

## To ESOP or Not to ESOP— That Is the Question

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An Employee Stock Ownership Plan (ESOP) is a kind of “qualified” defined contribution employee pension plan that invests in the stock of the employer company. Being tax “qualified” means that plan sponsors and plan participants receive tax benefits in exchange for complying with Internal Revenue Service and U.S. Department of Labor rules and regulations that come with the qualified plan.

The primary tax benefit for plan sponsors is that they can deduct their contributions to the plan. Plan participants benefit because they do not have to pay tax on contributions to their account (until they withdraw the contributions in retirement). An ESOP is a special kind of qualified plan that has some unique characteristics that other qualified plans do not have—characteristics that might make an ESOP the right choice for your company.

### **ESOP Basics**

ESOPs come in two varieties: unleveraged and leveraged. In an unleveraged ESOP, the company contributes to the ESOP either shares of its own stock or cash to buy shares. A leveraged ESOP is more common and is generally more attractive for a closely held corporation. A leveraged ESOP borrows money on the credit of the employer or other related parties to buy company stock. The ESOP then purchases the company's stock outright. This creates cash for the company or the shareholders. The loan is then repaid over time through contributions the company makes to the ESOP.

Regardless of how the plan acquires stock, company contributions to the trust are generally tax deductible by the company.

Shares in an ESOP are gradually allocated to individual employee accounts as the company makes contributions to the ESOP on behalf of the employees. Allocations are generally made on the basis of relative compensation, so that

higher paid employees receive more stock allocations in their ESOP accounts.

In addition, the longer an employee has been employed, the greater right the employee has to the stock allocated to his or her account in the ESOP. In other words, employees gradually “vest” in their ESOP account.

Employees must be 100 percent vested within 3 to 6 years, depending on whether the plan uses a cliff vesting schedule or a gradual vesting schedule.

When employees leave the company, they can take the vested portion of their account with them. In most cases, where there is no general market for the company shares, instead of giving the employee stock, the company buys back the stock from the departing employee at its fair market value.

### **ESOP Pluses**

A number of features make ESOPs favorable to other qualified plans. Under an ESOP, an employer can do the following:

**Buy out an owner.** Owners of privately held companies can use an ESOP to create a ready market for their shares and to cash out the value of the company without selling it to a third party that might not have the employees' interests at heart. The company either makes tax-deductible cash contributions to the ESOP to buy out the owner's shares, or the ESOP borrows money to buy the shares outright.

**Borrow money at a lower after-tax cost.** ESOPs are unique among qualified pension plans in their ability to borrow money. As explained above, in a leveraged ESOP the ESOP borrows cash, which it uses to buy company shares or shares of the existing owner. When the company makes tax-deductible contributions to the ESOP over the subsequent years, the ESOP uses the contributions to repay the

loan. The result is that both the loan principal and interest are deductible.

**Create an additional employee benefit.** An ESOP can also be used instead of or in addition to another qualified pension plan. Rather than matching employee contributions to a 401(k) plan, the company can match them with contributions to an ESOP.

**Motivate employees.** Employees who participate in an ESOP are more likely to think and act like owners.

### **ESOP Minuses**

As attractive as the ESOP benefits are, there are also downsides to an ESOP. These include:

**Cash flow problems.** If a private company establishes an ESOP, it will have to repurchase shares from departing employees because there is no ready market for the shares. This can create significant cash flow problems.

**Cost.** The cost of setting up an ESOP is much higher than with other qualified plans. A small private company will probably not be able to do it for less than \$20,000 or \$25,000. In addition, ongoing administrative costs of an ESOP can be higher than a regular defined contribution plan such as a 401(k) plan. For example, private companies must have an annual outside valuation to determine the fair market value of their shares.

**Employee control.** Greater employee involvement has its benefits but can also have its downside. For example, in public companies, employees must be able to vote their shares on all issues. In private companies, employees must be able to vote their allocated shares on major issues, such as relocating the business, or a merger or acquisition, but the company can choose whether to pass through voting rights on more minor issues, such as voting for the board of directors.

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