



# Bulletin

## ESOP (Employee Stock Ownership Plan)

### INTRODUCTION

The Employee Stock Ownership Plan ("ESOP") is an innovative planning device allowing for tax-favored transfers of stock ownership in a closely held business, which received substantial statutory blessing under ERISA. In spite of numerous tax law changes since then, most of which have cut tax benefits generally, the ESOP retains nearly all of its advantages and has become even more beneficial in some cases.

### WHAT IS AN ESOP?

A. ESOP Requirements. An ESOP is a defined contribution deferred compensation plan which is qualified to hold stock in its corporate sponsor. Generally, an ESOP is a "stock bonus" plan, except that (1) contributions are not necessarily dependent on the employer's profits, and (2) benefits are distributable in the stock of the employer.<sup>1</sup>

Investments in an ESOP are made largely or exclusively in "employer securities," which is common stock of the plan sponsor that: (1) are registered and publicly traded on a recognized exchange; (2) have voting and dividend rights no less favorable than any other class of common stock outstanding, or (3) is noncallable preferred stock that is convertible at any time into common stock having such rights.<sup>2</sup>

An ESOP is exempt from the requirement that the trustees strive for a "fair return" on investments, at least to the extent that it acquires employer securities.<sup>3</sup>

B. Leveraged ESOPs. A "leveraged" ESOP is one that is empowered to borrow from third parties to purchase employer securities. The loan may be (and usually is) guaranteed by the corporate sponsor and is secured by the purchased securities, contributions, and plan earnings; it cannot be a liability of the ESOP itself.

### PLANNING OPPORTUNITIES

A. Deductions for Employer Contributions. As in the case of defined contribution plans, generally an employer may contribute to an ESOP and claim as a deduction up to 25 percent of the compensation paid or accrued by participants in the plan.<sup>4</sup>

In the case of an ESOP, however, the contribution can be made in the form of employer securities. Thus, the employer can gain a tax deduction without expending cash—a substantial benefit to any growing company.

B. Providing a Market for Insider Stock. Stock in a closely-held business provides control over operations and an opportunity to share in the profits generated. However, it is extremely difficult to sell to an outsider who does not

understand the business. When a stockholder seeks to withdraw from the business, the most logical purchasers of his stock are the corporation itself, other stockholders, or key employees who deserve to be rewarded (or need an incentive to stay). Sometimes, however, these candidates do not have the funds available to purchase the stock; moreover, the funds they would use for payment are after-tax dollars (income after federal and state taxes have been paid).

The ESOP is a better purchase candidate because it uses funds that were deductible when contributed, but were not reduced by any taxes to the ESOP. Thus, there are more funds available to make the purchase. Moreover, the stock acquired by the ESOP will be allocated principally to those employees with the highest salaries and greatest seniority—generally the same key employees you wished to benefit anyway.

C. Provides Financing on a Deductible Basis. If an ESOP borrows to purchase employer securities, it pays back the loan from its earnings and company contributions. To the extent that principal payments on the loan are made with company contributions, the company has financed the sale of its stock on a deductible basis.

To the extent dividends on employer securities held by the ESOP are used to make ESOP loan payments, they will also be deductible to the employer.<sup>5</sup> The company is also allowed to deduct cash dividends paid with respect to stock held by an ESOP, provided that the ESOP allows participants to elect to either receive the dividends in cash or reinvest them in the ESOP.<sup>6</sup>

D. Provides Favorable Tax Treatment to Sellers. One who sells stock to an ESOP will also enjoy tax benefits specifically designed to en-

courage such sales.

For example, no gain is recognized if a taxpayer sells employer securities to an ESOP if (1) after the sale, the ESOP owns at least 30 percent of the total outstanding stock of the company; and (2) within one year after the sale (or three months prior to the sale), the seller purchases “replacement securities” (which can include publicly traded stocks and bonds) of equal value.<sup>7</sup> The gain is deferred until the replacement securities are sold or may be unrecognized entirely if they are held until death when their basis is stepped up. The ESOP must hold the purchased employer securities for three years to avoid an excise tax.<sup>8</sup>

E. Create Employee Incentives. Employees who are constantly interested in getting a “piece of the pie” can be satisfied in knowing that, as plan participants, they are truly sharing in the future growth of the company; moreover, upon retirement, they may be paid out in company stock and can retain their interest.

