Employee Stock Ownership Plans

May 2013 Topix Primer Series

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AICPA Employee Benefit Plan Audit Quality Center

The AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) has developed this primer to provide Center members with a general understanding of employee stock ownership plans (ESOPs). This primer discusses ESOP attributes and types of ESOPs, operations and recordkeeping, leveraged ESOPs, tax benefits and related compliance requirements, prohibited transactions exemptions, valuation of employer securities and accounting and auditing resources.

What is an ESOP?

ESOPs are defined contribution pension plans that invest primarily in the stock of the plan sponsor

Prior to passage of the Employee Retirement Income Security Act of 1974 (ERISA), the employee ownership concept was generally limited to stock bonus plans of large (generally public) corporations. ERISA specifically recognized a qualified retirement plan designed to invest primarily in employer securities and permitted to use related party financing to acquire such securities. This recognition was followed by many tax incentives creating the ESOP concept of today. ESOPs can be beneficial to both employers and employees by promoting employee ownership, providing productivity incentives and retirement savings, as well as significant tax benefits to the company, shareholders and plan participants. ESOPs also provide a company with a method of capital formation and tax-favored financing, business ownership succession, and liquidity for shareholders in closely held corporations.

The ESOP sponsor may be either a company whose shares are publicly traded on an established securities market or a privately held company whose shares are not publicly traded, and may be organized as either a C corporation or an S corporation. A company has several alternatives to designing an ESOP but the plan must include a stock bonus element to qualify as an ESOP. An ESOP may be either non-leveraged or leveraged. In a non-leveraged ESOP, the employer contributes company stock to the plan or cash to buy the stock. In a leveraged ESOP, the plan borrows money (from a third-party lender or plan sponsor) to purchase stock of the employer (see a discussion of leveraged ESOPs below). For most ESOPs, the plan sponsor is also the employer of the plan participants; however, the plan sponsor could be a parent company of the employer. For purposes of this primer, the plan sponsor and the employer are considered the same entity, and are referred to as the employer.

ESOPs must be designed to invest primarily in “qualifying employer securities.” The Internal Revenue Code (IRC) defines qualifying employer securities as:

- Common stock issued by the employer which is readily tradable on an established securities market;
- In situations where there is no readily tradable common stock, common stock issued by the employer having a combination of voting power and dividend rights equal to or in excess of that class of common stock of the employer having the greatest voting power and the greatest dividend rights;
- Noncallable preferred stock, if such stock is convertible at any time into common stock, which meets either of the above requirements.

While in some respects ESOPs are similar to 401(k) and other defined contribution retirement plans, they have unique features not found in other plans. While profit sharing, stock bonus or 401(k) plans can receive contributions or hold investments of employer securities, only ESOPs have the ability to borrow money to purchase qualifying employer securities. Other characteristics that distinguish ESOPs from other defined contribution retirement plans include their tax qualification requirements, operations and recordkeeping, and the requirement to obtain independent appraisals.

A plan sponsor may combine an ESOP with a 401(k) plan, forming a plan commonly referred to as a "KSOP". A KSOP includes features of both an ESOP and a 401(k) plan, which allows employees to make 401(k) contributions to the plan, and the employer can match employee contributions with company stock, rather than cash. KSOPs are not addressed in this primer.

Operations and Recordkeeping

ESOP assets are held in a trust

ESOPs must establish a trust to receive and hold contributions and investments on behalf of the plan participants. The trust is administered by a trustee, which typically is appointed by the board of directors of the sponsoring company. The trustee can be an officer or group of employees of the sponsoring corporation, members of an administrative committee, or an independent bank or trust company. The trustee is a plan fiduciary and must fulfill the fiduciary responsibilities of ERISA.

ESOP operations and recordkeeping involves determining eligibility and vesting; allocating investment earnings, contributions and forfeitures; processing distributions; tracking account balances (including cash, shares and cost basis); tracking loan balances; maintaining suspense accounts; accounting for shares; and issuing proxy statements (for voting rights that pass through to participants.) Other responsibilities include reconciling plan assets (net of outstanding loans) with participant account balances; reconciling loan payments and stock held in suspense accounts; complying with restrictions on transactions and special tax rules; determining the proper collateral release; performing coverage and nondiscrimination testing; obtaining, reviewing and approving the annual valuation; preparing periodic participants statements; preparing annual financial statements; and preparing an annual Form 5500, *Annual Return/Report of Employee Benefit Plan* (Form 5500).

