

# CHAPTER | 10

## SELLER-FINANCED ESOPs AND LEVERAGED QRP TRANSACTIONS

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The key motivation for many ESOP transactions in closely held companies is the ability of the selling shareholder to defer capital gains tax on sale of shares to an ESOP under Section 1042 of the Internal Revenue Code (the “Code”). Section 1042 requires as a condition of capital gains tax deferral that upon completion of the sale, the ESOP own at least 30% of the outstanding shares of each class of company stock or stock representing 30% of the value of all company stock. At this time, the Section 1042 tax deferral is available only to selling owners in C corporations, not S corporations.

Section 404 of the Code imposes significant limitations, as a percentage of participant compensation, on how much may be contributed to an ESOP in a single year. Most ESOP transactions in closely held companies are therefore leveraged, as very few companies have a significant enough payroll base that 30% of the company’s stock can be contributed to participants in a single year in compliance with applicable Section 404 limits on tax-deductible contributions to an ESOP. In a leveraged transaction, the ESOP uses borrowed money to acquire a significant block of company stock and promises to repay the loan from future company contributions.

Often, the ESOP borrows from an outside lender, such as a bank, to obtain the funds to buy company stock. However, sellers may prefer to finance the ESOP transaction themselves, either because they want to avoid bank financing (due to cost or other considerations) or because it is simply difficult or impossible to obtain bank financing. Under this approach, the selling shareholders receive a note from the ESOP as payment for some or all of the sale price. This chapter will discuss seller financing, its advantages and disadvantages, and the use of “leveraged QRP.”

## **Rationale of Seller Financing**

One condition of Section 1042 capital gains deferral is that the selling shareholder purchase “qualified replacement property” (QRP) with a value equal to the amount received in the qualifying ESOP transaction. (The shareholder can choose to purchase QRP equal to only part of the amount received, in which case the shareholder will pay taxes on the remainder of the proceeds.) QRP can include the stock and bonds of most, but not all, domestic operating corporations. It does not include mutual funds, real estate investment trusts (REITs), or government bonds. The selling shareholder defers capital gains tax until sale or other taxable disposition of the QRP. Banks generally consider the QRP to be purchased by a selling shareholder as excellent collateral for an ESOP loan.

Selling shareholders generally view a pledge of QRP or other seller guarantees of bank ESOP financing as creating a level of personal risk similar to providing the financing for the transaction themselves. Moreover, the company or the ESOP usually do not provide additional compensation to the selling shareholder in exchange for the pledge of QRP or the guarantee. The question is often framed as, “Why shouldn’t I (the selling shareholder) collect the interest rather than the bank?”

## **Structure of Seller Financing**

Most ESOP transactions use a “mirror loan” format. The lender makes a loan to the company and the company makes

a loan to the ESOP to finance purchase of company stock from a shareholder. This structure can be followed where the lender is the selling shareholder, but is not always desirable.

In a mirror loan structure, the company makes a loan to the ESOP, and the ESOP uses the proceeds of the loan to purchase shares from a shareholder. The shareholder makes a loan to a company, and the company issues a note to the shareholder. The advantage of this structure is that the holder of the note has direct recourse to company assets, some technical legal issues concerning “fraudulent conveyance” are avoided, and there may be advantageous timing differences between the company’s payment of contributions or tax-deductible dividends to the ESOP to repay the loan and the company’s payment of the obligations under the note. For example, a company with extra cash would pay off the external loan faster, using a slower schedule to pay off the seller, either to avoid Section 404 deduction limit problems or to stretch out allocations to include more future employees. The disadvantage of this structure is that a shareholder who does not elect capital gains deferral under Section 1042 may not elect installment sale tax treatment as an alternative based on the deferred note payments. In other words, the seller will be taxed on the proceeds.

The deferred payments to the shareholder may be structured as a direct obligation of the ESOP. Usually, the company will provide an additional guarantee of the note from the ESOP. In this scenario, a shareholder who does not elect Section 1042 capital gains deferral may instead elect installment sale treatment with respect to the proceeds of the note. The balance sheet treatment of the ESOP obligation on the financial statements of the company is unaffected by whether the company provides a guarantee of the ESOP’s obligation.

A selling shareholder providing seller financing and electing Section 1042 may accomplish direct recourse against the ESOP sponsor if desired. The selling shareholder may exchange a direct note from the ESOP for a similar note from the ESOP sponsor. Alternatively, the selling shareholder may borrow funds for a single day and loan the proceeds to the

ESOP sponsor at closing in exchange for a note. The ESOP sponsor then loans the funds to the ESOP and the ESOP nominally pays cash for the selling shareholder's stock at closing. The selling shareholder then uses the proceeds of the sale of stock to the ESOP to repay the "one-day" loan. The net result is that the selling shareholder has a note from the ESOP sponsor rather than the ESOP itself. The inability to obtain installment sales treatment is irrelevant if the selling shareholder is deferring capital gains tax under Section 1042.

## **Section 1042 Considerations**

Section 1042 requires, as a condition of capital gains deferral, that the selling shareholder purchase QRP during the 15-month period commencing 3 months before and ending 12 months after the date of a qualifying sale to an ESOP. This period is not extended by the ESOP's payment of the purchase price for the shares in the form of a note.

This creates a dilemma for a shareholder who is otherwise willing to sell shares to an ESOP in exchange for a note. Payment of the sale proceeds to the shareholder may occur over several years. Purchase of the QRP must, however, take place within one year of the date of sale. For a shareholder who receives a note as payment in an ESOP transaction to elect capital gains deferral under Section 1042, he or she must use other available funds to purchase QRP during the applicable period. (The IRS ruled in Private Letter Ruling 9102017 that the money used to buy QRP need not be the actual sale proceeds.) Relatively few shareholders have sufficient liquid assets to accomplish this funding.

