

FUNDING ESOP REPURCHASE OBLIGATIONS

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Introduction

- ◆ The goal of planning for ESOP repurchase obligations is to make sure that you will be able to fund distributions to participants when they are required



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Defining repurchase obligation studies

- ◆ The first step in the planning process is usually a repurchase obligation study
- ◆ This is a long range actuarial projection that predicts the **magnitude** and **timing** of a company's ESOP repurchase obligations



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Introduction

- ◆ In order to do this, you need to address three key questions:
 - How large are the repurchase obligations and when will they occur?
 - What is the best way to handle repurchases (redeem or recirculate) in light of the company's objectives?
 - How can the repurchases be funded?



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Quantifying repurchase obligations

- ◆ These projections are usually accomplished through the construction of a **financial model** that is carefully built to incorporate all of the complexities of the ESOP



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Quantifying repurchase obligations

- ◆ **Model must include sufficient detail to provide meaningful projections**
 - Plan features (eligibility, vesting, distributions, etc.)
 - Demographic and actuarial variables
 - Financial assumptions
 - Redeeming vs. recirculating shares
 - Funding



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Quantifying repurchase obligations

- ◆ **The process is often iterative**
 - The results of one scenario may suggest alternatives that should be examined



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Quantifying repurchase obligations

- ◆ **Assumptions need to be reasonably based and internally consistent**
- ◆ **It's often appropriate to project more than one scenario to reflect a likely range of values for key variables**



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A sidebar – redeeming vs. recirculating shares

- ◆ **Implicit in the forecast (and the funding decisions) is the issue of whether repurchases will be made by the company (“redeemed”) or handled through the ESOP (“recirculated”)**
- ◆ **The decision depends on a number of factors, and can be changed as circumstances dictate**



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Redeeming vs. recirculating

The two basic choices are redeeming and recirculating

- ◆ **Redeeming**
 - ESOP distributes stock and company buys it
 - Payments are not deductible
- ◆ **Recirculating**
 - ESOP distributes cash, shares stay in ESOP
 - Payments are deductible (not relevant in S corp)



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Redeeming vs. recirculating

- ◆ Redeeming is not necessarily less expensive than recirculating over time, even though fewer shares are repurchased



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Redeeming vs. Recirculating

There are different consequences for the ESOP and the participants

- ◆ **Redeeming**
 - # of shares in ESOP declines
 - ESOP's ownership % declines
 - Lower # of shares repurchased
 - Individual account balances have less shares
- ◆ **Recirculating**
 - # of shares in ESOP unchanged
 - ESOP's ownership % unchanged
 - Higher # of shares repurchased
 - Individual account balances have more shares



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Redeeming vs. recirculating

- ◆ The cost is affected by several factors:
 - **Per share value**
 - » Redeeming shares may have an antilutitive effect
 - ◆ The lower number of shares outstanding may result in a higher per share value over time
 - **Tax savings**
 - » Redemptions are paid for with after-tax dollars
 - » Not relevant in an S corporation ESOP
 - **Cost of alternative benefits**
 - » If benefits are not provided through ongoing contributions to the ESOP, they will almost certainly have to be provided through another qualified retirement plan



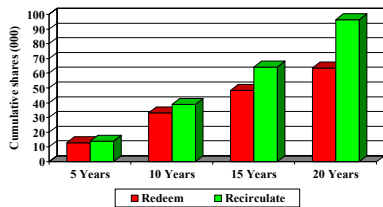
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Redeeming vs. recirculating

The cumulative number of shares repurchased is higher when recirculating

Example:

- Same per share value for redeeming or recirculating
- 40% tax bracket
- Company provides a 3% 401(k) match as alternative benefit



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Redeeming vs. recirculating

◆ A few final thoughts on redeeming vs. recirculating...

