Family Business
THE GUIDE FOR FAMILY COMPANIES
www.familybusinessmagazine.com

Is an ESOP appropriate for your company?

Here are some points to consider in determining whether an employee stock ownership plan would help you achieve your business goals.

By Gregory K. Brown

Employee stock ownership plans, or ESOPs, are innovative, exciting and—because they involve employee ownership of the company where they work—controversial. These plans can help to achieve multiple corporate ownership goals. When used appropriately, ESOPs play a unique role in employee compensation and corporate succession.

ESOPs are often promoted as a means of giving workers "a piece of the action." ESOP advocates claim that employee-owners have a greater incentive to produce, since they share in the fruits of their efforts. Indeed, many companies have shown impressive productivity gains after establishing an ESOP. But it would be a mistake to assume that every ESOP will result in improved corporate performance. Companies not willing to adapt to the special dynamics of employee ownership and to put forth the extra effort often needed to make the ESOP successful may not be able to realize all the benefits ESOPs can provide.

Uses of ESOPs

ESOPs can be used for many purposes, such as:

• To create a market for owners of closely held companies who wish to sell their shares on a tax-deferred basis and allow the corporation to use tax-deductible dollars to pay for those shares.

• To allow shareholders with management responsibilities in closely held companies to sell gradually on a tax-deferred basis and ease out of the business over a planned period.

• To finance corporate acquisitions. The ESOP could borrow funds (likely with a corporate guaranty) and use those funds to purchase stock from the corporation. The corporation would use the stock sale proceeds to purchase the stock or assets of a target company and thereafter make tax-deductible contributions to the ESOP to enable it to repay its borrowings.

• To enhance corporate performance and job satisfaction by creating a corporate "ownership" culture.

• To reward employees with a benefit tied to corporate performance while affording the company substantial tax benefits.

Gregory K. Brown, Esq., *is a partner in the Employee Benefits and Executive Compensation Practice of Katten Muchin Rosenman LLP. His practice emphasizes ESOPs, ERISA fiduciary matters, tax-qualified retirement plans, executive compensation and ERISA litigation.*

How an ESOP works

An ESOP is a tax-qualified, defined-contribution employee benefit plan that invests primarily in the stock of the employer. As a tax-qualified plan, an ESOP provides meaningful tax benefits to the employer and its owners. In exchange, the ESOP must meet certain U.S. government rules designed to protect the interests of plan participants.

To set up an ESOP, an employer creates a trust fund for employees and funds it in one of three ways: (1) by contributing employer stock, (2) by contributing cash to buy employer stock, or (3) by having the plan borrow money to buy shares, after which the employer makes payments to the ESOP to repay the loan. Employer contributions—not employee contributions—are normally used to fund the plan.

Shares that are purchased can be corporate treasury shares, newly issued shares or shares of existing shareholders. Employees do not directly buy or hold shares through the plan. Rather, the plan trustee buys and holds the shares in the trust's name for the benefit of the employees. The ESOP may own any percentage of the employer's stock. Plans typically cover all full-time, non-union employees who have achieved age 21 and have completed one year of service. The plan's shares are allocated to individual participant accounts on the basis of relative compensation, and such allocations are subject to vesting requirements applicable to all types of tax-qualified plans. Participants normally receive their vested stock, or its cash value, when they resign or retire from the company.

In a leveraged plan, the ESOP borrows money from a bank or the employer (which has borrowed from a bank and re-loaned the proceeds to the ESOP) to buy shares from the employer and/or its shareholders. In subsequent periods, the employer makes tax-deductible contributions to the ESOP in order to enable the ESOP to repay its indebtedness. Within the ESOP, the shares are held in a "suspense account," and each year as the loan is repaid, a portion of the shares in the suspense account is released to employee

accounts.

The ESOP trust is governed by a trustee appointed by the employer's board of directors. The trustee can be an "insider," such as an officer of the company, or an "outsider," such as a bank trust department. The trustee is responsible for making sure that the ESOP operates primarily for the benefit of employees.

ESOP tax incentives

Employees participating in an ESOP are not taxed on stock allocated to their accounts until they receive distributions when they leave the company. Additionally, ESOPs offer four significant tax advantages for corporations and selling shareholders:

1. The owner of a closely held C corporation can defer taxation on his or her gains from the sale of employer stock to the ESOP, provided the ESOP owns 30% or more of the employer's equity after the sale, and provided the seller reinvests the sale proceeds in stocks, bonds or other securities of U.S. operating companies within 12 months after the sale.

2. The employer can deduct contributions to the ESOP, including both principal and interest on loans the ESOP uses to buy company stock. Moreover, ESOPs allow for higher contribution and deduction limits than are normally available for profit-sharing plans.

3. The employer, if a C corporation, generally can deduct reasonable cash dividends paid on ESOP stock and used to repay an ESOP loan or passed through to participants.

4. S corporation ESOPs are not taxed on their share of corporate earnings.

Getting started

An employer should carefully consider whether the business has the characteristics that foretell a potentially successful ESOP. Among these factors are the following:

• There must be sufficient payroll to amortize the loan if the ESOP is leveraged. In other words, the size of the potential ESOP transaction depends upon a company's payroll.

• The company must be profitable. While ESOPs have sometimes been used to save a failing company, most are adopted by companies that can easily afford to repay the loan to purchase company stock.

• The business must be stable. This is an important factor not only from the obvious standpoint of loan repayment, but also because yearly fluctuations will be reflected in the annual stock valuations, possibly resulting in adverse employee reaction.

• Management must be committed to employee ownership. The real value of the ESOP as a method of improving operating results would be lost without this commitment.

Once it has been determined that an ESOP is worth investigating, the following steps are needed in order to implement a plan:

1. Be sure that shareholders are willing to sell.

2. Conduct a feasibility study, which can be a formal analysis prepared by a consultant or a careful business plan prepared by management. Any analysis should assess how much cash flow the employer must dedicate to the ESOP to enable the ESOP to repay its loan, whether this is sufficient for the ESOP's intended purposes, whether the employer has adequate payroll to make ESOP contributions deductible, and the employer's ability to redeem vested shares from terminated employees in the future.

3. Have an independent appraisal performed. This will help determine the interest of selling shareholders and whether the purchase can be financed on a tax-deductible basis.

4. Have an experienced ESOP attorney prepare the necessary documentation, obtain IRS approval of the plan and provide advice and counsel on plan issues.

5. Obtain financing for the plan from a lender or lenders.

6. Establish a process to operate the plan, including appointment of a trustee, an ESOP committee to direct the trustee and a third-party administrator to keep books and records and assist in government reporting.

7. Spread the word about the ESOP to employees. This may require the assistance of an experienced ESOP communications firm.

At any point, the employer may determine that an ESOP isn't appropriate for the business.

With careful, deliberate planning, the owners of a private business may be able to sell a portion of their equity in the business on a tax-deferred basis to an ESOP. By doing so, they may diversify their holdings and have the business fund that sale with tax-deductible dollars while providing a meaningful employee benefit. FB

Reprinted from The Family Business Policies & Procedures Handbook • © Family Business Magazine Company
1845 Walnut Street, Suite 900 • Philadelphia, PA 19103 • (215) 567-3200 • www.familybusinessmagazine.com