Approved February 7, 1990
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Elizabeth Baker at
Chairperson

3:40 ~~a.m.~~/p.m. on Tuesday, January 30, 1990 in room 423-S of the Capitol.

All members were present except: Representatives Barkis, Shumway, Chronister, Weimer, Heinemann, and Dean. Excused.

Committee staff present:
Lynne Holt, Research
Elaine Johnson, Secretary

Conferees appearing before the committee:
Jack Montgomery, Director of Division of Existing Industry Development, Dept. of Commerce
Duncan Harwood, Director of ESOP Services, EPI Qualified Plan Consultants

The meeting was called to order by Chairman Baker at 3:40 p.m.

Representative Baker opened the hearing on HCR 5035 and recognized Lynne Holt of the Research Department.

Ms. Holt briefed the committee on ESOPs. The term "ESOP" means Employee Stock Ownership Plan. ESOPs produce certain federal tax advantages that enable the transfer of stock ownership from company to employee. They are not necessarily suitable for all types of companies and are not devoid of risk. A company must be prepared to buy back the stock of retiring employees which could entail a considerable outlay of funds. ESOPs also represent a loss of revenue to the federal government.

Jack Montgomery, Director of Division of Existing Industry Development, of the Department of Commerce testified in support of HCR 5035. Mr. Montgomery stated the Department of Commerce has provided a number of its staff with in-depth information on leveraged buyouts and ESOPs allowing them to recognize those companies which may be likely candidates for implementing an employee stock ownership plan. With the encouragement of the Department, the certified development companies have also explored this subject at a meeting of their statewide association. Attachment 1.

Duncan Harwood, Director of ESOP Services, CPI Qualified Plan Consultants was the next conferee to testify in support of HCR 5035. Mr. Harwood stated that this resolution is the first step to providing information to companies on ESOPs. ESOPs will keep ownership of companies in the state. He also stated that distressed companies can use ESOPs for refinancing large corporate debt and he is also aware of a bankruptcy where employees raised funds and found financing to save the company. Attachment 2.

Mr. Harwood responded to questions from the committee.

The meeting adjourned at 4:00 p.m.

Elizabeth Baker

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Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

Date: 1/30/90

GUEST REGISTER

HOUSE

Committee on Economic Development

NAME	ORGANIZATION	ADDRESS
Duncan Harwood	CPI Qualified Plan Consultants	1900 Polk Great Bend
MIKE HELVEY	Rep. Kline's staff	182-W
JACK MONTGOMERY	KDOC	TOPEKA
BRAD MEARS	KDOC	TOPEKA

TESTIMONY ON H.C.R. 5035

presented by

Harland E. Priddle
Secretary of Commerce

House Eco Devo Committee
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TESTIMONY ON H.C.R. 5035

Thank you for the opportunity to appear before the committee in support of H.C.R. 5035 which endorses the concept of employee stock ownership plans (ESOPs).

The Kansas Department of Commerce supports the ESOP-type of business transaction and its use by Kansas businesses where appropriate. As the committee has heard, ESOPs can provide a number of benefits and advantages to a company, its management, and its employees.

The Department has provided a number of its staff with in-depth information on leveraged buyouts and ESOPs allowing them to recognize those companies which may be likely candidates for implementing an employee stock ownership plan. With the encouragement of the Department, the certified development companies have also explored this subject at a meeting of their statewide association. We have made efforts to promote ESOPs by educating Department staff and business assistance organizations which work closely with business financing alternatives.

Our staff will continue its efforts to identify possible candidates for an ESOP and work with authorities in this field in an attempt to successfully structure such a plan where it is in the best interest of the business and its employees.

Again, the Department of Commerce supports this resolution and its intent to encourage the use of ESOPs with the Kansas business community where appropriate.

I. INTRODUCTION

Employee Stock Ownership Plans (ESOPs) have become extremely attractive since the passage of favorable legislation beginning in 1984 Corporations both large and small are establishing ESOPs to provide an attractive employee benefit plan and/or to utilize the ESOP as a means of corporate finance. The result has been the broadening of corporate ownership in the United States (U.S.) by including employees as beneficiaries of financial transactions. Strong Congressional support in the form of ESOP tax incentives has led to the growing use of ESOPs to transfer ownership of a company to its employees, to fund capital investment, as a means of divesting or acquiring a subsidiary through a leveraged buyout; and as a vehicle to facilitate virtually any type of legitimate corporate financial transaction. Not only do corporations and selling shareholders benefit from the tax savings that is unavailable through traditional transactions but employees gain significant, financial and retirement benefits.

An ESOP is a qualified employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) which must meet the unique and complex requirements under the law. Because of the highly technical and flexible nature of ESOPs, CPI Qualified Plan Consultants, Inc. (CPI) has prepared this booklet. It is intended to provide the reader with information regarding the structure of ESOPs and to explain how they can best be used to achieve corporate financial goals while at the same time providing employees with a beneficial interest in the corporation in which they work.

A. THE ESOP AS AN EMPLOYEE BENEFIT PLAN

Unlike other employee benefit plans, which are invested in a variety of diversified investments, ESOPs are intended to invest primarily in company stock and to make employees beneficial owners of the company where they work. ESOPs are also the only employee benefit plan which may be used as a technique of corporate finance so that employees can share in the benefits realized through corporate financial transactions.

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Because ESOPs are invested primarily in the stock of the sponsoring corporation, they are a means of transferring ownership of the company to its employees. As owners, employees may be more motivated to improve corporate performance because they can benefit directly from company profitability. A growing company showing significant increases in the value of its stock can mean significant financial benefits for its employees. In fact, studies have shown that ESOPs are providing employees with significant amounts of capital which often result in financial benefits far superior to other employee benefit plans.

Because the assets of the ESOP trust are invested primarily in the stock of the company, there may be a higher degree of risk for the employee. There is also a greater potential for reward as well, and by making employees part-owners of the company where they work ESOPs provide more workers access to the risks and rewards of our free enterprise system.

B. ESOPS CAN IMPROVE CORPORATE PERFORMANCE

Sharing the risks and rewards of capital ownership with employee can have a significant impact on corporate performance. A mounting body of evidence suggests that employee ownership improves employees' attitude towards their company. Many studies confirm this result, that employee ownership can improve employee attitudes and corporate performance. For example, a 1980 study reported in the Journal of Corporate Law, found that ESOP companies have twice the annual productivity growth rate of comparable non-ESOP companies during the 1975-1979 period.

More recent studies by the National Center for Employee Ownership and the ESOP Association of America provide evidence that employee owned companies enjoy faster rates of growth after installing an ESOP than before; that companies that have ESOPs enjoy faster rates of growth than companies that offer no ownership; that employee owned companies have greater sales growth, operating margins and returns on equity than similar non-employee owned companies have greater sales growth, operating margins and returns on equity than similar non-employee owned companies; and that on the average, ESOPs have provided substantial financial benefits to employees over the last 10 years.

ESOPs provide an excellent means of encouraging workers to take a more active interest in company productivity simply because they share in the profits created through productivity increases. As might be expected, employees tend to react to employee ownership in financial terms, and if contributions to an ESOP are small and account balances in an ESOP are negligible, the motivational effort may also be negligible. Another study found that the key factor determining positive employee attitudes towards an ESOP was the amount of stock and/or cash contributed to the plan on an annual

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basis. In other words, the greater the commitment a company makes to employee ownership by actually giving employees ownership the greater the likelihood that employees will respond positively as owners.

