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Employee Stock Ownership Plan (ESOP)

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What is an ESOP?

An employee stock ownership plan (ESOP) is a type of qualified defined contribution plan that you can use to help fund your employees' retirement. An ESOP can be a stock bonus plan, or a combination stock bonus plan and money purchase pension plan. ESOPs, and stock bonus plans generally, are unique in that benefits can be paid to participating employees in the form of the employer's company stock.

An ESOP generally requires you to establish a trust to hold the plan assets. The trust fiduciary generally must set up individual accounts within the trust for each of your participating employees. As the employer, you then contribute either cash or shares of your own company stock to the trust on behalf of your participating employees. If you make cash contributions, the trust uses that money to purchase shares of company stock either from shareholders or from your company itself.

The funds of an ESOP must at all times be invested primarily in employer securities. There is no specific percentage requirement, however, and "primarily" is a flexible term that takes into account the facts and circumstances of your particular situation. For example, the investment performance of your company's employer stock may be one factor that is considered.

Caution: A "leveraged" ESOP typically borrows funds from the employer, or from a bank or other lender with the loan guaranteed by the employer, and uses the proceeds to purchase employer stock from the employer itself, or from a selling shareholder. In addition, an existing profit-sharing contribution plan may be converted to an ESOP in some cases. These issues are somewhat complex and require the assistance of a retirement plans specialist experienced with ESOPs. See also Selling to an ESOP.

Tip: As mentioned, an ESOP is a type of qualified defined contribution plan. For more information, see Retirement Plans and Defined Contribution Plans.

Caution: On August 17, 2006, President Bush signed the Pension Protection Act of 2006 into law. The law attempts to shore up the nation's pension system by making sweeping changes to the funding rules that apply to defined benefit plans. The Act also protects workers' retirement benefits and encourages savings by making numerous changes to the rules governing defined contribution plans like ESOPs. Finally, the Act makes permanent the IRA and retirement plan provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which had been scheduled to expire at the end of 2010. Several of the provisions of the Act are discussed in this article. For a fuller discussion, see The Pension Protection Act of 2006.

Caution: Special rules apply to ESOPs maintained by S corporations.

How does an ESOP typically work?

The trust fiduciary allocates the shares of your company's stock among the plan participants' accounts according to a pre-established formula. As an employee's length of service with your company increases, he or she acquires rights to the shares in his or her individual account. (This process is known as "vesting.") When an employee retires or terminates employment, the employee generally receives a distribution of his or her vested benefits in the ESOP in the form of cash or company stock. If the distribution is in the form of stock, the employee can choose to either hold or sell the stock. If the stock is not publicly traded, the employee must have the right to sell the stock to your company at its fair market value. This is not a requirement, however, if the stock is publicly traded, as the employee can simply sell the stock on the open market.

Example(s): Jane, age 41, works for BCD Company. BCD offers its employees the opportunity to participate in an ESOP. Since Jane is a full-time employee and meets other requirements, she is

eligible to participate in BCD's ESOP. BCD establishes a trust and makes cash contributions to the trust. The trust fiduciary uses BCD's cash contributions to purchase shares of BCD stock. The trust fiduciary then establishes individual accounts for ESOP participants (including Jane) within the trust, and allocates the stock purchased with BCD's cash contributions according to a formula spelled out in the plan document. After Jane is fully vested in her ESOP account, she terminates employment and receives a distribution of her shares of BCD stock. Jane then chooses to sell the stock. Since BCD's stock is not publicly traded, Jane has the right to sell the stock to BCD at its fair market value.

Tip: An ESOP participant generally can demand a distribution of benefits in the form of employer securities, and cannot be required to sell the securities back to your company. However, an ESOP may prevent a participant from obtaining a distribution of employer securities if the company's corporate charter or bylaws restrict the ownership of "substantially all" employer securities to employees or the ESOP. Consult a tax or retirement plans specialist for more information.

Tip: To keep the employer securities from falling into the hands of competitors, either the ESOP or your company may be given the right of first refusal if an ESOP participant attempts to sell the securities to a third party on the open market.

What is a stock bonus plan?

