American National Bank

ESOPs: A versatile business strategy

The idea of an Employee Stock Ownership Plan (ESOP) has unmistakable appeal. It stands to reason that employees with an ownership interest would be more dedicated to their company's success. Managers would then see a greater and better focused work effort, reduced turnover and a generally happier workplace.

In fact, studies have shown that companies with ESOPs in place tend to attribute productivity gains to their plans, crediting them as well with increases in job creation and retention. Moreover, stocks of public companies with substantial employee ownership have been shown to outperform their peers in the stock market.

Yet, thanks to favorable provisions of the tax code, the appeal of ESOPs to business owners goes well beyond these gains in efficiency.

The mechanics

ESOPs are structured as retirement plans, providing deferred compensation to employees. Company stock is held in an employee stock ownership trust (ESOT). Employees' accounts must vest to them at least as quickly as a seven-year stepped schedule prescribed in the tax code. Account balances are distributed in stock or cash on retirement or separation from service either in a lump sum or over a period of up to five years.

A closely held company must provide departing employees with the opportunity to sell their shares back to the firm. It may, therefore, be necessary to maintain a reserve or to buy insurance in order to be able to repurchase the employees' shares.

In their simplest form ESOPs are funded by company contributions, either in stock or in cash with which to buy stock on the open market. Contributions are then deductible to the company. Dividends paid on stock held in the ESOT also are deductible within liberal limits—unlike dividends paid to shareholders.

More common, however, and more useful are *leveraged* ESOPs in which the plan or the sponsoring company borrows from a qualified lender, usually the firm's bank, the money with which to purchase stock for the plan. The lender than holds the stock as security for the loan, releasing it sequentially as the loan is amortized.

Strategies

Proceeds of the loan may be used to purchase newly issued stock, providing the company with a particularly attractive means of financing expansion plans or capital improvements. The advantages of this course derive from the tax deductibility of plan contributions. In effect, the company will be deducting both principal and interest payments on the loan.

This can reduce by as much as 34%, the pre-tax dollars needed to repay the principal depending on the company's tax bracket. Also, as mentioned above, dividends used to repay the loan or passed through to employees will be deductible, freeing more cash than would be available with conventional financing. Each year the company can deduct contributions of up to 25% of the payroll of covered employees plus any dividends paid on the ESOP stock. Contributions used to pay interest on the loan are deductible without limit.

Leveraged ESOPs also are used to create a market for the stock of retiring owners–potentially avoiding the need for sale of the company and providing the selling owner with a significant tax advantage. If the company were to repurchase such shares, the proceeds of the sale would be taxable as ordinary income. However, if the ESOP will hold 30% of the company's shares immediately after the sale, the seller can defer federal income taxes through an ESOP rollover.

To qualify, the departing owner must invest the proceeds in the stock of domestic corporations within a 15-month period beginning three month prior to the sale date. Whether used to acquire a new company or to diversify holdings, the original basis carries over, and gains, when the new stock is sold, qualify for capital gains treatment.

Your ESOP resource

Does an ESOP make sense for your business? Our business consultants will be happy to discuss the issues with you and help to design a plan that meets your objectives. We can assist in such areas as determining a fair value for closely held stock, providing financing for leveraged transactions and acting as trustee for your ESOT.