Is There an Ideal ESOP Plan?

Bill McIntyre

Virtually every ESOP service provider begins an answer to every ESOP question with the phrase, "It depends." What they mean is that their answer depends upon the specifics of the situation. Regardless of the specifics, we know that employee ownership combined with an ownership culture results in improved corporate performance. We also know that ESOP Plan provisions can either facilitate the development of an ownership culture or be obstructive to its creation. Relatedly, we know that certain ESOP Plan provisions provide incentives for ESOP participants to behave in ways that could cause financial distress for companies.

The ideal ESOP Plan should provide an incentive for all ESOP Plan participants at all times to work for the long-term success of the company.

By looking at the behavioral implications of ESOP Plan provisions, we can arrive at an ideal ESOP Plan. "Yes, Virginia, there is an ideal ESOP Plan."

Let's look at the basic ESOP Plan provisions in the sequence in which they would be encountered by an ESOP Plan participant and determine the ideal Plan provisions (ideal provisions are in *italics*).

1-ESOP ELIGIBILITY:

Age = 21, but with credit for years of service prior to age 21
Time of Service = 12 months of continuous service
Hours Worked = 1,000 hours during the 12 months

These are the typical maximums allowed by Law, and they are the most common choice of ESOP companies. Choosing an age less than 21 might be appropriate; however, given the reality of typical rapid turnover of 16-20 year-old employees, it's worth avoiding the administrative expense by not making employees eligible for the ESOP until they reach age 21. For those teenagers that do stay, they are rewarded by having those years worked count as years of service for ESOP vesting purposes. Having a months-of-service and hours-worked requirement will avoid administrative costs for short-term employees as they will never enter the ESOP and fulfilling those requirements will be a badge of honor for those employees who are then eligible for the ESOP. Making it too easy to be eligible reduces the impact of the accomplishment of becoming eligible.

2-ENTRY DATE:

Immediately after fulfilling eligibility requirements.

This avoids the largest problem with new hires' perceptions re the ESOP. They believe that when they are "eligible" to be in the ESOP, they are "in" the ESOP; however, the reality is that they do not enter until the next Entry Date after they have become eligible. If the next Entry Date is Jan 1 and the Plan Year ends on Dec 31, then, even though the new employee might have become eligible at any time Jul-Dec, they will not receive an allocation of ESOP shares on Dec 31 because they would not technically "enter" the ESOP until Jan 1. This is a huge negative surprise for new Participants. Having the Entry Date be the same date as the date the person becomes eligible for the ESOP avoids this problem entirely and allows employees who are "eligible" for the ESOP to truly be "in" the ESOP, too.

3-CALCULATION OF COMPENSATION FOR FIRST YEAR:

All compensation during the year as reported on the W-2 are included in the allocation formula. Although not reported as W-2 income, Compensation would include 401(k) deferrals or 125 Plan (aka Cafeteria Plans or Flexible Spending Account plans) contributions.

The philosophy expressed is: Participants are eligible for the Plan Year and contributed during the entire Plan Year; therefore, we'll count all compensation earned during the year – rather than, the Participant was eligible as of Aug 15; therefore, we'll count only compensation earned after Aug 15. If this philosophy was not adopted and only compensation earned after the Eligibility Date was used in the allocation formula, this would result in new Participants having only a small allocation in their first year, perhaps an embarrassingly small allocation, thereby possibly causing them to be quite negative and cynical about the worth of ESOP. That is not a desired result. This choice makes sure that the eligibility and entry into the ESOP will be a pleasant experience for new Participants.

