MAKING INFORMED DECISIONS FOR YOUR BUSINESS, EMPLOYEES AND SHAREHOLDERS

ESOP Advisory Group
Frequently Asked Questions

EMPLOYEE STOCK OWNERSHIP PLANS
What is an Employee Stock Ownership Plan (ESOP)?
An ESOP is a qualified retirement benefit plan designed to provide employees with an ownership interest in the company for which they work by investing primarily in stock of the employer. The ESOP is funded with tax-deductible contributions by the employer in the form of company stock, or in cash which is used to purchase company stock. An ESOP operates through a trust, under the direction of a trustee or other named fiduciary.

To be an ESOP, the plan must be specifically designated as an ESOP in the plan document and must comply with special ESOP requirements of the Internal Revenue Service (“IRS”).

What are some characteristics of companies where ESOPs work best?
ESOPs operate successfully in a broad range of companies - large and small, public and private. The ideal private company candidate for an ESOP will meet most of the following criteria:

- Strong cash flow
- History of stable sales and profits
- Generating taxable income
- Capable management team in place
- Annual payroll of $1 million or more

What is a leveraged ESOP?
An ESOP is leveraged if it borrows money to purchase shares of the company’s stock. The loan may be from a financial institution or the selling shareholder may finance the transaction by taking back a note for part or all of the purchase price. The sponsoring company usually uses its assets to secure the financing.

How does a leveraged ESOP work?
The ESOP borrows to purchase company’s stock. The shares can be outstanding shares held by existing owners, treasury shares or newly issued shares. The company can then make tax-deductible contributions to the ESOP to enable it to pay the loan. As the loan is repaid, shares held by the ESOP are released and allocated to employee accounts.

How does the ESOP benefit the company?
An ESOP is a technique of corporate finance as well as an employee benefit plan. ESOPs have tax benefits that increase the company’s cash flow and thus, its ability to finance the acquisition of stock.

- ESOP financing permits the repayment of acquisition debt with pretax dollars. This favorable tax treatment means that ESOPs are effective vehicles for financing management buyouts.
- In C corporations, dividends on ESOP stock are tax-deductible if the proceeds are used to repay the ESOP's stock acquisition loan. Reducing loan principal with pre-tax contributions and dividends generates significant tax savings, which in turn increases the ESOP company's cash flow.
- Studies conducted by The National Center for Employee Ownership (NCEO) and Rutgers University have demonstrated improved performance with employee ownership. A total of 343 pairs (1 ESOP : 1 Non-ESOP) of comparable companies were followed for six years with resulting statistics showing that companies adopting ESOPs between 1988 and 1994 realized increased overall sales, employment and increased sales per employee of 2.3% over the Non-ESOP company paired for the study.

How does the ESOP benefit selling shareholders?
One of the most popular uses for an ESOP is to provide a ready market for some or all of the shares owned by shareholders in a closely held company. With an ESOP in place, a majority or controlling shareholder has an exit strategy when he or she is ready to retire. Likewise, an ESOP is sometimes the only market for a minority shareholder in a closely held company.

- Internal Revenue Code Section 1042 provides an owner of closely held C corporation an opportunity to defer, and potentially eliminate, all state and federal capital gains taxes on their sale to an ESOP. This is done by reinvesting the sale proceeds in Qualified Replacement Property (QRP) within 12 months of the sale. The selling shareholder is able to defer taxes for as long as they maintain the QRP. If held until death, these securities can receive a stepped-up cost basis and be passed on to the selling shareholder’s heirs. Even if the business owner does not receive all cash at closing, they may still be able to defer all taxes. These tax savings can be significant considering that many owners of C corporations maintain a low basis in company stock.
- In order for a security to qualify as Qualified Replacement Property (QRP), the security can be equity or debt from a qualifying domestic operating corporation. These domestic companies must meet several specific requirements, including: (a) have at least 50% of its assets in the active conduct of a trade or business and (b) cannot have more than 25% of gross receipts from passive income sources. Investments that typically do not qualify as QRP include US government bonds, municipal bonds, foreign securities, bank CDs, and real estate investment trusts.
- For S corporations, it may be beneficial to terminate the S corporation status prior to the sale of stock to the ESOP to allow the selling shareholder to elect Internal Revenue Code Section 1042. However, if the shareholders have a high basis stock, the C corporation election may not prove beneficial. It is important to note that the tax law does not allow a corporation to re-elect S corporation status for five tax years after such termination.
- ESOPs do not have to own a controlling interest, which offers the selling shareholders a unique opportunity to sell a minority interest and still maintain control of the company.
How does the ESOP benefit employees?
Each year company contributions to the ESOP, both cash and stock, are allocated to the accounts of participating employees in the ESOP trust. The accumulated balance in a participant's account is distributed to the participant after retirement or termination of employment with the company.

