
ESOP PLANS: WHAT YOU NEED TO KNOW

WHAT IS AN ESOP?

An Employee Stock Ownership Plan (ESOP) is a qualified employee benefit plan that makes corporate employees owners of stock in the corporation. Several features make ESOPs unique as compared to other employee benefit plans. First, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. Second, an ESOP is unique among qualified employee benefit plans in its ability to borrow money. Borrowing by an ESOP to purchase stock is known as a “leveraged ESOP.” Leveraged ESOPs will be explained in further detail below.

As with other qualified plans, employer contributions are tax deductible. Contributions are not currently taxable to the employee, and accumulate on a tax-deferred basis. Funding is fairly flexible, and contributions may be varied each year. ESOPs can be combined with 401(k) plans, in which case, employer matching contributions are made in company stock.

WHY USE AN ESOP?

ESOPs are primary utilized by small business owners for these reasons:

- As a diversification strategy
- As business exit strategy
- To provide an additional employee benefit

ASSET DIVERSIFICATION VIA SALE TO ESOP

Stockholders who have most if not all of their wealth invested in one business may decide to implement an ESOP as a method of creating a ready market for selling their shares.

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ESOPS AS A BUSINESS EXIT STRATEGY

An owner of stock in a closely held corporation can utilize an ESOP as a business exit strategy or simply as a method of diversifying his/her assets. When stock of a closely held corporation is sold to an ESOP, the seller may defer or completely eliminate taxes on the realized gain if, immediately after the sale, the ESOP owns at least 30% of all outstanding stock in the corporation and if within 12 months the seller reinvests the sale proceeds in stock or bonds issued by other U.S. corporations. The seller's basis in the employer stock is carried-over to the replacement securities. If or when the replacement property is sold, the tax deferred by the original sale will be owed at that time. However, if the seller holds the replacement securities until death, his/her heirs receive a step-up in basis allowing the tax to never be paid.

ESOP TO CREATE EMPLOYEE BENEFIT

An ESOP can be utilized as a method of providing employees with a significant benefit without costing the corporation ongoing cash outlays. To avoid the normal cash outlays required by most qualified plans, a company can simply issue new or treasury shares to an ESOP, deducting their value (for up to 25% of covered pay) from taxable income.

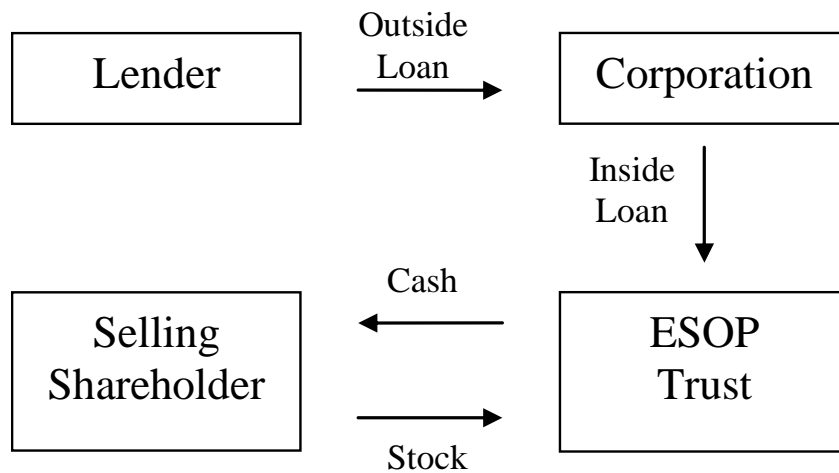
A company sponsoring an ESOP can always contribute cash and then have the ESOP buy shares from existing public or private owners.

MECHANICS OF A LEVERAGED ESOP

In a leveraged ESOP, the ESOP or the target corporation borrows money from a bank or from some other lender. The corporation will usually be required to give the lender a guarantee that it will make contributions to the ESOP trust which will enable the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If setting up a leveraged ESOP as a means of providing new capital for expansion or capital improvements, the corporation will use the borrowed funds to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares.

