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ESOPs: Something Old, Something New, Something Borrowed, Something for You?

On the occasion of the 60th anniversary of the first ESOP, here's an in-depth look at where ESOPs came from, what's new, and where they're going.

BY DAVID BENOIT

Employee Stock Ownership Plans (ESOPs) have been around for many years, and most practitioners in the field have at least a passing familiarity with them.

For the last 15 years or so, questions about ESOPs and use of an ESOP as an “exit strategy” for a business or as a way to finance another corporate priority have been relatively rare. Many are now seeing this relative rarity change. ESOPs are coming back into the discussion. This article hopes to help refresh the reader as to certain aspects of, change in, and uses of ESOPs.

Increasingly, business owners may seek to “tie the knot” with — to become essentially wed to — an ESOP as a business succession or advancement tool. Accordingly, and as a token of good luck and future prosperity, we discuss something old, some things new, something borrowed, and whether, in light of the above, an ESOP might be something for you.

SOMETHING OLD

Congratulations are in order in this, the 60th anniversary of first ESOP. Yes, ESOPs predate ERISA. The first ESOP was created in 1956 as the brainchild of attorney Louis Kelso in order to allow the employees of Peninsula Newspapers, Inc. of Palo Alto, Calif. to purchase the company from its retiring founders. Prior to that time, various formulations of stock ownership among employees had been tested, such as stock bonus plans, but ESOPs were fundamentally different in that an ESOP was conceived of not just as a benefit to employees, but also as a mechanism to finance transition of the plan sponsor from one owner to another — from a selling shareholder to the company’s employees.

Still, ESOPs were relatively exotic creations prior to their specific inclusion and authorization under ERISA in 1974. After that, their use

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exploded during the decades of the 1970s, ‘80s and ‘90s. Companies that have established an ESOP at one time or another include Avis, Exxon, Polaroid, United Airlines, Chrysler, Standard Oil of California and gasoline retailer Atlantic Richfield (ARCO). Top-10 supermarket chain Publix, which employs more than 180,000 employees and is the 35th largest retailer in the world, is currently wholly owned by an ESOP. As of 2015, the National Center for Employee Ownership (NCEO) estimates there were roughly 7,000 ESOPs covering about 13.5 million employees.¹ Of these, roughly 55% (covering over 90% of all ESOP participants in the United States) were created prior to 2000. However, due to a number of reasons, ESOPs somewhat fell out of favor since the beginning of the new millennium. It now appears that the tide is turning and ESOPs — something old — are resurfacing in many discussions. Certain tax friendly characteristics, as well as their utility as a business transition strategy, are currently being rediscovered by many companies and business owners.

¹ See, NCEO at <http://www.esop.org/> (as retrieved May 12, 2016).

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What exactly is an ESOP? At its most basic level, an ESOP is a qualified retirement plan under which the sponsoring company contributes either stock or money to purchase stock from an existing owner, to a trust established in conjunction with the plan for the benefit of the company’s eligible employees.² ESOPs should not be confused with employee stock options plans or stock bonus plans, which are not retirement plans at all.³

The following is a basic overview of how an ESOP functions. Please note that there are many details and potential pitfalls not discussed in this article, and, if considering implementing or exploring an ESOP for your company, one is advised to consult with an expert familiar with the drafting and operation of an ESOP.

While the specific statutory authority for ESOPs can be found

under Code Section 4975(e)(7) (and to a lesser degree, ERISA §§ 407(b) and (d)), an ESOP is also subject to many of the other requirements of a qualified retirement plan under Code Section 401(a). It is designed and operated in accordance with the same basic qualification and tax benefit rules as any profit sharing or 401(k) plan. Generally, all full-time employees over age 21 will be participants under the plan, and their shares will be subject to similar vesting schedules as are other qualified retirement plans.

Although ESOPs share many of the characteristics and requirements of other qualified retirement plans, there are significant and important differences. First and foremost, an ESOP is designed to invest a significant portion, indeed often the majority,⁴ of its assets in employer securities.⁵ Importantly, it can also borrow money from the company, a third party (such as a bank), or even a selling shareholder in order to acquire the company stock without violating ERISA’s or the tax code’s rules against prohibited transactions. This type of an ESOP — one formed using a loan from any source — is generally called a “leveraged ESOP,” and the company making cash contributions to the plan to enable it to repay the loan.

