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Benefits of ESOPs

An ESOP (Employee Stock Ownership Plan) is an employee benefit plan that makes the employees of a company beneficial owners of stock in that company. The tax code has several provisions which encourage ESOPs. This article summarizes the tax and non-tax benefits of ESOPs as well as some of the potential drawbacks.

Benefits to the Selling Shareholder

ESOPs can provide liquidity for business owners and trusts that hold closely held businesses. Non-tax advantages of selling to an ESOP include:

- An ESOP can help to diversify the shareholder's investments prior to retirement and allow shareholders with management responsibility to sell over time and ease away from the business.

- Apart from acquiring the shares of the primary shareholder, an ESOP can also be used to purchase shares from smaller shareholders.

- The ESOP establishes a market for future selling shareholders.

- Selling to an ESOP passes the business on to the employees who helped build the company and can preserve the legacy, independence, and local ownership of the business.

For C corporations, one of the most explicit benefits for the selling shareholder is the ability to defer capital gains taxes on the sale of stock to the ESOP. This benefit does not exist for S corporations. The deferral of capital gains falls under I.R.C. section 1042 and is referred to a 1042 rollover. The basic requirements of the 1042 rollover are as follows:

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- The selling shareholder must have owned the stock for at least three years before the sale.

- The ESOP must own at least 30 percent of the stock of the company after the sale.

- The seller's proceeds from the sale to the ESOP must be invested in qualified replacement securities either three months before or twelve months after the sale. Qualified replacement securities include the securities of domestic operating corporations.

- No portion of the assets attributable to qualified securities sold to an ESOP through a 1042 rollover may be allocated to the taxpayer seeking 1042 rollover treatment, any person who is related to that taxpayer, or any other person who owns more than 25 percent of the value of any class of qualified securities of the issuing corporation.

By investing the proceeds in replacement securities, the selling shareholder achieves a more diversified portfolio to ensure security in retirement. Capital gains are deferred until the qualified replacement properties are sold. The seller's tax basis in the stock that was sold will be carried over to the replacement property. The capital gains tax from the sale can be completely eliminated if the selling shareholder retains the qualified replacement securities until his death, at which time the estate's basis in the investments are stepped-up to the fair market value at the time of death.

Benefits to Employees

An ESOP can be thought of as an additional employee benefit.

- The ESOP gives employees the opportunity to enjoy capital growth. In a healthy growing company, an ESOP may well be the most financially lucrative benefit plan a company could set up for its employees. However, since ESOPs result in a sharing of both the risks and rewards of ownership with employees, they may involve a somewhat higher degree of risk than other plans. To address this concern, an employer may maintain an ESOP to allow employees to participate in the capital growth of the company and also maintain a 401(k) plan to allow employees to defer income in a more diversified, lower risk plan.

- An ESOP may provide employees with greater incentives to improve productivity by making them partial owners of the company. Aside from enhancing the performance of current employees, it can also improve company performance by attracting key personnel from the outside.

- In cases where management does not have sufficient wealth to finance an outright purchase of the company, an ESOP can provide a way for them to buyout major shareholders. Continuity of management is typically associated with continuity of employment throughout the company.

- The ESOP may serve as an incentive for companies to adopt more participatory management programs. Many ESOP companies communicate company goals and financial results to rank-and-file employees. Modern management tools such as work circles, participatory management, TQM, and open book management all fit easily into an employee ownership environment.

- By giving workers a vested interest in their employer, ESOPs provide a means of breaking down confrontation between labor and management. Employees feel more a part of the company and its success, and the ownership culture improves job satisfaction and tends to reduce employee turnover.

Benefits to Company

The tax code also provides advantages to the sponsoring employer.

- Many ESOPs qualify for higher maximum deductible contributions then other qualified retirement plans. Also, contributions can be either in cash (which is then used by the ESOP to buy employer securities) or directly in the form of employer securities. Where employer securities are contributed directly, the employer may take a deduction for the full value of the stock contributed. By doing so, the employer actually increases its cash flow by the value of the taxes saved through the deduction.

- The deductibility of contributions to an ESOP becomes even more attractive in the case of a leveraged ESOP. The employer may deduct contributions to the ESOP which are used to repay not only the interest on the loan, but principal as well. The ability to take an additional deduction that roughly equals the principal payment makes an ESOP an attractive form of debt financing.

- The tax benefits available to ESOPs may enhance the cash flow coverage to finance debt. In fact, in some cases, it may be possible to structure a leveraged ESOP so that the ESOP loan is paid for substantially through tax savings on distributions or contributions.

- With an ESOP, an S corporation's income continues to be taxed directly to its shareholders. However, because the ESOP is not a taxable entity, its share of the earnings is not subject to federal tax. In the case of a 100 percent ESOP-owned S corporation, this results in no federal tax being paid. Distributions from the trust will ultimately be taxable as ordinary income to the beneficiaries when they withdraw their accounts in retirement.

- I.R.C. Section 404(k) allows a C corporation to take a deduction for dividends paid on the stock held in the ESOP if the dividends are used to pay principal or interest on the ESOP loan incurred to buy that stock; or if the employee elects to reinvest the dividends back into the plan to purchase more company stock; or if dividends are passed through to participants (who pay ordinary income tax on them).

While the tax benefits of ESOPs are the most explicit financial benefit, there are other benefits resulting from ESOPs.