A stock bonus plan is a type of employer-sponsored retirement plan that is similar to a profit-sharing plan, except that plan benefits are available to participating employees in the form of shares of the employer company's stock. An ESOP is a type of stock bonus plan that meets specific statutory requirements.

Generally, a stock bonus plan permits, but does not require, current investments to be made in the employer company's stock. By contrast, an ESOP must invest primarily in the employer company's stock. In addition, an ESOP may borrow money to acquire employer securities. This is generally not allowed in a stock bonus plan that is not designed to qualify as an ESOP.

Tax benefits of ESOPs

Tax considerations for employees

When you contribute cash or shares of stock to an ESOP on behalf of your participating employees, those employer contributions are not currently included in the employees' taxable income. The employees will not pay income tax on the contributions allocated to their plan accounts as long as those contributions remain in the plan. In addition, since an ESOP is a qualified plan, participating employees enjoy the benefits of tax-deferred growth. This means that any earnings on your contributions (in this case, any increase in the value of the employer stock) are not currently included in the employees' taxable income. Depending on investment performance, this creates the potential for more rapid growth (and a larger retirement fund) than money invested outside the plan.

Of course, when a participating employee begins to receive distributions from his or her ESOP account (during retirement, for example), there will generally be federal (and possibly state) income tax consequences. However, the rate at which a distribution is taxed depends on the employee's federal income tax bracket for the year, and many employees may be in a lower tax bracket by the time they begin receiving distributions. If an employee receives a distribution from the plan prior to age 59½, he or she may be subject to a 10 percent premature distribution penalty tax (unless an exception applies), in addition to ordinary income tax.

With a distribution of retirement plan assets *other than* employer securities, all of the distribution (excluding any after-tax contribution amounts) is generally taxable income to the employee for the year of distribution. However, when a distribution includes employer securities (as in the case of an ESOP), special rules may apply. Under these rules, the employee may only have to pay income tax on a portion of the distribution and, in addition, may receive a considerable income tax benefit in the future. For more information, see Tax Considerations Specific to Employer-sponsored Retirement Plans.

Tax deduction for employer

As the employer sponsoring an ESOP for your employees, your contributions to the plan (whether in the form of company stock, or cash that is used to purchase company stock) are generally tax deductible on your federal income return for the year in which you make those contributions. To be eligible for this employer tax benefit, your plan generally must remain a "qualified" plan (see above).

The maximum tax-deductible contribution that you, the employer, are allowed to make cannot exceed 25 percent of the total compensation of all employees covered under the plan. Any contribution in excess of this limit is not tax deductible, and may also be subject to a 10 percent federal penalty. For purposes of calculating your maximum tax-deductible contribution, the maximum compensation base that can be used for any one plan participant is \$230,000 in 2008 (\$225,000 in 2007).

Caution: If, in addition to an ESOP, you maintain a defined benefit plan covering some of the same employees, your annual tax-deductible contribution for both plans is limited to the greater of 25 percent of the total compensation of all covered employees or the amount necessary to fund the defined benefit plan. If the amount necessary to fund the defined benefit plan is greater than 25 percent, any contributions to the ESOP are not tax-deductible. Consult a tax advisor for more information.

Tip: The Pension Protection Act of 2006 significantly changes the deduction rules if you maintain both a defined contribution plan like an ESOP and a defined benefit plan. First, the Act provides that the overall limit doesn't apply after 2005 to multiemployer plans. Second, the Act provides that the combined limit doesn't apply after 2008 if your defined benefit plan is insured by the Pension Benefit Guaranty Board (PBGC). Finally, beginning in 2006, the Act provides that in any year that the combined limit does apply, only your contributions to the defined contribution plan in excess of 6 percent of the total compensation you pay to plan participants in that year count toward the combined limit.

Caution: Annual additions to any one participant's plan account are limited to the lesser of \$46,000 (for 2008, \$45,000 for 2007) or 100 percent of the participant's pretax compensation. Annual additions include total contributions (employer and employee) to the participant's plan account, and any reallocated forfeitures from other plan participants' accounts. This may limit the relative amount of funding for older, highly compensated employees. All defined contribution plans you maintain are aggregated for this purpose. By contrast, a defined benefit plan may allow a much higher level of employer funding for such employees.