## **Use of Leveraged Qualified Replacement Securities**

Section 1042 concerns based on a need for short-term funds to purchase QRP may be addressed by purchase of QRP that may be used as collateral for a margin loan at a relatively high loan-to-value. The major brokerage houses will typically offer margin loans on securities without other collateral at

specified ratios and at or near the “broker call” rate. Advance ratios against stocks are 50%, while advance ratios against debt instruments (e.g. bonds) range from 70% to 75% depending on whether the coupon is fixed or floating. (Banks are not subject to the same margin restrictions that brokerage houses are, so with a bank the advance ratio against a stock could be over 50%.) The broker call rate reflects short-term interest rates and varies at around 0.5 to 2.0 percentage points below the prime rate. If the value of the underlying margined security drops, the brokerage house may make a “margin call” requiring sufficient repayment of the loan such that the advance ratios described above are not exceeded.

The desired attributes of the QRP are therefore (1) a debt instrument (to maximize the potential amount of the margin loan), (2) high safety and credit quality (to reduce risk and price fluctuations based upon the creditworthiness of the issuer), (3) a long maturity and call protection (so that the capital gain deferred on sale of shares to the ESOP will not be recognized upon maturity or call of the debt instrument), and (4) a floating interest rate (to avoid price fluctuations and potential margin calls based upon changes in underlying interest rate conditions).

Several brokerage houses offer a form of QRP with these attributes called a “Floating Rate Note” (FRN). These securities, generally issued by large corporations, have high credit ratings, normally AAA or AA, and a floating interest rate, therefore insuring relative price stability and security. The term of the notes usually range from 30 to 60 years. It is relatively easy to purchase this security with a down payment of as little as 10% of the underlying value of the FRN, with financing from a lending institution or a broker.

✓ **Example of Seller-Financed ESOP with Leveraged QRP** The following example illustrates the use of leveraged QRP in a seller-financed Section 1042 ESOP transaction:

1. Seller sells \$10 million stock to the ESOP in exchange for \$1 million cash and a note for the \$9 million balance (the proportion of cash and note may vary).

2. Within 12 months of sale date, Seller deposits \$1 million cash proceeds with an outside bank or brokerage house (“Lender”).
3. Simultaneously, Seller purchases \$10 million as QRP under Section 1042.
4. Lender loans Seller \$9 million on (30-day) LIBOR-based rate secured by pledge of FRN.
5. Seller receives ongoing payments from ESOP as principal and interest on Seller note. Seller may use payments to reduce Lender loan or may otherwise invest or spend proceeds.

The net cash flow of interest from these transactions is illustrated below:

*Sample applicable rates (as of September 2004):*

Seller note @ prime + 2	6.25%
FRN yield @30-day LIBOR – 25 basis points	1.75%
Bank loan secured by FRN @ 30-day LIBOR + 50 basis points	2.50%

*First-year interest cash flow:*

Seller note interest income (\$9 million @ 4.25%)	\$562,500
FRN income (\$10 million @ 1.75%)	175,000
Less: Interest expense to Lender (\$9 million @ 2.50%)	<u>225,000</u>
Net interest income	\$512,500

*(First-year effective yield = 5.69%)*

## Pros and Cons of Seller Financing

Seller financing is especially appropriate for consideration in a Section 1042 transaction where the seller will likely pledge all of the QRP to be acquired with the proceeds of the transaction as collateral to the lender. Seller financing may provide a greater financial return relative to risk as the

seller may capture a premium representing the gap between the rate charged by a lender on a loan collateralized by QRP and the rate a seller may command as a “reasonable rate” on the seller note. Seller financing, when appropriately subordinated, may help companies subject to bonding or other balance-sheet related credit tests, where the outside bonding agency or creditor might view bank financing as excessive leverage. Seller financing may also provide greater flexibility to structure a leveraged transaction around seasonal or fluctuating cash flow. Seller-financed transactions are also less expensive to accomplish and require less documentation and due diligence.

Seller financing using leveraged QRP may subject the seller to an underlying lack of diversification if one were to invest 100% in a single security. Sellers can use the proceeds from the note to purchase a diversified portfolio of investments, but they will do so over time. In essence, the sellers would be dollar-cost averaging into the market, buying fewer shares when stock prices are high and more shares when prices are low. During a period of rising stock prices, the rate of return on the notes, even with the positive interest float from the ESOP note to the seller, will be below the typical rate of return on equities; thus, the seller would lose out on the opportunities a Section 1042 transaction provides to get this higher rate sooner by investing immediately. For example, if a seller elects Section 1042 treatment and invests in equities with a 10% annual return, that seller will be better off than one who invests in a FRN with an effective rate of 5.69% (adding in the extra interest from the note to the seller).

A selling shareholder may also find it difficult to balance his or her lender concerns against his or her management or ownership concerns if the company experiences difficulty in making timely repayment of the seller note. Additionally, bank financing imposes discipline and due diligence on a company to ensure that the projected ESOP debt is appropriate and that there are no other concerns that militate against the proposed ESOP transaction.

However, the leveraged QRP approach allows a seller who cannot obtain, or does not want to obtain, bank financing

to elect Section 1042 treatment on the entire amount of the sale proceeds.

## **Conclusion**

Seller financing may be a desirable alternative to conventional bank financing; it also may provide a level of subordinated debt to achieve a desired debt package in certain leveraged ESOP transactions. If the seller desires to elect Section 1042 treatment but needs short-term funds to purchase QRP within the required 15-month period, the leveraged QRP approach described here can be used to provide those funds within the context of seller financing.