What is an ESOP?

An ESOP is a retirement plan that is designed to provide employees with an ownership interest in the company for which they work by investing primarily in stock of the employer. ESOPs are unlike other retirement plans, which typically diversify their holdings by investing in a variety of assets. The ESOP is funded with tax-deductible contributions by the employer, which can be in the form of company stock, or in cash which is used to purchase company stock. An ESOP operates through a trust, under the direction of a trustee or other named fiduciary (See #8 & 9).

To be an ESOP, the plan must be specifically designated as an ESOP in the plan document, and must comply with special ESOP requirements of the Internal Revenue Service ("IRS").
How does the ESOP benefit the company?

An ESOP is a technique of corporate finance as well as an employee benefit plan. An ESOP can be used to finance ownership transition, raise new equity capital, refinance outstanding debt or acquire productive assets. ESOPs can also be used to increase cash flow by making plan contributions in stock instead of cash.

Since contributions to the ESOP are fully tax deductible, an employer can fund both the principal and the interest payments on an ESOP’s debt service with pre-tax dollars.

Dividends on ESOP stock are tax deductible if they are applied to repay principal of the loan made to acquire the company stock on which the dividends were paid. Reducing loan principal with pre-tax contributions and dividends generates significant tax savings, which in turn increases the ESOP company’s cash flow. This favorable tax treatment means that ESOPs are effective vehicles for financing ownership transition.
# 2 (con’t.)

How does the ESOP benefit the company?

There is strong statistical evidence that employee ownership improves employee morale and productivity, and reduces turnover. Surveys conducted by The ESOP Association show that most Association members report improved employee morale and productivity from their ESOPs. A study by the National Center for Employee Ownership found that ESOP companies grew more than 5% a year faster than their non-ESOP counterparts, and that ESOP companies with “participative” management styles grew at a rate three to four times faster than traditionally managed ESOP companies.

An article by University of Pennsylvania Professor Steven F. Freeman in 2007 summarized the extensive evidence on employee ownership and concluded that combining employee ownership with increased employee participation can generate “astounding” returns on investment, and it is now generally accepted that ESOPs, especially in participatively managed companies, can improve a company’s productivity.
# 3

How does the ESOP benefit stockholders?

One of the most popular uses for an ESOP is to provide a ready market for some or all of the shares owned by shareholders in a closely held company. With an ESOP in place, a majority or controlling shareholder has an exit strategy when he or she is ready to retire. Likewise, an ESOP is often an attractive buyer for a minority shareholder in a closely held company.

The ESOP rollover described in Question 24 permits a shareholder to sell C corporation stock to an ESOP and defer capital gains taxes. This option can also be used to obtain estate planning benefits. While the tax deferral is not available for an S corporation selling shareholder, ESOPs offer many advantages to S corporations (See #12).

With an ESOP, a majority shareholder has the option of selling only a portion of his or her stock to increase personal liquidity while maintaining control of the company.
How does the ESOP benefit employees?

Each year company contributions to the ESOP, in cash or stock, are allocated to the accounts of participating employees in the trust established as part of the ESOP. The accumulated balance in a participant’s account is distributed to the participant after his or her retirement or other termination of employment with the company (See #40).

So long as a participant’s account remains in the ESOP trust, the value of the account--including the appreciation in stock value--is not taxable to the employee.

Employees age 55 or older with 10 or more years of participation in the ESOP are allowed to diversify a portion of their ESOP accounts (See #36).
# 5

Can we keep an existing plan if an ESOP is set up?

Yes, but company contributions to the other plan may need to be reduced.

If the company maintains a 401(k) plan, it is possible to increase cash flow by using company stock instead of cash to match employee salary deferral contributions to the 401(k) plan.
In what kinds of privately held companies do ESOPs work best?

ESOPs operate successfully across a broad range of industries - large and small, public and private, but most ESOPs are established by private companies. The ideal private company candidate for an ESOP will meet most of the following criteria:

- The company has strong cash flow, and a history of increasing sales and profits.
- The company is in a high federal income tax bracket.
- The company is not heavily leveraged and has substantial stockholder equity.
- The company has capable second-line management in place.
What is a leveraged ESOP?