ESOPs are required to file an annual Form 5500, with the U.S. Department of Labor (DOL). Additionally, if participants have the right to direct deferrals into and out of company stock, the plan is likely to be faced with securities law considerations and may be required to register its shares and file a Form 11-K annually with the U.S. Securities and Exchange Commission (SEC). ESOPs that only accept employer contributions generally are not required to file a Form 11-K with the SEC.

Leveraged ESOPs

An ESOP that borrows money to purchase qualifying employer securities is considered a leveraged ESOP

ERISA generally prohibits the lending of money or other extension of credit between a plan and a party in interest. However, ERISA provides ESOPs a specific exemption under certain conditions that allows them to borrow money, directly or indirectly, from a party in interest to finance the purchase of qualifying employer securities. An ESOP that borrows money to purchase qualifying employer securities is considered a leveraged ESOP.

Financing Stock Purchases

A leveraged ESOP borrows money to purchase new or treasury stock of the employer or to purchase stock owned by current shareholders. The ESOP can borrow money directly from the employer, the seller of the securities or a bank or other financial institution. Frequently, the employer will borrow money from a third-party lender (outside loan) and then loan the proceeds to the ESOP (inside loan). Whenever an ESOP borrows money, it must be in the form of a term loan (a demand loan is not permitted) and the only assets that legally can be used as collateral are the employer securities being purchased. While not required by ERISA, the employer often is required by the lender to guarantee the loan.

The employer usually agrees to make annual cash contributions or pay dividends to the ESOP trust at least equal to the amount of principal and interest due on the loan. The company contributions are then used by the ESOP trustee to repay the ESOP loan. This sequence of transactions between the employer and the ESOP occurs whether the money is borrowed from the employer, a third-party lender or a stockholder. If the employer loans money directly to the ESOP, the employer is still required to make a contribution to the plan in order for the plan trustee to repay the principal and interest.

Suspense Account

The shares of company stock purchased by the ESOP are used as collateral for the loan and initially are held in a suspense account until allocated to the individual participant accounts. As the loan is repaid, a pro-rata amount of the purchased shares are released from the suspense account and allocated to eligible participant accounts, generally based on the proportional annual compensation of participating employees, subject to annual limitations. The earnings from the stock held in the suspense account are allocated to participants' accounts unless the ESOP provides for the use of earnings to repay the loan. The shares held in the suspense accounts are considered *unallocated* shares because they are not included in the individual participant account balances.

Share Release Formula

The plan administrator must use a pre-determined share release formula, as specified in the plan or loan document, to release shares for allocation to individual participant accounts. ERISA allows ESOPs to use one of two share release formulas: the *principal and interest method* which uses a ratio of principal and interest paid to total principal and interest due, or the *principal only method* which is allowed only if the ESOP loan meets certain conditions.

Debt Service Payment

Using employer contributions received by the plan, the ESOP repays the loans in accordance with an amortization schedule. The plan also may use dividends and earnings received on the unallocated shares and earnings received on reinvested earnings of the collateral to repay the debt. In certain situations, the plan can use dividends on allocated qualifying employer securities for debt service, provided that such shares were purchased with the loan and they satisfy the return for value rule. This rule states that when allocated dividends are withdrawn from a participant's account to service debt, the participant must receive shares with a "fair market value" at least equal to the amount of dividends withdrawn. On occasion, an ESOP may be required to depart from the scheduled debt service payments. Such departure could result in a prepayment of principal due to tax or employee benefit planning objectives, the refinancing of the loan to extend payments over a longer term due to changes in covered payroll or the termination of the loan due to a sale of the plan sponsor. Such actions must be consistent with the terms and conditions of the plan and trust documents and any loan agreements.

