

# **ESOPs**

## **Questions & Answers**



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## **ATLANTIC MANAGEMENT COMPANY**

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The following monograph discusses issues involving questions and answers pertaining to Employee Stock Ownership Plans (ESOPs). It is intended to offer information only, and not legal, tax or accounting advice. A thorough analysis of legal ramifications and the Internal Revenue Code is recommended before any action is undertaken.

## **What is an ESOP?**

ESOPs are unlike other employee benefit plans, which typically diversify their holdings by investing in a variety of assets. An ESOP is a retirement plan that is 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, which can be 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.

## **How does an ESOP benefit the company?**

An ESOP is a technique of corporate finance as well as an employee benefit plan. An ESOP can be used to raise new equity capital, to refinance outstanding debt, or to acquire productive assets through borrowing from third party lenders. ESOPs can also be used to increase cash flow by making contributions to the Employee Stock Ownership Trust (ESOT) in stock instead of cash.

Since contributions to the ESOT are fully tax deductible, an employer can fund both the principal and interest payments on an ESOP's debt service with pre-tax dollars.

Dividends on ESOP stock are also tax deductible if they are applied to repay ESOP loan principal. Reducing loan principal with pre-tax contributions and dividends generates significant tax savings, which in turn increases a company's cash flow.

There is strong statistical evidence that employee ownership improves employee morale and productivity and reduces turnover. Surveys conducted by The ESOP Association show that most Association members report improved employee morale and productivity due to their ESOPs. A study by the National Center for Employee Ownership ("NCEO") during the 1980's found that ESOP companies grew more than 5 percent a year faster than their non-ESOP counterparts. Moreover, the study showed that ESOP companies with "participative" management styles grew at a rate that was three to four times faster than traditionally managed ESOP companies. The NCEO results have been replicated by a number of later studies, and it is now generally accepted that ESOPs can improve a company's productivity.

## **How does the ESOP benefit the 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 often the only market for a minority shareholder in a closely held company.

Section 1042 of the Internal Revenue Code permits a shareholder to stock to an ESOT and defer the capital gains tax on the sale. To qualify for this provision, the ESOT must own at least 30 percent of the outstanding corporate stock immediately after the transaction, and the shareholder must acquire "qualified replacement securities" within a 15 month period that begins 3 months prior to the transaction and ends 12 months after the transaction.

With an ESOP, a majority shareholder has the option of selling all or only a portion of his or her stock to increase personal liquidity, while maintaining control of the company.

In the context of estate planning, a sale of closely held stock to an ESOT freezes the value of those shares. If the shareholder elects the Section 1042 rollover, the qualified replacement property can be incorporated into the estate plan and provide greater planning flexibility.

## **How does the ESOP benefit the employees?**

Each year company contributions to the ESOT, both cash and stock, are allocated to the accounts of participating employees in the trust established as part of the ESOP. The accumulated balance in a participant's account is distributed to the participant after his or her retirement or other termination of employment with the company.

During the period of years when an employee's share of ESOP assets are held in the ESOP trust, the value of the account - including the appreciation in stock value - is not taxable to the employee.

Employees have the option to diversify 25 percent of their ESOP stock, provided they are at least 55 years old and have been ESOP participants for at least 10 years. At age 60, employees have an option to diversify up to 50 percent of their account balances, less any previously diversified amounts. The ESOP must offer at least three investment options to meet the diversification requirements.

Distributions of benefits from an ESOP may be in the form of cash or employer securities. If the employer securities are not readily tradable on an established market, the employee has a "put option" that requires the employer to repurchase the shares under a fair valuation formula.

The tax favored treatment accorded to ESOPs make them an effective vehicle for financing a management buyout. ESOP financing permits the repayment of acquisition debt with pre-tax dollars while generating increased cash flow through tax savings.

### **Can we keep our existing 401(k) plan if an ESOP is set up?**

Yes. In fact, the company can use stock to match the employee's contribution to the 401(k) plan, which will increase a company's cash flow.

### **Can we keep our existing profit sharing plan if an ESOP is set up?**

Yes.

### **Is an ESOP a defined contribution plan, or a defined benefit plan?**

ESOPs are known as defined contribution plans.

In defined contribution plans, there is generally no fixed schedule of benefits that is guaranteed to the employees. Instead, the company may make a contribution to the plan each year, which often varies in direct proportion to the company's profit levels.

