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Exploring the ESOP Concept

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What is an employee stock ownership plan (ESOP)? It is a qualified retirement plan, a succession plan, a market for non-publicly traded stock, an employee incentive program, and more.

Employee stock ownership plans (ESOPs) are a small portion of the world of qualified retirement plans. There are about 6,500 ESOPs in the United States. There are about 600,000 401(k) plans. However, an ESOP has many benefits not available under a 401(k) plan.

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Retirement Plan

An ESOP is the only type of qualified retirement plan that is designed to invest *primarily* in "qualifying employer securities" (defined below). An ESOP provides benefits to employees based on the value of the employer's stock and, in so doing, provides a powerful equity incentive that motivates employees to grow the value of employer stock. The participant is rarely required or even allowed to make contributions to an ESOP. It is an employer-funded benefit. Most ESOP companies also sponsor 401(k) plans.

ESOPs are subject to the standard participation, vesting, and allocation features common to all qualified plans, but with certain unique exceptions. They are also subject to the same nondiscrimination rules, Internal Revenue Code (Code) Section 415 limits and top-heavy requirements as other qualified plans. And an ESOP benefit is tax-deferred as in other retirement plans.

On the other hand, as discussed above, ESOPs are different from other retirement plans because they are designed to invest primarily in employer stock. Most retirement plans may not have more than a 10 percent investment in employer stock. An ESOP also can sell employer stock to and buy employer stock from the employer, another shareholder or a plan fiduciary. Buying and selling plan assets with the employer is generally prohibited in other retirement plans. In addition, the participant has the right to demand his benefit is paid in employer stock (unless the employer is an S corporation under Code Section 1361(b), or the employer's bylaws restrict ownership to the ESOP and active employees).

Succession Plan

An ESOP also serves as a corporate finance tool to provide liquidity to existing shareholders, potentially on a highly tax-advantaged basis, while at the same providing for a transfer of partial or full ownership of the company to employees as beneficial owners.

In an outright sale to a strategic or private equity buyer, the shareholder may lose operational control. There are confidentiality issues, as well. Business owners typically want to avoid disclosing information to a person who either is a competitor or could become a competitor, in case the deal does not go through. With an ESOP, however, the owner can access wealth built up in the company without losing control or having to reveal confidential information regarding the company to any potential competitors.

Qualifying Employer Securities

The term "qualifying employer securities" includes common stock of the employer (or a corporation that is a member of the employer's controlled group) that is readily tradable on an established securities market, which does not include securities on the over-the-counter (OTC) market or traded on "pink sheets," but does include most foreign securities. If the employer stock is not readily tradable, "qualifying employer securities" means the common stock issued by the employer or its affiliate having a combination of voting power and dividend rights equal to or greater than the class of common stock with the greatest voting power and the class of common stock with the greatest dividend rights. Under certain circumstances, membership units in an LLC may also qualify. If the stock is not readily tradable, it must be valued on an annual basis by an independent appraiser.

Leveraged ESOPs

As mentioned above, ESOPs can borrow money to purchase employer securities. The ESOP is called a "leveraged" ESOP in this case. Because a retirement plan borrowing money is normally a prohibited transaction (if the lender is the employer or another related entity) or a transaction that produces unrelated business income, the ESOP loan must meet stringent requirements to be exempt from these rules. The employer must either make the loan to the ESOP or guarantee a loan provided by a third party. Any proceeds of a loan will be used, within a reasonable time after the loan is obtained, only to purchase employer stock, repay the loan, or repay any prior loan. A loan will provide for no more than a reasonable rate of interest. The maturity date under the loan must be definitely ascertainable at all times (for example, no lines of credit). In the event of a default, the loan can provide for a transfer of ESOP assets only upon and to the extent of the failure of the ESOP to meet the repayment schedule of the loan. The only plan assets that may be given as collateral on an ESOP loan are the shares of employer stock acquired with the proceeds of the loan.