Greater employee productivity does not happen automatically, however, and communications efforts are vital to achieving the benefits that many ESOP companies have realized. Getting workers to think and act as owners may be a challenge. But as employees begin to understand that they will share in the profits realized through corporate growth, a more cooperative environment can be created. With consistent ESOP contributions, extensive education programs, and other efforts to reinforce the ownership model, ESOPs can result in significant productivity improvements. The experience of thousands of ESOP companies provides positive evidence for the effectiveness of employee ownership as a means of improving productivity while broadening the ownership wealth in this country. These benefits have in turn justified the tax incentives bestowed on ESOPs.

C. ESOPS AS A TECHNIQUE OF CORPORATE FINANCE

Many of the tax incentives granted to ESOPs have been to promote the use of ESOPs as a technique of corporate finance, and these incentives can make it attractive for corporations to share the benefits of corporate financial transactions with their employees. Leveraged ESOPs are being used with increasing frequency as a means of buying out outside shareholders, financing capital expansion, taking public companies private, spinning off divisions, acquiring new divisions and for virtually any other legitimate corporate financial transaction.

The net effect of using ESOPs to finance companies' purchases of existing company stock, new equipment, retail outlets, other enterprises, etc., is to allow employee to become owners and therefore benefit from capital ownership and corporate financial transactions. In addition, the tax benefits ESOPs provide to the sponsoring employer can reduce the costs of borrowing and enhance cash-flow and debt financing.

D. ESOPS DEFINED

ESOPs are a type of qualified employee benefit plan which must conform to the guidelines established by ERISA. There are two broad categories of employee benefit plans which are regulated by ERISA, defined benefit plans and defined contribution plans. ESOPs fall under the defined contribution category. The retirement benefits provided for each employee by defined contribution plans are not guaranteed nor are they determined when the employee enters the plan as in defined benefit plans. Defined benefit plans are funded annually by actuarially determined required contributions which are sufficient to provide a normal retirement benefit payable at the employee's normal retirement age. Defined contribution plans by

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contrast generally do not provide guaranteed levels of payment at normal retirement age and contributions made by the employer may vary with the level of the employer's profits or may be totally discretionary. The amount of employer (and possibly employee) contributions to the plan along with the gains, losses and administrative expenses of the plan determine the benefits provided by a defined contribution plan. In a defined contribution plan, the employer contributions are allocated to an individual employee account generally in the ratio that the individual's compensation bears to the total compensation of all employee participating in the plan.

An ESOP is a special kind of defined contribution plan which is designed to be invested primarily in the stock of the sponsoring employer. As with all defined contribution plans, ESOPS must be in writing and must provide that the sponsoring employer establish a trust to receive the employer's contributions to the plan.

As with all defined contribution plans, company contributions to an ESOP are fully tax deductible within specified limits. In addition, the trust is generally exempt from any tax on the income generated by the assets held by the trust and plan participants are not liable for taxation of their benefits until they actually receive a distribution from the plan.

There are two basic kinds of ESOPs, non-leveraged and leveraged.

A non-leveraged ESOP is defined as a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan that has bought stock using money that was not borrowed. The contributions to a stock bonus plan need not be based on profits (although they may be). Contributions under a stock bonus plan may be based on some other kind of formula, or left up to the discretion of the employer. To be an ESOP a stock bonus plan must specifically designate itself as an ESOP in the plan document and comply with special ESOP requirements of Internal Revenue Service (IRS) regulations. Only those plans which are specifically designated as ESOPs may benefit from the incentives provided for ESOPs.

Normally, an employer may deduct contributions of only 15% of annual covered payroll under a stock bonus ESOP. By combining a stock bonus plan with a money purchase pension plan, however, an employer can deduct up to 25% of annual payroll from taxes. A money purchase pension plan is a defined contribution plan which must have a fixed contribution based on some formula which is not dependent on profits. Also, forfeitures - the portion of departing employees' accounts which is not vested and to which they therefore lose their entitlement - may be reallocated to other employees.

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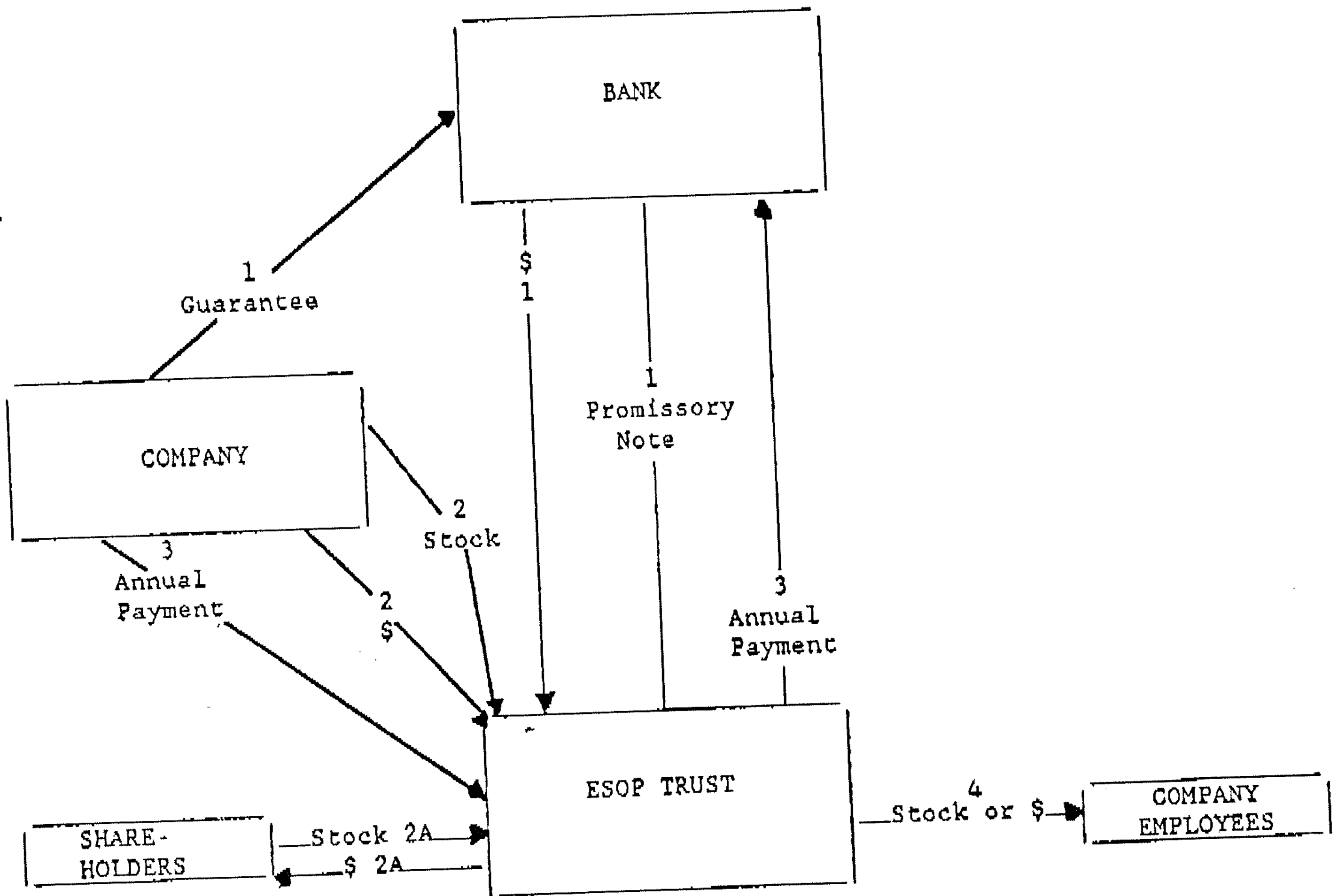
E. LEVERAGED ESOPS

