



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

Special Purpose Valuations
ESOPs & Buy-Sell Agreements

Attorney CLE Series – Fall 2013



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Special Purpose Valuations
ESOPs & Buy-Sell Agreements

INTRODUCTION

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Special Purpose Valuations: ESOPs & Buy-Sell Agreements

INTRODUCTION

- **ESOPs** – Employee Stock Ownership Plans
 - *Qualified retirement plans invested primarily in the stock of the companies that adopt and sponsor them*
 - *Employees share in capital appreciation of company*
 - *Use governed by IRC and ERISA*



Special Purpose Valuations *ESOPs & Buy-Sell Agreements*

ESOP MECHANICS

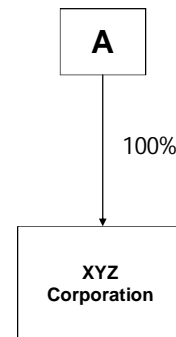


Special Purpose Valuations: ESOPs & Buy-Sell Agreements

ESOP MECHANICS

▪ Assumptions

- *A owns 100% of XYZ Corp. (a C corp)*
- *Children cannot run the business*
- *A's total estate = \$20M*
- *90% of estate is his stock in XYZ, which is worth \$18M*
- *A wants out in the next several years – he is 55*

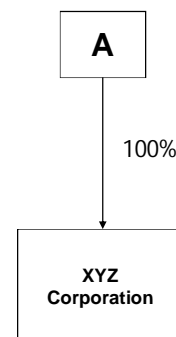


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ESOP MECHANICS

▪ Issues

- *Illiquidity of estate*
- *No plans for business succession*
- *Disproportionate percentage of wealth invested in a single asset*
- *Built-in gain issues*
- *No transition plan exists*





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ESOP MECHANICS

▪ A's Options

- *Sell or transition the business to family members*
- *Sell to management or key employee*
- *Sell or merge with a third-party
(financial buyer or strategic or investment buyer)*
- *Sell stock through IPO*
- *Liquidate the business*
- *Sell to an ESOP*

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ESOP MECHANICS

▪ Fundamentals

- *Company creates a trust to which it makes annual contributions that are allocated to individual employee accounts within the trust*
- *Allocations to employees' accounts are subject to vesting*
- *Employees given options to diversify at different times*
- *Various options for distributions*

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ESOP MECHANICS

▪ Tax Incentives

- Enacted by Congress to encourage creation of ESOPs
- Incentives make ESOPs attractive as employee benefit plans, techniques of corporate finance, and as tools for business and estate planning

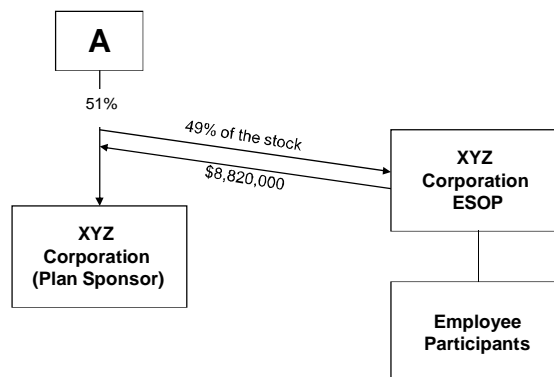
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ESOP MECHANICS

▪ Inception



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ESOP MECHANICS

▪ Benefits to A

- *Can sell any % of the Company to the ESOP for “adequate consideration”*
- *Will defer tax as long the ESOP owns at least 30% of the Company after the sale (section 1042)*
- *To get deferred tax treatment, must invest the proceeds in qualified domestic replacement securities (can choose amount to be taxed)*