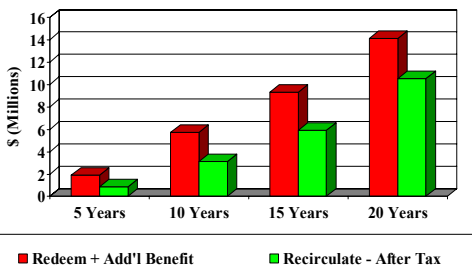
- The “common wisdom” that it is less expensive to redeem may not be valid, depending on the antilutitive effect of redemptions and the tax benefits of recirculating



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Redeeming vs. recirculating

But the after-tax cost may be lower, especially if the cost of alternative benefits is taken into account



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Redeeming vs. recirculating

◆ A few final thoughts on redeeming vs. recirculating...

- The implications for the ESOP and the participants may be just as important as the cost



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Redeeming vs. recirculating

- ◆ A few final thoughts on redeeming vs. recirculating...
 - How you handle repurchases can change from year to year, but some funding methods lack flexibility



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Funding alternatives

- ◆ There are basically five types of funding for repurchase obligations
 - Current cash flow
 - Advance funding/“sinking fund”
 - Debt
 - Internal markets
 - Third party solutions



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Developing a funding strategy

- ◆ Once you have a reasonable set of projections, the next step is to analyze the results and develop a funding strategy.



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Funding alternatives

- ◆ Most companies find that a **combination** of funding methods works best
- ◆ The **challenge** is to find the combination that is most appropriate for your company



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Funding alternatives

- ◆ **Finding the right combination requires that you address several questions:**
 - To what extent can repurchases be handled out of current cash flow?
 - Is some sort of advance funding (sinking funds or insurance) necessary and feasible?
 - Will it be necessary to use debt or look to third party solutions to meet the repurchase obligations?



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Current cash flow

- ◆ **Advantages:**
 - Allows you to retain flexibility to handle repurchases by redeeming or recirculating shares
 - Doesn't tie up assets
- ◆ **Disadvantages:**
 - Provides no cushion
 - Repurchases may exceed contribution limits in some years



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Current cash flow

- ◆ **Funding out of current cash flow involves no prefunding**
 - Repurchases are just handled as they come along



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Current cash flow

- ◆ **Funding out of cash flow is most appropriate when:**
 - Repurchase obligations are relatively low and not too “lumpy”
 - When used in combination with other funding methods



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Sinking funds

- ◆ A sinking fund is the systematic accumulation of assets to meet a future liability
 - A sinking fund can be established in the ESOP or in the corporation



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Sinking fund in ESOP

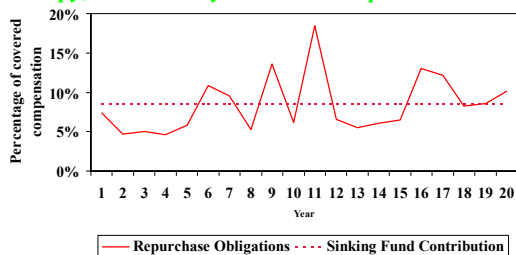
- ◆ A sinking fund in the ESOP is created by making contributions to the ESOP in excess of current distributions to accumulate funds for future repurchases
 - In S corporations, the receipt by the ESOP of S corp distributions creates a sinking fund in the ESOP



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Sinking funds

Sinking funds are useful when repurchase obligations are lumpy, because they smooth the expense



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Sinking fund in ESOP

- ◆ **Advantages:**
 - Contributions are deductible
 - Investment yields are tax-free
 - Makes repurchase obligations a predictable expense
 - Provides a mechanism for new participants coming into the ESOP to get stock in their accounts
- ◆ **Disadvantages:**
 - Lacks flexibility – can only be used for recirculating
 - Removes assets from the balance sheet and from operations
 - May create potential fiduciary issues in extreme situations



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Sinking fund in ESOP

◆ Making a sinking fund in the ESOP work...

