Should you consider an employee stock ownership plan (ESOP)?

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General overview

What is an ESOP?

An ESOP is a unique type of qualified retirement plan that invests primarily in employer stock, putting ownership in the hands of employees and giving them a higher stake in the company's success. Similar to other qualified retirement plans, such as profit sharing or 401(k) plans, employers make contributions to the ESOP, accounts are maintained for individual employees and employees are generally taxed on the amounts when distributions are received from their accounts. With the plan's investment in employer stock, the employees' accounts can appreciate as the company grows. In addition to providing employees with an ownership stake in the company that grows until their retirement, an ESOP also gives current shareholders a market in which they can sell their stock.

How does an ESOP work?

The first step is for the company to form and adopt the plan. As with other qualified retirement plans, many considerations go into the initial plan design, including eligibility requirements, vesting provisions and distribution timing.

After initial setup, the stock purchase occurs. The ESOP may purchase all, or any portion, of the company's stock. The company may contribute cash or shares to the plan without using any financing. However, most commonly, the stock purchase occurs through a leveraged structure in which the company loans the purchase amount to the ESOP and holds the shares as collateral on the ESOP loan. Then, the ESOP releases shares to participant accounts over time as the loan is repaid using cash contributions from the employer to the ESOP. To assist with the transaction, the company may also obtain an outside loan from a bank to have the cash available to fund the ESOP's share purchase.

What factors make a company a good ESOP candidate?

An ESOP provides unique opportunities to employees, the company and selling shareholders. Therefore, all three parties should be considered to ensure the plan is a good fit. Is the current employee base open to ownership, and do the employee demographics make an ESOP financially feasible for the company? Are the unique benefits available to selling shareholders desirable to the current owners? Can the company afford to make the required contributions and purchase employees' stock when they separate from service?

Although ESOPs can be very attractive, they involve implementation and annual administration costs. Thus, a company should ensure the ESOP will be sustainable before proceeding with implementation. The company should have a history of profitability and good growth potential to ensure it can make contributions to the ESOP, fund distributions to participants leaving the plan, and the benefits to employees will increase in value. In addition, the company should have a qualified management team who can carry on the business, support employee ownership and be prudent in ESOP compliance matters. The company should have a culture that encourages employee involvement and fosters communication and participation. In addition, certain characteristics of the employee base should be considered, such as the number of employees, level of payroll compared to company value, turnover rates and the average age of employees. This analysis helps ensure that obligations related to contributions to the plan and distributions from the plan can be met within the company's cash flow and desired employee benefit levels.

What makes an ESOP successful?

Good communication is another key to a successful ESOP structure. Not only are there legal requirements to supply participants with certain information, but employees need to understand the value of the ESOP to feel an increased sense of engagement. Management needs to be willing to invest in employees and plan for succession, in addition to adhering to strict legal and financial rules. Qualified third-party advisors can also help an ESOP run smoothly. With proper attention given to its significance, an ESOP can provide both tangible and intangible benefits to making great companies even better.

What happens after the implementation of the ESOP? For example, what are the considerations five years down the road?

As with other qualified retirement plans, an ESOP does have certain annual reporting obligations, including those related to audit, tax, valuation and administration. Most often, outside advisors handle all the reporting requirements. In addition to reporting obligations, certain planning for distributions, required diversification options and employee benefit levels will need to be completed for the company to continue to manage its cash flow. The plan administrator and the company's advisors can manage these issues. Outside of this basic, ongoing maintenance over time, the tax savings and added employee incentives provided by the ESOP should position the company for growth and prosperity.

Current owner perspective

Why sell to an ESOP instead of an outside party?

