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Employee Stock Ownership Plans (ESOP)

by

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I. INTRODUCTION

A. ESOP Is a Stock Bonus Plan Where the Employer Uses Stock as a Financing Vehicle.

1. An ESOP can either be a stock bonus plan or a stock bonus *and* a money purchase plan. It must be qualified under I.R.C. § 401(a), and be designed to invest primarily in Qualifying Employer Securities (QES). *See* I.R.C. § 4975(e)(7); ERISA § 407(d)(6).

2. Although the term ESOP has been used to describe a variety of qualified plans which hold employer securities, one of the primary features of an ESOP is that the employer's stock is used to secure a loan. The loan is usually from a commercial lender, and the loan proceeds are paid to the party selling stock to the ESOP. This party could either be the company or an individual shareholder. The loan is then repaid through deductible employer contributions to the ESOP which, in turn, repays the loan. Profits or accumulated earnings are not a pre-requisite for the employer contributions to the ESOP to be deductible.

B. Pension Protection Act of 2006 Requirement of Diversification of Investments in Employer Stock.

1. The Pension Protection Act of 2006 requires any defined contribution plan holding publicly traded employer securities to permit participants to diversify account balances invested in such employer securities. At least three materially different investment alternatives must be available.

2. The diversification requirements apply to employee elective deferrals and after-tax contributions.

3. Participants with three or more years of service must be permitted to diversify the investment of employer contributions (e.g., employer matching or non-elective contributions). This rule is phased in ratably over three years for securities acquired prior to 2007 (except for participants age 55 or older with 3 years of service by the first plan year beginning in 2006; such participants may diversify 100% in 2007).

Plan Year	Applicable Percentage
2007	33%
2008	66%
2009	100%

4. Participants must receive 30 day advance notice of the diversification requirement. A $100 per day penalty per participant applies for failure to provide the notice. The DOL will provide a model notice.

5. These provisions do not apply to ESOPs that have no elective deferrals, after-tax contributions, or matching contributions and do not form part of another qualified plan. Collectively bargained plans and affected ESOPs have later effective dates.

C. In Addition to Benefiting Employees, ESOPs Can Be Used to Benefit Employers and Shareholders.

1. Facilitating a company's cash flow and raising capital.

If the company provides the stock, it can provide an immediate benefit to employees with an amortized cost. A company can also use an ESOP to raise capital without selling its stock in the general market. A leveraged ESOP can be used to obtain loans to effectively deduct both principal and interest on the loan repayment.

2. Providing a market for non-marketable stock and estate planning techniques.

Often shareholders of private or closely held corporations have difficulty finding a market for their stock. An ESOP can create a friendly buyer while at the same time providing an incentive for employees who now have an ownership interest. Estate planning is facilitated because currently a shareholder who sells stock to an ESOP can defer taxes on the gain by purchasing Qualified Replacement Property (QRP). *See* I.R.C. § 1042.

3. Employee incentive.

One of the principal benefits of an ESOP can be employee motivation. In order to be successful, however, the program must be properly communicated to employees in a positive fashion and followed-up with efforts to continue employee involvement.

4. Other uses of ESOPs.

Exchanging stock in a family-owned business for stock which is more readably tradable; fighting take-overs (note: fiduciary duty requirements could preclude this option if the financial transaction is less favorable to the ESOP than it is to other parties); and as part of a plan to help a company go private.

D. ESOP as Shareholder Exit Strategy.

1. An ESOP can provide an exit strategy for a shareholder who may have concerns about selling his or her business in more conventional methods. For example, some shareholders only want to sell a portion of their stock, are concerned about the tax consequences of selling their businesses (including the ability to generate sufficient funds to pay estate taxes if their businesses are not sold prior to death) or are concerned about the impact that selling their businesses may have on their employees. These issues can often be addressed with an ESOP.

2. In addition to the Code and ERISA ESOP rules, ESOPs can also involve other areas of the law. For example, because an ESOP will become a shareholder of the Employer, state corporate laws often need to be considered along with the Code and ERISA ESOP rules. Sometimes an ESOP transaction may raise issues under federal and state securities laws. Just like any other transaction involving the purchase or sale of a business, an ESOP transaction required knowledge of many different areas of the law.

