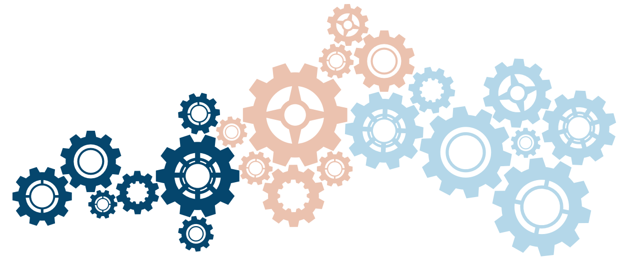
EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

A White Paper From Newport Group



CASH MANAGEMENT CONSIDERATIONS
for ESOP Repurchase Obligations

Funding a plan with company stock can be a great finance and employee motivational tool. But eventually, the piper must be paid. Employees will eventually terminate employment and want a cash payout from the ESOP.

Where Will That Cash Come From?

The law requires employers to create a market for the ESOP stock if is not actively traded on a public market. Some ESOPs are designed so that shares will be distributed to participants to sell back to the company. Others are designed to distribute cash. In either scenario, there is a need for cash as participants terminate employment or retire.

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There are several alternatives for an ESOP sponsor to fund employee distributions. These are not mutually exclusive and many ESOP sponsors use a combination of methods to meet their obligations. Following is an overview of the most common alternatives. You should consult with your ESOP advisor on the issues that each alternative may present in your specific circumstance.

Pre-Funding and Recycling

One of the most common tactics is for the company to make periodic contributions of cash to create a cash reserve in the ESOP for future distributions. As with any other contribution, the cash from these contributions is allocated to the accounts of all participants. The amount of cash deposited is the amount determined by the company's cash flow and tax planning and that meets their employee benefit objectives. Any such contribution is subject to the general Code limits for contributions and allocations. Funds will be invested as plan assets and will grow, tax-deferred.

As participants become eligible for distributions, this cash can be used to fund those distributions. Shares that were in the accounts of former participants would be reallocated to the accounts of active participants in the same ratio as the cash that had been subtracted from their accounts. This is commonly referred to as "recycling" the shares.

This approach has the following results:

1. The employer receives a tax deduction for the amounts required to fund distribution obligations.
2. Contributions increase the balances of every participant in the plan for the year of the contribution. Thus, the eventual amount due each participant is increased.
3. Amounts are only deductible within the general rules of the Code. If the employer is still servicing the original ESOP debt, there may not be sufficient room under the Code limitations to make additional cash contributions. However, if the plan sponsor is an S corporation, it may be possible to use S corporation tax distributions as another source of cash deposits into the ESOP. Similarly, a C corporation could deposit dividend payments into the ESOP. These deposits would not be subject to the contribution limitations of the Code but may not be tax deductible.
4. Finally, the shares previously allocated to the former participants continue to be outstanding and are now held in existing participants' accounts. In other words, by recycling the shares, the shares will need to be "repurchased" over and over again.

Pay-As-You-Go and Recycling

In this approach, the company would make a cash contribution sufficient to fund the distribution obligation for a particular year, instead of creating and using a cash reserve within the ESOP. Again, any such contribution must fit within the Code limitations on deductibility and allocation or must be supplemented by the use of an S corporation distribution or C corporation dividend. For example, if a participant with a substantial balance died during the year, the contribution limits may not allow a large enough "contribution" to fund the distribution obligation.

The advantage of this approach over pre-funding is that funds do not sit in the trust accumulating taxdeferred earnings that serve to increase the amounts due to former participants. However, the actual contribution is allocated to the accounts of that year's participants. Thus, account balances are increased, but to a lesser degree.

This approach is best used in cases where distributions are deferred for a longer period from the date of termination. This gives the plan sponsor time to plan how and when to fund the obligation.

Redeeming the Stock

The employer may choose to repurchase the stock of the participants who are eligible for a distribution and put those shares into Treasury stock.

In this scenario, the cash paid to fund distributions is not currently tax deductible. On the plus side, the amount of cash required to fund distributions is not limited by the Code provisions and does not increase the account balances of the remaining plan participants. This transaction has an anti-dilutive impact on share value since repurchased shares are retired or put into Treasury stock spreading future growth in the value of the company over a fewer number of shares.

One way to accomplish this is a direct sale of the shares from the ESOP to the company. However, the ESOP fiduciary must agree that it is prudent to sell the securities back to the plan sponsor. This decision must be carefully analyzed in light of participant interests since the fiduciary cannot force the employer to make a contribution to fund distributions and the distributions must be made pursuant to the plan terms. The purchase of the shares by the sponsor must meet ERISA (Employee Retirement Income Security Act of 1974) rules for a related party transaction. This includes a valuation as of the date of the transaction. Certain S corporation ESOPs may be prohibited from making this sale without prior approval from the Department of Labor.

The requirement for an updated valuation as of the date of the transaction can be an obstacle to this approach.

Another alternative is to make the distribution to the former participant in the form of shares of company stock. The participant can then sell the shares back to the company. Now the transaction is between the former participant and the company so that the fiduciary and prohibited transaction concerns raised above would not apply. However, many ESOP sponsors may be concerned that former participants will choose to hold the shares rather than sell them back to the company. If the company is an S corporation or has a bylaw restriction on stock ownership, it may be possible to force the former participant to immediately sell back the shares.

