95th Congress }
2d Session }
COMMITTEE PRINT

ESOPs and TRASOPs

An Explanation for Employees

Prepared by the Staff of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

NOVEMBER 1978

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
35-086 WASHINGTON : 1978

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402
Stock No. 052-070-04736-4

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM D. HATHAWAY, Maine
FLOYD K. HASKELL, Colorado
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York

CARL T. CURTIS, Nebraska
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
PAUL LAXALT, Nevada
JOHN C. DANFORTH, Missouri

MICHAEL STERN, *Staff Director*
GEORGE W. PRITTS, Jr., *Minority Counsel*
JOHN E. CURTIS, Jr., *Counsel*

CONTENTS

ESOPs and TRASOPs—An Explanation for Employees

Introduction

Since 1974, the United States Congress has by legislation created two programs which are designed to give employees the chance to acquire a stock ownership in their employer. In the Employee Retirement Income Security Act of 1974, Congress first defined the employee stock ownership plan, or "ESOP" as it is usually called. In the Tax Reduction Act of 1975, and the Tax Reform Act of 1976, Congress implemented, and expanded, a different form of employee stock ownership plan, usually called a "TRASOP." The ESOP and TRASOP provide stock ownership for each employee without requiring the employee to spend any of his own money; his investment is the time and effort he puts into his job to make his employer profitable. Although some ESOPs and TRASOPs permit or require employees to put money into the ESOP or TRASOP, most provide that the employer will make all necessary ESOP and TRASOP payments.

What Is An ESOP or TRASOP?

An ESOP or TRASOP is an employee benefit plan which is "qualified" under the Internal Revenue Code. That is, it has been written in such a way that it satisfies the requirements of the Internal Revenue Code. As a qualified plan, the ESOP or TRASOP is required to be operated for the "exclusive benefit" of participating employees (and their beneficiaries).

How Does an ESOP Work?

The ESOP is designed to acquire stock of an employer for the benefit of employees. To do so, the ESOP may borrow money from a bank or other lender (including the employer). The stock is bought directly from the employer or from shareholders. When the ESOP borrows money, the employer guarantees to the lender that the ESOP will repay the loan. Employees are never required to assume any obligation for the repayment of the money borrowed by the ESOP. The employer is required to make annual payments to the ESOP in an amount at least equal to the amount the ESOP must pay on the money it borrowed. These amounts are then paid by the ESOP to the lender each year.

The employer is also permitted to make additional payments of cash or stock to the ESOP each year. The amount of these additional payments is usually decided by the board of directors of the employer. Because the ESOP is "qualified," the employer gets a tax deduction for all payments to the ESOP, up to a maximum limitation established by the Internal Revenue Code. This tax deduction is available for the required employer payments and any additional payments, and its effect is to reduce the annual cost of the ESOP to the employer. Cash put into the ESOP by the employer will be used primarily to purchase employer stock. In addition, this cash may be invested temporarily in savings accounts or certain other permitted investments.

How Does a TRASOP Work?

An employer which adopts a TRASOP may claim a tax credit against its Federal income taxes if it makes payments of its stock, or cash which is used to purchase its stock, to the TRASOP. The amount of the credit which the employer may claim is limited by law, and part of it may only be claimed if the employees make payments to the TRASOP which match the payments made by the employer. Only employers which buy things like equipment and machinery are generally able to adopt a TRASOP, because the tax credit is based upon the amount spent for things like capital equipment and machinery.

What Do Employees Get as Part of the ESOP or TRASOP?

Each year, all amounts of cash and employer stock paid by the employer and employees to the ESOP, and employer stock bought with cash held in the ESOP, are allocated among the accounts of employees who are participating in the ESOP. This allocation is usually done on a formula related to each employee's salary or wages as compared to the salaries or wages of all other participating employees. Take as an example an employee who earns $10,000 per year from a company where the total salaries of all participating employees equal $500,000. That employee's salary or wages is 2 percent of the total, and so his share of allocations of cash and employer stock under the ESOP for that year would be 2 percent. If the employer contributed $100,000 to the ESOP during the year, the employee's share would be $2,000.

A trust will be established (under the ESOP) to hold the cash and employer stock paid to the ESOP for the benefit of employees (and their beneficiaries). It is created by a separate written trust agreement and will be administered by a trustee. This is done to assure that each employee's interest in ESOP assets will be protected.

