Part I: Using ESOPs to Grow Your Business and Build a Dedicated Workforce

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Given the right circumstances, an employee stock ownership plan (ESOP) can be used as a vehicle to enhance the economic viability of the proposed growth transaction by making debt repayments fully deductible, while also providing benefits to the company's employees.

The "grow or die" business ethos may have been discredited, but sometimes growth is essential to maintain market share or fend off challenges from competitors. A business growth strategy can take many forms, such as expanding capacity or a strategic acquisition, but the common element is the need for capital. A great strategy will come to nothing if the company cannot pay for it.

What is an ESOP?

An ESOP is a tax-qualified employee retirement plan (specifically, a form of "stock bonus plan") to which a company makes discretionary contributions of its stock or cash that is used to buy the company's stock. Alternatively, an ESOP can borrow money itself from a third party to buy existing or new stock in the company. The stock contributed or purchased is then allocated to separate accounts established for each participating employee under the ESOP. While contributions are not required to be made to an ESOP every year, the Internal Revenue Service (IRS) will require the company to make substantial and recurring contributions to the plan. For practical purposes, an ESOP loan typically requires annual employer contributions.

Tax-qualified retirement plans permit the employer to deduct contributions to the plan on a current basis, but allow the employee participants to defer recognition of income on their share of these contributions (including earnings) until actually distributed, generally after retirement or other separation from service. When an ESOP is used to fund an acquisition or capital expansion, the tax benefit of current deductibility can significantly enhance the financial viability of the transaction.

Key Objectives and Uses of an ESOP

Perhaps the most common use of an ESOP by a privately owned corporation is to purchase the stock of a deceased or retiring stockholder, but this article focuses on two quite different uses, which can be pursued simultaneously and in a synergistic fashion to enhance the likelihood of achieving both objectives:

- *ESOPs in Acquisitions and Expansions.* Whether the company raises the capital needed to implement a growth strategy by borrowing or equity investment, it will typically need to repay the loan or provide a return to the investors. Instead of making these payments directly with after-tax dollars (except for deductible interest payments, although there may be limits to interest deductions under the 2017 Tax Cuts and Jobs Act), the company can sell stock to the ESOP on terms that mirror the required payments on the underlying loan or equity investment. Within applicable limits, this effectively lets the company make the payments with pre-tax dollars.
- *Establish an Effective Employee Retirement Program.* Because an ESOP is designed to invest in the employer's stock, growth in the value of the participants' accounts is tied to growth in the value of the company. When properly implemented and communicated to employees, the connection between retirement benefits and the company's value can help promote loyalty and create a self-sustaining culture of commitment to the company's goals within the workforce.

ESOP Basics

There are a number of legal requirements that must be satisfied in order to qualify for the favorable ESOP tax treatment. The limitations imposed by these rules will often define the parameters of an ESOP transaction and will determine whether use of an ESOP is viable in a given situation.

Non-Discrimination Rules. Subject to a few important exceptions that will be addressed below, ESOPs are generally subject to the same minimum coverage, participation, non-discrimination and other rules that apply to all tax-qualified retirement plans. Two of these rules will be of particular importance for any analysis of the viability of an ESOP in a particular situation:

- The maximum amount that can be allocated to a participant's account in a defined contribution plan is equal to the lesser of 100 percent of the participant's compensation or the annual dollar limitation, which in 2018 is $275,000; and
- The maximum deductible employer contribution to the plan in any tax year is equal to 25 percent of aggregate participant compensation.

Prohibited Transactions and Fiduciary Responsibility. There are also fiduciary responsibility requirements imposed on employers, trustees and others serving in a fiduciary capacity with respect to a retirement plan:

- IRS and the United States Department of Labor (DOL) have overlapping jurisdiction for enforcement of the rules against "prohibited transactions" including loans, plan asset sales and other self-dealing between a plan and a fiduciary or other "disqualified person". IRS can impose excise taxes (and possible plan disqualification) for prohibited transactions and the DOL can assess substantial penalties for engaging in a prohibited transaction and other breaches of fiduciary duty. In particular, transactions involving employer securities between a qualified plan and the employer (such as loans or other extensions of credit) could be prohibited unless an exemption is available.
- The DOL also enforces the general fiduciary responsibility rules, which include the requirement that a fiduciary act for the exclusive benefit of plan participants and beneficiaries. These rules directly affect the decision-making process to approve the ESOP's participation in transactions with the employer and fiduciaries.

Qualifying Employer Securities. An ESOP is only permitted to invest in "qualifying employer securities." As long as the employer has only one class of common stock, it will be a qualifying employer security. However, if the company's stock is not publicly traded and it has more than one class of stock, the employer securities that may be acquired by the ESOP must be common stock having a "combination of voting power and dividend rights" equal to or greater than: (a) the class of stock having the greatest voting rights; and (b) the class of stock having the greatest dividend rights. For purposes of applying this rule, the employer stock may be stock of another corporation that is a member of a controlled group that includes the employer.

Fair Market Value. If the employer's stock is not publicly traded, the stock must be valued by an independent appraiser both at the time it is acquired by or contributed to the ESOP and annually thereafter. This valuation is used for all purposes under the ESOP, including: (a) determining the price for ESOP purchases of company stock; (b) applying the annual addition limits for allocations of company stock to participants' accounts; and (c) determining the amount to be paid to a terminated participant.

Exempt Loans. There is a prohibited transaction exemption for certain loans between the ESOP and the employer that facilitates use of an ESOP to acquire company stock:

- Although investment in qualifying employer securities is generally permitted for any defined contribution plan (subject to certain limits for 401(k) plans), the acquisition and sale of the securities generally cannot involve a loan, loan guaranty or other extension of credit between the employer or another disqualified person and the plan.
- However, a loan to the ESOP from a disqualified person for the purchase of employer stock is permitted. Exempt loans are subject to a variety of rules including: (a) maximum limits on the amortization period; (b) the requirement that annual payments be made in substantially equal payments of principal (plus accrued interest) or equal payments of principal and interest; and (c) that the stock must be held in a suspense account, to be allocated to participants' accounts as the loan is repaid.
- Debt service payments on an exempt loan to an ESOP are eligible for a higher annual deduction limit equal to 25 percent of participants' aggregate compensation plus all interest paid on the exempt loan for that year. Dividends paid to the ESOP that are declared on stock acquired with the proceeds of an exempt loan also may be deductible if they are used to make payments on the exempt loan. Note that neither of these additional deductions is available if the ESOP is maintained by an S corporation.

Part Two of this article will discuss in detail how an ESOP can be used to meet the twin goals of corporate growth and development of a stronger and more committed workforce.

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ATTORNEYS MENTIONED

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