

UPDATE

News of Developments in the Financial Sector and Related Areas

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Utilization of an ESOP/KSOP

Ask UPDATE

[Questions from Readers]

Utilization of an ESOP/KSOP

An Employer Stock Ownership Plan ("ESOP") is an employee benefit plan designed to allow employees to become owners of stock of their employer. The ESOP invests primarily in employer's stock for the benefit of employees. To set up an ESOP, an employer creates a trust for its employees and funds the trust by (i) contributing its shares, (ii) contributing cash to buy its shares, or (iii) having the ESOP borrow money to buy its shares and then making contributions to the ESOP to repay the loan. The shares are held in trust under separate accounts for each participating employee. Generally, the employee receives the stock or a cash equivalent when he retires, becomes disabled or otherwise is no longer employed by the company. There are a number of advantages to having an ESOP, including the following:

- A closely held company can borrow money to purchase company stock with pre-tax dollars from shareholders who want to sell their stock;
- The owner of a closely held company may wish to sell his stock and to defer the capital gains on the sale;

- Proceeds from the sale of stock by the employer to the ESOP can be used for capital expenditures, retirement of debt and other business purposes;
- The ESOP gives employees a tax deferred benefit, allowing them to share in the growth of the company while at the same time creating employee satisfaction and longevity;
- The ESOP creates a market for stock in a closely held business; and
- The ESOP results in attracting and retaining employees.

There are basically two types of ESOPs, one being a non-leveraged ESOP with the employer contributing its shares to the plan and the other is a leveraged ESOP which borrows money to buy the employer's stock. A significant advantage of an ESOP is in a situation where a single shareholder or family owns a company and has made a decision to sell the company because of age, illness or other reasons. In this situation, if the owner sells to a third party, he will lose control of the company and possibly suffer immediate capital gains. If the owner sells to an ESOP, he may defer capital gains, continue to maintain control of the company and invest the proceeds in a portfolio of stocks and bonds while at the same time rewarding employees of the company. In this situation, once a company is then acquired by the ESOP, by making a subchapter S election for tax purposes, the company becomes virtually a tax-free operating entity by passing the tax obligations to the tax exempt ESOP trust,

which is not liable for the payment of income taxes. This results in a significant benefit for the company and the ESOP, as the new shareholder, in that the pretax cash flow enables the ESOP to rapidly repay any transaction debt and to fund future growth and benefits to employees as owners of the company through the ESOP. Many employers have established a 401(k) plan for their employees, while others have established ESOP plans. A 401(k) allows an eligible employee to contribute part of his salary to a retirement plan on a tax deductible basis, while at the same time allowing matching contributions by the employer equal to some percentage of what the employee contributed to the plan, such as 50% of the employee's 401(k) contribution, but not more than 3% of his salary. A combined 401(k) and ESOP is known as a *KSOP*. ESOP stock purchased with a loan can be allowed as a matching contribution under a 401(k) plan. For example, if an employee contributes \$2,000 to a 401(k) plan with a 50% matching formula, \$1,000 worth of stock would be allocated to that employee as the annual matching contribution. This has the advantage of allowing all employer cash contributed to the plan to be used to repay the ESOP loan, thereby resulting in the earlier loan repayment. This also allows an incentive for employees to make 401(k) deferrals. In this situation, all cash contributed by the employer will be used to repay the loan using tax deductible dollars, while at the same time the cash doubling as a 401(k) matching contribution. Even if no loan is involved, the *KSOP* can still be used. The employer could contribute newly issued shares each year to the ESOP equal to the matching contribution of the employees, thereby improving cash flow to the employer, since a tax deduction is available to the employer for the fair market value of the contributed stock. The cash, which would have been otherwise used to make the employer contribution, may be retained by the company for capital expenditures

and other purposes. An ESOP or *KSOP* is an effective tool in providing incentives to both employers and employees.

Ask UPDATE

[Questions from Readers]

QUESTION: What are the costs to a bank holding company when issuing trust preferred securities? [SEE: **UPDATE**, January 2006, *Trust Preferred Securities*]

RESPONSE: Fortunately, because of the competition among placement agents, there are basically no costs either initially or on an ongoing basis, except for the interest on the trust preferred securities. In recent years the placement agents and investors have picked up the trustee administration costs both initially and yearly, saving the issuing bank holding company thousands of dollars over the life of the securities. Generally, the placement agent will also reimburse the issuer of trust preferred securities for legal expenses. Issuers of trust preferred securities no longer have to pay an underwriting or placement fee which at one time was in the range of three percent. Trust preferred securities are an excellent vehicle for use in funding branch expansions, acquisitions, retirement of outstanding indebtedness, core growth and stock repurchase programs. Trust preferred securities are advantageous to bank holding companies because they are treated as equity for bank regulatory purposes and as debt for tax purposes.

*If you have a question regarding a topic appearing in **UPDATE** or a suggestion for a topic you would like to see in a future issue of **UPDATE**, please contact:*

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