3. The selling shareholders may elect to sell any amount of their stock from a small block to 100%. Selling a small amount of stock initially will help to make the transaction more easily financed. If §1042 treatment is to be elected, however, the ESOP must own at least 30% of the outstanding shares following the transaction. If a stepped sale approach is adopted, the selling shareholders may remain in control of the company until a controlling block of shares is transferred to the ESOP. Such an approach can help the company to avoid excessive leverage.

4. Personal tax planning.

An ESOP can be a key component of a major shareholder's personal tax plan. Although an ESOP cannot be contractually bound to purchase employer securities in advance of the purchase date (Treas. Reg § 54.4975-11(a)(7)(i); DOL Reg. § 2550.407d-6(a)(6)), a shareholder's personal tax plan could take into account an ESOP which could provide liquidity before or after the shareholder's death.

II. REQUIREMENTS OF AN ESOP

An ESOP Must Be Established to Invest Primarily in Qualifying Employer Securities (QES).

A. I.R.C. Definition Is More Restrictive Than Under ERISA.

QES are common stock issued by the employer, which are readily tradable on an established securities market. Alternatively, with respect to non-tradable securities, QES constitute an employer's common stock which have a combination of voting and dividend rights which equal or exceed the common stock of the employer which has the greatest of those rights. *See* I.R.C. §§ 4975(e)(8) and 409(i).

B. "Primarily" Invested in Employer's Securities Means More Than Fifty Percent.

This is a Department of Labor requirement. An ESOP, however, will not lose its qualification status because investments in QES temporarily go below fifty percent.

C. Special Controlled Group Rules Apply in Testing QES Definition.

These rules are set forth at I.R.C. § 409(l)(4), and are based upon the controlled group rules of I.R.C. § 1563(a). However, with respect to a parent-subsidiary, a fifty percent test, as opposed to an eighty percent test, is used.

D. *ESOP cannot consist of preferred stock* unless the preferred stock is at all times convertible into common stock which constitutes QES. I.R.C. § 409(l)(3).

E. Leveraged ESOP Assets Must Be Held in a Suspense Account.

As the ESOP loan is repaid, assets from the suspense account are proportionally allocated to the participant's account pursuant to one of two described formulas. Treas. Reg § 54-4975-7(b)(8)-11(c).

F. Participants Generally Must Have the Right to Receive Their Distributions in the Form of Stock.

An ESOP, however, is not precluded from making distributions in cash. I.R.C. § 409(h). Also, an employer can have a right of first refusal to buy back the stock from a participant if the stock is not publicly traded and was purchased with an exempt loan. Reg. § 54.4975-(b)(9).

G. Participants of ESOPs of banks or companies whose stock ownership is substantially restricted by law or by charter.

Participants of ESOPs of banks or companies whose stock ownership is substantially restricted by law or by charter do not have to be given the right to receive distribution in stock. I.R.C. § 409(h)(2) and (3). Additionally, if the sponsoring corporation's charter or bylaws restrict stock ownership to the ESOP or current employees, stock will not be distributed to former participants.

H. Participants in S Corporation ESOPs Do Not Have the Right to Receive Distributions in Stock.

I. Prohibited Transaction Exemption.

ESOPs qualify for exemption from many of the prohibited transaction provisions of I.R.C. § 4975 including the entitlement to enter into an ESOP loan transaction.

J. Certain Voting Rights Must Be Passed Through the ESOP to the Participants.

If the QES are subject to § 12 of the Securities Exchange Act of 1934 and, thus, are publicly traded, a participant must be allowed to direct the plan on how to vote his allocated shares. If the QES are not publicly traded, the participants need only be given the right to direct their votes on corporate matters with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution or sale of substantially all assets of a trade or business. I.R.C. § 4975(e)(7); § 409(e). The voting rights requirements will be satisfied if the plan permits one vote to each participant with respect to each issue and the trustee votes the shares held by the plan in the same proportion as the total participant votes. I.R.C. § 409(e)(5).

The ESOP trustee votes the ESOP stock either directly or pursuant to the direction of the Plan Committee or Plan Administrator. The Sixth Circuit Court of Appeals held that an ESOP Administrative Committee did not have to pass through voting rights even though the ESOP owned eighty-five percent of the employer stock and a failure to pass through the voting rights resulted in a “corporate entrenchment.” *Grindstaff v. Green*, 133 F.3d 416, (6^{th} Cir. 1998).

