

401(k) and Employee Ownership: Employee Stock Ownership Plans

If you work at a publicly traded company (one whose stock is listed on a stock exchange), or at one of the thousands of privately owned businesses that have given employees an ownership share in the company, read on.

Employee ownership occurs when you own your employer's stock through a company-sponsored program. This ownership is intended to align the interests of employees and employers for the benefit of both. For your employer, it generates workforce commitment, profitability, and growth. For you, it serves your long-term goals-savings, security, and wealth. Employee ownership is a way for you to share in your employer's financial success. Who better to own a piece of corporate America than you and the other employees at your company who collectively have the greatest impact on your company's bottom line and long-term success.

Companies that share ownership with their employees do so through an employee stock ownership plan (ESOP), a 401(k) plan, or a plan that combines both (KSOP). The government encourages this practice by providing special tax advantages to both the company and the employee owner. Other employees enjoy ownership in company stock through programs such as stock purchase plans (section 423) or incentive stock option plans (section 421). Stock purchase and stock option plans are not considered tax-qualified retirement plans under federal law and are subject to separate tax code rules.

Employee Stock Ownership Plans (ESOPs)

An employee stock ownership plan (ESOP) is a qualified defined contribution plan designed to provide employees with stock ownership in their company. ESOPs are required by law to invest primarily (at least 50 percent of its assets) in company stock. ESOPs can be either leveraged or non-leveraged. A leveraged ESOP has a special ability to borrow money to purchase the sponsoring corporation's stock. As the loan is repaid, the stock is allocated to the employees. This can be a useful financing technique for the company and its employees. It is most often used when an owner/manager of a company wishes to sell the company to his or her employees. A nonleveraged ESOP is like a deferred profit sharing plan in which the company contribution is made in the form of company stock or the company contribution is used to purchase company stock. It can also be allocated to the employees in the form of a 401(k) match.

ESOP Rules That Might Affect You

Because ESOPs receive special tax treatment, they are subject to a number of rules that do not necessarily apply to 401(k) and other defined contribution plans.

- If an ESOP is offered at a privately held company, the company is required to annually obtain an outside appraisal of the value of the company stock. The appraisal is done by a person independent from the company who reports directly to the ESOP trustee.
- Certain ESOPs are required to allow you to diversify your stock holdings once you have 3 years of service. Otherwise, when you have participated in an ESOP for more than 10 years and are age 55 or older, you can diversify up to 25 percent of the value of your assets in each year during the first 5 years. In the sixth year, that figure increases to 50 percent. Some companies permit you to diversify at a younger age. When diversification is available to you, it can be accomplished by allowing you to transfer your cash account balance to your 401(k) plan, your IRA, or as a distribution to you.

- You may have the choice of using a dividend pass-through system, which means that you may be able to deposit the dividends pretax into your 401(k) plan or receive the dividend as taxable income.
- ESOPs must, by law, own the "best" class of company stock. The "best" class of company stock must have the greatest dividend and voting rights; for example, common stock or convertible preferred stock. The ESOP trustee is responsible for voting the shares held in the ESOP. However, there are special issues that may arise that require a direct vote by the participants of the ESOP. Publicly traded companies must allow participants to vote on issues that regular shareholders are allowed to vote on.

In many cases, owning company shares through an ESOP plan gives you a say in some of the choices your company makes. If you own company stock registered with the SEC, you may have the right to be a part of the governing process for some special company matters put to a vote of shareholders. If you own unregistered stock, your plan may have to solicit your approval or disapproval when your company is considering corporate matters that could affect your stock, including but not limited to:

- Merger or acquisition
- Recapitulation
- Reclassification
- Liquidation, dissolution, or sale of substantial assets