The Ins and Outs of Employee Stock Ownership Plans

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Overview

- What is an ESOP?
- Potential Benefits of an ESOP.
- Potential Transaction Structures.
- Creating an ESOP.
- ESOP Plan Design.
- Recent Developments.
- Questions.

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What is an ESOP?

Employee Stock Ownership Plan

A tax-exempt, defined-contribution **Employee Benefit Plan** governed under the Internal Revenue Code and ERISA that is designed to provide employees with an ownership interest to invest in company stock.

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Current Numbers

- Between 7,000 and 12,000 ESOPs in the U.S.
- Approximately 13.5 million employees are participants in an ESOP.
- Approximately 10% of private sector workforce.

*Source: www.esop.org and National Center for Employee Ownership

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Why it Matters

- Provides transition planning options for Baby Boomers and other founders and shareholders.
- Provides financing options.
- Tax friendly.
- If you haven't heard about ESOPs yet, you likely will.

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Statistics

- According to recent surveys:
  - Over one-third of all ESOPs own 100% of the company.
  - Half of all current ESOPs own stock in an entity taxed as an S corporation.
  - Approximately 80% of all new ESOPs own stock in entities taxed as an S corporation.

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Markets and Industries

- An ESOP is not market- or industry-specific.
- An ESOP fits better with certain industries, such as government contracting.

Potential Benefits of ESOP

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Generally

- Transition planning.
- Allows to "sell" while keeping skin the game and a level of control over the company.
- Very tax efficient.
- Employee friendly.
- If properly structured, can be a "win-win" for all involved.

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ESOP Uses for Your Clients

- Exit strategy while remaining in control.
- Income attributable to S corporation stock owned by an ESOP is not subject to federal income tax.
- Deduction for C corporation that makes contributions to ESOP.
- Promotes faster growth.
- 401(k)/ESOP combination plans.

Benefits for Shareholders

- Tax-free rollover accessible to sell stock to an ESOP and comply federal and state capital gains taxes. This is an ESOP 1042 rollover and offered only to C corporations. This selection can also be beneficial to acquire estate planning benefits.
- Majority shareholders are given a unique opportunity to sell all or just a portion of their stock to grow personal liquidity while maintaining control of the company.

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Benefits for Shareholders (cont.)

- Supplementary equity incentives available (bonus, purchase, stock option, phantom stock, etc.).
- Generates liquidity at fair market value.
- Provides flexibility.

Benefits for Employees

- The employee's account that stays in ESOP trust, the appreciation in stock value included, is not taxable to the employee until distributions are withdrawn from employee's account.
- Shared ownership of a company offers employees with an incentive to increase both individual and company performance
- Buy-sell agreements ensure future employee ownership through the ESOP.
- Employees have participated in the ESOP for 10 or more years or 55 and older can diversify a portion of his or her accounts.

Benefits for Company

- ESOP financing allows the repayment of acquisition debt with pretax dollars. This favorable tax treatment means that ESOPs are valuable agents for financing management buyouts.
- Promotes accelerated groth through substantial reduction of tax liability. This effect is compounded with an S corporation
- S corporations can generally operate tax free if they are owned 100% by its ESOP.
- Tax-deductible C corporation dividends.

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Potential Transaction Structures

Leveraged
and
Non-Leveraged

Leveraged ESOPs

- Proceeds are used from ESOP loans to acquire stock from current shareholders.
  - **Shares are kept in trust and allocated to employee accounts as debt is satisfied.**

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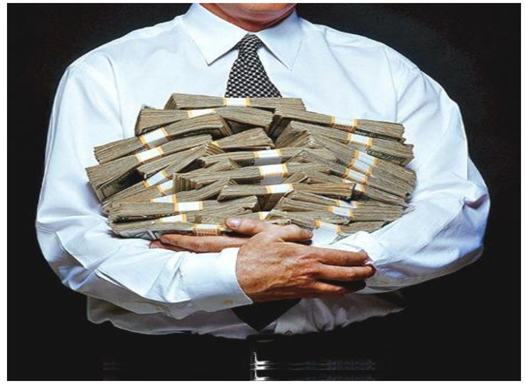
Leveraged ESOP



