How Plan Design Affects Repurchase Liability

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When an ESOP is implemented, it is common for the distribution provisions in the plan document to follow the ESOP specific distribution rules defined by Section 409(o) of the Internal Revenue Code. This section of the code specifies the outer limits within which a plan must make distributions to participants. (For additional information about these rules, see the box below.)

These provisions may function perfectly well in the early years of an ESOP, when the ESOP is leveraged, the account balances are small, and not many participants are eligible for a distribution.

But as an ESOP matures, companies often conduct studies of their repurchase liability. And it is not uncommon for organizations to determine at this point that their distribution provisions need to be modified.

Why Changes Might Be Needed

The main objective of a repurchase liability study is to determine how much money the company should allocate for repurchasing shares from terminated participants. If the study shows the repurchase obligation will have an unacceptable impact on corporate cash flow, this may prompt changes to the plan.

Other reasons that may prompt a company to consider plan changes may include:

- The repurchase obligation may require the plan to be funded at such a high level that contribution and/or annual addition limits will be exceeded.
- The company may be dissatisfied with the benefit levels provided through the ESOP.
- Terminated employees may not get their final distribution check for many years, and during that time may remain vested in company stock, thereby participating in the changes in share value, dividends, or S distributions on their shares.
- A mature ESOP in which the ESOP loan has been paid off and all shares have been allocated may have trouble obtaining enough shares to grant to new employees.

Some Options

Some of the elements a company may first consider changing are the timing and method provisions discussed above. For example, a company could choose to pay some distributions in a lump sum. The most frequent provision is to pay amounts of $1,000 and under in a lump sum in the plan year following the year of termination. (Amounts this size do not require the participant's consent to receive a distribution.)

Another option is to increase the threshold to a higher amount, to clear out smaller balances more quickly.

Distribution Rules

The general distribution rules defined by Section 409(o) of the Internal Revenue Code are as follows:

Timing. Participants who separate from service after normal retirement age (as defined in the plan document), or due to death or disability must start to receive distributions in the year following the year of termination.

Distributions for all other participants must start being paid out by the end of the sixth plan year following the year of termination. A leveraged ESOP could delay commencement even further for distributions of shares acquired by a loan until the loan is repaid. (Most ESOP professionals interpret this exception to apply only to C corporations.)

Method. Once distributions begin, they can be paid in substantially equal installments (at least annually) over a period not to exceed five years. For balances in excess of $1,070,000, the installment period can be extended by one year up to five additional years for each $210,000 by which the participant's account balance exceeds $1,070,000.

Note: These limits are as of 2016, and are indexed for cost of living increases.

Other considerations. An ESOP must comply with other qualified plan rules in the Code that require distributions due to attainment of age 70½, death, or retirement. In addition, an ESOP must allow participants to diversify a percentage of their shares once they have reached both age 55 and 10 years of participation in the plan.

	Redeeming	Recycling
Contribution/ Deduction	There is no contribution to the trust and no tax deduction for the payments to participants.	Contributions to the ESOP Trust to fund the recycling generate a tax deduction to the company (up to allowable limits).
ESOP Ownership	Shares leave the trust and the number of shares owned by the ESOP trust decreases.	The ESOP uses these payments to distribute cash to participants and the shares remain in the ESOP so ESOP ownership remains unchanged.
Total Shares Outstanding	Reduced.	Remains the same.
Impact on Allocations	No current allocation, although distributed shares can be held in treasury and contributed back to the ESOP in the future.	Provides ongoing share allocations so even newer participants are included in ownership after the ESOP loan is repaid.
Benefit Levels	Determined by company based on number of shares re-contributed annually. Shares could be immediately sold to the ESOP in a releveraging transaction with benefit levels determined by the terms of the loan. (Releveraging will be covered in a future article.)	Unless the company prefunds for future repurchase obligations, the annual repurchase liability determines benefit levels to participants.
Impact on Future Liability	May result in fewer shares to be repurchased over the life of the ESOP, but repurchases may occur at a higher value than under recycling, as redeeming decreases the total number of shares outstanding.	May result in a higher number of shares required to be repurchased over the life of the ESOP, as shares are recycled to other participants and then are again part of the future repurchase liability.

Some companies choose to accelerate both the timing and method for terminations due to death, disability, and retirement and treat these distributions differently than those for individuals who are terminated due to other reasons.

To address the concern of leaving terminated participants' accounts invested in company stock, a segregation strategy could be implemented that converts terminated participants' shares into other investments upon termination. This also could address the lack of shares available for allocation to new participants, because these shares are immediately recycled to current participants.

It is important to keep in mind that even though the other investments are kept in the ESOP and not immediately distributed, segregation accelerates the repurchase liability in the same way as lump sum distributions. As an alternative, the company could partially fund segregation, helping to control benefit levels but still recycling some shares from terminated to current participants.

Purchase Decisions

Another important decision that affects repurchase liability is how the shares will be purchased at the time of the distribution.

While share recycling is the most common means of handling repurchases, redeeming the shares out of the ESOP is another possible strategy. This could be accomplished by the company buying the shares directly from the ESOP, and using the cash deposited into the ESOP to make cash distributions to participants. However, because this is a transaction between the ESOP and a party-in-interest (the company), an updated fair market value as of the date of the transaction is required.

Another way to accomplish the same goal is to make stock distributions to avoid the updated value requirement. Because participants in C corporations generally have the right to demand a distribution in the form of stock, they will be issued a put option to sell the shares back to the company.

The right to demand stock does not apply to ESOP participants of either an S corporation, or a C corporation that has bylaws that restrict ownership to employees. In those situations, the stock distribution is accomplished by distributing shares to the participant with the requirement that the participant automatically sell them back to the company.

To compare these strategies, see the box above.

This article was reviewed and approved by the Chair of the Administration Advisory Committee, Lynn H. DuBois, Partner, ESOP Law Group, LLP.