by an ESOP. In addition, dividends paid on such securities cannot be used to repay the ESOP loan if the shares have been allocated to participant's accounts. (Dividends paid on unallocated shares in the suspense account can be used to repay the ESOP loan.)

Contribution and Deduction Limitations. While regular corporations which maintain leveraged ESOPs are entitled to increased annual plan contribution and deduction limitations to the extent employer contributions to the ESOP are used to repay an ESOP loan, S corporations are not entitled to any deduction for plan contributions used to repay an ESOP loan. However, as noted earlier, the denial of this deduction may not be critical to an S Corporation wholly owned by an ESOP, since no matter what the level of the S corporation's income, it is passed through to a tax-exempt entity and is therefore not subject to taxation.

Disqualified Persons and Prohibited Allocations. An individual who holds a significant percentage of the S corporation's "synthetic equity" (i.e., options, warrants, restricted stock or stock appreciation rights) may not be able to participate in the ESOP. An ESOP holding stock of an S corporation must provide that no portion of the assets attributable to or allocable in lieu of such securities may, during certain periods, accrue under the ESOP or be allocated directly or indirectly under any qualified retirement plan of the employer (including the ESOP) for the benefit any "disqualified person." If such a prohibited allocation is made, the amount allocated under the ESOP to the disqualified person will be included in his or her income for the year and the S corporation will be subject to a 50% excise tax on such prohibited allocations, as well as a separate 50% excise tax on such

participant's synthetic equity, although the ESOP itself will not be disqualified. For these purposes, a "disqualified person" is one whose aggregate number of shares deemed owned through the ESOP and number of shares of synthetic equity is at least 10% of the sum of the total number of ESOP shares and the person's synthetic equity shares of the corporation (20% on a family aggregation basis).

Distribution of employer securities. ESOPs maintained by S corporations are not required to provide participants with the right to demand distributions of their account balance in the form of employer securities but can provide for distributions only in cash. This is true even if the S corporation's bylaws do not restrict share ownership only to employees or the ESOP. Alternatively, the ESOP can distribute shares subject to the requirement that they be immediately resold to the company. In either event, sufficient cash needs to be available (either within the ESOP or at the company) so that the participant can receive the then fair market value of the stock. S corporation stock received in a distribution from an ESOP cannot be rolled over to an IRA because an IRA is not permitted to be a shareholder of an S corporation.

LLCs, Partnerships and other Pass-Through Entities. Since institutional investors and other private equity firms cannot be shareholders of S corporations, many clients have inquired whether some of the benefits of using an S corporation to sponsor an ESOP could be obtained using another pass-through entity (such as a limited partnership or a limited liability company). Unfortunately, however, an ESOP can only invest in "qualifying employer securities" (see Part I), which term includes only shares of a corporation, and not equity interests in a limited partnership or limited liability company.

IV. ESTABLISHING A LEVERAGED ESOP

Establishing a leveraged ESOP is not particularly difficult, but it does take time, since it involves many technical requirements and it is important that certain key events take place. Outlined below are some of the essential items for consideration in determining whether a leveraged ESOP would be viable.

Analysis of the company's financial information. The company will need to determine the maximum available annual deductions to the ESOP (based on the company's payroll) and the tax effect of the deductions (*e.g.*, if the company has net operating losses, these tax deductions may not produce an immediate increase in the company's cash flow).

Contribution rate. A determination will need to be made of the maximum permissible annual contributions and allocations of employer stock from the suspense account, in order to determine the ESOP's ability to service the debt on the ESOP loan.

Analysis of the company's overall employee benefits structure. The company will need to determine which employees are to be covered and the possibility (or necessity) of shifting contributions from other existing plans to the ESOP in order to service the debt on the ESOP loan.

Development of the plan's features. This should be reasonably straightforward, since it merely involves compliance with the minimum ERISA standards set forth above concerning, for example, such items as coverage, vesting and the amount of benefits.

Pass-through voting and tender rights; put options. Consideration needs to be given to the exercise of voting and tender rights by participants; *i.e.,* the company may wish to pass through the rights for both allocated and unallocated shares. In addition, consideration needs to be given to the financial effect of the put option requirement. In the event the employer is an S corporation, consideration should be given as to whether distributions in stock can even be made.

Selection of an administrative committee and a trustee. A crucial question is whether the trustee should be an institution or a group of the company's management. If an institutional trustee is chosen, the company may have less input into the ultimate disposition of stock in a hostile takeover situation. (Consideration should be given to avoiding having any lender act as a plan trustee).

ESOP loan and related stock purchase issues. The source of the plan loan needs to be selected and financing terms negotiated. To avoid possible problems under ERISA's fiduciary and prohibited transaction rules, it is desirable to have the ESOP retain independent legal and investment counsel to assist it in structuring financing and in valuation of the company's stock. Among other things, the lender will want to analyze the company's financial information for the past several years, pro forma financial statements for the next several years indicating the effect of the ESOP loan, the Company's preliminary valuation for ESOP purchases, and the potential repurchase liability analysis.

If you wish further information on ESOPs, please contact the individuals listed below, or the Simpson Thacher & Bartlett LLP partner you typically contact.

Alvin H. Brown
212-455-3033
abrown@stblaw.com

Richard Grimm
650-251-5285
ragrimm@stblaw.com

Gregory Grogan
212-455-2477
ggrogan@stblaw.com

Andrea Wahlquist
212-455-2622
awahlquist@stblaw.com

Brian D. Robbins
212-455-3090
brobbins@stblaw.com

Susan B. Kaufman
212-455-2613
skaufman@stblaw.com

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under federal, state or local tax law or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.