- A participant's account that remains in the ESOP trust, including the appreciation in stock value, is not taxable to the participant until the participant takes distributions from his or her account.
- Employees age 55 or older with 10 or more years of participation in the ESOP are allowed to diversify a portion of their ESOP accounts.

How do I set up an ESOP?
Step 1: Determine the company's value. The IRS and the U.S. Department of Labor (“DOL”) have issued guidance that the ESOP must pay fair market value for the stock it purchases.
Step 2: Conduct a feasibility study to analyze the overall framework for the transaction and to determine:
- How much the company can afford to contribute to the ESOP each year
- Whether part of the contribution cost can be offset by eliminating other benefit programs
- How the ESOP will affect the company's earnings and cash flow
- How the transaction will be structured
- How the ESOP will be financed
Step 3: Obtain financing to purchase stock if a leveraged ESOP is established.
Step 4: Document the transaction with experienced ESOP counsel to prepare all ESOP plan documents once financing has been arranged.
Step 5: Negotiate a stock purchase agreement between the ESOP fiduciary and the selling shareholder(s), setting the price and terms/conditions under which the ESOP will purchase stock from the selling shareholder(s).
Finally: Arrange for the delivery of an opinion from an independent appraiser, which is required under DOL regulations, to provide the necessary assurance that the ESOP is not paying more than fair market value for the company stock it purchases.

Once an owner decides to proceed with an ESOP, the transaction can be typically closed within three months.

What is the total cost of implementing an ESOP?
Costs are a function of the complexity and size of the transaction. The cost is typically $100,000 to $150,000 on the low end and can be 1.5% to 2.5% of the transaction size for larger deals. If owners take the time to gain a better understanding of ESOPs, initial costs can be reduced. Ongoing ESOP administrative expenses are similar to most profit sharing plans, with the exception of the annual valuation update needed to value company stock held in the ESOP.

Must the ESOP be approved by the Internal Revenue Service or the Department of Labor?
As with any tax-qualified plan, ESOP companies typically file their ESOP plan with the IRS and request a determination letter which confirms that the ESOP plan document meets the IRS requirements for tax qualified retirement plans.

Who controls an ESOP?
The ESOP is governed by a trustee (fiduciary) who must act for the exclusive benefit of participants. In closely held firms, employees must be able to direct the trustee as to the voting of the shares only on certain issues; in publicly traded firms, votes pass through on all shareholder issues.

Who are ESOP fiduciaries and what are their responsibilities?
Any person with discretion over the management or administration of a plan, or who exercises any authority or control over plans assets, is a fiduciary under the Employee Retirement Income Security Act (ERISA). The ESOP trustee, or any other person or committee designated in the plan documents as responsible for making investments in company stock, is a “named fiduciary.” ERISA requires that plan fiduciaries act prudently and solely in the interest of plan participants. Three of the most important responsibilities of an ESOP fiduciary are:
- Securing a proper valuation of the stock
- Assuring that the interests of plan participants are protected in ESOP transactions
- Approving all transactions affecting the ESOP's ownership interest, which may include transactions between other shareholders if the ESOP would be diluted

Do all company employees have to participate in the ESOP?
No. However, in order to satisfy IRS non-discrimination guidelines, the ESOP must cover a substantial percentage of non-highly compensated employees who have attained age 21 and completed at least a year of service. For this reason, ESOPs established by smaller companies usually cover all employees who have satisfied these minimum age and service requirements.

What information is required to be disclosed to participants in an ESOP?
The only party that has a right to financial information is the shareholder. Technically in an ESOP the trustee is the shareholder. The participant must receive an annual statement from the employer which includes the number of shares allocated to his or her account in the trust and the fair market value of those shares. In addition, the participant has the right to inspect the summary annual report and the plan’s tax form 5500. However, many ESOP companies disclose more information.

