Pitfalls In Selling Stock To Fund ESOP Repurchase Obligations - Part II
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In the first article on this subject that we recently posted, we considered the administrative and fiduciary issues that arise when an ESOP sells company stock to the company to fund its benefit distributions. The fiduciary issues under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") include the need to obtain a new valuation opinion letter from the ESOP's appraiser updated to the date of the sale. This updated opinion letter is required for the sale to be exempt from the prohibited transaction rules of under Section 4975(c)(1)(A) of the Internal Revenue Code of 1986, as amended ("Code") and Section 406(a)(1)(A) of ERISA. In this second article, we consider alternative methods for handling benefit distributions which avoid (or at least reduce) the administrative and fiduciary issues associated with the sale of company stock and the updated valuation opinion. We assume the company's objectives are: (1) to make ESOP distributions in the form of cash in order to avoid having former employees retain stock in the company, (2) to make no additional ESOP contributions to fund this obligation and (3) to preserve stock ownership for ESOP participants who are active employees.

Stock Distributions with Mandatory Company Buyback

If the ESOP sponsor is a company that restricts ownership of substantially all of its stock to active employees and the ESOP (as contemplated by Section 409(h)(2) of the Code) through its Articles of Incorporation or By-laws, or for a company that is an S corporation for federal tax purposes, the ESOP may distribute shares to ESOP participants subject to the requirement that the shares be immediately and automatically resold to the company. The Treasury regulations that define an ESOP would permit this repurchase to occur at the most recent prior year end value. An updated valuation would not be needed (unless the distributee was a "party-in-interest" under Section 3(14) of ERISA).

If the ESOP sponsor does not have an ownership restriction on its stock and is not an S corporation, then an ESOP participant who receives company stock in a distribution is not obligated to sell the shares to the company. He may retain the shares and become a long term shareholder.

Use of Secured Promissory Notes

If an ESOP sponsor is an S corporation or has a stock ownership restriction as described above, the ESOP could make distributions in a lump sum in the form of company stock. The purchase price for the mandatory buyback of the stock could be made in installments using a secured promissory note, as contemplated under Section 409(h)(5) of the Code. Former employees would then become creditors rather than shareholders of the company. The company's future payments on the promissory notes would not be contributions.

By following this procedure, the company could prevent former employees from becoming shareholders. Also, the company would avoid making additional contributions into the ESOP. Note that the IRS has made clear that momentary ownership of S corporation stock through ESOP distributions to an ineligible person or individual will not affect the company's S election.

Temporary Suspension of New Contributions

If the desire to avoid additional contributions is temporary, the ESOP could make distributions in the form of company stock and repurchase the shares from participants using the proceeds of a new ESOP loan from the company at the prior year-end fair market value. (However, if the former employee is a party in interest under Section 3(14) of ERISA an updated valuation may be needed). The shares acquired by the ESOP would be credited to an ESOP loan suspense account, and would be released only as payments are made on the ESOP loan. Contributions to the ESOP to repay the loan could be minimized (using an interest-only loan for awhile), with principal amortization to begin once the company can again begin making substantial contributions to the ESOP. This alternative would defer, but not eliminate the need for future ESOP contributions. Also, distributions of stock could be subject to an immediate and automatic repurchase by the company so long as the company had an ownership restriction on its stock or is an S corporation.

Alternatively, the company could assist the ESOP in funding cash distributions by using an interest free loan, as contemplated under DOL Prohibited Transaction Class Exemption 80-26. The ESOP would use the proceeds of the interest-free to make benefit distributions. Then, in the next year or two, the company would make contributions large enough to allow the ESOP to repay the principal balance of the loan.

Installment Distributions

A company may find that it is willing and able to make continuing cash contributions into the ESOP, but not contributions which are large enough to fund all benefit distributions. In this case, the ESOP could choose to make cash distributions in annual installments from the ESOP over a period of up to five years (see Section 409(o)(1)(C) of the Code), reducing the amount of new cash needed each year by the ESOP (relative to the cash needed to make lump sum distributions). So long as the company maintained an ownership restriction on its stock or was an S corporation, all distributions could be made in cash and not in company stock. Under this approach, participants would retain a declining balance of equity in the company over the installment period. Therefore, two of the objectives stated above of (i) avoiding distributions in company stock and (ii) avoiding additional contributions to the ESOP are

met. However, former employees remain partially invested in company stock during the installment period (although they do not receive distributions of stock) and additional contributions are required in order to fund the installment payments.

Conclusion

A company may wish to fund ESOP benefit distributions without allowing former employees to remain invested in company stock and without permitting former employees to become long-term shareholders. If the company does not wish to make current cash contributions to the ESOP to fund these distributions, the company and the ESOP should consider a distribution policy that avoids the need to have the ESOP regularly sell company stock back to the company. These sales create both administrative and fiduciary issues that may be avoided by choosing one of the alternative methods of distributions described in this article.

Editor's note: this posting is based in part on an article that appeared in The ESOP Report of The ESOP Association several years ago.