What is an employee stock ownership plan (ESOP)?

Wealth Management

An employee stock ownership plan (ESOP) is a qualified retirement plan that provides tax advantages to both the employer and employees. Similar to a traditional profit-sharing plan, an ESOP offers many additional advantages.

Benefits for the employer

ESOPs provide a unique way for business owners to diversify their risk on a tax-advantaged basis. They allow business owners to cash out some or all of their equity in the company while keeping operational control. Closely held business owners can use an ESOP as an excellent estate-planning tool that generates liquidity for their shares and creates succession options for those involved in the business.

Designed to invest mainly in the stock of the employer, an ESOP can be a stock bonus plan or a combination stock bonus plan and money purchase pension plan. The Internal Revenue Code (IRC) gives tax incentives to employers who sell their company stock to the ESOP. Companies can benefit from tax savings in many ways using this unique corporate financing strategy.

Benefits for the employee

A unique aspect of ESOPs is that benefits are paid to participating employees in the form of company stock. A trust fiduciary sets up individual accounts within the trust for each participating employee. The employer then contributes either cash or shares of company stock to the trust on behalf of participating employees. If employers make cash contributions, the trust uses that money to purchase shares of company stock either from shareholders or from the company itself.

An ESOP is an excellent way to reward employees with retirement benefits at no cost to them while inspiring them to participate in the growth and success of the company. Because ESOPs have many tax advantages, employees do not pay tax on the stock allocation to their accounts until distributions are taken, usually after retirement.

Who qualifies for an ESOP?

A growing trend

ESOPs have existed for many years. The concept was first developed in the 1950s and legislation implementing tax advantages for ESOPs was passed in 1974. While there was only a handful in the 1970s, today there are more than 11,000 ESOP plans.*

The National Center for Employee Ownership (NCEO) estimates that ESOPs have 13.7 million plan participants and control over $900 billion in plan assets. ESOP legislation continues to provide incentives and advantages to both companies and employees, adding to the attractiveness of this liquidity option.*

Because of the broad appeal of these plans, ESOP candidates can vary widely. Most ESOPs (approximately 97 percent) are established for privately held companies.* Any company—whether a manufacturing, distribution or service business—that can borrow enough money to fund the ESOP is a viable candidate. However, high-end service businesses with educated workforces— such as architecture, engineering or consulting firms—tend to be better represented in ESOPs today.

The potential ESOP candidate

While each situation is different, here are some characteristics of a possible ESOP candidate:

- The company must currently be a C corp, or a Sub S, or the business owner must be willing to convert.
- The company must have sufficient collateral or cash flow to support funded debt.

- A successor management team should be in place or developed over time.
- The company should have been in business for several years and be experiencing steady and controlled growth.
- The company should have had strong earnings and cash flow over the previous two years and be able to reasonably predict future revenue and cash flows (probably more important than having hard assets to support the loan).
- The selling shareholders should want to participate in the future growth of the company after the sale.

Exit strategies

Baby boomers are retiring rapidly these days, and over the next decade, approximately 30 to 40 percent of businesses in the U.S., will be changing ownership as a result. ESOPs offer important benefits to help company owners make this transition. These benefits make ESOPs an excellent alternative to other exit strategies. They can facilitate family business succession planning and estate planning through the transfer of different types of assets to family members with different levels of involvement. And because ESOPs can be structured as a series of transactions, they can be either an intermediate or long-term exit strategy.

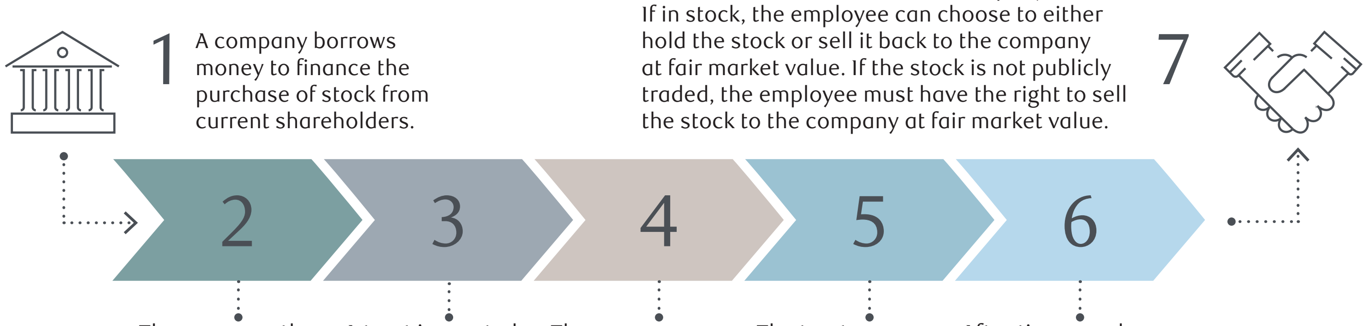
Tax advantages

The tax code gives sellers the ability to defer capital gains tax while giving the company tax deductions. ESOPs are tax exempt and pay no tax on their pro-rata share of company earnings. In addition, only 30 percent of the business needs to be sold to the ESOP to obtain these tax benefits, while the owner can continue to participate in their business.

Tax benefits of an ESOP produce financial rewards not just for the company but also for the owner and the employees. As the employer sponsoring an ESOP for your employees, your contributions to the plan—in the form of company stock or cash used to purchase company stock—are generally tax-deductible on your federal income return for the year in which you make those contributions. To be eligible for this employer tax benefit, your plan must remain a “qualified” plan.

How ESOPs work

The following steps illustrate the way most companies establish an ESOP



1 A company borrows money to finance the purchase of stock from current shareholders.

2 The company then lends these funds to the ESOP.

3 A trust is created to buy stock of the company on behalf of the ESOP plan.

4 The company makes annual cash contributions from its operating profits to the trust (which are tax deductible).

5 The trust uses the cash to pay down the ESOP loan while a trust fiduciary releases and allocates shares of the company's stock to the accounts of plan participants (employees) according to a pre-established formula.

6 After time, employees are vested based on years of service for the shares in their account.

7 When employees retire or leave the company, they receive a distribution of their vested benefits in the form of cash or company stock. If in stock, the employee can choose to either hold the stock or sell it back to the company at fair market value. If the stock is not publicly traded, the employee must have the right to sell the stock to the company at fair market value.

*National Center for Employee Ownership (NCEO)