In a defined benefit plan, a fixed schedule of benefits determines what each employee will receive upon retirement. The employer is then obligated to contribute to the an amount to meet the rights of departing employees under the fixed schedule.

### **What is the description of an ideal ESOP company?**

ESOPs operate successfully in a broad range of companies - large and small, public and private. The ideal ESOP company candidate will meet most of the following criteria:

- The company has strong cash flow, and a history of increasing sales and profits.
- The company has been consistently in a high federal income tax bracket.
- The company has substantial shareholder equity.
- The company has capable second line management in place.

### **What is the difference between a leveraged and non-leveraged ESOP?**

An ESOP is leveraged if it borrows money to purchase shares of the employer's stock. The loan may be from a bank or financial institution, or the selling shareholder may finance the transaction by taking back a note for all or part of the purchase price.

A non-leveraged ESOP is funded by the corporation making contributions of its stock, or with cash contributions, which are then used to purchase stock from the corporation or the existing shareholders.

An ESOP is the only employee benefit plan that can use corporate credit to finance the purchase of company stock. For all other qualified employee benefit plans, this would be a prohibited transaction under the Employee Retirement Income Security Act of 1974, as amended (ERISA).

### **Who appoints the trustee(s) of the ESOP?**

Typically, the company's board of directors appoints the trustee(s). The trustees can be officers or employees of the company, members of an administration committee, an independent bank or trust company, or disinterested individuals.

### **What are the responsibilities of the ESOP trustee(s)?**

ERISA requires that plan trustee(s) act prudently, and solely in the interest of the plan participants. Three of the more important responsibilities include:

- Securing a proper valuation of the stock
- Assuring the interest of plan participants are protected in ESOP transactions
- Approving purchase and sale of ESOP stock

### **Can a sole shareholder remain in control of the company after selling stock to an ESOP?**

The best way to accomplish this is to sell only a minority interest in the company to the ESOP. In addition, a shareholder may participate in the administration of the ESOP.

### **Aren't ESOPs expensive to set up and administer?**

Costs are a function of the complexity of the transaction. If owners take the time to get a better understanding of ESOPs, initial costs can be reduced. Ongoing ESOP administration 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.

### **Can an S Corporation adopt an ESOP?**

Yes. Effective January 1, 1998 it became advantageous for an ESOP to be a shareholder of an S corporation under the federal tax laws. To the extent that the S corporation is owned by an ESOP, no federal income taxes on corporate income are payable by either the shareholder or the corporation. This can create a significant competitive advantage for S corporations, which are substantially ESOP owned.

### **How do I set up an ESOP?**

The first step in the process is determining the company's value, since the ESOP cannot pay more than fair market value for the stock it purchases. Both the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) have issued guidelines governing the valuation of company stock in ESOP transactions.

The next step is a feasibility study to analyze the overall framework for the transaction. Among the issues the study addresses are: 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; and how it will be financed.

If a leveraged ESOP is established, the next step is securing a loan to finance the transaction. For the uninitiated, financing an ESOP transaction can be a difficult task. However, it doesn't need to be more complex than any other corporate financing.

Once financing has been arranged, legal counsel should prepare the ESOP plan documents. An ESOP sponsor has many choices to make in designing a plan that will work well in its corporate culture. For that reason, it is advisable to work with experienced ESOP attorneys in designing the ESOP.

The next step is to negotiate a stock purchase agreement between the ESOP fiduciary and the selling shareholder(s). The stock purchase agreement sets forth the price and other terms and conditions under which the ESOP will purchase stock from the selling shareholder(s). As in any stock purchase transaction, the stock purchase agreement typically contains representations and warranties about the company's assets, operations and financial condition.

The final step before closing the transaction is an opinion from the valuation consultant who initially

appraised the company. This opinion provides the necessary assurances that the ESOP is not paying more than fair market value for the stock and that the transaction is fair and equitable to the ESOP from a financial point of view.

### **Does the ESOP plan have to be filed with either the Internal Revenue Service or Department of Labor?**

No. It is not a legal requirement for the IRS to approve the plan prior to setting up the ESOP or having the ESOP acquire company stock, nor is it necessary to file the ESOP with the DOL or any other governmental agency. However, as with any tax-qualified retirement plan, ESOP companies usually submit their ESOP to the IRS with a request for a determination letter, which confirms that the form of the ESOP satisfies the requirements of the Internal Revenue Code.