An ESOP is leveraged if it borrows money or uses credit to acquire shares of company stock. The loan may be from a bank or financial institution, or the selling shareholder may finance the transaction by taking back a note for part or all of the purchase price. ESOP loans are usually structured in two parts: an “outside” loan to the company the proceeds of which are then reloaned through an “inside” loan to the ESOP. The proceeds of the inside loan are then used to purchase company stock. In this two loan structure, the outside loan is secured by assets of the sponsor company and, in some cases, a guarantee or asset pledge from the selling shareholder. The inside loan is secured only by a pledge of the shares purchased by the ESOP. The two loans need not have the same repayment terms; the inside loan is often for a longer term, which allows the purchased shares to be allocated over a longer period (See #19). An ESOP is the only kind of employee benefit plan that can use the credit of the company or a selling shareholder to finance the purchase of company stock. For all other qualified employee benefit plans, this would be a prohibited transaction under the Employee Retirement Income Security Act of 1974 (“ERISA”), as amended (See #43).

Most ESOPs used for ownership transition purposes are designed as leveraged ESOPs, although non-leveraged ESOPs can also be structured to provide significant benefits in connection with corporate acquisitions and divestitures.
Who are ESOP fiduciaries and what are their responsibilities?

Any person with discretion over the management or administration of a plan, or who exercises any authority or control over plans assets, is a fiduciary under ERISA. The ESOP trustee, or any other person or committee designated in the plan documents as responsible for making investments in company stock, is a “named fiduciary”.

ERISA requires that plan fiduciaries act prudently and solely in the interest of plan participants. Three of the most important responsibilities of an ESOP fiduciary are:

- Securing a proper valuation of the stock;
- Assuring that the interests of plan participants are protected in ESOP transactions; and
- Approving purchases and sales of ESOP stock.
# 9

Who appoints the ESOP fiduciaries?

The company's board of directors appoints a trustee or trustees to hold and invest the company stock and other assets of the ESOP, and to negotiate the price and terms of purchases and sales of company stock by the ESOP. The ESOP trustee(s) can be officers or employees of the company, an independent bank or trust company, or disinterested individuals. It is not uncommon for an ESOP trustee to be directed by an individual or committee identified in the ESOP plan document. If the trustee is a directed trustee, the individual or committee that directs the trustee will be primarily responsible for fulfilling the fiduciary responsibilities described in #8.
Can a sole shareholder remain in control of the company after selling stock to an ESOP?

The best way to accomplish this is to sell only a minority interest in the company to the ESOP. However, a shareholder who sells a majority interest may continue to serve as an officer and employee of the company and to participate in company and ESOP governance after the sale, subject to the fiduciary requirements of ERISA.
Are ESOPs expensive to set up and administer?

Costs are a function of the complexity of the transaction. If owners take the time to get a better understanding of ESOPs, initial costs can be reduced. Ongoing ESOP administrative expenses are similar to most profit sharing plans, with the exception of the annual valuation update needed to value company stock held in the ESOP.
Can an S corporation adopt an ESOP?

Yes. Effective January 1, 1998 it became advantageous for an ESOP to be a shareholder of an S corporation under the federal tax laws. For S corporation purposes, the ESOP trust is considered to be a single shareholder, so the number of participants in an S corporation ESOP is not subject to the limitations on the maximum number of S corporation shareholders. To the extent that the S corporation is owned by an ESOP, no federal income taxes on corporate income are payable by either the shareholders or the company. In addition, most states do not tax the income of ESOP-owned S corporations. These tax benefits create a significant competitive advantage for S corporations which are substantially ESOP owned.

However, S corporation ESOPs are subject to certain limitations and restrictions described in detail in #33.
How do I set up an ESOP?

The first step in the process is determining the company's value, since the ESOP cannot pay more than fair market value for the stock it purchases. Both the IRS and the U.S. Department of Labor ("DOL") have issued guidelines governing the valuation of company stock in ESOP transactions.

The next step is a feasibility study to analyze the overall framework for the transaction. Among the issues the study should address are: how much the company can afford to contribute to the ESOP each year; whether part of the contribution cost can be offset by eliminating other benefit programs; how the ESOP will affect the company's earnings and cash flow; how the transaction will be structured; and how it will be financed.

If a leveraged ESOP is established, a loan must be secured to finance the stock purchase transaction. Financing an ESOP transaction can be difficult if the lender is not familiar with ESOPs. If the seller finances the purchase transaction, the company’s costs will likely be reduced.
How do I set up an ESOP?