Regardless of how an ESOP acquires the company securities held by the plan, there are certain rules regarding how those shares are held, who they benefit, and what happens to the shares when individual plan participants terminate, retire or otherwise are entitled to receive a distribution (or diversification, as we shall discuss) from the plan. The ESOP component of the plan

is often essentially the entire plan, but an ESOP component may also form a portion of a plan, the balance of which includes a 401(k) or other pension, profit-sharing, or stock bonus portion which is not invested in company stock.

In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. The plan maintains an account for each employee participating in the plan. An interest is allocated each year to individual employee accounts proportionate to that individual’s share of certain assets (generally company stock or cash) held in the trust. With an ESOP, you never buy or hold the stock directly while still employed with the company. Rather, the accounts are essentially bookkeeping entries. Allocations are made either on the basis of relative pay or some more equal formula. If an employee is terminated, retires, becomes disabled or dies, the plan will distribute the shares of stock in the employee’s account. ESOPs are also subject to the distribution provisions of Code Section 401(a)(14) and must further comply with the distribution and payment requirements of Code Section 409(o).

ESOPs are also generally required to provide participants with the right to demand distributions in the form of employer securities (albeit subject to significant exceptions and limitations) and to provide certain voting rights if the employer has a registration-type class of securities.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value

2 For the more technically minded among us, an ESOP is an individually designed stock bonus plan, which is qualified under Internal Revenue Code Section 401(a), or a stock bonus and a money purchase plan, both of which are qualified under IRC Section 401(a), and which are designed to invest primarily in qualifying employer securities. An ESOP may form a portion of a plan the balance of which includes a tax-qualified pension, profit-sharing, or stock bonus plan which isn’t an ESOP. ESOPs generally have participation, vesting and allocation features common to all qualified plans. ESOPs are subject to the distribution provisions of IRC Section 401(a)(14), but must also comply with the distribution and payment requirements of IRC Section 409(o).

3 In addition to employee stock ownership through ESOPs, the NCEO estimates that there also are about 2,000 profit sharing and stock bonus plans that are substantially invested in company stock and that as many as 5 million employees participate in 401(k) plans that are primarily invested in employer stock. Up to another 11 million employees buy shares in their employer through employee stock purchase plans. See, NCEO at <http://www.esop.org/> (as retrieved May 12, 2016).

4 While it is not precisely clear what constitutes “primarily” invested in employer stock, most ESOPs are structured such that they invest more than 50% of plan assets in employer stock, and most practitioners believe that amounts above 50% would be considered as meeting the “primarily” invested requirement.

5 Most other retirement plans are prohibited from holding more than 10% of their assets in employer securities or real property.

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(unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In an ESOP, just as in every other form of qualified pension plan, employees do not pay taxes on the contributions until they receive a distribution from the plan when they leave the company. ESOP distributions are qualified distributions that can be rolled into an IRA.

The law provides ESOPs with several special features that are either unavailable or available only on a limited basis to other plan types. One significant difference between an ESOP and most other qualified retirement plans is the ability of the ESOP to purchase employer securities from or sell employer securities to the company, a related company, current shareholders, plan fiduciaries, corporate officers or certain other “parties in interest” without having such transaction be considered a “prohibited transaction” under ERISA or the Internal Revenue Code.

Another significant difference is the ability to purchase the securities at issue with a loan either from the plan sponsor or from a third party. Again, but for a special exemption specific to ESOPs, this type of direct or indirect loan between the plan and the plan sponsor would be a prohibited transaction. One final important area of differentiation

from most retirement plans is the exemption enjoyed by ESOPs from certain limitations on the maximum contributions that may be allocated to any single participant’s account and the total amount of employer deductions found under Code Sections 415 and 404. Both of these sections allow leveraged ESOPs greater latitude than is permitted to most plans. This expands the ability of the ESOP to purchase larger amounts of employer stock than would otherwise be permitted in any single plan year.

A KSOP is a specific sub-set of ESOPs that combine a standard ESOP with a 401(k) plan. Under this type of retirement plan the company will often match employee contributions with stock rather than cash. KSOPs benefit companies by reducing expenses that would arise by separately operating an ESOP and 401(k) retirement plans.