Step 1:
Bank loans money to ESOP

Step 3:
Sale proceeds (Tax-free) to shareholder for the ESOP's purchase of stock

ESOP

Step 2:
Company guarantees loan

Non-leveraged ESOP

- Can take many forms, but typically involves—
  - Source of funding other than ESOP loan (such as cash on hand, seller notes, or general company debt).
  - Typically a stock purchase or redemption with separate funds transferred to the ESOP through rollovers (401(k) plans or IRAs).
  - Generally the ESOP and the 401(k) plan will be integrated to some degree (safe harbor, matching, profit sharing).

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Examples

- Accelerated growth.
- Models.

Creating an ESOP

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Preliminary Analysis

- Typically involves legal, financial, accounting, and other advisors.

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Phase 1 - Preliminary

- Preliminary valuation.
- Feasibility study.

Phase 2 - Implementation

- Plan design.
- Financing.
- Employee communication.
- Repurchase obligation planning and funding.
- Independent transaction valuation.
- Negotiation process.
- Closing.

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Phase 3 - Ongoing

- Administration.
- Annual valuation.
- Communications.

ESOP Plan Design

- Three questions of employee (“EE”) and Employer (“ER”):

EE	ER
When do I get in?	Whom can I exclude?
What do I get?	How much will it cost?
When do I get it?	How long can I keep contingent or in plan?

- Qualified plan rules of code.
- Special ESOP rules.

Whom can I exclude?

- "When do I get in?" or "Whom can I exclude?" can be complicated questions.
- What these questions involve are the ESOP's eligibility requirements.
  - How long can the plan delay participation?
  - Often, particularly with government contractors in this area, ESOP have few eligibility conditions.
  - ER's use ESOP and other benefits to compete with others in industry.
  - When a large part of the workforce is professional and highly paid, eligibility is less of an issue.
  - Still, many times even government contractors with highly educated workforce will need to think about this requirement (e.g., ones with low cost division or related entities).

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Code's Requirements

1. Code restricts the type of factors that can be basis of exclusion.
2. Otherwise, the code allows exclusions from participation as long as ESOP passes discrimination testing, coverage testing.

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1. Age and Service Conditions

- Code prohibits age and service based eligibility conditions except for two:
  - Can exclude EE under 21.
  - Two permissible YOS requirements
    - If participant's 100% vested upon participation, plan may require two years of service as an eligibility conditions (not on deferrals, if the ESOP accepts elective deferrals from the company's 401(k) plan).
    - If ESOP contains vesting schedule, then maximum YOS requirement is one year.

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What is a YOS?

- Detailed rules in calculating what is a YOS.
  - YOS – 12-consecutive month period during which EE completes at least 1,000 HOS
    - Plan will determine how calculate HOS – actual vs. elapsed time.
  - Generally, ESOP must count all of the service of an employee (EE) including pre-plan service.
    - There is a different rule when calculating YOS for vesting purposes, if ESOP has vesting schedule. For vesting purposes, ER can exclude pre-plan YOS, but if do so, must have same rule for all EE's, including founders.
  - Exception, if EE has a break in service (BIS), do not count pre-break YOS.
    - Re-employment rules.
  - Under USERRA, qualified military service cannot cause BIS.

2. Permissible Eligibility Conditions

- As long as the ESOP's eligibility conditions are not age or service based, ESOP can exclude certain EE's from participating in the ESOP.
- ESOP must still pass coverage testing. Code § 410(b).
- ER's may want to place placing additional eligibility conditions on participation if, for instance, maintaining a low-cost division.
- With EE's from 50-250 EE's, coverage testing can be a concern.

