Why ESOPs are good for Iowa

An Employee Stock Ownership Plan (ESOP) is a type of retirement plan that is "qualified" under the Internal Revenue Code. As a "qualified" retirement plan, there are federal tax advantages to the companies that sponsor such a plan for their employees as well as for those employees. The most common type of qualified retirement plan is a 401(k) plan.

While an ESOP is similar to a 401(k) plan, there are some significant differences. One of those differences is that an ESOP is designed to be invested primarily in the stock of the sponsoring company, which is often a privately-held company. Another difference is that an ESOP is often used as a part of an ownership transition event for the owners of an existing business.

There are likely many owners of businesses in Iowa that may be considering their options relating to the sale of all or a portion of their company. Perhaps the owner is looking for partial diversification since all of his or her wealth is tied up in a closely held business. Or perhaps the owner would like to retire completely and is seeking the sale of the company in its entirety. Often the owner would like to sell to his or her employees but those employees lack the funds to make the purchase. An ESOP can be used to purchase all or a portion of a corporation in these situations.

If an ESOP purchases all or a portion of an existing Iowa company, it is likely that such business will be retained in the state. If the company is sold to a third party, particularly an out of state purchaser, there is a possibility that some or all of the jobs in Iowa will be eliminated.

So what exactly is an ESOP? An ESOP is . . .

- An excellent vehicle for ownership transition as it can offer the following:
  - Cash flow efficiencies to the company that stem from the ESOP's tax advantages
  - Potential tax advantages to the selling shareholder(s)
  - An alternative to a third party buy-out
  - An opportunity for an owner to diversify his or her personal holdings over time.
- A great employee benefit program in that it offers the following to employees:
  - Tax deferral on account accumulation while employed
  - Above average account accumulation
  - Favorable tax treatment upon distribution
- A business enhancement tool.
  - In the summer of 2011, the Employee Ownership Foundation released its 20th Annual Economic Performance Survey (EPS), which noted that 92.21% of companies with ESOPs declared that creating employee ownership through an ESOP was "a good decision that has helped the company."

As noted above, a qualified retirement plan is afforded certain tax advantages under the federal Internal Revenue Code. In very general terms, those tax advantages include:

- The contributions made by an employer on behalf of its employees are tax deductible.
- The contributions made by an employer on behalf of its employees are not currently taxed to such employees. Rather, the contributions remain in a tax –deferred account until the employee terminates employment and receives a distribution from the plan.
- A selling shareholder may be able to defer the gain on the sale of the stock sold to an ESOP if certain conditions are satisfied.

A typical leveraged ESOP would work as follows:

- Owner of A would like to sell 30% of his or her shares
- Company A establishes an ESOP to buy this 30% ownership interest
- The ESOP borrows the funds needed to purchase the 30% ownership interest
- Company A makes tax deductible contributions to the ESOP which in turn, the ESOP uses to repay its loan.
- Over the term of the loan, the eligible employees of Company A participating in the ESOP receive annual additions to their ESOP accounts in the form of shares of Company A stock.
- When an ESOP participant terminates employment with Company A, his or her vested ESOP account will be distributed and can be rolled over into another tax qualified plan such as an IRA.

Some key considerations relating to the operation of an ESOP are as follows:

- The value of the stock to be purchased by the ESOP is determined by a qualified, independent appraiser.
- The ESOP must comply with a myriad of regulations issued by the Internal Revenue Service and the Department of Labor. Such regulations protect the interests of the ESOP participants.
- In addition, an independent trustee often represents the interests of the employees, particularly with respect to the ESOP's purchase of shares.

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