Under a TRASOP, allocations to employees' accounts is done in the same way as under an ESOP, except that the maximum of any employee's salary or wages which can be taken into account under a TRASOP is $100,000 each year.

What Do I Own in the ESOP or TRASOP?

An ESOP, like most employee benefit plans, is designed to benefit employees who remain with the employer the longest and contribute most to the employer's success. Therefore, an employee's ownership interest in cash and employer stock held in the ESOP is usually based on his number of years of employment with the employer. The employee's ownership interest in the ESOP is called his "vested interest," and the language in the ESOP which determines his vested interest is called a "vesting schedule." Although there are many vesting schedules which may be used by an ESOP, most vesting schedules are set up so that the longer an employee stays with the employer, the greater his vested interest becomes.

If an employee terminates employment with the employer for any reason other than his retirement, or, in some cases his death, his vested interest will be determined by looking at the vesting schedule and measuring how many years he has worked for the employer. All cash and employer stock in which he does not have a vested interest because he has not worked for the employer for enough years will be treated as a "forfeiture," to which the former employee will not be entitled. Forfeitures are usually allocated among the ESOP accounts of the remaining employees on the same basis as employer payments to the ESOP are allocated.

The vesting schedule applies only where an employee does not end his employment because of retirement or, in some cases death. If an employee retires, or, in some cases if he dies, he will immediately have a 100-percent vested interest in all ESOP assets held for him.

Under a TRASOP, each employee automatically has a 100 percent vested interest in all amounts which he or his employer contribute to the TRASOP and which are allocated to his account. Therefore, there are never any forfeitures under a TRASOP.

When Do I Receive What I Own From the ESOP or TRASOP?

Even though employer stock and cash are usually put into the ESOP or TRASOP for an employee each year, and put into a special account under his name, he will normally not be able to actually get any employer stock and cash from the ESOP or TRASOP until after his employment with the employer terminates and he ceases to be a participant in the ESOP or TRASOP.

After an employee's participation in the ESOP or TRASOP ends, he (or his beneficiary) will be eligible to receive a payment of his vested interest.

There are many permissible times and methods for making the payment to him from the ESOP or TRASOP. For example, it may provide that payment will be made as soon as possible after an employee's termination of employment. On the other hand, it may require that any payment be deferred until some later time, such as the employee's death or his normal retirement date. However, payment of a former employee's vested benefit must start soon after his death or attainment of age 65. Payment may be made to a former employee (or his beneficiary) in a lump sum, or it may be made in installments.

Payment of an employee's vested interest from an ESOP or TRASOP may be made in cash or employer stock, as determined under the ESOP or TRASOP, subject to the right of the former participant (or his beneficiary) to demand a distribution of his benefit in shares of employer stock.

What Can I Do With My Shares of Employer Stock From the ESOP or TRASOP?

Once a former employee (or his beneficiary) gets his shares of employer stock from the ESOP or TRASOP, they are his property and he can do what he wants with them. He can vote the shares of employer stock at shareholders' meetings, receive any dividends paid on the stock by the employer, and he may keep the stock as long as he wishes.

However, if he wishes to sell or otherwise transfer ownership of the stock to a third party, he may be required by the terms of the ESOP or TRASOP to first offer to sell the stock to the employer and the ESOP or TRASOP. This requirement is called a "right of first refusal" for the employer and the ESOP or TRASOP; they can exercise this right and purchase the employer stock at its fair market value. Generally, the price offered by the prospective buyer or the price at which the stock is publicly traded would establish the fair market value for the stock. The purpose of this right of first refusal is to protect the employees or the employer by preventing the stock from being acquired by outside parties who have no interest in the employer or the ESOP or TRASOP and to protect the employer whose stock is closely held from violating any Federal law as a result of having its stock sold when it does not satisfy certain Government rules.

In addition, at the time the former employee (or his beneficiary) receives employer stock which is not publicly traded from the ESOP or TRASOP, he must be given a "put option," the right to demand that the employer buy his shares of employer stock at their fair market value. In such a case, the

ESOP or TRASOP may provide that the ESOP or TRASOP may buy the employer stock, although the ESOP or TRASOP may not be required to buy the stock under the put option. The purpose for including a put option is to assure that each former employee (or his beneficiary) will have someone available to buy his shares of employer stock if he wishes to sell.

