What is an ESOP?

An ESOP is a qualified, defined contribution employee benefit plan that invests primarily in the stock of the employee company.

To set up an ESOP, a company creates a trust fund for employees, which is funded by one of the following methods.

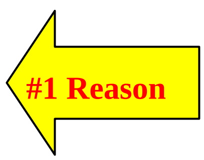
1. Contributing company shares.

2. Contributing cash to buy company shares.

3. Borrow money to buy shares; company makes payments to the ESOP trust to repay the loan (leveraged ESOP)

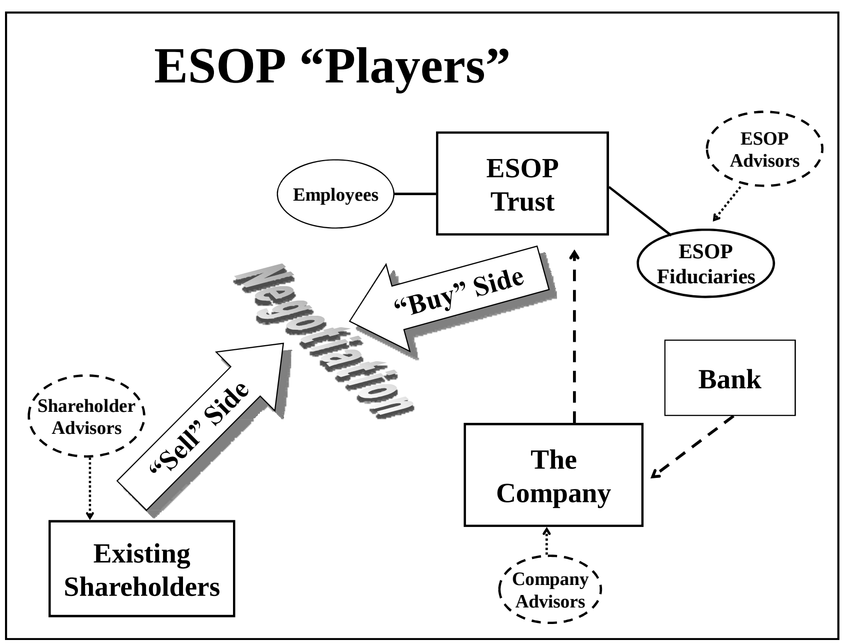
Three Common Uses of ESOPS

- Buy stock of a retiring owner.



- Extra employee benefit plan.

- Source of capital for new acquisitions, etc.



Advantages and Disadvantages of ESOPs

The advantages and disadvantages to *Existing Shareholders* are as follows

Existing Shareholders

Benefits

- Tax Free § 1042 Rollover
- Liquidity
- Sell a minority interest & keep control
- Employee motivation

Pitfalls

- Cost and Complexity
- Bank Loan Guarantee
- Loss of control to obtain a control premium
- Dilution for new stock issues

§ 1042 Rollover Requirements

- Seller must have owned stock for 3 years.

- 30% Rule:
  - ESOP must own at least 30% of a "C" corporation's stock
  - Two or more shareholders can be combined
  - Single transaction

- Qualified Replacement Property:
  - Includes – stocks, bonds, & other U.S. corporation "securities"
  - Does not include – gov't bonds, mutual funds, REITs, partnerships

- Reinvestment Time Period:
  - 3 months before sale
  - 12 months after sale

Note:
10% Excise tax to the Company if ESOP sells § 1042 stock within 3 years form the date of Purchase.

Big Tax Saving Strategy!

Step #1: A C Corporation purchases all of the privately held stock; the selling shareholders obtain the *tax-free § 1042 rollover* advantages

Step #2: The Corporation elects to be taxed as an S Corp

ESOP
Advantages and Disadvantages

Advantages

1. Tax Free Rollover

If an ESOP acquires at least 30% of the stock, the selling shareholders are eligible for a tax-free §1042 rollover reinvestment of the proceeds into qualifying securities. The shareholders must make the reinvestment within the period 3 months before and 12 months after the ESOP stock acquisition.

Note

If the rollover investments are held until the selling shareholder's death, the estate can achieve a stepped-up basis for the securities, enabling the avoidance of capital gains tax on the proceeds from the sale to the ESOP altogether.

