

Warrants in ESOP Transactions

James G. Steiker

This article describes how warrants are used as part of the financing structure of leveraged ESOP transactions and discusses key corporate finance and federal tax considerations in structuring ESOP financing arrangements involving warrants.

Warrants are often used in employee stock ownership plan (ESOP) transactions to provide an enhanced return to investors and/or debt holders who provide a portion of the ESOP company's debt capital. A warrant is a financial instrument that gives the holder a right to purchase issuer stock at a specified price at a future date or during a future period. Warrants are identical in financial structure and effect to stock options (in fact, a warrant *is* a form of stock option), and the term "warrant" applies to an option granted to a holder by an issuer to purchase another issuer security, like common stock, preferred stock, notes, or bonds. This article describes some common uses for and effects of warrants in ESOP transactions.

Warrants and Corporate Finance

All companies consist of invested capital. The invested capital may be equity owned by shareholders or debt held by lenders or investors. Traditional corporate finance structures for invested capital form a pyramid of returns and related risk, as shown in the simplified diagram in figure 1.

At one end, common equity has both the greatest risk and greatest potential return, while at the other end, senior secured debt has the lowest risk and the lowest return. Preferred stock and subordinated debt, both of which capture a slice of company cash flow ahead of

James Steiker is the chairman and CEO of SES Advisors, Inc., an ESOP advisory firm, and the founding partner in the related law firm, Steiker, Fischer, Edwards & Greenapple, P.C. He has more than 20 years of experience as a legal and financial advisor in ESOP and other employee ownership matters.

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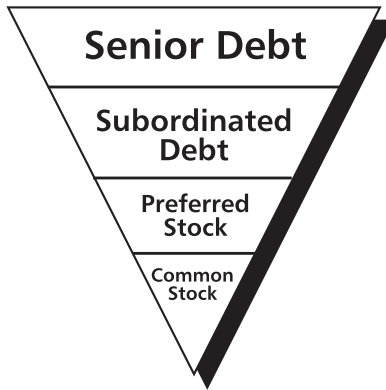


Figure 1

the common equity holders but behind the senior debt lenders or investors, have return and risk somewhere between senior debt and common stock. Many middle-market companies are capitalized exclusively with senior debt and common stock.

There are many studies, indexes, and reports that measure expected returns for investors at each level of the pyramid. These expected returns are greatly affected by general economic conditions, specific financial market circumstances, and industry- and company-specific concerns and risks. Broadly speaking, equity investors in privately held middle-market companies look for total returns between 15% and 30%, preferred stockholders and subordinated debt providers look for total returns between 10% and 18%, and senior debt lenders look for returns based on prevailing short-term rates expressed as a margin over LIBOR with senior debt interest rates that, as of early 2008, generally range from 4.5% to 6.5%. There are more specific forms of capital investment with mixed return/risk attributes at each level in this pyramid (including, for example, multiple classes of common stock or second-lien loans).

The manner in which investors achieve their expected returns also varies greatly. Common equity investors may achieve small pieces of their expected returns through dividends or distributions but often expect to realize their returns as a capital gain through sale of the common stock. By contrast, senior debt lenders and investors usually expect monthly or quarterly payments of interest as their return on investment. Preferred stock and subordinated debt investors often expect to achieve their returns in part through

current payment of interest and/or dividends and in part through sale or redemption of the underlying investment. Few companies can afford to pay a 10% to 18% current cash return on preferred stock or subordinated debt. Warrants are often the tool of choice to provide a subordinated debt investor with additional deferred returns to augment a lower cash interest payment.

Subordinated debt instruments commonly provide a regular cash interest payment of between 8% and 12% under current (early 2008) market conditions. There are typically warrants attached to the subordinated debt instrument that are projected, at the time of exercise, to provide enough additional return so that the overall investment provides an appropriate rate of return to the subordinated debt investor.

Warrants and ESOP Transaction Financing

Many ESOP transactions are intended to create a 100% ESOP-owned S corporation. In an S corporation, corporate income is attributed to the shareholders for tax purposes. An ESOP is a tax-exempt trust that does not pay federal income taxes on attributed income from employer S corporation stock. A tax-free for-profit entity without any tax-driven need to distribute income to shareholders creates the unique potential for a highly leveraged finance structure to facilitate the purchase or redemption of larger blocks of company stock from non-ESOP sellers.