### **Do all company employees have to participate in the ESOP?**

No. However, in order to satisfy IRS guidelines, the ESOP must cover a substantial percentage of non-highly compensated employees who have attained age 21 and completed 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.

### **How are the ESOP participants vested?**

As with all tax-qualified benefit plans, ESOPs must comply with one of two minimum vesting schedules as established in the Internal Revenue Code.

In a "cliff vesting" plan, a participant will be 100 percent vested after five years, but need not be vested at all before that time.

In a "graded vesting" plan a participant must become 20 percent vested after three years, increasing 20 percent annually until 100 percent is reached after seven years. Any vesting schedule which provides for more rapid graded vesting than this minimum is permitted.

Vesting is normally calculated using years of service with the employer, including service with affiliated employers. Credit for service before the ESOP was adopted may (but need not) be recognized by the ESOP. When a participant who is not fully vested leaves the company, his vested interest will eventually become a forfeiture and be reallocated among the remaining ESOP participants.

### **Can the ESOP participants be 100 percent vested from day one?**

Yes, although this is not common.

### **How are the company's contributions to the ESOP allocated among ESOP participants?**

An ESOP must include a definite formula for allocating employer contributions and forfeitures to the individual accounts of plan participants.

Usually, employer contributions to an ESOP are allocated among the participants' accounts in the plan based on their compensation from the company. However, the allocation can also be based on a combination of compensation and years of service with the company. The latter option is more complicated and expensive to administer.

There is a ceiling on the amount of annual compensation that can be recognized for determining participant allocations in a qualified plan. The ceiling is currently set at \$200,000 and is adjusted based on annual cost of living increases. This means that an employee who is compensated at an annual rate of \$350,000, for example, will receive the same allocation within the ESOP as an employee who is paid \$200,000.

### **How is company stock allocated to participants in a leveraged ESOP?**

Shares acquired by a leveraged ESOP are initially held in an unallocated suspense account within the ESOP. As the loan is paid down, the shares are released from the suspense account and allocated among participants. The release from suspense must satisfy one of two alternative formulas specified in IRS regulations, which require release in proportion to either (i) principal paid on the loan for the year, or (ii) total principal and interest paid on the loan for the year.

### **Can I use the ESOP to refinance existing corporate debt?**

Yes. Refinancing existing corporate debt through an ESOP should improve after-tax cash flow. The refinance is accomplished through a loan to the ESOP which uses the borrowed money to purchase newly issued stock from the company. The company uses the cash to pay off the existing debt, which is thus replaced with ESOP debt. After the refinancing, the company's contributions used to pay the principal portion of the ESOP debt will become tax deductible, whereas principal payments on the prior corporate debt were not.

### **Once an ESOP is set up, am I stuck with it forever?**

No. Just as a company can terminate a profit sharing plan, it can also terminate an ESOP. At that point, all participants are deemed 100 percent vested. Benefit distributions from the ESOP are eligible to be rolled over into an IRA; ESOP distributions not rolled over are taxable, but may be eligible for special favorable tax treatment.

### **Who is legally responsible for the valuation of company stock held in the ESOP?**

Under ERISA, the legal responsibility for valuing ESOP stock rests with a named fiduciary who is responsible for fulfilling this trustee responsibility. The named fiduciary must carefully select and monitor the performance of the ESOP appraiser. If the independent appraiser's valuation is challenged, the fiduciary would look to the appraisal firm to defend its conclusion of value.

### **Why do I have to retain an independent?**

The Department of Labor and Internal Revenue Service have issued guidelines stating the factors that must be taken into account when appraising a company, and who should do the valuation.

A qualified appraiser is one who: (1) holds himself/herself out to the public as an appraiser or performs appraisals on a regular basis - and is qualified to make appraisals of the type of property being appraised; and (2) is independent with respect to the employer corporation and the other parties to the ESOP transaction.