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Coverage Testing

- Coverage testing is a fraction with benefitting percentage of NHCE in the numerator and benefitting percentage of HCE in the denominator:

$$\frac{Benefiting\ NHCE/Nonexcludable\ NHCE}{Benefitting\ HCE/NonexcludableHCE} \geq 70\%$$

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Coverage Testing

$$\frac{Benefiting\ NHCE/Nonexcludable\ NHCE}{Benefitting\ HCE/NonexcludableHCE} \geq 70\%$$

- Non highly compensated employees (NHCE) – those EE's not HCE.
- Highly compensated employees (HCE) –two tests:
  - 5% owner test.
  - Compensation test (2014 - $115,000, prior year compensation).
- Nonexcludable EE – those EE's not considered excludable under code.
  - Excludable EE – EE's under 21, less 1 YOS, Leased EE (within limits), nonresident alien with no US sourced salary, EE terminates during year with less than 500 HOS.
    - Example, HCE or NCHE terminates mid-year with more than 500 HOS. That EE is included in the denominator of the relevant fraction but not included in the numerator. If the terminating EE is a HCE, can make passing coverage easier since now less than 70% of NHCE must benefit to pass coverage.

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Coverage Testing for Smaller Companies

- Coverage testing places a hard cap on the number of EE that can be excluded from the ESOP.
- Fraction reduces to shorthand expression (assumes 100% of HCE participate and benefit):

  $\frac{x}{x+y} \geq .7$; where, "x" is the number of benefiting NCHE and "y" is the number of NCHE who are not excludable and not benefiting (because excluded from plan or because don't satisfy an allocation condition).
- **Example:** If ER has 45 total NCHE, only 12 can be excluded from ESOP.
- For larger companies, this test becomes less of a concern.

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Related Entities

- What makes coverage more difficult is often the presence of related entities.
- The related entity rules are some of the most complex rules in the code.
- Most common issues involve controlled groups of corporations and affiliated service groups.
- Leased employees are also an issue.

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Examples of Related Entities

- Fairly easy to spot controlled groups
  - **Parent-Sub.** If ER owns at least 80% of a subsidiary, the employees of the subsidiary are included in the coverage testing.
  - Ownership is the total combined voting power.
  - **Brother-Sister.** If same five or fewer individuals, trusts, or estates own at least 80% of each of the entities, all such entities are part of the same controlled group, and all employees tested together for coverage.
  - The related entities do not have to join the ESOP of the parent, but ESOP must pass coverage testing

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Affiliated Service Group

- Affiliated Service Groups (ASG) are more difficult to spot.
- **Example:**
  - One company provides high-level engineering services.
  - Owns less than 80% of another entity, which such subsidiary provides lower-end work.
  - There is some level of interaction between the high-end company and the subsidiary (high-end company may subcontract work to subsidiary).
  - Are the employees of subsidiary aggregated for testing purposes with the employees of the high-end company? This is another way to ask – does the ESOP have to include the employees of the subsidiary. Almost always, the answer the company wants is “No.”

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Affiliated Service Group

- The answer is not straightforward. Clearly, though, there's no controlled group.
  - No parent-sub controlled group.
  - No brother-sister controlled group.
- Still, there may be an ASG.

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Affiliated Service Group

- In some situations there can be an ASG with the high-end company owning as little as 10% of the subsidiary.
  - In this example, aggregation would be based on the so-called B-org ASG rules. ASG analysis is dependent on the particular facts.
  - Factors can include—
    - Whether high end company is a C corporation or S corporation (easier to find aggregation with S corporation, because of the attribution rules applicable to S corporations).
    - Capital structure of high-end company.
      - More concentrated ownership in HCE, more likely that ASG could be found.
    - Fluid tests, annual testing.

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Leased Employees

- Leased EE – someone who works under an agreement between the recipient ER and leasing company:
  - Substantially full-time for at least one year.
  - Under primary direction and control of recipient ER.
- Provided, a common law (CL) EE of recipient ER is not treated as a leased EE (if CL EE, treated as EE at all times).
- If Leased EE, treated as EE unless leasing company has 10% money-purchase pension plan with immediate vesting (uncommon).