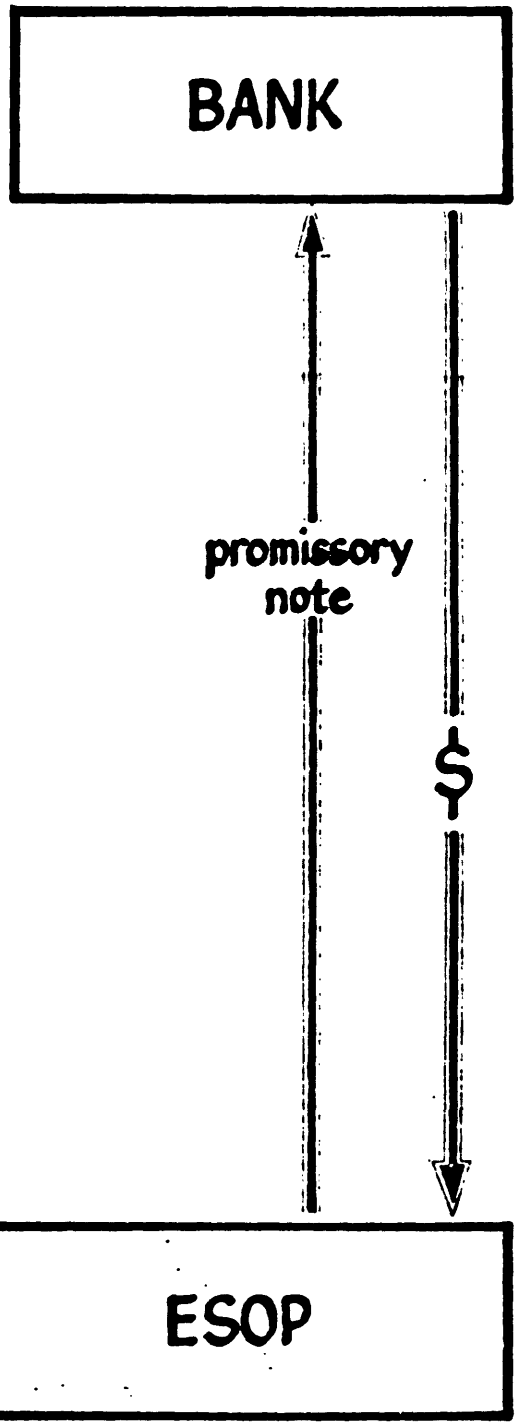
How Does the ESOP or TRASOP Help My Employer?

The employer benefits primarily from the favorable tax treatment it receives for all payments made to the ESOP or TRASOP. As explained before, an employer receives a tax credit for amounts paid to a TRASOP and a tax deduction for amounts paid to an ESOP. This is very important when the employer uses the ESOP as a means of borrowing money. In order to understand how the use of the ESOP to raise money benefits the employer, a comparison must be made with the usual method of borrowing money.

