Issue Brief

Issue Brief #1

WHAT IS AN ESOP?

Introduction

An ESOP is an employee benefit plan which makes the employees of a company beneficial owners of stock in that company. Several features make ESOPs unique as compared to other employee benefit plans. First, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer.

Second, an ESOP is unique among qualified employee benefit plans in its ability to borrow money. As a result, a "leveraged ESOPs" may be used as a technique of corporate finance.

How Do ESOPs Work?

A company which wants to set up an ESOP creates a trust to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. A number of different formulas may be used for allocation. The most common is allocation in proportion to compensation, but formulas allocating stock according to years of service, some combination of compensation and years of service, and equally, have all been used. Typically employees might join the plan and begin receiving allocations after completing one year of service with the company, where any year in which an employee works at least 1000 hours is counted as a year of service.

The shares of company stock and other plan assets allocated to employees' accounts must vest before employees are entitled to receive them. Vesting is a process whereby employees become entitled to an increasing percentage of their accounts over time. The least liberal vesting schedule allowed by law 20% per year until employees are fully vested after 7 years of service. Some companies, however, vest employees' entire accounts right away.

When an ESOP employee who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying his/her ESOP account up to 25% of the value. This option continues until age sixty, at which time the employee has a one-time option to diversify up to 50% of his/her account.

Employees receive the vested portion of their accounts at either termination, disability, death, or retirement. These distributions may be made in a lump sum or in installments over a period of years. If employees become disabled or die, they or their beneficiaries receive the vested portion of their ESOP accounts right away.

In a publicly-traded company employees may sell their distributed shares through the stock market. In a privately held firm, the company must give the employees a put option on the stock for 60 days after the distribution. If the employee chooses not to sell at that time, the company must offer another put option for a second sixty day period starting one year after the distribution date. After this period the company has no further obligation to repurchase the shares. The law permits some companies, such as an S corporation, to distribute cash equal in value to the stock in the participants account.

An ESOP company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a retirement distribution, within five years for a pre-retirement distribution, and not to exceed five years in duration in either case. The company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.

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Uses of ESOPs

The two most common uses of ESOPs are to buy the stock of a retiring owner in a closely held company, and as an extra employee benefit or incentive plan. These two uses probably account for over eighty percent of all the ESOPs now in existence. The proportion of ESOPs created to buy out a retiring owner is attractive, because tax provisions encourage retiring owners to sell to an ESOP. Other companies have used ESOPs as a technique of corporate finance for a variety of purposes--to finance expansion, make an acquisition, spin off a division, take a company private, etc. In a small number of cases--about 2%--ESOPs have been used to buy out a failing firm that would otherwise close.

Buying the Stock of a Retiring Owner

Many closely held companies have no plans, or incomplete plans, for business continuity after the departure of retirement of the founder or major shareholder. If the company repurchases a retiring or departing owner's shares, the proceeds will be taxed as ordinary income. A sale to another company will also be taxed as ordinary income, and finding a buyer is not always easy even for a profitable closely-held company.

An ESOP can provide a market for the equity of a retiring owner -- or any interested major shareholder -- of a closely held company, and provide a benefit and job security for employees in the process. Retiring owners of closely held companies incur no taxable gain on a sale of stock to an ESOP, provided that the ESOP owns at least 30% of the company immediately after the sale (sales by two or more stockholders may be counted in this 30% if these sales are part of an integrated transaction), and that the sale's proceeds are reinvested in qualified securities within a fifteen month period beginning 3 months before the date of the sale. This tax-deferred rollover is a most tax favored way for an owner of a closely held company to sell his or her stock. [Note, this unique tax benefit is not available if the stock sold is part of an S corporation. S corporation's sponsoring an ESOP have different tax incentives from the traditional corporation. See Issue Brief #21].

Employee Benefit or Incentive

Most ESOP companies had the desire to set up an employee benefit or incentive as one reason for starting their plan, but for many companies that's the only reason. Some companies hope that by making employees owners they will increase their dedication to the firm, improve work effort, reduce turnover, and generally bring a more harmonious atmosphere to the company. Research has shown that giving workers a significant stake in their companies can improve employees' attitudes towards their companies, and that these improved attitudes towards their companies can translate into bottom line improvements. Other companies want to set up some kind of benefit plan, and find that an ESOP is the best choice.

The Many Uses of a Leveraged ESOP

In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust, which will enable the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly-traded stock, or for any other corporate purpose.

Two tax incentives make borrowing through an ESOP extremely attractive to companies, which might otherwise never consider financing their employees' acquisition of stock. First, since ESOP contributions are tax deductible, a corporation which repays an ESOP loan in effect gets to deduct principal as well as interest from taxes. This can cut the cost of financing to the company significantly, by reducing the number of pre-tax dollars needed to

repay the principal by as much as 34%, depending on the company's tax bracket. Second, dividends paid on ESOP stock of a C corporation passed through to employees, or reinvested by employees for more company stock, or used to repay the ESOP loan are tax deductible. This provision of federal tax law may increase the amount of cash available to a company compared to one utilizing conventional financing. [Again as above, the ESOP dividend deduction is not available to S corporation sponsors of ESOPs].

A Brief History

Employee ownership has a long history in the United States, but the ESOP in its current form was devised and perfected in 1956 by a San Francisco attorney and economist, Dr. Louis O. Kelso. Dr. Kelso believed that unless more people owned significant amounts of capital, many economic and social problems would prove intractable, making an expansion of government's role in the economy, and perhaps socialism, increasingly unavoidable. Accordingly, he set out to design devices to broaden the ownership of capital. The ESOP was one of those devices.

Kelso won a powerful supporter in former Senator Russell B. Long (D-LA). Under Senator Long's leadership Congress passes more than 17 laws encouraging the growth of ESOPs, starting with the passage of ERISA in 1974 through 1986. From 1987 through 2004, Congress has amended some of these laws, both adding new incentives for ESOPs, and also limiting some of those passed 1974 through 1986.

Congress encourages employee ownership with tax incentives in order to broaden the ownership of capital and to provide a means of corporate finance. The ownership of corporate stock is more concentrated than either the distribution of income or of any other kind of asset.

Studies have shown that ESOPs may provide employees earning very modest amounts of income with tens and even hundreds of thousands of dollars of stock.

Thus, the visions of Dr. Kelso and Senator Long have proven to be realistic because of ESOPs.

Further Assistance

The ESOP Association recommends the booklet *How The ESOP Really Works*, which provides a thorough overview of ESOPs' legal and business mechanics. Contact the Publications Department at (202) 293-2971.

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