# Introduction to ESOPs for Business Owners

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*All private company business owners eventually have to address the issue of ownership transition. For business owners of private companies, viable opportunities to liquidate their business interests are often (1) limited and/or (2) suboptimal. Many business owners have some level of familiarity with the employee stock ownership plan ("ESOP") structure. They may have heard of ESOP sponsor companies through the local or national media, from a trusted adviser, or from a friend who works for an ESOP sponsor company. For many business owners, the ESOP concept can sound either (1) too good to be true or (2) too complicated and burdensome to implement. This discussion addresses questions that business owners typically have related to an ESOP. The answers to these questions may allow these business owners to make an informed decision regarding their business ownership interests.*

## Introduction

This discussion provides an overview of an employee stock ownership plan ("ESOP") for private company business owners.

This discussion specifically addresses the following questions that such business owners may have with regard to an ESOP:

- What is an ESOP?
- What are the benefits of selling my private company shares to an ESOP?
- How will my business operate after an ESOP stock purchase transaction?
- What are the legal and regulatory requirements for an ESOP formation?

## What Is an ESOP?

An ESOP is an employee benefit plan that is uniquely positioned to:

1. use the shares of employer corporation stock to fund tax-preferred employee retirement benefits and
2. serve as a corporate financing vehicle.

Though similar in many ways to both Internal Revenue Code ("Code") Section 401(k) plans and profit sharing plans, an ESOP differs from most retirement plans in that it:

1. is designed to invest primarily in shares of employer corporation stock and
2. may borrow money from the sponsor company to finance its investment—so long as certain legal standards are met.

According to the latest-available data from the National Center for Employee Ownership ("NCEO"), there are approximately 6,460 ESOP sponsor companies in the U.S.[1]

## What Are the Benefits of Selling Shares to an ESOP?

While an ESOP is not appropriate for every private company, sponsoring an ESOP is worth consideration by any private company business owner. ESOPs are

often used by private company business owners who wish to:

1. give back to the employees who helped build the business,
2. secure the business a place in the community, and
3. bolster their legacy while securing a succession plan and equity strategy for the business.

Accordingly, the most typical application of an ESOP is to sell all—or part—of the ownership interest in a closely held corporation on a tax-advantaged basis.

Several of the advantages of this application of an ESOP include the following:

- An ESOP can provide a market for the employer corporation stock, particularly when a market otherwise does not exist.
- An ESOP can be funded by a company with pretax dollars, as long as Internal Revenue Service ("Service") deduction limits are met.
- An ESOP can enable a business owner to sell his or her interest in a private company while continuing his or her involvement in both the company's management and operations.
- An ESOP can present a private company business owner with significant income, estate, and gift tax advantages.

ESOPs provide a great deal of flexibility for shareholder liquidity, ownership succession, and employee incentives. For instance, the ESOP may initially acquire either:

1. a small, noncontrolling ownership interest or
2. a 100 percent ownership interest of the outstanding equity.

Some of the benefits available to business owners and to the ESOP sponsor company vary depending on:

1. the structure of the ESOP and
2. the corporate organization of the sponsor company.

## Leveraged ESOPs

There are countless ways in which an ESOP may buy sponsor company stock. The most common transactional structure results in a "leveraged ESOP."

The leveraged ESOP structure is often used because it provides a means for employers to fund ESOP stock acquisitions with tax-favored capital. If used properly, the sponsor company can use a leveraged ESOP to simultaneously provide:

1. significant corporate income tax savings and
2. substantial benefits for employees.

To form a leveraged ESOP, the sponsor company generally will borrow money—using the credit of the sponsor company itself or that of its corporate officers—to purchase the employer stock for the ESOP. While there are many permutations of this transaction, the basic transaction structure requires the following components:

- The sponsor company, in consultation with legal counsel, drafts the documents necessary to create an ESOP. These generally consist of a written ESOP plan document and a written ESOP trust document.

  As part of this process, the sponsor company must identify one or more named Employee Retirement Income Security Act ("ERISA") fiduciaries to control and manage the operation and administration of the ESOP and its assets.
- The sponsor company appoints the trustee (the "Trustee") to manage the ESOP.
- The Trustee, on behalf of the newly created ESOP, either borrows money from a bank, with the sponsor company guaranteeing the loan, or borrows money from the sponsor company.

