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Institutional Retirement and Trust

A look at the good, the bad, and the ugly of an Employee Stock Ownership Plan

Employee Stock Ownership Plans (ESOPs) are unique among retirement plans. An ESOP merges the tax benefits of a qualified retirement plan with corporate finance, and aligns employees' retirement benefits with corporate goals. This combination of tax-favored employee and corporate benefits is complex, but with planning and an expert team of advisors, it can be a win-win scenario for both employees and employers.

Why have an ESOP?

An ESOP can be the solution to a number of employer concerns. It can:

- provide employees with a stock-based benefit plan;
- provide tax-favored corporate financing;
- provide a means for business perpetuation (e.g., when there is no buyer for a departing owner);
- provide a market for thinly traded stock;
- provide special tax advantages for shareholders selling stock in a closely held C corporation;
- make an S corporation non taxable;
- provide liquidity for estates of business owners;
- provide an anti-takeover device by keeping company stock in "friendly" hands; and
- make dividends deductible at the corporate level.

Congress recognized the advantages of employee ownership by authorizing and encouraging, through favorable tax treatment, the establishment of ESOPs. However, with all these benefits, ESOPs come with a unique set of challenges. This paper looks at the good, the bad, and the potentially ugly sides of ESOPs.

What is an ESOP?

The technical definition of an ESOP is: A tax-qualified retirement plan designed to invest primarily in qualifying employer securities of the sponsoring employer. This simple definition belies the complexity of ESOPs. Let's examine the key elements of this definition.

First, an ESOP is a "tax-qualified retirement plan." This means that all the provisions of the Internal Revenue Code, IRS regulations, and other government pronouncements that apply to tax-qualified retirement plans (such as "profit sharing" plans) apply to ESOPs.

Therefore, an ESOP must satisfy the following requirements:

- the plan must be written;
- plan assets must be held in trust for the benefit of the plan participants;
- the plan may not discriminate in favor of "highly compensated" employees;
- the plan must cover a reasonably broad cross section of the company's employees;
- employees must become vested in their plan benefits according to minimum standards; and
- the employer and the trustee have a fiduciary responsibility to guard the interests of plan participants.

The second key element of the definition is, the ESOP must be designed to "invest primarily in qualifying employer securities."

This element raises two important questions; first, "What is a qualifying employer security?" This is generally the common stock of the company sponsoring the plan or a company that is part of the same "controlled group" with the sponsor. If this common stock is not readily tradable on an established market, it must possess voting power and dividend rights at least as favorable as any other class of common stock. Noncallable preferred stock can also be a qualifying employer security if it is convertible at any time into common stock satisfying the above requirements at a "reasonable" conversion price.

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The other question that must be posed is, "What is meant by "invest primarily"? Neither Congress nor the IRS has provided a good answer to this question, but most experts agree that the plan

should invest at least one-half of its assets in qualifying employer securities to satisfy the "invest primarily" requirement.

The introduction of employer securities into a tax-qualified retirement plan opens the door to a hodgepodge of rules and considerations — some of which are good and some are bad.

The good

An ESOP can borrow money to purchase qualifying employer securities. An ESOP is the only tax-qualified retirement plan that can be leveraged. The plan can borrow money from a lender (e.g., a financial institution, the plan sponsor, or an owner) to acquire qualifying employer securities. The plan may, for example, borrow money to buy newly-issued common stock from the company; the company then makes tax-deductible contributions to the ESOP, which are used to repay the loan. By borrowing money through an ESOP, the company can raise cash and deduct both the principal and interest payments on the ESOP loan.

Typically, a financial institution will lend the money to purchase the qualifying employer securities to the company or an owner, who will then lend the money to the ESOP. The terms of the loan to the ESOP must be at least as beneficial to the ESOP as the terms of the loan from the financial institution.

Shares of stock purchased with the loan are used as collateral for the loan and are held in "suspense." As the loan is repaid, shares are released from suspense and allocated to the ESOP accounts of the plan participants.