Financial Statements Balances May be Different than Participant Account Balances

The timing of the release of the shares for when debt is repaid and the allocation of those shares to participant accounts often is different. Shares may be allocated to participant accounts when the contribution receivable is recorded but the shares are not actually released until the related debt is paid. As such, the financial statements and the participant account balances may be different.

Tax Benefits and Related Compliance Matters

ESOPs are subject to special plan operational and qualification requirements

ESOPs can provide significant tax advantages to the employer, shareholders and plan participants. In general, the employer can take a tax deduction for contributions to an ESOP up to 25% of qualifying compensation (this limit also includes employer contributions to other defined contribution plans). Plan participants defer paying taxes on the stock allocated to their individual accounts as well as elective contributions and related income earned until the benefits are distributed to the participants.

ESOPs are tax-qualified retirement plans under the IRC. They must satisfy the same general qualification requirements as other defined contribution pension plans, including the minimum coverage, minimum vesting and nondiscrimination rules. These compliance requirements are discussed in the EBPAQC Primer, *Tax and Compliance Issues for 401(k) Plans*. Because ESOPs are structured to invest primarily in qualifying employer securities, they are subject to additional qualification requirements. An ESOP must specify its intent to meet the terms and conditions of Section 4975(e) of the Code and it must include the specific qualification requirements of an ESOP. This includes the annual requirement to have the shares appraised, the requirement to hold primarily "qualifying employer securities," the diversification requirement, the voting pass-through requirement and the distribution form and timing requirements. Further, to obtain the special tax incentives available to ESOPs, a series of additional operational rules apply. Violation of these rules would not typically disqualify the ESOP, but would reduce or eliminate one or more tax advantages.

Plan Document Must be in Writing

Just like any qualified retirement plan, an ESOP must have a written, signed plan document that defines the terms and conditions related to the operation and administration of the plan. The plan document should stipulate the criteria an employee must meet in order to participate in the plan; state whether the annual employer contribution is a specified or discretionary amount and how the amount is to be calculated (for example, whether the contribution is based on company profits, employee salaries, or a combination of both); and specify how contributions and forfeitures should be allocated to participant accounts. For leveraged ESOPs, the plan document, or the associated loan agreements, must specify the formula used to repay debt and when shares are released from the suspense account and allocated to plan participants.

Adequate Consideration

An ESOP may not pay more than "adequate consideration" for employer stock. Adequate consideration is the asset's fair market value and it must be determined as of the date of the transaction. For shares in public companies that are actively traded on an established securities market, fair market value is the prevailing market price. An ESOP that holds securities that are not readily tradable on an established securities market must have at least an annual independent appraisal of the securities it holds to determine their fair market value (see the "Valuation of Employer Securities" section below).

Contribution Limits

Generally, total annual employer contributions to all defined contribution plans (including ESOPs) are limited to 25% of qualifying compensation, as defined in the plan document. C corporations are allowed to make an additional 25% contribution to a leveraged ESOP to repay principal on a loan used to acquire qualifying employer securities. For example, a C corporation could make a 25% contribution to its ESOP to repay such a loan, and also make a 25% contribution to its 401(k) plan. Any related interest paid by the C corporation on those loans is tax deductible and is not considered part of the 25% of qualifying compensation contribution. These expanded deduction rules are available only where no more than one-third of such allocations go to the benefit of highly compensated employees.

Diversification

ESOP participants who are at least 55 years old with ten years of plan participation must be given the option to diversify their account balances that contain employer securities acquired by the ESOP after 1986. Those participants are allowed to diversify at least 25% of those balances during each of the first five years of a six-year eligibility period. In the final year of the eligibility period, those participants are allowed to diversify at least 50% of the eligible employer stock account balance. Diversification options that may be offered to participants include: (1) a distribution in the amount of the eligible account balance; (2) the opportunity to invest in at least three other investment options within the ESOP; or (3) a transfer of the eligible balance to another qualified defined contribution plan. Special diversification rules apply to plans sponsored by publicly traded corporations that invest employer matching contributions in company stock. Those plans must offer plan participants the right to diversify the matching contributions invested in company stock. This right could be offered immediately, but in no situations longer than three years.

