



A comprehensive guide to ESOPs



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Introduction

Employee stock ownership plans (ESOPs), tax-qualified retirement plans that invest primarily in the sponsoring company's stock, offer a range of benefits to the owners of closely held companies and to their employees. First, since ESOPs invest in company stock, they create a market for the shares of departing owners. By selling to an ESOP, owners are able, under certain circumstances, to defer and even avoid capital gains taxes arising from the sale. Second, because ESOPs can borrow money for investment purposes, which is unique among retirement plans, ESOPs offer financing options to facilitate purchases from departing owners. Additionally, ESOPs offer employees retirement benefits and an ownership stake in the company for which they work.

Without the ESOP option, owners of closely held companies wishing to sell all or a portion of their equity often face undesirable options. If the departing owner sells shares back to the company itself or to another company or individual, the proceeds from the sale will be subject to taxation. In many cases, the company may not possess the resources to redeem the shares, and finding an outside buyer willing to pay a fair price can be difficult – even for a profitable company. Finally, owners may prefer to sell to family members or to a management team. ESOPs provide a compelling solution to the unique succession challenges of privately held companies. Moreover, they provide unique benefits for departing owners, the company, and employees alike:

- By selling all or a portion of their equity to the ESOP, which can borrow funds to purchase that equity, departing owners can defer and, possibly, avoid federal taxes on any capital gain arising from the sale. This tax deferral occurs through what is known as a “Section 1042 rollover.” Section 1042 refers to the provision of the Internal Revenue Code (IRC) that

allows owners to defer paying federal taxes on proceeds from the sale of shares to an ESOP, provided that the owner reinvests the proceeds in the securities of certain U.S.-based companies.

- Within limits, the sponsoring company can deduct the principal and interest payments on the loan the ESOP used to purchase shares. The company can also deduct certain dividends paid on ESOP-held stock, including those dividends used to repay the ESOP loan, so the cost of borrowing is further reduced.
- Participating employees receive company shares through the ESOP as a retirement benefit (rather than purchasing them directly). They pay taxes on the balances that accumulate in the ESOP only when those balances are withdrawn, just as with any tax-qualified retirement plan.
- While typically used to finance buyouts of privately held company owners, ESOPs can also use their borrowing power to fund purchases of stock newly issued by the company. The proceeds can be used for any legitimate corporate purpose, making ESOPs a unique, flexible, low-cost financing option for many

companies. To achieve any or all of these benefits, companies and selling shareholders must carefully structure the ESOP transaction. After the transaction, the company must make sure that the ongoing operation of the ESOP adheres to the requirements of the IRC and the *Employee Retirement Income Security Act of 1974* (ERISA) as amended.

The first step in tapping into the many benefits offered by ESOPs is to determine whether establishing an ESOP is right for your situation. We have created this guide to help you answer that question. In the following pages, you will find an overview of the design, structure, and operation of ESOPs, as well as a discussion of key issues you should consider before establishing an ESOP.

Please note that none of the information included in this pamphlet is to be taken as definitive financial, accounting, or legal advice. Each company’s situation is unique, and any company considering an ESOP should seek the guidance of competent ESOP professionals who can design, install, and maintain an ESOP that is most appropriate for its specific circumstances.

What is an ESOP?

An ESOP is a financing tool, a method for transferring ownership, a retirement plan, and a way to encourage accountability and responsibility among employees – all in one.

Historical background

The ESOP concept was first developed by Louis O. Kelso. Kelso saw this mechanism as a way to broaden capital ownership and, ultimately, provide for more equitable distribution of wealth.

Companies began establishing ESOPs in the 1950s. Congress took notice of Kelso's concept and included ESOP enabling provisions in ERISA. Later, it included significant tax incentives promoting ESOPs in the *Tax Reform Act of 1986*. In 1998, Congress created unique ESOP tax benefits for S corporations. With this consistent congressional support, the number of ESOPs nationwide has grown from several hundred in the early 1970s to approximately 12,000 today.

Tax-qualified retirement plan

ESOPs, along with pension plans, 401(k) plans, and profit-sharing plans, fit under a broad umbrella of retirement plans known as tax-qualified retirement plans. In return for following rules contained in the IRC, ERISA, and regulations issued by the Internal Revenue Service (IRS) and the U.S. Department of Labor, both the sponsors of and the participants in tax-qualified retirement plans receive special tax treatment. Specifically, sponsoring employers receive deductions for contributions to these plans and participants' accounts grow on a tax-free basis as long as those accounts remain in a tax-qualified plan or individual retirement account.

A defined contribution plan

ESOPs are defined contribution plans, one of two subsets of tax-qualified retirement plans. Plans belonging to the other subset, known as defined benefit plans, guarantee employees a fixed schedule of benefits at retirement. The retirement balances of defined contribution plans, on the other hand, are determined by the contributions to the plan and the earnings experience of those contributions. The contribution amount may be discretionary or specified and, in

an ESOP, may be made in the form of cash or company stock. In some cases, the contribution amount is tied to the employer's profitability. The amount of the deductible contribution generally cannot exceed 25 percent of participating employees' aggregate payroll.

