Employee Stock Ownership Plans – What You Need to Know
By Tammy Wener, CFP®, MBA

Introduction

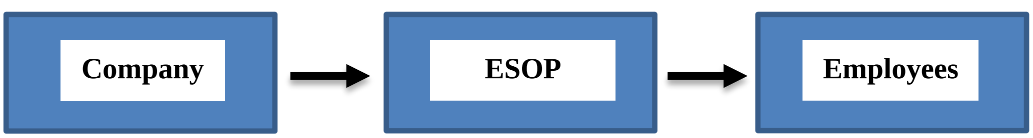
Employee Stock Ownership Plans, commonly referred to as ESOPs, are the most common form of employee company ownership in the United States. According to the National Center for Employee Ownership (NCEO), as of 2014, the most recent year for which data is available, there were 6,717 ESOPs in the United States, holding total assets of more than $1.3 trillion, and covering 14.1 million employees. Companies continue to create new ESOPs; since 2010, an average of 229 plans have been created annually.

Unfortunately, the ESOPs most familiar to many are the small number of large plans (Enron, RadioShack, and United Airlines to name a few) that have caused thousands of employees to lose millions of retirement benefit dollars. Less familiar are the majority of plans that have successfully funded significant retirement accounts for employees while helping the company owners diversify their assets.

What they are and how they work

ESOPs are qualified defined contribution retirement plans covered under ERISA (Employee Retirement and Income Security Act of 1974) the same federal law that governs the more commonplace 401(k)s and profit sharing plans. One key difference between ESOPs and other qualified plans is that the plan assets are primarily invested in the sponsoring company's stock and the contributions are all made by the employer. ESOPs and other types of retirement plans are not mutually exclusive. For example, a 401(k) may be paired with an ESOP whereby the employer matching contributions are made in company stock to the ESOP and not in cash directly to the 401(k).

In a typical non-leveraged ESOP, a company establishes an ESOP trust agreement which dictates how the plan will operate, and then makes a tax-deductible contribution of company stock, or in some cases cash, which the ESOP then uses to purchase company stock. Each employee is then allocated a portion of the ESOP based on the terms of the trust agreement.



Company stock, or cash to purchase stock, is contributed

Shares are allocated to employees per the terms of the ESOP Trust Agreement

An additional difference between ESOPs and other qualified plans is that ESOPs are permitted to borrow money. When an ESOP opts to engage in borrowing to purchase stock, the plan is referred to as a leveraged ESOP (more on this below).

Reasons companies establish ESOPs

While there are numerous reasons why companies establish ESOPs, most do so to accomplish one or more of the objectives below:

1. To reward employees with a benefit tied to corporate performance;
2. In privately held companies, to create a market for the shares of the owner(s);

3. Finance corporate acquisitions or other large capital projects by implementing a leveraged ESOP; and/or
4. To take advantage of numerous income tax advantages, one of which is that contributions of stock and cash are tax deductible (including if the cash is contributed to repay the leveraged ESOP's loan).

Benefits for employees

For most companies, the decision to implement an ESOP is not just for the good of the company. Employees employed by firms with ESOPs receive:

1. A retirement nest egg, assuming the stock appreciates over time, with no direct employee contribution;
2. Opportunity to share in the growth of the company over time and feel a sense of ownership; and
3. Tax deferral on employer contributions.

Interestingly, a 2010 Georgetown University study by two economists, Phillip Swagel and Robert Carroll, found that during the 2008 recession, S corporations with ESOPs in place increased employment by nearly 2 percent while employment in the general private sector fell by nearly 3 percent. In addition, the ESOP companies reported an 18.6% increase in contributions to employees' retirement benefits, while other U.S. companies increased their contributions by only 2.8%. This research supports the general thinking that ESOPs benefit employees and the company over the long term.

Potential risks for employees

Unfortunately, despite all of the positives associated with ESOPs, there are risks that plan participants should be aware of:

1. While some ESOPs allow employees to diversify out of the company stock, most do not (and for those plans that do allow for diversification, employees rarely take advantage of it). As a result, for some employees, their largest retirement asset, and in some cases their largest of all assets, is invested in a single company. Unfortunately, when the company suffers financially, not only does its stock price decline, which also impacts the ESOP, it is often a time for employee layoffs. As a result, an employee may suffer a double whammy, the need to cash out of the ESOP despite the low stock price in order to pay for expenses no longer covered by a salary.

2. For private companies, the value of the stock must be determined by an independent appraiser, often chosen by the employer. An unscrupulous employer could attempt to manipulate the stock price for his or her own benefit. For example, an employer may benefit from a lower stock price if an employee with a large ESOP balance is ready to cash out. On the other side, an employer may benefit from a higher stock price if he or she is planning to sell personal shares to the ESOP.

3. As discussed above, ESOPs are permitted to take out loans, which is a unique feature among retirement plans, as most plans cannot use retirement plan assets to finance company operations. Leveraged ESOPs allow a company to borrow money, then loan that money to the ESOP to use to purchase stock. Unscrupulous owners may try to, and failing businesses may not have a choice but to, manage the loans in a manner which puts the employees' benefits in grave risk.

4. Unlike other qualified plans, ESOPs funded with privately held stock are permitted to amend the plan at any time, without notice, to eliminate lump-sum payouts and require all payments to be over 5 years.

5. When a company with an ESOP is purchased, the ESOP accounts are generally held in escrow until the sale is complete. If an employee retires or leaves the company while the sale transaction is still in process, he or she may not have access to the funds.

Timing of employee distributions

In most cases, employees cash out of the plan upon leaving the company, although the timing of the distribution is different based on the reason for leaving. For employees leaving due to normal retirement age (which, by definition for ESOPs, cannot be later than the earlier of age 65 or the plan's retirement date, or the 10th anniversary of plan participation) or due to death or disability, the distribution must begin during the next plan year. For employees who quit or are terminated, distributions must begin no later than 6 years after the plan year in which the employee left. For certain types of corporations with leveraged ESOPs, the distribution of shares acquired through the loan can be delayed until the year following the year the loan is paid in full.

Distribution options and tax considerations

Similar to other employer retirement accounts, employees can choose to take a lump sum distribution, spread the distributions over 5 years, or elect to roll over the funds to an IRA account. Distributions can be made in cash or stock.

Distributions are typically taxed as ordinary income just like distributions from traditional 401(k)s and IRAs. However, if the distribution is made outright in stock (not rolled over to a retirement account), income tax will be due on the cost basis (the value of the contributions to the plan), and upon sale of the shares, the transaction will be subject to capital gain tax. (This concept is referred to as net unrealized appreciation (NUA) which you can read more about here).

Final thoughts

ESOPs are complicated plans, which when properly established, can provide employees with retirement benefits they may not otherwise have and employers with a tax efficient manner in which to diversify assets and benefit/motivate employees. While it is the responsibility of the company and the ESOP trustee to properly administer the plan, it is the responsibility of the employee to understand the terms of the plan and how any ESOP benefits fit into the employee's future planning. The best place to start to obtain more information is to review the ESOP trust agreement which should be available upon request. For advice, seek out a financial, legal, or tax professional with experience creating and/or administering qualified retirement plans.

About the author: Tammy Wener, CFP®, MBA, is the co-founder of RW Financial Planning, LLC in Lincolnshire, IL, a financial planning firm dedicated to providing objective, thoughtful, and candid advice on an hourly or project basis. She is also the Director of Public Awareness for the Financial Planning Association of Illinois.

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