Since those with the highest compensation and greatest seniority benefit the most, employees should be encouraged to remain loyal to the employer and to strive for increasing responsibility—all of which benefit the company’s operations.

## **DISADVANTAGES AND CONCERNS**

A. Loss of Control. Whenever stock in a closely held business is transferred to non-stockholders, the prior stockholders have, to some extent, given up some control. Sales or contributions of stock to an ESOP, in fact, results in a minimal loss of control. In the first place, contributed stock rarely exceeds one-third of the outstanding stock; under most states’ laws, votes of at least one-third of the stock needed to

have any meaningful say in corporate operations. Secondly, ESOPs closely held businesses must allow their participants to vote the stock held in the ESOP, but only on matters that require the consent of shareholders holding greater than a simple majority. On other matters, the trustees of the plan can exercise the voting powers. Finally, any shares that are not allocated to the participants' accounts (such as recently contributed shares or forfeited shares held in suspense) may be voted by the plan trustees, who are probably the principal stockholders.

More problematic is that the distributions to plan participants must be distributable in the form of employer securities. ESOP participants include many employees not among the desired "key" group. In general, such persons are not a long-term problem because their current rights are limited to the voting rights outlined above. Upon retirement, few would prefer to receive stock in their old employer and nearly all elect to receive cash instead. The ESOP need only allow them to elect to receive stock<sup>9</sup> and the employer may impose a right of first refusal on any distributed stock to prevent sales to unfriendly third parties.<sup>10</sup>

**B. Valuation of Employer Securities.** Aside from the expense of instituting the ESOP, the most troublesome administrative cost is incurred in securing an independent appraisal of its value to determine the amount of the contribution. Any closely-held corporate sponsor must use an "independent" appraiser<sup>11</sup> to value the contributed stock, and appraisal fees can be quite high.

**C. Securities Laws.** Participants' interests in an ESOP, and the employer securities it acquires, may be subject to the antifraud and registration provisions of the federal securities laws. Competent counsel should be consulted to avoid problems.

**D. Diversification.** An ESOP must provide "qualified employees" (those over 55 years old with at least 10 years in the Plan) an opportunity to diversify their plan holdings.<sup>12</sup> The ESOP must permit these individuals to diversify at least 25 percent of their investment during the six-year period when the participant reaches age 55 (or, if later, when the participant completes 10 years of participation). Further, in the final year of the six-year period, the percentage increases to 50 percent. For companies whose ESOP shares are not readily tradable, this provision will accelerate the Plan's repurchase liability.

**E. S-Corporations.** Beginning in 1998, S-corporations could sponsor an ESOP without adversely affecting their S-corporation status. However, there are restrictions, including, in the case of certain S-corporations whose stock is at least 50 percent owned by "disqualified persons" (i.e., related individuals), allocations under the ESOP may not be provided to such persons.<sup>13</sup>

Also, the following tax advantages of C-corporation ESOPs do not apply to S-corporation ESOPs: The rule allowing deduction of contributions exceeding 25 percent of contributions if the excess is applied to ESOP-loan interest payments, does not apply to S-corporations; the rule permitting deduction of dividends paid to ESOPs does not apply to S-corporations; and the rules permitting sellers to roll over their gain on sale to an ESOP (if the ESOP owns at least 30 percent of the total outstanding shares of the company) does not apply to S-corporations.<sup>14</sup> On the other hand, the earnings of an S-corporation attributable to ESOP stock are not currently taxed to the ESOP,<sup>15</sup> so that taxation on that income is effectively delayed until the employee's account is distributed. Moreover, an S-corporation ESOP does not need to give employees the right to elect to take

distributions in the form of company stock; rather, an S-corporation ESOP may distribute solely in cash.<sup>16</sup>

## CONCLUSIONS

The ESOP is a “fair-haired” child of the Congress, and while many recent legislative changes have reduced prior tax benefits, ESOPs have emerged less harmed than most.

