Employee Stock Ownership Plan (ESOP)

The basics: The ESOP is essentially a stock bonus plan in which employer stock may be used for contributions.

How It Works

- Employer contributes company stock or cash to the plan.
- Employer contributions are tax deductible.
- Contributions are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging,[1] or, at retirement from the current employer, rolled over to a traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- Except for more than 5% owners, required minimum distributions (RMDs) must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 70½, or (b) the year following the year in which the participant retires. More-than-5% owners must begin to receive distributions by April 1 of the year following the year they reach age 70½.
- A "KSOP" is an ESOP that allows for employee deferrals and employer matching contributions.

Additional Considerations

- **Maximum annual deduction:** Up to 25% of covered payroll (up to 25% for a leveraged ESOP) can be contributed and deducted by the firm.

[1] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

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- **Individual limits:** For 2015, the annual allocation of contributions to a participant's account may not exceed the lesser of 100% of includable compensation or $53,000 per year. If the plan is a KSOP permitting participant deferrals, participants age 50 and older may also make a $6,000 "catch-up" contribution.

- **Employer contributions:**

  - Most plans are discretionary as to the amount that the employer contributes. If there are profits, the employer is expected to make substantial and recurring contributions.[1]

  - For a "C" corporation, up to an additional 25% of covered compensation may be contributed and deducted if this contribution is used to repay the principal of a loan used by to the plan to acquire employer stock. Contributions used to pay interest on loans used to acquire stock are deductible without limit.

- **Excluding persons:** Certain persons can be eliminated on the basis of months of service, age and coverage in a union plan; for example, persons under age 21 can be excluded from the plan.

- **Investment of plan assets:** Plan assets are required to be invested in employer stock with some exceptions for those participants nearing retirement. In addition, assets may be used to purchase life insurance in some circumstances.

  - **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures.

  - **Parties which are favored:** Typically, younger participants are favored because they have a longer time for their fund to grow. Also, there may be some special advantages to the major shareholders.

[1] See IRS Reg. 1.401-1(b)(2).

How Much Will There Be at Retirement

This will depend upon three factors:

- The frequency and amount of contributions,
- The number of years until retirement, and
- The investment return.

The risk of poor investment returns rests upon the employee. However, if the investment results are favorable, the participant will have a larger fund at retirement age.

An Example of What $10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax[1]				
Years	**4.00%**	**6.00%**	**8.00%**	**10.00%**
5	$54,163	$56,371	$58,666	$61,051
10	$120,061	$131,808	$144,866	$159,374
15	$200,236	$232,760	$271,521	$317,725
20	$297,781	$367,856	$457,620	$572,750
25	$416,459	$548,645	$731,059	$983,471
30	$560,849	$790,582	$1,132,832	$1,644,940
35	$736,522	$1,114,348	$1,723,168	$2,710,244

Top-Heavy Plans

If more than 60% of the plan assets are allocated to key employees,[2] the employer must contribute at least as much for non-key participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includable compensation (higher in some instances).

[1] The rates of return used in this illustration are not indicative of any actual investment and will fluctuate in value.

[2] A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded $170,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

How ESOPs Differ from Stock Bonus Plans

- Under an ESOP the participants have the absolute right to demand distribution of company stock.
- The plan may repurchase the distributed shares of stock but is not required to do so; only the employer is so required.
- The plan must pass certain voting rights through to the participants. If the stock is not publicly traded or is restricted, the participant or his or her heirs must have the right to offer the stock for sale to the employer.
- The plan may borrow money from a bank to purchase stock, with the employer guaranteeing such loan, without it being considered a prohibited transaction.
- The plan may borrow money from a prohibited person without incurring any penalty.
- The plan may not be integrated with Social Security.
- Whereas a stock bonus plan is not required to invest in employer securities, an ESOP must invest primarily in employer securities, to the extent that employer stock is available.
- The employer can contribute company stock directly to the plan.[1]
- The plan may purchase the securities on the open market for public companies, from the company itself or from the shareholders.
- The employer can contribute and deduct up to 25% of compensation for a leveraged ESOP, which is repaying loan principal. In addition, it can make deductible contributions to pay interest on the loan used to purchase securities.

[1] However, it may be better to contribute cash and then have the plan purchase stock from the employer. The valuation of stock directly contributed to the plan may be challenged by the IRS. Contributing cash clearly establishes the value of the contribution.

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Advantages to Employer

- Contributions are tax deductible.
- Contributions and costs are totally flexible, subject to required loan payments.
- The plan is easy to understand by the employees.
- It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- Since all or substantially all of the assets may be invested in employer's stock, this is a good method for raising additional capital without going to the market place.
- In effect, the corporation can raise capital with deductible contributions to its plan.
- Stock, rather than cash, can be contributed to the plan.
- An ESOP may be used to facilitate the buyout of a stockholder.
- Dividends paid on stock owned by the ESOP may be deducted if, in accordance with plan language, several requirements are met.
- In effect, both the interest and principal of loans are made on a deductible basis.
- If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than $5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds $1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than $1,000.

Advantages to Employees

- Annual employer contributions are not taxed to the participant.
- Earnings on the account are not currently taxed.
- Special treatment of unrealized gains upon the distribution of stock permits significant tax deferral.

- Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA or a Roth IRA.
- There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.
- Younger employees can accumulate a larger fund than with a defined benefit plan.
- The forfeited, unvested portion of accounts of former participants is allocated to the active participants' accounts. This can have a major impact on the future benefits.
- Employee participates in employer's growth.
- A potential market is created for deceased owner's stock.
- At distribution, the gain on the stock is not taxed until it is sold.
- The ESOP can provide significant estate planning benefits for shareholders.
- The gain on the sale of employer securities to the ESOP can be deferred under certain situations.
- Participant may borrow from the plan within certain guidelines if provided for in the plan documents.
- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.
- Effective July 1, 2012, plan sponsors are required to provide participants in self-directed plans with expanded investment fee and performance data. This additional information is intended to aid participants in making better-informed investment choices.

Disadvantages to Employer

- The ESOP will generally not produce as large of a contribution and deduction for older employees as will a defined benefit plan.
- Deductible contribution limits are set at 25% of covered compensation.

- Certain voting rights must be passed through to the participants.
- An ESOP can be costly to set up. Ongoing administration can also be expensive because of the need to have the stock value appraised each year.
- Future repurchases may not come at a convenient time and must be made with after-tax dollars. This could place a financial strain on the employer.
- Effective July 1, 2012, if a plan gives participants the right to direct any investments, plan sponsors must provide participants with expanded, standardized investment fee and performance information. Failure to comply with these ERISA requirements may results in a breach of fiduciary duty to plan participants and the loss of ERISA Section 404(c) protection (meaning the plan fiduciaries may be held responsible for the results of the participants' own investment choices).

Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risks rest on the participant.
- There is no assurance as to the frequency and amount of employer contributions.
- Older participants may not receive as great of a benefit as with a defined benefit plan.
- The value of closely held stock may be difficult to determine at retirement age.
- If the founder or key people die, retire or terminate employment, the company stock may be worth very little.
- The company may not be financially able to repurchase the stock, even though required to do so.
- If the employer's stock is depressed in value at retirement time, there could be a significant loss in the retirement account.
- Both the participant's current livelihood and retirement savings are dependent on the employer's ongoing viability.