How much can the company deduct for its ESOP contributions?
Sponsors of leveraged ESOPs are allowed to deduct contributions of up to 25 percent of covered payroll annually to permit the ESOP to pay debt service on the ESOP loan or to fund repurchase obligations. In a C corporation, interest payments on the ESOP loan do not count toward the 25 percent limit and are deductible without limitation. Additional deductible contributions are permitted up to 25 percent of covered payroll for the sponsor’s contributions to other tax-qualified retirement plans. In an S corporation, interest payments are counted against the 25 percent limit and additional deductible contributions are not permitted.
Are annual contributions to the ESOP mandatory?
The IRS does require that “recurring” contributions must be made to a tax-qualified retirement plan to maintain its qualified status. However, in a leveraged ESOP, companies need to commit to contribute enough cash each year to service the ESOP loan debt. If the ESOP has sufficient client cash to pay the ESOP debt (as may be the case if the ESOP receives dividends or distributions), additional contributions are not required.

How are ESOP benefits distributed?
Distributions to ESOP participants can be made in the form of cash or stock. Stock distributions can be subject to certain restrictions, depending on the company’s policies, and are “puttable” back to the company immediately upon distribution to the participant. Please refer below for a description of the “put option.” Benefits may be distributed in a lump sum or in installments. If installment distributions are available, the minimum distribution period may not exceed five years (with an exception for very large account balances (over $935,000.00) which may be paid over an extended period as specified under regulations).

What is the put option?
The ESOP put option requires a privately-held ESOP company to repurchase company stock distributed to ESOP participants during a 15-month period, beginning with the date the stock is distributed, for its appraised fair market value. The 15-month term will include at least two different annual valuations. The ESOP may be given the right to purchase the departing participant’s stock (with cash accumulated in the ESOP or with current contributions, distributions or dividends) by “picking up” the put option, but only the employer company can be legally required to honor the put option.

Payments under the put option may be made in a lump sum or in installments at least annually. The put option installment payment period may not exceed five years (except for certain large account balances), and the company must provide adequate security and pay reasonable interest on deferred installment payments.

Can distributed shares be freely traded?
Shares distributed from the ESOP may be subject to a right of first refusal in favor of the employer or the ESOP, or both. This optional provision prevents the shares from being freely transferable by the former participant, as many ESOP companies prefer to restrict ownership to current employees.

When are ESOP benefits distributable to participants?
At a minimum, unless the participant elects to defer distribution, the ESOP must commence distributing vested benefits no later than the plan year following the plan year in which the participant retired, reached normal retirement age, became disabled, or died. If an ESOP participant leaves the company before reaching normal retirement age for any other reason (“terminated participant”), the participant must be allowed to elect to begin receiving a distribution of vested benefits no later than the close of the sixth plan year after the plan year in which the participant separated from service.

Distributions from terminated participants’ accounts (or cash in lieu thereof) acquired with the proceeds of a still-outstanding ESOP loan may be delayed until that ESOP loan has been fully repaid, the participant dies or reaches normal retirement age.

Distributions that are deferred as a result of a former participant’s election are typically payable at normal retirement ages; they may not be deferred beyond age 70 1/2.

What is repurchase obligation?
Because the company is required to repurchase the stock of departing ESOP participants under the put option discussed above, all privately-held companies have an obligation to purchase company stock from participants. The liability is determined by a number of factors, including the size of the annual contribution to the ESOP, changes in value of the stock, the vesting schedule, ages of the participants, number of participants, turnover rates, the proportion of stock and cash in the annual ESOP contribution, method of distribution and purchase of the ESOP shares, and the diversification options of eligible participants. A company’s repurchase obligation can grow, however, so it must be properly planned for and managed.

S corporation vs. C corporation ESOPs: Can an S corporation adopt an ESOP?
Yes. Effective January 1, 1998 it became legal for an ESOP to be a shareholder of an S corporation under the federal tax laws. To the extent that the S corporation is wholly owned by an ESOP, no federal income taxes on corporate income are payable by either the shareholder or the company. This can create a significant advantage for S corporations which are substantially ESOP owned. However, S corporation ESOPs are subject to additional limitations and restrictions.

What is Chase’s experience with ESOP companies?
Chase works with approximately 1,200 ESOP companies in all aspects of financing, including senior lending, mezzanine financing, investment banking and wealth management. Our dedicated ESOP Advisory Group is ready to assist with any questions you may have about ESOPs.

For more information, please contact your Chase representative.