An ESOP is the only qualified employee benefit plan which can borrow money using corporate credit to finance the acquisition of company stock. The ESOP can borrow from a commercial lender, the company, or an individual or other company which may be a party in interest to the ESOP. For all other qualified employee benefit plans this would be a prohibited transaction under ERISA, but a special exemption is provided for ESOPs. When an ESOP borrows money, the shares of stock it purchases with the loan are credited to a suspense account, from which they are released and allocated to employee accounts on a pro-rata basis as the loan is repaid. In order to facilitate loan repayments, leveraged ESOPs are specifically exempted from the 15% of covered payroll contribution limit for profit-sharing and stock bonus plans. Leveraged ESOPs are thus allowed to make a tax-deductible contribution of up to 25% of covered payroll to repay the principal on the loan. All contributions used to repay loan interest are also deductible. Interest payments are not included for purposes of calculating the 25% contribution limit, provided certain allocation tests are met. Also, dividends on stock held by the ESOP which are used to repay an ESOP loan (which are tax-deductible), are not counted when determining the 25% deductible contribution limit.

Proceeds from an ESOP loan must be used to purchase employer stock or to repay a prior exempt ESOP loan within a reasonable time period after they are received. The interest rate must be reasonable and an ESOP loan must be a term loan, not a demand loan. The only collateral the ESOP can provide is the qualifying employer securities purchased. These securities must be released from pledge on a pro-rata basis as they are allocated to employees' accounts. The lender's only recourse against the ESOP is to go against whatever collateral remains pledged, contributions to the ESOP for loan repayment, earnings on those contributions and cash dividends on the employer's stock.

Often the employer will give the lender a guarantee that it will make contributions to the ESOP which are sufficient to enable the ESOP to repay the loan on schedule. If the lender prefers, the loan may be made to the employer instead of the ESOP, provided the employer then makes a loan for a like amount to the ESOP. The tax effect is the same either way. Also, the employer may provide other collateral to the lender.

The following is a diagram of how a leveraged ESOP works:



(1) Bank lends money to ESOP with company guarantee. (2) ESOP buys stock from company or (2A) from existing shareholders. (3) Company makes annual tax deductible contributions to the ESOP which, in turn, repays bank. (4) Employees collect stock or cash when they retire or leave the company.

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F. OBTAINING THE ESOP LOAN

As with any other type of loan, lenders evaluate ESOP loan request primarily from a risk perspective. Though tax-advantaged ESOP financing can improve the cash flow of the borrower, the lender will first want to assure itself of the credit risk of the prospective borrowing company. Without this assurance, even the potential advantages of an ESOP will not suffice to make a loan available to an unstable business. In general, banks assess the credit-worthiness of a company by looking at its ability to generate cash, the liquidity of its assets and the underlying value of the company. An important consideration unique to ESOP loan requests is that the lender needs assurance that the company is able to comply with the Internal Revenue Code and ERISA regulations that govern ESOPs, which are enforced by the IRS and the Department of Labor.

Lenders also look at a company's ability to utilize the ESOP tax incentives. If the company is projecting profits and has a large payroll, it will be able to take full advantage of the benefits afforded leveraged ESOPs. These benefits enhance a company's ability to repay an ESOP loan, and ESOP loans can be very attractive to a lender. Because companies whose shares are not publicly traded are obligated to repurchase employees' shares as employees retire, lenders often require prospective ESOP companies to perform a repurchase liability analysis prior to receiving funding to help predict future cash-flow requirements. Lastly, a lending institution will assess its own ability to fully benefit from the 50% interest exclusion for qualified ESOP loans which is explained on page 23. The prospect of significant tax-savings on interest income earned from an ESOP loan provides lending institutions with an additional incentive to offer a company such a loan (although a lender with a low effective tax rate may find this less attractive). The savings gained by the lender are usually, in part, passed on to the ESOP company in the form of a reduced interest rate. Companies seeking to acquire an ESOP loan at reduced interest rates should first locate a lender who is currently in a taxable position, or who is able to syndicate the loan to a lender who is, and therefore able to benefit from the lender exclusion. Some lenders may offer securitized ESOP loans which are immediately resold to other lending institutions.

G. THE USE OF ESOPS IN CORPORATE FINANCIAL TRANSACTIONS

In addition to the special attributes of ESOPs as an employee benefit plan, ESOPs are the only employee benefit plan which can also be used as a technique of corporate finance. Leveraged ESOPs may be used for an legitimate financial purpose, since the employees are the ultimate beneficiaries through the acquisition of employer securities by the ESOP. The following are common examples of how ESOPs are used in corporate financial transactions:

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1. The owner of the business may be interested in selling part or all of his stock on a tax deferred basis to get an immediate return on his investment in his business. The ESOP creates a private market for the owner's stock. The owner's objective may be to pass control of the business or its management to his descendants over a period of time in anticipation of his eventual retirement from the business. The owner can defer tax on his gain by reinvesting the sale proceeds in stock or debt instruments of privately or publicly held U.S. companies. The owner can permanently defer the tax on his gain if these securities pass to his estate.

2. The business may need to refinance existing debt to improve its cash flow. Existing debt can be financed through an ESOP resulting in lower interest rates, a longer term and with greatly reduced cash flow needs to service this debt since the principal is a deductible expense. Commercial lenders get a tax break on the ESOP loan interest and will pass through part of their tax savings by giving the ESOP a lower interest rate.

3. A company with multiple shareholders may be faced with the obligation to buy stock back from employee shareholders who retire or otherwise leave the company. The ESOP can be used to provide a market for the stock making the purchase a deductible expense to the company and financing such acquisition at reduced costs.

4. An ESOP can be used as a means of corporate finance to create working capital or to finance the acquisition of equipment and property. The ESOP debt is fully tax deductible and a lower loan interest rate can be obtained. In exchange for the substantially lower financing costs, the employees are provided with a motivational employee benefit program which can increase productivity and profits, with the proper company reinforcement through employee communication and educational programs.

5. Corporate management may be attempting to purchase the company from the owner(s). Using an ESOP to finance all/or part of the acquisition of stock makes the acquisition debt a fully deductible expense to the company with a reduced interest rate. Management gains effective control of the company and employees receive a beneficial interest in the company through the ESOP motivating the employees to become more efficient and productive.

