

THE EMPLOYEE STOCK OWNERSHIP PLAN

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All business/stock valuations are based on hypothetical sales transactions. In the market approach, there is a hypothetical sale of the corporate stock. The fact the company does not actually sell its stock does not invalidate the use of the market approach. Likewise, the fact that the company does not actually sell its assets does not invalidate the use of the asset-based approach. In a hypothetical sale of the corporate asset, a hypothetical BIG tax liability would be paid.

Keywords: *price, gains tax, securities, transactions, stock, investment*

1. Introduction

The valuation of the stock of a closely held business is an integral component of the formation, financing, contribution, and redemption phases of an employee stock ownership plan (ESOP). In the case of an ESOP formation, the closely held business may be a family-owned or other privately owned corporation that is sold (in total or in part) to the trust. Or, the closely held business may be a division or subsidiary of a publicly traded corporation that is being divested through an employee buy-out.

In any event, due to the ERISA adequate consideration requirements, employer corporation stock that is sold to or purchased from the ESOP must be independently valued. In addition, the employer corporation stock owned by ESOP must be independently valued at least annually.

In compliance with both internal Revenue Service and U.S. Department of Labor guidelines, analysts use three generally accepted approaches to value the securities involved in ESOP transactions. These three approaches are called the income approach, the market approach, and the asset-based approach. Analysts typically synthesize the quantitative value indications of two or more of these analytical approaches in reaching a final ESOP stock value conclusion. The income approach values a corporation as the present value of the future income expected to be earned by the

owners of the business. The most common income approach business/stock valuation methods are (1) the direct capitalization method and (2) the yield capitalization (or discounted cash flow) method.

The market approach values a corporation by reference to market-derived pricing multiples extracted from actual sales of comparative companies or securities. The most common market approach business/stock valuation methods are (1) the guideline merged and acquired company method and (2) the guideline publicity traded company method.

The asset-based approach values a corporation by reference to (1) the current value of all its assets (both tangible and intangible) less (2) the current value of all of its liabilities (both contingent and recorded). The most common asset-based approach business/stock valuation methods are (1) the net asset value method (where total corporate asset appreciation is estimated collectively) and (2) the asset accumulation method (where the company's individual tangible and intangible assets are separately identified and valued).

2. The Big Tax Liability Issue

In the asset-based approach, the analyst estimates the value of the corporation's assets either in aggregate (the net asset value method) or individually (the asset accumulation method). In any event, this appraised value (either aggregate or individual) is typically in excess of the income

tax basis of the subject corporate assets. This is almost always the case with regard to the corporation's intangible assets. This is because these intangible assets typically have little or no income tax basis. If the company's assets were sold in a fair market value transaction (i.e., the conceptual premise of the asset – based approach), the corporation would have to pay capital gains tax. The amount of the capital gains would be based on the appreciation of the company's assets – that is, the assumed fair market value sales price of the asset less the income tax basis of the assets. The capital gains tax liability would be based on (1) the amount of the capital gains (i.e., the asset appreciation over income tax basis) and (2) the corporate capital gains tax rate.

Since this capital gains tax liability is associated with the appraised value of the corporate assets, it is typically called the built-in gains (or BIG) tax liability. The asset-based approach analysis is often performed use, as part of going concern. This premise of value assumes that the subject corporate assets would be sold as a going-concern business. However, such a hypothetical sale would, in fact, trigger the BIG tax. This conceptual issue ultimately relates to a basic procedural question: how should the analyst account for the BIG tax liability in an asset-based business/stock valuation?

There are three possible answers to this procedural question. First, the analyst can ignore the BIG tax liability. Historically, this is the procedure that many courts (and many analysts) have adopted.

Second, the analyst can estimate the amount of the BIG tax liability that corresponds to the appraised corporate asset values. Then, the analyst can adjust this gross BIG tax liability by an estimated probability reflecting (1) whether the subject company actually will sell its assets and (2) when that asset sale will take place. Because of perceived conceptual inconsistencies in this alternative, most analysts have not adopted this procedure. However, in recent years, many courts (implicitly or explicitly) have applied this probability-adjustment procedure.