  Often, bank lenders prefer to lend money directly to the sponsor company. In these situations, the sponsor company will obtain a bank loan and then lend the proceeds of that loan to the ESOP. The loan from the sponsor company to the ESOP does not have to be on the same terms as the loan from the bank to the sponsor company.

  However, any loan from the sponsor company to the ESOP should be as fair to the ESOP as an equivalent "arm's-length" financing transaction.
- Using the loan proceeds, the Trustee authorizes the ESOP trust to purchase the employer corporation stock either from an existing business owner or directly from the sponsor company.
- Once the ESOP trust purchases shares of employer stock, the purchased shares

are held in a suspense account within the ESOP trust as security for the stock acquisition loan.

- The ESOP trust will repay the loan using tax-deductible annual contributions from the sponsor company. As the loan is repaid, shares of the employer corporation stock are periodically released into employee accounts within the ESOP trust.

## C Corporation ESOP Sponsor Companies

An important motivation for many ESOP transactions in private companies taxed under subchapter C of the Code is the ability of the business owner to defer capital gains tax on the sale of his or her shares to the ESOP. This tax deferral is available under Code Section 1042.

In order for a business owner to enjoy this capital gains tax deferral opportunity, the following requirements in Section 1042 must be met:

- The sponsor company is a C corporation.
- The business owner holds the employer corporation stock for at least three years prior to his or her sale to the ESOP.
- The employer corporation stock sold has not been acquired through options or another employee benefit plan.
- Upon completion of the sale, the ESOP trust owns at least (1) 30 percent of the outstanding shares of each class of sponsor company stock or (2) stock representing 30 percent of the value of all of the sponsor company stock.
- The shares acquired by the ESOP trust may not be allocated to accounts of the business owner's children, spouses, parents, or brothers and sisters.
- The shares acquired by the ESOP trust may not be allocated to the accounts of over 25 percent shareholders.

## S Corporation ESOP Sponsor Companies

An ESOP also has income tax benefits for businesses structured as S corporations. As a tax deferred retirement plan, an ESOP-owned S corporation is not subject to federal income taxes (and possibly state income taxes, depending on the state).

Often, S corporations make distributions to shareholders so as to meet their income tax liability. Distributions received by the ESOP may be used to repay the ESOP loan or to purchase additional shares of employer stock. If an ESOP owns 100 percent of the stock of an S corporation, then the sponsor company is exempt from federal income taxation.

Business owners should be aware that some of the tax incentives that are provided for C corporations do not apply to S corporations. For example, S corporations are not allowed to deduct cash dividends paid on stock held by an ESOP.

S corporations also do not benefit from the increased limits for tax deductions for contributions to a leveraged ESOP when those contributions are used to pay interest on an ESOP loan. S corporation business owners are ineligible for the capital gains tax deferral under Code Section 1042.

## What Qualities Make for a Good ESOP Sponsor Company?

In general, companies that are good candidates to successfully implement an ESOP and to sponsor a sustainable ESOP have the following characteristics:

- Employ more than 25 full-time employees
- Have an established record of consistent profitability and cash flow
- Have at least 10 years of operating history
- Have one or more owners who are interested in investment liquidity and in a diversification of personal wealth
- Have one or more owners who are interested in ownership/management succession planning and in transitioning the ownership of the company to the employees
- Report at least $10 million in company annual revenue
- Have one or more owners who are open to accepting a reasonably conservative stock value (i.e., a fair market value price)
- Have a strong management team that supports the concept of an ESOP formation (and of the employee ownership of the sponsor company)[2]

An ESOP can be an important tool to increase performance at private companies that have a strong management team and an ownership culture. The ESOP can promote employee productivity, job satisfaction, job stability, and employee tenure.

## How Will My Business Operate after an ESOP Installation?

### Who Runs the Sponsor Company?

The Trustee will act as shareholder of record of the shares owned by the ESOP. Although the Trustee of a majority-ESOP-owned company will be responsible for electing and overseeing the sponsor company board of directors (the "board"), the Trustee will typically refrain from making business and governance decisions (with the exception of potentially bargaining for the addition of one or two independent board members).

The corporation's board of directors will continue to run the sponsor company following an ESOP transaction.

The following list provides some examples of typical board-level functions (before and after an ESOP is established):

- Approving budgets
- Enacting corporate policies and objectives
- Appointing officers
- Hiring management to run the day-to-day operations of the company

### Ongoing ESOP Maintenance Expenses

An ESOP has annual expenses associated with sponsorship—just like any other employer sponsored benefit—that are borne by the sponsor company and/or the ESOP trust. Because the ESOP holds stock, however, most of those expenses will need to be funded by the employer (versus being paid for with plan assets).

