Employee Stock Ownership Plans - Significant Opportunities Are Available

By Thomas C. Senter

GREENBAUM, ROWE, SMITH, RAVIN, DAVIS & HIMMEL

This article will provide an overview of employee stock ownership plans ("ESOPs") and of certain significant planning opportunities they can provide to both privately and publicly held corporations. This article will also discuss the significant tax planning opportunities an ESOP can provide to the shareholders of a closely held corporation which adopts such a plan.

What Is An ESOP?

1. An ESOP is a form of retirement plan which is qualified under the pertinent provisions of the Internal Revenue Code of 1986, as amended (the "Code") and which is designed to invest primarily in employer securities.

2. An ESOP is a defined contribution plan which is a stock bonus plan alone, or a stock bonus plan combined with a money purchase pension plan.

3. An ESOP provides its sponsor, as well as the participants and beneficiaries, the tax benefits generally afforded qualified retirement plans. These include the following: contributions made by an employer to an ESOP are currently deductible for income tax purposes; the earnings on the assets held in trust under an ESOP (including any appreciation in the value of employer securities) are not currently taxable; and distributions from the ESOP qualify for favorable income tax treatment.

4. As a form of qualified retirement plan, an ESOP is generally subject to the same qualification requirements under the Code as apply to other qualified retirement plans. These include minimum coverage; annual allocation limits as modified for ESOPs; minimum vesting standards and prohibitions on discrimination in favor of highly compensated employees.

5. An ESOP is a "pension plan" within the meaning of the Employee Retirement Income Security Act of 1974 ("ERISA"). Accordingly, in addition to being subject to the Code requirements concerning qualified plans, ESOPs are subject to the ERISA's requirements including those pertaining to fiduciary duties and prohibited transactions as well as the administration and enforcement provisions of ERISA.

What Are The Fundamental Purposes For Which An ESOP May Be Established?

1. To provide the sponsoring employer's employees with a retirement benefit which is based, in large part, on the value of the employer securities held in the plan.

2. To create a private market for a controlling shareholder(s) who desires to dispose of all, or a portion, of his stock in the corporation previously maintaining, or adopting an ESOP. An ESOP may also allow such individual(s) to dispose of their stock while still retaining control of the corporation.

3. To provide a capital raising vehicle at favorable borrowing rates, on an after tax basis.

4. To provide improved cash flow for an employer desiring to fund a retirement plan as stock contributions to an ESOP do not require a cash outlay.

5. By making employees owners, morale and motivation may increase with a corresponding increase in productivity.

What Are The Special Tax Incentives Provided By An ESOP?

1. *Full Deduction of Interest and Principal Payments on ESOP Loans.* Contributions to an ESOP which are used to repay loans incurred for the purpose of acquiring qualifying employer securities are fully deductible provided the contributions are otherwise within the statutory limits concerning the deductibility of contributions to qualified retirement plans. Thus, an employer may replace what would otherwise be nondeductible principal payments on a note with fully deductible ESOP contributions.

2. *Tax Deferral Opportunities for Selling Shareholders.* A shareholder who sells to an ESOP qualifying employer securities which are not readily tradable on an established securities market may defer the income which would otherwise be recognized on the sale provided certain replacement property is acquired by the selling shareholder. The sale must be one which would otherwise have resulted in long-term capital gain and the shares must not have previously been received as compensation for services rendered, including as a distribution from a qualified retirement plan, or by exercising a stock option.

To take advantage of this significant deferral opportunity, immediately after the sale, the ESOP must own at least 30 percent of the common stock of the sponsoring employer. In addition, the shares acquired by the ESOP from the selling shareholder may not be allocated for a certain period of time for his benefit, the benefit of his family members or owners of more than 25 percent in value of any class of outstanding securities of the employer.

The selling shareholder must purchase replacement securities within the 15 month period ending 12 months after the sale to the ESOP and the replacement securities must be issued by an unrelated domestic operating company which uses in excess of 50 percent of its assets in the active conduct of a trade or business and whose passive investment income does not exceed 25 percent of its gross receipts.

The Code imposes a 10 percent excise tax on certain premature dispositions of the employer securities acquired by the ESOP. In addition, the sponsoring employer must consent to the election of the tax deferral treatment by the selling shareholder.