6. A part owner of a company may be considering buying out another owner who is needing to sell out for various reasons (retirement, health, etc.). The ESOP can be used to reduce the amount of cash flow necessary to service the debt required to finance the acquisition. The part owner does not have to come up with the capital to buy out the owner wanting to leave. The part owner who remains with the business gains effective control

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of the business and the employees gain a beneficial interest in the business which increases their motivation and productivity. The selling owner can sell his stock and defer the tax (which may be deferred permanently) resulting in substantially greater after tax income from the sale or this tax savings could be shared with the ESOP to reduce the ESOPs's purchase price.

7. The company may be in an acquisition mode to acquire other businesses to compliment its existing business and increase its market share. An ESOP can be used to acquire all or a portion of another business. The ESOP can motivate the owners of the target business to sell because of the tax advantages to the seller. The acquiring business may acquire a small percentage of the stock and finance the remaining portion through an ESOP at a lower rate and with reduced cash flow needs to service the debt since the principal payments are deductible. The employees of the acquired business gain a beneficial interest in the business and may view the takeover in a favorable light.

8. Hundreds of publicly-traded and closely-held companies divest subsidiaries, divisions and product lines every year. An ESOP can be used as an effective tool for allowing employees to make a competitive bid for part or all of a division of a company undergoing divestiture. The tax benefits associated with ESOP buyouts offer employees a chance to finance a significant ownership stake in the company. ESOPs are also, on occasion, used to prevent plan closings.

9. An ESOP can enable a company to buy back all or a significant block of its publicly traded stock. The motivation behind this use of an ESOP may be to make a hostile takeover more difficult, or simply to acquire stock at a perceived discount price for the benefit of employees. The result for employees is a substantial (up to 100%) share of ownership in their company.

II. ESOP REQUIREMENTS

ESOPs, like all qualified deferred compensation plans, must meet certain minimum requirements spelled out in Section 401(a) of the Internal Revenue Code (IRC) in order for the contributions to be tax deductible to the sponsoring employer. The ESOP must provide a trust to which the plan sponsor makes contributions. The trust must be for the exclusive benefit of participants and their beneficiaries. The sponsor must intend to have the trust's assets and income distributed to the plan participants and their beneficiaries when they are eligible to receive benefits, and the plan must not discriminate in favor of highly compensated employees.

A. COVERAGE REQUIREMENTS

In general, plan sponsors must ensure that at least 70% of all non-highly compensated employees are covered by the plan. However, there are several different tests that may be applied for purposes of meeting the coverage requirements. Employees covered under a collective bargaining agreement, certain part-time employees, employees under the age of 21 and employees with less than one year of service may be excluded from the plan before applying the coverage tests.

IRC Section 401(b)(1) provides three alternative coverage tests for determining that an ESOP does not discriminate in favor of highly compensated employees. Highly compensated employees are generally those who are greater than 5% owners of the company, those earnings over $75,000 (indexed) in compensation, those earnings over $50,000 (indexed) and who are in the top 20% of employees in terms of compensation, or those employees who are at any time an officer and received compensation greater than 50% of the defined benefit limits in effect under IRC Section 415(b)(1)(A) for the year.

An ESOP must meet one of the following coverage tests.

1. At least 70% of all non-highly compensated employees must be covered by the plan.

2. The percentage of employees who are not highly compensated must be at least 70% of the percentage of highly compensated employees, benefiting under the plan.

3. The average benefit for employees who are not highly compensated must be at least 70% of the average benefit for employees who are highly compensated.

An ESOP meeting any one of these three tests will satisfy the coverage requirements. All employee benefit plans must comply with one of these tests for plan years beginning after December 31, 1988, (with limited extensions for collectively bargained plans). Alternatively, a plan may be treated as meeting the coverage requirements if it benefits such employees as qualify under a classification set up by the employer and found by the Secretary of Treasury not to be discriminatory in favor of highly compensated employees. Employees who have not met minimum age and service requirements, non-resident aliens not receiving any U.S. source earned income, and (usually) employees covered by a collective bargaining agreement, are not counted when applying these tests.

As noted above, ESOPs may include minimum age requirements and minimum years of service, but they may not have a maximum age limitation. An ESOP may provide that employees who have incurred a break in service (those who have worked less than 500 hours in a specified 12 month period) will cease to participate in the plan.

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Also, an ESOP may provide that employees will not share in an allocation of an employer contribution or reallocation of forfeitures for any year in which they have less than 1,000 hours of service, or if they terminate during the year. The plan must benefit no fewer than the lessor of 50 employees or 40% or more of the employees of the plan sponsor. The corporate sponsor must intend the plan as a permanent program when the plan is started, although it may subsequently terminate the plan for valid business reasons.

B. PRIMARILY INVESTED IN EMPLOYER STOCK

An ESOP is required by law to be designed to invest primarily in the stock of the sponsoring employer (most other employee benefit plans may invest no more than 10% of their assets in employer securities). This helps insure that employees will have a significant ownership stake in the company where they work. Though no strict quantitative guidelines have been established by the IRS to determine the meaning of "invested primarily", it is generally thought that the ESOP should be at least 50% invested in employer securities on an ongoing basis. The remaining trust assets may be invested in other prudent investment to allow for diversification and liquidity.

"Employer securities" may be common stock which is readily traded on an established securities market, or, if no such stock exists, then the ESOP must invest primarily in common stock which has a combination of voting rights and dividend rights equal to or greater than those of any other class of common stock (or preferred stock which is readily convertible into common stock.

C. VESTING

There are two basic minimum vesting schedules under IRC Section 411. These are five-year cliff vesting or 20% vesting after three years, increasing 20% per year until 100% vesting is reached after seven years. Under five-year cliff vesting, a participant must be 100% vested after five years of service, but need not be vested at all before that time. These vesting schedules were required by the Tax Reform Act of 1986 and all qualified employee benefit plans must comply with these requirements for plan years beginning after December 31, 1988, (with limited extensions for collectively bargained plans).

Vesting is calculated using years of service with the employer, not years of participation in the plan. A plan may provide that any years in which an employee does not complete a year of service (at least 1,000 hours of service) will not count for vesting purposes. Years of service during which the plan did not yet exist, or during which the employee was not yet 18 may all be disregarded by a plan for vesting purposes.

D. DEDUCTIBLE CONTRIBUTION LIMITS

Generally, an employer may claim a federal income tax deduction equal to the amount contributed to the ESOP not to exceed 15% of the compensation paid to participants for that year. The contribution must be made no later than the due date for the filing of the employer's federal income tax return, including extensions. In the case of an ESOP which is currently leveraged the employer's deductible contribution to the ESOP to repay the principal portion of the ESOP loan is limited to 25% of compensation. There is no limit on deductible contributions to the ESOP to repay interest on an ESOP loan. Dividends paid on allocated and unallocated stock held by the ESOP may be used to repay an ESOP loan and/or may be passed through to participants. Such dividends are deductible to the corporation and are not counted in the 25% deductible limit if they are reasonable. If the employer has other qualified employee benefit plans in addition to the ESOP, any contributions made to the other plans must be aggregated with the contribution to the ESOP for purposes of determining the maximum deductible contribution. If the employer makes any contributions which exceed the 15% or 25% limits, the employer will be assessed a 10% excise tax on these non-deductible contributions.