These expenses often include the following:

- Sponsor company legal adviser fees
- Trustee fees
- Trustee valuation adviser fees
- Trustee counsel (limited involvement) fees
- Third-party administrator fees

### Investment Planning Strategies

An ESOP implementation should not prohibit other investment planning strategies. An ESOP may co-invest with other investors willing to provide capital to the sponsor company. Such contribution may be at a lower-tier limited liability company ("LLC") level (i.e., below the sponsor company) or a direct investment in the sponsor company, alongside the ESOP trust.

There are certain structural design requirements that would require planning (e.g., how a corporation structure may be used within an LLC "blocker" structure and where each investment occurs). However, many ESOPs successfully own companies that include other forms of outside investment.

An ESOP also does not forestall other transaction considerations. To the extent that an ESOP-owned company is an attractive "takeover" target, ESOP ownership simply means that the ESOP participants will participate in the value paid for the sponsor company.

### Compensation Structure

The sponsor company is permitted to provide appropriate and market-based compensation for its management and employees. To the extent a board determines that implementation of an equity-based program (or "synthetic" equity program, e.g., phantom stock) is appropriate, such a program may be

implemented and awarded as the board—or the board compensation committee—sees fit.

The appropriate standard for compensation remains a corporate decision, subject to corporate fiduciary judgment and related requirements. While a Trustee may request information on these matters, the Trustee typically will not vote on the compensation awards.

## What Are the Legal and Regulatory Standards for an ESOP?

An employee's retirement benefit under an ESOP is the sum of contributions, forfeitures, and earnings during participation in the ESOP. Because an ESOP ties employees' retirement to the value of the sponsor company, an ESOP is governed by strict federal standards.

To take advantage of an ESOP's income tax benefits, a sponsor company must comply with process, valuation, written plan document, eligibility, contribution, allocation, vesting, voting, diversification, and distribution requirements prescribed by the Code and ERISA.

### Process Requirements

ERISA standards and state-level corporate law influence the corporate governance of an ESOP-owned company. ERISA requires that any company that creates an ESOP, does so only in the best interest of its employees—the people who actually expect a portion of their retirement savings to consist of stock in the company for which they work.

ERISA requires that the ESOP be represented by a Trustee. The Trustee acts as the shareholder of record of all shares held by the ESOP.

ERISA mandates certain actions (i.e., fiduciary duties) that require that an ESOP's fiduciaries—which generally include the Trustee and the sponsor company—establish and operate the ESOP for the exclusive purpose of providing benefits to ESOP participants and beneficiaries.

ERISA provisions govern the board—to the extent of the board's responsibility to appoint, monitor, and remove the Trustee and/or where the board otherwise acts in an ERISA fiduciary capacity.

ERISA also prohibits certain actions ("prohibited transactions") by a fiduciary that may involve self-dealing and conflicts of interest.

To avoid a prohibited transaction, the ESOP must:

1. purchase sponsor company shares at a price that is no more than "adequate consideration" or
2. sell sponsor company shares at a price that is no less than "adequate consideration."

In the case of private company stock, the U.S. Department of Labor ("DOL") defines "adequate consideration" as the fair market value of the stock, as determined:

1. in good faith by the Trustee or named fiduciary pursuant to the terms of the ESOP and
2. in accordance with DOL regulations.

Generally, an ESOP must be established as a "permanent arrangement." While this *does not* mean the ESOP must exist "forever," it does mean that at the time of implementation there was not a short-term plan to terminate or eliminate the arrangement.

For example, if an ESOP is terminated within three years of its implementation, there should be

good facts indicating that such termination was in connection with an event not contemplated at the time the ESOP was established as a benefit form.

## Valuation Requirements

The ERISA reporting and disclosure rules work in tandem with the Code qualification standards to require that an independent appraiser value a private sponsor company ESOP's stock holdings on at least an annual basis for the purpose of contributions and distributions made during that year (i.e., the "administrative valuation").

The Code requires that administrative valuations be performed by an independent appraiser who works for/responds to the Trustee (as defined below) only. The independent appraiser cannot provide any other services to—or otherwise be related to—the sponsor company.[3]

The Service, DOL, and federal court guidance make clear that reliance on a given ESOP valuation—for whatever purpose—is a fiduciary decision that must be exercised on a nondiscriminatory basis and in good faith.