K. Put Option to Receive Cash in Lieu of Stock for Leveraged ESOP If Stock Is Not Publicly Traded.

Upon a distribution, the participant has a non-terminable option against the employer to receive cash instead of stock. Although the plan may not be required to satisfy a put option, it may assume the rights and obligations of the employer at the time the put option is exercised. The option must be given twice: for a period of at least sixty days following the distribution; and for at least a sixty day period in the following plan year. I.R.C. § 4975(e)(7); § 409(h)(4), and Reg. § 54.4975.

L. Payment upon exercise of put option.

Payment upon exercise of put option (for stock acquired after 1986 TRA enactment date). I.R.C. §§ 409(h)(5) and (6). Requires that in the case of a lump sum distribution of employer securities, if employee “puts” securities to employer, put option price be paid in substantially equal installments over a period not exceeding five years, and

1. The five-year period during which the employer must purchase a lump-sum distribution of securities with respect to which a participant has exercised a put option begins thirty days after the date of exercise of the put option;

2. The employer must provide security with respect to the put option installment payments; and

3. In the case of a put option exercised with respect to a distribution other than a lump sum, the employer must pay the full option price to the participant within thirty days after the close of the sixty-day option period.

M. Trust Investment in Employer Securities Exception.

As an Eligible Individual Account Plan (EIAP), an ESOP is not subject to the normal (I.R.C. § 401(a)(22)) limitation that no more than ten percent of plan assets can be invested in employer securities. ERISA § 407(b)(1).

N. An ESOP Cannot Be Integrated with Social Security or be Cross-Tested.

The prohibition on integration does not apply to ESOPs established before 11-1-77. Reg. § 54.4975-11(a)(7)(ii).

Reg. §1.401(a)(4)-8(b)(1)(i) provides that an ESOP cannot be cross-tested. An ESOP may not be tested for nondiscrimination on the basis of benefits.

O. An ESOP Must Meet All of the Other Requirements of a Qualified Plan as Applicable.

P. Conversion of Existing Plan into an ESOP.

The conversion of an existing pension, profit-sharing or stock bonus plan into an ESOP may constitute a termination of the existing plan. This would require the full vesting of all participants in the plan at the time of the conversion into an ESOP. DOL Reg. § 2550.407d-6(a)(5). Use of existing plan assets to purchase employer securities can result in potential fiduciary liability. *Eaves v. Penn*, 587 F.2d 453 (10th Circ. 1978). If employee-source funds are involved, securities considerations must be reviewed.

III. DEFERRING TAXES FROM THE SALE OF STOCK TO AN ESOP BY PURCHASING QUALIFIED REPLACEMENT PROPERTY. I.R.C. § 1042, § 4978

A. I.R.C. § 1042 Requires an Election to Be Made.

Seller must file election by the due date (including extensions) of the income tax return corresponding to the year of the sale. The seller must be an individual, trust, estate, partnership or S corporation. The seller *cannot* be a C corporation. A "statement of purchase" must be signed and notarized within thirty days after the purchase of each item of Qualified Replacement Property. Temp. Reg. § 1.1042-IT (Q&A 3).

B. Rollover Must Be from the Sale of Qualified Securities and the Purchase of Qualified Replacement Property.

1. "Qualified securities" are defined at I.R.C. § 1042(c)(1). They are:

a. Issued by a domestic corporation that has no outstanding readily tradable securities (*i.e.*, *not* publicly traded);

b. Neither attributable to a distribution from a qualified plan nor pursuant to the exercise of a compensatory stock option;

c. Securities that have been held by the seller for at least three years prior to the sale to the ESOP (I.R.C. § 1042(b)(4)) *and* would qualify for long-term capital gain for the seller (I.R.C. § 1042(a)); and

d. Securities that are "best common" as defined by I.R.C. § 409(l). Common stock with voting and dividend rights at least equal to the class of common stock with the greatest dividend and voting rights, or certain noncallable preferred stock which is convertible into such common stock.

2. Qualified replacement property is at I.R.C. § 1042(c)(4).

Stock which the seller purchased within the replacement period. This time period commences three months before the date of the sale to the ESOP and ends twelve months after the date of the sale. I.R.C. § 1042(c)(3).

