



The Potential Advantages of an Employee Stock Ownership Plan (ESOP)

Presented by:

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4:30 p.m. - 6:00 p.m., Sunday, October 16, 2005
Ft. Lauderdale, Florida


Evaluation # 05-122

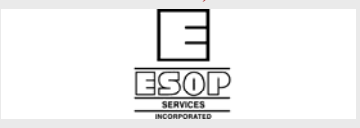


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The potential advantages of an EMPLOYEE STOCK OWNERSHIP PLAN

COMPANY	STOCKHOLDERS	EMPLOYEES
<ol style="list-style-type: none"> 1. Substantial tax savings (up to 100%) 2. Corporate Perpetuation 3. Cash flow increased 4. Pre-tax dollars repay debt 5. S corporation stock owned by an ESOP is not subject to federal tax 6. Tax-deductible dividends 7. Net worth increased 8. Provides a match on employees' 401(k) deferrals 9. Justifies accumulated retained earnings 10. Buy/sell agreements funded with pre-tax earnings 	<ol style="list-style-type: none"> 1. Creates liquidity at fair market value 2. Control maintained (if desired) 3. "Tax-free rollover" treatment available to sellers in closely-held companies 4. Establishes valuation and provides liquidity for estate tax purposes 5. Selling stockholder-employee participates in ESOP if the "tax-free" rollover not elected 6. Selling shareholders excluded from ESOP participation can be "made whole" by the corporation 7. Additional equity incentives still available (stock option, bonus, purchase, phantom stock, etc.) 	<ol style="list-style-type: none"> 1. Employees share directly in equity growth of company 2. ESOP employer contributions tend to be larger than profit sharing contributions 3. Proven motivator. Builds unity and team spirit. Retains key employees 4. Accounts accumulate tax-free. Tax favored at distribution 5. Employees can realize dividend income 6. Buy/sell agreements insure future employee ownership through the ESOP 7. 401(k) Plans can be enhanced with ESOPs


and
Perpetuation Planning
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107th Annual Conference
October 16, 2005


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ESOP:
Employee Stock Ownership Plans

- A perpetuation alternative for pharmacies.



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SUMMARY OF ESOP USES

- An ESOP is a very flexible financial and equity incentive instrument that uses corporate tax-deductible dollars to achieve a variety of individual and corporate objectives, including *shareholder liquidity, perpetuation, mergers and acquisitions, divestiture of a subsidiary, tax-free corporate income and charitable giving.*

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History of ESOPs

- 1974—ERISA
- 1984—§1042 “Tax-Free” Rollover
- 1998—Tax-Free S Corporation Income
- There are approximately 10,000 ESOPs covering approximately 12 million employees

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SUMMARY OF ESOP USES

- Provide a market (at fair market value) for partial or complete sale by existing shareholders with “tax-free rollover” treatment if ESOP ownership is 30% or greater (IRC 1042).
- Borrow from a bank, the sponsoring company, or sellers to purchase a block of stock.
- Make corporate tax-deductible contributions, including loan principal and interest payments via the ESOP.
- Gain a corporate tax deduction for dividends passed through the ESOP to employees, or used to repay ESOP debt.

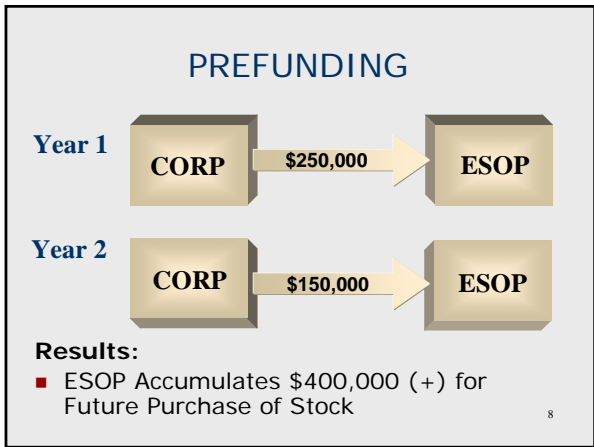
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SUMMARY OF ESOP USES

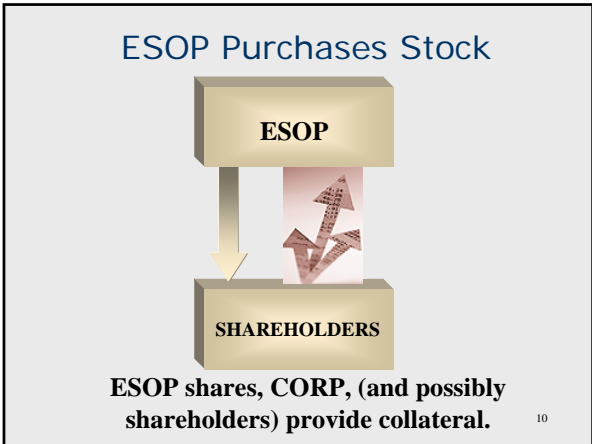
- Acquire a company and provide the sellers with the “tax-free” rollover
- Divest a division or subsidiary
- Income attributable to S Corporation stock owned by an ESOP is not subject to federal tax (most states mirror)
- Charitable giving