Legal counsel should prepare the ESOP plan documents. An ESOP sponsor has many choices to make in designing a plan that will work well in its own corporate culture. For that reason, it is advisable to work with experienced ESOP counsel in designing the ESOP.

The next step is to negotiate a stock purchase agreement between the ESOP fiduciary and the selling shareholder(s). The stock purchase agreement sets forth the price and other terms and conditions under which the ESOP will purchase stock from the selling shareholder(s). As in any stock purchase transaction, the stock purchase agreement typically contains representations and warranties about the company’s assets, operations and financial condition.

The final step before closing the transaction is an opinion from an independent appraiser described in detail in #22. This opinion is required under DOL proposed regulations, and provides the necessary assurance that the ESOP is not paying more than fair market value for the company stock it purchases. In some cases the appraiser will also be asked to give an opinion that the transaction as a whole is fair to the ESOP from a financial point of view.
# 14

**Must the ESOP be approved by the Internal Revenue Service or the Department of Labor?**

No. It is not a legal requirement for the IRS to approve the plan prior to setting up the ESOP or having the ESOP acquire company stock, nor is it necessary to file the ESOP with any governmental agency. However, as with any tax-qualified retirement plan, ESOP companies usually submit their ESOP to the IRS with a request for a determination letter which confirms that the form of the ESOP satisfies the requirements of the Internal Revenue Code (“Code”).
# 1 5

Do all company employees have to participate in the ESOP?

No. However, in order to satisfy IRS nondiscrimination guidelines, the ESOP must cover a substantial percentage of non-highly compensated employees who have attained age 21 and completed a year of service. For this reason, ESOPs established by smaller companies usually cover all employees who have satisfied these minimum age and service requirements.
How do the ESOP participants become vested in their ESOP accounts?

As with all tax-qualified retirement plans, ESOPs must comply with one of two minimum vesting schedules established in the Code.

In a "cliff vesting" plan, a participant must be 100 percent vested after three years, but need not be vested at all before that time. In a "graded vesting" plan, a participant must become 20 percent vested after two years and the vested percentage must increase 20 percent annually thereafter until 100 percent vesting is reached after six years. A vesting schedule which provides for more rapid vesting than these minimums is permitted. Participants must become fully vested when they reach normal retirement age.

Vesting is normally calculated using years of service with the employer, including service with affiliated employers within a “controlled group.” Credit for service before the ESOP was adopted may (but need not) be recognized by the ESOP. When a participant who is not fully vested leaves the company, his non-vested interest will eventually become a forfeiture and be reallocated among the remaining ESOP participants.
Can all ESOP participants be fully vested from day one?

Yes. Although this is not common, it is not prohibited.
How are the company’s contributions to the ESOP allocated among ESOP participants?

An ESOP must include a definite formula for allocating employer contributions and forfeitures annually to the individual accounts of plan participants.

Employer contributions to an ESOP are usually allocated among the participants' accounts in the trust which funds the plan in proportion to the participants’ compensation from the company during the plan year. However, the allocation can also be based on a combination of compensation and years of service with the company. The latter option is more complicated to administer because of IRS rules designed to prohibit discrimination in favor of the highly compensated.

There is a ceiling on the amount of annual compensation that can be recognized for determining participant allocations in ESOPs and other tax-qualified retirement plans. The ceiling is set at $255,000 for plan years beginning in 2013, with future adjustments based on cost of living increases. For calendar 2013, an employee who is compensated at an annual rate of $350,000 will receive the same allocation within the ESOP as an employee who earns $255,000.
# 18 (con’t.)

How are the company’s contributions to the ESOP allocated among ESOP participants?

The Code also imposes limits on the maximum “annual additions” to a participant’s ESOP account. Annual additions consist of the participant’s allocated share of the company’s contribution and any forfeitures (See #16). The maximum annual additions amount includes contributions to other plans such as a 401(k) plan. For 2013, the maximum annual addition is the lesser of $51,000 or 100 percent of a participant’s compensation from the employer. For leveraged ESOPs which satisfy a special nondiscrimination test, interest paid on the ESOP loan and forfeitures do not count as an annual addition (only C corporations). Another special rule allows certain leveraged ESOPs to determine the maximum annual additions by using the fair market value of the company stock released from the suspense account (See #19), if this value is less.
How is company stock allocated to participants in a leveraged ESOP?