As always, careful full consideration of the benefits and disadvantages, and reliance on experienced counsel, are necessary to make the most of the planning opportunities, and to avoid the pitfalls.

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## NOTES:

1. Treas. Regs. Section 1.401-1(a)(iii) and (b)(2)(iii)
2. Section 409(l) of the Int. Rev. Code (all section references are to the Code unless otherwise designated)
3. Rev. Rul. 69-65, 1969-1 C.B. 114
4. Section 404(a)(3)(A)
5. Section 404(k)(2)
6. Section 404(k)
7. Section 1042(a) and (b)
8. Section 4978(a)
9. Section 409(h)
10. Treas. Regs. Section 54.4975-7(b)(9)
11. Section 401(a)(28)(c)
12. Section 401(a)(28)(B)
13. Section 409(p)
14. Sections 404(a)(9)(C), 404(k)(1) and 1042(c)(1)
15. Section 512(e)(3)
16. Section 409(h)(2)(B)(ii)(II)

# Employee Stock Ownership Plans

*The following are examples of Employee Stock Ownership Plans and the experiences of those companies that established them. The Management Methods Committee is grateful to these companies for sharing this information which may assist other MCAA members in creating ESOPs.*

## **AZCO Inc.**

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In 1949, four individuals, including F. John Barlow, founded AZCO Inc. as a full service (A-to-Z) industrial, mechanical contractor. Starting with a pickup truck and set of tools, Mr. Barlow (also a former president of MCAA) built a strong regional construction and fabrication business.

In 1998, with family members not involved and not interested in the business, Mr. Barlow, at age 84, turned his attention to selling the company to the management team. The original tax basis for the corporation was quite low. The potential capital gains implications for Mr. Barlow were considerable.

After considering alternatives with a highly respected consultant based in Appleton, Wisconsin, the management team settled on an Employee Stock Ownership Plan (ESOP). Under ERISA, the proceeds from the sale of the corporation stock must be invested in publicly traded domestic securities. In exchange for holding the replacement securities for three years, the seller's gain from the sale is deferred. Continuing to hold these publicly traded shares until death results in the stepped-up basis for the owner's estate, avoiding the gain tax altogether.

The ESOP proved to be the only viable alternative because of the high degree of leverage involved. A trustee now holds the shares of AZCO Inc. for the plan which is governed by ERISA. The ESOP takes the place of the former AZCO Inc. Profit Sharing Plan. As the debt in the plan is paid down, the equity of the corporation increases.

Mark Loper, president of AZCO Inc., reports the ESOP has worked well for the company's employees. A greater percentage of the company earnings is going into the employees' retirement account than was the case under the former profit sharing plan. Employees have a tangible stake in the company's well being, which has made them more attuned to the details of the business.

As the company's profits have grown, so has the value of the shares held in the individual participants' accounts. Each year, the trustee directs a third party appraisal of the corporation's value. AZCO Inc.'s management team has anticipated a couple of issues. First, as the company's employees approach retirement, the ESOP may face a long-term cash flow problem as employees liquidate their AZCO Inc. holdings. A repurchase obligation study has been conducted for the ESOP to gauge the extent and timing of the issue. The management team has already created an opportunity for participants to diversify their individual ESOP account. ERISA allows employees who have reached the age of 55, or who have completed 10 years of participation in the plan, to diversify their accounts. AZCO Inc. has accelerated this diversification.

The second concern addresses the perception of an ESOP by potential purchasers. AZCO Inc.'s young management team has a few years to analyze its corporate structure in the event

an exit strategy would entail a sale to a third party.

**Tougher Industries, Inc.**

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When Don McKay co-purchased Tougher Industries, the company had only 200 shares of stock. Over the years, its value increased substantially (at one point, the stock split 1000/1). About 15 years ago, McKay and the other Tougher owners started looking for ways to pull their equity out of the company without compromising its financial position.

They settled on the ESOP. McKay and another owner decided to contribute 31 percent of their shares of Tougher stock to the ESOP, which is required by federal law if the seller is to avoid tax obligations (the gain is not recognized as taxable because the sold stock benefits the company's employees).

