Rewarding Employees with an ESOP

(A Case History)

Meet Jill. Jill is an assistant in the Human Resource Department of American Lock Company (ALC), a commercial distributor of door and lock systems serving the Midwest. Jill started with ALC 40 years ago, right out of high school. Her role has expanded as the company has grown and Jill completed the Certified Employee Benefits Specialist certification ("CEBS"). Jill plans to retire in 7 years when she reaches age 65.

Twenty years ago, ALC implemented an ESOP when the family that owned it decided to sell it to the ESOP. ALC also has a 401(k) Plan.

ESOP Overview: An ESOP is a qualified retirement plan very similar to a profit sharing plan. When the transaction is complete the ESOP owns a part of or all of the equity of the business. The ESOP then allocates a portion of the equity of the business that it owns to the ESOP participant/employee accounts over time. An ESOP can be used as a succession planning strategy for almost any successful business. Typically, businesses with 20 or more employees and that have EBITDA of $1,000,000 or more are good candidates for the ESOP Strategy. The business typically has a team of senior managers that currently manage the day to day operations of a business or will, in 1 – 5 year time frame, be able to manage the day-to-day operations. If such senior management team does not exist, the business owner needs to be willing to develop a senior management team over the next 1 -5 year time frame.

An ESOP provides Jill with the following enhanced work environment and benefits:

- Creates a "We Can" vs. an "Us and Them" attitude and engages all employees in their works
- Provides employees with increased retirement plan contributions and an equity interest without requiring the employees to make additional contributions
- Makes a significant difference in the funds available for the retirement of long-term employees
- Creates a competitive advantage in employee retention and recruiting by offering employees a benefit not available from other employers in the community
- Allows employees to maintain positions and remain employed in their community

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Comparison of 401(k) only vs. 401(k) with ESOP

- Jill's 401(k) Account is projected to have a value of about $190,000 at retirement
- The 401(k) would be the only retirement benefit Jill would have if no ESOP was implemented
- Jill's ESOP is projected to have an account balance of approximately **$600,000** at retirement
- Without the ESOP Jill would have $600,000 less for retirement
- Jill is not being taxed on retirement assets from either plan until they are distributed to her and she has IRA rollover capabilities from both plans
- Jill is eligible to diversify her ESOP Account if she desires to do so to reduce the risk associated with having a highly concentrated equity position in a privately-held company

Diversification is available to ESOP Participants:

- The year a participant reaches age 55 and has 10 Years of Participation in the ESOP
- The 1st 5 years the participant may diversify up to a cumulative 25% of their ESOP shares
- In the 6th year, the participant may diversify up to a cumulative 50% of their ESOP shares
- The ESOP or ALC purchases the number shares elected for diversification
- The proceeds from the sale of diversified sales are transferred to the 401(k) and invested as the participant selects based on the 401(k) investment options

For more on Saving Taxes and Transaction Fees with ESOPs conduct Brian A. Eagle, J.D. , Eagle & Fein, P.C., 8500 Keystone Crossing, Suite 555, Indianapolis, Indiana 46240, 317-726-1714, Beagle@eagleandfein.com