ISSUE BRIEF #1

WHAT IS AN ESOP?

Introduction

An ESOP is an employee benefit plan, in which the employees of a company become owners of stock in that company. Compared to other employee benefit plans, there are several features that make ESOPs unique.

First, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. Second, an ESOP is unique among qualified employee benefit plans in its ability to borrow money. As a result, "leveraged ESOPs" may be used as a technique of corporate finance.

How Do ESOPs Work?

A company, who wants to set up an ESOP, creates a trust to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. There are a number of different formulas that may be used for allocation. The most common allocation is a contribution in proportion to compensation. Formulas allocating stock according to years of service or some combination of compensation and years of service have all been used. Typically employees might join the plan and begin receiving allocations after completing one year of service with the company, where any year in which an employee works at least 1000 hours is counted as a year of service.

In a publicly traded company employees may sell their distributed shares on the market. In a privately held firm, the company must buy the shares of any departing ESOP participant. The requirement to buy the ESOP shares exists in the form of a “put option.” The company must give the employees a put option on their stock for 60 days after the distribution. If the employee chooses not to sell at that time, the company must offer another put option for a second sixty-day period starting one year after the distribution date. After this period the company has no further obligation to repurchase the shares. The obligation to repurchase the shares of departing ESOP participants is the responsibility of the sponsoring corporation and represents a claim on the future earnings of the company. It’s wise for sponsoring ESOP companies to forecast their repurchase liability and implement a funding strategy in advance.

The shares of company stock and other plan assets allocated to employees' accounts must be vested before employees are entitled to receive them. Vesting is a process whereby employees become entitled to an increasing percentage of their accounts over time. The least liberal vesting schedule allowed by law 20% per year after the third year of service until employees are fully vested after 7 years of service. Some companies, however, vest employees’ entire accounts right away.

When an ESOP employee who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying his/her ESOP account up to 25% of the value. This

option continues until age sixty, at which time the employee has a one-time option to diversify up to 50% of his/her account. This requirement is applicable to ESOP shares allocated to employee's accounts after December 31, 1986.

Employees receive the vested portion of their accounts at termination, disability, death, or retirement. These distributions may be made in a lump sum or in installments over a period of years. If employees become disabled or die, they or their beneficiaries receive the vested portion of their ESOP accounts right away.

An ESOP company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a retirement distribution, within five years for a pre-retirement distribution, and not to exceed five years in duration in either case. The company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.

Uses of ESOPs

The two most common uses of ESOPs are to buy the stock of a retiring owner in a closely held company, and as an extra employee benefit or incentive plan. According to the ESOP Association, these two uses probably account for over two thirds of all the ESOPs now in existence. The proportion of ESOPs created to buy out a retiring owner can be expected to increase with time, because tax provisions encourage retiring owners to sell to an ESOP. U.S. demographics also favor the increase in the number of retiring business owners as the "baby boom" generation approaches their 50's and 60's. Other companies have used ESOPs as a technique of corporate finance for a variety of purposes--to finance expansion, make an acquisition, spin off a division, take a company private, etc. In a small number of cases--about 2%--ESOPs have been used to buy out a failing firm that would otherwise close.

Buying the Stock of A Retiring Owner

Many closely held companies have no plans, or incomplete plans, for business continuity after the departure or retirement of the founder or major shareholder. If a shareholder sells his/her stock back to the company, the proceeds may be taxed as a capital gains or ordinary income. In order to receive favorable capital gains treatment, the owner must sell all or at least 80% of their ownership interest in their company. An owner could sell to an outside, third party and receive capital gains treatment. However, coming to terms with a third party buyer can be an arduous, frustrating and time consuming undertaking, even for a profitable closely held company. Additionally, in a family business, a retiring owner may face an unpleasant choice between selling to a competitor or conglomerate, or liquidating.

These challenges can be avoided by using an ESOP. An ESOP can provide a market for the equity of a retiring owner -- or any interested major shareholder -- of a closely held company, and provide a benefit and job security for employees in the process. Retiring owners of closely held companies incur no taxable gain on a sale of stock to an ESOP, provided that the ESOP owns at least 30% of the company immediately after the sale (sales by two or more stockholders may be counted in this 30% if these sales are part of an integrated transaction), and that the sale's proceeds are reinvested in qualified securities within a fifteen month period beginning 3 months before the date of the sale. This tax-deferred rollover is a most tax-favored way for an owner of a closely held company to sell part or all of his or her stock.

