Deferred comp issues for entities with Employee stock ownership plans (ESOPs)

For both privately held and publicly traded companies, employee stock ownership plans (ESOPs) have become a popular way to provide employee ownership. Like any other company, an ESOP-owned company must attract, retain, and reward key executives. Moreover, owners of privately held businesses often want to remain in management of the company and the ESOP, as a qualified plan, can't meet this objective alone. In addition, seller financing is often required to allow an ESOP to buy a majority stake in a company.

Nonqualified deferred compensation plans can help address all of these goals — and may also enhance the company's balance sheet and cash flow. It's important to recognize, however, that when an ESOP owns a significant portion of a company's stock, that ownership will influence the design and financing of deferred comp plans.

Financing strategies

An ESOP in a privately held company may help an owner exit the business, while leaving the company's management intact. This usually involves the use of a **leveraged ESOP**. A leveraged ESOP borrows money to finance the purchase of the business from the owner, and the company then makes periodic contributions to the ESOP to pay principal and interest on the debt. This debt may be with an outside bank or with the shareholder (i.e., seller financing). All contributions to the ESOP are typically tax-deductible because the ESOP is a qualified plan. During the loan-repayment period, some leveraged ESOP companies may find themselves with limited available cash.

Another factor ESOP companies must consider is their need to fund the **ESOP repurchase obligation**. As employees with vested stock balances leave employment, the ESOP usually pays these participants in cash based on the current value of their stock ownership. ESOP companies are permitted to delay the repurchase obligation until the ESOP loan is repaid, but the repurchase obligation, along with the leveraged ESOP debt, often combine to make cash flow an important concern. In order to meet this obligation, ESOP companies may set up a sinking fund to meet future liquidity needs, but due to cash flow constraints, few companies actually do this.

Financing of deferred compensation plans in ESOP companies

An ESOP company's tax and cash-flow issues, therefore, require special consideration when financing deferred compensation plan liabilities. ESOP companies especially need to consider their short- and long-term tax position and the effect of their ESOP repurchase liabilities on cash flow. Possible financing approaches for deferred compensation obligations include:

- **Unfinanced.** The company keeps participant deferrals to use as corporate cash and pays future benefits out of cash flow. For a company with a highly leveraged ESOP, this may prove attractive because it provides immediate cash. Nonetheless, as with any unfinanced deferred compensation plan, the company must take great care to ensure liquidity is available to pay out future distributions.
- **Financed with taxable assets.** If a leveraged ESOP puts the company in a low or zero income-tax position, the company avoids the typical cash-flow drain from taxes due on realized gains. If the

company remains in a taxable position after the ESOP contribution, however, then taxes due on realized gains would reduce cash flow. In the long term, this financing technique will provide funds for nonqualified distributions, but it will not provide any additional cash flow the company may need to meet its ESOP repurchase obligation.

- **Financed with corporate-owned life insurance (COLI).** Regardless of tax status, obtaining COLI for key persons provides an opportunity, in the long term, to finance both the ESOP repurchase obligation and deferred compensation plan liabilities. Outside lenders to the ESOP often insist on key-person insurance. Also, in the case of leveraged ESOPs, after the debt is repaid, the company may return to taxable profitability. If COLI is used as a financing method, the corporate asset will continue to grow on a tax-deferred basis.

A company with significant ESOP ownership and a deferred compensation plan should carefully consider the consequences of each financing technique, especially weighing cash flow and tax positions as the ESOP matures.

S corporation issues

One tax-savings strategy for closely held companies involves the company electing S corporation status with the ESOP as a stockholder. Since an ESOP is a qualified plan and the S corporation is a "pass-through" entity for tax purposes, both the corporation and the ESOP may avoid paying income taxes. To prevent abuse of this strategy, final tax regulations provide that "disqualified persons" may not own 50% or more of the equity in the company. "Equity" includes directly owned outstanding shares, ESOP shares, and "synthetic equity."

There are two definitions of a "disqualified person":[1]

1. Anyone who individually owns 10% or more (or for a family group, 20% or more) of total ESOP shares is a disqualified person.
2. Anyone who owns 10% or more (or for a family group, 20% or more) of ESOP shares, plus their individual synthetic equity as a proportion of total ESOP shares, plus the individual's synthetic equity. Note that the denominator of this ratio does not include total synthetic equity, only the individual's synthetic equity. Synthetic equity includes any stock options, warrants, and restricted stock — or any other right that may give the holder more stock in the S corporation in the future. Also, since deferred compensation could reduce stock value, synthetic equity also includes the equivalent amount of company stock that would be represented by the participant's balance in the deferred compensation plan.
3. The intent of these regulations is to limit the tax benefits that ESOPs provide to S corporations, unless these ESOPs, in turn, provide significant benefits to "rank-and-file" employees. These rules, therefore, would chiefly affect employees of S corporation ESOP companies who have large deferred compensation balances, significant ESOP account balances, or both.

S corporation note: Due to individual tax considerations (the interaction of K-1 and W-2 income), shareholder-employees of S corporations with significant ownership positions typically do not defer employee salary into deferred compensation plans. For more information on issues associated with S corporations, please see the Applied Knowledge article titled, "Deferred comp plans and pass-through tax entities."

[1] See IRC Sec. 409(p)(4).

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