Voting Requirements

It is a qualification requirement that participants have certain voting privileges with respect to the shares allocated to their ESOP account. For publicly traded employer securities, the participant must be permitted to vote such shares in any situation involving a shareholder vote. For private company securities, the participant must have the right to direct the vote of such shares in situations involving a shareholder vote for significant corporate events such as a merger, liquidation, recapitalization, sale of a major portion of the company's assets, etc.

Distribution Requirements, Put Options and Employer Repurchase Obligations

Distributions from an ESOP are made to participants upon separation from employment. For separations due to retirement, disability or death, the distribution typically must be paid (lump sum) or commence (periodic payments) within one year of the end of the plan year in which the separation was made and be completed not later than five years following commencement. For all other separations, the distributions typically must commence within six years of the end of the plan year in which the separation occurred and be completed within 5 years. Very large account balances are eligible for distribution over a longer period. Distributions must be made either in cash or, if the corporate bylaws do not restrict ownership of substantially all stock to current employees, in employer securities. If the securities distributed are not readily tradable, participants must be given an option to "put" the employer securities to the company for their fair market value (referred to as a put option). The first put option is available following distribution. If a participant does not exercise the put option at this time, he or she must be informed of the price as of the following plan year and be provided with another put option.

Prohibited Transaction Exemptions

ESOPs are exempt from certain prohibited transactions

ERISA provides ESOPs with certain exemptions from the prohibited transaction rules. Specifically, ERISA permits ESOPs to purchase employer stock from a party in interest and to incur debt.

Leveraged ESOP Borrowing

A leveraged ESOP is permitted to finance the acquisition of employer stock if the employer meets specific requirements:

- The loan must primarily benefit plan participants and beneficiaries;
- The loan must bear interest at a reasonable rate;
- The collateral for the loan must consist only of qualifying employer securities that were purchased by the ESOP with the proceeds of the loan;
- The ESOP must use the proceeds from the loan to either acquire qualifying employer securities or to repay a prior exempt loan;
- The terms of the loan may not allow for recourse against the ESOP outside of the pledged collateral;
- The loan must provide for the release of the underlying collateral as the loan is repaid as required by the exemption regulations;
- The terms of the loan must be at least as favorable to the ESOP as the terms of a comparable loan resulting from arm's-length negotiations between independent parties;
- A non-publicly traded employer security must include a put option in favor of the participant to sell the employer securities to the employer under a fair valuation formula
    - Where such put option is honored with a note from the company or the ESOP, the note must bear a reasonable interest rate and be adequately secured;
- The loan must be for a fixed term;
- The loan must stipulate that a party in interest lender may not accelerate payments in the event of default, and
- The loan must not be payable on demand of the lender except in the case of default.

Stock Purchases from Parties in Interest

ESOPs sponsored by privately held companies generally purchase employer securities directly from the employer and/or shareholders. ERISA generally would prohibit party in interest transactions, however, ESOPs are exempt from this restriction if the purchase is for qualifying employer securities and the stock price is not less favorable to the plan than adequate consideration and no commission is charged to the plan. The EBPAQC Primer, *Employee Benefit Plans – Parties in Interest and Prohibited Transaction* provides a detailed description of parties in interest and discusses prohibited transactions and their potential consequences.

Valuation of Employer Securities

A trustee must obtain a contemporaneous, updated stock valuation from an independent valuation specialist before employer stock is sold to an ESOP

In order for the trustee or named fiduciary of an ESOP sponsored by a privately held company to conclude that the plan pays no more than adequate consideration for employer securities purchased by the ESOP, the trustee is required by law to have an independent appraisal performed to determine the fair market value of any non-public company stock acquired by the plan. Since public companies' shares are actively traded on an established securities market, which determines the prevailing market price, an independent valuation is not required for employer securities of public companies. In situations where the non-public company stock is contributed to the plan, the trustee or named fiduciary of the ESOP needs to establish the fair market value of the stock as of the contribution date.

