ESOP Basics

What is an ESOP?

Employee Stock Ownership Plans, or ESOPs, were designed as a way to put ownership into the hands of American workers. Begun in 1974 with the passage of federal laws, ESOPs comprise an estimated 11,000 companies in the US, employing an estimated 11.5 million workers. The laws enacted to encourage employee ownership allow certain incentives for lenders, selling owners, and ESOP companies. The tax advantages of ESOPs often make them a lower-cost source of corporate financing than conventional sources.

An Employee Stock Ownership Plan, or ESOP, is a qualified benefit plan with special features. These features make ESOPs quite different from other types of retirement plans. Created in 1974 under federal law, ESOPs must meet governmental regulations issued by the Department of Labor (DOL) and the Internal Revenue Service (IRS).

Some Facts about ESOPs:

- An ESOP can borrow money to purchase a company or some portion of it. Other pension plans cannot borrow funds. ESOPs can also borrow funds for company expansions or capital improvements.
- An ESOP invests primarily in employer stock, whereas regular pension plans normally diversify their investments. ESOPs can own anywhere from a fraction of 1% to 100% of a company's stock.
- ESOP stock is held outside the company in a separate trust. The trustee acts on behalf of, and in the best interests of, all the employee participants. Within the trust, separate accounts are maintained for the individual stockholders.

Common Questions about ESOPs

Q: As an ESOP shareholder am I personally liable for the company's debts?

A: No, your personal property is not at risk. Like regular stockholders, ESOP participants are not personally liable for the debts of the corporation.

Q: Who gets the profits in ESOP companies?

A: As stockholders, you get a portion of company earnings. Your portion could be kept in the company, in which case it increases the value of your stock. Or, your portion may be distributed to you in the form of a dividend, in which case you will receive a cash payment. The board of directors determines what portion of the earnings will be distributed to stockholders and what portion will be retained by the company.

Q: Can I vote my Stock?

A: It depends. In most cases, the trustee votes the stock because the stock is held in trust. However, federal law requires that voting rights be passed through to all ESOP participants on major issues such as liquidation, merger, or purchase offers. In some ESOPs, the trustee must vote all stock according to the participants' instructions; in these companies, ESOP participants have essentially the same voting rights as typical owners of common stock.

Q: What happens if the company goes under?

A: If a company is dissolved, employee owners have a claim on the company's assets after all debts of the company have been paid.

Q: Can I sell my stock?

A: Yes, though usually you sell it back to the company according to the ESOP agreement. ESOPs are pension plans so you do not usually receive the bulk of your stock until retirement. Federal law requires closely held ESOP companies to repurchase distributed stock from participants who have left the company.

The ESOP Trust

The trust has two basic parts, a holding account for unallocated shares, and individual accounts that hold the stock allocations for each participant in the ESOP. Remember that the trust is a separate entity from the company.

The holding account, which is commonly called a suspense account, holds stock shares until they are allocated. Upon allocation, the stock moves from the suspense account into individual accounts.

Individual accounts hold the allocations, interest earnings, and any reinvested dividend or dividend interest earnings accumulated by individual participants. It is the responsibility of the ESOP Trustee to insure that the transactions are made according to the ESOP plan rules, and to represent the interests of ESOP participants at shareholder meetings.

The Purchase

A simple transaction involves only four parts.

1. The bank makes a loan to the company. Usually this loan is made with an agreement that the company will make a "mirror loan" to the ESOP.
2. The company makes a mirror loan to the ESOP. Since the ESOP has no assets, the bank makes the loan to the company, secured by the assets of the company.
3. The ESOP pays the original owners and is given their stock. Another option is to set up a new company. Then the ESOP purchases stock from the new company, and the new company uses the cash to purchase the assets from the original company.

A complex transaction involves one or more additional investors. In such a transaction:

1. The outside investors give the company their equity investment in return for stock **and** the bank makes a loan to the company.
2. The company makes the "mirror loan" to the ESOP. The ESOP purchases shares from the company.
3. The company uses the funds received from both the outside investors and the ESOP to purchase either the stock of the original company from the original owners, or the assets directly from the original company.

