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LEVERAGED ESOPS: A MANAGEMENT ACQUISITION TOOL

by Rod Goodwin • The Commonwealth Group, Newman Lake, WA
Special Consultant, Robert W. Wood PC • San Francisco

The management of a company often decides to make an offer to purchase the business from the owner(s). Whether the business consists of a $5,000,000, local, closely-held business, or the $200,000,000 subsidiary of a publicly traded company, one of the major obstacles to overcome is the pre-tax income necessary to carry the debt on the purchase price. Usually, the prospective acquirers are a team of senior managers, nonowner executives, and they need financing.

This is particularly true when the purchase price is for stock in the business from the owner(s). Even businesses with significant discretionary cash flow can have that cash flow quickly eroded when a new buyer purchases the business.

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Just the Facts, Ma'am...

Suppose our management team wants to make a stock purchase of a $6,000,000 closely-held C corporation. The founder, president, and CEO no longer makes the day-to-day decisions and long term planning. Now, all this is done by the Vice President of Operations, the Chief Financial Officer, and the Vice President of Sales. The founder has been increasingly relying on the senior officers to make most of the important decisions.

These senior officers form a team to purchase the business from the founder. Fortunately, there are no heirs to take over the business so many family issues are not present. The CFO is asked to work up a purchase offer that the team believes is financially workable. It is almost understood that no price under $6,000,000 will be acceptable.

From a psychological standpoint, the team knows that if the initial offer is less than $6,000,000, the founder will be offended. This may trigger having the owner shopping the business to a business broker and other buyers found. Therefore, the task is to construct a transaction that will enable the team to satisfy the founder in a manner that the team reasonably believes can be accomplished within the constraints of the company's cash flow.

The team believes that the purchase term should not exceed ten years. The CFO has prepared a series of reports that the CFO believes should be presented to the team in a very specific order. The first scenario is an 80 percent ($4,800,000) bank loan at 8.75 percent for ten years, and a seller carry back, subordinated to the bank, of $1,200,000, interest only for nine years with a balloon in the tenth year. The principal of the bank loan is evenly amortized over the ten year period. Ignoring interest payments for the sake of simplicity, the pretax income necessary to repay the $6,000,000 is:

1 Year	2 Annual Principal Payment	3 Pretax Income Needed For Debt Service	4 Less Income Taxes 35 percent	5 After-tax Cash Flow For Debt Service
1	$480,000	$738,462	$(258,462)	$480,000
2	$480,000	$738,462	$(258,462)	$480,000
3	$480,000	$738,462	$(258,462)	$480,000
4	$480,000	$738,462	$(258,462)	$480,000
5	$480,000	$738,462	$(258,462)	$480,000
6	$480,000	$738,462	$(258,462)	$480,000
7	$480,000	$738,462	$(258,462)	$480,000
8	$480,000	$738,462	$(258,462)	$480,000
9	$480,000	$738,462	$(258,462)	$480,000
10	$1,680,000	$2,584,615	$(904,615)	$1,680,000
	$6,000,000	$9,230,769	$(3,230,769)	$6,000,000

The $9,230,769 in pretax income is *in addition* to all existing expenditures, other than the elimination of the founder's costs. In effect, there is no available deduction for the purchase price of the shares. The team does not believe that the company can support the loss of that much pretax income and asks the CFO if there are any other possibilities. The CFO begins the discussion of alternate strategies with the other members of the team by beginning with what net cash the founder would obtain from the $6,000,000 payment. Questions arise as to what the "net" to the founder means. The founder simply wants $6,000,000.

Key is Founder's "Net"

Excluding various charitable planning scenarios, the founder will receive a cumulative total of $6,000,000 and pay income taxes, at capital gain rates, of $1,200,000, for a net cash to invest of $4,800,000. If the team can design a transaction that will provide the founder with $4,800,000 in after tax investments, the founder might reduce the price to $4,800,000. The CFO provides the following alternative plan to provide the founder with the $4,800,000, and allow the corporation to deduct the payments from pretax income.

Under the new scenario, the principal payments on the loan are deductible to the corporation as a contribution to a qualified retirement plan, and therefore do not require a pretax income of more than the $4,800,000 principal amount. The Vice President of Operations asks how the founder is going to accept $4,800,000 after the imposition of a capital gain tax of $960,000 ($4,800,000 x .2 = $960,000).

After all, in the original scenario, the founder received a total of $4,800,000, not $4,800,000 reduced by $960,000 in taxes for a net of $3,840,000. This is where the leveraged employee stock ownership plan (ESOP) truly shines. It allows the founder to avoid paying capital gain taxes on the $4,800,000 under certain circumstances.

