What is an Employee Stock Ownership Plan?

An Employee Stock Ownership Plan (ESOP) is a defined contribution plan under which a company contributes corporate stock to the plan for the benefit of the company's employees. These may be established for privately held or public companies, but cannot be used in sole-proprietorships or partnerships. With an ESOP, the stock may be purchased through a stock exchange, contributed from corporate treasury stock or purchased directly from a majority shareholder. Shares are valued at the time of the contribution to the plan, and then may be allocated to employees in a similar manner as a profit sharing contribution. At retirement, employees may be paid in stock or may sell back their shares to the plan at the current fair market value to be paid out in cash.

Uses of an ESOP:

- **To buy the shares of a departing owner: Owners of privately held companies may use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares.**
- **To borrow money at a lower after-tax cost: ESOPs are unique among retirement plans in their ability to borrow money under an arrangement called a Leveraged ESOP. The ESOP borrows cash, which it uses to buy company shares of shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan. Shares are released to the participants' accounts as the loan is amortized.**
- **To create an additional employee benefit: A company can issue new or treasury shares to an ESOP, deduction their value (limited to 25% of total eligible compensation) from taxable income. Or, a company can contribute cash, buying shares from existing public or private owners. In public companies, ESOPs are often used in conjunction with 401(k) plans. Rather than matching employee contributions with cash, the company will match them with stock from an ESOP, often at a higher matching level.**

ESOP Rules: Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over age 21 must participate in the plan. Allocations are generally made on the basis of salary. As with most retirement plans, the shares vest as the employee accumulates seniority with the company. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or gradual. Additionally, employees must be given the right to diversify their holdings when they are five years from retirement into other investments so they are not solely invested in company stock.

When employees leave the company, they can elect to receive their stock, or have the company buy back the shares from them at its then current fair market value to receive cash. Private companies must have an annual outside valuation to determine the price of the shares. Additionally, employees must be able to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass though voting rights on other issues such as for the board of directors. In public companies, ESOP participants must be able to vote their shares on all issues.

Major Tax Benefits:

- **Contributions of stock are tax-deductible to the company, although existing owners' shares may be diluted.**
- **Cash contributions are deductible as well, and may be used to buy terminated employees' shares or to purchase additional shares.**
- **Contributions used to repay the principle and interest of the loan under a Leveraged ESOP are tax-deductible.**
- **Shareholders of a corporation can get an extra tax deferral when selling the shares to the ESOP by investing the proceeds into other domestic securities. Note - this does not apply to Sub-chapter S corporations.**
- **In Sub-chapter S corporations, the percentage of ownership held by the ESOP is not subject to income tax at the federal level.**
- **Reasonable dividends used to repay an ESOP loan, passed through to employees, or reinvested by employees in company stock are tax-deductible.**
- **Employees pay no tax on the annual contributions to the ESOP, only at the distribution of their accounts, and then at potentially favorable rates. The difference between the current value and the cumulative cost basis, if any, can be taxed as long term capital gains.**