Stock issued by a domestic corporation which does not, for the taxable year in which such stock is issued, have passive investment income exceeding twenty-five percent of its gross receipts. PLR 8724009 provides that shares of stock in a mutual fund do not constitute qualified replacement property.

a. Qualified Replacement Property can include common stock, preferred stock, corporate bonds and notes and convertible bonds.

b. Qualified Replacement Property does *not include* U.S. government securities, municipal bonds, foreign securities, mutual funds or limited partnerships.

C. ESOP Must Meet Certain Requirements for § 1042 Treatment to Apply:

1. Immediately after the sale, the ESOP must own at least thirty percent of the total value of the employer securities outstanding as of such time. I.R.C. § 1042(b)(2). Thus, the seller need not sell all of his stock to qualify for § 1042 treatment. For example, if the selling shareholder owns eighty-one percent of the company stock, he could sell thirty percent to the ESOP and still maintain control of the company.

2. The seller must specifically elect non-recognition treatment not later than the due date (plus extensions) for filing the seller's income tax return for the taxable year in which the sale occurs. I.R.C. §§ 1042(a)(1), (c)(6).

3. The seller must receive from the employer, and file with the IRS, a statement consenting to an excise tax (equal to ten percent of the amount realized on the sale of the stock) if there is a disposition of stock (for reasons other than participants retiring or separating from service) within the three-year period after the sale to which § 1042 applied which causes the employer stock held by an ESOP to fall below thirty percent of the total value of all employer securities. I.R.C. § 4978(a).

4. The seller, a member of his family (determined under I.R.C. §§ 267(b) and (c)) or any person who owns more than twenty-five percent (attribution rules of I.R.C. § 318 apply) of any of the employer's outstanding securities may not participate in the ESOP to the extent of the securities purchased by the ESOP or any assets attributable thereto. I.R.C. § 409(n). The *nonallocation period* begins on the date of the sale of the qualified securities and ends on the later of (i) ten years after the date of the sale; or (ii) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale. I.R.C. § 409(n)(3)(C). Stock allocated to the employee's account under the ESOP is included in the determination of whether the employee is a twenty-five percent shareholder. I.R.C. § 409(n)(1)(B). Allocations are permitted, however, if the individual is a lineal descendent of the taxpayer selling the securities and the total allocation to all such lineal descendants during the non-allocation period does not exceed five percent of the total securities held by the plan which are attributable to the sale. I.R.C. § 409(n)(3).

If the ESOP allocates assets to a person in violation of the I.R.C. § 409(n) restrictions, the amount allocated is deemed distributed to that person under I.R.C. § 409(n)(2)(a). Additionally, an excise tax equal to fifty percent of the prohibited allocation and any other improperly accrued benefit is imposed on the employer sponsoring the plan. I.R.C. § 4979A.

IV. OTHER ISSUES RELATING TO ESOPs

A. Upon Disposition of QES by a Participant, an Employer or the ESOP May, But Need Not, Have a Right of First Refusal If:

1. The stock, which was purchased with an exempt loan, is not publicly traded (as of the time of the right of refusal).

2. The right is in favor of the employer or the ESOP.

3. The terms under the right to the participant-seller are as favorable as the *greater* of the stock's value based upon a good faith valuation *or* a good faith offer by another buyer to purchase the stock.

4. The right lapses fourteen days after the stockholder gives written notice to the holder of the right. *See* Reg. 54.4975-7(b)(9).

B. Deductibility of Dividends Paid on ESOP Stock. § 404(k).

EGTRRA Expansion of § 404(k) Dividend Deductions. The deduction for dividends paid in cash on employer stock held by an ESOP includes dividends payable at the election of participants (1) in cash directly to plan participants or beneficiaries, (2) to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of that plan year, or (3) to the plan and reinvested in qualifying employer securities. The standard for disallowing abusive dividends was broadened.

Under § 404(k) such dividends must be paid to the plan or paid directly in cash to the participants. If paid to the plan, dividends must be distributed to the participants within ninety days after the close of the plan year. In order for the employer to get the deduction, the dividend must be actually paid, and not just accrued.

Dividends may also be deducted if used to make payments on exempt loans. The deduction for dividends paid to an ESOP which are used to repay an exempt loan under § 404(a)(9) is limited to dividends paid on stock acquired by the loan. § 404(k).