About three years ago, PSEG, a utility company, approached Tougher with a purchase offer. PSEG wanted to buy the whole company, including all the stock, and was not interested in retaining the ESOP. Since the stock held in the ESOP was to be liquidated, the Tougher owners had to hire an independent appraiser to determine the stock's value. And, the liquidation process had to be approved by the federal ERISA (Employee Retirement Income Security Act) agency and the Department of Labor. That appraisal proved very costly for the Tougher owners.

To complicate the process, the buyer ordered its own independent appraisal of the company's value. And, that process produced several claims against the company. Ultimately, the

two Tougher owners gave their 80 employees several million dollars, about one-third of the proceeds from the company's sale. McKay said, "I received four thank-you's from those employees."

If he could do it again, what would he do differently? McKay said, "I would have sold 100% of the stock to the ESOP. It's the only way to go to avoid the hassles we encountered."

**Murray Company**

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Murray Company was a family-owned mechanical contracting firm based in southern California that has been in business for more than 90 years. When the owner started making plans for retirement and the sale of the company, he discovered that the tax consequences of selling a company (capital gains taxes) are formidable. Murray's CPA suggested the establishment of an employee stock ownership plan (ESOP) to ease the tax consequences of the sale.

The process of establishing Murray's ESOP began in the mid-1990s. By 1998, the legal foundation for the ESOP was completed. According to Rick Stafford, Murray's chief financial officer, just getting that far took considerable time, effort, paperwork, and legal costs. "The process is complicated and requires specialized expertise in financial planning and tax law."

When the time came time for the final step – the sale of stock in the company to the employees – the owner wasn't ready. The ESOP was "put on hold" indefinitely.

In the spring of 2002, after

Murray's owner became seriously ill, the senior managers decided to finish the ESOP. That process began in early April, and by May 31 (about seven weeks), Murray Company was a 100 percent ESOP. Stafford said, "We got it done with the support of the bank, a lot of hard work and very long hours."

A year later, Stafford said the company is still adjusting to the changes brought about by the ESOP. Stafford explained, "Even though an ESOP is a financial instrument, it also transforms a company's culture from the top down."

"Management decisions no longer just affect the owner or principals. All the employees of the company are affected, and that takes some getting used to."

Stafford has also observed changes in the employees' work habits and attitude. "The employees became owners almost overnight, and there was no time allowed to educate and inform them about what the changes would be and mean," he said.

With hindsight and experience, would Stafford have taken a different route than the one his company followed? "Definitely. We would have allowed a lot more time to manage the cultural changes, which are substantial. We also would have eased into the financial commitment over a much longer period of time."

Federal tax laws allow this more leisurely paced approach:

... No gain is recognized if a taxpayer sells employer securities to an ESOP if (1) after the sale, the ESOP owns *at least* 30 percent of the total outstanding stock of the

company; and (2) within one year after the sale (or three months prior to the sale), the seller purchases "replacement securities" (which can include publicly traded stocks and bonds) of equal value. The gain is deferred until the replacement securities are sold or may be unrecognized entirely if they are held until death when their basis is stepped up. The ESOP must hold the purchased employer securities for three years to avoid an excise tax. (Management Methods Bulletin TX 5).

Stafford also offered advice for companies beginning the ESOP process. "First, do your homework, and there's a couple of really good organizations that provide excellent information on ESOPs. The National Center for Employee Ownership, based in Washington, D.C. is accessible online at [www.nceo.org](http://www.nceo.org). There's a small membership fee, but it's worth it. The ESOP Association, based in Washington, D.C. is another great source of information ([www.esopassociation.org](http://www.esopassociation.org)).

"Second, when you begin forming the ESOP, find advisors with ESOP experience, whether they're attorneys or CPAs," he said. "This is a very different area that needs specialized expertise. The attorney who's worked for your family and your business for years will probably not be your best choice, nor will the CPA who does your taxes every year. Hire the experts to protect the interests of both the owners and the employees."

Stafford concluded by giving the Murray Company's ESOP experience positive marks. "The ESOP allows the company to go forward when the owner is ready to retire and 'cash in his chips.' Just be sure to hire the right advisors and allow enough time for the planning and transition to occur."