Companies generally prefer to accomplish leveraged ESOP transactions through relatively inexpensive senior debt. However, using senior debt alone is often not possible in highly leveraged transactions designed to result in 100% ESOP ownership. Subordinated debt may be required. Selling shareholders often hold this subordinated debt, and the subordinated debt instrument is often structured to address the particular needs and concerns of the selling shareholder. Third-party investors may also provide subordinated debt to fund an ESOP transaction. While this article generally describes subordinated debt in ESOP transactions as seller financing, the descriptions below apply equally to third-party investors who might provide subordinated debt.

Subordinated debt is generally issued by a company as an “investment unit” consisting of the interest-paying note with a separate warrant instrument. An ESOP cannot issue a warrant directly,

so seller-financed leveraged ESOP transactions using this form of investment unit must use the company as a direct participant in the ESOP financing. These transactions can be done with both S corporations and C corporations, as described below.

S Corporation ESOP Transactions

S corporation ESOP transactions involving subordinated debt are often structured in part or in whole as redemptions rather than direct ESOP purchases of shares from shareholders. There are three main reasons for this. First, the deferral of capital gains taxes permitted by Section 1042 of the Internal Revenue Code (the “Code”) for the sale of shares directly to an ESOP is not available to an S corporation shareholder. The shareholder is therefore indifferent as to whether the shares are purchased directly by the ESOP or redeemed by the company. In either case, the proceeds are subject to capital gains taxes. Second, if the company is to become an effectively tax-free 100% ESOP-owned S corporation, the company will not be using tax deductions relating to payments of the principal and interest of the third-party ESOP loan or for contributions to the ESOP. Finally, redemptions may create less fiduciary risk for the ESOP trustee because the trustee does not participate directly in a high-dollar purchase of company shares in reliance on a regulated exemption from ERISA prohibited transaction rules.

There are other considerations beyond the scope of this article to determine whether an S corporation should redeem shares from non-ESOP shareholders or fund a direct ESOP purchase of shares, including benefit funding levels, the ability of newer and younger employees to receive additional shares, and repurchase obligation planning concerns. Many transactions mix a redemption component with an ESOP direct purchase component.

A typical redemption transaction to create 100% ESOP ownership is illustrated in figure 2. In this transaction, the company is redeeming all or a portion of the outstanding shares of the company from shareholders. The ESOP is becoming the 100% shareholder either by purchasing some shares directly from the individual shareholders or by purchasing newly issued shares from the company. If the shares are acquired from the individual shareholders, the purchase price should be identical to the redemption price. If the shares are newly issued shares acquired from the company, the

S Corporation ESOP Redemption Transaction

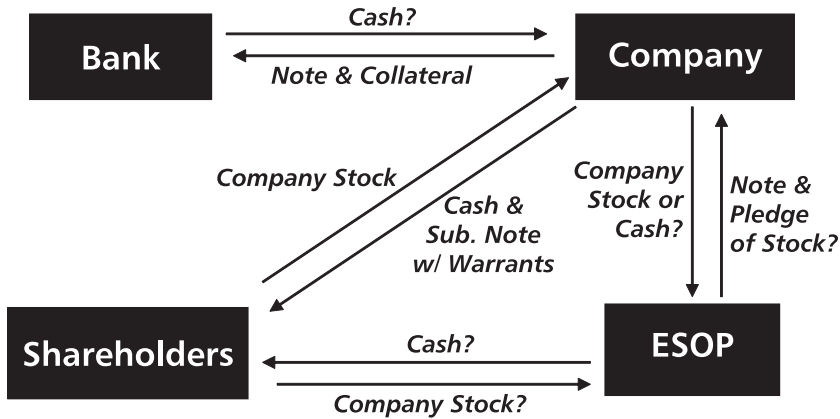


Figure 2

acquisition price should be based on the fair market value of the shares after redemption.

C Corporation ESOP Transactions

Seller-financed C corporation ESOP transactions usually occur because the company cannot finance the transaction through third-party senior debt. Again, the goal is often to achieve 100% ESOP ownership and facilitate an attractive election for the company to become an S corporation. These transactions occur with direct purchases of stock by the ESOP from the selling shareholder to allow the selling shareholder to elect to defer capital gains tax indefinitely under Section 1042.

A typical C corporation ESOP transaction involving selling shareholder financing occurs through a short-term loan for up to several days from a third-party lender. The company temporarily borrows funds from a lender and lends the proceeds to the ESOP. The ESOP then uses the proceeds to purchase stock from the selling shareholder. The selling shareholders uses the sale proceeds to make a loan to the company in exchange for an investment unit from the company consisting of a note and warrants. The company then returns the proceeds the third-party lender as repayment of

the short-term loan. The period of the short-term loan is usually one to five days.