Shares acquired by a leveraged ESOP are initially held in an unallocated suspense account within the ESOP trust. As the loan to the ESOP (the inside loan) is paid down, the shares are released from the suspense account and allocated among participants as described in #18. The release from suspense must satisfy one of two alternative formulas specified in IRS regulations, which require release in proportion to either (i) principal paid on the loan for the year (for certain loans repayable over 10 years or less), or (ii) total principal and interest paid on the loan for the year.

Dividends on shares held in a leveraged ESOP may also be used to pay down the loan used to acquire the shares. In that case, company stock equal in value to the dividends paid on the allocated shares in each participant’s account must first be allocated before the remaining shares released from suspense for the year are allocated.
Can I use the ESOP to refinance existing corporate debt?

Yes. Refinancing existing corporate debt through an ESOP should improve after-tax cash flow. The refinance is accomplished through a loan to the ESOP which then uses the borrowed money to purchase newly issued stock from the company. The company uses the cash to pay off the existing debt, which is thus replaced with ESOP debt. After the refinancing, the company’s contributions used to pay the principal portion of the ESOP debt will be tax deductible, whereas principal payments on the prior corporate debt were not.
Once an ESOP is set up, can it be terminated?

Yes. Just as a company can terminate a profit sharing plan, it can also terminate an ESOP. At that point, all participants must become 100 percent vested and their accounts in the plan must be distributed within a reasonable time. Benefit distributions from the ESOP are eligible to be rolled over into an IRA; ESOP distributions not rolled over are taxable, but may be eligible for special favorable tax treatment.
Who determines the value of company stock in the ESOP?

Valuations of company stock in the ESOP must be made by an independent appraiser annually, and any time the ESOP purchases company stock from the company or an employee, officer, director, or 10 percent or greater shareholder.

The DOL and IRS require that an independent appraiser value company stock in the ESOP. An independent appraiser must (i) hold himself/herself out to the public as an appraiser or perform appraisals on a regular basis, and be qualified to make appraisals of the type of property being appraised; and (ii) be independent of the company and other parties to the ESOP transaction.
#23

Who is legally responsible for the valuation of company stock held in the ESOP?

Under ERISA, even though an independent appraisal is required for company stock held in the ESOP, the legal responsibility for valuing the stock rests with the ESOP trustee or other named fiduciary designated in the ESOP plan document as responsible for valuation. The named fiduciary must carefully select and monitor the performance of the ESOP appraiser.
What is a tax-free ESOP rollover?

Shareholders of privately held C corporations who sell their stock to an ESOP can elect to defer federal income taxes on the gain from the sale, if the sale qualifies as a tax-free rollover under Section 1042 of the Code.

In order to qualify for the rollover, the ESOP must own at least 30 percent of the company's stock immediately after the sale, and the selling shareholder must reinvest the proceeds in "Qualified Replacement Property" within a 15-month period, beginning 3 months prior to the date of the sale. The stock sold to the ESOP must be common stock (or certain convertible preferred stock) with the greatest voting power and dividend rights. In addition, the stock sold to the ESOP must have been acquired as an investment and not in an employment-related transfer, the seller must have owned the stock for at least 3 years, and the company must consent to pay a penalty tax if the acquired shares are sold or disposed of by the ESOP within 3 years after the sale.

The selling shareholder, any 25 percent or greater shareholder of the company, and certain family members are generally prohibited from receiving plan allocations of stock acquired through a tax-free ESOP rollover.

A shareholder may elect to roll over all or any portion of the ESOP sale proceeds. The election must be filed with the selling shareholder’s federal income tax return.
What securities are considered Qualified Replacement Property?

Qualified Replacement Property includes stock and bonds of most domestic operating companies which qualify under the rules of Section 1042 of the Code. It does not include treasury bonds, treasury bills, municipal bonds or mutual funds. The selling shareholder must sign an affidavit which identifies the Qualified Replacement Property and file a copy with the IRS. An experienced advisor familiar with the rollover rules should be consulted to make sure that replacement securities satisfy the requirements for Qualified Replacement Property.
After the ESOP acquired at least 30% of the company’s stock, will subsequent stock sales to the ESOP qualify for the tax-free rollover?

Yes. There is no limit on the number of shares that must be sold to the ESOP in a single transaction, so long as the requirements described in #24 and #25 are met.
#27

Can I sell stock to an ESOP in return for a note from the ESOP and still qualify for a tax-free rollover?