SOME THINGS NEW

While ESOPs have been around for a while, there are some recent developments of which one should be aware, including the impact of the DOL’s final fiduciary rule, the impact of recent Supreme Court cases on the presumption of prudence in investment in plan sponsor stock, and certain administrative changes.

When the DOL finalized its final fiduciary regulation in April,

it consciously omitted a previously set forth rule specifically excluding those who provide appraisals, fairness opinions, or similar statements from the definition of a fiduciary.⁶ Instead, the final rule did not address appraisals, fairness opinions or similar statements concerning the value of ESOP securities or other property in any way. In its comments section, the DOL noted that it will be reviewing certain issues related to valuations as part of a separate regulatory initiative. As a result, one should expect further guidance and perhaps further regulation in the areas of appropriate and arm’s length appraisals, fairness opinions and other similar statements issued in conjunction with the purchase and sale of stock to or from an ESOP.

Another recent development has been the decisions by certain courts, and confirmed by the United States Supreme Court in the unanimous 2014 decision under *Fifth Third Bancorp v. Dudenhoeffer*,⁷ revising what was previously thought to be a relatively settled area of law. In the past, courts often recognized a special status for the purchase of employer securities under an ESOP — a presumption that since an ESOP is required to invest primarily in employer securities, the purchase was automatically prudent provided that adequate steps were taken, and that the decision to purchase employer securities would be reviewed under an

⁶ 81 FR 20969 (April 8, 2016), § IV.A.(5).

⁷ *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. ____, 134 S. Ct. 2459, 189 L. Ed. 2d 457 (2014) (ERISA fiduciaries are not entitled to a presumption of prudence but are “subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund’s assets.”) 573 U. S., at ____ (slip op., at 1–2)

abuse of discretion standard and only invalidated by the courts if the action was found to be unreasonable given the circumstances. In *Dudenhoeffer*, the Supreme Court found that while an ESOP is exempted from ERISA's diversification standards, it is still under an obligation of prudence and fidelity to the best interests of plan participants and beneficiaries. This new line of authority has been further extended in the recent 2016 case of *Amgen Inc. v. Harris*.⁸

In addition, there are other areas that are being studied by the IRS, such as whether it is permissible under the Code and related regulations for an ESOP to provide that the plan sponsor may transfer S-Corporation stock from a non-ESOP plan (or non-ESOP portion of a plan) back to the ESOP (or ESOP portion of the plan) if a non-allocation year would not occur, as well as certain issues regarding timing of stock repurchase and diversification rights.

SOMETHING BORROWED

Perhaps the most important recent development, however, is not intrinsically ESOP-related, but rather a concept that has and been prevalent with regard to, is in essence borrowed from, other types of defined contribution plans for many years: the concept of pre-approved plan document language. In Revenue Procedure 2015-36, published July 6, 2015, the IRS expanded its procedures for issuing opinion and advisory letters regarding the acceptability of pre-approved master and prototype and volume submitter plans under Code Sections 401, 403(a) and 4975(e)(7).

In past, ESOPs and the attorneys drafting the ESOP plan documents have often faced long waits and lengthy negotiations in the process of obtaining a determination letter with regard to the plans. In addition, there are multiple areas of disagreement between the IRS and certain practitioners based on varying

ESOP Pros and Cons

Pros

- Provides a ready-market for a privately-held company as an alternative to a third-party sale.
- Flexible succession or estate planning tool. It allows owner(s) the flexibility of liquidating whatever portion of ownership desired over any chosen period of time.
- Preserves jobs for loyal employees and preserves legacies that are typically lost in third-party mergers and acquisitions.
- ESOP can borrow funds if needed to fully or partially liquidate an owner and both the principal and interest paid on the loan are tax deductible through employer contributions to a qualified retirement plan.
- In a C-Corporation, the capital gains tax on the proceeds of a sale to an ESOP can be deferred if 30% or more of the company's outstanding stock has been sold to the ESOP at the completion of a transaction and the proceeds are invested in "qualified replacement property" (QRP).
- In an S-Corporation, the ESOP is a tax-exempt owner, so in a 100% ESOP owned company, the corporation is entirely tax exempt.
- ESOP companies outperform. An ESOP establishes an incentive-based retirement plan for company employees, allowing them to share in the growth of the company. Independent national studies show that ESOP companies out-perform non-ESOP companies in annual growth and revenue. Projected out over 10 years, an ESOP company is typically one-third larger than a comparable non-ESOP company, and the overall profits equate to an average of 8% to 11% higher than non-ESOP counterparts.
- Dividends on company stock that are used to repay an ESOP loan, or paid directly to participants are deductible under IRC 404.