2. Favorable Corporate Tax Deductions

ESOP contributions are tax deductible for employers just like contributions to any other qualified retirement plan.

In the case of payments made to service the debt in a "Leverage ESOP", the sponsoring company can obtain the following tax deductions:

- Up to 25% of eligible payroll to service debt principal.
- Dividends paid to service debt principal.
- Interest expense associated with the ESOP debt.

3. Source of Capital

An ESOP can purchase (or the company can make non-cash contributions of) newly issued shares and thus generate new capital for the company on a tax-deductible basis.

4. Employee Motivation

ESOPs can be an important means to motivate employees and increase productivity. Greater productivity hopefully produces larger profits, which in turn increases the value of the company and future retirement benefits of the employees.

ESOP
Advantages and Disadvantages (cont)

Disadvantages

1. Repurchase Liability

ESOPs are normally required by law to have a "put option". This enables departing employees with vested shares to "put" their shares either to the company or to the ESOP in order to gain liquidity. This "emerging liability" grows over time as shares vest with the employees – becoming even larger as the value of the company grows.

2. Fiduciary Liability

An ESOP must have one or more trustees responsible for the operation of the Plan for the exclusive benefit of the employee. Independent fiduciaries may be preferred, but normally key managers or employees are placed in the position of ESOP trustees. Trustees must be aware of possible conflicts of interest which may arise between the ESOP, the company, the bank, or the selling shareholders.

3. Administrative Cost and Complexity

ESOPs are more complex and expensive to operate than most other retirement plan types. Legal, accounting and appraisal fees are normally highest the first year. The company will incur ongoing costs with an independent administration firm to handle the ESOP accounting.

In addition, there is an annual requirement for an independent appraisal; more frequent appraisals if the ESOP engages in transactions with "insiders".

4. Selling Shareholder Loan Guarantees

The qualified lender in a "Leveraged ESOP" often takes possession of the selling shareholder's rollover investments as additional collateral for the ESOP loan. The selling shareholder's collateral may be released as the ESOP loan is paid down.

5. Risk to ESOP Participants

Ideally, the value of employer securities owned by an ESOP will appreciate over time. However, companies often encounter problems and experience financial distress which can cause the value of the shares to decline, along with a decline in employee retirement benefits.

Note: In a "Leveraged ESOP", it is not uncommon to see an immediate post transaction decline in value in part because of: a) tax-effected ESOP debt is normally deducted from the enterprise value; b) cash flow is diverted from normal operations to service the ESOP debt; c) the ESOP leverage factor can cause an increase in valuation discount or capitalization rates; and d) the repurchase liability puts further long-term pressure on earnings.

ESOP Feasibility Checklist

	Yes	**No**
1. Has a successor management team been identified, and will they be amenable to having a company sponsored ESOP?	≠	≠
1. Are the sellers willing to sell their shares at *fair market value*, even if the ESOP pays less than what an outside buyer would pay?		
2. Is the company large enough to warrant an ESOP? Rule of Thumb: company must have more than 20 employees	≠	≠
3. Is the business "mature" enough to where an ESOP will not conflict with growth plans? (not suitable for startups or an already highly leveraged company)	≠	≠
4. Has the company had a history of strong earnings and operating cash flows which is expected to continue into the future?	≠	≠
5. If a *leveraged ESOP* is planned, does the company have a strong balance sheet, and will existing lending agreements and bonding covenants allow for the additional financial leverage?	≠	≠
7. Are the tax incentives for the selling shareholder(s) attractive? (e.g. low basis stock relative to *fair market value*)	≠	≠
8. If the sellers are seeking a tax deferred "1042 Rollover", is the company a C corporation? (not permitted in S Corps)	≠	≠
9. Is the "corporate culture" conducive to shared management?	≠	≠
10. Are the ESOP stakeholders aware of and willing to accept the inherent costs and complexities of an ESOP?	≠	≠

"Yes" Scoring

8 – 10	Good Candidate
5 – 7	Possible Candidate
Under 5	Not a Good Candidate

Note: Question #1 should be answered "yes" in all cases!

The *National Center for Employee Ownership* provides a great deal of information on ESOPs.

Their website is: www.nceo.org