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ESOP MECHANICS

▪ Benefits to A

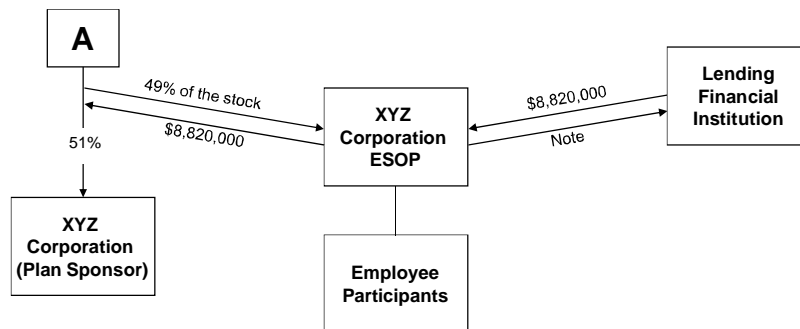
- *Can maintain control of the Company and continued equity in the Company*
- *Can continue to receive salary*
- *Will receive greater investment income since no tax will be paid and more will be invested*
- *Immediately achieves a more diversified portfolio*



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ESOP MECHANICS

▪ Inception



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ESOP MECHANICS

▪ ESOP with ESOT

- *Company establishes Employer Stock Ownership Trust (ESOT) with the ESOP, which is a qualified, defined contribution, employee benefit plan*
- *ESOT holds shares as the beneficial owner for the employees' retirement account, to be allocated to the employees over time*
- *Contributions are allocated to individual employee accounts*
- *Diversification for employees can be achieved at a certain age*

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ESOP MECHANICS

▪ Tax Benefits

- *XYZ Corp can take federal and PA corporate tax deductions for both the interest and principal payments on loans borrowed to fund the purchase of A's shares*
- *Annual contributions to the plan are tax-deductible*
- *Cash contributions are deductible*
- *Dividends paid in cash on shares held by an ESOP can be tax deductible by sponsoring corporation*



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ESOP MECHANICS

▪ Tax Benefits

- *Cash dividends passed through to ESOP employees are tax deductible for the Company*
- *Because an ESOP is an employee benefit plan, it can serve to attract, retain and motivate quality employees*
- *ESOPs can qualify as shareholders in an S corporation*
- *In an S corporation, percentage of ownership held by ESOP is not subject to income tax at the federal level*



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ESOP MECHANICS

▪ Benefits to Employees

- *Employees acquire beneficial ownership in the Company without having to invest their own money*
- *Employees are able to acquire ESOP stock without paying current income tax on the stock*
- *Growth of employees' interest not subject to tax until distribution*
- *Employees share in current and future economic rewards of Company ownership*

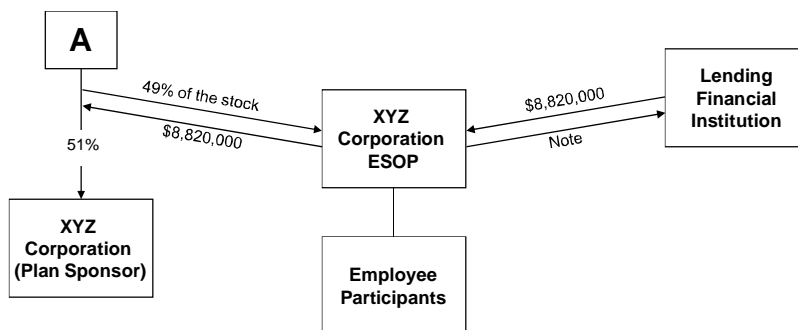
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ESOP MECHANICS

▪ Inception



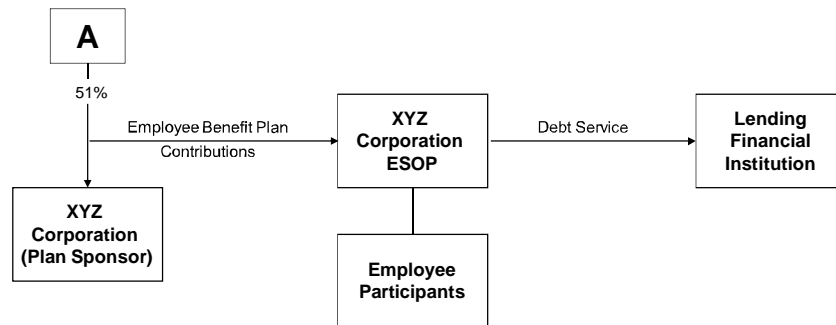
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ESOP MECHANICS