In terms of qualifications, the amount of credibility the IRS or DOL attaches to the conclusion of value will be greatly influenced by their assessment of the expertise demonstrated by the appraisal. The same can be said for the independence of the appraiser firm. To satisfy the independence criteria, the valuation cannot be done by:

- The taxpayer that maintains the ESOP
- A party to the transaction in which the ESOP acquired the property
- An employee of the taxpayer that maintains the ESOP
- An individual or firm regularly used by the taxpayer maintaining the ESOP, who does not perform a majority of his or her appraisals for entities other than the taxpayer maintaining the ESOP

A review of case law and complaints filed by the IRS and DOL indicates that most of the challenges to ESOP valuations relate to one or more of the following:

- Do-it-yourself valuations where the corporation, or one of its employees, determines the value of the corporate stock
- Using the corporation's regular accounting firm which may lack the necessary independence
- Having the valuation done by a person or firm not thoroughly experienced in ESOP valuations
- Using unconventional valuation methods that are not acceptable to IRS and DOL
- Failing to adequately document the valuation in a written report
- Basing an ESOP transaction on a valuation that is out of date at the time of the transaction

### **What is the tax-free ESOP rollover?**

Shareholders of privately held companies can sell their stock to an ESOT and defer - or possibly eliminate - federal income taxes on the gain from the sale, if the sale qualifies as a tax-free rollover under Section 1042 of the Internal Revenue Code.

To qualify for the rollover, the ESOT must own at least 30 percent of the company's stock immediately after the sale, and the proceeds must be reinvested in "Qualified Replacement Property" within a 15 month period, beginning three months prior to the date of the sale. The stock sold to the ESOT must be common stock (or certain convertible preferred stock) with the greatest voting and dividend rights. The stock must have been owned by the seller for at least 3 years, and the company cannot be an S corporation.

The seller, certain relatives, and 25 percent or greater shareholders in the company are prohibited from receiving allocations of stock acquired through an ESOP rollover.

A shareholder may rollover all or any portion of the ESOT sale proceeds. The company must agree to pay a penalty tax if the ESOP shares acquired through the rollover are sold or disposed of by the ESOP within 3 years after the date of sale.

### **What securities are considered Qualified Replacement Property?**

Qualified Replacement Property includes stocks and bonds of most domestic operating companies. It does not include treasury bonds, treasury bills, tax-free bonds or mutual funds. The selling shareholder must sign an affidavit within 30 days after each purchase of Qualified Replacement Property, and file a copy with the IRS. An experienced adviser familiar with the rollover rules should be consulted to make sure that replacement securities satisfy the requirements for Qualified Replacement Property.

### **If the ESOT owns at least 30 percent of the stock, can subsequent sales of stock to the ESOT qualify for the tax-free rollover?**

Yes. There is no limit on the number of shares or size of the block of shares that must be sold to the ESOT in a single transaction.

### **Can I sell stock to an ESOP in return for a promissory note from the ESOT and still qualify for the tax-free rollover?**

Yes. However, the Qualified Replacement Property must be purchased within a 15-month period, beginning 3 months prior to the date of the sale. If the note has not been fully paid by the time the Qualified Replacement Property must be purchased, the selling shareholder will have to use other funds to purchase enough Qualified Replacement Property to rollover all of the sale proceeds. Seller financed transactions can use Floating Rate Notes to avoid this problem.

### **When is gain recognized on the sale of a Qualified Replacement Property?**

During the first 12 months after the sale to the ESOP, the selling shareholder may use the proceeds to buy and sell securities as often as desired. During this period, any gains over the ESOP sale price are taxable. When the selling shareholder has purchased (and identified to the IRS) the securities which constitute Qualified Replacement Property, the shareholder's basis in the Qualified Replacement Property will be the same as the seller's basis in the corresponding company stock sold to the ESOT. In a subsequent sale of all or any portion of the Qualified Replacement Property, taxable gain will be recognized to the extent the selling price exceeds the shareholder's basis of the Qualified Replacement Property.

Selling shareholders who desire to actively trade the securities in their portfolio can use "floating rate notes" to avoid the capital gain taxes that are incurred

when Qualified Replacement Property is sold. These long-term notes constitute Qualified Replacement Property and can be used as collateral for margin loans which are used to actively trade securities with a tax basis equal to the purchaser's cost.

Dividend and interest income received from the Qualified Replacement Property is taxable.

If the selling shareholder holds the Qualified Replacement Property until death, his or her estate will receive a stepped up basis for the property, and no gain or loss will be recognized for income tax purposes. Qualified Replacement Property owned by the decedent will, however, be included in the decedent's estate for federal estate tax purposes.