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Shareholders of closely held C corporations can sell qualifying employer securities to an ESOP and defer tax on the capital gains. Section 1042 of the Internal Revenue Code (IRC §1042) allows the seller to roll over the proceeds from the stock sale into "qualified replacement property." No tax is paid until the replacement property is sold. (See "Tax-favored sales to an ESOP" section for details about IRC §1042 transactions.)

An S corporation may now sponsor an ESOP, and the S corporation distributions paid on this stock to the ESOP will not be considered unrelated business income to the plan. Although many of the beneficial ESOP provisions described above do not apply to S corporations, the potential tax benefit to an S corporation that adopts an ESOP is huge! (See "Slash taxes with an S Corporation ESOP" section for details about S corporation ESOPs.)

Deduction and maximum addition rules are relaxed. Generally, deductions for contributions to all defined contribution plans of an employer are limited to 25% of covered payroll. However, except for S corporations, interest payments on exempt loans are fully deductible and principal payments are deductible up to 25% of covered payroll. Thus, the total deductible amount (particularly in the early years of the loan) could greatly exceed the normal 25% of pay limit. These deductions are not reduced by deductions for contributions to other tax-qualified plans sponsored by the employer. Generally, the maximum amount that can be allocated to a participant's account as contributions or forfeitures in a defined contribution plan is limited; however, if no more than one-third of the employer contribution is allocated to highly compensated employees, interest payments and the reallocation of certain forfeitures do not count toward this limit. Again, this exception to the general rule does not apply to S corporations. Furthermore, the amount allocated can be calculated based on the amount of the contribution made by the employer rather than the value of the shares of stock actually allocated to the participant's account.

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Dividends of C corporations can be deductible. Dividends paid on qualifying employer securities held by an ESOP can be deducted to the extent the dividends are:

- paid in cash to the participants;
- paid to the plan and distributed in cash to the participants within 90 days after the end of the plan year;
- used to pay principal or interest on the exempt loan used to purchase the securities; or
- at the election of the participants, reinvested in qualifying employer securities.

The IRS has the authority to disallow deductions for excessive dividends, so care must be taken to assure that dividends are reasonable.

Employees think like owners. Organizations that support employee ownership frequently tout the higher profitability of employee-owned companies and offer supporting statistics. Will simply establishing an ESOP increase profits? Of course not. However, tying an effective and ongoing employee communications strategy to the ESOP can cause employees to think more like a business owner, which can certainly improve profitability.

The bad

Participants in an ESOP sponsored by a closely held company must be able to sell their stock back to the company. With some key exceptions, benefits to participants under an ESOP are paid in the form of stock. When the stock of a nonpublicly traded company is distributed to a participant, that participant must be given a "put option" on the stock, which allows the participant to force the company to repurchase the shares at market value. When establishing an ESOP, many closely held companies do not consider the future repurchase obligation. Projecting and planning for this liability is crucial in determining the long-term viability of an ESOP. (See "ESOP repurchase liability" section.)

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ESOP recordkeeping is complex. The special rules for tax deductions, §1042 transaction restrictions, loan balance tracking, suspense account maintenance, and general share accounting make ESOP recordkeeping complicated and relatively expensive. Also, there is the potential for significant liability if correct information is not maintained. An ESOP recordkeeper must have experience, expertise, and strong internal technical support. (See "ESOP Recordkeeping Issues" section.) Voting rights must be passed through to participants. For publicly traded securities, each participant is entitled to direct the plan as to the voting of shares in the participant's ESOP account. For nonpublicly traded securities, the participant must be able to vote the shares in his account with respect to any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all assets of the trade or business. The ESOP recordkeeper must be able to determine the number of shares held by plan participants and should be able to assist in producing proxy statements.

The employer and the trustees should consult with legal counsel to make sure they understand where their duty to the employer stops and their fiduciary duty to the ESOP and its participants begins.

Fiduciary responsibilities must be taken seriously. Consider a plan that invests primarily in the stock of a single company — the assets of the plan are not diversified. Furthermore, the directors and officers of that company have decision-making powers over the plan, and often serve as plan trustees.

The employer and plan trustees are fiduciaries, and a fiduciary must always act in the best interest of the plan participants. The risks are obvious and the liability is real. The employer and the trustees should consult with legal counsel to make sure they understand where their duty to the employer stops and their fiduciary duty to the ESOP and its participants begins.

