ESOP Law Group

DESCRIPTION AND PURPOSE OF AN ESOP

General Description

An Employee Stock Ownership Plan ("ESOP") is an employee benefit plan which is qualified for tax-favored treatment under the Internal Revenue Code ("Code"). A plan is qualified if it complies with various participation, vesting, distribution and other rules established by the Code to protect the interests of the employees. An ESOP is classified as a special type of employee benefit plan since it is designed to invest primarily in stock of the employer corporation. An ESOP must also comply with various reporting and disclosure requirements and fiduciary responsibility rules of the Employee Retirement Income Security Act of 1974 ("ERISA").

An ESOP is a "defined contribution plan" and an "individual account plan." That is, the company's contribution is defined and the employee's benefit is variable. Each participating employee's separate account is credited with an appropriate number of shares of company stock over the period of his employment. After retirement, death, disability or other termination of service, the employee's account is distributed to him (or his beneficiary) in shares of stock or in cash equal to the fair market value of the stock allocated to his account. An employee's benefit, thus, is not defined — as with a defined benefit pension plan — but is dependent upon the value of his stock.

What Do Employees Receive From an ESOP?

ESOP assets (company stock and other investments) are allocated each year to the accounts of all employee participants in the ESOP, by a formula usually based on the proportion of an employee's salary to total covered payroll. Assets of the ESOP are held in an ESOP trust established under a written trust agreement and administered by a trustee and/or administrative committee responsible for protecting the interests of employees (and their beneficiaries).

An employee is not taxed on contributions to his ESOP account (or income credited to the account) until his benefits are actually distributed to him. Even then, "rollovers" (into an IRA, for example) or special tax treatment available for ESOP distributions can reduce or defer the income tax consequences of distributions.

An ESOP, like most employee benefit plans, generally is designed to benefit employees who remain with the employer the longest and contribute most to the company's success. Therefore, an employee's ownership interest (in company stock and other assets held in the ESOP) usually is based on his number of years of employment. The employee's ownership interest in the ESOP is called his "vested benefit," which is based upon the "vesting schedule." Although there are various vesting schedules which may be used (extending for periods up to six years), most are designed so that the longer the employee stays with the employer, the greater his vested benefit becomes.

If an employee terminates employment for any reason other than retirement, death or disability, his vested benefit under the ESOP will be determined by referring to the vesting schedule. Any company stock in which the employee does not have a vested benefit (because he has not worked long enough) will be treated as a "forfeiture," which will be allocated among the ESOP accounts of the remaining employees, usually on the same basis as company contributions. If an employee retires, dies or is disabled, he generally will be 100% vested in his total account balance.

After an employee's participation in the ESOP ends, he (or his beneficiary) is eligible to receive a distribution of his vested benefit. There are many permissible times and methods for making this distribution. For example, it may be made as soon as possible after an employee's termination of employment, or it may be deferred for a period of up to six years. However, distribution of a former employee's vested benefit generally must start in the year following his retirement, disability or death. Payment may be made in a lump sum or in installments over a period of up to five years. In a closely-held company, distributions are usually made in cash or in shares of stock which may be sold back to the company.

How Does an ESOP Benefit Employers?

As a technique of corporate finance, the ESOP can be used to finance an ownership transition, to raise new equity capital, to refinance outstanding debt or to acquire productive assets through leveraging with third party lenders. Since contributions (and certain dividends) paid to an ESOP are tax-deductible, a company can fund both the principal and the interest payments on an ESOP's debt service obligations with pre-tax dollars.

Federal Income Tax Effects to the ESOP Sponsor

Company contributions to an ESOP are tax deductible within the limitations of the Code. A company may contribute to an ESOP up to 25% of eligible payroll per taxable year. If the ESOP is leveraged and the company was a C corporation, the company may increase contributions beyond the 25% level to the extent that the excess is used to pay the ESOP's interest expense. In addition, cash dividends paid by a C corporation on ESOP stock are deductible if applied to the repayment of ESOP debt or if currently distributed in cash to ESOP participants. Under Section 415 of the Code, the "annual additions" which may be allocated to the account of an individual ESOP participant each year normally may not exceed the lesser of 100% of his compensation or $53,000 (adjusted annually after 2015). The "annual additions" include employer contributions (but not dividends), any employee contributions and certain forfeitures which are allocated to the employee's account, although contributions used to pay loan interest will usually not be treated as "annual additions" for a C corporation.

Tax Benefits to Selling Shareholders

An ESOP provides an internal market for stock of a closely-held company. The Code provides a special tax incentive for certain sales of stock to an ESOP, subject to satisfying a number of specific rules. A shareholder of a closely-held C corporation may be able to sell stock to an ESOP, reinvest the proceeds in other securities and defer taxation of the long-term capital gain resulting from the sale (so long as a number of special requirements are satisfied).