▪ Annual



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ESOP MECHANICS

▪ Uses for ESOPs

- *Provide liquidity and diversification for shareholders*
- *Provide a means of capital formation*
- *Finance corporate acquisitions*
- *Incentive to increase productivity and retain personnel*
- *Provide a succession plan for current owners*
- *Provide liquidity in divorce situations*
- *Provide negotiating leverage for any proposed transaction*

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ESOP MECHANICS

- **C Corporations vs. S Corporations**

- *Attributes of C corporations*
- *Attributes of S Corporations*
- *Tax incentives differ for each*



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ESTABLISHING AN ESOP



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ESTABLISHING AN ESOP

▪ Detriments

- *An ESOP is a complex tool, subject to both ERISA and Internal Revenue Code rules*
- *Substantial costs for feasibility studies, implementation*
- *Substantial costs for annual compliance, business valuation*
- *Department of Labor rules on valuation mandate fair market value versus fair value or strategic value*
- *Company must sell at least 30% of the stock to the ESOP to qualify for tax-deferred treatment*

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ESTABLISHING AN ESOP

▪ Common ESOP Misconceptions

- *ESOP is primarily an employee benefit plan*
- *ESOP buyout requires owners to sell 100% of their stock*
- *Selling stock to ESOP results in a loss of control by owner*
- *Owner can get a higher price selling to a third party*
- *ESOP creates a “repurchase liability” that can jeopardize the continued existence of the business*
- *ESOP must be 100% invested in shares of company stock*

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ESTABLISHING AN ESOP

- **Initial Considerations**

- *Feasibility issues*
- *Design specifics*
- *Financial goals integrated with regulations, obligations*
- *ESOP advisor, attorney, accountant and other professionals should be consulted in planning process*



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ESTABLISHING AN ESOP

- **Initial Considerations**

- *ESOP's effect on existing stockholders should be estimated*
- *Repurchase obligations should be addressed*
- *Firm's stock must be valued by an independent appraiser before shares are put into the ESOP*



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ESTABLISHING AN ESOP

▪ Reporting Requirements

- *ASU2011-04, Fair Value Measurement – requires companies to disclose any significant methodologies and assumptions used in the fair value determination of non-publicly-traded company securities, effective December 2011*
- *Required disclosure would appear in a footnote to the ESOP audit report, which is filed with Form 5500*



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ESTABLISHING AN ESOP

▪ Reporting Requirements

- *April 2013 - FASB gave ESOP companies an indefinite deferral on disclosure of quantitative information*
- *Qualitative information will still need to be disclosed*
 - Valuation method and main inputs
 - Presented in a way that would not allow competitors or others to back into a valuation figure



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ESOP VALUATION CONSIDERATIONS

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ESOP VALUATION CONSIDERATIONS

- **ESOP fiduciaries should appoint valuers that:**
 - *Are qualified,*
 - *Are independent, and*
 - *Meet requirements of both IRS and ERISA*

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ESOP VALUATION CONSIDERATIONS

- **ESOP Valuation Fundamentals**

- *DOL requires “adequate consideration”*
- *Valuator must consider factors that are specifically applicable to ESOPs*



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ESOP VALUATION CONSIDERATIONS

- **ESOP Valuation Fundamentals**

- *Identification of valuation subject*
 - Total of all stock held by ESOP
 - Can have a control interest valuation



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ESOP VALUATION CONSIDERATIONS

- **ESOP Valuation Fundamentals**

- *Level of value*

- Liquidity
- Ownership control



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ESOP VALUATION CONSIDERATIONS

- **ESOP Valuation Fundamentals**

- *Contractual rights and restrictions*

- Put options, call options, shareholder buy-sell agreement provisions, S corporation tax election agreements, etc.
- State corporation rights



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ESOP VALUATION CONSIDERATIONS

▪ ESOP Valuation Fundamentals

– *Standard of value*

- Under DOL rules and ERISA, standard of value is adequate consideration
- Fair market value



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ESOP VALUATION CONSIDERATIONS

▪ ESOP Valuation Fundamentals

– *Premise of value*

- Value in continued use, as a going concern
- Value in place, but not in current use, in the production of income
- Value in exchange – orderly disposition, voluntary and involuntary liquidation



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ESOP VALUATION CONSIDERATIONS

- **ESOP Valuation Fundamentals**

- *Valuation date*

- “As of” date
- Value can change materially over time due to internal and external influences