Yes. However, the Qualified Replacement Property must be purchased within a 15-month period, beginning 3 months prior to the date of the sale. If the note has not been fully paid by the time the Qualified Replacement Property must be purchased, the selling shareholder will have to use other funds to purchase enough Qualified Replacement Property to roll over the entire sale proceeds. Seller-financed transactions may use “floating rate notes” (See #28) to avoid this problem.
When is gain recognized on the sale of Qualified Replacement Property?

During the first 12 months after the sale to the ESOP, the selling shareholder may use the proceeds to buy and sell securities as often as desired. During this period, any gains over the purchase price for the securities are taxable. When the selling shareholder has purchased the securities which constitute Qualified Replacement Property, the shareholder’s basis in the Qualified Replacement Property will equal the cost of the Qualified Replacement Property less the amount of gain not recognized. In a subsequent sale or disposition of all or any portion of the Qualified Replacement Property, taxable gain will be recognized to the extent the selling price exceeds the shareholder’s basis as transferred to the Qualified Replacement Property.
When is gain recognized on the sale of Qualified Replacement Property?

Selling shareholders who desire to actively trade the securities in their portfolio can use floating rate notes to avoid the capital gain taxes that are incurred when Qualified Replacement Property is sold. These long-term notes constitute Qualified Replacement Property and can be used as collateral for margin loans which are used to actively trade securities with a tax basis equal to the purchaser's cost.

Dividend and interest income received from the Qualified Replacement Property is taxable.

If the selling shareholder holds the Qualified Replacement Property until death, his or her estate will receive a stepped up basis for the property, and no gain or loss will be recognized for income tax purposes. Qualified Replacement Property owned by the decedent will, however, be included in the decedent's estate for federal estate tax purposes.
Can I make a tax-deductible charitable contribution of Qualified Replacement Property?

Charitable contributions of Qualified Replacement Property are tax deductible under the Code and are not taxable dispositions under the ESOP rollover rules. Qualified Replacement Property may also be contributed to a charitable remainder trust or annuity, which allows the donor to receive continuing income on a tax-advantaged basis, and removes the property from the donor's estate for estate tax purposes. Charitable giving techniques can maximize the tax and financial benefits of an ESOP rollover.
# 30

How much can the company deduct for its ESOP contributions?

Sponsors of leveraged ESOPs (except S corporations as discussed in #33) are allowed to deduct contributions of up to 25 percent of covered payroll annually to repay principal on the ESOP loan. Interest payments on the ESOP loan do not count toward the 25 percent limit and are deductible without limitation. Additional deductible contributions are permitted up to 25 percent of covered payroll for the sponsor’s contributions to other tax-qualified retirement plans or to increase the contributions to the ESOP.

"Covered payroll" is defined in the ESOP document and is usually total compensation of the ESOP participants, excluding annual compensation to any participant in excess of the IRS ceiling (See #18).
When are dividends paid on ESOP shares tax deductible?

A special tax deduction is permitted for reasonable dividends on C corporation stock held in the ESOP if they are (i) used to repay the ESOP loan used to acquire the employer securities on which the dividends were paid, (ii) distributed in cash to participants no later than 90 days after the close of the plan year in which they were paid, or (iii) paid to the plan and reinvested in company stock. Distributed dividends are taxed as ordinary income.
# 32

Are annual contributions to the ESOP mandatory?

Not for each year, although the IRS does require that recurring and substantial contributions must be made to any ongoing qualified plan to maintain its qualified status. In a leveraged ESOP, however, participating employers usually commit to contribute enough cash to service the ESOP loan debt. In some cases companies make contributions in excess of the annual required ESOP debt payments to accumulate cash in the ESOP as a hedge against years in which their cash flow may be restricted.
What restrictions apply to S corporation ESOPs?

A shareholder who sells S corporation stock to an ESOP is not eligible for the tax-free ESOP rollover described in #24, and the S corporation ESOP deduction limits are less favorable than the ESOP deductions available to C corporations. S corporation ESOP deductions are limited to 25 percent of covered compensation annually, including both principal and interest on an exempt loan. In addition, corporate distributions to S corporation shareholders are not tax deductible (See #31), and it may not be possible to defer distribution of S corporation shares acquired with a loan to participating employees who have left the company until the loan is repaid (See #40). However, S corporation distributions paid on allocated shares of S corporation stock can be applied to repay an ESOP loan, in which case company stock equal in value to the distributions must first be allocated from the released shares in the manner described in #19.
What restrictions apply to S corporation ESOPs?