Individual employee accounts

ESOP assets are held in a trust established specifically for the ESOP. These assets comprise contributions to the ESOP; assets, including employer stock, purchased by the ESOP; and earnings or losses. All of the assets in an ESOP are allocated to individual accounts established for each participant. When participants retire or leave the company, they receive benefits equal to the value of the assets accumulated in their accounts.

Because the balances in employees' ESOP accounts are primarily invested in the stock of the sponsoring employer, participating employees become beneficial owners of the company. If the company's value increases, participating employees stand to directly gain through the resulting growth of their ESOP accounts. The more substantial an ownership stake the ESOP provides employees, the more motivated they may be to improve company performance.

Minimum coverage and entry provisions

Like all tax-qualified retirement plans, ESOPs must meet certain requirements related to the percentage of employees who benefit under the plan. However, a defined group of employees, such as one covered under a collective bargaining agreement, may be excluded from ESOP participation. When establishing an ESOP, companies may make participation in the plan dependent on a minimum period of service with the company – generally no more than a year. Companies may also set a minimum age requirement for participants, up to age 21.

Vesting

ESOPs can specify a vesting period for plan participants. A vesting period is a period of time, which must be no more than six years, during which a portion of the assets in a participant's account is forfeited if the participant leaves the company for reasons other than retirement, disability, or death. A vesting schedule specified in the document governing the ESOP determines the percentage of the participant's account that is nonforfeitable based on the period of time the employee has worked for the company. The participant will receive those nonforfeitable benefits upon leaving the company.

ESOPs as a corporate financing mechanism

Three key factors make ESOPs a unique, flexible, and low-cost option for financing buyouts of company founders and other majority shareholders, as well as for financing other corporate initiatives.

- Unlike all other tax-qualified retirement plans, ESOPs can and must invest primarily in the stock of the sponsoring company.
- Also unlike all other tax-qualified retirement plans, ESOPs can borrow money to finance the purchase of company stock.
- Tax incentives encourage companies to use ESOPs.
- Because of their unique structure and tax advantages, ESOPs can substantially reduce a company's borrowing costs and improve cash flow, and because ESOPs make employees beneficial

owners of the company, employers can experience productivity increases driven by employees who are more highly motivated. Why are employees more motivated? Because they stand to directly gain from improved company performance.

Leveraged ESOPs

“Leveraged” ESOPs are those that borrow to finance the purchase of their sponsoring company's stock. Private companies typically use leveraged ESOPs to buy out company founders and other shareholders. However, because ESOPs may be used to finance any legitimate corporate activity, they also can be established to:

- Finance capital expansion
- Spin off divisions or subsidiaries
- Make acquisitions

When an ESOP finances the purchase of company stock, the shares it purchases are pledged as collateral for the loan and are held in a special “suspense account” by the ESOP trust. Shares are released from the suspense account based on loan payments made in any given year and are allocated to participants' accounts, generally based on the compensation of eligible participants.

Lenders can loan funds directly to an ESOP. In such cases, the lender requires the sponsoring company to guarantee that it will make contributions to the ESOP in amounts sufficient to enable loan repayment. Generally, however, loans are made to the company, which then loans the funds to the ESOP. An ESOP loan must be used only to purchase company stock or to repay a prior ESOP loan; must not be payable on demand, except in case of default; and must be properly documented.

C corporations¹ sponsoring a leveraged ESOP can generally deduct:

- Contributions to the ESOP used to pay the loan principal – up to 25 percent of the eligible participants' aggregate payroll
- All contributions used to repay loan interest, without limit
- Cash dividends² paid on ESOP stock, to the extent that those dividends are used to repay the loan; passed through to participants; or, at the participants' election, either passed through or reinvested in company stock

Although many ESOPs are leveraged, some are not. A nonleveraged ESOP is an ESOP that receives contributions of company stock or that buys company stock using money that has been contributed, not borrowed. Company contributions to this sort of plan are discretionary and can be deducted by the company, as long as they do not exceed 25 percent of participants' annual payroll.

S corporations sponsoring either a leveraged or nonleveraged ESOP, on the other hand, can generally deduct contributions to the ESOP – up to 25 percent of the eligible participants' aggregate payroll.

The Section 1042 rollover

A powerful ESOP tax incentive is the Section 1042 rollover. IRC Section 1042 gives certain shareholders of closely held C corporations the ability to sell their stock to an ESOP and defer – and possibly avoid altogether – federal taxes on any capital gain arising from the sale. Although ESOP rollover transactions must follow IRS regulations and must be carefully documented, a properly constructed rollover can provide significant benefits to the selling shareholder, the company, and its employees.

