Managing Employee Stock Ownership Plan (ESOP) Repurchase Liability

Why a Defined Benefit Pension Plan Can Help a Mature ESOP Corporation Better Manage Repurchase Liability Obligations

Many ESOP corporations are presented with the challenge of maintaining an ESOP over the long-term:

- ESOP sustainability can raise internal concerns about the finances of the business, as well as the general perception of employee ownership within an ESOP corporation.
- As the ESOP company becomes more successful, the repurchase liability to cash out retiring or terminated workers increases and proper financial planning becomes critical.
- Employee demographics and retirements are important factors in planning for the cash funding requirements of the ESOP repurchase liability.
- The success of the company and the high value of the ESOP account balances can both be a retention tool or, conversely, an incentive for early retirement.

It may be counter-intuitive, but with proper planning and design, a pension plan can effectively help to manage the repurchase liability through its impact on the financial statements and ESOP valuation.

Earnings will be lower for an ESOP corporation with a pension plan when compared to an ESOP corporation without a pension plan. The valuation of a company with a pension plan will be lower than the valuation without a pension plan. Thus, the total cash required for repurchase liability will be less for an ESOP company with a pension plan and workers will have protected retirement benefits.

A pension plan can be adopted for all active participants, selected individuals and new hires, provided certain discrimination rules are satisfied.

The Benefits to a 100% Employee-Owned ESOP Corporation to Adopt a Pension Plan

- **Repurchase Liability Reduction:** Lower and better management of ESOP repurchase liability obligation while shifting benefits to participants in a pension plan
- **Participant Retirement Diversification:** A more diversified retirement benefit with less reliance on the performance of company stock
- **Wealth Creation:** Greater value and wealth creation for participants potentially limited by Internal Revenue Code Section 409(p)
- **Lifetime Benefit:** Lifetime guaranteed income with spousal protections provided to participants through a qualified pension plan
- **Bankruptcy Protection:** PBGC insurance protections through a qualified pension plan
- **Replacement Income:** Adequate and consistent retirement replacement ratio – less volatility in retirement benefits
- **Distribution Options:** Greater flexibility regarding participant distributions and withdrawals
- **Improved Cash Flow:** Business will have improved cash flow since payments from a pension plan can be paid as a life annuity

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Pension Plan Design

A pension plan can provide a set monthly income (also known as a pension or annuity) at retirement through a formula based on age, years of service and average annual compensation. This monthly income is then paid to the retiree as a monthly pension over the course of their retirement. Pension benefits can be based on past service or accrue going forward over time.

Disqualified persons can participate in a pension without violating Internal Revenue Code section 409(p) anti-abuse rules. In addition, pension plan benefits are not considered synthetic equity for purposes of the 409(p) anti-abuse rules.

A pension benefit at retirement cannot exceed the lesser of 100% of the participant's compensation over the three years of highest compensation or $220,000 (2018, indexed). At age 65, the value of this benefit can be approximately $3.1 million in a lump sum form.

Bankruptcy Protection

A pension plan can provide Pension Benefit Guaranty Corporation (PBGC) protections for ESOP participants. Different from ESOP benefits, the pension benefits are by law guaranteed retirement benefits that are insured by the PBGC. In case the ESOP corporation enters bankruptcy, the pension benefits are protected.

At age 65, benefits are insured by the PBGC up to $65,045 per year (2018, indexed). In exchange of PBGC guaranteed benefits, pension plans pay premiums based on participant counts and unfunded vested benefits.

Key Risks and Holistic Approach

An ESOP corporation should understand the key risks associated with the establishment of a pension plan and how it correlates with the current ESOP.

- Pension plan design, funding and plan investments will have an impact on the organization's enterprise value.
- Rather than managing a pension trust as a separate silo, we suggest a holistic approach in which the pension plan is viewed as part of the organization's overall capital structure, and pension management practices are aligned with the enterprise risk management system.
- This holistic approach to pension plan management and performance measurement strives for the same degree of rigor that organizations use when managing their overall business.
- Pension strategies should be developed with an eye toward managing the ESOP repurchase liability and pension benefit obligation. If handled correctly, managing pension plan volatility will make managing ESOP repurchase liabilities much easier.

The Employee Benefits Practice of PKF O'Connor Davies can assist companies and business owners with pension plan design and implementation, ESOP transactions, including feasibility analysis, succession planning, tax, accounting, employee benefit transformation services and executive compensation analysis.

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