Third, the analyst can estimate the amount of the BIG tax liability that corresponds to the appraised corporate asset values. Then, the analyst can adjust (i.e., reduce or “discount”) the total net asset value by the full amount of the tax liability. Based on the facts of each individual analysis, this

last procedure appears to represent the developing consensus of the business valuation community.

This valuation issue has not been specifically addressed in an ESOP – related court case. However, it has been addressed over the years in several federal gift and estate tax court cases. Recently, the Fifth Circuit weighed in on this valuation issue (based on an appeal of a U.S. Tax Court estate tax case). While this recent Fifth Circuit decision does not relate specifically to ESOP matters, it does provide important professional guidance to valuation analysts who practice in the ESOP area.

3. Case Summary

In the Estate of Beatrice Ellen Jones Dunn, NO. 00-60614, 2002 U.S. App. Lexis 15453 (5th Cir. Aug. 1, 2002), rev'g and rem'g TC Memo 2000-12 (jan. 12, 2000), the U.S. Court of Appeals for the Fifth Circuit accepted the taxpayer argument that C corporation stock valuations should be adjusted for the potential BIG tax on appreciated corporate assets. Prior gift and estate tax cases have held a C corporation holding company valuation may be adjusted (i.e., discounted) for the potential BIG tax liability. However, the valuation discounts allowed by the courts in these previous holding company valuation cases typically did not reflect the full 34 percent corporate capital gain tax rate.

The Estate of Dunn provide practical guidance on two issues related to the application of the BIG tax discount. First, the Appeals Court upheld the taxpayer position of a BIG tax valuation discount on appreciated asset based on the full 34 percent corporate capital gains tax rate.

Second, in addition to allowing a valuation adjustment for the full BIG tax liability, the Estate of Dunn is significant because of the type of business enterprise involved. The subject corporation in the Estate of Dunn is an operating company, not a property holding company. The previous judicial precedent related to the BIG tax valuation discount all involved property holding companies. Such companies included real estate development companies or companies that just owned a portfolio of marketable securities.

4. Recent Precedent on the Issue

For example, in the Estate of Davis, 110 TC 530 (1998), the Tax Court allowed a 15 percent valuation discount on the appraised net asset value (NAV) for the potential BIG tax liability. The

subject corporation was a holding company that owned a large block of publicly traded stock with substantial capital appreciation. Because the hypothetical willing buyer could buy the same publicly traded stock on an open market without assuming a BIG tax liability, the Tax Court allowed a valuation discount from the company's net asset value.

In addition to the Tax Court cases, the application of a BIG tax valuation discount has been accepted by various circuits of the U.S. Court of Appeals, for example, the same type of valuation adjustment – a discount for the BIG tax liability associated with a company appreciated net asset value-was accepted in:

1. Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir. 1998) related to a real estate holding company and
2. Estate of Helen Bolton Jameson v. Commissioner, 267 F.3d 366 (5th Cir. 2001) related to a timberland holding company

5. The Facts of the Case

On the date of her death, Beatrice Ellen Jones Dunn owned a block of stock in Dunn Equipment, Inc. (the Company). Dunn Equipment, Inc., was incorporated in Texas in 1949. it was a family-owned business thought its existence. The Company operated from four location throughout Texas. In 1991, the Company had 134 employees, including three executives and eight salesman.

Dunn Equipment, Inc. owned and rented out heavy equipment and provided related services, primarily in the petroleum refinery and petrochemical industries. The personal property rented from the company by its customers consisted principally of large cranes, air compressors, backhoes, man lifts, and sanders and grinders.

The Company frequently furnished operators for the equipment that it rented to its customers, charging for both equipment and operators on an hourly basis. For example, a significant portion of the Company's revenues resulted from the renting of large cranes, both with and without operators.

The Company was consistently profitable. Historically, however, the Company's stock return on equity was lower that contemporaneous rates of return on various risk-free investment instruments.