An employer with a leveraged ESOP can deduct dividends on ESOP stock that is not being held as collateral for an acquisition loan only if the dividends are used to make scheduled payments on the acquisition loan. The IRS has imposed two criteria for dividends to be deductible: (1) employer securities with a fair market value not less than the amount of such dividends must be allocated to participants; and (2) the dividends cannot constitute in substance, an avoidance of taxation. PLR 8921101.

C. No Deduction Limitation on Contribution to Plan to Pay Interest on a Loan Used to Purchase QES.

The contribution must be made by the due date for filing the employer's tax return (including extensions). Where no more than one-third of the ESOP account balances inure to Highly Compensated Employees (HCEs) and the ESOP is not sponsored by an S corporation, deductible contributions in excess of twenty-five percent of compensation are permitted to the extent that the excess is used to pay interest on an ESOP loan. I.R.C. § 404(a)(9)(B). Although the employer's deduction for principal repayment is twenty-five percent of covered compensation, amounts in excess can be deducted in future years. § 404(a)(9)(A).

D. Allocating the Stock of a Closely Held Corporation or Stock Which Is Not Traded on the Open Market.

1. *In order to determine the fair market value of the stock of a corporation that is not publicly traded, an independent appraisal is necessary*. The appraisal of the stock directly coincides with the company's contributions and deductions.

2. Although such appraisals can be costly and the contributing shareholders are going to want the appraisal to be as favorable as possible, it is important to remember that the appraisal must be able to withstand IRS and DOL scrutiny. Valuations of non-readily tradable employer securities must be made by an independent appraiser.

E. Professional Corporations.

Although ERISA and the I.R.C. do not preclude a professional corporation from establishing an ESOP, there could be an issue under state law as to whether legal title to the stock is held by someone other than a member of the applicable profession. If the trustee is deemed by the applicable state to hold legal title to the stock held in the ESOP, there should not be a problem with the applicable state's corporate law if the trustee is a member of the class of professionals covered under the professional corporation. The ESOP would be required to contain a provision prohibiting the distribution of stock to former employees/participants of the professional corporation. Ohio Attorney General (OAG) Opinion 85-065 permits shares of stock in a professional corporation to be held in trust for the benefit of non-professionals if legal title is held by a trustee who is duly licensed or otherwise legally authorized to render the professional service.

F. Distribution Requirements (Applies to Stock Acquired by the ESOP After December 31, 1986). I.R.C. § 409(o)(1).

1. Unless an employee elects otherwise, payment of ESOP benefits must begin no later than one year after the close of the plan year:

a. In which the participant terminates employment due to retirement, disability or death; or

b. Which is the fifth plan year following separation from service for any other reason (provided the participant does not return to service prior to that time).

G. Investment Diversification Rules (Effective for Stock Acquired After December 31, 1986). I.R.C. § 401(a)(28)(B); § 409(h)(7).

1. Participants eligible to diversify.

Any employee who has completed at least ten years of participation under the plan and has attained age fifty-five is considered a "qualified participant" and is eligible to diversify a certain percentage of his or her account balance over a six-year period. I.R.C. §§ 409(h)(7) and 401(a)(28)(B).

2. Election period.

Each "qualified participant" has the option to elect within ninety days after the close of each plan year to direct the plan as to the investment of at least twenty-five percent of the participant's account in the plan for the first five plan years after becoming a qualified participant. Election in the sixth and final year may be made up to fifty percent of his or her account balance less any amounts which were previously diversified. I.R.C. § 401(a)(28)(B)(i).

V. S CORPORATION ESOPS (SESOPS).

A. ESOPs and S corporations.

I.R.C. § 1361(c)(7) permits an ESOP (as well as other tax-qualified retirement plans) to be a shareholder in an S corporation. To avoid the seventy-five-shareholder limit applicable to S corporations, the legislative history provides that "[f]or purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder." H. Rep't No. 104-137, 104th Cong., 2d Sess. 60 (1996).

B. Section 1042 treatment not available.

The nonrecognition of gain provisions of § 1042 are *not* available with respect to the sale of S corporation stock to an ESOP.

