

EXCERPTS FROM

An Introduction to **ESOPs**

How an employee stock ownership plan
(ESOP) can benefit your company,
its owners, and its employees

12th Edition

SCOTT RODRICK

Copyright © 2011 by the National Center for Employee
Ownership (NCEO). Do not reproduce or republish this
material without the express written permission of the NCEO.
See our Web site at www.nceo.org for more information.

Contents

Introduction.....	1
Chapter 1: What Is an ESOP?.....	2
Chapter 2: Types of ESOPs and Their Financing.....	7
Chapter 3: ESOP Tax Incentives	12
Chapter 4: Uses of ESOPs.....	17
Chapter 5: Valuing the Company Stock	20
Chapter 6: ESOPs for S Corporations.....	26
Chapter 7: Contribution and Allocation Limits	32
Chapter 8: Employee Coverage and Entitlement to Benefits	35
Chapter 9: Distributing Proceeds to the Participants.....	38
Chapter 10: Fiduciary Matters.....	44
Chapter 11: The Rights of ESOP Participants	46
Chapter 12: Is an ESOP Right for Your Company?.....	49
Chapter 13: Implementing and Administering an ESOP.....	52
Chapter 14: A Final Caveat	55
Index.....	56
About the NCEO and Its Publications.....	59

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. ESOPs are “qualified” (i.e., tax-qualified) in that in return for meeting certain rules designed to protect the interests of plan participants, ESOP sponsors receive various tax benefits. ESOPs are “defined contribution plans.” The employer makes yearly discretionary contributions that accumulate to produce a benefit that is not defined in advance. In contrast, under defined *benefit* plans (like traditional pension plans), employees are guaranteed a specified benefit funded by the company through required contributions.

Technically, an ESOP is simply a variation of a stock bonus plan or combination stock bonus/money purchase pension plan that is designed to invest primarily in employer stock. (Under a stock bonus plan, the employer pays out an employee benefit in the form of company stock. Money purchase pension plans are retirement-oriented plans that commit the company to a minimum annual contribution.) An ESOP is the only type of qualified employee benefit plan that can also borrow money from or on the credit of the employer, provided the ESOP uses the money to buy employer stock.

How ESOPs work. To set up an ESOP, a company creates an employee stock ownership trust (ESOT) (also referred to as the ESOP trust) and funds it 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 in other compensation when an ESOP is set up, employees only rarely buy stock directly for their ESOP accounts.

The ESOP may acquire treasury shares, newly issued shares, or shares of existing shareholders. Employees do not directly buy or hold shares

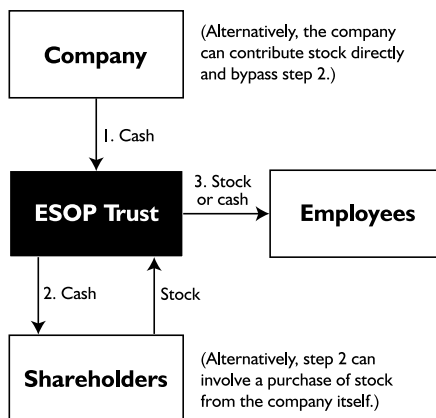
Types of ESOPs and Their Financing

ESOPs belong to a broad category of employee benefit plans known as defined contribution plans. Other examples of defined contribution plans are 401(k) plans and profit-sharing plans. Like a small private bank, a defined contribution plan maintains a separate personal account for each participating employee. An ESOP may be funded either with a loan (a “leveraged ESOP”) or with discretionary contributions (a “nonleveraged ESOP”). Additionally, ESOPs may be combined with or converted from other employee benefit plans.

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 diagram below). Contributions generally may equal up to 25% of covered payroll, which is the combined payroll of all employees eligible for participation. Employer contributions to other defined contribution plans are included in the same 25% limit and may reduce the amount the company can contribute to the ESOP.

A Nonleveraged ESOP

1. Company contributes cash and/or stock to ESOP. 2. If cash was contributed, ESOP buys stock from shareholders and/or company. 3. Employees receive vested account balances (in stock and/or cash) when they retire or otherwise leave the company.



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 generally are tax-deductible up to a limit of 25% of covered payroll (this limit also includes employer contributions to other defined contribution plans). For a C corporation with a leveraged ESOP, the 25% limit does not include contributions to pay interest on the loan.¹ The law appears to allow a C corporation to also contribute up to an additional 25% that is not used for payments on an ESOP loan (see chapter 7).

The deduction limits for an S corporation ESOP are the same as for a nonleveraged C corporation ESOP. However, even if the S corporation ESOP is leveraged, the company is not entitled to exclude the loan's interest expense from the 25% limit. In a C corporation, the company takes the deductions and reduces its taxes. In an S corporation, the deduction reduces the taxable income that is reported on the tax returns of any non-ESOP shareholders, who then benefit from the deduction.

Deductibility of dividends paid on ESOP-held stock. C corporations can deduct dividends paid on ESOP-held stock in three ways. First, dividends may be paid in cash to ESOP participants, either directly or as payments to the ESOP that are distributed to participants within 90 days after the close of the plan year. Second, dividends may be applied to a leveraged ESOP's loan payments. (However, only dividends paid on the shares purchased with the loan may be used to make payments on the

1. 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).

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.

As a tool of corporate finance. A leveraged ESOP can be used to borrow money that could be used to buy another company or new equipment, or to refinance debt. To accomplish these goals, the company issues new shares and sells them to the ESOP in a leveraged transaction, using the proceeds from the sale of new shares to finance acquisitions or to refinance debt. The company raises new capital by allowing the ESOP to buy new shares; this is funded by corporate contributions to the ESOP that come from pretax company cash flow. While this dilutes the ownership of the non-ESOP shareholders, it allows a much less costly repayment of the loan and simultaneously provides an employee benefit plan. If prop-

Valuing the Company Stock

Valuation is one of the most important ESOP issues. The ESOP cannot pay more than fair market value for stock it acquires, and in a closely held company, all transactions involving company stock must be based on a valuation from an independent appraiser. There is a potential conflict of interest here, especially when the ESOP trustee (who is responsible for determining that the ESOP is not paying more than fair market value for the stock) is a selling shareholder who would benefit from high price,¹ but the ESOP and its participants would benefit from a lower price.² Given this conflict and the effect valuation has on the benefits participants receive from the ESOP, it is not surprising that many ESOP-related lawsuits involve valuation. The basic rules are as follows:

1. *The stock must be valued at least annually, and as needed for transactions.* The laws and regulatory authority governing ESOPs require that all assets held by an ESOP, not just company stock, be valued at least once per year. Even if there are no transactions during the year, that value is used for the participants' account statements and for the ESOP's Form 5500 annual report filed with the U.S. Department of Labor. Additionally, stock must be valued when it is sold (or contributed) to the ESOP, which ensures that it will not pay more than fair market value. When employees are cashed out of their ESOP shares, the price they receive is the fair market value. ESOPs are often set up so that after the appraiser delivers the annual appraisal report, account statements are provided to employees and shares
1. A corporate officer who reports to a selling shareholder could also be in a conflicted situation, feeling pressure to give his or her boss "the right price" for the shares. If the company contributes stock directly to the ESOP, it too would benefit from a higher price because it would receive a greater tax deduction (assuming it is paying taxes and can thus use the deduction).
2. The conflict of interest is especially grave if the selling shareholder is also the trustee. For this reason, it is very unwise for the seller to become the trustee, even though it is not against the law.