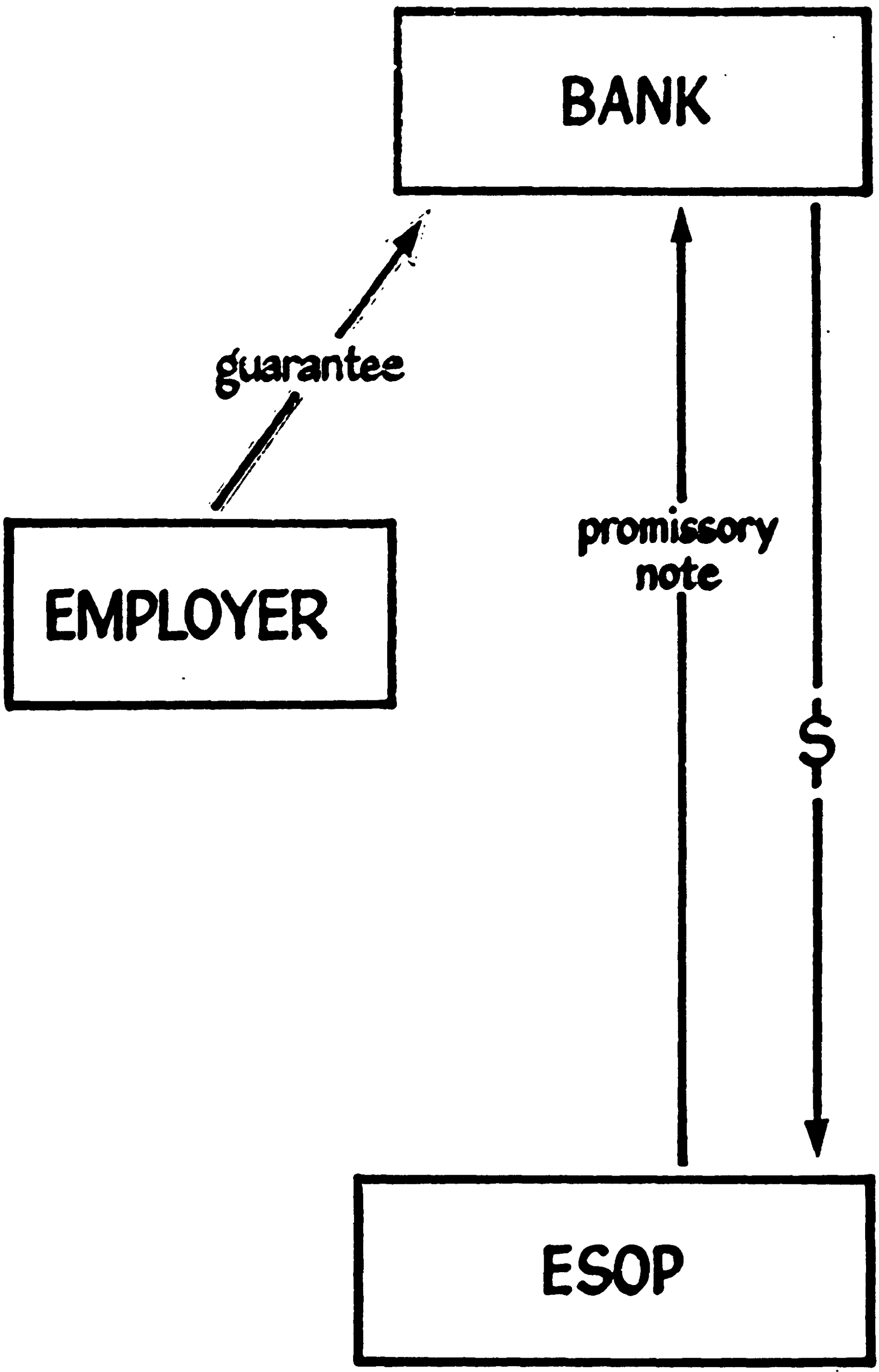
If an employer which does not have an ESOP wishes to borrow money to build a new building, expand production, or for any other reason, the employer would go to a bank to borrow money. When the employer repays the loan, it will also pay interest on the loan, just like an individual person would do with a charge account. Although the interest payments would be tax deductible, the principal payments on the loan would not. This means that the employer would first figure its taxable income, then pay its income taxes, and then make its payment on the loan.

The use of an ESOP for this purpose greatly helps the employer because of the effect it has on the employer's taxes.