4-VESTING:

Graded 6-Year Schedule (i.e., 0%-20%-40%-60%-80%-100%)

The typical choice is between the 6-year graded schedule and a 3-year cliff (0%-0%-100%) schedule. The 6-year graded schedule still requires 2 years of service before a person begins to be vested; thus, people who stay only a short time still do not enter the ESOP and do not become a hassle to track administratively because they never become vested in their ESOP account. Plus, the graded schedule offers an incentive for a person to stay another year because, not only will they receive another allocation, but also they will become an additional 20% vested in their ESOP account. The cliff schedule only offers that incentive in 1 year (year 3) and has been known to offer the perverse incentive for people to leave the company after year 3 because "their ship has come in." Finally, employees who have worked 6 years at the company are generally going to stay at the company, and that is the desire – keep the good employees at the company.

4A-PLAN YEAR:

The company's fiscal year and the ESOP Plan Year will be the same.

Administration of the ESOP is vastly simplified if the company's fiscal year and the ESOP Plan Year are the same.

next page ▶

4B-YEAR OF SERVICE:

A Plan Year in which an employee works 1,000 hours counts as a Year of Service.

This is very much the norm for ESOP companies and is consistent with the eligibility requirement of working 1,000 hours before becoming eligible.

4C-CREDIT FOR SERVICE PRIOR TO THE ESOP:

Unless the employees paid out of their own pockets to purchase ESOP shares from a selling owner (e.g., using their 401(k) funds) or an existing plan is converted into an ESOP, for vesting purposes, no credit will be given for service prior to the establishment of the ESOP.

The ESOP is new, and everyone starts off on the same basis re vesting. Years of service to the company are taken into account in the Allocation Formula [see 5B].

4D-VESTING & RETIREMENT

An ESOP Participant reaching the Retirement Age for the ESOP is automatically 100% vested, even if the Years of Service requirement is not achieved.

The ESOP is fundamentally a retirement plan, so allowing a Participant who works until Retirement Age to become 100% vested is consistent with the intent of the Plan. This is also required by Law.

4E-VESTING & DEATH & DISABILITY:

An ESOP Participant who dies or becomes disabled is automatically 100% vested, even if the Years of Service requirement was not achieved.

Although not required by law, vesting on disability or death is pretty much a universal ESOP design feature.

5-ACCUMULATION OF SHARES

5A-RELEASE OF SHARES AS ESOP NOTE IS PAID OFF:

Principal + Interest formula [i.e., the % of shares held in the ESOP Suspense Account that are released each year is the same as the % of remaining Principal + Interest paid during the Year on the ESOP Note]

The other allowed method is "Principal Only," which can result in strange allocations if the loan structure involves a balloon payment. The safer bet is to go with the "Principal + Interest" method. Further, the law permits "Principal Only" only if the term of the ESOP Note is for 10 years or less.

5B-ALLOCATION INTO INDIVIDUAL ESOP ACCOUNTS OF SHARES RELEASED:

Eligible ESOP Participants would receive an allocation of shares released and of company cash or stock contributions into the ESOP based on a formula weighted as follows:

50% - W-2 compensation with no deductions for 401(k) deferrals or 125 Plan deferrals

50% - Years of Service including years of service prior to the establishment of the ESOP

By far, the most common Allocation Formula among ESOP companies is W-2 compensation, and the W-2 allocation formula is a "safe harbor" formula and would allow the company to avoid certain ESOP discrimination tests, thereby saving the company $500-1,000 in ESOP administration fees per year. Nevertheless, there is growing interest in other factors being included in the Allocation Formula:

1) Compensation is included in the formula because, while imperfect, compensation is probably the best single indicator of an individual participant's ability to influence the performance of the company. Highly paid new employees are thus incentivized.

2) Years of Service are included in the Allocation Formula because the company should want to reward loyalty to the company. All participants are incentivized to stay employed at the company year after year.

Please note – using multiple factors in the formula may require specialized non-discrimination testing because this would not be a "safe harbor" formula.

5C-ELIGIBILITY FOR INCLUSION IN ALLOCATION FORMULA – GENERAL RULE:

ESOP Participants who have worked at least 1,000 hours during the Plan Year and who are employed as of the close of business on the last day of the Plan Year are eligible to receive an allocation.

The incentive here is simple. If participants want to receive an allocation, they should stay as employees.

