

An **INTRODUCTION** to **ESOPs**

20TH EDITION

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Introduction

In the U.S. today, about 10.2 million employees in roughly 6,250 companies own stock in their companies through an employee stock ownership plan (ESOP), joined by a few million more ex-employee participants who are in the process of receiving distributions.¹ An ESOP is a company-funded retirement plan, very similar to a profit-sharing plan, that holds company stock in accounts for the participants. Both public and private companies can set up ESOPs. ESOPs are used for a variety of reasons, including to buy out existing owners, borrow money to acquire new assets, or provide a reward system that fits today's participative management styles. These and other applications receive substantial tax benefits.

Most ESOPs (more than 90%) are closely held companies. ESOPs are usually set up in healthy companies, although a handful have been used to save distressed companies. Most ESOPs are set up in companies

1. To be more exact, there are about 6,250 companies with ESOPs but about 6,500 ESOP plans because some companies have more than one plan. And in addition to the roughly 10.2 million employee participants, there are a few million ex-employees who still have balances in their ESOP accounts, for a total of almost 14 million participants.

Although most ESOPs are in private companies, most ESOP *participants* are in public companies because they have more employees. About 1.5 million current employees, plus about a half-million more ex-employees who still have account balances, are in private company ESOPs.

In addition to ESOP participants, more than a million employees in roughly 4,700 companies participate in profit-sharing plans and other ESOP-like plans that hold a substantial amount of company stock.

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What Is an ESOP?

ESOPs Defined

An ESOP is a qualified, defined contribution employee benefit plan that invests primarily in the stock of the employer company. “Qualified” retirement plans are those that meet certain Internal Revenue Code (“Code”) requirements. “Defined contribution” retirement plans are those that accumulate contributions to accumulate a benefit that is not defined in advance, unlike a defined *benefit* plan (like a traditional pension). ESOPs follow the same legal requirements as an ordinary 401(k) profit-sharing plan, like eligibility and nondiscrimination tests. They are funded with tax-deductible employer contributions and include various features such as distributions that may be rolled over to IRAs.

How ESOPs Work

To set up an ESOP, a company adopts an employee stock ownership plan and trust (ESOT) (also referred to as the ESOP trust). It is funded by one or a combination of the following methods: contributing company shares; contributing cash to buy company shares; or having the plan borrow money to buy shares and then making payments to the ESOP trust to repay the loan.

Note that company contributions, not the employee-participants themselves, fund the plan. While in some cases there may be changes

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Types of ESOPs and Their Financing

An ESOP may be funded either with a loan (a “leveraged ESOP”) or with discretionary contributions (a “nonleveraged ESOP”), and at the beginning can be funded solely by cash. Additionally, ESOPs may be combined with or converted from other employee benefit plans.

Prefunding with Cash

Although an ESOP must be primarily invested in employer stock over the life of the plan, it is possible to start an ESOP with cash contributions that are allowed to build up for a few years before the ESOP starts acquiring stock. This can prefund a large stock purchase, allowing for a smaller leveraged transaction down the road. There is no clear rule as to how many years an ESOP may be cash-funded for a stock purchase.

Nonleveraged ESOPs

With a nonleveraged ESOP, the sponsoring employer contributes newly issued or treasury stock and/or cash to buy stock from existing owners or the company (see figure 2-1). Contributions generally may equal up to 25% of covered payroll, which is the combined payroll of all employees benefitting under the plan. Employer contributions to

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ESOP Tax Incentives

Congress has enacted tax incentives for ESOPs that provide advantages for not only the sponsoring company but also the employees, the lender to an ESOP, and selling shareholders in closely held companies. Most states have laws that automatically track these provisions, thus magnifying the tax incentives.

Deductibility of ESOP Contributions

Employer contributions to the ESOP that are not used for payments on an ESOP loan are tax-deductible up to a limit of 25% of covered payroll. This limit also includes employer contributions to other defined contribution plans.¹ For a C corporation with a leveraged ESOP, a separate 25% limit is available to contribute up to an additional 25% used for payments on an ESOP loan (see chapter 7). This separate 25% limit does not include contributions to pay interest on the loan if the ESOP meets a special discrimination test for allocations of the ESOP shares purchased with the loan.²

1. Since the Tax Cuts and Jobs Act of 2017 became effective, the ability of companies with average revenue of \$25 million or more to deduct interest expenses has been limited. If such a company forms an ESOP and borrows a very large amount, it may find that the limit reduces the amount it can deduct. This is irrelevant to 100% ESOP-owned S corporations because they have no federal tax liability.
2. If not more than one-third of the contributions are allocated to the accounts of highly compensated employees, these interest payments are also excluded from the per-employee “annual addition” limit (discussed in chapter 7).

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Uses of ESOPs

Aside from their obvious use as a tax-advantaged way of providing an employee benefit, ESOPs have a variety of special applications, such as the following.

