

# The Nuts and Bolts of ESOP Loans

Just as with nuts and bolts, ESOP loans come in all shapes and sizes. Understanding the many facets of ESOP loans and the share-release process is the key to ERISA compliance.

BY KEVIN T. RUSCH



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**A**s a young boy on our family farm in rural Wisconsin, one of my tasks was to sort our nuts and bolts. Besides the vast variety of sizes, I quickly learned the differences between hex nuts, lock nuts, flange nuts and wing nuts. Bolts came with different threads and purposes as well: carriage bolts, lag bolts, eye bolts and U-bolts.

I've had the pleasure of experiencing a similar variety of employee stock ownership plan (ESOP) loans over my consulting and administration career. While an ESOP is a defined contribution plan like a 401(k) plan or a profit sharing plan, they have many special characteristics and requirements. One unique aspect of ESOPs is the ability for the plan to purchase qualifying employer securities with a loan, also known as being leveraged, for the benefit of the plan participants. Just as with nuts and bolts, ESOP loans come in all shapes and sizes. The purpose of this article is to provide an understanding to properly administer ESOP loans and the share-release process to stay in compliance with ERISA.

There is a very high probability an ESOP will be leveraged during its lifecycle. When this leveraging occurs and the ESOP takes on debt to acquire company stock, a number of legal documents are drafted to record the terms of the transaction and the requirements of the involved parties. As the TPA of an ESOP, it is important to understand the reason these documents exist and the differences between ESOP internal loans versus external loans.

#### **INTERNAL VS. EXTERNAL**

Many leveraged ESOP transactions involve both internal loans and external loans. The internal loan is between the ESOP Trustee, on behalf of the ESOP Trust, and the company.

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The external loan is between the company and the selling shareholder in seller-financed transactions and between the company and a financial lender, such as a bank, in externally financed transactions.

Having separate loan transaction documents allows the plan sponsor more repayment and refinancing flexibility. For example, a plan sponsor can change the term of the internal loan to assist in releasing a desired number of shares to the plan participants at the company's desired benefit level. In addition, the company can have a much shorter loan term on the external loan in order to remove debt from the company's books and, in a seller financed transaction, pay off a selling shareholder without affecting the share allocation in the ESOP. It is common, for example, to see ESOP internal loans with terms of 15 to 30 years, while external loans have terms of 5 to 7 years.

For accounting purposes, external debt is recorded on the company's balance sheet as a liability. As a result, many companies have a goal to get the external loan paid off as quickly as possible. The ESOP internal loan is recorded as a contra-equity account on the balance sheet, with adjustments being made to the account as the shares purchased with the ESOP loan

are released and allocated to the plan participants in the ESOP.

#### TRANSACTION DOCUMENTS

Common documents which are drafted as part of the ESOP leveraged transaction include:

- the ESOP Loan Agreement;
- the ESOP Stock Purchase Agreement;
- the ESOP Stock Pledge Agreement; and
- an ESOP Promissory Note.

There are various ways to structure these transactions. The following paragraphs illustrate one common approach of drafting the legal documents in a seller-funded transaction.

The **ESOP Loan Agreement** is a contract between the selling shareholder, the plan sponsor, and the Trustee of the ESOP. The loan agreement will state the selling shareholder has agreed to sell and the ESOP Trustee has agreed to purchase a certain number of shares of company stock at a specified purchase price. To facilitate the transaction in this example, the seller lends funds to the ESOP Trust to purchase the company stock. The seller and Trustee agree to assign this loan to the company and the company will then have a loan to the ESOP. This two-step process creates the external loan between the seller and the plan sponsor and the internal loan between the company and the ESOP.

The **ESOP Stock Purchase Agreement** is the legal contract between the seller and the Trustee of the ESOP on behalf of the ESOP Trust. The document is the agreement of the sale of the stock by the seller and the purchase of the stock by the ESOP Trust. It will include the number of shares being sold, the purchase price paid by the ESOP Trust, and the time and place of the closing. In addition, the document will contain detailed representation and warranties.

The **ESOP Stock Pledge Agreement** pledges the stock

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purchased by the ESOP Trust in the leveraged transaction as collateral for the debt owed to the plan sponsor. As payments are made on the ESOP internal loan, shares are released from the collateral pledge and the administrative loan suspense account and allocated to ESOP participants (see Treas. Reg. §54.4975-11(d)(2)). Loan payments by the ESOP Trust can be made using ongoing contributions made to the plan by the company, earnings attributable to the contributions, or C Corporation dividends or S Corporation distributions attributable to the shares acquired with the proceeds of the loan being repaid. The pledge agreement will indicate how the shares are released from the collateral suspense account.

