

Making ESOP Cash Distributions – Hitting the Fairway and Avoiding Hazards

ESOPs must make benefit distributions available in company stock unless the company is (i) an S Corp., or (ii) a C Corp. whose by-laws restrict ownership primarily to active employees. Code section 409(h)(2)(B). If either of these two exceptions applies, the ESOP may eliminate the right to stock distributions and only distribute the cash value of the company stock.

Why would an ESOP company eliminate stock distributions?

When an ESOP distributes stock to the participant, the participant has a right to sell (“put”) the stock back to the company at fair market value as of the most recent valuation date provided under the ESOP document (typically December 31 for calendar year plans). The company can require that this put be “mandatory” whereby the transfer of stock ownership from the ESOP to the participant is recorded but actual distribution of a stock certificate to the participant does not occur. Even with a mandatory put, however, many ESOP companies (particularly larger S Corps.) prefer to avoid issues like the limit on the number and type of S Corp. shareholders, as well as the general complexities of the put distribution process.

If the ESOP is going to distribute only cash benefits to participants, where will it get this cash?

Since cash does not grow on an ESOP tree, the ESOP can obtain cash from the company in four ways:

- **Contribution**
- **Dividend/Distribution**
- **Loan**
- **Redemption**

Contribution. Cash contributed to the ESOP is allocated to eligible participants’ accounts based on the ESOP’s allocation formula (typically a uniform percentage of pay). The ESOP trustee must invest this cash prudently and such cash (and any earnings thereon) will be reflected on the participant’s statement in what is called the Other Investment Account (OIA). A cash contribution to the ESOP is a deductible expense but, of course, generates no federal tax savings in the case of a 100% S Corp. ESOP.

When this cash is used to make benefit distributions, the ESOP trustee will exchange cash pro rata from other participant accounts for the shares of those participants receiving distributions. This internal ESOP process is called “recycling.” This cash contribution approach may be less useful if the contributions would (i) cause your ESOP allocation as a percentage of compensation to be higher than desired, or (ii) cause the ESOP to hit the IRS contribution limits.

Dividend. The company can declare a dividend (or in the case of an S Corp. a distribution) payable to all shareholders. A dividend is not subject to the IRS limits on contributions. The ESOP trustee would exchange the cash dividends pro rata from other participant accounts for the shares of those participants receiving

distributions. Dividends paid to ESOPs may be deductible by C Corps. under Code section 404(k).

Unlike a contribution that is allocated only to ESOP-eligible employees, the dividend is allocated inside the ESOP based on the number of shares held by each participant. Thus, former employees holding shares inside the ESOP will receive these dividends, often an undesirable result from the company's perspective.

Loan. It is common for the company to make a long-term loan to the ESOP so the ESOP can buy stock from selling shareholders, but the company also can lend cash to the ESOP on a "short-term" basis to pay benefits. DOL PTE 80-26 is a class exemption that permits the company to make an interest free, unsecured loan to the ESOP to pay benefits. "Short-term" is not defined in the PTE but has been applied to loan periods of several years. Of course, this loan must be documented and eventually repaid by the ESOP out of future company cash contributions.

When this loan method is used, the trustee "swaps" the borrowed cash for the shares eligible for distribution. The cash is paid out to eligible participants and their swapped shares are then held in "suspense" inside the ESOP until released by the company's future cash contributions and ESOP repayment. This process can be cumbersome and is not commonly used simply to fund ESOP distributions. On the other hand, this loan approach has more appeal if all ESOP shares have been allocated and the company uses multiple short-term loans as an indirect way to re-leverage the ESOP.

Redemption. The ESOP can obtain cash for benefit distributions by selling the applicable stock back to the company. The stock sale provides the ESOP with cash but since the payment of the purchase price to the ESOP is not a contribution, it is a nondeductible capital expense. The transaction must be documented by a sales agreement between the ESOP and the company.

Importantly, this sale is between "parties in interest" which is a prohibited transaction under Code section 4975(c)(1)(A) and ERISA section 406(a)(1)(A) unless the sale is exempted by adhering to the ERISA section 408(e) rules.

The exemption requires that the sale be for "adequate consideration." The proposed regulations under ERISA section 3(18) state that "adequate consideration" is the asset's fair market value and it must be determined as of the date of the sale. Prop. Reg. section 2510.3-18(b) (2) (ii). While these 1988 proposed DOL regulations have yet to be finalized, most courts have embraced their underlying principles.