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What do you do with leased EE?

- Include them in the ESOP.
- Exclude them, but pass coverage testing.
- Co-sponsor a plan with the leasing organization.
- In my practice, ER’s often want to exclude them. We do that by—
  - Keeping such EE from providing services for less than one year.
  - Conducting coverage testing.

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Whom can I exclude?

- In summary, it is possible for ER to exclude some division of EE, but coverage testing makes this difficult.
- IRS and DOL are stepping up audits of qualified plans, and the standard audit questions do elicit responses directed to identifying ASGs and controlled groups.
- To correct a failure to pass coverage, ER may retro-actively amend the ESOP within 9½ months of the close of the plan year to include enough of the excluded EE's so to pass coverage.

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How much will it cost?

- Three Questions of EE and ER.
- Second question – What do I get?/How much will it cost?

EE	ER
When do I get in?	Whom can I exclude?
What do I get?	How much will it cost?
When do I get it?	How long can I keep contingent or in plan?

How much will it cost?

- ESOP costs.
  - Front-end costs:
    - Formation, transaction-related to get ER ESOP owned.
      - Legal, accounting, ESOP advisor; ESOP trustee; appraiser.
      - For government contractors, are these allowable costs?

How much will it cost? (cont.)

- Costs of administration and contributions:
  - ER will obtain a third party administrator to conduct testing, coverage and other testing, annually for ESOP. Costs similar to those of TPA for other qualified plans.
  - With ESOPs, most plans require that benefits be allocated to participant accounts based on a uniform percentage compensation of such participants.
  - Can use other formulas, such as a weighted formula based on age and YOS, but such contributions must pass a form of discrimination testing called rate-group testing under the 401(a)(4) regulations.
  - Not much ability to differentiate between contributions to NHCE and HCE.
  - Contributions will be in cash or ER securities.

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401(k) plan and ESOP

- By way of comparison, under 401(k) plans, it is easier to differentiate between the benefits offered to one set of EE from those offered to another set.
- The reason is that under a 401(k) plan, we can cross-test by groups of EE. The details are complex and the testing is performed by actuaries, but the end result is that often it is possible to provide up to 3x the contribution to HCE than NCHE under a cross-tested 401(k) plan.

Cross-tested 401(k) plan/ESOP

- **Example:**
  - ER two plans, 401(k) and ESOP.
  - 401(k) plan.
    - Standard 3% non-elective, safe-harbor contribution.
    - Discretionary safe-harbor matching contribution (uniform match percentage, whatever that % is).

Cross-tested 401(k) plan/ESOP

- Profit sharing contribution
  - A typical safe harbor PS contribution is allocated on a uniform basis of compensation. If a PS contribution is not a safe-harbor contribution, the contribution is tested for discrimination under the rate-group test of Code § 401(a)(4).
  - If the 401(k) is amended to provide for cross-testing, instead of all EE getting the same % of compensation, the NHCE may receive none of the PS contribution funds.
  - This is so because the 3% non-elective can satisfy the cross-tested PS contribution for NHCE (called the "minimum gateway contribution").

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Cross-tested 401(k) plan/ESOP

- 401(k) plan costs to ER for NHCE:
  - Standard plan:
    - 3% nonelective.
    - x% match, where x% is the same match %, but depends on whether and at what rate NHCE defer.
    - x% PS, where x is the same percentage as provided to HCE.
  - Cross-tested plan:
    - 3% nonelective.
    - x% match, where x% is the same match %, but depends on whether and at what rate NHCE defer.
    - 0%, PS (this can be the case, but does depend on testing).
    - (Can cross test plans without also having in place an ESOP.)