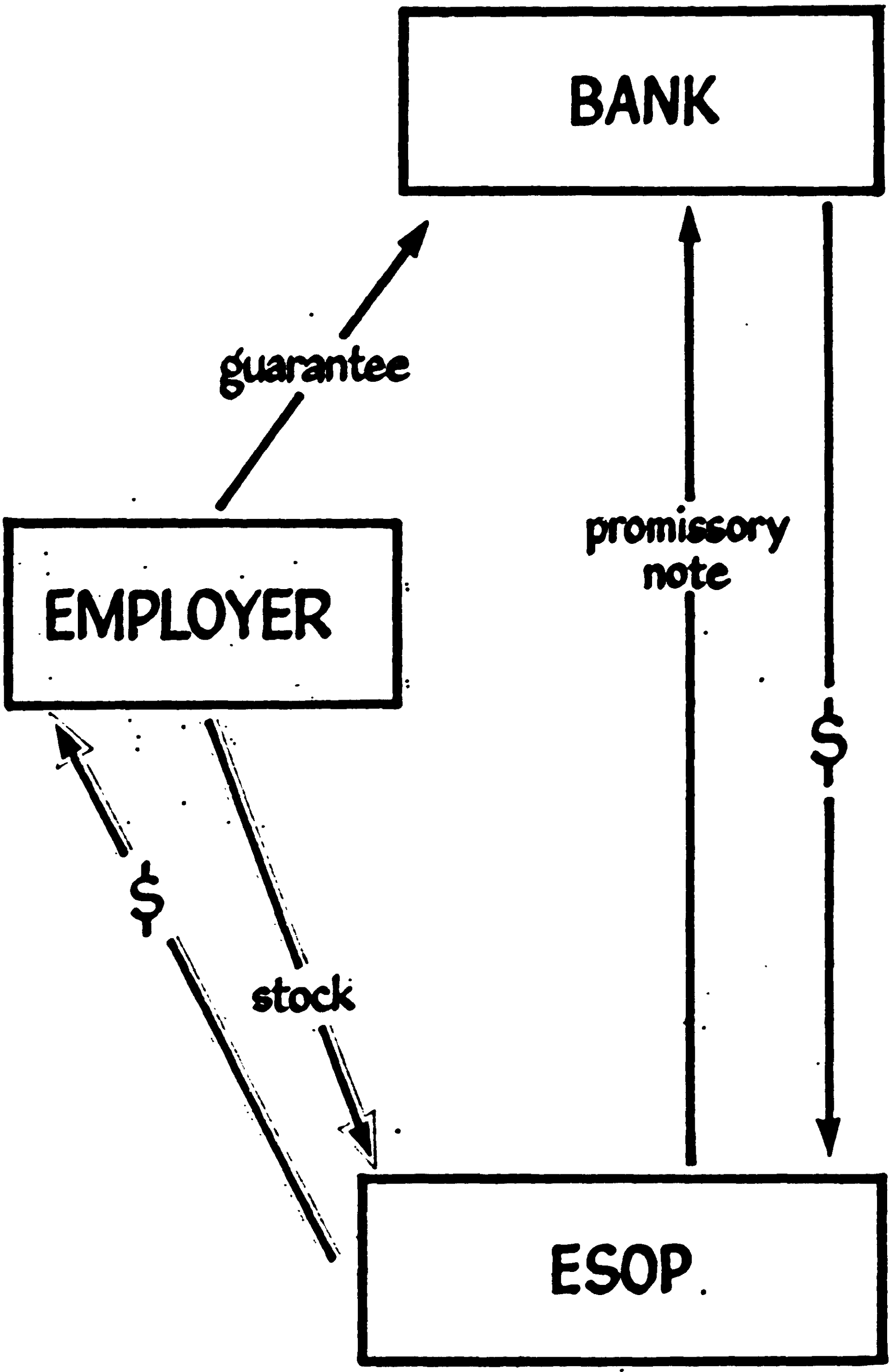
In this situation, the ESOP borrows the money from a bank, and signs a promissory note for the money:



