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# Employee Stock Ownership Plans (ESOPs): An Overview

## Introduction

An Employee Stock Ownership Plan (ESOP) is a defined contribution (DC) pension plan that invests primarily in shares of stock issued by one employer, called *qualifying employer securities*. Employees accrue shares of their employers' stock in individual accounts as part of their compensation. After separating from employment or retiring, employees receive the cash value of their shares, which can be used as part of their retirement income.

Company owners commonly use ESOPs to transfer ownership. While company owners may have several avenues by which to sell their companies (e.g., initial public offerings or direct sales to other owners or to private equity firms), some owners find ESOPs attractive because, in addition to tax advantages, an ESOP allows the owner to sell part or all of the company to an ESOP trust, and the company becomes employee owned. Congress has expressed interest in facilitating employee ownership of firms: In the 119th Congress, various bills—such as S. 1727, S. 1728, S. 2403, and S. 2458—would promote employee ownership or modify rules for ESOPs.

ESOPs can be complicated business structures that give rise to potential conflicts of interest and have specific rules depending on which type of stock the ESOP holds. ESOPs, like other private sector retirement plans, are governed by the Employee Retirement Income Security Act of 1974 (ERISA, P.L. 93-406). This In Focus provides an overview of these plans and discusses selected policy issues.

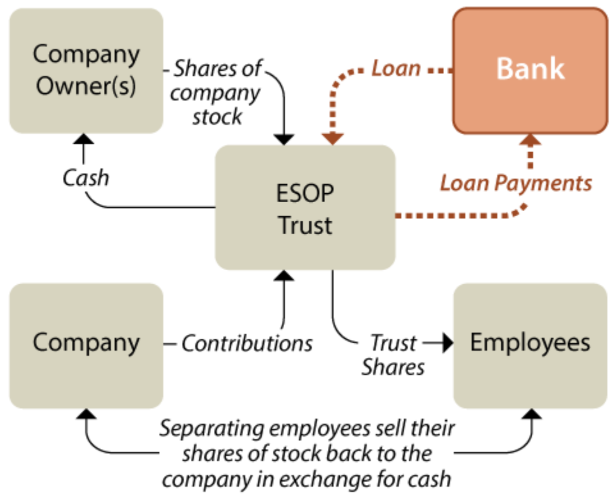
## Mechanics of an ESOP

A company first sets up an ESOP trust (see **Figure 1**). The company buys shares of company stock from the existing owner(s) (or issues new shares) to put into the ESOP trust. To buy shares, the company can do one or a combination of the following: (1) pay the owner directly using company funds or (2) take out a loan (typically from a bank) or finance the transaction using a seller note to pay the owner back over time (referred to as a *leveraged ESOP*). To pay back the loan, the company makes tax-deductible contributions to the ESOP trust. The trust can own a portion or all of the employer's stock. If the trust owns 100% of the employer stock, it is a 100% ESOP-owned corporation.

Company contributions to an ESOP, whether to make loan payments in a leveraged ESOP or to contribute to employees' accounts, may be deducted from corporate income for federal income tax purposes up to the deduction limit for contributions to qualified plans—generally 25% of participants' compensation in a year (see 26 U.S.C. §404).

Employees receive shares in the trust allocated to their individual accounts, typically based on their pay and tenure. Ownership of the shares vests over time, subject to requirements in law. After an employee leaves the company or retires, the company buys back the stock at fair market value, and the employee receives that value (typically in cash).

**Figure 1. Mechanics of an ESOP**




**Source:** Adapted from Georgetown University Transactional Law Clinic Collaborative, "ESOPs," https://www.american.edu/wcl/academics/experientialedu/clinical/theclinics/elc/tlcc/for-businesses-nonprofits/upload/esops-info-sheet.pdf.

**Notes:** Leveraged ESOPs take out loans to buy new or existing shares from owners (represented by the orange shaded section). A non-leveraged ESOP does not involve a loan from a bank or loan payments to pay back the loan. This is a simplified explanation of ESOP mechanics. In practice, it can be more complicated (e.g., separating employees may receive stock, rather than cash, distributions).

## Features of an ESOP

ESOPs differ from other tax-qualified DC plans, such as 401(k) plans, in several ways. Contributions to ESOPs are made only by employers—no participant contributions are permitted. Participants can contribute to a KSOP—an ESOP that includes a 401(k) feature, allowing employees to make elective deferrals—or, if the company offers, to a separate 401(k) plan.

Additionally, ESOPs are invested primarily in employer stock, whereas 401(k) plans are required to offer a variety of investment options. Because most, if not all, of the employees' retirement savings are invested in the stock of the company for which they work, ESOP participants must be allowed to diversify a portion of their accounts after reaching certain age and plan participation requirements.