This transaction is illustrated in figures 3 and 4. Here, the ESOP gains 100% ownership of company stock by purchasing all of the outstanding shares from individual shareholders. The short-term loan process allows the ultimate seller financing arrangement and the issuance of the investment units with warrants to be between the company and the selling shareholder without direct ESOP involvement. Again, the subordinated financing and related investment units could be issued to another investor rather than to a selling shareholder. This would result in cash proceeds to the selling shareholder.

In this form of transaction, the selling shareholder has received the proceeds of the sale in full and reloaned the proceeds to the company. This is a capital gains event unless the selling shareholder properly elects to defer the gain under Section 1042 by purchasing qualified replacement property (QRP). There are appropriate techniques using leveraged QRP for a selling shareholder to defer gain while having access to most or all of the proceeds from the sale transaction.¹

How Is the Number of Warrants Determined?

The number of warrants issued as part of a subordinated debt-based investment unit should provide a total return to the holder/investor appropriate for the risk of the instrument. The most common method to determine the proper number of warrants is to (1) determine the value of the company in the future based on the company's projected growth rate, (2) determine the cash flows to the holder/investor based on the projected repayment of debt along with the stated interest, and (3) calculate the percentage of the projected growth of the company from the post-transaction value necessary to reach the proper rate of return for the investment unit.

Table 1 presents an example of this calculation, assuming a company with a \$10 million EBITDA, a projected growth rate of 6%, and a pre-transaction value of \$50 million arriving at 100% ESOP ownership through \$40 million of subordinated debt payable in eight equal installments of principal with a stated interest rate of 5% and warrants exercisable at the end of 10 years.

1. See Bruce F. Bickley and James G. Steiker, "Seller-Financed ESOPs and Leveraged QRP Transactions," in *Selling to an ESOP*, 8th ed. (NCEO, 2005).

