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Retirement Plan Administrators, Consultants, Actuaries

Employee Stock Ownership Plans

More than a retirement plan

An employee stock ownership plan (ESOP) is a distinct type of qualified retirement plan. In addition to providing retirement benefits for employees, an ESOP can be a phenomenal financial tool for a corporation or its current owners. The rules are complex, but in the right situation an ESOP can make a lot of sense. To help you understand the ESOP concept, we have prepared this brief summary highlighting the advantages.

What is an ESOP?

An ESOP is an employee benefit plan that invests primarily in the stock of the sponsoring company. The stock is allocated to the individual accounts of the plan participants who become shareholders of the company. When a participant retires or terminates, their benefits are based on the current market value of their individual account.

What are the potential advantages for the employees?

- An ownership stake in the company they work for
- A retirement benefit with tax-deferred growth of the contributions of cash and stock made on their behalf

What are the potential advantages for the employer?

- A productivity incentive for employee-owners
- Tax deductions for contributions to the plan
- Tax deductions for stock dividends
- A ready market for company stock
- Increased cash flow and working capital
- Tax-deductible financing of the company's growth

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What is the ESOP's productivity incentive?

Employees with an ownership investment in the company find that they can work to increase the company's earnings and the value of their own retirement account at one time.

Are there limits on the contributions?

Yes, employer contributions of cash or stock are generally limited to 15% of the participant's compensation, provided that no single participant's share exceeds the lesser of \$30,000 or 25% of pay. For this purpose, compensation for any participant is limited to \$150,000, and contributions to any other qualified plans of the employers may reduce the ESOP contribution.

Can employees also contribute to an ESOP?

Yes. An ESOP can be designed to allow employees to contribute and purchase stock for their retirement accounts, subject to contribution limits. Some ESOP's (known as KSOPS) have been combined with 401(k) Plans to allow employees to use their elective contributions to invest in company stock.

Do stock dividends reduce contributions?

No, tax-deductible dividends are not considered part of employer or employee contributions.

How can dividends on ESOP share be used?

Dividends from ESOP stock may be (1) used to increase participants' accounts, (2) paid in cash to plan participants as addi-

tional employee benefits, or (3) paid to the lender to pay off a loan the ESOP may have used to purchase stock. Dividends paid in cash directly to the participants are taxable when paid.

What problem can a "ready market" solve?

For the departing owner of a privately held corporation, the ESOP can provide an otherwise unavailable market for the owner's stock.

Is there a tax incentive to sell to an ESOP?

Yes. An owner of a privately held corporation who sells stock to the company's ESOP can defer income tax on the entire gain of the sale of stock provided (1) at least 30% of the company is owned by the ESOP, and (2) the seller invests the proceeds of the sale in "replacement securities", securities of other US industrial companies.

Regulations also govern the types of stock that may be sold, the allocation of stock to family members and other owners participating in the ESOP and the time frame for purchasing the replacement securities.

Can a shareholder's estate benefit from selling company stock to an ESOP?

Yes. By selling the deceased shareholder's stock to the ESOP at fair market value, the estate can raise the cash it may need to pay estate taxes.

How is the fair market value of a privately held corporation stock determined?

The ESOP requires that the stock's value

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must be determined each year by an independent appraisal if the company's stock is not publicly traded. In addition, when a privately held company's ESOP purchases stock from a shareholder or an estate, an independent auditor must also determine the stock price.

How can an ESOP increase a company's cash flow and working capital?

- The company can contribute stock to the ESOP and get a tax deduction for the fair market value of the contribution. The contribution of stock keeps cash in the company and provides cash flow from the tax savings deduction.
- ESOP can purchase employer stock from the company and the company can use the proceeds as working capital.

How can financing the company's growth be tax-deductible with an ESOP?

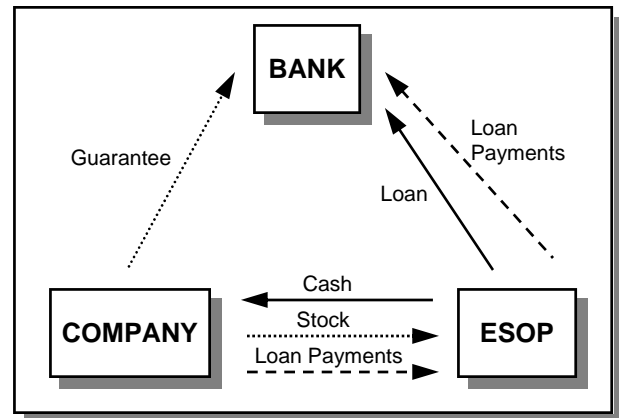
An ESOP can borrow money from its sponsoring company, a shareholder or lender and the sponsoring company can guarantee the repayment of the loan.

How does that work?

- Unlike other employee benefit plans, an ESOP can borrow money from its sponsoring company, a shareholder or commercial lender, and the sponsoring company can guarantee repayment of the loan.
- The ESOP uses the loan proceeds to purchase company stock, the company has the use of the money received from the sale; the company

then makes contributions of cash to the ESOP to repay the loan, then the payments of *both* the principal and interest are tax-deductible.

Here's an example of an ESOP loan.



Are there limitations on the amount that an ESOP can borrow?

The ESOP can borrow as much as can be repaid through the company's contributions to the plan. If contributions are going to be used to repay the loan, then the overall 155 limitation on contributions is raised to 25% of a participant's compensation.

Can these contributions limits be increased?

Yes, if not more than one-third of the plan's allocation to an individual account is for a highly compensated employee. Only the principal part of the contribution counts towards the 25% limit. Any amount contributed for interest payments would be unlimited.

Who votes the stock in an ESOP?

The participants have their right to vote based on the shares allocated in their accounts. In a publicly trade company, the

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participants have full voting rights. Whereas in a privately owned company, the participants only vote on major issues such as merges, liquidation or sale of the company. The plan trustee or any other designated fiduciary votes any unallocated shares held in the trust.

Who are the ESOP's fiduciaries?

The ESOP's fiduciaries are those individuals or entities that exercise any discretionary authority or control over the plan's management, assets or administration. Typically this includes the plan's sponsoring company, trustee and administrator.

What are the fiduciaries duties?

They must act solely in the best interest of the plan's participants and beneficiaries. Because ESOP's are financial tools as well as employee benefits, the fiduciaries must be especially careful to make plan decisions exclusively with the participants' welfare in mind.

How are ESOP benefits distributed?

Distributions are made as employer stock or cash to the participant. Privately held companies have "repurchase liability",

where the company must offer to buy back the stock at fair market value.

Is the repurchase liability an important issue?

Yes. As the value of their ESOP accounts grow, and the plan participants near retirement age, the company's repurchase liability becomes increasingly important. If not carefully planned for and funded, it can present a substantial cash drain for the employer.

What are the keys to a successful ESOP?

1. Commitment to the employee ownership concept
2. Effective employee education and participatory management programs
3. Good economic, financial and retirement benefit analysis
4. Coordination with other employee benefit plans of the sponsoring company.

Is an ESOP right for you? We can help explore the pros and cons. Please call us.



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