Fundamental Aspects of an ESOP Leveraged Buyout

The ESOP transaction is nothing new. In the Tax Reform Act of 1986, Congress enacted several provisions to increase the tax incentives for C corporation business owners to sell their companies to ESOPS. The new rules primarily affected sellers. Recall, that the essential element that may make the founder accept the ESOP leveraged buyout is that the founder should end up, after tax, with the same amount he or she would have from a straight cash sale for $6,000,000. If that is true, there should be no objection on the part of the founder. The provision of the Code that most greatly affects the founder is Code Section 1042. (The founder's tax is deferred, not eliminated, a difference to which we'll return later.)

Benefits to the Seller From Code Section 1042

Section 1042 offers incredible benefits, which include the reinvestment of sales proceeds, a liberal period of time in which to do it, and the ability to stretch the gain out and defer it.

Reinvestment of Sale Proceeds

Section 1042 provides that a seller of a nonpublicly traded C corporation shares will not recognize gain on the sale if: (i) the seller makes a qualified election, (ii) the seller purchases the securities of a domestic operating corporation, generally defined as a corporation, more than 50 percent of the assets of which are used in an "active trade or business." Volumes have been written on what constitutes an active trade or business. Here, though, the effect of this rule is to remove municipal bonds, mutual funds and similar passive entities from the type of securities that may be purchased with the sale proceeds.

Time by Which Reinvestment Must be Made

The seller (the founder in our example) must reinvest the sale proceeds in qualified securities within a period beginning three months prior to the sale and twelve months following the sale. This is a far cry from a 60-day rollover rule which would apply to retirement plan distributions.

Gain on Disposition Of Replacement Securities

If the replacement securities that were used to avoid the gain on the original sale are disposed of, gain is recognized based on a carryover of the founder's basis in the stock sold to the ESOP. Therefore, if the founder purchases bonds, it is essential to make sure that the bonds are not callable. If the bonds are called, gain will be recognized.

Summary Section 1042

In our example, the founder is able to reinvest the $4,800,000 received from the ESOP buyer and thereby have the same "after-tax" investments as a non ESOP sale. While negotiations may result in a price between the original $6,000,000 and the minimum $4,800,000, the ESOP does provide a mechanism to allow such negotiations. One point that should not be overlooked during the negotiations, is the increased cash flow to the company. Due to the tax deduction for principal payments, the company should have better cash flow. That, in turn, should allow for more readily accessible bank participation. There will be increased loan security, and a reduction in the amount of the loan needed. Negotiations might involve placing the reinvestment through the bank's brokerage arm or affiliate.

Benefits to the Buyer

As discussed above, a purchase by the team using conventional financing methods would have required a cumulative total pre-tax income of $9,230,769. In contrast, with the leveraged ESOP, the total pre-tax income needed to purchase the company is reduced to $4,800,000. This should result in $4,430,769 in pre-tax income being available for other expenditures. The reduction in the necessary pre-tax debt service is a result of the following series of steps in the typical leveraged deal:

1. The ESOP borrows $4,800,000 for the purchase of the founder's stock.

2. The ESOP pays the $4,800,000 to the founder for the stock.

1 Year	2 Pretax Income For Debt Service	3 Annual Income Tax Deduction	4 Taxable Income	5 Less Income Taxes 35 percent	6 After-tax Cash Flow For Debt Service
1	$480,000	$(480,000)	$0	$0	$480,000
2	$480,000	$(480,000)	$0	$0	$480,000
3	$480,000	$(480,000)	$0	$0	$480,000
4	$480,000	$(480,000)	$0	$0	$480,000
5	$480,000	$(480,000)	$0	$0	$480,000
6	$480,000	$(480,000)	$0	$0	$480,000
7	$480,000	$(480,000)	$0	$0	$480,000
8	$480,000	$(480,000)	$0	$0	$480,000
9	$480,000	$(480,000)	$0	$0	$480,000
10	$480,000	$(480,000)	$0	$0	$480,000
	$4,800,000	$(4,800,000)	$0	$0	$4,800,000

3. Annually, the company contributes the necessary cash needed to fund the annual debt service. This contribution is deductible as a contribution to a qualified retirement plan, and thus, reduces the amount of pre-tax income necessary to satisfy the debt.

Deferral, and Final Words

Of course, the reduction in pre-tax debt service is a *deferral,* the same as the founder's reinvested securities. As employees retire, the founder's stock allocated to the retiring employees will be repurchased by the corporation with pre-tax dollars and no offsetting deduction. If the founder owns the replacement securities at death, an increase in basis is allowed.

In the right circumstance, the considerable tax incentives for leveraged ESOP buyouts can save a transaction that otherwise would not be feasible. Plus, death can solve any remaining income tax problems. Still, the significant tax benefits of an ESOP do not come without a cost. The cost of preparing the plan documents can be quite high. There are also precarious fiduciary issues, expensive and mandatory appraisals, and return filings. All of these hurdles can make the ESOP deal slightly less sweet. Still, it's worth a look.