All stock transactions must be based on fair market value. For a thinly-traded security, the proper valuation of the asset is a fiduciary responsibility. The plan trustee must be satisfied that the value being used is appropriate. Generally, an independent valuation by a qualified appraiser is sufficient; however, multiple valuations may be necessary for transactions between the ESOP and a "disqualified person" (e.g., the company, an owner of the company, a corporate officer, director, or a plan trustee). Stock valuations are expensive but the liability for a faulty (albeit cheap) valuation can be devastating.

The ESOP may have a negative impact on the company's balance sheet and income statement. The loan in a leveraged ESOP will typically be treated as a debt on the company's balance sheet.

While participants must be allowed to vote shares held in their ESOP accounts, the trustee has a fiduciary responsibility to vote securities that are held in suspense. This can be a conflicted responsibility if a closely held company is being sold and the trustees are officers of the selling company. The ESOP may have a negative impact on the company's balance sheet and income statement. The loan in a leveraged ESOP will typically be treated as a debt on the company's balance sheet. If the loan is substantial relative to the company's net worth, this debt can have a significant effect on its stock value. If this lowers the current account value of ESOP participants, the company could conceivably face a fiduciary issue as to whether the loan was in the best interest of plan participants. Leveraged ESOPs can also have a negative impact on the corporate income statement. These issues should be reviewed with the company's accountant prior to the establishment of the ESOP.

The ugly

There is nothing quite as ugly in the employee benefits world as an ESOP gone bad. An improperly designed loan can be a prohibited transaction rather than an exempt loan. The failure to roll over assets during the replacement period can invalidate a §1042 transaction. Any number of errors can potentially cause the plan to lose its tax-qualified status.

Of course, an ESOP is only as good as the company's stock, and the worst case scenario is the ESOP of a company going into bankruptcy. In this situation, not only do employees lose their jobs, but their ESOP accounts are worthless. This is the major reason most benefit experts recommend that an ESOP not be the only retirement benefit vehicle offered by an employer.

Tax-favored sales to an ESOP

IRC §1042 allows an owner of a nonpublicly traded C corporation who sells "qualified securities" to an ESOP to defer recognition of the gain on that sale by purchasing qualified replacement property. A §1042 election can be a tremendous tax- and estate-planning tool for an individual who owns a substantial portion of a privately held corporate entity — especially if the entity has appreciated in value. For example, a young entrepreneur started Gizmos Inc. with $50,000 in capital. Over time, Gizmos has prospered and is now worth $1 million. If our still-youthful entrepreneur were to sell 50% of his "qualified securities" in Gizmos, the taxable gain on the sale would be $475,000. Instead, he decides to sell his shares to the Gizmos-sponsored ESOP and reinvest the proceeds in qualified replacement property — generally the stock of other U.S. corporations. By doing this, he can defer the gain on the sale of his shares until he sells the replacement property.

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If he holds the replacement property until his death, his heirs will enjoy a stepped-up basis on the inherited securities, and no income tax will be paid on the gain from the original §1042 transaction. However, the value of the replacement property is subject to estate tax at the time of death. Recent changes in federal estate tax laws may make this strategy more advantageous than ever before.

As you might have guessed, Code Section 1042 and related Treasury regulations offer specific definitions for the terms "qualified securities" and "qualified replacement property." There are also specific rules establishing the timeframe that a shareholder has to buy replacement property, as well as a rule that requires the ESOP to hold at least 30% of the value of the company's stock after the sale in order for a shareholder to make a §1042 election.

If you own a substantial portion of stock in a nonpublicly traded corporation that has appreciated in value and you are interested in transferring ownership of that stock to employees of the corporation, a §1042 election is an option you should consider.

Slash taxes with an S Corporation ESOP

How would you like to exempt your company's profits from Federal tax? That is exactly what you can do if you have an S corporation that is 100% ESOP-owned. The income of an S corporation is passed through and taxed to the individual shareholders. If the sole shareholder of an S corporation is a tax-exempt entity (i.e., an ESOP trust), tax on those profits is generally deferred until benefits are distributed from the trust.