Normally, retiring owners or other majority shareholders in a privately held company have the following options for selling all or part of their interest in the company. Each of these options typically gives rise to taxable income:

- Selling shares back to the company, if such a transaction is feasible
- Selling shares or assets to another company or individual, if a willing buyer can be found

Under the authority of IRC Section 1042, however, shareholders selling to an ESOP will defer capital gains taxes indefinitely. Additionally, unlike most other transactions involving the sale of a privately held company, departing owners selling to an ESOP are not required to sell all of their shares at once but can withdraw from the business gradually by selling their shares in a series of transactions.

For a sale to an ESOP to qualify for the Section 1042 tax deferral:

- The stock being sold to the ESOP must:
 - Constitute “employer securities,” as defined in IRC Section 409(l)

- Have been issued by a domestic C corporation that has no outstanding stock that is tradable on an established securities market
- Have been owned by the seller for at least three years prior to the sale
- Not have been acquired by the seller in a distribution from a tax-qualified retirement plan or a transfer under an option or other compensatory right to acquire stock granted by the employer corporation
- Otherwise qualify for long-term capital gains treatment under the IRC
- The ESOP must own at least 30 percent of the company's stock immediately after the sale.
- The selling shareholder must reinvest the proceeds from the sale in "qualified replacement property" within a 15-month period beginning three months prior to the date of sale. Neither government securities nor mutual funds currently qualify as qualified replacement property for purposes of the Section 1042 rollover.
- Generally, the seller, certain relatives of the seller, and other shareholders who individually own (or are attributed ownership of) 25 percent or more of outstanding company shares are prohibited

from receiving allocations of the stock acquired by the ESOP in the Section 1042 rollover transaction.

- The rollover must be elected in writing on the seller's tax return for the taxable year of the sale.
- The seller must file a copy of the corporation's consent form and one or more notarized forms to notify the IRS that qualified replacement property has been purchased.
- If the ESOP sells the stock acquired through a Section 1042 rollover transaction within three years, the company must pay a 10 percent penalty tax on the amount of the transaction.

If these conditions are met, the seller's gain on the sale of stock to the ESOP is deferred by adjusting the seller's basis in the qualified replacement property up to an amount equal to the basis in the employer stock sold to the ESOP. If qualified replacement property is disposed of, a gain may be recognized at that time. Alternatively, if the replacement securities are held until the taxpayer's death, the basis of the securities is stepped-up and, under current tax law, the taxpayer's beneficiaries will be able to entirely avoid the recognition of such gain.

The legal structure of ESOPs

ESOPs, like all tax-qualified retirement plans, operate within a legal framework including the IRC, ERISA, and regulations applicable to both, as well as case law. Companies sponsoring ESOPs must meet requirements detailed in this framework in order to realize the benefits of ESOPs and avoid potential fines and penalties.

For the sponsoring company's contributions to be tax-deductible, the ESOP must be a defined contribution plan meeting IRS qualification requirements, which include:

- Establishing a trust to hold the ESOP's assets for the exclusive benefit of participants and their beneficiaries.

- Satisfying nondiscrimination rules designed to ensure the ESOP does not operate solely or primarily for the benefit of highly compensated employees (HCEs).

An HCE is an employee who:

Was at least a 5 percent owner of the company at any time during the current or preceding plan year; or earned more than \$120,000 in the previous year and, if the employer elects, was in the top 20 percent of employees with regard to compensation during the previous plan year. The \$120,000 amount is adjusted for increases in the cost of living in \$5,000 increments.

- Complying with certain minimum participation rules.
- Meeting minimum vesting requirements and distribution rules.
- Intending that the ESOP be permanent and that the trust's assets and income will be distributed to participants and their beneficiaries. However, the company can terminate the ESOP at any time for valid business reasons.

ESOPs also must meet other qualification and statutory requirements. These include:

- Allowing participating employees to determine how stock in their ESOP account is to be voted on certain company issues.
- Giving participants the right, except under certain circumstances, to demand that benefits be distributed in the form of company stock.
- For privately held firms, providing for annual independent valuations of company stock.
- The company must repurchase stock that is not readily tradable from participants who have received stock distributions.

Plan entry and participation

ESOPs, like other qualified plans, can set a minimum age requirement for participation, but there can be no maximum age limitation. The minimum age requirement must not exceed 21 years of age. They can also require employees to complete a minimum period of service, which cannot exceed two years, before they can participate. If this minimum period of service exceeds one year, the ESOP must provide for immediate 100 percent vesting.

ESOPs may mandate that employees who have had a "break in service" (working no more than 500 hours in a 12-month period) will cease participating in the plan. They may also require participants – employees who have met the requirements to enter the plan – to perform at least 1,000 hours of service within a 12-month period and/or be employed on the last day of the plan year in order to receive an allocation of the employer contribution or reallocation of departing employees' forfeitures.

