ESOP BRIEF # 7

The ESOP as an Employee Benefit

By The ESOP Association

A broad overview of how ESOPs compare to other employee benefit plans, like 401(k) plans, and what the benefits of ESOPs are to employee owners.

The Employee Stock Ownership Plan, or ESOP, has grown in popularity in recent years as a way of compensating employees. There were probably fewer than 2,000 ESOPs in 1976, but that number has grown to approximately 7000 ESOPs at the end of 2017. Often employee owners have many questions about ESOPs, and this issue brief addresses some of those questions, specifically:

- How do ESOPs compare to other employee benefit plans? What benefits is an employer entitled to under an ESOP? What are typical ESOP account balances like after 10 to 20 years?
- When will an employee receive the ESOP stock in her/his account? What are my options for an employee when a benefit is received?

Comparison with Other Employee Benefit Plans

On balance, ESOPs compare very favorably to other employee benefit plans. ESOPs may involve a higher degree of risk than other plans because the ESOP trust is primarily invested in one kind of asset: employer stock, and because ESOPs are a "defined contribution" plan instead of a "defined benefit" plan. In a defined benefit plan participants are promised that they will receive a fixed amount per month or per quarter, for life after retirement. The benefits to be received are defined. A defined benefit plan is what is most often referred to as a "pension plan".

An ESOP is a defined contribution plan. Vested ESOP participants own the plan's assets and are entitled to receive their full value: if the stock held by an ESOP rises in value, the ESOP participants, not the plan sponsor, receive that benefit; but if the value of the shares falls, the plan sponsor has not promised participants any specific minimum benefit: the value of the plan to its participants is equal to the value of the shares it holds.

The value of an ESOP's assets may fluctuate more than the value of the assets of a benefit plan, such as a pension plan, which diversifies by investing in a variety of assets. In a healthy, and especially in a growing company, an ESOP may well be the most financially lucrative benefit plan a company could set up for its employees. In sum, ESOPs place less emphasis on financial security, because their purpose is to share both the risks and rewards of ownership with employees.

A company should provide participants information on the value of each person's ESOP account at least once a year, with a statement which shows the amount of the company's contribution, the change in the price per share of your ESOP stock, the total balance in the account, the percentage of your account which is vested, and other data.

Suppose a company contributes 10percent of payroll to an ESOP every year and the ESOP participant earns $30,000 a year. Assume that the company is experiencing good but not enormous growth, resulting in an annual stock price increase of 10 percent, starting with an initial stock value of $100. An ESOP account would grow like this over 5 years:

Year	Old Balance	Contribution	New Balance
1	----------	$3,000	$3,000
2	$3,300	$3,000	$6,300
3	$6,930	$3,000	$9,930
4	$10,923	$3,000	$13,923
5	$15,315	$3,000	$18,315

Of course, the ESOP participant may not be fully vested in the ESOP benefits from year one. "Vesting" is the process by which right to the account balance becomes non-forfeitable, even if he/she changes jobs. For example, an account might be 20 percent vested after year three, and then vest by another 20 percent per year until it was fully vested after seven years. Thus in the above example the participant would be entitled to 20 percent of $6930, 40 percent of $10923, and so on, to 100 percent of the full value of $28,462 after seven years. This amount will be distributed to the participant. The exact timing of the distribution may vary in accordance with the ESOP plan, and often depending on why the individual participant leaves the plan. All ESOPs must reach full vesting within seven years.

Any number of factors could change this calculation: for example, salary raises increase a company annual contribution, while a lower appreciation of company's stock value would slow the accumulation of assets in an account.

Diversification

When an ESOP participant who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying the investment of up to 25 percent of his or her ESOP account. This option continues until age sixty; when participant receive a one- time option to diversify up to 50 percent of their balance. This helps make the ESOP benefits more secure for participants approaching retirement age.

Timing and Taxation of Distributions

The rules in the Internal Revenue Code specifying the minimum requirements a company must meet in making payouts to ESOP employees are complex. The rules for an ESOP are spelled out in the ESOP trust document, which a participant may ask to see and have explained. Many companies have a special ESOP administrator who handles employee requests of this sort, who may be able to help explain the timing and nature of distributions.

The minimum distribution requirements, in brief, are as follows: Generally, the company must begin distributing vested benefits in the plan year (note: an ESOP's plan year may be different from the calendar year) within one year following the end of the year in which an employee owner retires.

If an employee leaves the company for some other reason, the company may wait as long as five years after the ESOP plan year-ends to begin paying out benefits. In either case, distributions must be completed over not more than five years, in "substantially equal" payments. There are limited and specific exceptions to these rules if the ESOP is leveraged or if the distributee has a large (over $800,000) account balance. Plan participants may, however, elect to have a longer distribution period.

Employees who receive a distribution from an ESOP at any age below 70 1/2 may defer income and other taxes on that distribution by rolling it over into an IRA or other qualified benefit plan. Otherwise, proceeds from an ESOP are taxable as ordinary income.

A distribution from any kind of employee benefit plan before age 59 1/2 is subject to a 10 percent excise tax, in addition to ordinary income tax if not rolled over into another qualified plan or IRA.

There are complex rules governing automatic tax withholding on distributions that include assets other than employer securities if the plan sponsor does not have evidence the distribution will be rolled over.

For an ESOP distribution after age 59 ½, the recipient may use one time five year forward averaging to reduce the amount of your tax. That is, instead of having a $35,000 ESOP distribution push the recipient into a higher tax bracket for the year in which it is received, that distribution may be deemed to be income over five years. A reputable financial advisor can provide assistance on how to best to handle taxes on an ESOP distribution, as well as on investing that distribution.