Usually performed as of the end of the plan year, the valuation analysis typically is based on the fair market value standard of value. The administrative valuation is used to report benefits on benefit statements and to pay distributions to participants.

## Written Plan Document Requirements

The Code requires that an ESOP be administered based on a written defined contribution plan that complies with Code qualification rules. To comply with these provisions of the Code, an ESOP document must contain certain specific terms (detailed below).

### Eligibility Requirements

Employees over age 21 who work more than 1,000 hours per year must generally be eligible to participate in the ESOP. The ESOP document may provide eligibility criteria that are more favorable than this standard (e.g., employees over age 18; less onerous service requirements).

The ESOP document may exclude certain classes of employees, such as "union" employees, leased employees, nonresident aliens with no U.S. source income, temporary employees, or interns (provided that such designation is not intended to circumvent the maximum service requirement that may be imposed).

It is noteworthy that providing ESOP benefits to union employees outside of a collectively bargained agreement may cause a labor violation.

### Contribution Requirements

An ESOP may accept sponsor company contributions similar to those made to other qualified retirement plans, including matching contributions and profit sharing contributions.

Code provisions permit sponsor companies to make an annual tax-deductible contribution—in shares of employer stock or cash—that is equal to 25 percent of the total eligible payroll of ESOP participants. Shares of sponsor company stock contributed to an ESOP are valued based on current fair market value (for purposes of determining the amount of the contribution and applying appropriate Code limits).

Amounts paid toward interest on an ESOP loan are not included in calculating the 25 percent limit for C corporations.

The Code also permits a C corporation to deduct reasonable dividends paid on sponsor company stock held by an ESOP.

In order to take advantage of the dividend deduction, the terms of the written ESOP document should provide that the dividends are paid in one of the following ways:

- In cash to participants
- To the ESOP trust and, within 90 days after the close of the plan year in which the payment was received, distributed in cash to the participants
- To the ESOP trust and used to purchase additional stock

If sponsor company contributions exceed the deduction limits, the Code imposes a 10 percent excise tax on the excess. This includes dividends as well as contributions to other defined contribution plans.[4]

Contributions are—regardless of the 25 percent deduction limit—limited in amount on a participant basis by the Code. The limitation is that no participant may receive more than the lower of $57,000 or 100 percent of compensation as a contribution in a plan year.[5]

The sponsor company can increase current cash flow by issuing new shares or treasury shares and contributing those shares to the ESOP. In other words, an ESOP can be fully funded by contributing

shares of employer stock to the plan which will delay the need for cash amounts to be paid to the ESOP/participants.

It is noteworthy that this provision will dilute existing business owners. Therefore, the sponsor company must have sufficient shares authorized.

Many employers opt to use stock contributed to an ESOP as a 401(k) plan match feature, which provides a cash flow neutral (subject to limits under the Code) tax deduction opportunity.

## Allocation Requirements

Allocations of annual contributions must accumulate in an ESOP participant's account until the participant resigns, dies, retires, or is terminated. Code rules require that allocations be made generally at the end of the year either on the basis of relative pay or another equal, nondiscriminatory formula (i.e. per capita, seniority, or a combination thereof).

An ESOP may limit the ability to hold stock to active employees only. This is accomplished through terms of the ESOP document that require converting into cash the shares of employer stock held in the accounts of terminated employees and reallocating the shares amongst active employees.

ESOPs may condition participant eligibility for allocations on employment on the last day of the plan year and/or 1,000 hours of service.

The shares held by an ESOP should participate on a pro rata basis whenever the sponsor company declares a dividend payment.

## Vesting Requirements

Vesting refers to the amount of time an employee must work before acquiring a nonforfeitable entitlement to his or her benefit. A participant begins to vest according to a schedule incorporated into the ESOP plan document, generally after one full year (1,000 hours) of service.

The Code requires that participants fully vest in their ESOP accounts on a three-year cliff schedule (no vesting at all for the first years, followed by 100 percent vesting after the third year of service) or a six-year graded vesting schedule (20 percent vesting after the second year of service, followed by 20 percent each year until full vesting occurs).

ESOP plan documents may contain vesting that is more generous than a three-year cliff or six-year graded schedule.

