

Employee Stock Ownership Plans: Early Payment of an Exempt Loan May Not be Wise



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Many leveraged ESOPs are actually handled with two loans. When the corporation / employer borrows from an outside lender, we call it the “**outside loan**”. When the corporation lends to the ESOP, we call it the “**inside loan**”. The inside loan is also called an “**exempt loan**” because only ESOPs are exempt from the rules that normally preclude qualified retirement plans from borrowing money in order to purchase other assets.

There may be plenty of good reasons to pay off an outside loan as quickly as possible – reducing the interest expense from borrowing, improving company financial statements, etc. Thinking debt should always be kept to a minimum, many employers, ESOP committees, and Trustees may also want to pay off the *inside* loan as quickly as possible. The purpose of this article is to explain why that might not always be in the best interest of the corporation’s long-term cash flow. Consider these disadvantages:

Early payment of an exempt loan may not always be in the best interest of the corporation’s long-term cash flow.

- 1) If payments to the ESOP are simply returned to the corporation as loan payments, then making larger contributions, in order to make early payments, is still a wash and does not improve the *corporation’s* cash flow. (Of course, if the corporation is not wholly owned by the tax exempt ESOP then larger contributions *do* provide larger deductions.)
- 2) Assume a company lends to its own ESOP with a note scheduled to be paid over a 10-year period. By paying the loan off early, the repurchase obligation is impacted in two ways:
 - a) Those people who terminate when loan payments are being accelerated end up having more shares credited to their accounts than originally expected. This increases the cash needed in order to buy back shares from those participants. This could be particularly costly in a high-turnover industry.
 - b) A plan is allowed to have wording so that former employees’ distributions (with certain exceptions) can be deferred until the exempt loan is paid off. Paying off the loan in six years instead of 10 accelerates the point in time when more cash is needed to buy back shares.
- 3) In order to pay down the debt faster, the company is, in essence, agreeing to increase its retirement expense above what was originally planned. To anyone viewing the company’s financials (like lenders and potential buyers) this affects the bottom line and makes the company appear to be less profitable.



ESOPs - Early Loan Payment

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- 4) If an ESOP receives cash from dividends on employer stock, it is *permitted* to spend that cash to make early payments on the exempt loan. However, this means less cash is available later when participants terminate employment and want to sell their shares for cash.
- 5) Making larger contributions in order to pay down the debt quickly tends to build up employee expectation of larger contributions *every* year, even after the loan is paid off. Many companies prefer to budget an annual payment so that the contribution, or the value of the shares released from encumbrance, is in line with retirement expenses for their industry.
- 6) Finally, spreading the loan payments over more years, thus releasing shares from encumbrance over a longer period of time, postpones that point in time when there might not be many shares to be allocated to future hires. This avoids creating what many call the “haves and the have-nots.”