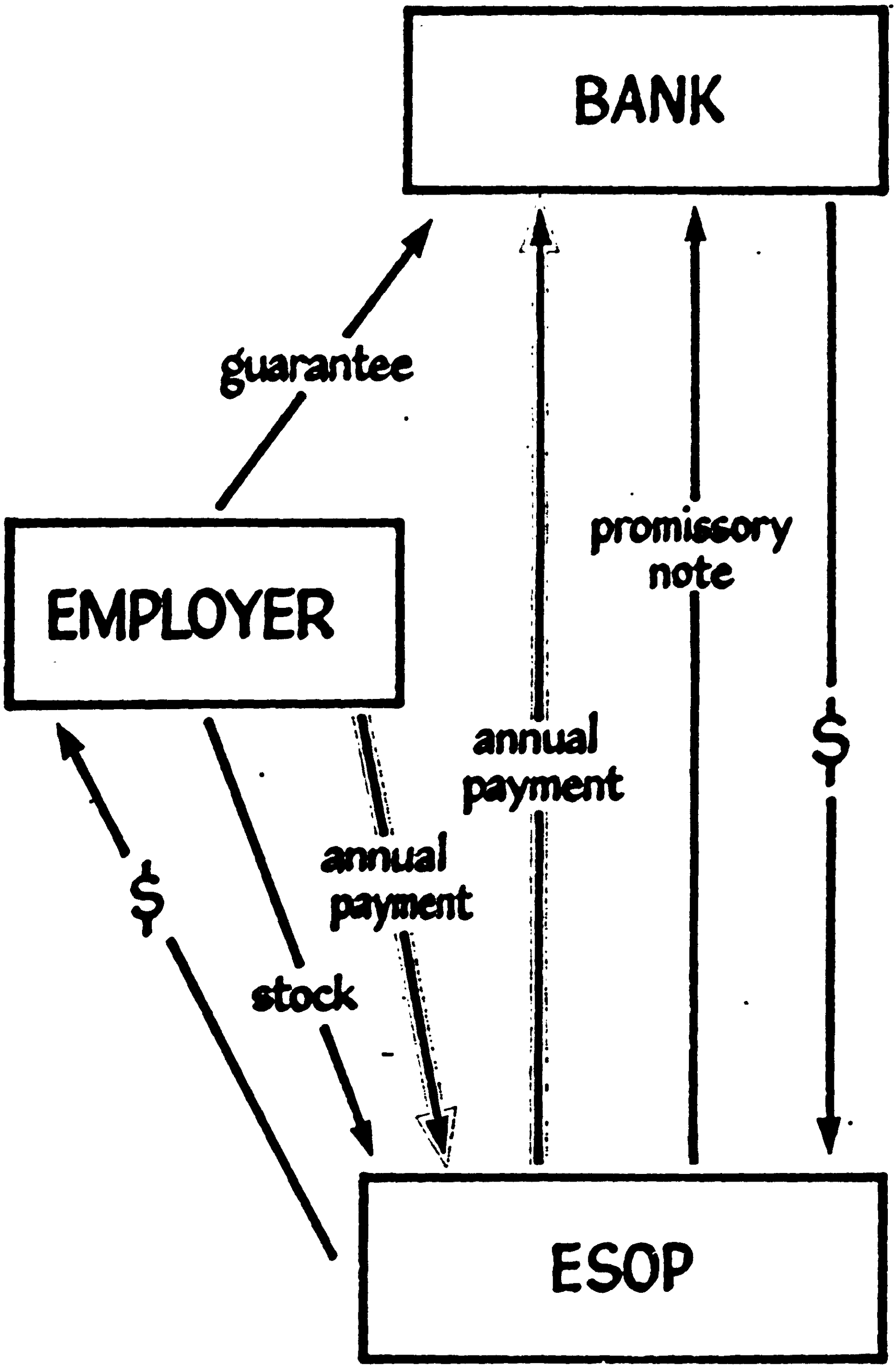
As part of the ESOP loan, the employer gives a written guarantee to the bank, promising that the ESOP will repay the loan and that each year the employer will pay to the ESOP enough money to permit the ESOP to make its annual repayment of the loan:



The ESOP then uses the money from the loan to buy stock from the employer:



Each year, the employer makes a tax-deductible payment to the ESOP, sufficient to let the ESOP make its annual debt repayment to the bank:



The effect of this transaction is to allow the employer to borrow money from a lender and repay the loan with tax-deductible dollars. Since the principal and interest repayments are deducted before the employer's taxable income is determined, the taxable income is lower than through regular borrowing and the employer's taxes are reduced.

Since the major portion of the ESOP or TRASOP assets are used to buy employer stock, the value of each employee's ESOP or TRASOP benefit is directly tied to the financial success of the employer. Also, the employer, as a result of the use of an ESOP or TRASOP, benefits because employees understand that their work performance directly affects the financial success of the employer and the value of ESOP or TRASOP assets. After all, they now own part of the company. This should encourage employees to work more productively and increase the profitability of their employer.

Another benefit to the employer is that the ESOP provides its shareholders with a buyer for their stock if they wish to sell. For stockholders of a small employer, this is a tremendous advantage, and it could also assist the employer in attracting additional investors.

Summary

The adoption of an ESOP or a TRASOP provides benefits for the employer, its shareholders and its employees. Our tax laws encourage the establishment and use of ESOPs and TRASOPs. Congress has passed seven laws in the past 6 years to encourage employers to consider ESOP and TRASOP. Will it continue? Senator Russell B. Long, chairman of the Senate Finance Committee, has repeatedly stated: "Just as in 1862, when Congress passed a law to allow Americans who had very little money to own and develop up to 160 acres of land, we should now give Americans the opportunity to become owners of our growing frontier of new capital (stock). The way to do this is through laws which encourage the development of programs like ESOP."

O