When owners are interested in selling their stock, one consideration should be whether an ESOP or an outside party would be the best option. One advantage of an ESOP is that it can create a more readily available market for the stock in a closely held company, where interested and able buyers may not be abundant. In addition, while negotiations with the ESOP on the stock sale must be at arm's length, they may be less burdensome and give the owner more control over the transaction terms than when negotiating with an outside party. Another interest of the owner may be not to disrupt the current workforce through an ownership transfer. By transferring ownership to the employees, there may be a smaller likelihood of the company operations, management or overall dynamics changing. Also, one valuable potential benefit of selling stock to an ESOP is a unique tax deferral option. Tax on the sale of stock to an ESOP that owns at least 30% of a C corporation may be deferred if the proceeds are reinvested in qualifying replacement securities, and other requirements are met.

What are the tax effects for a shareholder who sells to an ESOP?

If the company is a C corporation, the seller can potentially defer tax on any gain on the stock sale if the proceeds are reinvested into qualifying replacement securities. This favorable tax deferral provision is similar to a section 1031 like-kind exchange. Only it applies specifically to selling C corporation stock to an ESOP that owns at least 30% of the company stock after the sale. If this tax deferral option is elected, the seller and certain relatives cannot participate in the ESOP after the sale. In general, this option defers the tax consequences of the sale. However, under the current estate tax rules, if the seller dies before selling the replacement securities, the beneficiaries would receive a step-up in the stock basis, and the tax on any gain realized at the time of sale to the ESOP would essentially never be paid. This tax deferral option is unavailable if the company is an S corporation. Still, a selling shareholder receives capital gains treatment on the stock sale, which may not always be the result when selling to an outside party (i.e., the outside party may wish to purchase assets rather than stock). In addition, since tax deferral is not achieved in the S corporation scenario, the seller can participate in the ESOP after the sale.

Employee perspective

When do participants receive their benefits?

Because an ESOP is a qualified retirement plan, it will generally make distributions to participants like other retirement accounts. Ultimately, the ESOP plan provisions dictate how and when distributions occur, but the main events usually leading to distributions include death, disability, termination of employment and retirement. Distributions may occur in a lump sum or installments and may commence within certain time frames of these events. Participants are generally taxed at the time of distribution. But they can elect to roll over the distribution into another qualified plan, which defers taxation until a distribution is received from the rollover plan. Since a participant's account consists mainly of employer stock, the plan will either distribute the cash value of that stock at the time of distribution or, if stock is distributed, include a put option whereby the employee can immediately sell the stock to either the ESOP or the employer. This policy exists so the employees are not left holding employer stock that may not be easily converted into cash in an outside market.

Is an ESOP risky to the employees since it is not diversified?

An ESOP does have to remain primarily invested in employer securities to qualify as an ESOP and receive the associated benefits. Most individuals are more familiar with 401(k) plans, which generally allow employees to choose from an array of diversified investment options. In reality, though, employees at ESOP companies often end up with larger retirement account balances. Because most ESOP companies usually offer the ESOP in addition to other retirement plans, employees often receive the ESOP account on top of other diversified accounts. In addition, most ESOP companies contribute more as a percentage of pay to employees' ESOP accounts than non-ESOP companies do to employees' 401(k) accounts. Department of Labor research also shows that ESOPs have higher rates of return and are less volatile than 401(k) plans. Moreover, ESOPs generally cover more employees because they provide benefits to employees without the employee having to elect into the plan. Whereas employers typically only contribute to 401(k) accounts if the employee elects to participate in the plan first, and not all do. And lastly, diversification rules require the ESOP to provide participants at least age 55 who have been in the plan for at least 10 years the option to diversify 25% of their accounts over five years. In the final year of this diversification window, participants must be allowed to diversify up to 50% of their account balance if they so elect.

What are other employee considerations?

A positive consequence of having employees' retirement benefits invested in employer stock is the potential for increased employee engagement. An ESOP can provide additional incentives for employees to perform at a high level and may increase productivity and loyalty. The ESOP may also be a recruiting tool to attract new employees. Individuals who place high importance on environmental, social and governance (ESG) concerns may be particularly interested in an ESOP-owned company where they can obtain a stake in the company.