Phase I: Stock Sale to ESOP

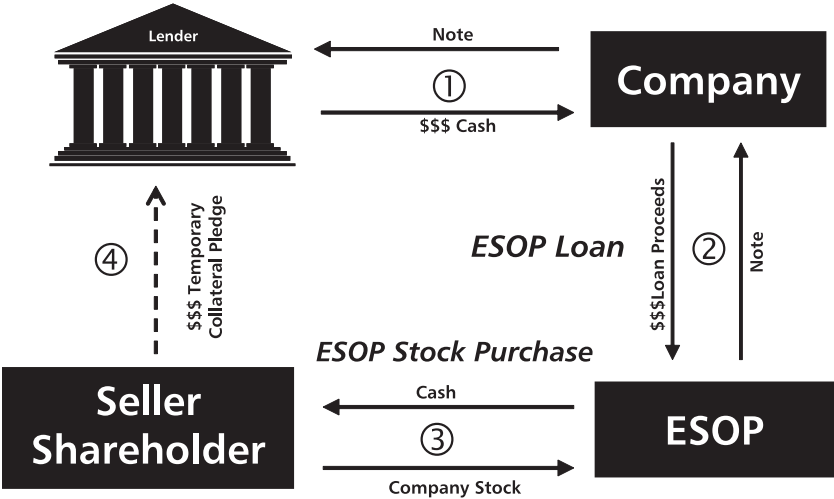


Figure 3

Phase II: Day 1–5 Debt Refinancing

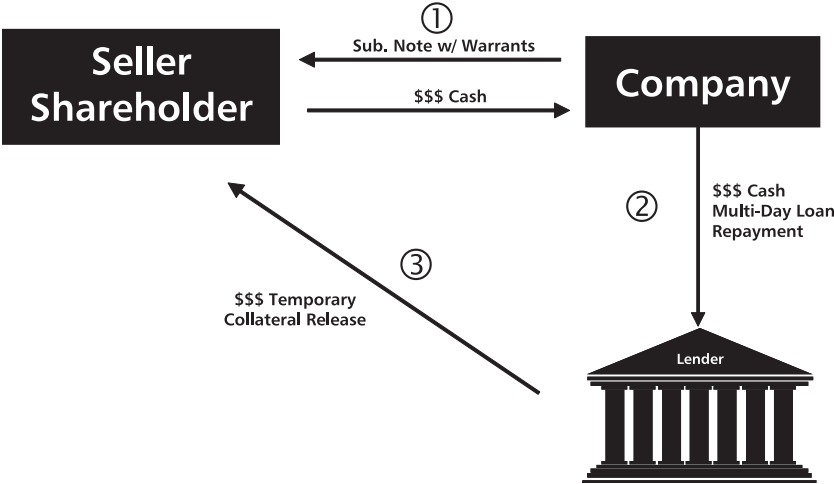


Figure 4

Table 1. Warrant Calculation

Company Value Estimate		
	Day 1	Year 1
Reported EBITDA	\$ 10,000,000	\$ 10,600,000
MVIC Multiplier	5.00x	5.00x
Enterprise Value	50,000,000	53,000,000
Less: Debt	(40,000,000)	(35,000,000)
Plus: Marketable Securities	-	-
Estimated Equity Value	10,000,000	18,000,000
Plus: Present Value of ESOP Tax Benefit (Kc=20%)	7,209,184	6,651,020
Equity Value for Common Shares	7,209,184	24,651,020
Less: Value of Total Equity Immediately After ESOP Transaction	17,209,184	17,209,184
Net Appreciation in Value Post Transaction	-	7,441,836
Portion of Total Equity Value Increase Attributable to Warrant		20.00%
Simple Value of Warrant Exercise (does not account for option value)		\$ 1,488,367

Seller Debt IRR—Pre Transaction Taxes

	Day 1	Year 1
Principal	\$ (40,000,000)	\$ 5,000,000
Interest Received		2,000,000
Equity Warrant Cash Out	-	-
Cash Inflow/(Outflow)	\$ (40,000,000)	\$ 7,000,000

Company Value Estimate

	Year 7	Year 8
Reported EBITDA	\$ 15,036,303	\$ 15,938,481
MVIC Multiplier	5.00x	5.00x
Enterprise Value	75,181,515	79,692,405
Less: Debt	(5,000,000)	-
Plus: Marketable Securities		5,000,000
Estimated Equity Value	70,181,515	84,692,405
Plus: Present Value of ESOP Tax Benefit (Kc=20%)	-	-
Equity Value for Common Shares	70,181,515	84,692,405
Less: Value of Total Equity Immediately After ESOP Transaction	17,209,184	17,209,184
Net Appreciation in Value Post Transaction	52,972,331	67,483,221
Portion of Total Equity Value Increase Attributable to Warrant	20.00%	20.00%
Simple Value of Warrant Exercise (does not account for option value)	\$ 10,594,466	\$ 13,496,644

Seller Debt IRR—Pre Transaction Taxes

	Year 7	Year 8
Principal	\$ 5,000,000	\$ 5,000,000
Interest Received	2,000,000	2,000,000
Equity Warrant Cash Out	-	-
Cash Inflow/(Outflow)	\$ 7,000,000	\$ 7,000,000

Year 2	Year 3	Year 4	Year 5	Year 6
\$ 11,236,000	\$ 11,910,160	\$ 12,624,770	\$ 13,382,256	\$ 14,185,191
5.00x	5.00x	5.00x	5.00x	5.00x
56,180,000	59,550,800	63,123,850	66,911,280	70,925,955
(30,000,000)	(25,000,000)	(20,000,000)	(15,000,000)	(10,000,000)
26,180,000	34,550,800	43,123,850	51,911,280	60,925,955
5,981,224	5,177,469	4,212,963	3,055,556	1,666,667
32,161,224	39,728,269	47,336,813	54,966,836	62,592,622
17,209,184	17,209,184	17,209,184	17,209,184	17,209,184
14,952,040	22,519,085	30,127,629	37,757,652	45,383,438
20.00%	20.00%	20.00%	20.00%	20.00%
\$ 2,990,408	\$ 4,503,817	\$ 6,025,526	\$ 7,551,530	\$ 9,076,688

Year 2	Year 3	Year 4	Year 5	Year 6
\$ 5,000,000	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000
2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
-	-	-	-	-
\$ 7,000,000	\$ 7,000,000	\$ 7,000,000	\$ 7,000,000	\$ 7,000,000

Year 9	Year 10
\$ 16,894,790	\$ 17,908,477
5.00x	5.00x
84,473,950	89,542,385
-	-
10,500,000	16,500,000
94,973,950	106,042,385
-	-
94,973,950	106,042,385
17,209,184	17,209,184
77,764,766	88,833,201
20.00%	20.00%
\$ 15,552,953	\$ 17,766,640

Year 9	Year 10
\$ -	\$ -
2,000,000	2,000,000
-	17,766,640
\$ 2,000,000	\$ 19,766,640

Estimated Pretax IRR on Seller Financing: 13%

This model illustrates that this investment unit requires warrants equal to 20% of the outstanding stock of the company in order to provide the holder with a 13% rate of return.

