ESOP Basics

When Employee Ownership Makes Sense

Overview

The number of Employee Stock Ownership Plans (ESOPs) in the United States has increased from approximately 200 employing 250,000 workers in 1974 to over 11,000 established ESOPs in 2005 covering an estimated 11 million employees. This dramatic increase is due in large part to the implementation of ESOPs as: a competitiveness strategy, a business succession plan, a strategy for tax-advantaged corporate financing and a means to avert a plant shutdown.

Employee Ownership in the United States

The mushrooming of employee ownership over the last decade is due in large part to the legal recognition of ESOPs in the Employee Retirement Income Security Act of 1974 (ERISA). This act gave statutory definition to a concept introduced by Louis Kelso and Patricia Hetter in *How to Turn Eighty Million Workers Into Capitalists On Borrowed Money* (1967). Kelso and Hetter believed greater economic growth could be achieved by a broadening of corporate ownership. Since capital is the primary source of an affluent society, "universal capitalism" is a prerequisite for real economic expansion. Corporate ownership had concentrated wealth and a vehicle was needed to encourage a broader population to accumulate shares of corporate ownership so individuals could gain a viable share of corporate wealth which they in turn could use to develop their personal wealth. As the number of people with multiplying net worth grew, so would the economy grow at a substantially increased rate, Kelso and Hetter proposed to motivate corporations via tax incentives and finance the leveraged acquisition of new capital through the discount window of the Federal Reserve. Less than a decade later their proposal was made part of U.S. economic policy as Congress awarded ESOPs tax-favored status in the Employee Retirement Income Security Act (ERISA) of 1974.

How an Employee Stock Ownership Plan Works

An Employee Stock Ownership Plan, or ESOP, is a tax-qualified employee benefit plan that invests primarily in stock of the sponsoring employer. ESOPs must meet governmental regulations issued by the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS). The simplest way to understand how an ESOP works is to conceptualize it as a variation of a traditional profit-sharing plan. Contributions made to the ESOP are tax deductible and income earned by the ESOP is tax-deferred. Since the ESOP is a retirement plan, employees are not taxed on their accounts until the money is withdrawn.

So what is the difference between an ESOP and the traditional profit-sharing plan or other pension plans? There are two key distinctions:

- An ESOP is the only qualified employee benefit plan that can borrow money; and
- An ESOP invests primarily in employer stock and may own anywhere from a fraction of 1% to 100% of a company's stock, whereas traditional pension plans are subject to stricter diversification requirements.

Similar to other pension plans, ESOP stock is held outside the company in a trust that is a separate legal entity. The trustee has a fiduciary obligation to act in the best interest of all employee participants in the ESOP. Within this trust, separate accounts are maintained for individual stockholders. In a leveraged situation, 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 and are therefore tax deductible business expenses, just like other contributions to a pension plan.

Tax Incentives for ESOPs

The most significant tax incentives established by Congress to encourage companies to set up ESOPs are:

1. An individual who sells 30% or more of his or her stock in a closely-held corporation to an ESOP may defer the capital gains tax if the proceeds of the sale are reinvested in other domestic securities. The income tax on the gain would be due upon the sale of the replacement property but if the replacement securities pass into the estate, the transfer to any beneficiaries is treated as a stepped-up basis and no capital gains is ever paid.
2. If the corporation uses an ESOP to obtain a loan, it may deduct the principal as well as the interest payments on the loan. For many companies, this is a excellent strategy for corporate financing and can cut borrowing costs by one-third. Imagine if you could do this on your home loan!
3. Dividends paid in cash on shares held by an ESOP are deductible by the sponsoring corporation if they are passed through to the participants in the plan or they are used to pay off a loan taken out to finance the purchase of company stock.
4. Participants in the ESOP have tax-sheltered accounts until their benefits are withdrawn, typically at retirement.

Employee Ownership Makes Sense . . .

Whether you are exploring employee-ownership as a strategy for stable business succession or a tool for tax-advantaged corporate financing, you should begin by assessing your philosophical beliefs and personal comfort level with the underlying concepts of employee-ownership. If communicated effectively and coupled with participation, employee ownership can also be a powerful tool to motivate employees.

. . . As a Competitiveness Strategy

In addition to the tremendous tax incentive and financing opportunities there are also many work performance advantages to employee ownership. The General Accounting Office's (GAO) recent survey of ESOP firms found that the combination of employee ownership and employee participation yielded substantial improvements in firm performance. There are numerous research studies that indicate this direct and positive correlation between high levels of employee participation on the shop floor in employee owned companies and increased performance and production.

. . . As a Business Succession Plan

Most employee-owned firms are successful and profitable businesses. Approximately 58 percent of Ohio ESOPs instituted employee ownership primarily to purchase shares from retiring owners. As previously mentioned, a retiring owner who sells thirty percent (30%) or more of the company's stock to an ESOP trust may defer capital gains if the proceeds of the sale are reinvested in other U.S. operating companies. This tax incentive is an attractive strategy for the owner to begin exiting the business while still maintaining control and taking care of his or her employees and the community by retaining jobs for the long haul.

. . . As a Strategy for Tax-Advantaged Corporate Financing

Unlike profit-sharing and other employee benefit plans, ESOPs may borrow money to purchase company stock. In fact, 10% of Ohio employee-owned businesses used an ESOP loan as the primary means to finance company expansion. This is really a tax-advantaged financing tool since the company can deduct both the principal repayments as well as interest on an ESOP loan. After the ESOP trustee uses the loan to purchase stock from the company, the company may then use the proceeds for any acceptable business purpose such as purchasing equipment, buying another company, taking a private company public, or financing the sale of the stock. This technique will greatly reduce the company's financing costs.

. . . As a Means to Avert Plant Shutdown

ESOPs may be used as a vehicle to save jobs and anchor capital in communities when job loss threatens. Although employee buyouts to avert plant shutdown are more common in Ohio than any other state, only five percent of Ohio firms instituted employee ownership primarily to avert job loss.

Turning around troubled companies through employee ownership is a difficult but worthwhile undertaking. There are approximately 300 companies that were bought by employees through an ESOP loan to avert a shutdown or major job loss in the United States. A few of these companies are: Northwest Airlines, Weirton Steel in West Virginia, and Bliss-Salem in Salem, Ohio. These companies and many others across the U.S. would no longer be operating today if they had not become employee-owned.

How to Get Started

If you are considering an ESOP for your company you may want to begin your exploration by talking with folks from other employee owned companies similar in size and culture. Sometimes this is the simplest and best way to gain a true understanding of all the costs and benefits of establishing an ESOP.

You may also want to search the Internet, attend seminars, and research journals to determine if employee-ownership fits your philosophical beliefs. If you find yourself comfortable with the concept, explore various alternatives in structuring an ESOP. Finally, if you want to use employee ownership to increase competitiveness, it is advisable to establish open channels of communication with the employees and maintain a consistent level of input for employee participation.