Coverage requirements and nondiscrimination

To ensure that ESOPs and other qualified retirement plans do not discriminate in favor of HCEs, the IRS requires the ESOP to meet minimum coverage tests, which are designed to ensure equitable participation in the ESOP. One such test, known as the ratio percentage test, requires that the percentage of non-HCEs who receive allocations under the ESOP be at least 70 percent of the percentage of HCEs receiving allocations. For example, if 80 percent of the HCEs receive allocations, then 56 percent (80 percent x 70 percent) of the non-HCEs must receive allocations.

The following employees are excluded when applying minimum coverage tests:

- Employees who are under age 21 or have not yet performed 1,000 hours of service in a 12-month period
- Employees who terminated during the plan year and performed less than 500 hours of service
- Nonresident aliens not receiving any U.S.-source earned income
- Employees covered by a collective bargaining agreement

In addition to the coverage requirements, there is a general requirement that the ESOP must make available its benefits, rights, and features in a nondiscriminatory manner.

Employer contribution limits

Two IRC provisions set limits on the amounts employers may contribute to a qualified retirement plan, including an ESOP:

- Section 404 limits the total amount of employer contributions that a company may deduct from its taxable income; and
- Section 415 limits the “annual additions” that may be allocated to the account of each individual

participant in any year to the lesser of 100 percent of the employee’s compensation or \$53,000, as adjusted for cost-of-living increases.

With regard to the Section 404 limits, employers sponsoring one or more qualified retirement plans may generally deduct employer contributions not exceeding 25 percent of the aggregate compensation of all eligible participants in all such plans.

The cumulative total of all employer contributions to all plans sponsored by the company must remain under this limit.

However, for C corporations, employer contributions used to pay the principal on an ESOP acquisition loan are deductible under a separate limit equal to 25 percent of the compensation of all eligible ESOP participants.

Also, for C corporations, employer contributions used to pay interest on an ESOP acquisition loan are fully deductible and do not fall under the limits imposed by Section 404.

A 10 percent excise tax is assessed on employer contributions in excess of the Section 404 limits.

With regard to the Section 415 limits, annual additions include:

- Employer contributions to all qualified retirement plans sponsored by the company, including ESOPs, although the contributions used to pay interest on an ESOP acquisition loan may be excluded in certain circumstances
- Certain reallocated forfeitures
- All employee contributions, including after-tax contributions, to any defined contribution plan, with the exception of “catch-up contributions” made by participants who are at least 50 years of age

The Section 415 and 404 limitations do not apply to dividends or S corporation income distributions paid on stock held in the ESOP.

Allocations to participant accounts

ESOPs and other defined contribution plans must have a defined formula for allocating company contributions and reallocating forfeitures to participants’ accounts. Although sponsoring employers have flexibility in determining this formula, it must meet laws and

regulations designed to ensure that it does not discriminate in favor of HCEs. Specifically, the formula used to allocate employer contributions and reallocated forfeitures must be based on:

- The relative compensation of participants
- The relative units of service, measured in periods not exceeding one week, accumulated by participants
- Certain combinations of age, service, and compensation

Alternatively, the same dollar or share amount may be allocated to each participant. ESOPs that do not apply these formulas exactly as outlined in the IRC must pass certain tests to prove that the allocation provisions are not discriminatory. In addition to providing nondiscriminatory allocations, ESOPs must be nondiscriminatory with regard to the form of the benefits and options available to participants. For example, HCEs cannot be permitted to take distributions immediately upon termination if other employees must wait for a period of time before receiving their distributions.

ESOP investment rules

ESOPs must be invested primarily in the securities of the sponsoring employer. This requirement is unique among all qualified retirement plans.

“Employer securities” of a publicly traded company generally refers to common stock that can be readily traded on an established securities market, while the “employer securities” of a privately held company refers to common stock that has voting power and dividend rights equal to or greater than the class of common stock having the greatest voting power and the class of common stock having the greatest dividend rights. Preferred stock also meets the definition of employer securities if it is noncallable and is convertible to common stock that qualifies as employer securities.

Although the assets of ESOPs must be primarily invested in employer securities, there are no strict quantitative guidelines for compliance; however, there is a general consensus that at least 50 percent of an ESOP’s assets should be invested in sponsoring company stock on an ongoing basis in order to maintain compliance. All nonemployer security assets should be invested in a manner that complies with the fiduciary requirements of ERISA.

Employee vesting

On Aug. 17, 2006, the *Pension Protection Act of 2006* (PPA) was signed into law. One important part of the PPA accelerated vesting requirements for retirement plans. ESOPs must now comply with one of two statutory minimum vesting schedules with regard to employer-provided benefits:

- Three-year “cliff” vesting, under which participants are zero percent vested until attaining three years of service, at which time they become 100 percent vested
- Six-year “graded” vesting, under which participants are 20 percent vested upon attaining two years of service, with vesting increasing an additional 20 percent per year so that participants attain 100 percent vesting upon attaining six years of service

The PPA rules generally took effect on the first day of the plan year beginning after Dec. 31, 2006; however, ESOPs that had an exempt loan outstanding as of Sept. 26, 2005, are not required to meet the accelerated vesting requirements until the later of:

- The date the loans are paid in full
- The date the loan is scheduled, as of Sept. 26, 2005, to be repaid

These are the longest vesting schedules permitted by law. Plan sponsors may use vesting schedules that are more generous.