## Voting Requirements

In general, the Trustee is only permitted to vote on matters reserved for a shareholder vote. On an annual basis, this would typically refer to board elections. If the ESOP holds private employer company stock, certain matters have to be "given" to participants who may direct the Trustee as to how to vote shares held in such participants' accounts.

These are limited matters including the voting of shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all assets of a trade or business.

It is noteworthy that a direct stock sale of all corporation stock typically does not trigger a pass-through vote to ESOP participants, but such a sale is subject to the Trustee's approval.

## Distribution Requirements

Employees pay no income tax on the contributions to an ESOP until distribution from their accounts. Participants can roll over their distributions to an individual retirement account or other retirement plan (and continue to defer taxes) or pay current tax on the distribution with any gains accumulated over time taxed as capital gains.

The income tax portion of the distribution is subject to a 10 percent penalty if made before normal retirement age.

Distributions from an ESOP are generally made at the election of the employee. Distributions may be made in lump sum or installments, and distributions may be immediate or deferred.

The Code generally requires that an ESOP begin the payment of benefits to a participant no later than one year after the end of the plan year in which the participant terminates employment because of normal retirement, disability, or death.

The Code provides that a participant that terminates employment for reasons other than death, disability, or retirement must begin to receive distributions within six years of his or her termination date.

The "repurchase obligation" triggered by distribution requirements is typically handled in one of the following ways:

- The sponsor company makes a tax deductible contribution to the ESOP in an amount equal to the distribution requirement owed in a given year. The ESOP allocates the cash among active, eligible employees.

> **"[ESOPs] provide a popular—and tax-effective—way to manage succession planning, business owner tax liability, employee retirement security, and employee retention."**

The cash amounts are immediately used to buy the shares from the to-be-distributed employees (e.g., the terminated employees). The cash allocation made to the active participants is replaced with these shares. So, as an end result, the terminated individuals receive the cash value of their investment, and the active employees receive the purchased shares.

The shares of the sponsor company stock stay within the ESOP in this instance and are "recycled" to active participants. In this instance the ESOP retains the same share ownership and is not diluted as a result of this process.

- The sponsor company pays the terminated participant directly and the shares of employer stock are retired to treasury. The sponsor company may then retain such shares in treasury stock (lowering the number of shares held by the ESOP and diluting ownership vis-a-vis non-ESOP shareholders) or make contributions of such shares to the ESOP.

### Diversification Requirements

When employees reach age 55 and have 10 years of participation in the ESOP, the Code requires that they be given the option of either:

1. diversifying 25 percent of their account balance in sponsor company shares among at least three other investment alternatives or
2. receiving cash distributions equal to 25 percent of their sponsor company share account balance.

At age 60, employees can elect to have 50 percent of their sponsor company share account balance diversified in other investments or distributed to them.

The Code states that diversification distributions must begin within 180 days—or six months—of the end of a given plan year. There is no similar timing rule with respect to distributions occurring at termination from service.

## Summary and Conclusion

There are successful ESOPs in almost every industry—and in companies of all sizes. Though a business owner must be mindful of the complex legal and regulatory requirements associated with the ESOP structure, these specialty retirement plans provide a popular—and tax-effective—way to manage succession planning, business owner tax liability, employee retirement security, and employee retention.

This discussion provided a summary of considerations for a private company business owner curious about selling to an ESOP, and explained why an ESOP is worthy of consideration by private company business owners.

Notes:

1. https://www.nceo.org/articles/employee-ownership-by-the-numbers. For reference, the NCEO and the ESOP Association are two prominent nonprofit organizations that provide a variety of resources for the purpose of educating business owners regarding ESOPs and employee ownership.
2. See Robert F. Reilly and Robert P. Schweihs, *Best Practices—Thought Leadership in Valuation, Damages, and Transfer Price Analysis* (Ventnor, NJ: Valuation Products and Services, LLC, 2019), 684.
3. Code 401(a)(28)(C).
4. "Reasonable dividends" that are distributed to participants or reinvested in stock do not count toward this limit for C corporations.
5. This Code Section 415 limit is applied across all employer-sponsored plans. This means that the limit includes not only amounts paid to an ESOP, but also amounts paid to the sponsor company's 401(k) plan.


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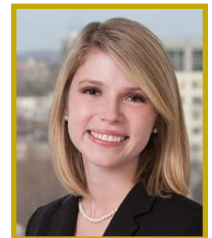

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