- **Corporate Finance Alternatives**. An ESOP can also purchase newly issued shares from the company. This expands the potential use of an ESOP from an ownership succession alternative to a mechanism of raising capital for other purposes such as purchasing capital equipment with pre-tax dollars, refinancing existing bank debt or financing corporate acquisitions.

- **Reduced Ownership Succession Risk**. Even after the initial acquisition of stock by the ESOP, the ESOP provides an important tool for reducing uncertainty regarding subsequent ownership issues. The ESOP can be used to cash out any shareholder that is no longer interested in having an investment in the company.

- **Maintain Company Independence**. Selling to the ESOP preserves the company's independent identity and can assure the continuation of jobs.

- **Improved Corporate Culture**. From a cultural perspective, the company benefits by giving employees an ownership stake in the company, which will likely lead to greater job satisfaction and improved productivity. ESOP benefits can also give the company an edge in attracting new employees. Employee ownership often increases goodwill between management and employees and results in lower employee turnover.

- **Enhanced Corporate Performance**. An improved corporate culture should lead to improved financial performance. A number of research studies have shown that ESOP companies are more efficient and more profitable than non-ESOP companies. Many ESOP participants become enthusiastic "employee owners" who are committed to the company's growth and profitability.

Potential Drawbacks

Are ESOPs right for everyone? Of course not. Potential drawbacks of ESOPs include:

- **Cost of ESOP Implementation and Administration.** ESOPs are complex entities and subject to substantial regulation and oversight by the Department of Labor and the Internal

Revenue Service. Properly implementing and maintaining an ESOP can be expensive. There are legal costs to prepare the plan document and amend it from time to time. A valuation is required when the plan purchases shares and at least annually thereafter. ESOPs often also use independent fiduciaries, plan administrators, and other professionals. In a large company, the benefits far outweigh the costs, but for a small company, these costs may offset much of the financial benefit of the ESOP.

- **Leverage.** A transaction involving a large block of stock may result in a high level of leverage. Some companies cannot generate the consistent cash flow to support the increased leverage. A 100 percent ESOP transaction often involves the selling shareholders taking back some seller debt.

- **Lender Understanding of ESOPs.** In the case of a leveraged ESOP, arrangements must be made for securing the financing needed to complete the transaction. Some banks are familiar with ESOPs, but some are not. Some bankers may be reluctant to lend to a leveraged ESOP because they are unfamiliar with ESOPs or don't understand how the tax advantages of ESOPs can enhance the company's cash flow and debt-service coverage. A company implementing a leveraged ESOP should find a bank that understands ESOPs or should be prepared to spend some time and effort educating its lender on the subject.

- **Repurchase Obligation.** The ESOP repurchase obligation is established by ERISA and is the company's obligation to repurchase its stock from participants with vested accounts who have retired, died, become disabled, terminated employment, or elected to diversify their holdings. The repurchase obligation is a claim on the company's cash flow. The company should develop a plan for honoring and funding the repurchase obligation. Failure to plan for the repurchase obligation could result in a liquidity crisis at the company or even contribute to a decision to sell the company outright.

- **Complicates Future Transactions**. Companies considering making future acquisitions (or being acquired themselves) may find the ESOP to complicate such transactions. However, there has also been a lot written on using ESOPs to facilitate such transactions.

- **S Corporation Anti-Abuse Laws**. Under Internal Revenue Code Section 409(p), the allocation of S corporation stock within an ESOP must be sufficiently broad-based. Section 409(p) is relatively complicated and also encompasses synthetic equity, treatment of unallocated shares and numerous definitions of specific terms. In summary, Section 409(p) identifies Disqualified Individuals as individuals who (i) own 10 percent or more of a corporation's Deemed Owned Shares or (ii) own, in conjunction with Family Members, 20 percent or more of a corporation's Deemed Owned Shares. If these Disqualified Individuals own, in aggregate, 50 percent or more of the corporation's stock, then the ESOP is in violation and is subject to an excise tax equal to 50 percent of the fair market value of all of the Deemed Owned Shares owned by Disqualified Individuals as well as other potential negative consequences. There are alternatives to avoiding these tax penalties, and they should be considered well in advance of a potential violation of 409(p).

Conclusion

ESOP's were created by Congress in order to promote the concept of broader ownership of capital by employee-owners. In support of this objective, the tax code provides numerous important tax advantages. However, ESOPs are most successful when they are implemented for reasons that go beyond the tax incentives. A company or business owner should consider both the tax and non-tax reasons for implementing an ESOP and also be mindful of the potential pitfalls. Fortunately, there is a community of professionals to advise companies considering the ESOP option.

About the Author

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Nick is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and has more than 20 years of experience in valuation, finance, and banking.

He serves on the Valuation Advisory Committee of The ESOP Association and is Co-chair of the Membership Committee of its Ohio/Kentucky Chapter. Nick has been a presenter on valuation topics for The ESOP Association, National Center for Employee Ownership (NCEO), Ohio Employee Ownership Center (OEOC), Southwest Ohio Tax Institute, the North Carolina Bar Association and Lorman Education Services. He has provided valuation training and judging for the Association for Corporate Growth's ACG Cup competition. Additionally, he has presented a full-day seminar on business valuation for the American Society of Appraisers.

Nick earned a Bachelor of Business Administration in Finance and Real Estate from the University of Cincinnati and an MBA from Xavier University.