Vesting schedules are based on years of service with the company, not years of participation in the plan. Plans generally stipulate that years in which an employee does not complete at least 1,000 hours of service are not counted toward vesting service. Generally, years prior to the establishment of the plan or prior to an individual's attainment of age 18 may also be disregarded for vesting purposes. However, if the ESOP was established using assets from another qualified retirement plan, years of service accumulated under the predecessor plan must be credited in the vesting calculation applied to the transferred assets.

ESOP share voting rights

In all cases, the ESOP trustee votes the shares held in the plan, but ESOP participants have certain rights related to directing the trustee in voting the shares of company stock held in their accounts. These rights vary depending on whether the sponsoring company is publicly traded or privately held. In general, privately held companies must pass through voting rights to participants only on "major corporate issues," such as:

- Merger
- Consolidation
- Recapitalization
- Reclassification
- Liquidation
- Dissolution
- Sale of substantially all of the assets of a trade or business of the company

On matters that do not constitute a major corporate issue, the ESOP trustee generally votes the shares held by ESOP participants without direction. Publicly traded companies must allow ESOP participants to direct the manner in which the shares held in their accounts are to be voted on all corporate issues requiring a vote.

Typically, each share in the ESOP is allotted one vote. Alternatively, voting can be on a one-vote-per-participant basis. The ESOP trustee will generally vote unallocated shares held in the trust.

Employee diversification rights

Generally, participants who have attained age 55 and have participated in the ESOP for at least 10 years must be offered the opportunity to diversify their stock balances for a period of six years. During the first five years, eligible participants are able to diversify up to 25 percent of their ESOP

stock balance, less any previously diversified shares. In the sixth and final year of eligibility, they must be able to diversify up to 50 percent of their stock balance, less any previously diversified shares. Sponsoring employers may permit higher percentages of participants' balances to be diversified and may also reduce the age and participation requirements. ESOPs must follow these rules for stock acquired after Dec. 31, 1986, and they may permit the diversification of stock acquired before that date.

To effect the diversification, ESOPs must do one of the following:

- Provide at least three investment options in the ESOP for the participant to diversify into
- Distribute to the participant the portion of the account balance the participant elected to diversify
- Allow that portion to be transferred to another qualified retirement plan.

The PPA accelerated diversification requirements for employer stock held in employee contribution accounts (401[k] deferral and after-tax contribution accounts) and employer matching accounts of ESOPs sponsored by publicly traded companies. Employer stock in employee contribution accounts is generally eligible to be diversified immediately, and employer stock

in matching accounts is eligible after three years of service with no age requirements. These rules took effect on the first day of the plan year beginning after Dec. 31, 2006.

Distribution of ESOP benefits

Unless the participant elects a later distribution, ESOPs must generally begin distributing an account balance to a participant no later than either:

- One year after the close of the plan year in which the participant separates from service due to normal retirement, disability, or death.
- One year after the close of the plan year that is the fifth year following the plan year of the participant's separation from service for any other reason. However, for ESOPs sponsored by C corporations, shares acquired with the proceeds of an ESOP loan need not be distributed under this provision until the loan is repaid. It is not clear if this delay applies to S corporations.

Minimum distributions must be made to participants who have attained age 70½ and have retired, or to participants who have attained age 70½ and own at least 5 percent of the company, whether or not

they have retired. These minimum distributions must be made each year and are based on the participant's life expectancy.

Distributions must be made either in a lump sum or in substantially equal periodic payments. Such multiple payments must be made at least annually over no more than a five-year period, unless the participant chooses otherwise. If an account balance exceeds \$1,070,000 (as adjusted for cost-of-living increases), payouts can be extended one year for each \$210,000 (as adjusted for cost-of-living increases) or a fraction thereof by which the balance exceeds \$1,070,000, but for no longer than five additional years, resulting in a payout over 10 years, at most.

Distributions may be made in either cash or company stock, but participants generally have the right to demand stock. However, if the sponsoring corporation is an S corporation or its charter or bylaws restrict ownership of substantially all company stock to current employees, then the ESOP need not offer stock distributions. In such cases, ESOPs generally distribute cash, but they may also distribute stock that is subject to a mandatory, immediate sale back to the company at fair market value. Moreover, stock that is not publicly traded may be

distributed subject to a "right of first refusal." This simply requires the distributee to first offer the stock back to the employer or to the ESOP before selling to another party. The repurchase of employer stock pursuant to a right of first refusal must be at a price no less favorable than the greater of the selling price offered by a good faith purchaser or fair market value.