There are many relevant variables, including most importantly:

1. the estimated required rate of return for the investment unit;
2. the estimated growth rate for the company;
3. the estimated valuation multiple for the company;
4. the repayment schedule for the subordinated debt;
5. the stated interest rate on the subordinated debt; and
6. the time of exercise of the warrant.

Tax Issues

There are several key potential tax issues relating to investment units that include warrants in an ESOP transaction designed to result in a 100% ESOP-owned S corporation:

- Does an investment unit including warrants create a second class of stock, thereby terminating or invalidating an S corporation election under Section 1361 of the Code?
- What are the original issue discount tax concerns with respect to the investment units?
- What are the income tax consequences of the warrants included in the investment unit?

Warrants and S Corporation Single-Class-of-Stock Requirement

Under Section 1361 of the Code, a company that has more than one class of stock cannot become an S corporation or continue election as an S corporation. Treas. Reg. 1.1361-1(l) provides that a company is treated as having only one class of stock if “all outstanding shares of stock of the company confer *identical rights to distribution and liquidation proceeds*” (emphasis added). (Voting rights are not considered for purposes of determining identical rights.) Whether

all shares of stock confer identical distribution and liquidation rights depends on the corporate charter, articles of incorporation, bylaws, state law, and binding agreements regarding distribution and liquidation rights.

An S corporation's debt may be considered an additional class of stock if the instrument (1) constitutes equity or stock under general principles of federal tax law; and (2) has a principal purpose of circumventing either (a) the rights to distributions or liquidation proceeds of the outstanding stock or (b) the limits on eligible shareholders for S corporations.² Convertible notes may also be considered an additional class of stock if (in addition to the above rules) the conversion rights (such as a call option) are substantially certain to be exercised, and the conversion price is substantially below the fair market value of the underlying stock.

Code Section 1361 provides certain safe harbors. "Straight debt" is not a second class of stock. "Straight debt," according to Section 1361(c)(5)(B), must (1) be in writing; (2) be an unconditional promise to pay a sum certain on a specified date or on demand; (3) have interest rate and interest payment dates not contingent on the borrower's profits, the borrower's discretion, or similar factors; (4) not be convertible directly or indirectly into stock; and (5) be owed to a creditor that is either eligible to be a shareholder of the S corporation or is otherwise regularly engaged in the business of lending money.³ Generally, the portion of an investment unit that is debt for a fixed amount and with a stated and non-contingent rate of interest should readily fit within the statutory definition of "straight debt" and should not be considered a second class of stock.⁴

A warrant or option issued by a company is treated as a second class of stock if, taking into account all facts and circumstances, the warrant is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock on

2. Treas. Reg. §1.1361-1(l)(4).

3. See PLR 9746038 (subordinate debt can still qualify as straight debt). See also PLR 9342019.

4. If the note fails to qualify under the straight debt safe harbor, courts apply a "facts and circumstances" analysis to determine whether it is debt or equity. Consistent with the factors that courts use in their debt/equity analysis, the IRS published guidance in Notice 94-47, 1994-1 C.B. 357 (Apr. 18, 1994), with respect to determining whether an instrument will be characterized as debt for federal income tax purposes.

the date the warrant is (1) issued, (2) transferred to an ineligible S corporation shareholder, or (3) materially modified.⁵ The regulations contain a safe harbor for call options if, on the date the call option is issued, transferred to an ineligible shareholder, or materially modified, the strike price of the option is at least 90% of the fair market value of the underlying stock on that date. A good-faith determination of value by the company will normally be respected.

If a warrant is granted as part of an investment unit with a strike price equal to or in excess of the fair market value of the underlying stock, it should not be considered a second class of stock when issued. This may be best accomplished by issuing warrants as part of an investment unit associated with an S corporation redemption at a strike price equal to or in excess of the price paid by the ESOP for newly issued company stock after the redemption, as described in the above S corporation redemption transaction. In a C corporation seller-financed transaction involving a direct sale of shares to the ESOP, the warrant should be issued shortly following the ESOP transaction based on a post-transaction valuation of the company stock. This is why the C corporation model above contemplates an interim loan for several days before the creation of the seller debt instrument. Moreover, to assure that the warrants cannot be transferred to an ineligible S corporation shareholder, the warrants should include restrictions on transferability that would prevent transfer to an ineligible S corporation shareholder.