Severe tax penalties are imposed on S corporations which sponsor ESOPs in any year in which “disqualified persons” collectively own or are deemed to own 50 percent or more of the company.

A disqualified person is a person who (i) individually owns 10 percent or more of the company’s “deemed-owned shares”, or (ii) collectively with other family members (very broadly defined) owns 20 percent or more of its deemed-owned shares. Deemed-owned shares include an individual’s allocated ESOP shares, a proportionate share of unallocated ESOP shares and any “synthetic equity” owned by disqualified persons. Synthetic equity is broadly defined to include the right to receive payments from a deferred compensation plan, and any right to acquire company stock in the future or to share in the company’s value or growth through an equity-based compensation plan.

These rules are complex, but will generally preclude small S corporations with 10 or fewer employees from adopting an ESOP. They will also require larger S corporations with as many as 50 or more employees to carefully monitor ESOP allocations, as well as their equity-based and deferred compensation programs.
Who votes the shares held in the ESOP?

The Code requires that ESOP participants must have full voting rights for the allocated shares of publicly traded common stock held in their ESOP trust accounts. In non-public ESOP companies, voting rights on shares allocated to ESOP accounts must be “passed through” to ESOP participants for votes on major corporate matters such as a merger or consolidation, recapitalization, reclassification, liquidation, dissolution or sale of substantially all of the assets of the corporation. Unallocated shares and allocated shares voting on other matters such as the election of the Board of Directors, may be voted by the trustee (who is technically the sole shareholder of the ESOP shares), or as otherwise designated in the plan. Non-public ESOPs may also pass through voting to participants on all matters, or provide for proportional voting for all shares held in the ESOP (both allocated and unallocated shares) on the basis of one vote per participant.
Are ESOP participants taxed on their ESOP accounts?

The value of a participating employee's ESOP account, including company contributions and any appreciation in the value of the account, is not taxable to the employee while it accumulates in the ESOP.

Distributions from the ESOP are taxable, usually as ordinary income, but favorable tax treatment may apply to lump sum distributions in the form of company stock.

For distributions received prior to age 59-1/2, an additional 10 percent excise tax is generally imposed unless the distribution was made on or after the employee's death, disability or separation from service after attaining age 55. Deductible cash dividends paid to ESOP participants are not subject to the early distribution excise tax; this favorable treatment does not extend to S corporation distributions.

Eligible ESOP distributions may be rolled over into an IRA or another qualified plan, in which case income taxes will be deferred.
Are ESOP accounts required to be fully invested in company stock?

ESOPs are not required to invest exclusively in company stock; many ESOPs have substantial investments in cash or other securities. However, ESOPs must be “designed” to invest primarily in company stock that constitutes “qualifying employer securities,” which means voting common stock or certain types of convertible preferred stock.

In addition, ESOP participants who are approaching retirement age must be given an opportunity to diversify their ESOP accounts out of company stock. For shares acquired by an ESOP after December 31, 1986, the ESOP must provide any participant who has attained age 55 and completed 10 or more years of participation in the ESOP with an annual option during a 5-year period to diversify 25 percent of his or her ESOP shares into investments other than company stock. In the sixth year, the participant must be given a one-time option to diversify up to 50 percent of his or her shares.

At least three investment options must be offered within the ESOP to meet the diversification requirements. Alternatively, the ESOP may satisfy the diversification requirements by transferring cash to another qualified plan with three or more participant directed investment options, or by making a distribution directly to the participant.
# 3 7

How are ESOP benefits distributed?

Benefit distributions from an ESOP may be made in cash or in company stock. If company stock is distributed it must be subject to the put option described in Question 39. ESOP participants must be given the right to require a distribution of their ESOP account balances in the form of company stock, unless the company's organizational documents restrict ownership of company stock to active employees or a qualified plan, or the company is an S corporation. In those cases, the ESOP can distribute either cash or company stock which must be immediately resold to the company on the terms described in #39.

Benefits may be distributed in a lump sum or in installments. If installment distribution are available, the minimum distribution period may not exceed 5 years.
Can distributed shares by freely resold?