E. INDIVIDUAL LIMITATION ON ANNUAL ADDITIONS

There are limits on how much can be added (this is called the "Annual Additions") to an individual Participant's account each year. The "Annual Additions" to an individual Participant's account may not exceed the lesser of 25% of the Participant's compensation or $30,000 (indexed). Annual additions to a participant's account includes contributions of cash or stock, contributions of cash to repay the principal portion of an ESOP loan, forfeitures of other investments, forfeitures of non-leveraged stock and any employee contributions. If no more than one-third of the employer's contribution for the year is allocated to highly compensated employees the $30,000 dollar limit may be increased to $50,000 and forfeitures of leveraged stock and contributions of cash to pay the interest portion of an exempt loan are <u>not</u> counted as annual additions. If dividends are paid on employer stock such dividends are not counted as annual additions. Realized and unrealized gain on employer stock and earnings on other investments (including interest and dividends) are not counted as annual additions.

All plans of the employer are aggregated to determine the extent of the annual additions. Therefore, the employer sponsoring more than one employee benefit plan must project the extent of the annual additions before making the deductible contributions.

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Most ESOPS do not allow employee before-tax or after-tax contributions. However, some employers are combining their ESOP and 401(k) plans (a qualified employee benefit plan which allows employees to make before-tax contributions) to allow employees to make before-tax contributions to be invested in employer stock. In this case it is necessary for the employer to comply with regulatory requirements under federal and state security laws.

G. DIVERSIFICATION REQUIREMENTS

For employer stock acquired after 12/31/86 the ESOP must provide any employee who has attained at least age 55 and completed at least 10 years of participation in the ESOP, an option to diversify 25% of his or her employer stock account balance if such account is greater than $500 in value. The ESOP can allow this diversification option to be applied to employer stock acquired before January 1, 1987. A qualified employee must be given the diversification option annually during a 90 day election period for those plan years after the employee attains age 55 and ending with the fifth succeeding plan year (this results in a six year election period). In the last year of the election period, an employee must be given a one-time option to diversify up to 50% of his or her account balance less any prior diversified amount.

The ESOP must offer at least three investment options to meet the diversification requirement. Alternatively, the plan may make a distribution to the participant of an amount equal to the participant's diversification election to meet the diversification requirement or transfer the amount the participant elected to diversify to another qualified employee benefit plan of the employer which provides for self-direction into at least three investment options which do not include investment in employer stock. Many employers sponsor 401(k) plans in addition to the ESOP and these 401(k) plans allow participants to self-direct the investment of their accounts into various investment funds. Thus designing the ESOP document to transfer the amounts the participant elects to diversify to the 401(k) Plan in which he is a participant is an effective way to satisfy this diversification requirement.

H. ESOP VOTING RIGHTS

ESOPs must meet the requirements of IRC Section 409(e) with respect to voting rights on employer stock. In general, employers that have "registration class securities" (publicly traded companies) must allow plan participants to direct the manner in which employer stock allocated to their respective accounts is to be voted on all matters.

Companies that do not have registration class securities are required to pass through voting rights to participants only on "major corporate issues". These issues are defined as merger or consolidation, recapitialization, reclassfication, liquidation, dissolution, sale of substantially all of the assets of a trade or

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business of the corporation and, under Treasury regulations, similar issues. On all other matters, such as the election of the board of directors, the shares may be voted by the designated fiduciary which is generally the trustee or an administrative committee unless the ESOP otherwise provides.

With respect to issues voted by Participants, voting is passed through on a one vote per whole share basis. As an alternative, voting may be passed through on a one vote per participant basis.

In regard to unallocated shares held in the trust, due to the purchase of stock with a loan, the designated fiduciary may exercise its own discretion in voting such shares. On issues such as tender offers the employer may want to consider drafting the plan to provide that the designated fiduciary votes the unallocated stock in the same proportion that the participants voted the allocated stock. This provision would protect the designated fiduciary against any charge that they violated their fiduciary duty to act in the best interests of the ESOP participants.

I. THE TIMING OF ESOP DISTRIBUTIONS

The timing of distributions to ESOP participants who are eligible to receive distributions must be specifically stated in the ESOP document. IRC Section 409(o) places requirements on the latest time the ESOP must specify that distributions of benefits commence. For distributions to participants who die or become disabled, the ESOP must specify when the distribution will commence and this commencement date can be no later then the end of the Plan Year following the plan year in which the Participant dies or becomes disabled. For distributions to Participants who retire, the latest the ESOP can begin making the distribution is the 60th day following the plan year in which the participant retires. The above distributions can be made, if the ESOP so specifies, in annual installments (or more frequently than annually). The ESOP must specify the installment period and such period cannot exceed five years.

For distributions to participants who separate from service for reasons other than death, disability or retirement, the latest the ESOP can provide for commencement of the distribution is the end of the plan year which is the fifth plan year following the plan year in which the participant separates from service. An exception is provided (if the ESOP so specifies) if a participant's account balance includes employer stock which was acquired in connection with a loan that has not been fully repaid, in which case distributions of stock acquired by the loan will commence after the loan is fully repaid. If the ESOP so specifies, the distribution can be made in annual installments (or more frequently than annual). The ESOP must specify the installment period and such period cannot exceed five years.

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If a participant's account balance exceeds $500,000, the installment period can be extended, if the ESOP so provides, one year for each $100,000 (or fraction thereof) by which the account balance exceeds $500,000 but for no longer than five additional years.

The ESOP may allow participants who have separated from service and are eligible to receive distributions to elect to defer commencement of their distributions until a date selected by the participant or beneficiary. The ESOP may also allow the Participant (or Beneficiary) to elect the installment period over which the benefit will be distributed.

In closely held companies the ESOP must provide its participant with an option to receive their distribution in employer stock but if the participant does not so elect, the distribution may be made in cash. ESOPs must provide that the distribution of the participant's stock account will be made in the form of stock and with respect to the other investment account (if any) the participant may elect to receive such benefit in the form of cash or stock in which case the participant generally elects to receive cash since the employer stock is not publicly traded.

The timing and method of distribution to separated participants in the ESOP significantly affects the company's repurchase liability. Therefore, prior to the drafting of the ESOP document the company should have a repurchase liability study done to include a comparison of the various distribution methods.

J. PUT OPTION ON STOCK DISTRIBUTIONS

If a participant elects to receive his benefit from the ESOP in the form of employer stock or if the ESOP automatically provides for distributions in the form of employer stock and the employer stock is not a readily tradable on an established securities market, the closely held company must provide a put option on the stock distributed from the ESOP.

If the distribution of stock from the ESOP is in a lump sum the employer is obligated to buy the stock back at the option of the participant at the option price which is the most recent fair market value of the stock as determined by an independent professional appraiser. The employer (or the ESOP at its discretion) can pay such option price in a lump sum within 90 days from when the participant exercises his or her put option. Alternatively, the employer can pay such option price to the participant in substantially equal payments (no less frequent than annually) over a period not exceeding five years and beginning not more than thirty days after the exercise of the put option. The employer must provide adequate security and a reasonable rate of interest.

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If the ESOP provides for installment distributions of stock (rather than a lump sum distribution of stock) the put option payment with respect to each installment distribution of stock must be paid in full within thirty days after the put option is exercised.

A participant may exercise his or her option during two periods of time: for 60 days after the date of the stock distribution or, if the participant elects to hold the stock through the first put option period, for 60 days after the date the Employer notifies the participant of the fair market value of the stock for the next valuation date under the ESOP.

