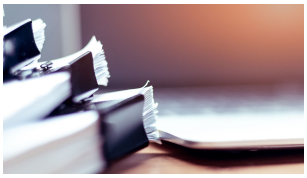

Anatomy of an Employee Stock Ownership Plan (ESOP)

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What is an employee stock ownership plan (ESOP)?

An ESOP is a means of providing an identity of interest between a broad-based group of employees and the company. An ESOP is a tax-exempt, qualified employee benefit plan designed to invest primarily in employer securities; as the company contributes to the ESOP, ESOP participants build an equity stake in their employer. Because it is a qualified retirement plan, an ESOP provides a company-wide benefit and generally cannot provide a higher benefit, as a percentage of pay, for executives than for other eligible employees.

Tax incentives for ESOPs have, more importantly, transformed them into potential financing vehicles capable of generating significant economic benefits for corporations, as well as shareholders, and these incentives have made them useful as an acquisition vehicle.

How does an ESOP compare with other qualified employee incentive plans?

An ESOP shares many of the advantages of qualified plans: currently deductible employer contributions, up to generous limits; earnings on contributions exempt from federal (and most state) income taxes; and deferral of tax on ESOP participants until they receive distributions. Unlike other retirement plans, an ESOP has a special exemption that allows this type of plan to buy stock in the employer — and it can borrow money to buy bigger blocks that become available. So, there are several unique ESOP advantages:

- Deductible dividends – A company may deduct dividends on ESOP stock if paid in cash to ESOP participants within 90 days after the close of the plan year, or used to make payments on an ESOP loan incurred to purchase qualifying employer securities. (Not available to S corporations.)
- Deductible principal payments and partially tax-free borrowing rates – A leveraged ESOP can lower the cost of

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raising capital.

- If an ESOP is an owner of stock in a corporation that has made an election to be taxed as a pass-through entity under Subchapter S of the Code, all of the company's income allocable to the ESOP's percentage ownership is tax-free each year, because the ESOP is a tax-exempt entity.
- If stock in a C corporation is sold to an ESOP, the seller can often defer income taxes on the gain in that sale, by claiming the benefits of Section 1042 of the Code.
- A company founder can sell his ownership to an ESOP and stay involved in the business, assuring that the local legacy and jobs the founder created remain in the founder's community.

An ESOP can borrow funds from the sponsoring company or a third-party lender (who typically obtains the company's guarantee to contribute annually sufficient funds to the ESOP to amortize the loan). The ESOP then uses the cash proceeds of the loan to purchase company stock. As the company makes contributions every year, the ESOP uses those funds to repay interest and principal, and it takes some of the stock purchased from the company out of a "suspense" or collateral account and allocates the stock among accounts of various participants/employees.

Given certain advantages, is an ESOP right for your business?

An ESOP is frequently used to provide a market for a closely held corporation's stock in a family-owned company where there is no family successor to own the business, or where the family wishes to diversify their financial fortunes to other types of investments rather than having all of its net worth in one business. It can also be a tool to assist management in an internal buyout of shareholders, and as an acquisition vehicle for complimentary businesses.

Any business considering an ESOP needs to have advisors that are highly knowledgeable in all types of equity incentive arrangements — often, an ESOP may not be the right answer for a particular situation. Employees can be given an incentive to improve the employer's financial performance in a number of ways, but

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executives often feel that giving employees a piece of ownership is the best way to create the correct incentives.

There are a number of ways to deliver this ownership interest. If a company desires to provide equity as an incentive or succession planning tool to just selected employees, then stock grants, stock options, restricted stock, restricted stock units, performance shares, stock appreciation rights, phantom stock plans or a traditional management buyout transaction should be discussed.

Why Frost Brown Todd for your ESOP queries?

Our employee benefits team is experienced and knowledgeable in all types of equity incentives, as well as other types of retirement programs. We can objectively describe the pros and cons of one alternative over another, so if an ESOP is not right for your company, we won't try to sell you one. As a Frost Brown Todd client, you also have ready access to a large and experienced corporate finance team to help with ESOP financing transactions, as well as numerous attorneys with experience in all merger and acquisition structures, whose creativity is often needed in an ESOP deal.

We always manage an ESOP project by putting important education about ESOPs and key decision-making first — before large costs are incurred needlessly for a deal that might not happen. For more information, contact Debbie Reiss Hardesty, Jennifer Cote, or any member of Frost Brown Todd's Employee Benefits & ERISA practice.

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