Other advantages of ESOPs

An ESOP may boost employee morale and productivity

Along with its tax benefits, an ESOP may offer additional benefits for both you and your employees, making it an attractive form of stock-based employee compensation. One of the main advantages of an ESOP is that it provides participating employees a stake or ownership interest in your company. This is primarily because plan benefits are in the form of your company's employer stock, and shares of stock represent a "piece" of the company. Having an ownership interest may boost company morale and give your employees an incentive to perform better, resulting in greater overall productivity. From your perspective as the employer, increased productivity may improve your business's bottom line over the long term. In addition, employees who feel well rewarded are more likely to stay with your company, allowing you to retain quality workers and reduce your employee turnover rate.

An ESOP is relatively cost effective

With most types of employer-sponsored retirement plans, employer contributions to the plan are made in the form of cash. This is not the case, however, with an ESOP in which the employer may contribute shares of company stock to the plan. An ESOP that is funded in this manner is often seen as more cost effective than other types of plans, because there is minimal cash outlay required on the employer's part. This is something to

consider if you would rather use your business's cash flow for purposes other than funding employees' retirement accounts.

Disadvantages of ESOPs

Company ownership is diluted

As discussed, to fund an ESOP, you make contributions to participants' accounts in the form of either shares of company stock, or cash that is then used to purchase shares of company stock. In either case, funding an ESOP often requires that you create new shares of your company stock. Your participating employees essentially become new shareholders (i.e., new part owners) of your company. This is potentially beneficial for both you and your employees (see above), but one drawback is that ownership of your company then becomes diluted among a larger pool of shareholders. As a result, each of your existing shareholders may end owning a smaller percentage of your company than prior to the establishment of the ESOP. It is possible that some of the existing shareholders may be unhappy with this arrangement.

An ESOP may carry high costs

Although an ESOP is often a cost effective form of employee compensation (see above), this type of plan often carries higher costs than other types of retirement plans. These costs typically come in the form of administrative expenses, as well as appraisal and professional fees. Consult a retirement plans specialist for more information about these costs.

Future cash outlay may be required

As discussed, one of the advantages of an ESOP compared to other types of plans is that the employer's initial cash outlay to fund the plan is often minimal. However, as the employer maintains the plan, you may experience a cash outlay when your participating employees retire or otherwise separate from your service. This is because a departing employee may begin to receive distributions of his or her vested benefits from the plan. When this happens, if your company's stock is not publicly traded, you will be required to repurchase shares of stock from the employee at fair market value. Unlike your employer contributions to an ESOP, the cash outlay needed to repurchase shares of stock is not a tax-deductible cost.

An ESOP is subject to various requirements

As a qualified retirement plan, an ESOP is subject to strict non-discrimination requirements under the Internal Revenue Code (IRC). Basically, this means that the plan cannot provide more favorable benefits or contributions for highly compensated employees than for non-highly compensated employees. An example of a plan that discriminates would be one that provides a contribution equal to 25 percent of compensation for high-paid executives, but only 10 percent for all other employees. To ensure that this does not happen, your plan is generally required to undergo some form of annual non-discrimination testing. Consult a retirement plans specialist for details regarding the testing requirements.

In addition, an ESOP is subject to federal "top-heavy" requirements. A plan is considered to be "top-heavy" if more than 60 percent of the account balances in the plan belong to the "key employees." (Generally, the key employees are the owners and/or company officers.) If your plan is top-heavy, you must make a minimum annual contribution of 3 percent of compensation to the accounts of all non-key employees. In addition, the plan must provide a more rapid vesting schedule than would otherwise apply.

Caution: The Pension Protection Act of 2006 applies this faster top-heavy vesting schedule to all employer profit-sharing contributions, whether or not the plan is top-heavy, generally effective for employer contributions made for plan years beginning after 2006. A later effective date applies to certain collectively bargained plans. See "When do employees have part or full ownership of the funds in their accounts?" in the Questions and Answers below.

Finally, an ESOP is also subject to all of the federal reporting, disclosure, fiduciary, and other requirements that apply to qualified plans under the Employee Retirement Income Security Act (ERISA).