J. RIGHT OF FIRST REFUSAL

Stock distributed to a departing employee may be subject to a "right of first refusal" which would require the distributees to first offer to sell the stock back to the employer (or to the ESOP) before selling to a third party. The purchase of employer stock pursuant to a right of first refusal must be at a price no less favorable to the distributees than the greater of the selling price offered by a good faith purchaser or fair market value.

K. VALUATION OF EMPLOYER STOCK

The Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code prohibit transactions between qualified employee benefit plans and parties in interest, which includes major shareholders of a company, officers, directors and plan fiduciaries. An exemption is provided for ESOPs, since they would often be unable to acquire employer stock otherwise. An ESOP may acquire employer stock from a party in interest provided that the plan pays no more than "adequate consideration" for the stock and pays no commission on the sale.

Adequate consideration for a company whose shares can be traded on a public market is the prevailing market price. For a company whose shares are not publicly traded, adequate consideration is the fair market value of the company's stock as determined by an independent appraiser.

The stock of a private company with an ESOP should generally be appraised at least every year. An appraisal is also usually needed before a company decides whether to set up an ESOP and is recommended for any significant transaction involving the ESOP. The valuation of closely held employer securities for ESOP purposes must be determined by an independent appraiser and the appraiser's name must be reported on the annual return filed with the Internal Revenue Service. The term "independent appraiser" means any appraiser meeting requirements similar to the requirements of the regulations prescribed under IRC Section 170(a)(1) which refers to appraisal standards for purposes of charitable foundations.

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In general, for the appraisal to be credible in the event of a challenge by a plan participant, the Department of Labor, or the Internal Revenue Service, it should be performed by a professional who is regularly in the business of appraising the value of firms for ESOP purposes. Also, while there is still debate on this point among professionals who provide services to ESOPs, it is prudent for the appraiser to be independent of other professionals who provide services to the ESOP.

The factors that a qualified appraiser will consider in determining the value of a closely held business are spelled out in IRS Revenue Ruling 59-60.

Appraisers also often assign a discount to the value of a block of stock which represetns a minority interest in company, sinca a minority shareholder cannot control corporate decision making. When an ESOP holds a minority interest in a company its shares are valued accordingly. However, when an ESOP holds the majority of a company's stock, appraisal practices vary as to whether a discount for lack of control is applied since each individual participant in the ESOP is a minority beneficial shareholder.

Finally, the extent of the company's ESOP repurchase liability and the amount of the ESOP's debt may have a significant affect on the value of the ESOP shares.

L. REPURCHASE LIABILITY

Once the ESOP is established, the sponsoring Employer, which if closely held, has an obligation to repurchase stock from employees eligible to receive distributions. The employer stock must be purchased at current fair market value. This emerging liability called the repurchase liability may grow suddenly depending on the structure of the ESOP and the actual performance of the company.

A company's repurchase liability is a function of the following factors: the amount and length of the ESOP loan; the size of the company's annual contribution to the ESOP; the change in the value of shares of stock between the date of contribution to the ESOP and the date of repurchase; the vesting schedules of the ESOP; the relative ages of the employee group; the number of employees; turnover; disability and mortality; the proportion of stock and cash in the company's ESOP contributions; the timing and method of distributions as spelled out in the ESOP document; and the diversification option of eligible employees.

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Obviously, a company cannot have an obligation to repurchase shares until it has ESOP participants with vested stock who terminate employment. However, a company which, for example, begins vesting participants after three years at 20% and increases this vested percentage by 20% per year until participants are fully vested after 7 years, would find that 20% of two years of contributions verses 100% of 7 years of contributions can be a significantly different, especially if the company has experienced substantial appreciation in the value of its stock and has low employee turnover.

The existance of a repurchase liability is rarely a reason not to set up an ESOP, but it does require planning. Companies often find it useful to project the repurchase liability before making the final decision to implement an ESOP. Companies use a variety of strategies to prepare for their ESOP's repurchase liability, including: making sufficient cash contributions on an annual basis, providing a variety of insurance/investment vehicles to generate funds to cover plan participants' account balances, and repurchasing shares by using excess corporate funds or borrowing. The Department of Labor "Adequate Consideration Regulations" now require that the independent valuation firm take into consideration the company's ability to repurchase employer stock from employees who have received distributions when determining any discount of the stock value due to a lack of marketability. Therefore, in most instances, an actuarial study to determine an ESOP's emerging repurchase liability may be advisable.

M. TAXATION OF PARTICIPANT BENEFITS

During the period in which a Participant's account which consists of Employer Stock and generally other assets is held in the ESOP trust, the value of the account, including any appreciation, is not taxable to the employee. Upon distribution, if an employee has attained the age of 59-1/2, the distribution is subject to taxation at the prevailing income tax rate. A 15% excise tax may apply to very large distributions. In the case of particularly large distributions this tax may in some circumstances be avoided by extending the payment terms over a number of years. Individuals over the age of 59-1/2 are also eligible for a one-time election of 5-year forward averaging on a lump sum distribution from the plan. Special transition rules may allow certain participants to elect 10-year forward averaging or capital gains treatment on lump sum distributions.

If an employee receives a distribution prior to age 59-1/2 a 10% excise tax will be imposed on the entire distribution amount. ESOPs are exempted from this tax for distributions made prior to January 1, 1990, under certain conditions. In addition, special exemptions are provided for death, disability, extraordinary medical expenses, cessation of unemployment benefits, retirement or just separation from service at or after age 55 if such retirement age is no longer required. Exemptions are also provided if proceeds are distributed in installments or are reinvested in annuities payable over life commencing on a separation from service, or if the distribution is rolled over into an IRA or another qualified employee benefit plan.

If a separated participant receives a distribution of stock, the need to define unrealized gain on such stock is not taxed to the participant. The unrealized gain is the difference between the cost basis of the stock and the fair market value as of the stock distribution date. However, the participant may elect to pay tax on the unrealized gain. Therefore, it is important to annually calculate the cost basis in the employer stock in order to determine unrealized gain.

Cash dividends paid to ESOP participants or amounts distributed as a result of the participant's diversification election are not subject to the early distribution tax.

N. ACCOUNTING RULES FOR ESOPS

Another important consideration for companies entering into a leveraged ESOP transaction is the impact of the required accounting treatment. In 1976, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 76-3 as a recommendation of the accounting practices which should be followed for ESOP companies. The statement made the following recommendations:

1. ESOP debt should be recorded as a liability on the financial statements of the employer;

2. The liability incurred by the ESOP debt should be offset by a reduction of shareholder's equity -- a "contra equity account";

3. Both the liability and contra equity account should be reduced symmetrically as principal payments on the loan are made;

4. Reductions in the contra equity account should be charged to compensation expense;

5. Reductions in the contra equity account resulting from the application of ESOP dividends to the reduction of the loan balance will reduce both the retained earnings and provision for taxes accounts;

6. Interest payments should be distinguished from principal payments and charged to interest expense;

7. All shares held by an ESOP, whether or not they are allocated should be treated as outstanding for purposes of earnings-per-share calculations;

8. All dividends paid on shares held by the plan should be charged to retained earnings.

The following example will illustrate how to account for an ESOP transaction. Assume that a company guarantees a $5 million dollar five-year ESOP loan secured at an 8% interest rate, which is used to purchase $5 million worth of the stock of the employer company. The

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The following example will illustrate how to account for an ESOP transaction. Assume that a company guarantees a $5 million dollar five-year ESOP loan secured at an 8% interest rate, which is used to purchase $5 million worth of the stock of the employer company. The

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journal entries necessary to record the initial transaction, the first principal payment on the loan, and the allocation of shares from the suspense account to participant accounts would be:

* Debit unearned compensation (contra equity account) $5,000,000
  Credit bank loan $5,000,000
  To record the employer company's guarantee of a loan used to purchase stock for the ESOP, which is placed in a suspense account.

