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

21ST EDITION

Scott Rodrick

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Introduction

In the U.S. today, about 10.7 million employees in roughly 6,322 companies own stock in their companies through an employee stock ownership plan (ESOP), joined by several 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 roughly 6,322 companies with ESOPs but about 6,533 ESOP plans because some companies have more than one plan. In addition to roughly 10.7 million employee-participants, there are several million ex-employees who still have balances in their ESOP accounts, for a total of about 14.7 million participants. See the infographic “A Statistical Snapshot of ESOPs” at the end of chapter 1. For details and updates, go to <https://www.nceo.org/r/esopnumbers>.

Although most ESOPs are in private companies, most ESOP *participants* are in public companies because they have more employees. About 1.7 million current employees, plus about 600,000 more ex-employees who still have account balances, are in private company ESOPs.

In addition to ESOP participants, about 76,724 employees in over 4,900 companies participate in profit-sharing plans and other ESOP-like plans that hold a substantial amount (20% of more) of company stock.

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. “Qualified” retirement plans are those that meet certain Internal Revenue Code (“Code”) requirements. “Defined contribution” retirement plans are those that receive contributions to accumulate a benefit that is not defined in advance, unlike a defined *benefit* plan (like a traditional pension). ESOPs follow many of the same legal requirements as an ordinary 401(k) or 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, with the company making contributions to the ESOP trust for it 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.

2

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, excluding pay over \$350,000

3

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). Contributions to pay interest on the loan are deductible as well, and in C corporations, they are not counted toward the 25% limit if the ESOP meets a special

-
1. Aside from this, since the Tax Cuts and Jobs Act of 2017 became effective, the total interest deduction allowed under Code Section 163(j) for large companies, meaning those with more than \$31 million in gross yearly receipts (as of 2025; the IRS adjusts this dollar figure yearly for inflation under Internal Revenue Code Section 448(c)) has been limited to the sum of business interest income, 30% of adjusted taxable income, and floor plan financing interest. 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 the (ESOP) shareholder has no federal tax liability.

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.

10

Fiduciary and Trustee Matters

The ESOP's operations are governed by a trustee or trustees as well as other fiduciaries. These can range from individual persons to committees to institutions.

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 (as noted below, this is not the ESOP's third-party administrator [TPA]), trustees, investment managers, and in turn those who appoint

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, as well as generally acting to protect plan interests against corporate actions that could harm them
- Documenting all decisions

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ESOP Sustainability: Keeping Your ESOP for the Long Term

Sustainability in the ESOP world means keeping the plan going for the long term. This was not much of an issue when ESOPs first emerged. Some ESOPs were created as one-time transactions to buy out a single owner, to be terminated later so remaining owners could assume 100% ownership. In other cases, the company implemented an ESOP but hoped to be acquired later. Even if the ESOP was intended to be a long-term plan, companies were not yet dealing with issues like massive repurchase obligations built up over many years. And there was not yet a huge financial incentive for companies to remain ESOP-owned.

How Having a Sustainable ESOP Became a Hot Topic

After ESOPs could own S corporations starting in the late 1990s, the idea of being ESOP-owned forever became more popular due to the S corporation tax shield. However, this massive financial incentive to keep the ESOP going was coupled with financial and other challenges: As ESOPs matured, more companies faced repurchase obligation pressures. Also, the idea of having a more satisfying and productive ownership culture spread, but this means incoming leaders should embrace

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