Ms. Dunn a long time resident of Texas, died on June 8, 1991, at the age of 81. after Ms. Dunn death, the estate timely filed Form 706 federal estate tax return. The decedent's block of share represented approximately 63 percent of the outstanding stock of the subject C corporation. Accordingly, the decedent's block of stock represented a controlling owner-ship interest in the subject closely held corporation.

At the trial level, the Tax Court found that the decedent's ownership of 63 percent of the stock gave her operational control of the Company. However, under Texas law she lacked the power to compel a liquidation, a sale of all or substantially all of Company assets, or a merger or consolidation. In order to initiate any these control events under Texas law, a "supermajority" equal to or greater than 66.67 percent of the outstanding shares is required.

The Tax Court further concluded that, in addition to lacking a super-majority herself, Ms. Dunn would not have been likely to garner the votes of additional shareholders sufficient to constitute the super-majority required to instigate liquidation or sale of all assets. This was because the other Company shareholders were determined to continue the independent existence and operations of Dunn Equipment, Inc., indefinitely.

In November 1994, approximately three and one-half years after the decedent's death and two and half years after he estate tax turn was filed, the Service issued a notice of deficiency. The notice of deficiency assessed additional estate taxes of 238.515\$. the estate filed a complaint in U.S. Tax Court.

In an amended answer filed in the Tax Court, the Service Increased the asserted estate tax deficiency to approximately 1.100.000\$. This deficiency was predicated on the Service's contestation that the decedent's 492.610 share of Dunn Equipment, Inc., stock had been undervalued on the estate tax return.

6. Conclusion

Valuation analysts typically use income and market approach methods in business stock valuation for ESOP purpose. However, the asset-based approach is an generally accepted approach for ESOP valuations. And, the asset-based approach is applied often enough so that the BIG tax discount conceptual issue should be resolved.

There appears to be growing consensus in the valuation community regarding this issue. The asset-based approach assumes that the subject company sells the business in an asset transaction. The corporate assets sell, as a going concern, at the total of their appraised fair market values.

After the assumed asset sale, the selling corporation would generally have to pay capital gains tax on the excess of the assets' sales price over the assets' tax basis. Since the repeal of the general Utilities doctrine in 1986, corporations have few options available to mitigate this capital gains tax.

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The Estate of Dunn concluded that a company's NAV should be adjusted (discounted) for the amount of this hypothetical BIG tax liability. The Appeals Court concluded that this adjustment should be made regardless of (1) whether or not the company plans to actually sell its corporate assets and (2) whether or not the company is an operating company or a property holding company.

In fact, the Appeals Court conclusion regarding this issue in the Estate of Dunn appears to be unambiguous:

We must reject legal error, then, the Tax Court's treatment of built-in gains tax liability and hold that - under the court's asset-based approach - determination of the value of Dunn Equipment, must include a reduction equal to 34% of the taxable gain inherent in those assets as of the valuation date.

The Estate of Dunn provides important professional guidance to valuation analysts on two issues.

First, when the asset-based approach - and specifically the NAV method - is used to estimate business/stock value, the Estate of Dunn supports the calculation of the BIG tax valuation discount at the full capital gains corporate tax rate. According to the Dunn decision, the estimated BIG tax liability should not be reduced by an estimate of the probability of a near-term corporate liquidation.

Second, the Dunn decision indicates that the BIG tax adjustment should be considered in the asset-based valuation of any going-concern business - and not just in the valuation of property holding companies. The estimation of the potential BIG tax liability on appreciated assets is an integral methodological step in any asset-based approach business valuation.

The consideration of the capital gains tax on revalued assets is a function of the selected valuation approach. The consideration of the capital gains tax is not a function of the type of subject business enterprise.

Although the Estate of Dunn does not have legal precedent value in an ESOP controversy, it does provide practical professional guidance to valuation practitioners. This is because the BIG tax valuation adjustment is as relevant an issue to ESOP business/stock valuation as it is to gift and estate tax business/stock valuations.

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