Cons

- Cost. The costs to design and implement an ESOP can often top \$50,000.
- Complication. ESOPs have a number of intricate tax rules (as can be seen above), and therefore expert advice from advisors, experts, attorneys and recordkeepers who regularly practice in this field is often the best protection against inadvertent, yet significant, mistakes.
- Ownership dilution. Sale of shares to an ESOP to finance the company's growth will result in dilution of the current owners' interests. Therefore, any expected gains must be weighed against this loss of ownership.
- Valuation concerns. An annual independent appraisal of the company is required to aid the plan trustee in establishing fair market value (FMV) of the stock. Most ESOP fiduciary issues revolve around the valuation procedure and methods used to establish FMV. The ESOP is prohibited by law from purchasing stock at a price greater than FMV.
- Claims against company liquidity. An ESOP is required to repurchase shares in certain occasions and at certain times. This repurchase obligation does not provide much flexibility, and can have a significant impact on cash flow. Careful planning is required to analyze and plan sufficiently to meet liquidity needs for repurchase obligation.

⁸ *Amgen Inc. v. Harris*, No. 15-278 (U.S. Jan. 25, 2016).

interpretations of statutory language and requirements as such relates to ESOPs. By allowing for and advisory letters with regard to certain ESOP language, the IRS hopes to both speed up the approval process as well as reduce misunderstandings. This could be a significant turning point regarding the drafting of ESOP plan documents.

Drafters will be able to include the specified ESOP provisions in the round after the current PPA restatements. This next round opens on Feb. 1, 2017, with newly drafted documents to be submitted to the IRS for review by Jan. 31, 2018. Given this timing, the first preapproved ESOP plan documents will likely not be available for adoption until sometime early in 2020.

In order to receive a favorable opinion letters under Rev. Proc. 2015-36, the plan document must include a statement that the plan is an employee stock ownership plan within the meaning of Code Section 4975(e)(7) and is designed to invest primarily in employer stock and that identifies the plan sponsor as being either a C-Corporation or an S-Corporation, as well as provisions addressing and adequately meeting each of the following items:

- Defining employer stock in accordance with Sections 409(l)(1) or -(2)
- Appropriate diversification requirements
- Appropriate valuation, independent appraiser, and allocation of earnings requirements
- Voting requirements
- The right to demand upon distribution that the plan buy back stock for which there is no public market
- Multiple distribution requirements
- Exempt loan requirements
- ESOP annual addition requirements
- Certain other requirements enumerated in the Revenue Procedure

Sections 6.03(4) and -(5) of Rev. Proc. 2015-36 set forth the specific areas for which opinion letters will and will not be issued for ESOPs. For purposes of Rev. Proc. 2015-36, ESOPs are considered to be “nonstandardized” plans.

For a more thorough discussion of the scope of Rev. Proc. 2015-36, as well as its many limitations, please see *ASPPA asap*, No. 15-11, June 14, 2015 (“IRS Expands Pre-Approved Plan Program to Include Cash Balance Plans and ESOPs”).

IS AN ESOP FOR YOU?

As discussed, ESOPs can be strong tools for business succession planning. In addition, multiple studies have pointed to productivity gains and increased employee involvement and job satisfaction in conjunction with establishment of an ESOP.

Some of the uses identified by the NCEO for an ESOP include:

1. *To buy the shares of a departing owner.* Owners of privately held companies can use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares (see below).
2. *To borrow money at a lower after-tax cost.* ESOPs are unique among benefit plans in their ability to borrow money. The ESOP borrows cash, which it uses to buy company shares or shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.
3. *To create an additional employee benefit.* 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. Or a company can contribute cash, buying shares from

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existing public or private owners. In public companies, which account for about 5% of the plans and about 40% of the plan participants, ESOPs are often used in conjunction with employee savings plans. Rather than matching employee savings with cash, the company will match them with stock from an ESOP, often at a higher matching level.⁹ **PC**



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⁹ <http://www.nceo.org/articles/esop-employee-stock-ownership-plan> (as accessed May 12, 2016).