The "put" option

If a sponsoring employer's stock is not readily tradable, participants receiving stock distributions from the ESOP must be given a "put" option. This option gives the participants the right to require the company to buy the stock back at the fair market value. The ESOP may assume the legal responsibility to purchase this stock, but it does not have to do so.

Participants must have at least 60 days after the date of the distribution to exercise a put option. If they do not exercise the put option during that time, they have an additional period of at least 60 days, beginning with the date that the subsequent plan year's valuation has been communicated to them. If stock was distributed to participants in an ESOP installment distribution, the company must pay the entire purchase price of the stock put to it within 30 days

after the put is exercised. If the stock distribution was made in a lump sum, the employer can pay for the stock in installments over a period not exceeding five years, with reasonable interest earnings applied. However, such an installment note must be “adequately secured” with tangible assets or with a surety bond. Since lenders will generally not permit such liens on assets and since surety bonds are difficult to purchase, in practice it is nearly impossible to adequately secure such an installment note.

Finally, put options may be assigned to an individual retirement arrangement (IRA) if the shares are rolled over by a participant to such a vehicle.

Valuation of employer stock

Normally, qualified retirement plans are prohibited from conducting certain transactions with “parties in interest,” a group that includes the company, major shareholders, officers, directors, and plan fiduciaries. However, ESOPs are exempt from this prohibition in certain circumstances, which enables them to acquire employer stock. ESOPs qualify for this exemption as long as they pay no

more than adequate consideration for the stock from such parties and as long as no commission is paid on the sale.

In public companies, adequate consideration generally means the stock’s current market price. For closely held companies or for thinly traded public companies, determining adequate consideration for employer stock is not as straightforward.

Whether the sponsoring company is publicly traded or closely held, all ESOP assets, including company stock, must be valued at least once a year. If those assets include employer stock that is not publicly traded, annual valuations must be performed by a qualified independent appraiser.

The independent appraisal process

It is widely understood that an independent appraiser (selected by plan fiduciaries) should be a professional who is:

- Regularly engaged in the valuation of businesses or business interests
- Independent of the sponsoring company, other parties to the ESOP transaction, and other professionals providing services to the sponsoring company

The government provides little guidance to ESOPs of closely held companies with regard to stock appraisals. Instead, independent appraisers are guided by generally accepted appraisal practices, as well as case law. An appraiser must consider the following factors, contained in IRS Revenue Ruling 59-60, when establishing the value of a privately held business:

- The nature of the business and the history of the enterprise since its inception
- The general economic outlook and, in particular, the condition and outlook of the specific industry
- The stock’s book value and the company’s financial condition
- The company’s earnings capacity
- The company’s dividend paying capacity
- Whether the enterprise has goodwill or other intangible value
- Sales of the stock and the size of the block to be valued
- The market price of stocks of corporations engaged in the same or a similar line of business and which have their stocks actively traded in a free and open market, either on an exchange or over the counter

Discount factors

When valuing a closely held company, an appraiser often discounts the stock relative to that of a comparable public company. This is done for the following reasons:

- **Lack of marketability.** Because a privately held company's stock is not readily tradable, appraisers generally will discount its value from 25 to 50 percent as compared to that of an otherwise identical public company. However, since ESOP participants have a put option that creates a reliable market for distributed stock, the marketability discount applied to ESOP shares typically ranges from zero to 25 percent.
- **Minority interests.** Appraisers usually will apply a discount to any stock representing a minority interest in a company. This practice extends to ESOPs holding a minority interest, since a minority shareholder normally cannot control corporate decision-making. Appraisal practices vary, however, in cases where an ESOP holds the majority of a company's stock.
- **ESOP obligations.** The amount of an ESOP's debt and the magnitude and timing of the sponsoring company's ESOP stock repurchase obligation can also have a significant impact on the valuation of ESOP-held shares.

The repurchase obligation

As discussed earlier, if a sponsoring company's stock is not readily tradable on an established market, ESOP participants receiving stock distributions must be given a put option that obligates the employer to buy those shares back. Companies paying cash-only distributions must similarly fund the conversion of stock into cash prior to distribution. Since this liability, often referred to as a "repurchase obligation," can grow substantially, companies exploring the possibility of establishing an ESOP should carefully consider it before proceeding. The repurchase obligation is rarely a reason to decide against an ESOP, but it should be projected and planned for carefully prior to making a final decision. A company's ESOP repurchase obligation is determined by a number of factors, including:

- The company's annual ESOP contributions in both stock and cash
- The share value differential between the date of contribution and the repurchase date
- The ESOP's vesting schedule
- Ages within the participating employee group
- Number of employees
- Employee turnover
- Disability and mortality

- The method and timing of share distribution and repurchase
- Diversification rights granted to participants
- Whether the company is structured as a C corporation or an S corporation

To financially prepare for the ESOP repurchase obligation, sponsoring employers can:

- Make annual cash contributions (or dividends/S corporation distributions) to the ESOP
- Invest in a variety of insurance and other vehicles to generate funds to meet the obligations
- Use excess company funds to repurchase shares
- Sell newly issued shares of company stock to meet an ESOP repurchase obligation
- Leverage or re-leverage the ESOP by borrowing money to fund the obligation

Fiduciary responsibilities

ERISA defines a "fiduciary" as anyone who exercises discretionary authority or control regarding the management or disposition of qualified retirement plan assets. With regard to ESOPs, plan fiduciaries normally include:

- Trustees
- Persons active in plan administration and who possess discretionary powers
- Members of an administrative committee
- Within limits, the sponsoring company's officers and directors who have the power to appoint these individuals

An ESOP's trustee can be an officer or group of employees of the sponsoring corporation, members of an administrative committee, or an independent bank or trust company. The ESOP plan document must clearly define the duties and responsibilities of the trustees and other fiduciaries. In some circumstances, an independent trustee or adviser may be appropriate. The trustee must act according to the directions of the ESOP committee but must still meet the fiduciary obligations of ERISA, which include acting prudently and exclusively in the interest of plan participants. The responsibilities of an ESOP's trustee include:

- Investing plan assets
- Securing proper stock valuations
- Assuring that participating employees' interests are protected in ESOP transactions

ESOP tax incentives and accounting rules

To promote the use of ESOPs, and particularly leveraged ESOPs, Congress has instituted a number of specific tax incentives targeting employers, lenders, and selling shareholders.

Deductibility of contributions

An employer's contributions to an ESOP, like those to other qualified retirement plans, are tax-deductible within certain limits, as follows:

- Contributions to a leveraged ESOP by a C corporation are fully deductible to the extent those contributions are used to pay interest on the ESOP loan.
- Contributions by a C corporation that are used to make ESOP loan principal payments are

deductible up to an amount equal to 25 percent of participating employees' compensation.

- All other contributions by a C corporation to an ESOP or any qualified retirement plan are generally deductible up to an amount equal to 25 percent of participating employees' compensation.
- All contributions by an S corporation to an ESOP or to any qualified retirement plan are deductible up to an amount equal to 25 percent of participating employees' compensation. There is no separate deduction for principal and interest payments on the ESOP loan for S corporations.
- A sponsoring company can also make contributions in stock and deduct the fair market value of the stock, subject to the above limits. By doing so, the employer can obtain the benefits of an ESOP with no immediate cash cost.

ESOP rollover tax incentives (for C corporations)

Tax incentives for Section 1042 rollovers, which apply only to C corporations, are summarized under "The Section 1042 Rollover" on pages 7 and 8.

Deductibility of Dividends C corporations can also deduct dividends paid on stock owned by the ESOP. Companies may take a tax deduction for dividends paid on C-corporation stock owned by the ESOP to the extent that such dividends are either:

- Paid in cash to the participants
- Paid to the ESOP and subsequently distributed in cash to participants within 90 days after the close of the plan year in which the dividend was paid
- Used to make payments on an ESOP loan, provided the dividends were paid on employer securities acquired with the proceeds of the ESOP loan
- At each participant's election, either paid in cash or reinvested in company stock within the ESOP

Paying cash dividends to participants either directly or from the ESOP trust, as outlined in the first two bullet points above, provides companies with a tax-advantaged means of passing dividends through to participating employees. Many companies have found such dividends to be an effective motivator, because they give employees a current, tangible benefit based on their stock ownership.

The deduction must be taken for the year the dividends are distributed to participants, used to repay the loans, or reinvested in company stock – not the year they are paid to the trust. Dividends paid to participants are taxed as ordinary income to the participant. To be deductible, the dividends must be “reasonable.” The IRS defines “reasonable” as an amount not substantially exceeding the rate the employer can reasonably be expected to pay on a recurring basis. Deductibility can be denied for dividends found to be an avoidance or evasion of tax. Finally, dividends received by the ESOP trust are not included for purposes of calculating the 25 percent contribution deductibility limit for leveraged ESOPs nor are they counted as annual additions under IRC Section 415.

Taxing participant benefits

Individual account balances are not taxable to participants as long as they are held in the ESOP trust. The funds are taxed only when distributed to participants or beneficiaries.

If stock is distributed to participants in a lump sum, the cost basis of the distributed shares is taxed at the individual's personal income tax

rate. The difference between the fair market value at the time of the distribution and the original cost of the stock is known as net unrealized appreciation (NUA). The individual is taxed on this NUA at long-term capital gains rates, regardless of how long the ESOP held the stock prior to distribution and how long the individual held the stock after distribution. The difference between the price at which the individual subsequently disposes of the stock and the fair market value at the time of the distribution is taxed as either a long- or short-term capital gain, depending on how long the individual held the stock after receiving the distribution from the ESOP.

Generally, if an employee receives a distribution from a qualified retirement plan before age 59½, a 10 percent excise tax is imposed on that amount, in addition to the individual's personal income tax. Exemptions from this excise tax are provided for death, disability, extraordinary medical expenses, termination of employment after age 55, or distributions of deductible dividends. No taxes or excise taxes are assessed when distributions are rolled over to an IRA or to another qualified retirement plan.