Warrants and Original Issue Discount

If a warrant is issued as part of an investment unit (consisting of a debt obligation and option rights), Code Section 1273(c)(2) requires allocation of the issue price of the note between the relative fair values of the note and warrant. The difference between the issue price of the note and its relative fair value is treated as original issue discount (OID) to the note holder. For example, assume X sells stock to Company A for \$1,000 and receives a \$1,000 note (face amount) with a warrant to purchase 500 shares of Company A stock at \$100 per share. If the warrant is determined to have a value of \$150, the value of the note would be \$850, and the additional \$150 paid by the company to equal the face amount of the note is treated as ad-

5. Treas. Reg. §1.1361-1(l)(4)(iii).

ditional interest on the note (ordinary income to the note holder) rather than return of principal (not taxable to the note holder). X must report OID ordinary income under Code Section 1272(a) ratably each year over the term of the note. Company A receives a corresponding deduction under Code Section 163(e).

X's inclusion in income of OID each year increases X's basis in the note. Upon exercise of the warrant, X does not realize gain or loss and takes a \$5,150 basis in the Company A stock (\$5,000 exercise price plus his \$150 basis for the warrant) he or she receives on exercise of the warrant. If X sells the warrant rather than exercising, he or she will realize capital gain or loss under Code Section 1234 on the difference between the \$150 basis and the amount realized on the sale. If the warrant lapses without exercise, X has a \$150 capital loss under Code Section 1234. Finally, Company A does not have any gain or loss on the issue, exercise, repurchase, or lapse of the warrants under Code Section 1032. See the discussion below on Revenue Ruling 78-182.

The proper allocation of fair value between the debt component and the warrant can be difficult to establish. There is little formal IRS guidance on valuing investment units. Over the years, the IRS has changed its stance in how it treats and respects the allocation of value among the parties involved in the transaction. The regulations under now defunct Code Section 1232 (repealed by the 1984 tax act) allowed OID to be eliminated on investment units by a written allocation agreement stating that the person acquiring the investment unit was paying face value for the note. The proposed OID regulations issued in 1986 (and withdrawn in 1992) also generally allowed OID to be eliminated by a written allocation agreement.

The final OID regulations issued in February 1994, however, do not provide for automatic IRS acceptance of the agreement of the parties. The regulations, instead, require consistency between the issuer and the holder of the investment unit. Pursuant to Treas. Reg. § 1.1273-2(h)(2), the issuer's allocation of the issue price of the investment unit is binding on the holder of the investment unit (but is not binding on the IRS) unless the holder discloses on its tax return for the year in which the investment unit is acquired that its allocation is different from the issuer's allocation.

In order to reduce the amount of OID on investment units, an issuer may issue an "out-of-the-money" warrant whereby the exercise price is significantly higher than the then current stock price

(the greater the exercise price is relative to the prevailing stock price, the lower the value of the warrant, all other variables held constant). Reducing the value of the warrant increases the amount of the issue price allocated to the note, thereby minimizing OID. Another means of reducing the value of the warrant is to shorten the time period of exercise.

Tax Consequences of the Warrants

The tax consequences for acquisition, exercise, and/or sale of a warrant are based on Revenue Ruling 78-182. The cost of a warrant acquired as part of an investment unit is a nondeductible capital expenditure. The gain or loss attributable to the sale or exchange of the warrant or the loss attributable to the failure to exercise the warrant is generally a capital gain or loss. This follows from the principle that a warrant will be considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates. If the stock to which the warrant relates would be a capital asset in the hands of the holder/investor, capital gain or loss results from the sale of the warrant before exercise. Under Code Section 1222, such a capital gain or loss is long-term or short-term depending on how long the taxpayer held the warrant before its sale. If the warrant is exercised, its cost is added to the basis of the stock purchased.

Why Are Warrants Important in ESOP Transactions?

ESOPs compete as a liquidity and succession alternative against other financial transactions. ESOPs are generally highly leveraged transactions, and it is often difficult or impossible to fund the transaction with senior debt. Junior lenders, including selling shareholders, may provide the necessary additional funds to complete a transaction if they are provided a fair rate of return commensurate with the risk of the investment. Warrants allow a company to provide a portion of this return without draining the company of necessary operating funds. The legal possibility to achieve liquidity and succession in privately held companies through ESOPs would be rendered meaningless if such transactions could not be funded on commercially

reasonable terms. Warrants issued in connection with subordinated debt are a critical tool to allow ESOPs to compete on a level playing field in financing buyouts of privately held companies.

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