How to set up an ESOP

Have a plan developed for your business

Due to the complex nature of the rules governing qualified retirement plans, you will most likely need a pension specialist to develop an ESOP that meets legal requirements, as well as the needs of your business. You will need to do the following:

- Determine the plan features most appropriate for your business--Carefully review your business, looking at factors such as your cash flow and profits, your desired tax deduction, and facts about your employee population (including years of service, ages, salaries, and turnover rate). This will assist you in determining appropriate plan features, including contribution levels and employee eligibility requirements.
- Choose the plan trustee--The assets of the plan must be held in a trust by a trustee or fiduciary. The trustee has overall responsibility for managing and controlling the plan assets, preparing the trust account statements, maintaining a checking account, retaining records of contributions and distributions, filing tax reports with the IRS, and withholding appropriate taxes. The plan trustee is typically an institutional third party, such as a bank.
- Choose the plan administrator--Administering the plan involves many duties, including determining who is eligible to participate in the plan, determining the amount of benefits and when they must be paid, and complying with reporting and disclosure requirements. The plan administrator may also have other duties, such as providing informational and other services to plan participants. The employer is legally permitted to handle these responsibilities in-house, but plan sponsors often hire a third-party firm to assist with the duties of plan administration.

Submit the plan to the IRS for approval

Once a plan is developed, if it is not a prototype plan previously approved by the IRS, the plan should be submitted to the IRS for approval. As there are a number of formal requirements that must be met (for example, you must provide a formal notice to employees), a pension specialist should assist you with this task. Submission of the plan to the IRS is not a legal requirement, but it is highly recommended. The IRS will carefully review the plan and make sure that it meets all of the applicable legal requirements. If the plan meets all requirements, the IRS will issue a favorable "determination letter." Otherwise, the IRS will issue an adverse determination letter indicating the deficiencies in the plan that must be corrected.

Adopt the plan during the year for which it is to become effective

You must officially adopt your plan during the year for which it is to become effective. A corporation generally adopts an ESOP or other retirement plan by a formal action of the corporation's board of directors. An unincorporated business should adopt a written resolution in a form similar to a corporate resolution.

Provide copies of the summary plan description (SPD) to all eligible employees

ERISA requires you to provide a copy of the summary plan description (SPD) to all eligible employees within 120 days after your plan is adopted. A SPD is a booklet that describes the plan's provisions and the participants' benefits, rights, and obligations in simple language. On an ongoing basis you must provide new participants with a copy of the SPD within 90 days after they become participants. You must also provide employees (and in some cases former employees and beneficiaries) with summaries of material modifications to the plan. In most cases you can provide these documents electronically (for example, through email or via your company's intranet site).

File the appropriate annual report with the IRS

Each employer that maintains a qualified retirement plan is generally required to file an annual report with the IRS. The annual report is commonly referred to as the Form 5500 series return/report. You must file the appropriate Form 5500 series return/report for your plan for each plan year in which the plan has assets. Consult a tax or retirement plans specialist for more information.

Questions & Answers

What employees do you have to include in your ESOP?

You generally must include all employees who are at least 21 years old and have at least one year of service. Two years of service may be required for participation as long as the employee will be 100 percent vested immediately upon entering the plan. If desired, you can impose less (but not more) restrictive requirements.

Tip: For eligibility purposes, a year of service is generally a 12-month period during which the employee has at least 1,000 hours of service.

When must plan participation begin?

An employee who meets the plan's minimum age and service requirements must be allowed to participate no later than the earlier of:

- The first day of the plan year beginning after the date the employee met the age and service requirements, or
- The date six months after these conditions are met

Example(s): Walter, age 48, was hired by STU Corporation on December 1, 2007. STU Corporation has an ESOP, and the plan year begins on January 1 of each year. Walter will have one year of service as of December 1, 2008. He must be allowed to participate in the plan by January 1, 2009.

What is a highly compensated employee?

For 2008, a highly compensated employee is an individual who:

- Was a 5 percent owner of the employer during 2007 or 2008, or
- Had compensation in 2007 in excess of \$100,000, and, at the election of the employer, was in the top 20 percent of employees in terms of compensation for that year.

When do employees have full ownership of the funds in their accounts?

