ESOP — No Fable, It's Fabulous

By Stephen M. Margolin

An Employee Stock Ownership Plan (ESOP), under the right circumstances is fabulous. For example, an owner (or co-owner) has operated a company for many years and now wishes to retire with a large lump sum payout. The beauty of the ESOP is that he could sell his shares to the ESOP and, under the circumstances below, defer (and maybe avoid) tax on the entire gain. Assume the selling price is $2 million. A bank loans the ESOP the $2 million. The ESOP buys the shares for that amount.

To amortize the debt to the bank, the company pays principal and interest, which is fully deductible through the ESOP, to the bank.

This should be contrasted with a stock dividend. When you have a stock dividend the company gets zero deduction and the income to the recipient is 100 percent includible. With an ESOP, the opposite occurs. The company gets a 100 percent deduction for the principal and interest, yet the recipient has zero includibility. The following discusses the technical mechanics of an ESOP.

ESOP Characteristics

An ESOP is a qualified employee benefit plan that has characteristics of a profit sharing plan, but is designed to invest primarily in the stock of the sponsoring corporation.[1] Technically, it is a stock bonus plan or a combined stock bonus/money purchase plan.

An ESOP may be used as a technique of corporate finance.[2] For example, it may be used to transfer corporate funds to a shareholder on a tax-favored basis.[3]

An S corporation cannot use an ESOP, but if a leveraged ESOP is desired, S-corp status is often unnecessary. This is because the deductions are so significant that there is no taxable income. Any other type of corporation can sponsor an ESOP.

Any employee of the sponsor or its affiliates, except independent contractors, consultants, and non-employee directors, may participate in the ESOP.

Contributions to the ESOP may be made in actual stock of the corporation and/or of cash to purchase the stock. The ESOP may borrow from a bank or other lending institution to obtain funds to purchase the sponsor's stock, with the sponsor guaranteeing the loan. This type of ESOP is called a leveraged ESOP.

With a stock bonus ESOP, the maximum deductible company contribution is 15 percent of all participants' compensation.[4] If the ESOP is combined with a money purchase pension plan, the maximum deductible company contribution is 25 percent of all participants' compensation.[5]

With a leveraged ESOP, the corporation can also deduct the interest payments on the loan and any dividend payments used by the ESOP to repay the loan.[6] This provision permits the maximum deductible amount to be well in excess of 25 percent of all participants' compensation.

There is no minimum contribution requirement. However, a leveraged ESOP is governed by the terms of any loans and all qualified plans must have recurring contributions.

The trustees of the ESOP are the legal owners of the stock. They exercise all rights of ownership until the stock is actually distributed to participants. However, if the stock is not publicly traded, participants must be allowed to vote the stock allocated to their accounts on major issues (e.g., on the liquidation, dissolution, merger, or consolidation of the corporation or on the sale of substantially all of the assets of the corporation).[7] The ESOP could permit one vote per participant.

Generally, the stock need never go to outsiders. This prohibition can be achieved by amending the charter or by-laws to restrict stock ownership to employees of the corporation.[8] Thus, employees would receive cash, rather than stock, when they terminate employment with the corporation.

If stock ownership is not so restricted, distributions can still be made in cash, subject to the right of a participant to demand company stock coupled with a put option directed to the corporation.[9] If corporation stock is distributed to a participant, the corporation can require the right of first refusal, unless the stock is publicly traded.[10]

ESOP Advantages

The advantages of an ESOP to the sponsoring corporation include:

1. The deductibility of contributions of stock or cash;
2. The deductibility of dividends paid to the ESOP;
3. If a contribution results in a net operating loss, it may be carried back for three years, producing a cash refund to the corporation;
4. The creation of a ready market for sale of corporation stock;
5. Greater employee motivation through stock ownership, resulting in higher productivity rates and lower turnover and absentee rates. Most of the firms surveyed by The ESOP Association gave credit to their ESOP for improvements in productivity;
6. Employees are locked in through the vesting mechanism;
7. Help in the resolution of shareholder disagreements by making it possible for one or more of the shareholders to be bought out on a tax-favored basis;
8. Ability to raise capital at a lower interest rate if the ESOP owns at least 50 percent of outstanding corporation stock;

9. Assistance in the acquisition of one corporation by another (whether or not in conjunction with a merger) through the purchase of some of the stock of the target corporation by an ESOP established by either the target or acquiring corporation. An ESOP can hold the stock of any member of a controlled group of which the sponsoring employer is a part; and
10. Resistance to a potential hostile takeover bid, by placing significant blocks of stock in the hands of stockholders presumably sympathetic to the present management and by dedicating surplus cash to employee benefits.

