

Employee Stock Ownership Plans (ESOPs)

What is an ESOP?

An ESOP is a type of profit sharing plan that invests primarily in the stock of the sponsoring employer and provides for benefit distributions in the form of employer stock.

How does it work?

The employer can contribute stock instead of cash to the ESOP as its plan contributions. The ESOP also can use the proceeds of a loan guaranteed by the employer to buy employer stock.

How does an ESOP loan work?

In a leveraged ESOP, loan proceeds go to the ESOP, which buys employer stock. The employer repays the loan by making cash contributions to the ESOP, which in turn pays off the lender.

Why is an ESOP loan any better than a conventional loan?

When an employer makes cash contributions to the ESOP, the entire contribution is deductible for tax purposes. This means both principal and interest payments are deductible. In conventional financing, only the interest payment is deductible.

Are there any other ESOP tax advantages?

A selling shareholder can indefinitely defer tax on the sale of his stock to an ESOP by buying securities of any domestic operating company with the sale proceeds. A specific tax provision also excluded 50 percent of interest paid on an ESOP loan from the income of the lender.

What are the disadvantages of an ESOP?

- \$ Participant Apass through@ voting rights
- \$ Decrease in stock value because of obligation to repay ESOP loan
- \$ The ESOP=s obligation to repurchase stock from participant accounts upon retirement, separation from service and reaching age 55 with ten years of ESOP participation
- \$ Transaction costs, both initial and ongoing

Who needs an ESOP?

Any business owner considering retirement or his estate plan can be an ESOP candidate. An ESOP may be the best way to allow a business owner to Acash in his chips@and at the same time provide for continuity of management.

What does a commercial lender need to look at when considering an ESOP loan?

Employer assets to provide adequate security and sufficient payroll to fund loan repayments. The employer=s repayment is made by ESOP contributions and those contributions are generally limited to 25 percent of the aggregate compensation of ESOP participants.

What=s new with ESOP=s?

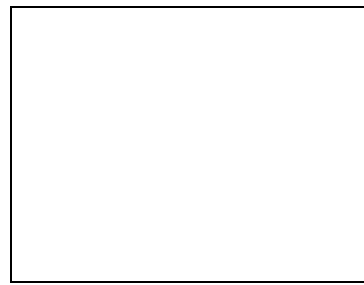
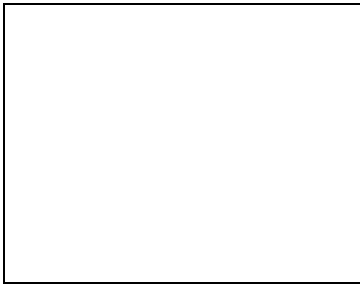
- \$ The 50 percent interest exclusion has been repealed for ESOP loans made after August 20, 1996, so ESOP loans now cost more (but requirements for the interest exclusion -- acquisition of 50 percent of the employer=s stock and extended participant voting rights -- no longer apply)

- \$ Starting in tax years after 1997, ESOPs can be adopted by S Corporations, but there will be reduced contribution limits and no Section 1042 rollover
- \$ Starting in tax years after 1997, the Section 1042 rollover will be restricted to purchase of securities in domestic operating companies that are not S Corporations

Section 1042 rollover requirements

- \$ Employer stock must be the best class of voting stock and not publicly traded
- \$ Three year holding period for stock of selling shareholder
- \$ ESOP must acquire at least 30 percent of employer's stock
- \$ Sale proceeds must be reinvested in securities (stocks or bonds) of one or more domestic operating companies (that's any U.S.-based company with no more than 25 percent of its earnings from passive investments excluding S Corporations after the 1997 tax year)
- \$ Reinvestment must be made no sooner than three months before and no more than one year after ESOP sale
- \$ ESOP allocations cannot be made to selling shareholder, his family members and 25 percent shareholders for a ten year period
- \$ ESOP must hold acquired employer stock for three years
- \$ IRS filing of written statements of employer and selling shareholder

Leveraged ESOP Transaction



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