

Employee Stock Ownership Plan (ESOP)

The basics: The ESOP is essentially a stock bonus plan in which employer stock may be used for contributions.

How It Works

- Employer contributes company stock or cash to the plan.
- Employer contributions are tax deductible. See IRC Sec. 404(a).
- Contributions are not taxed currently to the employee. See IRC Secs. 402(a) and 403(a).
- Earnings accumulate income tax-deferred. See IRC Sec. 501(a).
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging¹, or, at retirement from the current employer, rolled over to an IRA or to another employer plan if that plan will accept such a rollover. See IRC Secs. 402 and 403.
- A KSOP plan additionally includes 401(k) features.

Additional Considerations

- **Maximum annual deduction:** Up to 25% of covered payroll (up to 25% for a leveraged ESOP) can be contributed and deducted by the corporation.
- **Individual limits:** The annual allocation of contributions to a participant's account may not exceed the lesser of 100% of includable compensation or \$41,000 per year. For 2004, participants age 50 and older may also make a \$3,000 "catch-up" contribution.
- **Employer contributions**
 - Most plans are discretionary as to the amount that the employer contributes.
 - If there are profits, the employer is expected to make substantial and recurring contributions.²
- **Excluding persons:** Certain persons can be eliminated on the basis of months of service, age and coverage in a union plan; for example, persons under age 21 can be excluded from the plan.
- **Investment of plan assets:** Plan assets are required to be invested in employer stock with some exceptions for those participants nearing retirement. In addition, assets may be used to purchase life insurance in some circumstances.

¹ Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

² See IRS Reg. 1.401-1(b)(2).

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- **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures.
- **Parties which are favored:** Typically, younger participants are favored because they have a longer time for their fund to grow. Also, there may be some special advantages to the major shareholders.

How Much Will There Be at Retirement

This will depend upon three factors.

1. The frequency and amount of contributions,
2. The number of years until retirement, and
3. The investment return.

The risk of poor investment returns rests upon the employee. However, if the investment results are favorable, the participant will have a larger fund at retirement age.

An Example of What \$10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax¹				
Years	6%	9%	12%	15%
5	\$56,371	\$59,847	\$63,528	\$67,424
10	\$131,808	\$151,929	\$175,487	\$203,037
15	\$232,760	\$293,609	\$372,797	\$475,804
20	\$367,856	\$511,601	\$720,524	\$1,024,436
25	\$548,645	\$847,009	\$1,333,339	\$2,127,930
30	\$790,582	\$1,363,075	\$2,413,327	\$4,347,451
35	\$1,114,348	\$2,157,108	\$4,316,635	\$8,811,702

Top-Heavy Plans

If more than 60% of the plan assets are allocated to key employees², the employer must contribute at least as much for non-key participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includable compensation (higher in some instances).

¹ The results shown are hypothetical and simplified to facilitate understanding.

² A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded \$130,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded \$150,000.

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How ESOPs Differ from Stock Bonus Plans

- Under an ESOP the participants have the absolute right to demand distribution of company stock.
- The plan may repurchase the distributed shares of stock but is not required to do so; only the employer is so required.
- The plan must pass certain voting rights through to the participants.
- If the stock is not publicly traded or is restricted, the participant or his or her heirs must have the right to offer the stock for sale to the employer.
- The plan may borrow money from a bank to purchase stock, with the employer guaranteeing such loan, without it being considered a prohibited transaction.
- The plan may borrow money from a prohibited person without incurring any penalty. See IRC Sec. 4975(d)(3).
- The plan may not be integrated with Social Security.
- Whereas a stock bonus plan is not required to invest in employer securities, an ESOP must invest primarily in employer securities, to the extent that employer stock is available.
- The employer can contribute company stock directly to the plan.¹
- The plan may purchase the securities on the open market for public companies, from the company itself or from the shareholders.
- The employer can contribute and deduct up to 25% of compensation for a leveraged ESOP, which is repaying loan principal. In addition, it can make deductible contributions to pay interest on the loan used to purchase securities.

Advantages to Employer

- A. Contributions are tax deductible.
- B. Contributions and costs are totally flexible.
- C. The plan is easy to understand by the employees.
- D. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- E. Since all or substantially all of the assets may be invested in employer's stock, this is a good method for raising additional capital without going to the market place.
- F. In effect, the corporation can raise capital with deductible contributions to its plan.

¹ However, it may be better to contribute cash and then have the plan purchase stock from the employer. The valuation of stock directly contributed to the plan may be challenged by the IRS. Contributing cash preserves the value of the contribution.

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- G.** Stock, rather than cash, can be contributed to the plan.¹
- H.** An ESOP may be used to facilitate the buyout of a stockholder.
- I.** Dividends paid on stock and owned by the ESOP may be deducted if they are reinvested in employer stock, or if plan participants are given a choice of receiving the dividends in cash, or reinvesting the dividends in employer stock.
- J.** In effect, both the interest and principal of loans are made on a deductible basis.

Advantages to Employees

- A.** Annual employer contributions are not taxed to the participant.
- B.** Earnings on the account are not currently taxed.
- C.** Distributions may be eligible for 10-year income averaging², or, at retirement from the current employer, rolled over to an IRA or to another employer plan if that plan will accept such a rollover. See IRC Secs. 402 and 403.
- D.** Special treatment of unrealized gains upon the distribution of stock permits significant tax deferral.
- E.** Participants may also have a traditional, deductible IRA (subject to certain income level limitations based on filing status), a traditional, nondeductible IRA or a Roth IRA.
- F.** There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.
- G.** Younger employees can accumulate a larger fund than with a defined benefit plan.
- H.** The forfeited, unvested portion of accounts of former participants is allocated to the active participants' accounts. This can have a substantial impact on the future benefits.
- I.** Employee participates in employer's growth.
- J.** A potential market is created for deceased owner's stock.
- K.** The ESOP can provide significant estate planning benefits for shareholders.

¹ However, it may be better to contribute cash and then have the plan purchase stock from the employer. The valuation of stock directly contributed to the plan may be challenged by the IRS. Contributing cash preserves the value of the contribution.

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- L. The gain on the sale of employer securities to the ESOP can be deferred under certain situations.
- M. Participant may borrow from the plan within certain guidelines if provided for in the plan documents.
- N. If the plan meets the parameters specified by the U.S. Supreme Court in *Shumate v. Patterson*, 504 U.S. 753 (1992), participant plan accounts or accrued benefits are protected from creditors.

Disadvantages to Employer

- A. The ESOP will generally not produce as large of a contribution and deduction for older employees as will a defined benefit plan.
- B. Contribution limitations are set at 25% of covered compensation.
- C. Certain voting rights must be passed through to the participants.
- D. An ESOP can be costly to set up. Ongoing administration can also be expensive because of the need to have the stock value appraised each year.
- E. Future repurchases may not come at a convenient time and must be made with after-tax dollars. This could place a financial strain on the employer.

Disadvantages to Employees

- A. There is no guarantee as to future benefits.
- B. Investment risks rest on the participant.
- C. There is no assurance as to the frequency and amount of employer contributions.
- D. Older participants may not receive as great of a benefit as with a defined benefit plan.
- E. The value of closely held stock may be difficult to determine at retirement age.
- F. If the founder or key people die, retire or terminate employment, the company stock may be worth very little.
- G. The company may not be financially able to repurchase the stock, even though required to do so.
- H. If the employer's stock is depressed in value at retirement time, there could be a significant loss in the retirement account.