- A sinking fund in the ESOP is only appropriate as a funding method if the intent is to recirculate stock in the ESOP
- It works best when contributions don't exceed a level that is appropriate for the company as a retirement benefit expense



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Sinking fund in corporation

◆ Advantages:

- Retains flexibility to either redeem or recirculate shares
- Smooths the cash flow requirements for repurchase obligations
- Keeps assets on the corporation's balance sheet

◆ Disadvantages:

- Contributions not deductible
- Investment yields are taxable
 - » But in S corporations with ESOPs, this would not be a concern
- Removes assets from operations
- May cause an increase in stock value



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Sinking fund in corporation

A sinking fund in the corporation involves the systematic accumulation of a fund outside of the ESOP that is earmarked for repurchase obligations



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Sinking fund in corporation

◆ A sinking fund in the corporation works best when you:

- Plan to handle repurchases by redeeming shares
- Want to retain flexibility to redeem or recirculate
- Want to keep assets on the balance sheet



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Life Insurance Funding

- ◆ Life insurance funding may be used just to provide death benefits, or as an alternative to other investments in a corporate sinking fund
 - Term insurance is the usual choice when only death benefits are needed,
 - While variable universal life is the usual choice for a sinking fund alternative



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Life Insurance funding

- ◆ Cash value life insurance has certain **tax attributes** that can make it attractive as a sinking fund alternative:
 - No current taxation of increases in cash value
 - Death benefits are tax free
 - Withdrawals from cash value up to basis are tax free
 - Cash value can be borrowed
 - » Loan is not taxable event
 - » Minimal interest cost
 - » Doesn't have to be repaid until policy surrendered or insured dies



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Life Insurance Funding

- ◆ Term insurance ◆ Variable Universal Life (“VUL”)
 - No cash value, death benefits only
 - Premiums increase dramatically at older ages
 - Death benefits, plus cash value invested in choice of investment funds
 - Flexible premiums
 - Effective sinking fund alternative if policy expenses are less than tax savings

COLI = life insurance owned by a corporation to fund a future (benefits-related) liability. COLI usually refers to life insurance with cash value.



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Life Insurance funding

These tax attributes can result in higher after-tax rates of return than taxable investments, if the tax savings on the investment earnings in the VUL are greater than the policy expenses



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Life Insurance Funding

Example:

Investment earnings = 10%

Tax bracket = 40%

Policy expenses (sales, administrative, mortality charges) = 2.5%

◆ Taxable Investment

- Investment earnings 10%
- Less: Taxes 4%
- Net investment earnings 6%
- In S corp. ESOP, net investment earnings may = 10%

◆ VUL

- Investment earnings 10%
- Less: Policy expenses 2.5%
- Net increase in cash value 7.5%



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Life Insurance Funding

◆ An alternative approach is “cost recovery funding”

- No loans or withdrawals, repurchases paid for out of corporate cash flow
- When insured dies, corporation recovers cost of repurchases plus the cost of the premiums from the policy's death benefit
- Recovery may lag repurchases by many years



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Life Insurance Funding

◆ VUL is most effective when used to insure large account balances, where pre-retirement death benefit protection is needed in addition to a sinking fund

- Policy can be designed to fund repurchases at diversification and retirement through policy loans and withdrawals
 - » Note tax consequences if policy lapses with large loans, instead of maturing as death benefit



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Life Insurance Funding

◆ Life insurance policies to fund repurchase obligations **should be owned by the company, not the ESOP, even though premiums are not deductible**



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Life Insurance Funding

◆ The reasons...

- Maximizes advantage of tax shelter
- Corporation retains control over cash value and death benefits
- If ESOP owns policies, premiums are deductible, but:
 - » Corporation has no control over how cash value or proceeds are used
 - » There may be fiduciary issues about suitability of investment, because it is difficult to justify policy expenses when owned by tax-sheltered entity



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Debt

◆ Company redeems shares and issues installment note to participant

- Term can't exceed five years, must be at reasonable interest rate
- Company must provide "adequate security" for note



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Debt

Debt can be used in several different ways to fund repurchase obligations...



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Debt

◆ Loan from company to ESOP

- ESOP can only borrow to acquire shares, so must distribute shares then buy them back
- DOL Prohibited Transaction Class Exemption 80-26 allows company to make interest-free loan to retirement plan to fund distributions
 - » Issue: How should loan and shares be handled when loan not repaid within same plan year?



