The Autopsy

of an

ESOP

A home is often viewed as one of the largest assets you will own. However, when it comes to the small business owner, often times the value of their business will over shadow the value of the personal residence. The obstacle arises when faced with a need for cash flow for retirement needs, how is that value released or converted into cash. With a home, a 2nd mortgage, reverse mortgage, etc are possibilities. With a business, especially one that is closely held, and has limited marketability, some creative solutions can be employed.

A business owner can part with a portion of the business by selling it to the employees. This not only creates the needed cash for retirement, but also reduces part of his non liquid assets that may be subject to Federal Estate Taxation. In the next few pages are an explanation of the mechanics behind an ESOP, good, bad or otherwise and ways to deal with them in a prepared and efficient manner.

Overview

Repurchase obligation is the liability a company incurs when vested terminated participants are entitled to receive distributions from an Employee Stock Ownership Plan (ESOP) and request the payment of cash for the shares that are held in an account for their benefit. Closely held companies have an obligation to fund the cash amounts that will be paid to the participants. The timing of funding the obligation is determined by the plan document provisions, distribution policy and planning for the repurchase of stock.

To ensure distributions can be funded, several questions must be addressed, including:

- Size: How large are the repurchase obligations?
- Timing: when do they occur? How do the obligations vary over time?
- Form: Will the ESOP make distributions in stock or cash?
- Funding: How are the repurchases best funded?
- Method: What is the best way to handle repurchases (redeem or recirculate)?

A Repurchase Liability Study (RLS) is a projection of the emerging liabilities resulting from the obligation to repurchase distributed ESOP stock when employees retire, die, become disabled or terminate employment. Other events such as “diversification” will also influence the amount and timing of the repurchase liability. Most companies perform an RLS to estimate their future liability. However, not many firms analyze some of the best ways to meet their repurchase obligations

It is strongly recommend running a study to assist in projecting your potential ESOP repurchase liability based on your specific plan features and participant demographics.

Redeem vs. Recirculate

A primary consideration in any repurchase, plan and subsequent funding decision, is how shares will be purchased at time of distribution. The decision to recirculate or redeem the ESOP shares should align with the company's objectives with respect to the long-term ownership percentage goal it has for the ESOP.

REDEEM (REPURCHASE BY THE COMPANY)

- ESOP distributes stock and the company buys it.
- Payments are not deductible.
- Number of shares in the ESOP declines.
- Shares are held as treasury stock but can be contributed to the ESOP at a later date on a deductible basis, subject to qualified plan limits.
- If ESOP ownership of the company is less than 100%, ESOP ownership percentage declines.
- Typically, a lower number of shares are repurchased.
- Individual account balances have fewer shares.
- Value of remaining outstanding shares is likely to increase.

A thorough evaluation of the redeem/recirculate issue should be part of your repurchase liability study. This will help you to determine your repurchase liability strategy.

Cost of Repurchase

The actual cost of repurchase is affected by many factors including, but not limited to:

- Per Share Value – Redeeming increases the value of outstanding shares and may increase the cost of funding future repurchase liabilities.
- Tax Savings – Recirculation method buys shares with before-tax dollars.
- Plan Contributions – How large are the potential annual contributions and how long will the employer contribute to the ESOP?
- Timing of Contributions – Funding prior to distribution may reduce the overall cost of repurchase.
- Loan Repayment – If the ESOP is leveraged, how is the loan amortized; what is the loan interest rate; how are shares released from the suspense account; etc?
- Participant Demographics – Employee ages, retirement ages, experience for death, disability and turnover all impact repurchase costs.

Cost may not be the most important factor in creating a repurchase funding plan.

RISKS OF NOT FUNDING

All privately held companies have an obligation to purchase ESOP shares from separated employees. One of the intents of an ESOP is to provide a market and liquidity for the purchase of company stock. Thoughtful planning and funding of the repurchase liability can be a strong factor for maximizing the value of an ESOP.

RISKS

Companies that fail to plan properly to meet their ESOP repurchase obligation may have unexpected disruptions in cash flow and face the following risks:

- Poor employee morale because of the uncertainty of funding.
- Increased costs of capital.
- Lower company value, perhaps even the failure of the company as a viable business.

With proper planning, repurchase obligation issues are not difficult to resolve and are not unlike facing the liquidity needs of any closely held company.

Funding the Repurchase Liability

FUNDING OPTIONS

A variety of funding options are available to fund the repurchase liability. Some of the more common methods include:

- Cash Flow – Rely on future cash flows from operations to meet obligations.
- ESOP Sinking fund – Cash contributions to the ESOP.
- Corporate Sinking Fund – Contributions to a taxable sinking fund within the Corporation.
- Debt – Borrow funds to meet repurchase obligations.
- Corporate Owned Life Insurance – Advance funding using Corporate Owned Life Insurance (COLI) or "Corporate tax advantaged sinking fund".

CONSIDERATIONS

Often a combination of funding methods works best for the company. The challenge is to find the mix that best fits your situation. Considerations include:

- To what extent will cash be available in the future?
- To what extent is advanced funding possible based on current and projected cash flows?
- Availability and/or necessity of using debt.
- Availability of internal markets (key employee purchases).

LONG-TERM OWNERSHIP

A primary consideration in any repurchase plan and subsequent funding decision is how shares will be purchased at the time of distribution. The decision to redeem or recirculate the ESOP shares should align with the company's objectives with respect to the long-term ownership percentage it has for the ESOP.

Current Cash Flow
Option for Funding the Repurchase Liability

This is one of the most commonly used funding methods. Repurchases are handled as they occur.

WHEN TO CONSIDER

Funding from current cash flow is appropriate when:

- Repurchase obligations are manageable as a percentage of cash flow.
- Repurchase obligations are evenly distributed.
- Combined with other funding methods.
- Future earnings are likely to be stable.
- Employer contributions and dividends to fund the repurchase obligations are a normal level of benefit for your industry.