C. Deduction limit is 25% of compensation.

Unlike a C corporation ESOP, interest payments on an SESOP stock acquisition loan are included in the 25% deduction limitation.

The deduction limit for employer contributions for all defined contribution plans sponsored by an employer is 25% of the compensation for plan participants.

D. Non-access to I.R.C. § 404(k) corporate dividend deductions.

S corporations cannot deduct dividends paid to SESOPs.

E. S Distributions may be paid directly to all shareholders including the ESOP, and do not count against the 25% deduction limitation. S Distributions may be used to make payments on the ESOP acquisition loan.

F. SESOPs not subject to UBTI.

Thus, a SESOP's share of its sponsor's earnings is subject to tax only when distributed by the SESOP to its participants. I.R.C. § 512(e)(3).

If the SESOP owns 100% of the company stock, the company essentially pays no income tax.

G. SESOP entitlement to distribute cash rather than stock.

Due to the danger that distributed employer stock could end up by being held by an ineligible shareholder (*e.g.*, an Individual Retirement Account), SESOPs are <u>not</u> subject to the normal ESOP entitlement of participants to demand the distribution of employer stock.

H. EGTRRA Limitations on S Corporation ESOPs.

For plan years beginning after December 31, 2004, certain S corporations which sponsor an ESOP must prohibit the allocation of S corporation employer securities to certain disqualified persons. A "disqualified person" is a person who (1) has "deemed owned shares" constituting more than 10% of all of the deemed owned shares of the corporation's stock, or (2) is a member of a family that has more than 20% of the deemed owned shares. If more than 50% of the total equity of the company is owned by disqualified persons, then substantial financial penalties will be imposed.

VI. ROBS – ROLLOVER AS BUSINESS START-UPS.

A. ROBS arrangements were created to secure available funds held in tax-deferred savings (usually under a prior employer's plan) for an aspiring entrepreneur without incurring resultant tax liabilities that would ordinarily apply to a distribution.

B. While the form of ROBS transactions is not prohibited per se the IRS is concerned with these transactions for several reasons:

1. The ROBS transaction is accomplished without any imposition of the taxes that ordinarily attach to distributions from retirement plan savings accounts.

2. Distributions would normally be subject to treatment as ordinary income, taxable at the individual's personal tax rates, with possible additions to tax in the form of early distribution penalties.

3. ROBS transactions effectively avoid all these tax concerns.

C. When analyzing ROBS transactions on plans that were examined, the Service found several technical violations of the law applicable to employee benefit plans. For example:

1. The exchange of stock results in all shares contributed to the plan being allocated to the account of the entrepreneur only.

2. No other current or future employees will ever receive their required right to invest in employer stock, in possible violation of nondiscrimination requirements.

3. Stock is exchanged without any real attempt to determine its value. The stock is said to be equal in value to whatever happens to be available to exchange for it which creates a prohibited transaction.

VII. ESOP ISSUES TO CONSIDER

A. Advantages.

1. An ESOP can reduce the cost of financing debt for the company. Both the principal and interest payments on an ESOP acquisition loan are deductible to the employer. This is because the employer makes a fully tax-deductible contribution to the ESOP and the ESOP uses the contribution to make the loan payments on the ESOP acquisition loan.

2. The ESOP trust can be a mechanism to buy and sell shares of employer stock. The ESOP should, however, not be used to manipulate the price of a thinly traded stock.

3. The ESOP can provide employees with a stake in the company. This should, hopefully, motivate employees to work harder and more efficiently.

B. Disadvantages.

1. Fiduciary liability of the ESOP committee members who administer the ESOP. These can include fiduciary issues of whether employer stock is a prudent investment for the plan at any given time.

2. There can be investment diversification issues. If the employer stock does not perform as well as other investments employees could be upset and the ESOP could have a negative, rather than a positive, impact on employees. In the worst case scenario, the employer stock could become worthless and employees could lose a substantial portion of their retirement funds (e.g., ENRON).

3. Transaction and administrative costs of the ESOP, both initial and ongoing.

C. Additional Issues for Non-Publicly Traded Corporations.

In the non-publicly traded context, additional issues could be:

1. Advantages:

(a) Selling shareholder may be able to utilize IRC section 1042 treatment and indefinitely defer tax on the gain on the sale of the employer stock to the ESOP. However, if section 1042 treatment is elected, the ESOP must own at least 30% of all outstanding employer stock. Additionally, the selling shareholder, members of the family of the selling shareholder, and other 25% owners cannot participate in the ESOP.