Shares of employer stock purchased with a loan are placed in a suspense account. As loan payments are made, shares are released from suspense and allocated to participants' accounts. The ESOP will repay the loan by forwarding amounts contributed by the employer to the lender. Usually, the employer is the lender, so it is a net amount transaction. The employer contributes cash to the ESOP and the ESOP immediately pays the contribution back as a loan payment.

Disadvantages of ESOPs

The main disadvantages are the complexity and costs associated with the ESOP, both on an initial and ongoing basis. ESOPs require a number of service providers to operate, including valuation firms, recordkeeping firms, ESOP attorneys, and often independent trustees. As a result, costs of maintaining an ESOP can be significant. The overall expenses associated with an ESOP often are much higher than maintenance of a 401(k) or other employee benefit plan.

In addition, if the stock is not readily tradeable, the employer is always obligated to fund the ESOP's payment of benefits to terminated participants. ESOP participants can demand that the employer purchase the stock in their accounts when benefits are paid. This funding requirement is often called the repurchase obligation. There is no requirement to prefund or set aside funds, so sometimes the employer is surprised with a large obligation in certain years. To mitigate the surprise, employers use repurchase obligation studies that project future funding needs.

Tax Advantages of ESOPs

There are several tax advantages involved in selling to an ESOP and maintaining an ESOP.

1. *Shareholder Advantages*. Code Section 1042 tax deferral is an important tax advantage for shareholders. A shareholder who participates in a sale of shares to a C corporation ESOP, where the ESOP after the sale has at least 30 percent ownership in the employer, may take the proceeds of his sale and invest them in qualified replacement properties. In doing this, the shareholder only pays tax on the basis of the stock and defers taxation of the capital gains indefinitely. "Qualified replacement properties" include most publicly traded US securities.
2. *Company Advantages*. A C corporation employer sponsoring an ESOP may deduct the interest payments on the ESOP loan. In addition, all leveraged ESOPs have special rules under Code Section 415 that may allow more contributions to be allocated to participants' accounts than would be allowed in other qualified plans.
3. *Participant Advantages*. Participants also may have special tax advantages (other than the tax deferral on plan assets allowed for all qualified plans). If a participant receives a lump sum distribution of employer stock upon termination of employment, he can pay ordinary income tax on the basis of the stock, and capital gains on the increase in the value of the stock. This is called net unrealized appreciation (NUA) treatment. Assuming the capital gains rate is less than the participant's ordinary income tax rate, and the value of the stock has grown significantly, NUA treatment can lower the participant's tax liability immensely.

ESOP Myths

1. The shareholder or management of the company may worry that the ESOP or the ESOP trustee will take control of the company out of their hands. Experienced ESOP trustees do not want to get involved in running the company. They monitor the board of directors and the company financials at least annually, but it is extremely rare for a trustee to take control (unless there is gross negligence or willful misconduct in the management of the company).
2. Another common concern is that the employees will take over management of the company. In an ESOP installation, it is often said the "employees are buying" the company. This sounds nice, but it is not true. The ESOP trust buys the company and is the shareholder so is technically the party that appoints the Board of Directors. ESOP participants are considered "beneficial" owners. They have no rights to make decisions or insert themselves in management unless the employer says so.
3. Many companies are dissuaded from implementing an ESOP because they think they will have to provide open book financials to the employees as beneficial owners. Some ESOP companies do have open book financials, and some companies have them before even becoming an ESOP, but there is no requirement to share financials with employees.
4. A fourth myth is that an ESOP company is less attractive to potential buyers down the road. Granted, buying an ESOP company does have some complexities, due to the ESOP trust's fiduciary obligation to get the best deal for the ESOP. However, statistics have shown that ESOP companies can be more attractive to buyers because of their culture, loyal employees, and strong financials.

Conclusion

Obviously, ESOPs are not for every employer. However, they may be the right fit for shareholders who do not want to sell to a competitor. Or for companies that want to get their employees invested in the success of the company. Or for those who want to sell the company but also provide a retirement benefit for the employees. There are numerous reasons to consider an ESOP. For employers that want more retirement savings for their employees than a matching contribution to the 401(k), an ESOP might be the ticket. Whatever the reason, do not pass the ESOP concept by without consideration. ■

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