* Debit bank loan $500,000
  Credit cash $500,000
  To record the annual principal payment on the ESOP loan.

* Debit contribution expense $500,000
  Credit unearned compensation $500,000
  To record the allocation of released employer stock from the suspense account to the accounts of ESOP participants.

The recommendations the AICPA issued in SOP 76-3 have several important implications, particularly for public companies considering establishing an ESOP. The sizable liability incurred by a company guaranteeing an ESOP loan and the corresponding reduction in shareholder's equity can significantly change the balance sheet of the company. If the company issues new shares of stock to sell to the ESOP, it will initially experience a dilution in earnings per share. The combined negative effect these two factors can potentially have on a company's financial statements has, in the past, discouraged many publicly traded companies from establishing leveraged ESOPs.

Exceptions to the application of SOP 76-3 are quite rare and these accounting requirements should be considered carefully, especially for publicly traded companies considering a leveraged ESOP transaction.

O. FIDUCIARY ISSUES

ERISA requires that plan fiduciaries act exclusively in the interest of plan participants. A fiduciary is defined by ERISA as any person exercising discretionary authority or control regarding the management or disposition of plan assets. This includes anyone receiving investment advice for a fee with respect to the assets of a plan and anyone with discretionary authority or responsibility in plan administration. In terms of an ESOP, this means that the plan fiduciaries normally include the trustees, those persons responsible for plan administration, the members of the administrative committee, and the officers and directors of the plan sponsor who may appoint these individuals.

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Depending on the ESOP fiduciary's role, his responsibilities may include investing the plan assets (which must be invested primarily in the stock of the sponsoring corporation), securing a proper valuation of the stock, and assuring that the plan participants receive "adequate consideration" in transactions involving the ESOP.

Particularly in those cases in which an ESOP is used to borrow money, and is therefore used as a technique of corporate finance, additional care must be taken by the plan fiduciaries to ensure that the interests of the employees are protected. An ESOP loan is exempt from the ERISA prohibited transaction rules if the loan is primarily for the benefit of participants and beneficiaries and the loan bears a reasonable rate of interest, but Labor and Treasury Department regulations indicate that all the facts and circumstances will be considered in making a determination as to whether a leveraged ESOP is primarily for the benefit of the plan participants.

A trustee of an ESOP can either be an officer of the sponsoring corporation, member of the administrative committee or an independent bank or trust company. The ESOP plan documents must clearly define the duties and responsibilities of the trustee.

In special circumstances, such as very large transactions involving outside investors or in particularly complicated transactions, independent advisors may be appropriate. In many cases, however, a trustee acts according to the directions of the ESOP administrative committee.

III. ESOP INCENTIVES

In order to broaden the ownership of capital and provide employee with access to capital and credit, Congress has granted a number of specific incentives meant to promote increased use to the ESOP concept, particularly leveraged ESOPs that generally provide for a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer, seller and the lender.

A. DEDUCTIBILITY OF ESOP CONTRIBUTIONS

Contributions to ESOPs, as with all employee benefit plans, are tax deductible to the sponsoring employer, within certain limits. An ESOP thus gives an employer the option of making a contribution in cash or stock taking a tax deduction for the full value of the cash or stock contributed. By contributing stock the employer can provide an attractive employee benefit without any current cash cost, in fact, cash will be generated because of the tax saved through the deductible non-cash contribution of employer stock.

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The deductibility of contributions to an ESOP becomes even more attractive in the case of a leveraged ESOP. Since contributions to a tax qualified employee benefit plan are tax deductible, contributions to a leveraged ESOP used to repay an ESOP loan allow the company to deduct both the principal and the interest on the loan. This makes the leveraged ESOP an unusually attractive form of debt financing from a cash flow perspective. In repaying the principal portion of the ESOP loan, the company may deduct up to 25% of eligible payroll. Moreover, if deductible dividends paid on allocated and/or unallocated stock are used to repay ESOP debt, such amounts are not counted in this 25% of eligible payroll limit on deductible contributions. However, such dividends must be reasonable so as not to be deemed an evasion of tax.

B. LENDER INTEREST EXCLUSION

The 1984 Tax Reform Act provided significant new incentives for ESOP financing. One of the most significant of these new incentives was a provision which allowed banks, insurance companies and other commercial lenders to exclude from their taxable income 50% of the interest earned on a "securities acquisition loan" to a qualified ESOP (or to a company which then reloans the money to a qualified ESOP). This provision was subsequently expanded in the 1986 Tax Reform Act to allow mutual funds to qualify for the lender interest exclusion for ESOP loans.

A "securities acquisition loan" is any loan to a corporation (the amount of which is subsequently reloaned to the ESOP) or an ESOP where the loan proceeds are used to acquire corporate stock. The loan may be made directly to the ESOP or may be made to the sponsoring employer which, in turn, makes a matching loan to the ESOP.

The interest exclusion is also available with respect to a loan to a corporation to the extent that, within 30 days, employer securities are transferred to the ESOP in an amount equal to the proceeds of the loan. Such securities must be allocated to participants' accounts within one year after the date of the loan, and the loan commitment for purposes of this provision must not exceed 7 years. This provision allows corporations to secure financing at reduced rates.

How meaningful the interest exclusion is to a lender depends on the lender's corporate tax bracket and existing tax-free interest income. Those lenders who can use this exclusion will usually pass through part of their tax savings to the borrower in the form of a lower interest rate than the rate that would be charged in a similar situation to a borrower who is not using an ESOP.

C. DEDUCTIBILITY OF DIVIDENDS

Employers are also permitted a tax deduction for dividends paid on ESOP stock to the extent that the dividends are paid in cash to participants not later than 90 days after the close of the plan

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year. The dividends will be taxed as ordinary income when received by the participants. The deduction is allowed for the year the dividend is paid to participants, not the year it is paid to the plan. Additionally, the dividends must be "reasonable".

This provision allows companies to share the benefits of stock ownership with their employees. Many companies have found the pass through of dividends to employees to be a strong motivator because employees receive current benefits from their stock ownership. Care must be taken in drafting the ESOP plan document to determine how the decision to pay dividends is to be made from year to year.

The 1986 Tax Reform Act allows a deduction for dividends paid on ESOP stock to the extent that the dividends are used to reduce the principal and/or pay interest on the ESOP loan incurred to purchase Employer stock. Dividends used to repay ESOP debt must be "reasonable". The dividend deduction for loan repayments is not included for purposes of calculating the 25% deductible contribution limit for leveraged ESOPs.