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◆ **Releverage ESOP with bank debt**

- Again, technically ESOP must distribute shares and buy them back
- Debt to fund repurchases is non-productive
- Will have negative impact on value
 - » Consider impact on participants close to retirement



◆ **Advantages:** ◆ **Disadvantages:**

- Spreads cost over more than one year
- May not be available when needed
- Adds cost
- Has negative impact on value



- ◆ **Debt is usually used as a fallback when other funding is inadequate or unforeseen circumstances occur**



◆ **Funding repurchases obligations with debt is most useful when:**

- Repurchase obligations very high for one/several years
- Inadequate time to accumulate sinking fund
- Repurchases too big to fund out of current cash flow



Internal Markets

- ◆ **An internal market involves the establishment of a mechanism for shares that are distributed from the ESOP to be purchased by employees**
 - Employees may buy stock personally or through 401(k)
 - Federal and state securities laws impose certain disclosure requirements
 - The company must register securities or fit within exemption



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Internal Markets

- ◆ **An internal market is appropriate when:**
 - You want to expand employee ownership outside ESOP
 - Sufficient level of demand for company stock



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Internal Markets

- ◆ **Advantages:**
 - Reduces cash demands on company
 - Broadens employee ownership
- ◆ **Disadvantages:**
 - Securities laws requirements (disclosure requirements, registration or qualification for exemption)
 - Expense of establishing and maintaining market mechanism
 - Uncertainty about level of demand
 - Company still responsible if demand insufficient



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Internal Markets

- ◆ **Internal markets have been used in relatively few, mostly larger companies, because they tend to be complicated and expensive to maintain**



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Internal Markets

- ◆ In S corporations, restrictions on the number of shareholders limit the feasibility of using internal markets



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Third Party Solutions

- ◆ These **aren't** really funding methods – they eliminate the repurchase obligations by terminating the ESOP or creating a public market for the stock



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Third Party Solutions

- ◆ Third party solutions include a sale of the company or an IPO



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Third Party Solutions

- ◆ They are great when they are a result of the company's growth. The goal, however, is to plan and fund adequately to avoid a forced sale



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Third Party Solutions

- ◆ Another possibility is **sale of newly issued stock to a third party to fund growth**
 - Dilutes the ESOP's ownership
 - May be a solution when repurchase obligations are impairing the company's ability to grow



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S Corporation Issues

- ◆ Special issues...
 - The tax advantages associated with recirculating stock are eliminated (100% ESOP) or greatly reduced
 - A sinking fund in the company is more attractive because of the reduced corporate taxes



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S Corporation Issues

- ◆ S corporations that sponsor ESOPs have some **special issues** with respect to repurchase obligation funding...



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S Corporation Issues

- ◆ Special issues...
 - COLI is less attractive, because the value of the tax advantages is lost
 - S corporation distributions are not subject to the limits for contributions to the ESOP, allowing more funding



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◆ **Special issues...**

– **S corporation distributions are allocated pro rata to stock account balances and have the following effects:**

- » **Exacerbate the differences in account balances between “haves” and “have nots”**
- » **Make repurchase obligations “lumpier” because they cause stock to become more concentrated in fewer accounts as cash balances in the plan are used to purchase stock**



◆ **4 things to remember about repurchase obligations...**

– **The magnitude and timing of repurchase obligations need to be quantified in order to examine planning and funding options**



◆ **By way of summary, there are 4 things to remember about repurchase obligations...**



◆ **4 things to remember about repurchase obligations...**

– **How repurchases are handled – redeeming vs. recirculating – affects the ESOP, the plan participants, and the choice of funding alternatives, as well as the cost of repurchases**



Summary

- ◆ 4 things to remember about repurchase obligations...
 - There are basically five ways to fund repurchase obligations:
 - » Current cash flow (i.e., no advance funding)
 - » Sinking funds – in corporation, in ESOP
 - » Debt
 - » Internal markets
 - » Third party solutions



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In closing . . .

- ◆ Plan for repurchase obligations early in the life of your ESOP
- ◆ Revisit your assumptions and your strategy periodically to be sure they are still appropriate



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Summary

- ◆ 4 things to remember about repurchase obligations...
 - Each funding method has advantages, disadvantages, and situations where it is most (and least) effective
 - Most ESOPs rely on a combination of funding methods



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