

## ESOPS -- Recycling Stock vs. Retiring it

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When a former employee is being paid his stock from an ESOP, and he has the right to “put” the shares back to the company or the plan, the company often has to make a tough decision --- Do we retire (redeem) the shares (buying them back into the corporation’s treasury stock) or recycle the shares (having them bought back by the ESOP).

Here are thoughts to consider on the two approaches.

### *Recycle*

- 1) With ongoing contributions, the ESOP can buy back the shares from former employees and thus have new shares to allocate each year to all participants.
- 2) Without recycling, for many plans the only way shares get into the accounts of new participants would be if there are forfeitures from the accounts of participants who are terminating employment. However, the ones that have short tenure, and thus forfeit part of their accounts, are also the ones with small accounts. So there may not be much in the way of forfeitures to be reallocated.
- 3) If the ESOP is buying back the shares, often it can do so by liquidating the shares and spreading the distribution over several years. The downside is that cash for shares liquidated at a future date must be based on the future price per share. Doing something comparable while redeeming stock requires a reasonable interest rate and the use of some collateral other than the shares themselves.
- 4) If the amount to be bought back can be handled with the amount the company wishes to contribute for the year, then recycling makes a lot of sense.
- 5) Participant taxation
  - a) Another advantage to recycling is that whether the benefit is distributed in a lump sum or through installments, the participant can always choose to have the distributed shares (if the employer is a C corporation) or cash go into an IRA.
  - b) If the put is honored by the corporation through installment payments, then those payments made beyond 60 days after the ESOP distribution are not eligible for rollover into an IRA.
  - c) If the put is honored by the *plan*, as a lump sum distribution, then the participant has the ability to tax Net Unrealized Appreciation (NUA) at capital gains rates. This does not apply to installment distributions since NUA treatment requires a total lump sum distribution.



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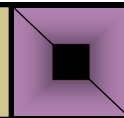
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- 6) If the amount to be bought back exceeds the cash available from the plan and the current year's contribution, then the company might consider:
  - a) A combination of recycling and redeeming;
  - b) Re-leveraging the ESOP to borrow more cash to be paid for with *future* contributions; or
  - c) Using some combination of (a) and (b) in order to "smooth" the cash needs of the plan.



***Redeem and retire***

- 1) In general
  - a) How do new participants get any stock credited to their accounts?
  - b) Redemption is often part of a long-term strategy to wind down the ESOP.
  - c) If there will be no more contributions, then the plan could be deemed "terminated" requiring full vesting of all participant accounts.
  - d) Oftentimes, a redemption is not expected to decrease the price per share because the cash going out to purchase the shares is offset by a reduction in the number of shares outstanding. The resulting ratio of value to number of shares can remain the same. But not all appraisals reach that same result.
  - e) If the corporation is buying back the shares, doing so through installments requires a reasonable interest rate and collateral other than the shares themselves.
  - f) If the shares are expected to appreciate faster than the cost of borrowing money, then (assuming legitimate collateral is available), retiring the shares with installment payments might lower the ultimate cost to the employer. This needs to be weighed against the loss of deduction, if any, by using the recycling method.
  - g) Will the shares bought by the corporation eventually be contributed to the ESOP at some later date?
- 2) S corporations wholly owned by the ESOP
  - b) If the company is an S corporation then usually former employees are not even allowed to own stock. Consequently, the participant doesn't have a "put" option. In these cases most companies use the recycling approach. A very small percent of companies in this situation get around this by having the company buy shares from the ESOP (requiring a lot of effort to avoid a prohibited transaction), and then have the ESOP pay the former employee.
  - c) For small S corporation ESOPS, constantly retiring the shares means the participants in the plan own an ever-increasing percent of the company. For the people with the largest balances, this could create anti-abuse problems (under Section 409(p) of the Code).
  - d) Retiring shares and later re-contributing those shares to the ESOP does not generate any meaningful deduction if the company is 100% owned by the ESOP.



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- 3) Situations other than S corporations wholly owned by the ESOP
  - a) If this is not an S corporation wholly owned by the ESOP, then buying back shares at one price in Year X, but contributing them in a later Year Y at a higher price, not only gives a Year Y deduction higher than the cash spent on the buy-back, but allows a Year Y deduction without contributing any cash at all.
  - b) Redeeming shares does not offer a deduction for the transaction, while contributing to the ESOP and having the ESOP purchase the same shares, can be deductible.
- 4) Participant taxation
  - a) If the participant rolls the shares into an IRA and the IRA is “putting” the shares back to the corporation, there may be difficulty in finding an IRA trustee willing to hold a note if the corporation wishes to honor the put through installment options.
  - b) If the participant personally “puts” the shares back to the corporation and then receives installment payments, the only way to defer taxes on the entire distributed value is to come up with cash equal to the whole value, even though the corporation can take several years to honor the put by way of distributions. (To avoid taxation, the entire taxable value must be rolled over within 60 days of the ESOP distribution.)

**Recap** --- Which approach is best boils down to weighing all the factors:

- 1) Whether the corporation is an S or a C corporation; and, if an S corporation, the percent of the company owned by the ESOP.
- 2) Whether the long-term plans for the ESOP include winding it down.
- 3) Cash required, as a percent of payroll, to service debt this year and also buy back shares.
- 4) The desired ESOP allocation of new shares as a percent of participant payroll.
- 5) The availability of and the value of a deduction for any contribution.
- 6) Whether the plan is getting close to any S corporation anti-abuse thresholds.
- 7) The importance of getting shares in the accounts of new ESOP participants.
- 8) The cost of borrowing if any new debt will be incurred in order to buy back shares.
- 9) Expected future appreciation in the value of the stock.
- 10) The availability of collateral if redeeming shares with installment payments from the corporation.
- 11) The likelihood of re-contributing shares to the ESOP after they've been bought back by the corporation.
- 12) The desire to buy back shares through installments instead of lump sums.