Voting Rights

In a closely-held company, unless otherwise determined by the Board of Directors, employees have voting rights on allocated shares only with regard to certain major corporate issues, such as merger, certain asset sales, recapitalizations or liquidation of the company. On all other matters, ESOP shares are usually voted by the ESOP trustee or administrative committee which has been appointed by the Board of Directors. In a publicly-traded company, employees have voting rights on all shares allocated to their accounts under the ESOP.

S Corporations

Since 1998, an ESOP has been permitted to be a shareholder of an "S" corporation. An ESOP is not subject to tax on its share of the S corporation's taxable income. The deduction for contributions to an S corporation ESOP will be limited to 25% of covered payroll even if the contributions are used for payments on an ESOP loan. In addition, dividends paid on S corporation stock in an ESOP will not be tax-deductible, and tax-deferred treatment will not be available to a shareholder who sells S corporation stock to an ESOP. The combination of the tax flow nature of S corporations and the tax exempt status of ESOPs permits a business to eliminate most if not all of its federal income tax if the ESOP becomes the 100% owner of the S corporation.

Legislative Environment

ESOPs have existed since the 1950's, but were first formalized under Federal law with the enactment of ERISA in 1974. Since that time, significant ESOP incentives have been included in numerous amendments to federal statutes.

The legislative history has been quite favorable for ESOPs and has served to expand their use. The intent of Congress was made abundantly clear when, in an unprecedented move, it included language in the Tax Reform Act of 1976 specifically endorsing the use of ESOPs as techniques of corporate finance. The Tax Reform Act of 1984 and the Tax Reform Act of 1986 included significant tax incentives for ESOPs and ESOP financing. In 2001, EGTRRA made clear the use of ESOPs in S corporations.

THE ESOP AS A FINANCING MECHANISM

Introduction

An ESOP is often defined as a "technique of corporate finance." A company may make tax-deductible contributions in cash or stock to the ESOP trust. If this contribution is made in company stock, the resulting tax deduction increases the company's cash flow and the additional cash can be used for any corporate purpose. If the contribution is made in cash, the ESOP can use the cash to purchase stock from the company itself, from existing shareholders or from retiring or terminated employees who have received distributions of stock from the ESOP.

Following termination of employment, a participant's vested benefit may be paid from the ESOP in cash or in stock. An ESOP participant generally has the right to demand to receive his distribution in stock and retain ownership of the shares individually. However, two important exceptions, one for S corporations and one for C corporations, largely eliminate any concerns that might otherwise be caused by this provision.

Corporate Finance Uses of ESOPs

An ESOP is mandated by law to invest its contributions primarily in stock of the sponsoring company. It is also the only qualified employee benefit plan which is permitted to borrow funds on company credit in order to acquire company stock. These differences provide significant flexibility for a company using the ESOP as a tool of corporate finance and make possible its use to accomplish a variety of corporate and shareholder objectives not readily achievable through other methods. Some of these objectives include:

- *Acquisition financing:* ESOP contributions allow the acquirer to amortize the principal payments on acquisition debt with pre-tax dollars. Because the ESOP thus generates more capital internally, the company enjoys a much healthier cash position and financing is easier to obtain for various transactions, including leveraged buyouts of publicly-traded and closely-held companies.

  After acquisition financing has been amortized, the ESOP can provide a market for stock of the founding shareholder group using pre-tax dollars. Without this market, it might be necessary to sell the company or take it public in order for the founders to obtain a return on their investment.

- *Acquisition of assets or general business financing using pre-tax dollars:* ESOP contributions can be used to shelter principal payments on normal corporate debt, effectively allowing the corporation to take tax deductions on principal payments which can significantly reduce the after-tax cost of borrowing. In a leveraged ESOP transaction, the company may effectively amortize the loan out of pre-tax income of the business, since the corporation's payments are treated as employee benefit plan contributions which are fully tax-deductible. In a conventional loan, only interest is deductible by the borrowing corporation. Assuming a marginal income tax rate of 40%, a corporation would have to earn approximately $10 million pre-tax to provide funds to amortize principal on a $6 million loan. Pretax income of only $6 million is needed to generate funds to amortize the $6 million principal of an ESOP loan. Thus, cash flow to service acquisition debt is increased substantially in a properly structured ESOP.

- *Purchase of stock from major shareholders:* The ESOP can provide a market for stock of major shareholders and their estates. Using the ESOP to buy the shares of principal shareholders has advantages over direct redemption by the company. The company's contribution to the ESOP is tax-deductible so that the stock purchase is accomplished with pre-tax dollars, thus conserving the company's cash and net worth. Controlling shareholders receive capital gains treatment on sales of their stock to an ESOP when selling only a small portion of their holdings. If certain conditions are met, selling shareholders of a closely-held company may defer or avoid capital gains tax on sales of stock to an ESOP.

- *An alternative to going public:* An ESOP can be used as a tool analogous to going public "internally." The ESOP can provide a market for stock of current shareholders or for the purchase of newly-issued shares. This can be accomplished without the problems and expenses normally associated with being a publicly-traded company. However, the ESOP does not prevent a future sale, merger or public offering of the company should that become desirable.