Tax Free Sale by Seller

The most important advantage of an ESOP to the selling shareholder is that the proceeds of the sale are tax-free to the seller if:

1. The seller owns the stock for at least three years before selling it to the ESOP.[11]
2. The ESOP owns at least 30 percent of the total value of outstanding corporation stock or 30 percent of each class of outstanding corporation stock immediately after the sale.[12] The ESOP must retain this stock for at least three years or the corporation is subject to a 10 percent excise tax.[13]
3. The shareholder invests the proceeds from the sale in stocks and/or bonds of domestic operating corporations or banks within one year of the sale (or the proceeds will be subject to capital gains tax).

The advantages of an ESOP to the remaining shareholders include:

1. They continue to control the corporation; and
2. The ESOP provides liquidity and a market for the corporate stock which can mitigate pressure to sell stock to outsiders.

The disadvantages of an ESOP to the corporation include:

1. The transaction costs (e.g., attorney fees and stock valuation reports) of establishing and maintaining an ESOP;
2. The dilution of stock ownership if terminated employees demand shares of stock and the corporate by-laws do not restrict stock ownership to employees of the corporation. However, such dilution rarely occurs because terminating employees usually prefer cash; and
3. The drain on cash for payouts to terminating participants.

The Cash Drain

However, the drain on cash caused by an ESOP is limited by the following:

1. As with any qualified plan, amounts to be paid out are limited to the participant's vested account balance.[14]
2. Payout need not begin until the earlier of (a) one year after the participant's death, disability, or attainment of age 65, or (b) six years after the participant's termination from employment. Death and/or disability can be hedged by the purchase of inexpensive term insurance. Payout can be further deferred until the loan is repaid in full in a leveraged ESOP.[15]
3. The payout can be spread over five years. Thus, employees who terminate employment for reasons other than retirement, death or disability need not be completely paid by the corporation until eleven years after termination, at the discretion of the corporation. If shares of stock are distributed by the ESOP and the participant exercises his put option with the corporation, the corporation can spread the cash payout over five years in substantially equal payments with reasonable interest, beginning thirty days after the exercise of the put option.[16]
4. After age 55 and 10 years of participation, a participant has the right to receive up to 25 percent of the value of the corporation stock attributable to his account. After age 60 and 15 years of participation, a participant has the right to receive up to 50 percent of the value of the corporation stock attributable to his account.[17]
5. A cash buildup can be created by replacing an existing pension plan with the ESOP.

Conclusion

When an owner of a business wishes to sell his shares on a tax favored basis, an ESOP should be considered. The owner is actually selling the business interest he owns (i.e. the shares) to an ESOP, which is a qualified trust, formed to buy his shares, and holding them for the company employees.

The company, in effect, is sponsoring the acquisition of those shares by funding the ESOP (the buyer) through tax deductible contributions.

1 Code Sections 409(a) and 4975(e)(7).
2 Code Section 4975; Treas. Reg. §54.4975-7 and 11.
3 Code Section 1042.
4 Code Section 404(a)(3).
5 Code Section 404(a)(7).
6 Code Sections 404(a)(9) and 404(k).
7 Code Section 409(e).
8 Code Section 409(h)(2).
9 Code Section 409(h).
10 Code Section 409(h).
11 Code Section 1042(b)(4).
12 Code Section 1042(b)(2).
13 Code Section 1042(c)(3).
14 Code Section 411.
15 Code Section 409(o).
16 Code Sections 409(h) and (o).
17 Code Section 401(a)(28).

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