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Cross-tested 401(k) plan/ESOP

- ESOP – same company:
  - Can’t cross-test ESOP contributions.
  - Under most ESOP’s, contributions are allocated based on uniform percentage of compensation.
  - Some contributions —those of ER securities—will be non-cash costs.
  - But some contributions will in cash. ESOP will need cash to cover diversification rights of participants and distributions.
  - As a result, to keep costs down for NHCE, ER must try to exclude NHCE, which such exclusions can make passing coverage testing difficult.

How long can I keep contingent?

- Three Questions of EE and ER.
- Third question – When do I get it?/How long can I keep contingent or in plan?

EE	ER
When do I get in?	Whom can I exclude?
What do I get?	How much will it cost?
When do I get it?	How long can I keep contingent or in plan?

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How long can I keep contingent?

- Mechanisms available to ER to control benefits and costs include:
  - Vesting schedules.
  - Allocation conditions.
  - Distribution provisions.

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Vesting Schedule

- For post 2006 DC plans, there are only two permissible vesting schedules under the code and ERISA:
  - 3-year cliff vesting
  - 6-year graded

Year (full years)	Cliff	6 year graded
Less than 1	0%	0%
Less than 1	0%	0%
1	0%	0%
2	0%	20%
3	100%	40%
4		60%
5		80%
6		100%

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Vesting

- This is not rolling vesting, as we do with options or restricted stock. The vesting period is measured from first YOS, with the exceptions below.
- Can exclude pre-ESOP YOS.
- Can exclude YOS before age 18.
- Typically, must include all YOS while ESOP in existence, even before a participant is eligible to participate in the ESOP.
- BIS rules apply.
- Forfeiture BIS rule: If a participant terminates service and incurs five consecutive BIS, the participant permanently forfeits the nonvested portion of his or her account attributable to service before BIS.
  - Note that if the participant is later re-hired, the participant's service before the forfeiture BIS counts towards satisfying the eligibility requirements of the ESOP, unless the participant was 0% at the time of termination.

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Allocation Conditions

- Allocation conditions can save costs to ER by limiting the required contributions.
- Common allocation conditions are 1,000 HOS or a last-day condition, with exception for terminations because of disability, death, and retirement (if past NRA (typically, 65)).
- If an EE does not satisfy an allocation condition, not entitled to contribution. Impact on coverage testing. Treated as not benefiting but, as long as had 500 HOS, treated as a nonexcludable EE (so included in the denominator but not numerator of relevant benefitting fraction).
  - If such terminating EE is NHCE, can make coverage test more difficult.
  - If such terminating EE is HCE, makes coverage test easier.

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Distribution Rules

- Distribution rules directly result in cash outflows from ESOP, particularly if ER is an S corporation. If ER is S corporation, the ESOP will provide either (i) that ESOP or ER shall purchase the ER securities immediately upon distribution, which such purchase requires cash, or (ii) that distributions will be in the form of cash.
  - One reason to have ER obligated to purchase ER stock is if the EEd have been promised some form of price protection. This would arise when EE funding ER stock purchase through rollovers to ESOP. Gives EEs more confidence on the rollover. Not required by code, but permitted if structured correctly.
- If ER is a C corporation, EE **must** have put right upon distribution.
- There can be multiple sets of distribution rules that apply to the ESOP.

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Distribution Rules

- If the ESOP accepted rollover contributions from ER's 401(k) plan or from EE's IRA to fund initial purchase of ER stock in taking ER to ESOP owned, ESOP will maintain separate accounts for those rollover funds.
  - If the rollover funds consist of elective deferrals, the same distribution rules will apply in the ESOP as in 401(k) plan. E.g., if hardship distribution was allowed under 401(k) plan, one will typically be allowed under ESOP, and only permissible events (those for restricted accounts) can trigger distributions.
    - Also security law issues if elective deferrals are accepted.
  - If rollover funds include ER contributions, a separate account will be maintained in ESOP for those funds with their own distribution rules consistent with pre-ESOP rules.