As mentioned, the process by which employees acquire full ownership of their benefits in an ESOP or other retirement plan is called "vesting." Employee contributions must vest immediately. In general, employer contributions either must vest 100 percent after three years of service ("cliff" vesting), or must gradually vest with 20 percent after two years of service, followed by 20 percent per year until 100 percent vesting is achieved after six years ("graded" or "graduated" vesting). Prior to the Pension Protection Act of 2006 employer contributions other than matching contributions could have a slower vesting schedule (unless the plan was top-heavy). Prior to the Act, these contributions could either vest 100 percent after five years of service, or gradually vest with 20 percent vesting after three years of service, followed by 20 percent per year until 100 percent vesting was achieved after seven years. An employer can provide faster vesting if it wishes.

Caution: The Pension Protection Act provision generally applies to plan years beginning on or after January 1, 2007, with respect to employees who are credited with an hour of service on or after that date. A later effective date applies to certain collectively bargained plans.

What happens to an employee's account if the employee terminates before he or she is 100 percent vested?

If a participant in your ESOP separates from service before being 100 percent vested in the plan, the employee will forfeit the amount that is not vested. The amount forfeited can then be used to reduce future employer contributions under the plan, or can be reallocated among the remaining participants' accounts. The IRS generally requires forfeiture allocation in proportion to participants' compensation rather than in proportion to their existing account balances.

Do you need to receive a favorable determination letter from the IRS in order for your plan to be qualified?

No, a plan does not need to receive a favorable IRS determination letter in order to be qualified. If the plan provisions meet IRS requirements, the plan is considered qualified and is entitled to the accompanying tax benefits. However, without a determination letter, the issue of plan qualification for a given year does not arise until the IRS audits your tax returns for that year. By that time, it may be too late for you to amend your plan to correct any disqualifying provisions. A determination letter helps to avoid this problem because auditing agents generally will not raise the issue of plan qualification with respect to the form of the plan (as compared to the operation of the plan) if you have a favorable determination letter (or if a preapproved "prototype" plan is used).

What happens if the IRS determines that your plan no longer meets the qualified plan requirements?

The IRS has established programs for plan sponsors to correct defects. These programs are designed to allow correction with sanctions that are less severe than outright disqualification. Your tax professional will be able to assist you in following these programs should the need arise. However, if you are unable to correct the defects in your plan as required, the plan may be disqualified. Loss of a plan's qualified status results in the following consequences:

- Employees could be taxed on employer contributions when they become vested, rather than when benefits are paid
- Your deduction for employer contributions may be limited or delayed
- The plan trust would have to pay taxes on its earnings

Must employees be allowed to diversify their investments?

Effective for plan years beginning after December 31, 2006, the Pension Protection Act of 2006 provides that certain ESOPs must provide diversification rights with respect to amounts invested in publicly-traded employer securities. These plans must allow "applicable individuals" to direct that the portion of the individual's account held in employer securities be invested in "alternative investments." These new diversification requirements apply only ESOPs that hold contributions subject to Section 401(k) or 401(m) nondiscrimination testing (e.g., KSOPS).

An applicable individual includes: (1) any plan participant; and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

These diversification provisions apply to all amounts attributable to employee elective deferrals and after-tax contributions that are invested in employer securities. In the case of amounts attributable to employer contributions that are invested in employer securities, the new rules apply to an applicable individual who is a participant with three years of service, a beneficiary of such a participant, or a beneficiary of a deceased participant. A transition rule applies to amounts attributable to employer contributions that are invested in employer securities acquired before the effective date of the Act.

A plan subject to the diversification requirements is required to give applicable individuals a choice (at least

quarterly) of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. It's intended that other investment options generally offered by the plan also must be available to applicable individuals. It's further intended that applicable individuals generally be given the opportunity to make investment changes with respect to employer securities on the same basis as the opportunity to make other investment changes, except in unusual circumstances.

Caution: Generally, a later effective date applies to collectively bargained plans.

Tip: A special effective date applies with respect to employer matching and nonelective contributions (and earnings) that are invested in employer securities that, as of September 17, 2003: (1) consist of preferred stock; and (2) are held within an ESOP, under the terms of which the value of the preferred stock is subject to a guaranteed minimum.

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