5D-ELIGIBILITY FOR INCLUSION IN ALLOCATION FORMULA – EXCEPTION FOR DEATH, DISABILITY & RETIREMENT

ESOP Participants who die, become disabled or retire during a Plan Year will receive an allocation for that Plan Year.

This approach is fair for deceased or disabled participants, who probably would have satisfied the requirements if they had not died or become disabled. It is also fair for retirees. It enables a retiree to retire without penalty on any day of the year, a fact that would be appreciated by retirees. Retirees receiving a nice ESOP benefit can be the best salespersons to current ESOP participants. Companies do not want ESOP retirees to be complaining about how they received no benefit from their hours worked during their last Plan Year. This avoids that possibility.

6-FORFEITURES:

Forfeitures of the unvested portion of ESOP Participants' individual ESOP accounts would occur:

For participants with 0% vesting = Immediately

For participants with 20-80% vesting = after completion of 5 consecutive years of break-in-service.

Ex-employee ESOP Participants have the right to step back into their ESOP account if they are re-employed by the company before they have completed 5 consecutive years of break-in-service. [A year of break-in-service is a year in which the person works less than 500 hours.]

A zero percent vested ex-employee ESOP Participant can be forfeited immediately as that is considered to be a "distribution" of the Participant's account; thus, they have no account to step back into – it's already been distributed.

However, a partially vested ex-employee ESOP Participant does have an account to step back into if they are re-

next page ►

employed before incurring the 5 years of break-in-service. If that Participant's shares have already been forfeited and allocated to other eligible Participants, the company may have difficulty finding shares to put back into the re-employed Participant's ESOP account. That is an unnecessary hassle that can be completely avoided if the forfeiture for partially vested Participants does not occur until they've completed 5 consecutive years of break-in-service. This assumes, however, the participant does not receive a distribution of their vested benefit.

6A-ALLOCATION OF FORFEITURES:

Shares that are forfeited are allocated based 50% on W-2 compensation and 50% on Years of Service.

The typical treatment of forfeitures is to have them reallocated in the same manner as contributions are allocated. This greatly simplifies administration and non-discrimination testing.

7-COMMENCEMENT OF ESOP BENEFIT DISTRIBUTION

7A-COMMENCEMENT OF BENEFIT DISTRIBUTION FOR "OTHER TERMINATION" (i.e. NOT Death, Disability or Retirement):

After the completion of 5 consecutive years of break-in-service (i.e., a 6-Year Wait)

There are four primary justifications for having ESOP Participants who leave for "Other Termination" reasons wait until they begin to receive their ESOP benefit distribution:

1) An immediate commencement of payout of their ESOP benefit distribution may provide ESOP participants with an incentive to leave the company simply so that they can receive their ESOP benefit distribution. That is not a desirable outcome. ESOP companies want to retain good employees, not provide them with an incentive to leave.

2) An immediate commencement of payout of their ESOP benefit distribution may provide ESOP participants with an incentive to leave the company if the company is having a bad year, which should result in the ESOP stock price declining from last year's higher price. Participants are thus incentivized to leave and be paid at last year's higher price. If the company is having a bad year, chances are it is not doing well financially, either. So, in this case, an immediate commencement of payout provides an incentive for participants to leave and begin to collect their ESOP benefit precisely when the company is least able to make those payments. That is not a desirable outcome.

3) Not having the ability to leave and collect cash immediately, but having to wait 6 years before receiving a payout, employees will be motivated to make the company successful for the long term, or else they will not receive their ESOP benefit.

4) An immediate commencement of payout of Participants' ESOP benefit distribution makes those immediate payments unpredictable and, therefore, unmanageable and will likely cause the company a financial crisis at some point due to the payout requirements at that point exceeding the company's ability to pay. That is not a desirable outcome. No ESOP company should have an ESOP Plan provision that puts the survivability of the company at risk.