Of course, Congress and the IRS do not offer such a unique tax saving opportunity without a price. For starters, an S corporation ESOP cannot make use of the relaxed deduction and maximum addition limits that are available to C corporation ESOPs. Congress has placed additional restrictions on the allocation of stock (or cash) in an S corporation ESOP. These restrictions are intended to ensure that stock ownership of the S corporation (and therefore, the tax benefit) is not concentrated within a very few individuals or families.

Another opportunity unique to S corporation ESOPs is the treatment of S corporation distributions (the equivalent of C corporation dividends). S corporation distributions generally are cash payments to the corporation's shareholders to help them pay taxes on the corporate profits. Although these distributions are not necessary for ESOP shareholders, they can be an important source of cash within the plan without violating maximum contribution limits.

> All business owners are interested in finding ways to reduce their tax burden. An S corporation ESOP could provide an answer.

One significant tax advantage of ESOP sponsorship that is not available to the shareholders of an S corporation is the IRC §1042 election, which is limited to C corporations that sponsor an ESOP.

While a business owner has to ask many questions before establishing an ESOP, it is safe to say that all business owners are interested in finding ways to reduce their tax burden. An S corporation ESOP could provide an answer.

ESOP repurchase liability

ESOP repurchase liability refers to the employer's obligation to buy back the distributed shares of stock from participants who have terminated or who are eligible to diversify their account balances. This liability stems from the requirement that a participant in an ESOP in which company stock is not readily

tradable on an established market must be given a "put" option, forcing the company to repurchase this stock.

There are five common events that lead to an ESOP repurchase obligation. The events, listed in order of most significant impact, are:
- pre-retirement termination of employment;
- retirement;
- diversification;
- disability; and
- death.

"Diversification" refers to the statutory right of the participant, upon satisfying certain conditions, to reinvest a portion of his or her stock account within the ESOP into more diversified investment options.

It is important to estimate a company's repurchase obligation to plan for the company's future cash flow and profitability. An ESOP repurchase liability study is a forecasting model to help the company prepare for its ESOP repurchase commitment. This study will project the amount of cash needed to meet the obligation and the timing of plan cash flow. Such a study will form the basis for a corporate repurchase obligation strategy.

A repurchase liability study is prepared by using current employee data and assumptions for projecting asset and demographic data, such as share value, share appreciation, employee turnover, starting salary, etc., along with actuarial tables for turnover, mortality, and disability. A repurchase liability study should be performed during the initial planning phase of an ESOP as well as periodically (annually in many cases) throughout the life of the ESOP.

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It is often beneficial to design a repurchase liability study to investigate several different scenarios to determine the best strategy for meeting the company's obligation. Using this approach, a company can compare the impact of different contribution levels, different stock appreciation levels, and other parameters. Distinct scenarios can also be used to compare different methods of funding the repurchase liability. For example, one scenario might assume the company will contribute additional cash to the ESOP, which is used to repurchase the shares within the plan (referred to as "recycling" of shares). A second scenario might assume the direct purchase of shares by the company (i.e., the shares leave the plan); these shares can later be added back to the plan as a company contribution.

Any company that is required to repurchase shares from its ESOP participants should have a repurchase liability study prepared in order to properly plan for the financial implications of this obligation.

ESOP recordkeeping issues

The laws and regulations affecting ESOPs are generally more complicated than those governing other defined contribution plans, so it is not surprising that the recordkeeping of an ESOP is also more complex. As with any defined contribution plan, a recordkeeper must:
- track account balances;
- determine eligibility and vesting;
- locate investment earnings, contributions, and forfeitures;
- process distributions;
- perform coverage and nondiscrimination testing;
- prepare periodic participant statements; and
- prepare an annual Form 5500.

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For ESOP the list goes on. The ESOP recordkeeper must track cash, shares, and cost basis accounts for each participant. In a leveraged ESOP (i.e., where an exempt loan is used to purchase company stock), the accounting for leveraged and nonleveraged must be performed separately.

