March 2017

Employee Stock Ownership Plans 101

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Employee Stock Ownership Plans (ESOPs) are the multi-taskers of the benefits world. As a liquidity tool, they can strengthen a company's financial position while sharing the wealth with the company's owners, who also happen to be the company's employees.

ESOPs merge the tax benefits of a qualified retirement plan with corporate finance and align employees' retirement benefits with corporate goals.

Congress recognized the advantages of employee ownership by authorizing and encouraging, through favorable tax treatment, the establishment of ESOPs. While not as common as 401(k) plans, ESOPs play an important role for sponsors and covered employees. ESOPs merge the tax benefits of a qualified retirement plan with corporate finance and align employees' retirement benefits with corporate goals. With all these benefits, however, ESOPs come with a unique set of challenges.

What is an ESOP?

An ESOP is a tax-qualified retirement plan designed to invest primarily in qualifying employer securities of the sponsoring employer. Unlike other qualified plans, however, an ESOP is the only tax-qualified retirement plan that can be leveraged. The plan can borrow money from a lender (e.g., a financial institution, the plan sponsor, or an owner) to acquire qualifying employer securities. Typically, a financial institution will lend the money needed to purchase the qualifying employer securities to the company or an owner, who will then lend the money to the ESOP.

Shares of stock purchased with the loan are used as collateral for the loan and are held in "suspense." As the loan is repaid, shares are released from suspense and allocated to the ESOP accounts of the plan participants.

Why choose an ESOP?

There are three main reasons to consider an ESOP.

1. Succession planning: An ESOP can be used to purchase the shares of a privately held company from its owner(s).
2. Borrowing money on a tax-favored basis: The ESOP borrows money to purchase shares, and the company repays the loan with tax-deductible contributions to the ESOP.
3. Employee ownership: Organizations that support employee ownership frequently tout the higher profitability of employee-owned companies and offer supporting statistics.

How do ESOP's work?

With some key exceptions, benefits to participants under an ESOP are paid in the form of stock. When the stock of a nonpublicly traded company is distributed to a participant, that participant must be given a "put option" on the stock, which enables the participants to sell their stock back to the company at market value.

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When establishing an ESOP, many closely held companies do not consider this future repurchase obligation to buy back the distributed shares of stock from participants who have terminated or who are eligible to diversify their account balances. There are five common events that lead to an ESOP repurchase obligation. The events, listed in order of most significant impact, are:

- Retirement
- Preretirement termination of employment
- Diversification
- Disability
- Death

Projecting and planning for this liability is crucial in determining the company's future cash flow and profitability as well as the long-term viability of the ESOP. A repurchase liability study should be performed during the initial planning phase of an ESOP as well as periodically (annually in some cases) throughout the life of the ESOP.

In perspective

Will simply establishing an ESOP increase profits? Of course not. Simply having an ESOP does not guarantee that a company will be profitable. Employees do not wake up the day after the ESOP has been announced thinking like owners; however, tying an effective and ongoing employee communications strategy to the ESOP can cause employees to think like a business owner, which can certainly improve profitability. Unfortunately, an ESOP won't improve the company's profitability if the company experiences diminishing returns that cannot be reversed by employee efforts.

The benefits of an ESOP can be significant, both to the sponsoring employers and their employees. However, the rules governing ESOPs are complex. For this reason, the cost of establishing and maintaining an ESOP is greater than for other retirement plans. It is important that the employer surround itself with knowledgeable advisors who can steer the company through the minefield of legal, accounting, and administrative issues peculiar to ESOPs.

Of course, an ESOP is only as good as the company's stock, and the worst case scenario is the ESOP of a company going into bankruptcy. In this situation, not only do employees lose their jobs, but their ESOP accounts are worthless.

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This is the major reason most benefit experts recommend that an ESOP not be the only retirement benefit vehicle offered by an employer. However, most ESOP companies seem to thrive under employee ownership and provide an excellent work experience as well as a significant retirement benefit. This combination of tax-favored employee and corporate benefits is complex, but with planning and an expert team of advisors, it can be a win-win scenario for both employees and employers.

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