USEFUL ESOP TERMINOLOGY

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The following glossary is the work of the authors, and does not necessarily represent legal interpretations of law and regulations that use the terms. For any detailed review of any legal terms related to ESOP law and regulations consider consulting ESOP counsel.

The following are some of the terms that are used in discussing ESOPs (many of these terms apply to other types of Qualified Retirement Plans also) NOTE: Terms that are capitalized in a definition are defined elsewhere in these definitions

401(k) Plan: This is a Qualified Retirement Plan that permits employees to elect to contribute (defer) some of his/her salary into the plan. Assets in the plan are invested (usually by the employee) and grow tax-free. A 401(k) Plan can also allow for employer Contributions in addition to employee deferrals.

409(p): This is a section of the Code that is designed to ensure that S-Corporation ESOPs do not heavily benefit members of the same family or a small group of people. This section was enacted when individuals began abusing the S-Corporation ESOP structure by making their family-owned business an ESOP, but with only the family members participating.

Administrator: This is the person or entity who is responsible for the administration of the ESOP according to the terms of the plan documents. The Employer usually serves as the Administrator, but often hires a Third Party Administrator to be responsible for the record keeping and other administrative functions for the ESOP. Some of the duties of the Administrator also may be delegated to committees established to help administrator the ESOP effectively.

Allocated and Unallocated Stock: Stock that is purchased by an ESOP with an Exempt Loan is held in a Suspense Account. Shares are released annually from the Suspense Account and allocated to the accounts of Participants as the Exempt Loan is repaid.

C-Corporation ESOP: A C-Corporation's income is taxed at the corporate level. To the extent shareholders receive dividends from the C-Corporation, they must pay income tax on such dividends at a special dividend rate. One advantage of a C-Corporation ESOP is that shareholders who sell shares of the Company to the C-Corporation ESOP may take advantage of a tax deferral on the gain by using the special tax incentive provisions of Section 1042 of the Code.

Code: The Internal Revenue Code of 1986, as amended. Qualified Retirement Plans are governed by the Code and ERISA.

Company Stock: An ESOP is legally required to invest "primarily" in the stock of the Employer (or a related company). The stock of the Employer that an ESOP can own is referred to as "Company Stock." Thus, an ESOP is a shareholder of the Company since it owns some or all of the issued and outstanding shares of the Company.

Contributions: The ESOP acquires assets to be used to provide a retirement benefit to its Participants by means of money or other property contributed by the Company and by earnings from that property. The amount the Company contributes to the ESOP for a given year is discretionary with the Company.

Control Premium: An amount or percentage by which the value of a controlling interest in a business exceeds its pro rata value of that business.

Discount for a Minority Interest: An amount or percentage deducted from the pro rata value of an ownership interest in a business to reflect the fact that the owner of that interest backs some or all of the powers of control.

Discount for Lack of Marketability: An amount or percentage deducted from the value of an ownership interest in a business to reflect the relative absence of a market for that ownership interest. This discount is important for the shareholders of privately-held companies since there is no established market for the buying and selling of the stock of such companies. Therefore, it is more difficult to find a buyer for shares of Company Stock.

Distributions: When an ESOP Participant reaches normal retirement age, dies, or becomes disabled, the Participant is entitled to receive a distribution of their ESOP account -- usually during the Plan Year following the year in which such retirement, death or disability occurs. If a Participant voluntarily quits, or is terminated prior to reaching any of these events, the Participant may need to wait up to five (5) years in order to begin receiving a distribution of the Vested portion of their ESOP account. Each ESOP is drafted differently, but generally, amounts invested in cash within the ESOP trust can be distributed quickly, while amounts attributable to Company Stock are often distributed in installments over a period of five (5) years.

Diversification: Participants are eligible to partially diversify up to 50% of the Company Stock in their ESOP account after the Participant has reached age 55 and performed 10 Years of Service.

Eligibility: These are the requirements before an employee can become a Participant in a Qualified Retirement Plan. In an ESOP, it is customary to require that an employee be at least 21 years old and have performed one Year of Service before they become a Participant.

Employer: This is the corporation which creates and maintains the ESOP to provide a retirement benefit to its employees who qualify to become Participants in the ESOP. Other companies which are related to the Employer also may choose or be required to adopt the ESOP and have their employees who qualify become Participants. The Employer also is referred to as the Company

Enterprise Value: The value of a business with out any premiums or discounts.

ERISA: This is the acronym for the Employee Retirement Income Security Act of 1974, as amended. ERISA protects employees' retirement benefits and gives the Department of Labor and the Internal Revenue Service the power to oversee retirement plans adopted by Employers for benefit of their employees.

ESOP: This is the acronym for Employee Stock Ownership Plan. An ESOP is a Qualified Retirement Plan that is designed to invest primarily in stock of the Employer. An ESOP is the only Qualified Retirement Plan that may borrow money.

Exempt Loan: This is a loan between an ESOP and the Employer that is exempt from the Prohibited Transaction rules. This loan allows for the ESOP to purchase stock from the Employer or from Company shareholders. The Trustee repays the Exempt Loan using amounts contributed to the ESOP by the Company as an annual contribution. An ESOP is the only Qualified Retirement Plan that may borrow money.