D. DEFERRAL OF GAIN ON SALE OF STOCK TO AN ESOP

An additional ESOP incentive provided by the 1984 Tax Reform Act allows major shareholders of closely held companies to sell their stock ("employer securities") to an ESOP and defer federal income taxes on the gain from the sale. In order for the seller to qualify for such tax treatment the ESOP must own at least 30% of the company's stock immediately after the sale, and the proceeds from the sale must be reinvested in qualified replacement property within a 15 month period beginning three months prior to the date of the sale. The seller, certain relatives of the seller, and greater than 25% shareholders in the company, are prohibited from receiving allocations of stock in the ESOP acquired from the seller in this manner. Lineal Descendants (children, grandchildren) of the selling shareholder may receive an allocation of this stock but as a group (if more than one) are limited to an allocation of 5% of the stock. Also the ESOP, to avoid a 10% excise tax (of the amount disposed), may not distribute or sell this stock for 3 years. However, exceptions to this are provided for distributions due to death, disability, retirement after age 59-1/2 and other separation from service after a one year break in service.

An ESOP rollover may be attractive to a selling shareholder for a number of reasons. Normally a retiring shareholder only has so many ways that he can sell his stock he can either:

1. Sell his or her shares back to the company, if such a transaction is feasible;

2. Sell to another company or individual if a willing buyer can be found; or,

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3. Exchange a controlling block of stock for stock from another company.

Selling to an ESOP on the other hand, allows the selling shareholder to sell all or a part of his stock and defer taxes on the gain by reinvesting the proceeds in "qualified replacement property" - generally, the stocks and bonds of domestic operating corporations. Federal, state and local government securities do not qualify as replacement property.

In addition to the favorable tax treatment, selling to an ESOP also preserves the company's independent identity, whereas other selling options may require transferring control of the company to outside interests. A sale to an ESOP also provides a significant financial benefit to valued employees and can assure the continuation of their jobs. In the case of owners retiring or withdrawing from a business, an ESOP allows them to sell all or just part of the company, and reduce their involvement with the business as gradually or suddenly as they like.

The type of "employer securities" that can be sold to an ESOP on a tax favored basis by the seller is common stock with the greatest voting and dividend rights (or convertible preferred stock) issued by a domestic corporation with no stock outstanding that is readily tradable on an established securities market. In addition, the securities must have been held by the seller for six months and must not have been received by the seller in a distribution from a qualified employee benefit plan or a transfer under an option or other compensatory right to acquire stock granted by or on behalf of the employer corporation.

The seller's gain on a sale of stock to an ESOP will be deferred by adjusting the seller's basis in the qualified replacement property. If, however, the replacement securities are held until death, the securities will receive a step up in basis. Thus, the gain on the sale of stock to the ESOP is deferred permanently and the tax is avoided. This tax treatment must be elected in writing on the seller's tax return for the taxable year of the sale. A statement of purchase must also be attached to the seller's tax return (for the year in which the sale occurred or the following year) for each replacement security purchased. Each statement of purchase must be notarized within 30 days of the purchase.

Careful documentation of the transactions is required and the transactions must conform to regulations developed by the Internal Revenue Service, but if constructed properly a sale to an ESOP can provide significant benefits to the selling shareholder, the employees and the company.

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year. The dividends will be taxed as ordinary income when received by the participants. The deduction is allowed for the year the dividend is paid to participants, not the year it is paid to the plan. Additionally, the dividends must be "reasonable".

This provision allows companies to share the benefits of stock ownership with their employees. Many companies have found the pass through of dividends to employees to be a strong motivator because employees receive current benefits from their stock ownership. Care must be taken in drafting the ESOP plan document to determine how the decision to pay dividends is to be made from year to year.

The 1986 Tax Reform Act allows a deduction for dividends paid on ESOP stock to the extent that the dividends are used to reduce the principal and/or pay interest on the ESOP loan incurred to purchase Employer stock. Dividends used to repay ESOP debt must be "reasonable". The dividend deduction for loan repayments is not included for purposes of calculating the 25% deductible contribution limit for leveraged ESOPs.

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An additional ESOP incentive provided by the 1984 Tax Reform Act allows major shareholders of closely held companies to sell their stock ("employer securities") to an ESOP and defer federal income taxes on the gain from the sale. In order for the seller to qualify for such tax treatment the ESOP must own at least 30% of the company's stock immediately after the sale, and the proceeds from the sale must be reinvested in qualified replacement property within a 15 month period beginning three months prior to the date of the sale. The seller, certain relatives of the seller, and greater than 25% shareholders in the company, are prohibited from receiving allocations of stock in the ESOP acquired from the seller in this manner. Lineal Descendants (children, grandchildren) of the selling shareholder may receive an allocation of this stock but as a group (ir more than one) are limited to an allocation of 5% of the stock. Also the ESOP, to avoid a 10% excise tax (of the amount disposed), may not distribute or sell this stock for 3 years. However, exceptions to this are provided for distributions due to death, disability, retirement after age 59-1/2 and other separation from service after a one year break in service.

An ESOP rollover may be attractive to a selling shareholder for a number of reasons. Normally a retiring shareholder only has so many ways that he can sell his stock he can either:

1. Sell his or her shares back to the company, if such a transaction is feasible;

2. Sell to another company or individual if a willing buyer can be found; or,

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G. Preservation of Net Operating Loss Carryforward

The 1986 Act imposed restrictions on the ulitization of a corporation's net operating loss (and certain other tax credits) carryforward following a more-than-50% change in ownership within prescribed period of time. However, if an ESOP acquires at least 50% of the corporation such acquistion of employer stock is not taken into account in determining whether an ownership change has occurred. Therefore, the loss carryforward tax credit may be preserved.

APPENDI.. SUMMARIES OF STATE LEGIS...ION

This appendix provides a summary of statutes concerning employee ownership of each state discussed in the preceding sections. Following each entry is a citation which refers to the compiled laws for that state or the source of the information. NCEO refers to the National Center for Employee Ownership. To facilitate comparison between state laws, their provisions have been grouped according to the following categories:[1]

INCREASING AWARENESS

- Policy declaration
- Educational programs (employees and business community)
- Interdepartmental awareness (annual reports and evaluations)

FACILITATING EMPLOYEE OWNERSHIP

- Method of notification
- Tax credits for contributions to ESOPS
- Other financial advantages
- ESOP exemption from securities regulations
- Legal recognition of employee cooperatives

PROVIDING TECHNICAL ASSISTANCE

- Provide actual assistance
- Provide help in finding assistance
- Provide financing for assistance
- Provide actual funds for assistance
- Types of assistance
  - -Feasibility studies
  - -Training and advice: financial, marketing, managerial, operational, accounting, legal
  - -Locating financial assistance

PROVIDING FINANCIAL ASSISTANCE

- Type of financial assistance
  - Interest rate subsidies
  - Below market interest rates
  - Loan guarantees
  - Loans
- Method of financing
  - Issuance of revenue bonds
  - Local non-profits
  - Revolving or Trust funds
  - Direct assistance from governmental agency

ENCOURAGING EMPLOYEE PARTICIPATION

- Financing contingent on participation requirements
- Legal recognition of cooperative structure
- Definition of employee ownership specified
- Special requirements on voting rights in ESOPs

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[1] This grouping was adapted from Corey Rosen, "Employee Ownership State and Local Agenda" *Ways and Means* (1981) pp.3-6, and *A Legislative Guide to Employee Ownership* (Arlington, VA: National Center for Employee Ownership, 1985).

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