3. *Deductions for Dividends Paid to ESOP Participants.* An employer may also deduct dividends it pays on stock held by an ESOP provided certain conditions are met.

What Are The Special Fiduciary Concerns With An ESOP Transaction?

1. *General Concerns.* A fiduciary must discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries (i) for the exclusive purpose of providing benefits to such individuals; (ii) with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; and (iii) by diversifying the investments of the plan so as to minimize the risks of large losses, unless under the circumstances it is clearly prudent not to do so (the diversification requirement is not violated by an ESOP's investment of all, or a substantial portion, of its assets in securities of the sponsoring employer).

While these fiduciary rules are generally applicable to all retirement plans, they are perhaps of greater concern with regard to ESOPs than with regard to any other type of plan. This is due, in part, to the conflicts of interest which may exist in ESOP transactions. For example, a corporate officer/director who is responsible for raising capital and deciding upon an appropriate form of qualified retirement plan for his employer may also be a shareholder who would be desirous of selling a substantial block of stock to an ESOP. Similarly, current shareholders as well as outsiders interested in acquiring an employer may assert that the ESOP represents an improper attempt to entrench current management and is not in the best interest of the current shareholders.

2. *Prohibited Transactions and ESOP Exemptions.* The Code and ERISA list certain transactions which are classified as "prohibited transactions" and in which a retirement plan may not engage unless there exists a specific exemption from the prohibited transaction rules. These rules are designed to help protect the interests of plan participants and beneficiaries by prohibiting self-dealing between a plan and certain related parties. Generally, a sale of property between a plan and a party-in-interest (including a sponsoring employer) as well as the lending of money or other extension of credit between a plan and a party-in-interest (including an extension of credit by way of a guarantee by an employer) constitutes a prohibited transaction.

Because of the special nature of ESOPs, exemptions are granted from the prohibited transaction rules which enable an ESOP to borrow money, the repayment of which is guaranteed by the sponsoring employer, and to use such money to acquire employer securities from the sponsoring employer. Certain technical requirements must be satisfied to qualify for these exemptions.

Additional Special ESOP Requirements

1. *Voting of ESOP Shares.* In the case of employers without a registration-type class of securities, the Code requires that voting rights be passed through on allocated shares on any issue with respect to a merger, consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transactions as may be set forth in regulations. In the case of employers with a registration-type class of securities, participants may vote shares allocated to their account on any issue.

2. *Independent Appraisal Requirement.* All determinations of the fair market value of employer securities which are not readily tradable on an established securities market with respect to activities of an ESOP must be determined by an independent appraiser.

3. *Special Diversification Requirements.* The Code requires that ESOPs allow participants who have at least 10 years of participation and who are at least 55 years of age to elect annually over a 6-year period to diversify up to 50 percent of their account balances.

4. *Special Distribution Requirements.* Special ESOP distribution rules apply to employer securities acquired by an ESOP. Distributions must commence by the last day of the plan year following the plan year of retirement, disability, or death, or the 5th plan year following the termination of employment for reasons other than retirement, disability or death. If the participant consents, the timing of the distributions may be delayed. In addition, any distribution attributable to employer stock which was acquired with the proceeds of an ESOP loan may be delayed until the end of the plan year in which the loan is paid in full. There are also special limits on the period of time over which distributions must be made.

5. *Participant Put Option.* A participant who receives a distribution of employer securities which are not readily tradable on an established market may require that the employer repurchase such securities under a fair market value formula. An employer may satisfy its repurchase obligation by paying for the securities in substantially equal annual payments over a period not exceeding 5 years. As a result of the put option as well as the diversification requirements and the special distribution rules applicable to an ESOP maintained by a closely-held employer, special consideration should be given to the cash flow requirements which would be created by the establishment of such a plan.

Conclusion

In the appropriate situation, an ESOP may provide significant tax, business and succession planning opportunities for corporations and their shareholders. It is important for counsel to be familiar with ESOPs and aware of the technical issues presented by them which are discussed above. It is also important for counsel to be able to identify the situations in which the adoption of such a plan may be appropriate.

Thomas C. Senter is a Partner in the Woodbridge, New Jersey Law Firm of Greenbaum, Rowe, Smith, Ravin, Davis & Himmel where he practices in the employee benefits, ERISA and tax areas.

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