(b) The ESOP can be created as a purchaser of the company where one might not otherwise exist.

2. Disadvantages:

   a. Dilution of the ownership of the current owners.

   b. Transaction costs including the requirement of an annual independent valuation of the company.

   c. Participant pass through of voting rights. There must be at least a limited pass through of stock voting rights to the ESOP participants.

   d. Decrease in stock value due to the obligation to repay the ESOP stock acquisition loan.

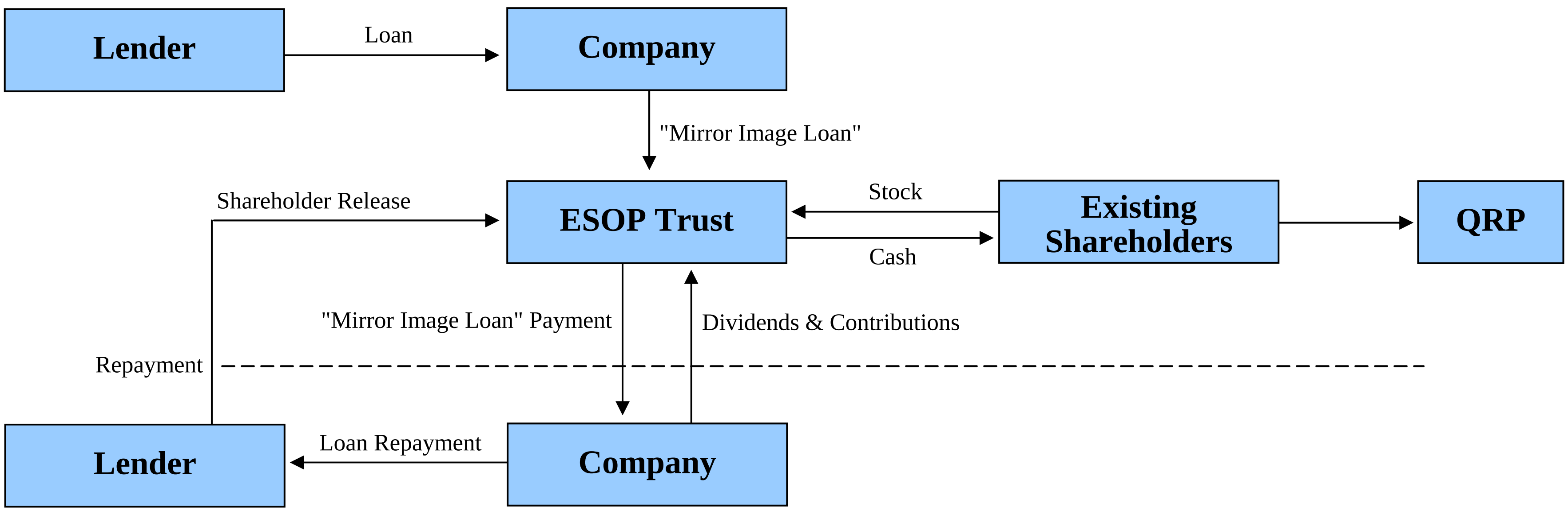
   e. The ESOP's obligation to repurchase stock from participant accounts upon retirement, death, separation from service and attainment of age 55 with 10 years of participation in the ESOP. These repurchase obligations can be huge and must be budgeted for by the company.

TYPICAL ESOP STRUCTURE

Non-Leveraged ESOP

— Company creates ESOP Trust
— Company allocates tax deductible employee benefit to ESOP in the form of cash / stock
— ESOP uses the funds to purchase shares of existing shareholders (if cash)
— As Company makes ESOP contributions, shares are released and allocated to the employee accounts

Leveraged ESOP



— Company creates ESOP Trust
— Company borrows funds and re-lends the proceeds ("Mirror Image Loan") to the ESOP
— ESOP uses funds to purchase shares of existing shareholders
— Company services the new debt by making tax deductible contributions to ESOP. ESOP repays the loan to Company and Company makes the debt payment to the lender
— As Company makes ESOP contributions, shares are released and allocated to the employee accounts