Finally, ESOPs have different distribution periods for separated employees compared to 401(k) plans.

ESOPs can be maintained by C corporations or S corporations. C corporations (commonly thought of as formal business structures and associated with larger companies) have profits taxed once at the corporate level and again at the individual shareholder level as dividend income. S corporations are pass-through entities (i.e., they generally do not pay corporate-level income tax) and must have no more than 100 shareholders, among other requirements. Some of the tax advantages of ESOPs differ between those sponsored by S corporations and C corporations, such as the deductibility limits for interest payments on loans in leveraged ESOPs.

## Number of ESOPs in 2022

In 2022, nearly 6,500 ESOPs covered 14.9 million participants and held $1.8 trillion in total assets (see **Table 1**). KSOPs represented 15.1% of all ESOPs.

**Table 1. Selected Characteristics of ESOPs in 2022**

| Type | Number of Plans | Participants (in Thousands) | Assets (in Millions of Dollars) |
|---|---|---|---|
| All ESOPs | 6,465 | 14,922 | $1,812,094 |
| Leveraged | 3,566 | 1,806 | $316,502 |
| Non-leveraged | 2,899 | 13,116 | $1,495,592 |
| KSOP | 973 | 13,060 | $1,587,994 |

**Source:** Calculated by CRS using the Employee Benefits Security Administration Private Pension Plan Bulletin and Private Pension Bulletin Data for the 2022 plan year.

**Notes:** KSOPs can be either leveraged or non-leveraged. The amount of assets is likely an overestimate of assets held in employer stock, as some larger plans report the value of non-ESOP assets in their reporting of ESOP plan assets.

## Benefits and Risks of ESOPs

ESOP proponents cite their ability to facilitate succession planning in instances when an owner wants the company to become employee owned. An ESOP gives workers at an employee-owned company a stake in the company and allow them to benefit if the company is successful.

An ESOP can also be used as a corporate finance tool. A company owner can sell his or her shares to the ESOP in a tax-advantaged exchange. Unlike other types of retirement plans, ESOPs may take out loans to expand operations, buy out outside investors, or refinance debt.

Participants in an ESOP are invested primarily in their employer's stock. Because both their employment and retirement savings are tied to one company, their retirement savings might not be diversified. Participants could lose both their jobs and a portion of their retirement savings if their employer experiences financial difficulties. To mitigate this risk, many employers also sponsor separate retirement plans (such as 401(k) plans), and Congress requires ESOPs to allow participants to diversify a portion of their ESOP investments after reaching specified age and service requirements.

## Selected Policy Issues

Policymakers may be interested in two current policy issues related to ESOPS: (1) the valuation of ESOPs and (2) contribution limits.

### Valuation

An ESOP without publicly traded securities requires an initial valuation when selling the company to the ESOP trust and periodic (typically annual) valuations of employer securities. Transactions involving valuations can give rise to conflicts of interest, because, for example, the company owner typically selects the company that does the valuation and has an incentive to receive a valuation that is as high as possible. Because the seller is a *party-in-interest*, the transaction would be a *prohibited transaction* under Section 406 of ERISA. Section 408 of ERISA provides an exemption to the prohibited transaction if the acquisition, sale, or lease of the securities is for fair market value (called *adequate consideration*). Determining the fair market value of a company whose stock is not publicly traded requires a valuation by a specialty appraiser. In such cases, Section 3(18) of ERISA requires that the fair market value be "determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary."

In 1988, the Department of Labor (DOL) issued proposed regulations that would have defined *adequate consideration*. The proposed regulations were neither finalized nor withdrawn, though ESOPs have relied on them as unofficial guidance. ESOPs have also relied on Revenue Ruling 59-60, which was issued in 1959 to determine fair market value of assets for estate tax purposes. Section 346 of the SECURE 2.0 Act of 2022 (P.L. 117-328) required DOL to issue regulations to define *adequate consideration*. DOL issued proposed regulations on January 16, 2025, but they were not published in the *Federal Register* before January 20, 2025, when the second Trump Administration froze all pending regulations.

### Contribution Limits

Some stakeholders believe that some ESOP participants may not be able to accumulate sufficient retirement savings because of DC plan contributions limits. DC plans, including ESOPs, are subject to statutory limits for employee contributions to plans (which are permitted by KSOPs) and overall contributions to plans (which include employee and employer contributions). Employer contributions include, for example, matching contributions, non-elective contributions, cash and stock contributions to an ESOP, and contributions to fund ESOP loan payments.

All DC plans sponsored by employers are aggregated for the purposes of these limits. Some employers that sponsor both ESOPs and other DC plans may find it difficult to make the required loan payments in leveraged ESOPs and also contribute to the separate DC plans for employees due to the aggregate contribution limits.

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