For Business Continuity

The most common use of an ESOP is to sell part or all of an owner's interest in a closely held company. In this situation, an ESOP provides substantial advantages over other alternatives:

- It provides a ready market for the stock.
- The company can fund the transaction with pretax dollars.
- The owner(s) may sell to the ESOP partially, or in stages over a period of years so they can gradually ease out of the company—a particularly important consideration for sellers with management responsibilities.
- In a C corporation, the selling owner(s) may defer taxation on the gains by using the Section 1042 “rollover” explained above.
- In an S corporation, distributions that would otherwise be used for shareholders to pay taxes on S corporation income may be used to fund a portion of the ESOP share purchase.

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Distributing Proceeds to the Participants

Distributions After Leaving Employment

The special rules for ESOP distributions provide that when employment terminates because the participant attains the normal retirement age under the plan, becomes disabled, or dies, the ESOP must begin to distribute vested benefits during the plan year following the event. When employment terminates for other reasons, such as when an employee quits, distribution must start no later than the sixth plan year after the plan year in which termination occurred (unless the participant is reemployed by the same company before then).

Under the special ESOP rules, distributions may be made in a lump sum or in substantially equal payments (not less frequently than annually) over a period no longer than five years (i.e., six payments over five years).¹ Distributions are made in the form of cash or stock.

If the ESOP is leveraged and in a C corporation, the plan may delay the commencement of distributions of shares acquired through the loan until the plan year after the plan year in which the ESOP loan is fully repaid. (It is unclear from the wording of the law whether

1. The five-year period may be extended when the account balance is very large: As of 2023, an ESOP distribution may be extended one year (up to a total of five additional years) for each \$265,000 or fraction thereof that the participant's benefit exceeds \$1,330,000 (these dollar amounts are indexed for inflation).

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Fiduciary and Trustee Matters

Who Is a Fiduciary?

Under the law, a fiduciary is someone who has a duty to act for the benefit of another with the highest standard of care, good faith, and honesty regarding the management of money or property. In the context of employee benefit plans such as ESOPs, ERISA defines a fiduciary as anyone who:

- exercises any discretionary authority or control over managing the plan or over the management and disposition of its assets;
- renders paid investment advice regarding its assets or has the authority or responsibility to do so; or
- has any discretionary authority or responsibility regarding plan administration.

This definition is broad and includes people such as plan administrators, trustees, investment managers, and in turn those who appoint others as fiduciaries. It includes not just those making decisions but also those who cause decisions to be made, regardless of their title. For example, an investment advisor who manages non-company stock assets is fiduciarily responsible for those assets; board members who choose plan fiduciaries are in turn fiduciarily responsible for that ac-

tion; and a CEO who influenced the voting of an ESOP administrative committee was found to be fiduciarily responsible for that action.

ERISA requires plan fiduciaries not only to act in the exclusive interest of plan participants but also to act prudently. Failure to do so may result in legal liability under ERISA for losses.

Inside vs. Outside Fiduciaries

An “inside” fiduciary is an employee of the company, and an “outside” fiduciary (a fiduciary who is not affiliated with the company, also termed an “independent” or “external” fiduciary) is not.

What Is the Trustee?

The trustee is a person or institution that is the legal owner of the ESOP’s shares and has a fiduciary role as the entity that runs the trust and serves as the shareholder of record.

ESOP Fiduciary Roles and Responsibilities

An ESOP, like all retirement plans under ERISA, must specify or provide a process for specifying a “named fiduciary” having the authority to manage the plan. Likewise, the ESOP trust must have a trustee to manage the plan’s assets, and a plan administrator, which is the plan sponsor itself if the administrator is not designated. (The “plan administrator” is not to be confused with the “administrator” serving as the plan’s recordkeeper, which is generally an outside third-party administrator [TPA].) The named fiduciary and plan administrator roles are often filled by the same entity, an ESOP administrative committee appointed by the board that assumes a fiduciary role in operating the plan (ESOP committees are discussed in chapter 13). In many companies, the board serves as the administrative committee. Those other than the named fiduciary who perform fiduciary functions are generally fiduciarily responsible only for the functions they perform.

Examples of ESOP Fiduciary Duties

Specific responsibilities for a fiduciary such as the trustee include, for example:

- Buying and selling company stock and other plan assets
- Accounting and reporting for plan assets
- Ensuring the plan is operated according to the plan document and in accordance with ERISA (such as rules for allocation, vesting, distribution, and so on being followed)
- Interpreting plan provisions
- Engaging the independent appraiser for transactions and yearly valuation updates
- Appointing other plan fiduciaries, and delegating responsibility among other fiduciaries
- Reviewing valuation reports and establishing the price of the ESOP's company stock based on the appraisal (in the relatively few public company ESOPs, there is no appraisal, and the market price is used)
- Voting ESOP-held shares, as for the board of directors; in situations where participants have pass-through voting rights (see chapter 11), conducting the vote properly, following the votes if participant directions comply with the plan and ERISA, and deciding whether to follow participant directions when voting unallocated and un-directed shares
- Monitoring issues such as the repurchase obligation, executive and director compensation, and the board's performance, and generally acting to protect plan interests against corporate actions that could harm them
- Documenting all decisions

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