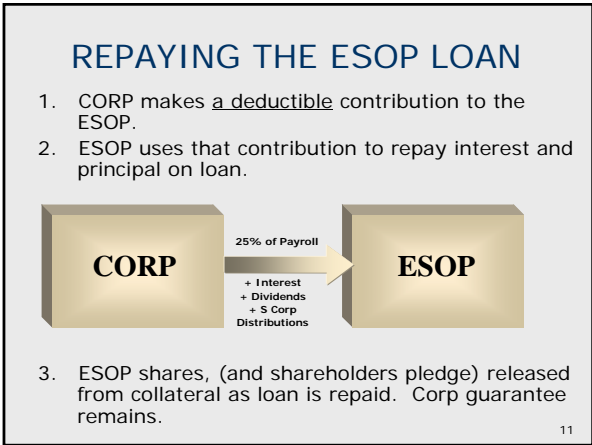
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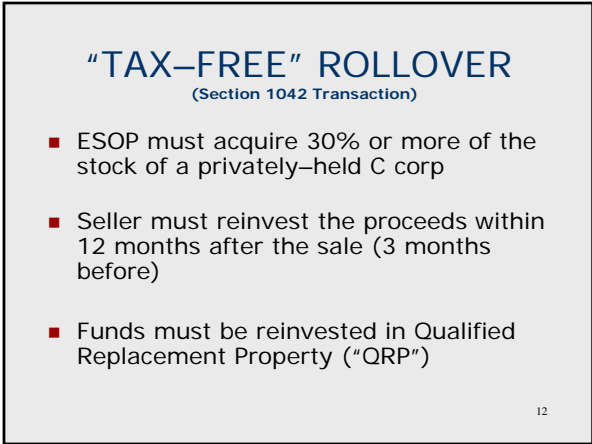












Qualified Replacement Property "QRP"

- Can be used as Collateral
- Stocks or Bonds
- Floating Rate Notes ("FRN's")
- U.S. Operating Corporations
- Public or Private Companies

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Non-Qualified Investments

- Mutual Funds
- Passive Income Exceeds 25% of Gross Revenue in Year Prior to Purchase
- Real Estate
- Government Securities
- Foreign Securities
- Limited Partnerships
- Limited Liability Companies (LLC)

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IMMEDIATE 100% SALE

- Usually involves a seller note for some portion of the purchase price
- Usually combined with a management equity incentive plan for the key employees

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Tax Shields

- C Corp
 - Sellers could elect §1042 "tax-free" rollover
 - Company could convert to S corp status after stock has been acquired by the ESOP

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Tax Shields

- S Corp
 - Company could convert to C corp status in order to qualify for §1042 "tax-free" rollover
 - Company could convert back to S corp status after 5 years

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The Potential Advantages of an Employee Stock Ownership Plan

COMPANY

1. Substantial tax savings (up to 60%)
2. Corporate perpetuation
3. Cash flow increased
4. Pre-tax dollars repay debt
5. S Corporation stock owned by an ESOP is not subject to federal tax (0% tax rate)
6. Tax-deductible C Corporation dividends
7. Justifies accumulated retained earnings

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The Potential Advantages of an Employee Stock Ownership Plan

STOCKHOLDERS

1. Creates liquidity at fair market value.
2. Control maintained (if desired).
3. "Tax-free" rollover treatment available to sellers in closely-held companies (IRC 1042).
4. Establishes valuation and provides liquidity for estate planning purposes.
5. Selling shareholders excluded from ESOP participation can be "made whole" by the corporation.
6. Additional equity incentives still available (stock option, bonus, purchase, phantom stock, etc.)

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The Potential Advantages of an Employee Stock Ownership Plan

EMPLOYEES

1. Employees share directly in equity growth of company.
2. ESOP employer contributions tend to be larger than profit sharing contributions.
3. Proven motivator. Builds unity and team spirit. Retains key employees.
4. Accounts accumulate tax-deferred. Tax favored at distribution.
5. Employees can realize dividend income.
6. Buy/sell agreements insure future employee ownership through the ESOP.

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Difference in Corporate Performance Post ESOP vs. Pre ESOP

■ Annual Sales Growth	+2.4%
■ Annual Employment Growth	+2.3%
■ Annual Growth in Sales/Employee	+2.3%
■ Average Increase in Productivity	+4.5%

Projected over 10 years, an ESOP company with these differentials would be a third larger than its comparable non ESOP company.

Source: Rutgers University, Kruse and Blasi 1998

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Average Value of All Retirement Accounts

ESOP Companies \$32,213

Non ESOP Companies \$12,735

Source: 1998, Kardas & Keogh, Washington Department of Community Trade & Economic Development and Adria Scharf, University of Washington

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Percentage of Companies Having Other Retirement Plans

	<u>ESOP Co</u>	<u>Non-ESOP</u>
■ Defined Benefit Plan	20.1%	4.9%
■ 401(k)	33.1%	6.2%
■ Non 401(k) PSP	35.7%	8.0%
■ Other DC Plan	14.7%	2.3%

About 70-75% of participants in plans that are heavily invested in Employer stock are in companies that also maintain diversified pension or other plans. Of all private sector employees only 32% participate in DB Pension plans.

Source: Rutgers University, Kruse and Blasé, 1998 and Bureau of Labor Statistics

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Summary

- ESOP transactions are more flexible than other type of buyout transactions
- ESOP transactions are more tax efficient than other types of buyout transactions (up to 60% tax shield)
- Tax-free S Corporation income
- ESOPs create a win-win situation for shareholders, company and employees

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What we do...

Preliminary Analysis (Preliminary Assessment Questionnaire)

"Phase I"

- Financial Analysis
- Repurchase Liability Study
- Design Study
- *Decision Package*

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"Phase II"

- Quarterback ESOP implementation
- Structure Financing
- ESOP Legal Documents
- Employee Communications
- Liaison with Advisors

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What we don't do...

- Independent Preliminary or Final Stock Appraisal
- Lending
- Insurance
- Plan Administration

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ESOP and Perpetuation Planning

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