### **How much can be contributed to the ESOT annually?**

Sponsors of leveraged and unleveraged ESOPs are allowed to make tax deductible contributions of up to 25 percent of covered payroll annually to repay the principal on the ESOP loan. It should be noted that interest payments on the ESOP loan, and dividends used to repay an ESOP loan, are not counted when calculating the 25 percent contribution limit.

Covered payroll is defined as the total wages of ESOP participants. It should be noted that wages over and above \$200,000 are not included.

### **What restrictions apply to S Corporation ESOPs?**

A shareholder who sells S corporation stock to an ESOP is not eligible for the tax-free ESOP rollover, and the S Corporation ESOP Deduction limits are less favorable than the ESOP deductions for C Corporations. S Corporation ESOP deductions are limited to 25 percent of covered payroll annually including both principal and interest for the ESOP loan. In addition, corporate distributions to S Corporation shareholders are not tax deductible, and distributions paid on allocated shares of S Corporation stock in the ESOP may not be used to repay a leveraged ESOP loan. Finally, distribution of S Corporation shares acquired with a loan to employees who have left the company may not be deferred until the loan is repaid.

Severe tax penalties are imposed on S corporations which sponsor ESOPs in any year in which "disqualified persons" collectively own or are deemed to own 50% or more of the company.

A disqualified person is a person who (i) individually owns 10% or more of the company's "deemed-owned shares", or (ii) collectively with other family members owns 20% or more of its deemed-owned shares. Deemed-owned shares include an individual's allocated ESOP shares, a proportionate share of unallocated ESOP shares, and any "synthetic equity" owned by disqualified persons. Synthetic equity is broadly defined to include any right to acquire company stock in the future or to share in the company's value or growth through an equity-based compensation plan.

These rules are complex, but will generally preclude small S corporations with 10 or fewer employees from adopting an ESOP. They will require larger S corporations with as many as 50 or more employees to carefully monitor ESOP allocations, as well as their equity-based compensation programs.

### **Are contributions to the ESOT tax deductible?**

Contributions to ESOTs are tax deductible to the company, within certain limits. In the case of a leveraged ESOP, contributions used to repay the ESOP loan allow the company to deduct both the principal and interest. In a conventional loan, only the interest portion would be deductible. In a non-leveraged ESOP, the fair market value of the stock contribution is deductible.

### **Are dividends paid to the ESOT tax deductible?**

A special tax deduction is permitted for reasonable dividends on C Corporation stock held in the ESOP if they are: (i) used to repay an ESOP loan, (ii) distributed in cash to participants no later than 90 days after the close of the plan year in which they were paid, (iii) paid to the plan and reinvested in company stock. Distributed dividends are taxed as ordinary income.

### **Are annual contributions to the ESOT mandatory?**

No. However, in a leveraged ESOP, employer corporations usually need to commit to contribute enough cash each year to service the ESOP loan debt. If the ESOT has sufficient cash to pay the ESOP debt, additional contributions are not required. In some instances, it may be wise to make contributions in excess of the required ESOP debt payments to offset years in which cash flow may be restricted. In that instance, the excess cash can be used to continue payment of the ESOP debt.

### **Who votes the shares held in the ESOT?**

The Internal Revenue Code requires that company stock in the ESOP must have full voting rights. In non-public ESOP companies, voting rights on shares allocated to ESOP accounts must be “passed through” to ESOP participants for votes on major corporate matters such as a merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of the assets of the corporation. Unallocated shares, and allocated shares voting on other matters (such as the election of the Board of Directors), may be voted by a named fiduciary, or as otherwise designated in the plan. Some ESOPs pass through voting to participants on all matters, or provide for proportional voting for all shares held in the ESOP (both allocated and unallocated shares) on the basis of one vote per participant.

### **Are the account balances of ESOP participants taxed?**

The value of a participating employee’s ESOP account, including company contributions and any appreciation in the value of the account, is not taxable to the employee while it accumulates in the ESOP.

Distributions from the ESOT are subject to taxation, but favorable tax treatment may apply to lump sum distributions in the form of company stock.

For distributions received prior to age 59½, a 10 percent excise tax is generally imposed on the entire amount, in addition to the income tax, unless the distribution was made on or after the employee’s death, disability, or separation from service after attaining age 55. Deductible cash dividends paid to ESOP participants are not subject to the early distribution excise tax.

ESOP distributions may be rolled over into an IRA or another qualified plan, in which case income taxes will be deferred.