Fair Market Value: The price at which property would change hands between a willing buyer and willing seller, acting at arm's length, in an open market where neither is under a compulsion to buy or sell, and when both have reasonable knowledge of the relevant facts. Under ERISA, it is critical that an ESOP may not purchase Company Stock for more than the Fair Market Value of the Company Stock on the date of a Stock Acquisition.

Leveraged ESOP: If an ESOP has borrowed money as an Exempt Loan to buy Company Stock, it is referred to as a Leveraged ESOP.

Participant: Employees who meet certain requirements established in the ESOP (the most common being the employee must be at least age 21 and have a Year of Service with the Employer) are eligible to become a Participant in the ESOP. Each Participant has an account in the ESOP, which account is used to provide a benefit to the Participant after the Participant's employment with the Employer terminates.

Prohibited Transaction: The Code and ERISA prohibit the buying/selling of property, the extension of credit, furnishing of goods or services, transfer of any plan assets between a Qualified Retirement Plan and certain persons or entities involved with the Qualified Retirement Plan, such as any fiduciary, a person providing services to a Plan, the employer sponsoring the Qualified Retirement Plan, an owner (direct or indirect) of 50% or more of the Company's Stock etc. The process by which an ESOP becomes a shareholder of a sponsoring Company technically is a Prohibited Transaction, but ERISA contains a specific exemption for that type of Prohibited Transaction.

Qualified Retirement Plan: A retirement plan that meets the requirements of Section 401(a) and other provisions of the Code. Qualified Retirement Plans provide special tax benefits to employers and Participants and, in the case of ESOPs, certain shareholders (see Section 1042 Deferral).

Repurchase Liability: This is the practical obligation of the Company to covert Company Stock owned by the ESOP to cash in order to facilitate cash distributions to Participants after their employment terminates.

S-Corporation ESOP: An ESOP sponsored by an S-Corporation. Because S-Corporations are pass-through entities for income tax purposes, individual shareholders are liable for the payment of income taxes on the Company's profits. For example, if two people each owned 50% of an S-Corporation, each year each shareholder would be personally responsible for paying income tax on 50% of the Company's profits. Ordinarily, S-Corporations make distributions to its shareholders to enable them to pay this tax. ESOPs are tax-exempt so, if an ESOP is the sole shareholder (100% owner) of a Company, no income taxes will be due from the ESOP and no distributions need to be made to the ESOP. This allows a 100% ESOP-owned S-Corporation to have a financial advantage over its competitors.

Section 1042 Deferral: Section 1042 of the Code is a provision that provides an incentive for shareholders of a C-Corporation (an S-Corporation can become a C-Corporation by terminating its S-Corporation election) to sell their shares of the C-Corporation to the corporation's ESOP (C-Corporation ESOP). If the requirements of Section 1042 are met, a shareholder may sell his or her shares of the C-Corporation to the C-Corporation ESOP and defer the payment of income taxes on the gain from that sale – usually forever. Section 1042 does not apply to the sale of shares to an S-Corporation ESOP.

Special or Transaction Trustee: This a Trustee hired by the Company for the purpose of representing the ESOP in the purchase or sale of Company Stock by the ESOP in a transaction where the regular Trustees have a conflict of interest.

Stock Acquisition: This is a transaction whereby an ESOP becomes a sole or partial shareholder of the Company as a result of a purchase of Company Stock from one or more shareholders, a purchase of new shares from the Company, or by a contribution of shares by the Company.

<u>Summary Plan Description</u>: This is the document a Qualified Retirement Plan is required to provide to each of its Participants describing in general terms what that plan is and how the that plan works.

<u>Suspense Account</u>: An ESOP is the only Qualified Retirement Plan that is allowed to borrow money. If an ESOP borrows money to purchase Company Stock, the shares of Company Stock purchased with those borrowed funds are placed in a Suspense Account. The shares in the Suspense Account are allocated to the accounts of Participants in future years as the loan that was used to purchase those shares is repaid by the ESOP.

<u>Third Party Administrator</u>: The administration of an ESOP requires that, from time to time, information and forms be obtained from Participants and information and forms be provided to Participants and that records be kept of each Participant's account. Administrators hire third parties who specialize in doing this type of administrative work and record keeping to carry out these functions for the ESOP and these third parties are referred to as Third Party Administrators.

<u>Trustee</u>: A Trustee is the person or persons who have the responsibility of overseeing the ESOP's trust, and managing the trust assets for the benefit of the Participants. Trustees must comply with the requirements of the Code and ERISA.

<u>Valuation</u>: ERISA requires that the value of an ESOP's Company Stock ownership be valued at least annually. Since most ESOPs own stock that is not publicly traded, it is necessary for a qualified, independent appraiser to determine the Fair Market Value of the ESOP's Company Stock ownership. The ESOP Trustee is responsible for reviewing, analyzing, and approving the annual Valuation.

<u>Vesting</u>: Vesting refers to the portion of a Participant's account that is non-forfeitable. Most plans have Vesting schedules that increase a Participant's vesting percentage little by little over the course of 6 years (graded schedule). Other plans use a cliff schedule that makes a Participant 100% vested after three years of service. A Participant's account automatically becomes 100% vested if the Participant's employment terminates due to retirement, disability, or death.

Year of Service: This is a calculation that usually means a period of 12 months during which an employee or Participant performs at least 1,000 hours of service.