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ESOP VALUATION CONSIDERATIONS

- **ESOP Valuation Fundamentals**

- *Report date*

- Date work is completed and report is issued
- A matter of fact



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ESOP VALUATION CONSIDERATIONS

▪ ESOP Valuation Fundamentals

– *User of the analysis*

- Valuations should specify:
 - Party that retained the valuator
 - Any and all parties who may rely on conclusion of value
- Intended use should be specified



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ESOP VALUATION CONSIDERATIONS

▪ ESOP Valuation Fundamentals

– *Repurchase obligation liability*

- Also known as put option requirement
- Requirement of the sponsor corporation to buy back shares of stock
- Considers annual valuation and employee census data



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ESOP VALUATION CONSIDERATIONS

▪ ESOP Valuation Fundamentals

– *Benefits typically required to be distributed by:*

- Close of fifth plan year following plan year of termination of employment, or
- Close of plan year following plan year of termination due to death, disability or retirement



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ESOP VALUATION CONSIDERATIONS

▪ ESOP Valuation Fundamentals

– *Marketability*

- Inability to quickly liquidate
- Lack of empirical data



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BUY-SELL AGREEMENTS

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BUY-SELL AGREEMENTS

- **Triggering Events**
 - *Include leaving the business (quitting/termination), retirement, death and disability*
 - *Can also encompass divorce and declaration of insolvency or bankruptcy*

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BUY-SELL AGREEMENTS

▪ Benefits

- *Allows for orderly transition of ownership*
- *Guarantees market for ownership interest*
- *Clarity minimizes adversarial legal intervention*
- *Minimizes stress relating to payment for interest*
- *Provides protection for sharing control of business*
- *Provides certainty and continuity*

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BUY-SELL AGREEMENTS

▪ Detriments

- *Lack of clarity in provisions can lead to owner disappointment, controversy and litigation*
- *Failure to adjust funding mechanisms as value changes can lead to issues upon a triggering event*
- *Absence of clear valuation terms can lead to conflict*

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BUY-SELL AGREEMENTS

- Categories

- *Cross-purchase agreement*
- *Redemption or entity-purchase agreement*
- *Hybrid agreement*

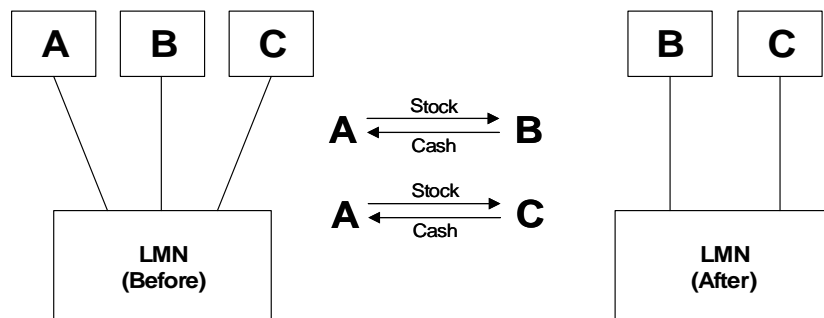
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BUY-SELL AGREEMENTS

- Cross-purchase agreement



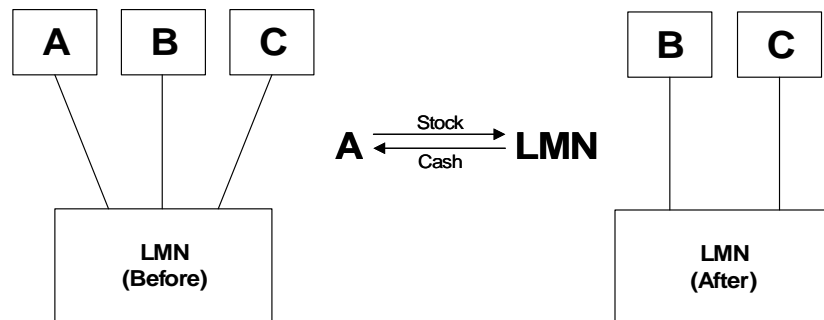
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BUY-SELL AGREEMENTS

- **Redemption agreement**



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BUY-SELL AGREEMENTS

- **Valuation Elements**

- *Standard of value*

- Ambiguous language in buy-sell agreements regarding standard of value can create valuation issues
- Fair market value most commonly used

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BUY-SELL AGREEMENTS

▪ Valuation Elements

– *Examples of confusing language*

- “The value of the departing shareholder’s shares will be determined based upon the market value...”
- “The price will be determined based upon the fair value of the shares and consider applicable discounts for lack of control and lack of marketability.”