Plan sponsors may use the option to redeem stock to supplement the reserve or pay-as-you-go alternatives in the event of unexpected and substantial distributions, such as the death of a participant.

Redeeming and Re-Contributing or Re-Leveraging

The employer can repurchase shares from the trust or former participants then contribute or sell them back to the Plan at a later date.

One of the most serious issues ESOP companies must deal with is continuing ESOP ownership once the initial block of stock has been purchased and paid for. If plans are not made to get additional shares into the ESOP, employees hired after the initial stock purchase date will find themselves without an ownership position. This option helps solve that problem.

There are several different variations for this approach, including:

1. Annual contributions of shares
2. Annual leveraged repurchases
3. Re-leveraging – a leveraged purchase of a substantial block of new shares by the ESOP

Annual contributions of shares

Consider a company that purchased shares from the ESOP or former participants and now has those shares in Treasury stock. At some point in the future, the company makes a tax-deductible contribution to the ESOP of all or a portion of these Treasury shares.

Even though the original repurchase of these shares by the company was a non-deductible cash cost, the company now has a deductible, non-cash employee benefit. The company will determine the amount of stock to contribute based on its employee benefit objectives. The deduction limit for this contribution and all other employer retirement contributions is 25 percent of eligible pay.

The advantage of this approach is that it is very simple and the contribution amount can be fixed by the company in response to its tax, employee benefit, and financial reporting objectives. Key disadvantages include the percentage limit on the contribution amount and the dilutive impact of newly issued shares.

Annual leveraged repurchases

Assume that the distributions are made in the form of company stock as outlined above. Instead of having former participants sell the shares back to the company to be placed into Treasury stock, the ESOP borrows the funds needed from the company to buy some or all of the shares distributed that year. The cash flow obligation for the current year is not reduced by using this alternative unless the company obtains outside financing. However, reallocation of the repurchased shares can be stretched out over the loan term which should help slow the next repurchase of these shares.

More substantial re-leveraging

In this approach, the ESOP sells all or a portion of the stock currently allocated to participants back to the company. The ESOP then borrows the funds needed to buy the stock back from the company. The shares will then be released and allocated to participants as the new debt is repaid. Unless the company has sufficient cash available, it will need to obtain outside financing.

Outside financing provides the funds necessary for the current repurchase obligation. This approach also helps with the “Haves” vs. “Have Nots” as releveraging the ESOP allows the shares to be reallocated over the term of the loan and avoids immediate reallocation of such shares. The inside loan term can be structured to provide shares to be released for many years into the future, which should slow the obligation to repurchase such shares again.

Too often companies that sponsor ESOPs with significant repurchase obligations provide a benefit level that is determined by the repurchase obligation and not by what would be a reasonable employee benefit. The new inside loan term can be structured to provide a reasonable and sustainable level of employee benefits.

As with all of the previous options, you need to carefully review the fiduciary, legal and valuation issues with your advisors.

Funding With Life Insurance

For a plan that has many participants, a term life insurance policy held on a group of employees with large account balances may be considered. This approach would provide some spread over when the cash from the insurance policy will actually be realized. However, life insurance is not really a separate means of funding this obligation. It simply offers another way to provide the cash needed to fund the obligation. Therefore, you should consider combining this approach with at least one of the other options.

To the extent that this option makes sense, the plan sponsor would purchase the coverage, not the plan. This may be more attractive to a C corporation than an S corporation.

How Newport Group Can Help

When considering the above funding alternatives, it is helpful to be able to prepare cash flow modeling that illustrates the specific impact of each alternative on the company as well as the ESOP participants. We offer this cash flow modeling.

When focusing on funding repurchase obligations, it is easy to overlook other ESOP issues. For example, as the ESOP rules have been changed over the years, shares acquired by the plan at different periods have different attributes. Some of those attributes limit the availability of cash for specific purposes.

Also, the funding of the repurchase obligation and the avoidance or correction of a "Haves" vs. "Have Nots" situation are closely interrelated. Be sure to keep an eye on the emerging obligation and to keep all of your options open.

Newport Group provides retirement plan solutions for small to midsized companies. Its experienced team of consultants offers plan design, administration, consulting and recordkeeping services to qualified and nonqualified retirement plans including employee stock ownership plans, 401(k) plans, money purchase plans, defined benefit plans, crosstested profit sharing plans, and many others.

We are well known for our work with ESOPs, serving the specialized needs of growing companies. Since we understand how an ESOP impacts both a company's financial and tax position, we work closely with its accountants to ensure that the operation of the ESOP will be integrated into the other aspects of company reporting.

We offer a full range of ESOP services:

- Feasibility studies
- Design and implementation
- Annual recordkeeping and reporting
- Plan document services
- Repurchase obligation studies
- Code section 409(n) non-allocation provisions compliance, if applicable
- Code Section 409(p) anti-abuse provisions compliance, if applicable (S corporation ESOPs only)

Our administrative services are provided by professionals who work exclusively with ESOPs. These services include all of the required tests to ensure compliance with current ESOP laws and regulations.

Find Out More:

To learn more about cash management considerations for ESOP repurchase obligations, contact your Newport Group representative at **newportgroup.com.**

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