Note: Both of these transactions are cases in which the money that purchases stock for the ESOP is borrowed or "leveraged." In leveraged buyouts, the stock which is given to the ESOP is placed in the suspense account. This stock is released to the individual accounts as the ESOP loan is repaid.

Repaying the ESOP Loan

Each year the company pays back part of the principal on its ESOP loan. The loan payments are made through the ESOP to the bank. The payments, therefore, are considered deferred income, like contributions to a pension plan (which is exactly what they are). This payment releases the stock in the suspense account to the individual accounts. The stock is released in amounts proportionate to the amount of the loan which is repaid. If the company pays 1/10 of the loan then 1/10 of the stock in the suspense account is released or allocated into the individual accounts. The number of shares allocated to individual accounts depends on the amount of the company's contribution and the allocation formula established by the ESOP. Under DOL guidelines, allocations must be based on a fair formula. For example, hours worked, W-2 earnings, equally, a combination of these, or some other formula that meets federal guidelines.

Once the stock is allocated to individual accounts, it is subject to a vesting schedule, like other pension plans. Vesting in an ESOP works just as it does in a regular pension plan. Although stock may be allocated to your account, you do not have a full claim on it until you are 100% vested. Federal law requires that employees be completely vested after seven years of being in the plan, although many ESOPs vest more quickly.

Getting the Value of Your Stock at Retirement

Typically, employees receive the stock allocated to their individual account (distribution) at retirement. A distribution can be in stock or cash, depending on the plan rules. If the stock is not readily tradable (not traded on a public stock exchange), the participant has the right to exercise a put option, which is a right to sell back the shares to the company. In turn, the company has an obligation to purchase your shares.

The company is required to repurchase the shares distributed to you at the price determined by the valuation of the ESOP stock for that year. Valuation is a determination of the "fair market value" of the stock. Federal guidelines specify that valuations should be conducted at least annually, and that they should be done by a qualified, independent appraiser.

Once the put option is exercised and the stock value is determined, the retired (deceased, disabled or terminated) employee is assured of payment of his or her account balance. However, the company may choose to pay in one lump sum, or in installments with interest over a maximum of five years.

Fair market value is the amount at which an asset would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

Advantages of ESOPs

The ESOP is a flexible way to hold company stock. An ESOP can own as little as a fraction of 1 percent of the company stock, or as much as 100 percent of the company stock. The ESOP is one form of corporate ownership which can be combined with other forms of stock ownership among employees and outside shareholders.

ESOPs can help to improve company performance. Studies have shown that companies that combine employee ownership and employee involvement are likely to outperform comparable conventional companies in productivity, job creation and overall corporate performance.

On top of improving their performance, ESOP companies enjoy significant tax advantages. The tax incentives make ESOPs an excellent mechanism for low cost financing, as well as another form of tax deferred income for employees.

Common tax advantages of ESOPs

- **Company:** Company contributions and dividend payments held within the ESOP are tax-exempt, with certain restrictions. A leveraged ESOP, one in which a loan is used to finance the purchase of stock by the ESOP, offers added tax benefits. Both principal and interest payments are pre-tax expenses.
- **S-Corp:** Subchapter S Corporations do not pay federal income tax directly. The shareholders of S-Corps show their share of the company's income as personal income on their own individual tax form and pay tax according to their own personal tax rate. Normally, an S-Corp distributes, at a minimum, sufficient cash to the shareholders to enable them to pay their tax liability. Since an ESOP is a tax exempt retirement trust, it has no tax liability. If it receives a cash distribution, this can be held in the ESOP participants' accounts for tax free investment growth. If the ESOP owns 100% of the S-Corp, there is no need to make a cash distribution at all, since none of the shareholders needs the cash to pay income tax. This leaves the company with a greater amount of cash for reinvestment and other business purposes.
- **Seller:**The seller has a tax incentive called the 1042 rollover or the capital gains rollover. This amounts to a deferral of capital gains tax payments on sale of stock to an ESOP. To take advantage of this tax incentive, the ESOP must own at least 30% of the firm.
- **Employees:** Company contributions to the ESOP are tax-sheltered for employees; so is the increase in value of employee accounts.Employees do not pay taxes on the stock in their accounts until they cash out at retirement or after leaving the company.