### **Are ESOP accounts required to be fully invested in company stock?**

ESOPs are not required to invest exclusively in company stock; many ESOPs have substantial investments in cash or other securities. However, ESOPs normally have more than half their assets invested in company stock.

In addition, ESOP participants who are approaching retirement age must be given an opportunity to diversify their ESOP accounts. For shares acquired

by an ESOP after December 31, 1986, the ESOP must provide any participant who has attained age 55 and completed 10 or more years of service of participation in the ESOP with an annual option to diversify 25 percent of his or her ESOP account into investments other than company stock. At age 60, a participant must be given a one-time option to diversify up to 50 percent of his or her account.

At least three investment options must be offered within the ESOP to meet the diversification requirements. Alternatively, the ESOP may transfer funds to another qualified plan, or distribute assets directly to the participant to satisfy the diversification requirements.

### **How are ESOP benefits distributed?**

Benefit distributions from an ESOT may be made in cash or in company stock. ESOP participants must be given the option to require distribution of their ESOP account balances in the form of company stock, unless the company’s organizational documents restrict ownership of company stock to active employees, or the company is an S Corporation. In these cases, the ESOT can distribute cash or company stock which must be immediately resold to the company.

### **Can distributed shares be freely resold?**

Shares distributed from the ESOP can be subject to a right of first refusal in favor of the employer or the ESOP, or both. This prevents the shares from being freely transferable by the former participant.

### **What is a put option?**

A put option requires a privately held employer company to repurchase company stock distributed to the ESOP participant 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) 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 normally exceed 5 years (except for certain large account balances), and the company must provide adequate security and pay reasonable interest on deferred installment payments.

### **When are ESOP benefits distributed to participants?**

Distribution of vested benefits must commence not later than the plan year following the plan year in which the participant retires, becomes disabled, or dies. If the ESOP participant leaves the company before reaching normal retirement age for any other reason, the participant can elect to begin receiving a distribution of vested benefits no later than the fifth plan year after the plan year in which the participant separated from service.

### **What is repurchase liability?**

Because the company is required to repurchase the stock of departing ESOP participants under the put option, all privately held ESOP companies have repurchase liability for the stock held in the ESOP. It is a liability that can grow, and one which should be planned for.

A company's repurchase liability is determined by a number of factors, including: the size of the annual contribution to the ESOP, change 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 repurchase of the ESOP's shares, and the diversification option of eligible participants.

### **How can I minimize the impact of repurchase liability?**

Companies often find it useful to project the repurchase liability before making the final decision to implement an ESOP. Companies can use a variety of strategies to prepare for their liability, including: making sufficient cash contributions on an annual basis, providing a variety of insurance and other investment vehicles to generate funds to cover plan participants account balances, and repurchasing shares by using excess corporate funds.

When repurchase liability is a concern, a repurchase liability study should be conducted to project the repurchase liability under varying assumptions.

### **What happens if ERISA requirements are violated?**

ERISA provides participants in all qualified plans, including ESOPs, with legal rights, and imposes penalties on fiduciaries who violate those rights. In addition, ESOPs are subject to the prohibited transactions rules of ERISA and the Code. The prohibited transactions rules are complex and impose penalties on purchases and sales of company stock, which violate the law, and on the fiduciaries who participate in a prohibited transaction.

The risks of a fiduciary violation are reduced if the ESOP engages experienced, competent ESOP advisors, and the ESOP fiduciaries exercise their best independent judgment after reviewing all aspects of the transaction and fully informing themselves of the alternatives.

### **In Conclusion**

Employee Stock Ownership Plans (ESOPs) are one of the best kept secrets in business today. Even with over 10,000 in existence, and hundreds more being set up each year, most business owners still haven't heard about the valuable financial and tax benefits ESOPs provide for shareholders and employees of closely-held companies. One reason ESOPs receive so little attention is that they appear to be more complex than they really are. An ESOP is simply a "qualified employee benefit plan," similar in some respects to the more familiar profit sharing plan.

Companies that are considering an ESOP will find the process takes some time and requires careful planning — but they'll also find the end result is worth the effort. As the company increases in value over the years, the employees share in the growth they help create.

Obviously, setting up an ESOP is a complex process. But it doesn't have to be complicated. The key is to assemble a team of advisors who have seasoned skills and proven track records in ESOP transactions. Working together, these advisors coordinate the entire ESOP process - from the initial valuation through implementation of the plan.