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BUY-SELL AGREEMENTS

▪ Valuation Elements

– *Examples of confusing language*

- “Value will be determined based upon the fair market value of the shares, which will be the shareholder’s pro rata interest of the enterprise value of the Company.”
- “The departing shareholder shall be bought out at the current value of his or her shares.”



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BUY-SELL AGREEMENTS

▪ Valuation Elements

– *As of Date*

- Specific point in time as of which the valuator's opinion of value applies – should be clearly defined
- All relevant information will be from the perspective of this date
- Issues arise with a significant change in business subsequent to this date



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BUY-SELL AGREEMENTS

▪ Valuation Elements

– *Level of Value*

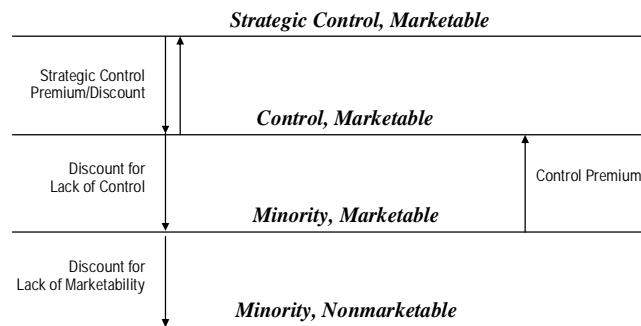
- Often the most misunderstood element of agreement
- Expanded model – four levels of value
- Important to clearly define level of value to be determined by a valuator upon a triggering event



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BUY-SELL AGREEMENTS

▪ Valuation Elements



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BUY-SELL AGREEMENTS

▪ Valuation Elements

– *Valuator Qualifications*

- Agreement can name specific firm or valuator
- Education, training, credentials, experience, etc. should be considered when selecting a professional

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BUY-SELL AGREEMENTS

▪ Problem Areas

– *Estate of Maurice F. Frink*

- Primary issue was definitions of “book value” and “fair market value”
- Company had used book value for past redemptions
- Court enforced buy-sell agreement

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BUY-SELL AGREEMENTS

▪ Problem Areas

– *Etienne v. Miller*

- Should buy-sell agreement be enforced against a trust
- Enforcement would result in significant federal estate tax burden
- Court enforced buy-sell agreement

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BUY-SELL AGREEMENTS

▪ Problem Areas

- *Tynes E. Mixon, III, MD v. Iberia Surgical, LLC*
 - Issue was the underpayment of expelled LLC member
 - Agreement stated shares would be repurchased at FMV, exhibit showed book value meant FMV
 - Court stated that book value is not FMV, but parties signed agreement defining FMV as book value

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BUY-SELL AGREEMENTS

▪ Problem Areas

- *In re the Marriage of Barnes*
 - Agreement noted withdrawal and dissolution as triggering events, not divorce
 - Trial court and appellate court treated as withdrawal as agreement did not make provision for divorce

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BUY-SELL AGREEMENTS

- **Problem Areas**

- *Estate of Blount*

- Established factors that must be present for agreement to define FMV for federal estate tax purposes
 - Price fixed and determinable
 - Binding in life and death
 - Bona fide business purpose



Special Purpose Valuations *ESOPs & Buy-Sell Agreements*

CONCLUSION AND PRACTICAL CONSIDERATIONS



Special Purpose Valuations: ESOPs & Buy-Sell Agreements

CONCLUSION AND PRACTICAL CONSIDERATIONS

- Many special-purpose valuations – future sessions will focus on other purposes
- Important for valuator to be involved at the onset of ESOP establishment and buy-sell agreement drafting
- Next CLE in Pittsburgh will provide more detail about ESOPs



THANK YOU
FOR ATTENDING!
