

**RUTGERS**

School of Management  
and Labor Relations

NJ/NY Center for Employee Ownership

4th Annual Conference

# Employee Stock Ownership Plans and Equity Compensation

2-day Virtual Format

*Bringing together the worlds of research, policy and practice*



## ESOP Plan Design

**Presented by:**

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# Joseph E. Marx

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Joe has over 30 years of experience in employee benefits and consulting on ESOPs, with a passion for expanding and enhancing employee ownership. He enjoys being a strategic partner with employee-owned companies.

He engages with business owners and companies to define their objectives and design, implement, and provide communications for ESOPs. He specializes in analysis related to repurchase liability planning, share repurchase strategies, and sustainability.

Joe graduated summa cum laude with a Bachelor of Business Administration degree from Niagara University in New York.

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He is also a Certified Public Accountant.

CPA is an educational certification and hold not provide accounting services on behalf of companies of Principal Financial Group®.



# Today's Focus and Agenda

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- Understand the basics of ESOP plan design
- Learn how plan design can impact your company objectives
- Get your questions answered...Q&A at the end or post your questions in the chat/questions section



# Definitions

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- Know what Definitions are used in your other qualified retirement plans
  - Compensation
  - Disability
  - Highly Compensated Employee
  - Normal Retirement Age
  - Year of Service
    - Eligibility
    - Benefits
    - Vesting



# Eligibility

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## Age requirement

- Maximum is 21

## Service requirement

- Maximum is 1 year if using a vesting schedule
- May require 2 years with full and immediate vesting
- Option of more liberal rules for the first plan year



# Eligibility

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Certain classes may be excluded as long as the plan can meet coverage and participation requirements:

- Union Employees
- Non-Resident Aliens
- Leased Employees



# Plan Entry

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Must enter the plan the earlier of:

- The first day of the plan year which begins after the date the employee completes the statutory age and service requirements, or
- Six months following the date the employee completes the statutory age and service requirements



# Plan Entry

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Typical entry dates:

- Semi-annual
- Quarterly
- Monthly
- Immediate
- First day of the Plan Year





# Contribution Allocation Requirements

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## Service Requirement

- Typically 1,000 hours of service

## Employment Requirement

- Typically must be employed on the last day of the plan year

May be waived for death, disability, and retirement



# Contribution Allocations

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Plan must have a definite allocation formula

- Proportionate to each participant's compensation
- Per capita
- Points allocation based on compensation and service

Plan must define compensation



# Compensation

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Definition

Exclusions

- Overtime?
- Bonuses?
- Commissions?
- IRS limit: \$290,000 (2021)

Include full-year compensation for participants who enter the plan mid-year?



# Earnings Allocations

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## Cash Accounts

- Pro rata to cash balances

## Stock Accounts

- Dividends on allocated shares
- Dividends on unallocated shares



# Minimum Vesting Schedules

6-Year Graded	
Years	Vested %
0	0
1	0
2	20
3	40
4	60
5	80
6	100

3-Year Cliff	
Years	Vested %
0	0
1	0
2	0
3	100

*More generous vesting schedule may be used*



# Vesting – Year of Service

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Typically a plan year in which a participant works 1,000 hours

- Can use a smaller number of hours
- Can use an equivalency method rather than actual hours
- Can use elapsed time method



# Vesting – Year of Service

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May disregard

- Service before the plan's effective date
  - Could give partial credit before the effective date
- Service before age 18



# 100% Vested

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- Fulfill requirements of vesting schedule
- Retirement
- Death (optional)
- Disability (optional)
- Partial plan termination
- Plan termination or complete discontinuance of contributions





# Forfeitures

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Terminate before 100% vesting

Forfeiture event

- After 5 consecutive breaks in service
- Entire vested account balance distributed

Forfeiture proceeds

- Reinstate previously forfeited balances
- Allocated to eligible participants
- Pay plan expenses



# Distributions

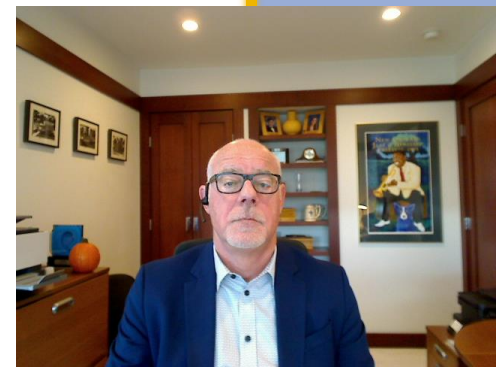
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Termination due to death, disability, or retirement

- No later than the plan year following the event

Other termination

- No later than sixth plan year after the plan year of termination
- Can be delayed further with leveraged ESOPs in some cases



# Distributions

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## Forms of ESOP Distributions

- ESOP participants have a right to demand distribution in the form of stock (subject to “put rights”)
  - Exceptions:
    - ✓ Charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a qualified plan trust;
    - ✓ Banks that are prohibited from purchasing their own stock; or
    - ✓ Plan Sponsor is an S Corporation (although an S Corporation may still distribute stock with the requirement that it be immediately sold to the company or ESOP)
- Cash distributions are permitted if exceptions apply or certain assets of the ESOP are not invested in stock



# Distributions

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## Method of ESOP Distributions

- Lump Sum
- Installments
  - Over a period not exceeding 5 years
  - Extension for large balances



# Distributions - Diversification

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Qualified participants are permitted to diversify a portion of the employer stock in their accounts

Qualified participant

- Completed at least 10 “years of participation” AND
- Attained age 55

Years of participation – should be defined

- Years with an account balance
- Years eligible for a contribution
- Years of vesting service



# Distributions - Diversification

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Ways to satisfy diversification election:

- Offer at least 3 investment options in ESOP
- Transfer to another plan with at least 3 investment options
- Distribution



# Compliance Testing

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## 415 Testing (Maximum Annual Additions)

- Lesser of Contribution or Fair Market Value of Shares Released
- Limitation Year

## 410(b) Coverage Testing

- Limit Highly Compensated Employees (HCEs) to Top Paid Group
- Include failsafe language

## 409(p) Testing

- Include provisions to make sure test passes



# Voting Rights

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No requirement to pass voting rights through to employees of closely held companies

- Exceptions
  - Merger or consolidation
  - Recapitalization
  - Liquidation
  - Dissolution
  - Sale of substantially all assets





# Other Plans Design Provisions to Consider

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- Distribution provisions for Qualified Domestic Relations Orders (QDROs)
- Segregation of Accounts
- Rebalancing of Accounts



# Questions ?

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