What is an Employee Stock Ownership Program (ESOP)?

An ESOP is a company where all or part of the business is owned by the employees through a specialized retirement plan designed to invest primarily in employer stock.

Ownership of the company is held in a trust which holds employer stock, administered by a trustee for the benefit of the ESOP participants (employees).

In an ESOP, ownership is a benefit program, although many ESOP companies also focus on fostering an ownership culture. Each year, shares are allocated to employees' individual accounts, usually based upon a formula of their relative compensation. Participation is generally open to every employee over 21 years old who works a minimum number of hours. When someone leaves the company, they receive their shares and the company is obligated to buy them back at fair market value.

Numerous studies have shown the benefits of employee ownership. ESOP companies are more productive and have a higher return on assets. ESOP participants have greater retirement savings and ESOP companies are less likely to layoff staff or close during economic downturns.

Tax benefits of an ESOP are significant. Properly structured, companies can avoid paying any federal corporate income tax.

In an S-Corp ESOP, the percentage of company held by the ESOP is not subject to federal income tax. For example, a 100% S-Corp ESOP company pays no federal corporate income tax on retained earnings, while a 30% ESOP would avoid taxes on 30% of its taxable income.

For C-Corp ESOPs, contributions to the ESOP are tax deductible. These contributions could include principal and interest payments related to paying off an ESOP loan. Business owners who sell their company to an ESOP can defer or potentially avoid paying capital gains taxes on the proceeds of the sale by reinvesting or "rolling over" the proceeds from the sale into qualified replacement property (this is called a 1042 Rollover).

ESOPs are usually set up to facilitate the sale of a company and use financial leverage, or borrowed money, to buy the company from the current owners.

When selling to an ESOP, the selling owner maintains significant control over the process and can remain with the business. In the basic ESOP transaction, the company adopts the ESOP and establishes the trust. The trust borrows money from a lender (or the selling owner) and uses that money to purchase some or all of the employer stock at fair market value. The proceeds of the loan pass through the trust to the company, and the stock is held in the trust.

Over time, the company makes annual contributions of cash to the trust to pay down the loan. As the loan is paid off, the ESOP releases a comparable amount of stock to employee's accounts. Each year, the trustee must engage an independent firm to determine the fair market value of the company stock.

There are ESOP companies in virtually every industry with roughly 6,600 ESOPs employing 10.8 million workers. The average ESOP has 100 employees, although they are common in both very large and very small companies.

The average ESOP participant has an account balance of over $100,000, much higher than the average American worker. For people of color this represents a significant opportunity for wealth building. One study found that for Latinos, ESOP participants had 12 times the wealth of the national average, while for African Americans, that ratio was 3 to 1.

paragus

AN EMPLOYEE OWNED COMPANY

Paragus IT
Hadley, MA

Paragus IT provides outsourced IT services to small- and medium-sized businesses in western Massachusetts. The company employs 50 full-time staff and became an ESOP in 2016. Employees elect one staff to the Board of Directors and use monthly owners meetings to gather input on key big picture decisions. This has furthered Paragus' collaborative culture and has shown increases in job satisfaction.

kph HEALTHCARE SERVICES, INC.

KPH Healthcare Services, Inc.
East Syracuse, NY

KPH is a national provider of pharmaceutical and health care services. They operate Kinney Drugs, a chain of 100 drug stores, an institutional pharmacy service, and a pharmacy benefit management company. KPH has over 4,000 employees and became 100% employee-owned in 2008. The ESOP is a critical element of the retirement plan and drives the customer focused culture throughout the company.

Employee-owned firms are supported by a robust community of practice. For more information on ESOPs, we recommend the resources found at the National Center for Employee Ownership (nceo.org) or the ESOP Association (esopassociation.org)

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ESOP | The ESOP Association