To satisfy the “independent” part of the valuation requirement, both the DOL and the Internal Revenue Service (IRS) require that the valuation of employer securities for which there is no active market held by an ESOP be performed by a third party with no personal or financial interest in the valuation result. The valuation specialist, also referred to as an appraiser, is not considered independent unless the plan fiduciary selects the appraiser, controls the relationship between the appraiser and the fiduciary, has the right to terminate the services of the appraiser, and has no financial interest in either the employer or the plan. The fact that the appraiser is paid by the employer would not affect his or her independence.

Additionally, in order for an ESOP plan to meet qualification requirements of the IRC, an independent valuation of privately held employer securities, acquired after December 31, 1986, must be performed annually. This annual valuation is used to allocate shares to participant accounts, and to redeem shares from retiring plan participants to put back to the employer. Valuations are also used for annual ESOP administration and reporting purposes. Note, under the IRC, such annual valuations are not technically required for shares purchased by the plan prior to January 1, 1987. However, the DOL strongly encourages all ESOPs holding private securities to obtain such an independent valuation and, as described above, requires a valuation for any employer security purchase or sale transactions between the plan and a party in interest.

Timing of the Valuation

For financial statement purposes, plan assets must be valued as of the statement date; however, many plans use a different valuation date for administrative purposes. For ESOPs that hold employer securities that are not traded on NASDAQ or a higher exchange, federal law requires that an independent appraiser value the securities at least annually. If an employer stock transaction occurs shortly after the valuation date, the appraiser often will provide a letter as of the date of the ESOP transaction, known as a “bring down” or “roll forward” letter, which reconfirms the valuation report and states that no material changes have occurred since the date of the report. In the case of a transaction involving the plan and a disqualified person, the value must be determined as of the date of the transaction.

Valuation Methods

The fair market value of the employer securities must be determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with DOL regulations. Fair market value generally is defined by both the IRS and the DOL as the price at which the asset would change hands between a willing buyer and a willing seller when the buyer is not under any compulsion to buy and the seller is not under any compulsion to sell, and both parties have reasonable knowledge of relevant facts. Appraisers use several different approaches and methods (or combinations thereof) to determine the fair market value of the stock of closely held companies. The three commonly accepted approaches to valuing a company are: 1) the *market approach*, which uses publicly available information about similar public companies and recent market transactions; 2) the *income approach,* which considers the business interest’s cash generating ability, and; 3) the *net asset approach* which considers the value of specific non-operating assets held by the company that can be readily sold (typically is used only in limited circumstances.)

Appraisers evaluate the market, market participants, observable information, and other company-specific considerations in determining the most appropriate method for estimating the value of the employer securities. The independent valuation generally considers the nature of the business and historical results, the general economic outlook and industry specific condition and outlook, the financial condition of the company and book value, the capacity for future earnings and ability to pay dividends, any goodwill or intangibles, the value of securities of similar public companies, the marketability of the company stock, and any "control premium" or applicable discounts.

Valuation Report
The independent appraiser will issue a valuation report that includes such information as the qualifications of the valuation professional; the valuation date; the purpose of the valuation; stock ownership characteristics; basic sponsor company information; an analysis of the economy; an industry outlook; comparative financial information; generally accepted business valuation approaches with supporting data and assumptions; and the valuation conclusion.

The plan trustee may also request the independent appraiser to provide a "fairness opinion" when the ESOP purchases the employer's stock or there is a tender offer to purchase all of the employer's stock. A fairness opinion is often issued by the independent appraiser stating that the overall material financial terms of an ESOP transaction are "fair" to the ESOP from a financial perspective.

The employer stock valuation used for financial reporting purposes must be calculated in accordance with valuation methods and assumptions acceptable under generally accepted accounting principles (GAAP). In most situations the financial statement valuations will not be significantly different from the appraiser's valuation prepared for the ESOP trustee.

Accounting and Auditing Resources

EBPAQC Employee Stock Ownership Plans Resource Center provides general information on ESOPs, including useful links to other publications and websites.

Fair Value Measurements and Disclosures Resource Center provides information relevant to employee benefit plans regarding fair value measures and disclosures.

AICPA Audit & Accounting Guide, *Employee Benefit Plans*, provides guidance on auditing ESOPs.

AICPA *Accounting Trends & Techniques – Employee Benefit Plans*, provides illustrative disclosure examples for ESOPs.

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