Employee Benefit or Incentive

Most ESOP companies had the desire to set up an employee benefit or incentive as one reason for starting their plan, but for many companies that's the only reason. Some companies hope that by making employees owners they will increase their dedication to the firm, improve work effort, reduce turnover, and generally create a more harmonious atmosphere at the company. Research has shown that giving workers a significant stake in their companies can improve employees' attitudes towards their companies, and that these improved attitudes can translate into bottom line improvements. Other companies value the fact that contributing stock to a qualified trust for the benefit of their employees creates a benefit plan and a tax deduction equal to the value of the stock contribution without spending cash.

1998 Hewitt Associates study of 382 companies over a 6 year period, 2 years before implementing an ESOP and 4 years after, found that companies who implemented an ESOP had a 2.7% higher (270 basis points) average ROA than non-ESOP companies in the study.

A 1995 ESOP Association study found that 60% of member companies cite an overall productivity increase due to their ESOP. 86% of those surveyed believed the ESOP was a "good decision" that helped the company; only 2% responded that it was a "bad decision". A 1993 study by the North-east Ohio Center on Employee Ownership found that 49% of Ohio ESOP companies reported outperforming their industry in job creation and retention during the previous three years; 50% said they were the same as their industry; and 1% fared worse.

A study of publicly traded companies by Joseph Blasi and Donald Kruse of Rutgers University and Michael Conte of the University of Baltimore found a positive relationship between employee ownership and stock performance. The unweighted Employee Ownership Stock Ownership Index reflects the average stock price of the 355 companies listened on the NYSE, AMEX, and NASDAQ exchanges with more than 10% of stock owned by employees. In 1991, the index was up 35.9% compared to increases of 26.3% for the Standard & Poor's 500-index and 20% for the Dow Jones industrial average. In 1992, the Employee Ownership Stock Ownership Index increased 22.9% versus gains of less than 4.5% for the other two indices.

In addition to other empirical studies that yield a similar positive correlation between ESOPs and company performance, much anecdotal evidence lends itself favorably to ESOPs. In the landmark business book *The 100 Best Companies to Work for in America* (by Robert Levering and Milton Moskowitz, published by Doubleday, 1993) 30 of the "best" corporations had ESOPs of 10% or greater. In 1992, all of the finalists for *Inc.* magazine's "Entrepreneurs of the Year Award" were ESOP companies.

The Many Uses of A Leveraged ESOP

In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust in which enable the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly traded stock, or for any other corporate purpose.

Two tax incentives make borrowing through an ESOP extremely attractive to companies, which might otherwise never consider financing their employees' acquisition of stock. First, since ESOP contributions are tax deductible, a corporation, which repays an ESOP loan in effect, gets to deduct principal as well as interest from taxes. This can cut the cost of financing to the company significantly, by reducing the number of pre-tax dollars needed to repay the principal by as much as 35% plus state income taxes, depending on the company's tax bracket. Two, dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are tax deductible. This provision of federal tax law may increase the amount of cash available to a company compared to one utilizing conventional financing.

A Brief History

Employee ownership has a long history in the United States, but the ESOP in its current form was devised and perfected in 1956 by a San Francisco attorney and economist, Dr. Louis O. Kelso. Dr. Kelso believed that unless more people owned significant amounts of capital, many economic and social problems would prove intractable, making an expansion of government's role in the economy, and perhaps socialism, increasingly unavoidable. Accordingly, he set out to design devices to broaden the ownership of capital. The ESOP was one of those devices.

Kelso won a powerful supporter in former Senator Russell B. Long (D-LA). Under Senator Long's leadership Congress passes more than 17 laws encouraging the growth of ESOPs, starting with the passage of ERISA in 1974. Over 17 states also have laws fostering employee ownership.

Congress encourages employee ownership with tax incentives in order to broaden the ownership of capital and to provide a means of corporate finance. Generally, the ownership of corporate stock is more concentrated than either the distribution of income or of any other kind of asset. ESOPs on the other promote the goal of Congress to "spread the wealth." The most recent major Congressional action supporting ESOPs was the 1998 ruling enabling Sub Chapter S corporations to implement ESOPs.

Studies have shown that ESOPs may provide employees earning very modest amounts of income with tens and even hundreds of thousands of dollars of stock. Thus, the visions of Dr. Kelso and Senator Long have proven to be realistic because of ESOPs.

ESOP Advisors Group provides one stop ESOP design formation and implementation services. Visit the ESOP Advisors Group website at ***www.esopadvisorsgroup.com.*** *Or call Mel Duffey (650) 468-5465.*

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