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A BRIEF OVERVIEW OF ESOPs

An employee stock ownership plan or ESOP is a qualified, defined contribution employee benefit plan that has two special characteristics. First, it is designed to invest primarily in the stock of the employer; and second, it can use borrowed funds to acquire employer stock.

How a Leveraged ESOP Works

The ESOP borrows money to buy stock in the company, either newly issued or treasury shares (in this case, the proceeds would be used for normal business financing purposes) or to buy shares from existing owners for purposes of succession planning. The company can then make tax-deductible contributions to the ESOP to enable it to pay the loan. As the loan is repaid, shares held by the ESOP are released and allocated to employee accounts.

What Tax Benefits Are Available

There are several significant tax benefits available through an ESOP.

1. Contributions to an ESOP are tax-deductible up to either 15% or 25% of eligible pay. The higher limits apply to ESOPs combined with a money purchase pension plan or ESOPs in C corporations that borrow money.
2. Sellers to ESOPs in closely held C corporations can defer any taxation they make on the sale, provided they have held the stock for at least three years, the ESOP owns 30% or more of all company stock at or immediately following the transaction, and the ESOP ownership does not drop below 30% within three years (with certain limited exceptions).
3. Principal and interest on loans paid through an ESOP are tax-deductible.
4. Dividends paid on ESOP shares in C corporations are tax-deductible when passed directly through to employees or used to repay an ESOP loan.
5. In S corporations, the ESOP does not have to pay taxes on its pro-rata share of profits.

How Employees Own Stock Through The ESOP

Each employee meeting eligibility requirements (generally full-time people with a year or more of service) participates in the plan and receives an allocation of stock each year. That allocation is subject to vesting. The employee actually gets the shares after leaving the company. Closely held companies must repurchase the shares or have the ESOP do it.

How The ESOP IS Governed

The ESOP is governed by a trustee who must act for the exclusive benefit of participants. In closely held firms, employees must be able to direct the trustee as to the voting of the shares only on very limited issues; in publicly traded firms, votes pass through on all shareholder issues.

What Kind Of Employer Stock An ESOP Must Own

The ESOP must hold a publicly traded security in the company or, if there is no publicly traded security, either the class of stock that has the highest combination of voting and dividend rights or preferred stock convertible into such stock.

This discussion of ESOPs is for informational purposes only and should not be considered legal, tax, or investment advice.