ESOPS Can Be Great

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This is the first in a series of three articles discussing benefits, incentives, and candidates for Employee Stock Ownership Plans. This first article focuses on federal tax benefits, the second will focus on Iowa and Nebraska ESOP formation incentives, and the third article will identify characteristics of companies and owners that are possible candidates to consider an ESOP.

Federal tax laws favor creation of Employee Stock Ownership Plans ("ESOPs") and sale of company stock to ESOPs. These advantages may make ESOPs attractive to many companies and to significant owners looking to sell company stock, reward valuable and loyal employees, and create an ongoing legacy in the form of a locally owned and managed business. This article describes some of the significant federal income tax advantages of ESOPs to companies, shareholders, and plan participants.

What is an ESOP

ESOPs are a type of qualified retirement plan usually in the form of a defined contribution "stock bonus" plan; that is, an ESOP is similar to a profit sharing plan but it is designed to be invested primarily in employer stock. Individual participant accounts are maintained and are credited with actual shares of employer stock or a proportionate amount of the value of employer stock held by the ESOP's trust. A unique feature of ESOPs is that they can enter into debt financed purchases of shareholders' stock where the borrowing is either from, or guaranteed by, the company and/or the selling shareholder. Normally, such transactions would be prohibited by ERISA.

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Motives for Creating an ESOP

ESOPs are frequently created by medium size private companies as a way to create a market to buy shares of a departing shareholder. The ESOP trust may either borrow money from a third party lender or from the company, or give the selling shareholder a promissory note to purchase shares. The company makes tax-deductible contributions to the trust to pay off the debt. As the debt is reduced, shares are allocated to participants' accounts. Because contributions are completely tax deductible, the company's borrowing cost to make a market for the seller's stock is less than if the company were to redeem the shares directly.

In cases of a taxable C corporation, the selling shareholder may make an election to defer recognition of taxable gain on the sale to the ESOP if the ESOP owns 30% or more of the shares of the company after the purchase and the seller purchases replacement securities. If the replacement securities are held until the seller's death, there will be a step-up in tax basis and, if sold shortly after death, no capital gain may ever be realized.

An ESOP can also be a significant employee benefit tying the interests of employees to the financial success of the company, thereby fostering increased employee productivity, efficiency, and loyalty.

Federal Tax Incentives

Additional significant federal tax benefits include:

- Company dividends used to repay an ESOP loan, distributed to ESOP participants or reinvested by participants in company stock, are deductible to the company.
- Company contributions of its own stock are tax deductible – essentially providing a non-cash deduction for diluting stock ownership.
- Dividends and earnings paid or attributable to S corporation stock held by an ESOP are exempt from federal income tax; and an S corporation 100% owned by an ESOP is exempt from federal income tax.
- As with other qualified retirement plans, employer contributions (whether used to pay a stock purchase loan, in the form of company stock or additional contributions), and gains and earnings from contributions, are not currently includable in participants' income.
- Higher deductible contribution limits may apply if necessary to re-pay an ESOP stock purchase loan.
- Participants can choose to receive cash or have the cash value of stock transferred to an IRA; or they may elect to receive stock and sell stock of the company back to the ESOP and pay tax at the current federal capital gains rates of 0% to 15%, based on the difference between

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the acquisition costs of shares in the ESOP compared to the sales price (however, the acquisition cost of the shares by the ESOP trust is taxed at ordinary rates). As with other qualified retirement plans, pre-age 59 early distribution penalties may apply. *[Note: ESOPs generally must provide that participants may elect to receive company stock and the ESOP or the company must make a market for participants to sell the stock for the current appraised value; however, the company's bylaws may require participants to sell shares they receive either back to the ESOP or to the company. Subchapter S corporation ESOPs are not required to permit actual distribution of shares.]*

Conclusion

ESOPs are as different as the companies that sponsor them and the owners who sell stock to them. There is no one-size-fits-all approach or design, and not all companies or shareholders are good candidates to use an ESOP. Initial steps include conducting a feasibility evaluation, obtaining a preliminary valuation, identifying possible design alternatives, and securing preliminary financial commitments before proceeding with establishment of an ESOP. Further, understanding and addressing on-going operational, liquidity, regulatory, fiduciary, record-keeping, and compliance requirements are essential.

Koley Jessen P.C., L.L.O. has a long and proud history of helping companies, shareholders, lenders, and fiduciaries in all phases of successful evaluation, design, implementation, and on-going administration of ESOPs. Koley Jessen is a nationally recognized leader in employee benefits, fiduciary guidance, labor, and tax law. Attorneys in the Firm's Employment, Labor, and Benefits Practice Group advise businesses, governments, and nonprofit/tax-exempt organizations on a wide variety of retirement plans, health and welfare benefit plans, non-qualified deferred compensation, and equity based compensation arrangements.