S corporation ESOP tax issues

S corporations were first authorized to sponsor ESOPs in 1998. Although there is a unique tax incentive for S corporation ESOPs, such plans do not offer many of the tax incentives available to C corporation ESOPs.

Specifically:

- Sellers of S corporation stock to an ESOP are not eligible for the Section 1042 rollover.
- S corporation income distributions paid on employer securities held by an S corporation ESOP are not deductible.
- The limits on annual additions under IRC Section 415 are generally more restrictive for leveraged ESOPs sponsored by S corporations than for those sponsored by C corporations
- Annual contributions to an S corporation-sponsored ESOP are limited to 25 percent of eligible payroll. C corporations are limited to 25 percent of eligible payroll for all contributions not related to the ESOP loan, plus an additional 25 percent of eligible payroll for the contribution used to fund principal payments on the loan and 100 percent of the contribution used to fund interest payments on the loan.

Congress has provided S corporation ESOPs with a significant tax benefit, however. Since S corporation income is taxed at the shareholder level, not the corporate level, and since ESOPs are tax-qualified entities, the ESOP's share of the S corporation's income is not subject to federal income tax. For example, if the ESOP owns 100 percent of the S corporation, the company will pay no federal income tax and, generally, no state tax. When an S corporation ESOP pays a distribution to a participant, that individual is then taxed on the distributions. So, rather than eliminating taxes completely, an S corporation ESOP simply defers them. But that deferral can be a significant benefit to an S corporation by allowing the company to fund its growth on a tax-free basis.

The ability of an S corporation ESOP to retain cash by deferring taxes can be diluted when the ESOP owns less than 100 percent of the company. Under S corporation laws, all shareholders must receive a pro rata share of any income distributions paid by the company. S corporation distributions are usually made so that non-ESOP shareholders can pay taxes owed on their pro rata share of the S corporation's taxable income. To the degree

other shareholders receive income distributions to pay taxes, the ESOP trust must receive the same per-share amount, thus reducing the company's available cash. However, the cash that accumulates in the ESOP offers S corporations a distinct advantage, because it allows them to build reserves to fund repurchase obligations.

The anti-abuse test

Fearful that the tax deferral capabilities of S corporation ESOPs would be abused, Congress created an "anti-abuse" test to help ensure that S corporation ESOPs are established to benefit a broad number of participants.

The first step of the anti-abuse test is to identify "disqualified persons" (DPs), who are defined as either:

- Individuals who own 10 percent or more of the ESOP stock and synthetic equity, which is, generally, deferred compensation and equity-based derivative securities
- Family members who collectively own 20 percent or more of the holdings described in the prior bullet point

If all those identified as DPs cumulatively hold more than 50 percent of the ESOP stock, non-ESOP stock, and synthetic equity, significant excise taxes are assessed on the DPs and on the sponsoring S corporation.

Before an S corporation establishes an ESOP, or a C corporation with an ESOP considers electing S corporation status, these anti-abuse rules must be fully considered.

ESOP accounting rules

Generally accepted accounting principles for leveraged and nonleveraged ESOP transactions have been established by the American Institute of Certified Public Accountants. Plan fiduciaries must carefully follow these rules in accounting for ESOP transactions. Major provisions of these rules include the following:

- **ESOP debt recorded as a liability.** Regardless of whether the sponsoring company has guaranteed an ESOP's debt, the debt must be recorded as a liability in the company's financial statements. The issuance or purchase of shares by the ESOP results in a charge to unrecorded

ESOP shares, a contra-equity account that is a reduction of shareholders' equity. This amount is commonly equal to the debt incurred for the purchase of the shares. The contra-equity account is reduced by the historical cost value of the shares released from the unallocated stock account. Companies sponsoring ESOPs leveraged with an employer loan should not report the loan receivable as an asset, nor should they report the ESOP's note payable as a liability.

- **Released shares recorded as compensation expense.** The fair value of shares released to individual employees is generally charged to compensation expense. This occurs in spite of the fact that the fair value may not be equal to the principal reduction of the ESOP debt or the reduction of the contra-equity account. The difference between the historical cost value of the shares being allocated and the compensation expense is charged to or credited to paid-in capital. The interest accrued on the note payable is treated as interest expense.

- **Treatment of dividends.**

Dividends on unallocated shares used for ESOP debt service will reduce the ESOP debt or accrued interest. Dividends on unallocated shares paid to participants, on the other hand, are treated as compensation expense. Dividends on allocated shares should be charged to retained earnings.



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¹ C corporations are subject to a corporate level federal income tax on taxable income. An S corporation's federal taxable income is divided pro rata among its shareholders and reported as income on their individual federal tax returns.

² Dividends must be considered "reasonable" and may be disallowed if determined to be an avoidance or evasion of taxation.

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