EXCERPTS FROM

An Introduction to ESOPs

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

18th Edition

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CHAPTER 1

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 through the plan. Instead, the plan trustee buys, holds, and sells the shares in the trust's name for the benefit of the employees. References in this book

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CHAPTER 2

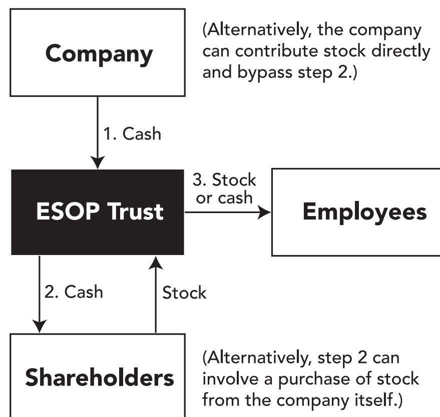
Types of ESOPs and Their Financing

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.



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CHAPTER 4

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 properly structured, the corporation's growth due to the additional capital will exceed the dilution caused by issuing new shares.

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CHAPTER 5

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 a 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 (DOL). Additionally, stock must be valued when it is sold (or contributed) to the ESOP, which ensures that the ESOP will not pay more than fair market value. When the ESOP buys stock from a selling shareholder or engages in a transaction with other parties in interest, such as the company, fair market value must be determined as of the date of the transaction. In contrast, when employees are cashed out of their ESOP shares, the price they receive is the fair market value as

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.

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