ESOPs

Workshop 20

Presented by

James C. Paul
Paul Benefits Law Corp.

W. Waldan Lloyd
Callister Nebeker & McCullough

Lee I. Swerdlin
Swerdlin & Company
INTRODUCTION

WHY HAVE AN ESOP?

• Motivate employees
  – Esprit de corps
  – “Have skin in the game”
  – Owners?
  – NOT shareholders
WHY HAVE AN ESOP?

• Exit strategy for owners
• ESOP culture

PLAN TYPES

• Employee Stock Ownership Plan (ESOP)
• Stock Bonus Plan
• KSOP
• Profit Sharing Plan
INVEST PRIMARILY IN EMPLOYER STOCK

• Qualifying Employer Securities
• Stock that is readily tradable
• Stock of parent company or affiliate
• Timing for initial investment

ALLOCATION AND VALUATION

• Employer contributions
  – Cash
  – Stock
• Allocated to individual accounts
• Valuation by Qualified Independent Appraiser
PLAN DESIGN AND ADMINISTRATION

• Stock and cash accounts
• Eligibility
• Vesting

PLAN DESIGN AND ADMINISTRATION

• Coverage
• Nondiscrimination
• Counting past service
DISTRIBUTIONS

• Right to demand stock
• Exceptions
  – Readily tradable
  – S Corporation stock
  – Restricted ownership

DISTRIBUTIONS

• Timing
  – 5 year delay after termination
  – Pay in installments
DISTRIBUTIONS

• Future repurchase liability

DISTRIBUTIONS

• Cash distributions
  – Sell stock
  – Valuation/Timing
  – Reshuffle
DISTRIBUTIONS

• Stock distributions
  – Put option if stock is not readily tradable
  – Timing
  – Valuation

DIVERSIFICATION RIGHTS

• Age 55 + 10 years of service
• Portion of account
• Distribute?
• Non-stock investment options
VOTING RIGHTS

• Pass through voting
• Stock that is tradable
• Stock that is not readily tradable

LEVERAGED ESOPS

• ESOP borrows from the employer or a third-party lender to buy a block of stock
• Stock is placed in suspense while loan is outstanding as security for the loan
• Each year, the company contributes enough to make a loan payment
  – Part of loan principal is paid
  – Proportionate amount of stock is released from suspense
  – Allocated to participants’ accounts
LEVERAGED ESOPS

• Exempt loans
  – Plan borrows from bank
  – Company borrows from bank; lends to ESOP
  – Seller carries back a note

• Suspense account
  – Share release formulas
  – Security for loan
LEVERAGED ESOPS

- **Prohibited transaction rules**
  - Exemption for loans
  - Exemption for purchase/sale
  - Timing for valuation

- Code Section 1042 – Defer gain on sale of stock
  - C Corporation
  - ESOP must own 30%
  - Must reinvest sale proceeds in Qualified Replacement Property
    - Timing for purchase of QRP
    - Holding Period
  - Non-allocation rules
LEVERAGED ESOPS

• Contributions/Deductions

LEVERAGED ESOPS

• Feasibility
  – Eligible payroll
  – Amount needed to make loan payments
LEVERAGED ESOPS

• How much stock to buy
  – All at once?
  – Buy in stages?

HOW AN ESOP WORKS

Step #1: Company contributes cash or stock to ESOP

Step #2: ESOP uses cash to buy stock from Company or shareholder

Step #3: Company stock is allocated to participant accounts
LEVERAGED ESOP

Stock Purchase

Step #1: Lender lends ESOP money
Step #2: ESOP buys stock from Company or shareholder

Step #3: Each year, Company makes contribution to ESOP

Step #4: ESOP makes loan payment to lender
Step #5: Shares released and allocated to participant accounts

LEVERAGED ESOP

Loan Repayment

Company

ESOP

Participant Accounts

Lender
S CORPORATION ESOPS

• Tax advantages
• Code section 409(p)
  – No allocation/accrual for Disqualified Person
  – DQP
    • Member of 20% shareholder group
    • 10% shareholder
    • Family member

S CORPORATION ESOPS

• Code section 409(p) [Cont.]
  – Violation
    • Not treated as “ESOP”
    • PT exemptions don’t apply; excise taxes
    • S Corporation election may terminate
    • Excise tax on prohibited allocations
FIDUCIARY ISSUES

• Who wears which hats?

FIDUCIARY ISSUES

• Conflicts and self-dealing
  – Purchase/sale
  – Valuation
  – Owner/Officer compensation and benefits
  – Other issues
FIDUCIARY ISSUES

• Avoiding prohibited transactions

FIDUCIARY ISSUES

• Potential Solutions
  – Independent trustee
    • Cost
    • Availability
  – Committee
  – Employee involvement
    • Pros
    • Cons
IRS/TAX QUALIFICATION

• Scrutiny
• No pre-approved documents – advisable to get individual determination letter

DOL SCRUTINITY

• Fiduciary issues
• Fees
• Acts by Company Directors, Officers and Shareholders
LITIGATION

- Couturier
- Moench
- Participant claims

ADVANTAGES TO ESOPS

- If company is a C corporation, dividends paid to the ESOP may be tax deductible
- ESOPs transfers ownership to employees
  - Encourages their productivity
- Creates a market for privately held shares
- Tax-deductible manner to finance company growth or expansion
- May contain 401(k) feature (generally called a “KSOP”)
QUESTIONS?

Presenters

James C. Paul
Paul Benefits Law Corp.
2356 Gold Meadow Way, Suite 240
Gold River, CA 95670
(916) 403-7242
jim@paulbenefitlaw.com

W. Waldan Lloyd
Callister Nebeker & McCullough
10 East South Temple, Suite 900
Salt Lake City, Utah 84133
(801) 530-7315
wwlloyd@cnmlaw.com

Lee I. Swerdlin
Swerdlin & Company
5901 Peachtree Dunwoody Road
Building B, Suite 170
Atlanta, GA 30328
(800) 507-9373
lswerdlin@swerdlin.net