5) If ESOP Participants complain about having to wait 6 years before they begin to receive their ESOP benefit distribution, they can be informed that if they want their ESOP benefit distribution to begin sooner, then they should stay employed at the company until they reach Retirement Age, and that is exactly the proper incentive for employees. They should be incentivized to stay until they reach Retirement Age. The company does not want good employees to leave!

7A-1-TREATMENT OF SHARES DURING THE WAITING PERIOD:

Leave Participants' ESOP shares as shares during the waiting period; i.e., do NOT convert them to cash.

Converting shares immediately to cash requires the company to have cash available at all times. The company cannot guarantee that cash will always be available. See 7A-3 above. Also, converting their shares to cash removes the incentive for Participants to work for the long-term success of the company and replaces it with an incentive to maximize stock price in the year before they plan on leaving. This is of special concern if the participant in question happens to be the CEO of the company. That's not a healthy incentive for the CEO or any employee to have and can be quite destructive to the company.

7B-COMMENCEMENT OF BENEFIT DISTRIBUTION FOR DEATH, DISABILITY OR RETIREMENT ("DDR"):

Prior to the end of the Plan Year following the Plan Year during which DDR occurred; i.e., if someone retires in 2012, they'll begin to be paid their ESOP benefit distribution before the end of 2013.

This is required by Law.

7B-1-RETIREMENT AGE

Retirement Age = 62.

That does not mean that a person must retire when they reach age 62. It simply means that if they leave the company before they reach age 62, they are paid their ESOP benefit distribution per the "Other Termination" rules and that if they leave after they reach age 62, they are paid their ESOP benefit distribution per the Retirement rules.

62 is younger than the current normal retirement age of 65-67 (depending on date of birth) as prescribed by the government for Social Security benefit purposes. Having a younger than "normal" retirement age sends a message that an ESOP participant is free to choose to retire younger than the normal retirement age and retire under Retirement rules. This is treating the company's retirees well – treating them as adults with freedom to choose. It's a provision that will be appreciated by ESOP participants. It also correlates with the Age 55 Diversification provision that ends at age 61 for participants who begin the election at age 55. It does mean participants are 100% vested at age 62 regardless of service.

next page ►

7C-OFFERING OF CONSENT TO DISTRIBUTION:

Require participant's consent for ESOP benefit distributions ≥ $1,000

The government requires consent for all ESOP benefit distributions from ESOP accounts with balances ≥ $5,000 but a separate government regulation requires the automatic rollover to an IRA of balances of $1,000-$5,000 for ESOP Participants who are eligible to receive their ESOP benefit distribution but who have provided no instructions to the ESOP as to how to make the payment to them. In most cases for which this applies, it is because neither the company nor the ESOP can locate the ESOP participant. Because banks (and other financial institutions) will likely be extremely reluctant to open an IRA account for a person whom they have never met and for whom they have no contact information, to avoid the hassle of trying to find a financial institution that is willing to open such an IRA, most companies avoid the problem by requiring consent for all ESOP benefit distributions ≥ $1,000. This is the prudent approach.

7C-1-FREQUENCY OF ASKING FOR CONSENT:

Every year until participants say "yes" & consent to commence the ESOP benefit distribution.

Note that once they say "yes" the die is cast. They have consented to all distributions in an installment distribution. They will NOT be asked to consent separately to each distribution in an installment distribution. Once they say "yes" they are not asked again.

Some Plans offer "consent" to an ESOP Participant when they are first eligible to receive their ESOP benefit distribution but then do not ask again until the Participant reaches Retirement Age per the ESOP Plan. For example, let's say ABC Company is such a company and that Harvey started with ABC Company at age 22 and quits at age 37 after 15 years of service. At age 43, after the 6-year wait, Harvey is eligible to begin receiving his ESOP benefit distribution. If Harvey says "no", then ABC Company would not allow him to begin receiving his ESOP benefit distribution until reaching age 65, the Retirement Age for ABC's ESOP. That is a wait of 23 years. In all likelihood, once that is explained to Harvey, he will change his mind and elect to begin receiving the ESOP benefit distribution. In effect, such a policy takes away the usefulness of the "consent" option. Harvey is pretty much forced to consent. Harvey will not be happy and will likely voice his displeasure to other participants. This is not a desirable outcome.