If an ESOP contains different classes of company stock, each class must be tracked individually. Most ESOP recordkeepers will track the market value of stock held by each participant and will report the value to the participant.

An ESOP recordkeeper will reconcile plan assets, net of outstanding loans, with the account balances maintained for participants, and also reconcile loan payments and company stock held in suspense.

The recordkeeper frequently assists with the pass- through of voting rights on all shares of publicly traded company stock allocated in the ESOP by preparing proxy labels and other voting materials. A knowledgeable recordkeeper will help the employer and the trustee manage distribution (terminating or retiring participants) and diversification (participants eligible to move assets from company stock to other investments) processes.

Most nonpublic companies perform ESOP allocations on an annual basis since the stock is only valued once a year. A publicly traded company may choose to perform allocations as infrequently as once a year if participants do not have the right to sell the stock until they terminate or attain the right to diversify. However, if the ESOP is combined with a 401(k) plan (see "KSOPs" section), the company may provide daily reporting.

An employer must be careful in selecting an ESOP recordkeeper. Clearly, ESOPs require special expertise. Many recordkeepers that can handle defined contribution plan recordkeeping are not up to the specific challenges presented by ESOPs.

KSOPs — Combining 401(k) contributions with an ESOP

Many employers have combined the participant tax benefits of 401(k) plans with the corporate tax benefits of ESOPs to form KSOPs.

The genesis of these plans came from employers that wanted to encourage employee stock ownership of their companies. These were generally large employers who already sponsored 401(k) plans. For many employees, the only capital available with which to buy company stock was their 401(k) balance. The solution seemed obvious — add company stock as an investment option in the 401(k) plan.

> In deciding whether to incorporate ESOP provisions with the 401(k) plan, or to simply add company stock to the 401(k) plan, an employer must also consider the fiduciary implications. These are significant and should be thoroughly reviewed.

However, this could have important securities law and fiduciary ramifications. A 401(k) plan can offer company stock without becoming an ESOP, so employers must explore the pros and cons of maintaining a 401(k) plan with company stock, or converting to a KSOP.

An employer wishing to add company stock to a qualified retirement plan should consult with securities and ERISA legal counsel. Generally, if employees are given the opportunity to invest their own 401(k) deferrals in company stock, the plan will be subject to state and federal securities laws and anti-fraud rules. This may not be an onerous issue for publicly traded companies that already deal with these requirements; however, for closely held companies, stock registration, along with the independent appraisal of company stock, can be an expensive proposition. Nonpublic companies will therefore typically add company stock to their 401(k) plan by keeping employee deferrals in other investments, but requiring that matching contributions be invested entirely in employer securities (subject to required diversification rules).

In deciding whether to incorporate ESOP provisions with the 401(k) plan, or to simply add company stock to the 401(k) plan, an employer must also consider the fiduciary implications. These are significant and should be thoroughly reviewed. Whether the plan is a KSOP or not, employer stock in the plan places an intense spotlight on plan fiduciaries.

Having a KSOP may arguably provide some relief from the fiduciary concerns of investing in employer securities; however, this relief is tenuous at best.

Lastly, the employer must understand all the technical requirements. If the desire is to "leverage" the plan by borrowing capital to invest in company stock, or the employer is an S corporation, the plan must be an ESOP. If the company is closely held and shareholders want to take advantage of the special IRC §1042 election to defer gains on the sale of their stock (see "Tax-favored sales to an ESOP" section), ESOP provisions are required. In addition, an ESOP is necessary if the goal is to make dividends deductible, or to take advantage of higher deduction and maximum addition limits. However, the pass-through voting and benefit distribution requirements are less complicated if the plan does not incorporate ESOP provisions.

In short, if to KSOP or not to KSOP is the question, the answer will require careful analysis and input from a team of knowledgeable advisers.

Conclusion

The benefits of an ESOP can be significant, both to the employer and the employee. However, the rules governing ESOPs are complex. For this reason, the cost of establishing and maintaining an ESOP is greater than for other retirement plans. It is important that the employer surround itself with knowledgeable advisors who can steer the company through the minefield of legal, accounting, and administrative issues peculiar to ESOPs.

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