Corporate perspective

How does the company benefit from an ESOP?

When an owner sells to an ESOP, the company has a new retirement plan, which requires regular and continuous contributions. Those contributions are tax-deductible employee benefit expenses.

Most ESOPs are structured so that the company obtains financing (from an outside creditor or seller) when stock is purchased. The debt brings cash into the company, which is then loaned to the ESOP to purchase stock from the company or selling shareholders. The payments the ESOP makes on that debt become tax-deductible to the company because it funds the ESOP's debt payments with its regular and continuous contributions to the ESOP. In addition, a C corporation may receive a tax deduction for dividends paid to an ESOP. An S corporation can receive even more favorable tax treatment because the ESOP is not taxed on its share of S corporation earnings. And since the S corporation is generally not taxed at the entity level, company earnings allocable to ESOP ownership escape current taxation. Along with providing tax incentives, an ESOP helps create a culture that promotes productivity, responsibility, loyalty and employee participation.

What are the costs to the company sponsoring an ESOP?

The benefits of an ESOP do not come without a cost to the company, but in most cases, the benefits far outweigh the costs. Costs incurred during the initial year of the ESOP will include those associated with an independent appraisal to support the stock price, accounting and legal services related to advising on ESOP effects and terms, and preparing and effecting documents, financing, and operating and administrating the plan. The initial costs depend on the company size, industry, availability of information for valuation purposes and financing structure, among other factors. After the initial year, ongoing annual costs include fees for an annual valuation, audit fees if the plan has 100 or more participants, administration costs (which usually include a flat fee plus a charge per participant) and tax return preparation fees.

How does an ESOP affect day-to-day business operations?

Generally, having an ESOP in place should not affect the company's day-to-day business. One aspect that changes slightly with an ESOP is corporate governance. Instead of shareholders electing the company's board of directors, the ESOP trustee and non-ESOP shareholders elect the board of directors. This aspect means that the dynamic of maximizing shareholder value now shifts to include employee interests since employees are now shareholders. Many times, the board of directors appoints the ESOP trustee, who represents the employees. Thus, governance can be somewhat circular, and the company should be careful to follow fiduciary standards. In addition, as explained previously, the existence of an ESOP should also foster a culture of employee involvement, responsibility and loyalty. Thus, while day-to-day tasks should not change, a more team-oriented culture may evolve, and productivity may increase. When combined with the tax benefits of an ESOP, these factors often lead to faster company growth for ESOP-owned companies.

What else should companies consider when implementing an ESOP?

Because some rules for ESOP sponsors differ depending on whether the sponsor is a C corporation or an S corporation, the company should carefully consider its tax status before implementation. In addition, completing accounting method planning before the transaction to report items in the most beneficial period may, in some circumstances, allow a company to achieve even greater tax benefits. The corporation needs to carefully consider the terms in the ESOP plan document to ensure it maintains the flexibility that allows it to operate the ESOP without undue burdens on the company.

These considerations include providing proper employee benefit levels, managing the repurchase obligation, and structuring contributions and terms the company can afford. Also, companies often need to consider the effect an ESOP has on other compensation arrangements to ensure the company's goals are met to incentivize all employees appropriately.

So, what's next?

After reading these frequently asked questions, if an ESOP is attractive to you, please consult with your advisor to discuss the next steps in exploring an ESOP.

To explore or complete an ESOP transaction, you will need to navigate whether an ESOP may be an ideal fit for your company. Throughout the early stages of considering an ESOP, through an ESOP transaction, and also on operations post-transaction, your advisors will need to:

- Assist you in determining whether an ESOP may be viable for your company
- Model cash flow to illustrate and project an ESOP transaction's tax and cash impacts on the company, selling shareholders and employees
- Work with a broad range of advisors to help you plan the legal, tax, financial and fiduciary aspects of the transaction to optimize tax benefits and ESOP operational aspects, meet the company's desired goals and comply with complex laws and regulations

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