An ESOP company should allow the consent option to be a real option for ESOP Participants; thus, the choice of allowing Participants to be offered the consent option every year until they say "yes."

8-FORM OF BENEFIT DISTRIBUTION

8A-INSTALLMENT DISTRIBUTION:

Up to a 5-Year Installment Distribution (may be up to 5 years longer, max of 10 years total, for accounts ≥ $985,000 with 1 additional year being allowed for each $195,000 above the limit – both the $985,000 and $195,000 are adjusted annually for inflation) with lower dollar amounts being paid in less than 5 years; for example, for ESOP Account balances:
$0-25,000 – lump sum payout
$25,001-50,000 – 2 payments, 1 immediate & 1 after 1 year
$50,001-75,000 – 3 payments, 1 immediate & 2 more after years 1 & 2
$75,001-100,000 – 4 payments, 1 immediate & 3 more after years 1, 2 & 3
$100,001-125,000 – 5 payments, 1 immediate & 4 more after years 1-4
>$125,000 – 6 payments, 1 immediate & 5 more after years 1-5

This methodology has numerous advantages:

1) Shorter distributions for small payouts gets smaller accounts off the books sooner.
2) Longer distributions for larger payouts minimizes the impact on a given year of a large balance payout.
3) Payouts at the end of years 1-5 are predictable and, therefore, easily incorporated into the company's comprehensive financial plan.
4) Provides an incentive for all employees to work for the long-term success of the company because, if the company is not successful, then their ESOP benefit distribution will be smaller.

8B-DDR DISTRIBUTION:

Distribution must be completed within 5 years of the date of DDR.

This is required by Law, unless the participant elects otherwise.

8C-STOCK PRICE USED IN CALCULATING VALUE OF SHARES:

Each year's payment is paid at the then current stock price per share; i.e., the stock price varies from year to year.

This methodology both provides an incentive for all employees to work for the long-term success of the company so that they will benefit from higher stock prices and also removes the element of "luck" from determining the size of an ESOP benefit distribution. ESOP Participants receiving a single lump sum payout may be hurt unfairly if they happen to be paid after a down year for the company and a corresponding low stock price and, similarly, may be rewarded unfairly if they happen to be paid after a boom year for the company and a corresponding high stock price. Installment payouts involving 6 payouts mean that participants are much more likely to receive a mix of payouts from good years, bad years and everything in between. That is perceived as a much fairer method versus a single payment in an amount determined only by the "luck of the draw".

8D-OPTION FOR PARTICIPANT TO CONVERT ESOP ACCOUNT TO CASH DURING THE WAIT PERIOD:

No.

See the explanation of the rationale for 7A-1 above. It applies here, too.

next page ►

8E-RECYCLING vs. REDEMPTION OF SHARES:

Recycling is preferred; i.e., ESOP benefit distributions will be paid by the ESOP (not by the company), and the shares will be reallocated amongst eligible ESOP participants.

With recycling, new eligible ESOP Participants will receive an allocation of shares repurchased. That would not happen with redemption unless the shares were re-contributed to the ESOP. There is no guarantee that shares would be re-contributed. Also, recycling is easier to understand. Here is an explanation of the mechanics of recycling vs. redemption.

RECYCLING:

1) The company contributes cash to the ESOP to cover the required payment of the ESOP benefit distribution to the departed ESOP Participants.
2) The cash contribution is allocated to all eligible ESOP Participants based on the formula described in 5B above.
3) Newly eligible Participants share in the allocation of the cash contribution.
4) Remaining Participants use the cash to pay the departed ESOP Participants their ESOP benefit distribution in return for shares from the departed ESOP Participants. So, newly eligible ESOP Participants receive some shares of stock.

