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VALUE ADDED™

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ESOP Ownership in S Corporations

IRS Issues Ruling on Tax Evasion Scheme

Compared to Employee Stock Ownership Plan (ESOP) ownership in traditional C corporations, current law offers incremental tax benefits to S corporations. The passage of the Small Business Protection Act of 1996 (as amended in 1997) opened the door for business owners to capitalize on the tax-advantaged treatment of S corporations with ESOP ownership and was further solidified by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

The key incentive for ESOP ownership of an S corporation is the fact that distributions to the ESOP are tax exempt. The higher the ESOP's ownership stake in the company, the lower the income tax due. If the ESOP is the sole owner of the S corporation, the organization pays no income tax. While an S corporation's value does not differ from its C corporation peer, this ability to retain and reinvest profits can accelerate internal growth and allow for more rapid growth through acquisitions.

> ***"Several companies reportedly attempted to delay the tax impact until 2005 by using a strategy involving 'off the shelf' S corporation ESOPs"***

The Internal Revenue Service is apparently catching up to some enterprising individuals seeking additional tax benefits. Under Section 409(p) of EGTRRA, S corporation ESOPs are penalized heavily when allocating ESOP stock to "disqualified persons." Allocations to a member of a "deemed 20 percent shareholder group" (including family members) or a "deemed 10 percent shareholder" are taxed as distributions to the disqualified person and as a 50% excise tax to the S corporation. The provision is effective in 2005 for ESOPs established before March 14, 2001. In the case of an ESOP established after March 14, 2001, or in the case of an ESOP company that was not an S corporation on that date, the provision is effective with respect to plan years ending after July 11, 2000.

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Key Man Risk

The Importance of Succession Planning

The success of a small business is often the result of the cumulative knowledge, expertise and determination of the founder. This person not only participates in the day-to-day operations of the business, but also provides strategic planning and vision for the firm.

Many closely held businesses have "key people" in their organization. These people may have certain manufacturing expertise or special customer relationships. Notwithstanding, it is not uncommon to find closely held businesses which have no management succession plans in place.

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Several companies reportedly attempted to delay the tax impact until 2005 by using a strategy involving "off the shelf" S corporation ESOPs. First, "shell" S corporation companies without any substantial assets were incorporated prior to March 14, 2001. Then ESOPs were structured for these companies. These off the shelf ESOP companies were then sold to business owners who would initiate a corporate reorganization resulting in the shell ESOP company's ownership of the existing business. The inventors of the scheme advertised that by having established an S corporation before March 14, 2001, income would be sheltered for a few years and substantial taxes would be saved. While employees are technically eligible to participate prior to March 14, 2001, nobody actually participates until after the corporate reorganization. (Or, alternatively, the ESOP could be structured to limit the number of participants to an exclusive group of executives.)

Revenue Ruling 2003-6 finds that such off the shelf S corporation ESOPs were not formed "to provide substantial benefits, or substantial participation in the ownership of the S corporations, to the initial purported participants in the ESOPs. The initial employees of the entity forming the ESOP do not receive more than insubstantial benefits or more than insubstantial ownership interests through the ESOP. […] an ESOP is not established until it is adopted by an employer for the purpose of enabling its employees to participate in a more than insubstantial manner in the ownership of the employer's business and to provide its employees with more than insubstantial benefits under the ESOP." The revenue ruling therefore does not grandfather shell company ESOPs as being established before March 2001.

As a result, business owners relying on off the shelf S corporation ESOPs face the punitive tax effects of EGTRRA. The IRS further amplified its ruling by stating that other transactions will receive identical tax treatment if the effects of the transaction are similar in nature.

If you have questions about valuation issues regarding ESOPs, please do not hesitate to contact us. ◆

Litigation Update

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Without proper succession planning the loss of a key person may result in:

- The loss of long-term, strategic direction for the company
- Difficulty in finding a replacement that has the necessary education, training or proprietary knowledge necessary to run the business
- "In-fighting" among senior executives or family members who stand to gain control of the company's operations
- Reduced employee morale which may impair the ability of existing management to recruit new employees who may question the long-term security of employment with the company
- The loss of key customers or supplier relationships
- The potential reassessment or loss of bank or financial institution support for lines of credit and/or capital funding (particularly if key people provide personal guarantees on company debt)
- Limiting the ability of a closely held business to raise capital
- The forced sale of the business

> ***"Business valuation professionals are frequently engaged to quantify, support and/or challenge damages in matters arising from the normal course and extraordinary circumstances of business activity"***

Unfortunately, planning for succession involves dealing with "uncomfortable" personnel issues and is often avoided. But the issue will not go away. In fact, it will only become more critical as time goes on. All too frequently the decisions are delayed until the remaining choices are clear: promote a member of management from within the company who may lack the ability to assume the lead and who does not have the confidence of his or her fellow employees, or bring in a stranger from outside the company and hope he or she will fit the bill.