Most leveraged ESOPs implemented as an exit strategy or for owner diversification will be structured like this:

LEVERAGED ESOPS



S CORPORATION ESOPS

Although an ESOP can be setup inside of an S corporation and can own S corporate stock, ESOPs are prohibited from allocating stock to what is known as a “disqualified person” during certain periods. This rule is designed to prevent an S corporation from establishing an ESOP and allocating shares to the accounts of a small group of shareholder-employees who control the company.

While this rule does not prevent an S corporation owner from selling his/her stock to an ESOP, it does provide several obstacles to prevent such seller from reacquiring an ownership interest in the corporation as an employee participant in the ESOP.

Aside from the non-allocation rules, S corporate ESOPs differ from C corporate ESOPs in a few other major respects:

- Only C corporations that sponsor leveraged ESOPs are permitted to deduct contributions in excess of 25% of their aggregate payroll if such excess relates to interest on the ESOP loan.
- S corporations are not allowed to deduct dividend payments on stock held by an ESOP.
- S shareholders who sell their stock to an ESOP must immediately pay tax on any gain in such stock and are not accorded the ability to purchase

replacement stock to obtain the tax deferral that C corporate stockholders can receive.

SUMMARY OF MAJOR ADVANTAGES AND DISADVANTAGES OF AN ESOP

ADVANTAGES

- A market can be created for a stockholder's closely-held stock.
- Stockholders can receive capital gain treatment (where they may otherwise have received dividend treatment had the corporation simply redeemed the shares).
- C corporation stockholders who sell their stock to the plan may defer capital gain recognition (even permanently) if certain requirements are met.
- Employers can reduce taxes through tax-deductible plan contributions, with little or no cash outlay.
- A C corporation can reduce accumulated earnings problems through plan contributions, and the plan may use those contributions to purchase a stockholder's stock, avoiding dividend treatment.
- The company can raise pre-tax funds for growth and expansion through sale of stock to the plan.
- Employees receive a stake in the company's success.
- Non-vested account balances of former employees are allocated to the accounts of active participants, creating an added employee incentive.
- Employees can defer income until distribution time.
- C corporation dividends passed through to participants can be deducted by the employer.

DISADVANTAGES

- On certain issues, voting rights must pass through to employees: merger, consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all of the assets, etc.
- The employee may demand that his distribution be paid in employer stock. If the stock is not publicly traded, the employee must also have the right to receive the value of the stock in cash.

- Eventually, employees might manage the company. Even where principal stockholders serve as plan trustees, they are required by law to vote the plan's stock solely for the benefit of plan participants.
- If an employer's stock is not readily tradable, the employee must be given the right to receive cash under a valuation formula made by an independent appraiser. Such appraisals are required at least annually and can often be quite expensive.
- In connection with the appraisal, principal stockholders may feel a conflict, preferring a lower valuation for repurchase purposes and a higher valuation for buy-out purposes.
- If the business prospers, the employer's repurchase obligations may grow to be quite significant over time, jeopardizing working capital and liquidity.
- Plans must cover a broad base of employees and cannot discriminate in favor of officers, shareholders or the highly compensated.
- Establishment and administration of the plans are complex and expensive, and SEC registration may be required of contributory plans. These factors generally make ESOPs attractive only to larger companies.
- Benefits are only payable at termination, retirement, disability or death. This may actually create an incentive for vested employees to terminate in order to receive benefits.
- Stockholders may be giving up their business at bargain prices. Whether this has a desirable impact on overall productivity may be subject to debate.
- Unlike most other qualified plans, integration with social security is not available. This may prevent a company from focusing benefit dollars where they can do the most good.

SUMMARY

This summary was not intended to be an exhaustive discussion of ESOPs. Business owners considering an ESOP should seek the assistance of an independent tax counsel and carefully consider the above as well as many other significant factors prior to implementing a program as complex as an ESOP.