REDEMPTION:

1) The ESOP distributes the departed ESOP Participants their ESOP benefit distribution in the form of shares of stock.
2) The departed ESOP Participants are required to immediately sell their shares of stock to the company.
3) The company pays the departed ESOP Participants the value of their shares of stock. This payment is in cash.
4) The company retires the shares of stock that were redeemed.
5) At this point, newly eligible ESOP Participants receive nothing – no cash (because there was no ESOP contribution) and no shares (because the shares were retired). Also at this point, existing old ESOP Participants see an increase in the value of their shares because there are now fewer shares outstanding. Many companies practicing redemption stop at this point.
6) If steps 1-5 are continued over a period of years, a “have” and “have-not” situation develops whereby old Participants are thrilled because the value of their shares keep going up and new Participants see no value in the ESOP because they’ve been in the ESOP for several years and never receive an allocation of anything!
7) To avoid the “have” and “have-not” situation, the company re-contributes to the ESOP the shares repurchased from departed ESOP Participants. Sometimes this is done on an equal basis with shares repurchased and sometimes it is done on a percent of payroll basis.
8) The re-contribution of ESOP shares is allocated based on the formula in 5B above.
9) Newly eligible Participants share in the allocation of the share re-contribution … and the “have” and “have-not” situation is avoided.

8F-TYPE OF DISTRIBUTION:

Cash. [Participant is NOT allowed to receive their ESOP benefit distribution in the form of shares. This requires a statement in the corporate bylaws.]

Ultimately, the objective for most ESOP companies is to become a 100% ESOP-owned company that then elects S Corporation status and becomes exempt from paying Federal and State income tax. [Ohio has no State corporate income tax at the moment – it has a Commercial Activity Tax (CAT) instead – so the exemption from State income tax is of no benefit.] If shares are allowed to go outside the ESOP, then it becomes difficult to become a 100% ESOP-owned S Corp. The bylaw restriction disallowing ownership of shares by anyone other than the selling owners or their beneficiaries or the ESOP facilitates companies becoming 100% ESOP-owned S Corps.

9-AGE 55 DIVERSIFICATION – FORM OF DIVERSIFICATION

Age 55 Diversification applies to those ESOP Participants who have achieved at least 10 years of active participation in the ESOP (i.e., 10 years of service) and have reached age 55 and allows them to elect in the Plan Year after the Year in which they qualify:
Years 1-5: 25% diversification of their ESOP stock
Year 6: 50% diversification of their ESOP stock
Years 7+: election disappears

The Age 55 Diversification is required by Law; however, the company has options as to how it allows Participants to implement the diversification. The ideal choice:

For eligible ESOP Participants electing Age 55 Diversification, the following alternatives in implementing the diversification are available for selection by the Participant:
--Rollover into participant’s 401(k)
--Paid as Cash to participant
--Direct Rollover to participant’s IRA

The primary other option available here is to make it mandatory that Participants electing the Age 55 Diversification roll over the amount diversified into their 401(k). That option represents the paternalistic philosophy that the ESOP is a retirement plan and the company is going to make sure that Participants keep the ESOP funds in a retirement plan, the company’s 401(k).

This is not ideal because of the basic belief that the ESOP benefit distribution belongs to the Participants and not to the company and that, therefore, the Participants should have a choice as to where the amount diversified (an ESOP benefit distribution) is paid.

SUMMARY

Each of these ESOP Plan provisions provide an incentive for all employees (old & young, long-term & new, top management & middle management & line supervision &

next page ▶

hourly employees, highly paid & lower paid) at all times (good times & bad times) to work as best they can for the long-term success of the company. As such, we have described an ideal ESOP Plan.

Is your ESOP Plan ideal?

If you have other thoughts on provisions for an ideal ESOP Plan, please let us know and we'll be happy to publish them.

PS Even this "ideal" ESOP Plan is not ideal. It does not address one problem. Please read the accompanying article on Early Diversification. **OAW**