Unfortunately, if a successor cannot be found, that leaves the final choice of being forced to sell out. Most likely the decision to hastily sell the business will not result in maximizing shareholder value. Rarely is it probable that a closely held business can be sold at maximum value if the purchaser is aware that the seller is under compulsion or is being forced to sell the business as a result of estate tax burdens.

Management is a key success factor in any closely held business. A plan of succession is critical for the uninterrupted continuation of the business in the event of an unplanned departure of a key person.

Business valuation professionals are frequently engaged to quantify, support and/or challenge damages in matters arising from the normal course and extraordinary circumstances of business activity. Disputes between plaintiffs and defendants can develop into legal action that requires professional business valuation expertise in order to quantify a plaintiff's claim or to challenge a defendant's liability (if any). Given the agenda of opposing legal counsel and the adversarial nature of litigation, appraisers should be prepared to objectively defend their conclusions and the underlying components used in developing them.

As with all business valuation assignments, appraisers must have a solid grasp of all critical assumptions from both sides of the aisle. A well-prepared valuation expert can anticipate how changes in those assumptions will affect conclusions.

Keeping in mind that the realm of potential engagements is beyond any list, business appraisers are typically engaged in damages suits involving the following situations and occurrences.

- Breach of Contract
- Condemnation
- Lost Business Opportunity
- Lost Profits
- Antitrust
- Personal Injury
- Insurance Casualty Claims
- Wrongful Termination of a Franchise

In many litigated damage situations, a plaintiff is charged with the burden of proving that the defendant's action's were the proximate cause of the claimed damages, that damages were, with reasonable certainty, actually incurred (or worsened as the case may be) as a result of the defendant's actions, and in contract disputes that such damages were a foreseeable consequence of the defendant's actions. These are matters of legal interpretation. ◆

Calculation of Damages

An Appraisal Perspective

In many business damages cases, business valuation professionals are called into service subsequent to the determination of legal exposure in order to help resolve the remaining question of magnitude.

The methodological approaches used to calculate damages vary with circumstance. In most cases there are substantial assumptions required in the construction of financial models.

"Parties involved in damage suits routinely fail to achieve a firm grasp of the complex issues required to develop and/or defend claims of damage"

Business valuation texts group the major methods of damage calculations under three general categories (1) the "before-and-after" approach; (2) the "yardstick" approach; and, (3) the "sales projections" approach (also referred to as the "but-for" or "hypothetical profits" approach). Damage claims are often calculated using the method best suited to take advantage of all available information. Claims that do not factor in the totality of information resources are more susceptible to an opposing expert's scrutiny.

The before-and-after method is best applied when adequate historical information (preceding the alleged acts) is available for comparison to the reported information and/or anticipated performance postulated after the alleged acts.

The yardstick (sometimes referred to as "comparable") approach is often used in cases where ample information on similar businesses exists such that an expert can formulate an expected level of performance likely to have been achieved if the alleged damages had not occurred.

The most critical factor in this approach, as with "guideline" based appraisals in other valuation arenas, is the selection of companies with close alignment to the subject. Additionally, an overview of the subject's industry and market are likely to be vital in making assumptions about reasonably attainable performance.

The sales projections method relies upon modeling the damaged party's business in such a manner as to create a pattern of performance that would have occurred but-for the alleged damages.

This method is probably the most relied upon approach in calculating damages. It is generally beneficial to use when the subject has consistently used forecasts and budgets in the normal course of business planning and has a track record of achieving its projected performance.

Regardless of the method(s) used to calculate damages, appraisers state

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Calculation of Damages

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their conclusions to reflect the present value of past and future damages. Opposing parties can be close in their estimations of lost profits or earnings during the period in which damages occurred but differ greatly in the application of discounting and compounding techniques in restating damages to present value terms.

> ***"In many business damages cases, business valuation professionals are called into service subsequent to the determination of legal exposure in order to help resolve the remaining question of magnitude"***

Parties on both sides must be aware of the rates applied and be sure that consistency is maintained throughout all analyses.

There can be significant difference of opinion among valuation experts as to appropriate rates for time value calculations and many jurisdictions have statutory requirements that establish applicable rates. The appraiser must test the sensitivity of all conclusions to the range of rates applied on both sides.

Parties involved in damage suits routinely fail to achieve a firm grasp of the complex issues required to develop and/or defend claims of damage. As a subject in any damage suit, companies and individuals as well their legal counsel can find themselves overwhelmed by the sheer size and number of trees in the forest.

In most cases, a business valuation expert can help. We would be pleased to discuss such matters in confidence with you. ◆

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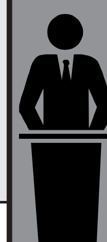
SPEAKER'S BUREAU

J.L. Pierson, AM is available to provide a customized and entertaining presentation to your firm or professional organization on topics relating to business valuation.

Call 203-325-2703 today for more information



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