



ESOP Plan

Employee Stock Ownership Plans (ESOPs) are qualified retirement plans that are designed to invest primarily in employer securities. Exempt from the diversification requirements that other qualified retirement plans are subject to, an ESOP is the only type of plan that may invest 100 percent of its assets in employer securities. ESOPs are established for numerous reasons. Publicly held companies set up ESOPs as a takeover defense. Both public and private companies hope that stock ownership will help to motivate employees. Private companies typically look to an ESOP as part of their succession plan. The ESOP provides a departing owner with a ready market for his or her closely held business.

C corporation shareholders may also enjoy significant tax advantages by selling their shares to an ESOP. The major advantage to the owner of a closely held C corporation selling stock to an ESOP is found in section 1042 of the Internal Revenue Code. Properly structured, the business owner may sell stock to the ESOP and defer (possibly indefinitely) the gain on the sale of those shares. In order to enjoy this tax benefit, the ESOP must own at least 30 percent of the company. Once in the ESOP, these "sec 1042" shares cannot be allocated to the accounts of the seller, certain relatives of the seller or any other shareholders who own more than 25 percent of the company, either directly or through family attribution.

Within a 15-month period, beginning three months prior to the sale and ending 12 months after the sale, the selling shareholder must reinvest the proceeds in qualified replacement securities, which include any domestic corporate stocks or bonds, but not mutual funds or Real Estate Investment Trusts.

The entire capital gain on the sale of the stock sold to the ESOP is deferred until these replacement securities are sold.

Regardless of the size of the gain, shareholders holding these replacement securities to their death can avoid income taxation entirely by passing away prior to Dec. 31, 2009; however, it's not recommended as a particularly attractive tax strategy. The step-up in basis rules are repealed for a decedent dying after Dec. 31, 2009. ESOPs are typically set up as new retirement plans. Existing profit-sharing plans may also be amended to become ESOPs. Once the plan is established, it needs to be funded with employer securities. Those securities may either be purchased from existing shareholders or the company may issue new stock or contribute treasury stock to the plan.

ESOPs are unique among retirement plans in their ability to borrow money. In addition to the ESOP's ability to get a loan from a bank, an ESOP may also get money from the sponsoring employer or the shareholder selling his stock to the plan. All of these activities would be considered prohibited transactions, if engaged in by retirement plans other than ESOPs. The leveraged ESOP borrows money from a lender and purchased stock either from a selling shareholder or the corporation. As mentioned previously, the sale of stock by a shareholder helps in succession planning and provides a market for otherwise illiquid securities. By selling shares to the ESOP, the company is provided with additional capital for expansion or other

corporate needs. Securities purchased by a leveraged ESOP are allocated to participants as employer contributions made to the plan and used to repay the loan. A very important consideration when establishing an ESOP is to determine if the company's cash flow and payroll are sufficient to provide the plan with contributions that are adequate to repay the loan. The maximum contribution that can be made to the ESOP in a given year is 25 percent of eligible compensation. As contributions are made to the plan, stock is released to the participants' accounts.

The ESOP may also be funded each year by the company contributions of stock. Again, the contribution is limited to 25 percent of eligible compensation. This provides the company with a tax deduction for the contribution without having to expend any cash. If an existing profit-sharing plan is converted into an ESOP, the plan may have funds available to purchase employer securities. Although permissible, the trustees need to exercise care in doing this. The trustees must demonstrate that the investment of the existing plan assets in employer securities is a prudent investment made for the exclusive benefit of the participants in the plan. ESOPs are not appropriate for every business. Establishing and maintaining an ESOP can be costly. Securities of closely held businesses contributed to an ESOP must be valued when contributed and each subsequent year.