WELLS FARGO ADVISORS

Employee stock ownership plans

Giving employees a vested interest in the company's values

An employee stock ownership plan (ESOP) is a tax-qualified, defined-contribution plan. An ESOP can help a business motivate employees to perform better, give employees a vested interest in increasing the company's value, take advantage of favorable tax treatment, and create a market for closely held company shares.

What is an ESOP?

An ESOP is a tax-qualified, defined-contribution retirement plan designed to invest primarily in employer securities. ESOPs are subject to the same nondiscrimination rules that apply to other qualified plan types. All employees are eligible to participate as long as they meet minimum age and service requirements. The sponsoring company can contribute shares of its securities to the ESOP, but more commonly, the ESOP purchases shares from shareholders for the participating employees' benefit. Shares are then allocated to employees based on each employee's compensation. Upon retirement, death, disability or termination, an employee receives his or her account's value according to the terms of the plan document.

What to consider when sponsoring an ESOP

Creditworthiness of the company. Bank financing is often used to purchase shares for the ESOP. The company usually guarantees and pays the ESOP loan.

Expenses. Establishing an ESOP requires incurring consulting and set-up fees, and as a qualified plan, it will incur ongoing administration fees. In addition, if the company is closely held, an ESOP must be valued each year by an outside business-valuation company.

Management. If an owner (or owners) is contemplating selling all of his or her shares to an ESOP, there must be a management team in place capable of running the company after the sale.

Contribution limitations. Like all qualified plans, there is a statutory limitation on ESOP plan contributions — currently 25% of eligible compensation. If the total allowable contributions are insufficient to pay the principal and interest on the acquisition loan, the use of an ESOP may not be possible.

Cash flow. The company must have sufficient liquidity to pay off the acquisition loan and to repurchase stock to pay cash distributions when employees leave the firm or retire.

You can count on us

Although an ESOP plan offers many benefits, it may not be right for every business. Wells Fargo Advisors offers a range of plans and can help you match the right plan with your needs and objectives.

Can you pair an ESOP with another plan?

An ESOP can be paired with another qualified plan — usually a 401(k). This pairing can be structured in one of two ways:

Separate plans. Each plan is operated independently; however, limitations on combined contributions cannot be violated.

Combined "KSOP" plan. Combining an ESOP with a 401(k) requires a third-party administrator with the capability of handling both types of plans. Under a KSOP arrangement, company contributions are generally made in the form of company stock. Employee salary deferrals into the plan are usually invested in mutual funds or similar vehicles.

Why sell shares to an ESOP?

Shareholders who sell company stock to an ESOP may realize these benefits:

- The ESOP can be a market for owners' closely held shares
- If the ESOP owns at least 30% of the outstanding shares and the company is a C corporation, the selling owner may be able to defer paying taxes on the gain realized from the sale. To take advantage of this "1042 exchange" tax treatment, the selling owner must use the sale proceeds to purchase qualified replacement property (QRP) consisting of stocks, bonds or notes of domestic corporations. The QRP takes on the cost basis of the stock sold to the ESOP. Any subsequent QRP sale will trigger taxes on any capital gains. Please consult your tax advisor for more information.

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