Shares distributed from the ESOP can be subject to a right of first refusal in favor of the employer or the ESOP, or both. This prevents the shares from being freely transferable by the former participant.
What is the put option?

The ESOP put option requires a privately held ESOP company to repurchase company stock distributed to ESOP participants for fair market value during two 60-day periods, the first beginning with the date the stock is distributed, and the second in the following year. This enables the participant to sell the distributed shares of company stock at two different annual valuations. The ESOP may be given the right to purchase the departing participant's stock (with cash accumulated in the ESOP) by "picking up" the put option, but only the employer company can be legally required to honor the put option.

Payments under the put option may be made in a lump sum or in installments at least annually. The put option installment payment period may not normally exceed 5 years (except for certain large account balances), and the company must provide adequate security and pay reasonable interest on deferred installment payments.
When are ESOP benefits distributable to participants?

Unless the participant elects to defer distribution, the ESOP must commence distributing vested benefits not later than the plan year following the plan year in which the participant retired after reaching normal retirement age, became disabled or died. If an ESOP participant leaves the company before reaching normal retirement age for any other reason, the participant must be allowed to elect to begin receiving a distribution of vested benefits no later than the close of the sixth plan year after the plan year in which the participant separated from service.

Distribution may be delayed until the ESOP loan (the inside loan in a two-loan structure - see #7) has been fully repaid if the leveraged loan was used to acquire C corporation stock.

Former participants may defer distributions until normal retirement age or later, but they may not be deferred beyond age 70-1/2.
# 4 1

What is repurchase liability?

Because the company is required to repurchase the stock of departing ESOP participants under the put option discussed in #39, all privately held ESOP companies have repurchase liability for company stock held in the ESOP. It is a liability that can grow, and one that should be planned for.

Many ESOPs “recycle” ESOP shares by distributing cash accumulated in the plan or contributed by the company to former participants, and then reallocating the company shares in the former participants’ accounts to the accounts of active participants in the plan. This approach maintains the ESOP’s percentage ownership of the company at a constant level.

A company's repurchase liability is determined by a number of factors, including: the size of the annual contribution to the ESOP, changes in value of the stock, the vesting schedule, ages of the participants, number of participants, turnover rates, the proportion of stock and cash in the annual ESOP contribution, method of distribution and repurchase of the ESOP shares, and the diversification options of eligible participants.
How can I minimize the impact of the repurchase liability?

Companies often find it useful to project their repurchase liability before making the final decision to implement an ESOP or to sell additional company stock to the ESOP. Companies can use a variety of strategies to prepare for the repurchase obligation, including: making sufficient cash contributions on an annual basis, providing insurance or other investment vehicles to generate funds necessary to cover plan participants' account balances, and repurchasing shares by using excess corporate funds.

When repurchase liability is a concern, a repurchase liability study should be conducted to project the repurchase liability under varying assumptions.
What happens if ERISA requirements are violated?

ERISA provides participants in all qualified plans with legal rights, and imposes penalties on fiduciaries who violate those rights. In addition, ESOPs are subject to the prohibited transactions rules of ERISA and the Code. The prohibited transactions rules apply to purchases of company stock by an ESOP for more than fair market value, and sales of company stock for less than fair market value. Substantial tax penalties are imposed on persons connected with the company or the ESOP who participate in a prohibited transaction.

The risks of a fiduciary violation are reduced if the ESOP engages experienced, competent ESOP advisors, and the ESOP fiduciaries exercise their best independent judgment after reviewing all aspects of the transaction and fully informing themselves of the alternatives.
Find out if an ESOP is right for your company. Visit www.sesadvisors.com to learn more.

SES ADVISORS has one of the nation’s largest core groups of ESOP professionals, with offices in Pennsylvania, New Jersey, New York, Massachusetts, Rhode Island, Vermont, Florida, Kentucky, Indiana, Virginia and Texas.

HEADQUARTERS: 10 Shurs Lane, Suite 102 | Philadelphia, PA 19127 | 215.508.1600

Consult your advisors for up-to-date legal and tax information. IRS CIRCULAR 230 DISCLOSURE: Pursuant to Treasury Regulations, any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used or relied upon by you or any other person, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing or recommending to another party any tax advice addressed herein. Please contact a member of the firm if you require a formal, written tax opinion that satisfies applicable IRS requirements.