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Distribution Rules

- Two sets of rules. One to ESOP and one to EE.
- **ESOP rule.** For all contributions to ESOP, unless ESOP permits and EE elects, ESOP must begin distributing the account balance within 60 days of close of plan year in which the later of takes place:
  - Participant reaches NRA.
  - 10th anniversary of participation.
  - Separation from service.
- Often ESOP's will allow or require distributions upon separation from service. Note: if account balance is more than $5,000, participant must consent to distribution until reaches later of 62 or NRA.

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Distributions

- **EE Rule.** Minimum Required Distributions (MRD).
  - Even if ESOP permits and EE elects to keep funds in ESOP after the later of termination or EE's 65th birthday, EE must take and ESOP must make MRD.
    - For EEs who own less than 5% of the ER, MRD distributions must begin by April 1 of the calendar year following the later of separation from service or age 70½.
    - For 5% owners, MRD must begin by April 1 of the calendar year following the year in which the EE attains age 70½.
    - The failure to make MRD is an operational failure that can disqualify the ESOP. The failure can be corrected under EPCRS.

Distribution Rules

- Within these rules, though, the ESOP can be designed to permit or restrict the access of EEs to their account balances.
- Often, particularly if the initial ER stock purchase is funded with rollovers from EE 401(k) and IRA balances, the ESOP will be designed so that EEs have as much access as possible yet also allow them to maintain funds in the ESOP to participate in the increase in value of ER post-ESOP stock purchase. This can be important from older EEs. Provides a measure of security.

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Special ESOP Rules

- The code has certain rules directed only towards ESOPs.
- Some of those rules include—
  - Diversification rights.
  - Distribution/put rights.
  - Prohibited allocations, Code § 409(p) (only if ER is an S corporation.
  - Voting rights.

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Diversification Rights

- Under Code § 401(a)(28), upon attainment of age 55 and 10 years of participation in the ESOP, for a six-year period, a participant may elect to direct the investment of up to an aggregate of 25% of such participant's account, with up to 50% of the account becoming subject to direction in the sixth and final year of the diversification period.
- ESOP's may give participants broader diversification rights (e.g., often by providing that the right of election can be exercised beyond the six-year statutory period).

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Put Rights

- In an ESOP, participants have a right to take distributions in the form of ER stock. If such stock is not readily tradable, under Code § 409(h), participant has the right to require the ER to repurchase such distributed stock.
- If ER is an S corporation, the ESOP may provide that distributions are in the form of cash or may provide that such stock must be resold to ER or ESOP.

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Prohibited Allocations

- This rule applies only if ER is an S corporation. Code § 409(p).
- The rule generally prohibits any allocations to a participant's ESOP account during a plan year, when—
  - The participant owns at least 20% of the deemed-owned shares of ER stock (in which case, the participant is referred to as a "disqualified person").
    - Deemed-owned shares include shares allocated to such participant under the ESOP and any synthetic equity of such participant (SAR's, options, etc.)
  - The total amount of shares owned by all disqualified persons is at least 50%.
- Because of tax advantages of having ESOP as shareholder of S corporation, rule limits such advantages to corporations with a broader shareholder base.

Voting Rights

- Under Code § 409(e), participants have limited voting rights when ER stock not publically traded.
  - Can direct voting of trustee for corporate mergers, recaps, or sale of substantially all assets.
- Often, ESOP will expand pass through voting rights to include rights to direct the votes of shares allocated to a participant's account for tender offers for ER stock.

Recent Developments

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$5.25M DOL settlement with GreatBanc Trust

- Company violated ERISA.
- GreatBanc, as trustee to the Sierra Aluminum Co. ESOP, allegedly permitted the plan to purchase stock from Sierra Aluminum's co-founders and top executives for more than fair market value.
- The settlement undertakes a 2012 department lawsuit that alleged GreatBanc neglected to effectively inquire into an appraisal that presented impracticable and aggressively positive forecasts of future earnings and profitability of Sierra.

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More Cases Coming?

Questions?

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