Thus, the trustee must obtain a contemporaneous, updated stock valuation from the ESOP appraiser before selling stock to the company. The ESOP should not simply rely on the prior year-end appraisal to satisfy the exemption.

- **What are some potential risks if an updated valuation is not obtained for the redemption?**

The prohibited transaction rules under Code section 4975 impose an annual 15% excise tax on the "amount involved" until the transaction has been corrected. The amount involved would be any increase in the value of the shares redeemed that was not reflected in the sale price. The company is responsible for this tax. There is no de minimis exception to the tax, even if the amount involved is very small. The

commission of a prohibited transaction also subjects the fiduciary to potential liability under ERISA section 502 to both the DOL and ESOP participants.

- **If an updated valuation is not obtained, how do you know if you flunked the exemption?**

The absence of an updated valuation likely would shift the burden of proof to the company to prove that the sale was for at least fair market value. For example, if the prior year-end value was \$10/share and the following year-end value was \$12/share, the DOL or IRS might assert, in the absence of contrary evidence, that the value for a sale taking place on July 1 was \$11/share. On the other hand, if the following year-end value was \$9/share, then redemption at \$10/share on July 1 might pass muster even if an updated valuation was not obtained.

The redemption process also raises some interesting administrative issues.

- **If the updated share value is higher than the prior year-end value, who receives the increased value?**

Your ESOP document likely provides that the amount to be distributed to participants is based on the ESOP's last valuation date, typically December 31 for calendar year plans. (You should confirm the specific language in your document and make any necessary changes if the language is too general and could be read to include the updated valuation.)

For example, if the December 31 value was \$10 and the updated July 1 sale date value is \$11, who benefits from the \$1 increase? Let's further assume 1,000 shares are eligible for distribution, representing the entire account of one participant, meaning \$10,000 is to be distributed.

The company could buy back the 1,000 shares at \$11 but this would put \$1,000 more cash into the ESOP than is needed to make the distribution. Another approach that may be preferable is to buy back only those shares needed to fund the \$10,000 payment: in this case, $\$10,000/\$11 = 909$ shares (rounded). Since the full benefit obligation to the participant has been satisfied, the other 91 shares in the account are reallocated to other participants in proportion to their stock balances as "earnings" from this sale (like a dividend would be). The 91 shares reallocated, of course, equal \$1,000 (rounded; $91 \times \$11$).

- **What happens if the updated share value is lower than the prior year-end value?**

The ESOP can sell the stock to the company for the higher year-end value because the ESOP always can sell the stock for more than its fair market value. The participant then would receive the \$10,000 distribution under the terms of the ESOP document.

- **What does the company do with the redeemed shares?**

Depending on its long range goals, the company can retire none, some, or all of the shares (e.g., shares retired are no longer outstanding). Any shares not retired would be recontributed to the ESOP.

If the ESOP owns 100% of the company stock, retiring the shares will not affect the ESOP's ownership percentage. However, always retiring redeemed shares will become problematic for sustainability purposes, for reasons we will not discuss here. Thus, the company will need to determine how many of the redeemed shares it wishes to recontribute to the ESOP for current allocation to employees.

If the ESOP owns less than 100% of the company, redemption without recontribution of all the shares will shrink the ESOP's ownership percentage. This could become significant, for example, if the ESOP's ownership were to shrink below 50% and lose its majority position. In this case, the ESOP trustee may wish to seek other enhancements from the company before agreeing to such sale -- perhaps accelerated vesting or additional cash contributions. If such agreement cannot be reached to proceed with redemption, the ESOP trustee would need to distribute the shares to eligible participants who then would exercise their put option back to the company.

- **What does an updated ESOP valuation entail?**

The process should be faster and less expensive than the annual valuation. Typically, the annual valuation for calendar year ESOPs is completed by early May. If your ESOP must make diversification distributions, these are due by June 30 so you will want to schedule your redemption for all distributions at the same time. If you do not have diversification distributions, the distributions need to be made before year-end. Note: the longer the period between the prior year-end and the redemption date, the greater the potential change in share value.

Let's take an example where redemption is to occur on June 15. The appraiser typically will issue a new valuation report as of June 1 based on all relevant information and factors then available. The appraiser also will issue a "bring-down" letter to bring the valuation forward to the actual sale date of June 15. Unless circumstances have dramatically changed since June 1, the bring-down letter will state that the June 1 value remains fair market value on June 15.