ADVANTAGES OF CURRENT CASH FLOW

- Doesn't tie up assets in a sinking fund.
- Retains flexibility to recirculate or redeem shares.
- Contributions are deductible up to qualified plan limits.

DISADVANTAGES OF CURRENT CASH FLOW

- Doesn't allow for contingencies such as downturns in a company performance.
- Timing of repurchase may be problematic from a cash flow or cash availability perspective.
- Doesn't plan for unanticipated large payments due to the death, disability or retirement of a key employee.

ESOP Sinking Fund
Option for Funding the Repurchase Liability

This method supports a recirculation strategy and involves building a cash position in the ESOP by maximizing contributions to the ESOP in order to accumulate funds for future repurchases. The ESOP then assumes the obligation to buy the stock, even though the ultimate obligation to repurchase remains with the employer.

WHEN TO CONSIDER

The Sinking fund Option is appropriate when the repurchase obligations are manageable as a percentage of cash flow and evenly distributed, and the company is generating significant cash in excess of total corporate needs.

ADVANTAGES OF ESOP SINKING FUND

- Contributions are deductible within limitations.
- Investment yields are tax-free.
- Cash is protected from creditors.
- Spreads out the funding of repurchase obligations, making them a more manageable expense.
- Provides a mechanism for new participants to get stock into their accounts.
- Provides comfort to plan participants that cash is being set aside for future repurchases.

Useful if the company chooses to recirculate the ESOP shares and it is important to maintain the ESOP's percentage of ownership in the company.

DISADVANTAGES OF ESOP SINKING FUND

- Lacks flexibility – Only useful for recirculation.
- Removes the assets from the corporate balance sheet.
- Potential to create fiduciary issues since ESOP is intended to invest primarily in corporate securities and the existence of cash may necessitate the use of alternative investment options.
- Employer still has the legal obligation to repurchase stock.
- As participants terminate with cash in their accounts, the cash is not available for funding the repurchase obligations.

Corporate Sinking Fund
Option for Funding the Repurchase Liability

This method involves the systematic accumulation of funds outside of the ESOP that are earmarked for the repurchase obligation. A sinking fund is effective in pre-funding because there are no limitations to the pre-funding effort.

WHEN TO CONSIDER

Pre-funding in a corporate sinking fund is appropriate when the company:

- Plans to repurchase by redeeming shares.
- Wants to retain flexibility to redeem or recirculate.
- Wants to keep assets on the balance sheet during accumulation phase and have flexibility in use of money.

ADVANTAGES OF CORPORATE SINKING FUND

- Retains flexibility to either redeem or recirculate shares.
- Smoothes cash flow requirements of repurchase.
- Keeps assets on the corporate balance sheet.
- If stock is subsequently contributed to the ESOP, the contribution is tax deductible.
- Provides comfort to plan participants that cash is being set aside for future repurchases.

DISADVANTAGES OF CORPORATE SINKING FUND

- Contributions to the sinking fund are not deductible.
- Investment yields may be taxable.
- Removes assets from working capital.
- May increase the stock value.
- In the event of a bankruptcy, assets in a corporate sinking fund are not protected from creditors.

EXTERNAL DEBT
Option for Funding the Repurchase Liability

Debt can be used as a fallback strategy when other funding is inadequate or unforeseen circumstances occur.

WHEN TO CONSIDER

Use of external debt is useful when:

- Repurchase obligations are very high for one or a few years.
- There is not enough time to accumulate a sinking fund.
- The corporation **cannot** meet repurchase obligations from cash flow.
- The corporation can deduct loan interest expenses.

ADVANTAGES OF EXTERNAL DEBT

- May be less expensive than pre-funding or current cash flow, depending on internal rate of return on capital.
- The corporation may be able to deduct interest expenses.

DISADVANTAGES OF EXTERNAL DEBT

- Financing may not be available when needed.
- Lender fees and interest expense may add additional costs.

Corporate Owned Life Insurance
Option for Funding the Repurchase Liability

Life insurance funding may be used to provide death benefits, as a compliment to other investments in a sinking fund, or for "cost recovery" funding.

WHEN TO CONSIDER

Use of Corporate Owned Life insurance is appropriate when:

- The company needs to ensure funding for large account balances.
- Pre-retirement death benefits reimburse the company for the loss of key employees.
- A sinking fund is needed in addition to death benefit protection.
- The net present value of benefits under the life policy meets corporate standards.
- Written ownership policy commits the ESOP to be maintained longer than the lives of the current participants.

ADVANTAGES OF COLI

- Cash value is an asset on the corporate balance sheet. The balance sheet impact traditionally associated with life insurance products may be minimized with newer life product designs.
- Potential to smooth cash flow requirements for some or all distributions.
- Provides liquidity in the event of an unanticipated death.
- Death proceeds are income tax-free.
- Potential recovery of repurchase and premium costs if held to death.
- Retains flexibility to repurchase or redeem shares.
- May provide additional financing and cost recovery options for nonqualified deferred compensation plans.

DISADVANTAGES OF COLI

- Expense and mortality costs associated with insurance.
- Life insurance premiums are not tax deductible.
- Investment return may be lower if policy is surrendered before death.
- For C corporations, cash values and death benefits may be subject to corporate Alternative Minimum Tax (AMT).

Coroners Summary

One of the most important elements in a successful repurchase plan is for the business to remain a viable, profitable going concern. More than likely, a key component of future success is the talent of the people working for your firm. Offering an ESOP can help a business :

RETAIN, RECRUIT AND REWARD

Contact you CPA for guidance and recommendation on how to proceed with a Repurchase Liability Study.

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