The **ESOP Promissory Note** identifies the repayment schedule for the ESOP internal debt. Key sections in the document include the date of the loan transaction, the dollar amount of the loan, the interest rate, the frequency and number of loan payments to be made, and the application of prepayments on the note.

#### RELEASE OF SHARES

A critical part of administering a leveraged ESOP is computing the share release as the internal ESOP loan is paid down. The share-release formula can be either of two formulas, as defined in Treas. Reg.

§54.4975-7(b)(8):

- General Rule (also known as the Principal and Interest Method)
- Special Rule (also known as the Principal Only Method)

The **General Rule** share-release formula is based on principal and interest payments made on the ESOP loan and is calculated as follows:

$$\frac{(\text{principal and interest paid for the year})}{(\text{principal and interest paid for the year} + \text{principal and interest to be paid for all future years})} * \text{shares in suspense}$$

The **Special Rule** share-release formula is based solely on principal payments made on the ESOP loan and is calculated as follows:

$$\frac{(\text{principal paid for the year})}{(\text{principal paid for the year} + \text{principal to be paid for all future years})} * \text{shares in suspense}$$

As noted in the Treasury Regulations, if the Special Rule is used to calculate the share release, three additional rules must be followed:

- The loan must provide for annual payments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments of such amounts for 10 years.
- Interest included in any payment is disregarded only to the extent that it would be determined to be interest under standard loan amortization tables.
- The term of the loan cannot exceed 10 years (including any renewal, extension or refinancing).

It is important to note that the current fair market value of the company stock does not affect the number of shares released during a plan year. It is quite common that the shares released from the ESOP suspense account will have a different value than the value of the contributions, C Corporation dividends or S Corporation

distributions used to make the loan payments. Earlier in the term of the loan, the shares released will most likely have a lower value due to the additional debt on the company's balance sheet to acquire the ESOP stock. As the external debt is paid off and the share value of the company stock increases, the value of the shares released as collateral on the ESOP internal loan may have a value greater than the contributions and dividends used for loan payments made on the outstanding loan.

Leveraged ESOPs can have more than one outstanding loan. From an administration standpoint, the loans and related share release should be record kept separately. The loan terms can be different. For example, one ESOP loan may use the Principal Only release method while the other ESOP loan may use the Principal and Interest release method. Most ESOP plan documents allow for either share release method to be used, making it important to have the executed copy of the ESOP Stock Pledge Agreement for each outstanding loan to properly determine the share-release formula.

More ESOP internal loans are being created with longer terms than 10 years to spread out the ESOP share release, allowing the plan sponsor to better manage the participant benefit levels and the ESOP repurchase obligation. As a result, the Principal and Interest Method must be used to compute the share release for the leveraged ESOP.

### **ESOP LOAN AMORTIZATION SCHEDULE**

More often than not, an ESOP loan amortization schedule does not accompany the other legal documents prepared in a leveraged ESOP transaction. Since future interest payments on the ESOP internal loan are included in the share-release formula, it is highly recommended for the TPA to draft an ESOP loan amortization schedule to properly identify all the nuts and bolts of that ESOP note. The ESOP

Promissory Note will provide the TPA with the terms and payment schedule to produce the loan amortization schedule.

The amortization schedule should properly reflect the loan start date and frequency of payments, as this will affect the interest portion of the loan payments. The interest rate provided in the promissory note should be used, paying attention if the interest rate is a fixed rate or a variable rate over the term of the loan. If the loan does use a variable rate of interest, such as LIBOR plus 2%, a new amortization schedule should be created at the end of each plan year. The interest rate used to determine the future interest component on the ESOP loan should be the interest rate in effect as of the last day of the plan year being administered (see Treas. Reg. §54.4975-7(b)(8)(i)).

The loan amortization schedule should include the proper compounding of interest as stated in the promissory note. Common interest compounding for ESOP loans include monthly, quarterly, annual, or exact days. The year length noted in the loan documents can also affect the computation of the interest payments due on the ESOP

loan. For example, a promissory note using exact days for compounding interest with a 360-day year will generate different results from a note using exact days for compounding interest with a 365-day year.

Another particularly important item in the promissory note is the prepayment provision, as prepayments on an ESOP loan will impact the current and future share releases to plan participants. The note will state that prepayments are first used to pay any interest due on the ESOP note. The remaining prepayment may then be applied to the principal balance on the loan either in "order of maturity" or the "inverse order of maturity." The order-of-maturity provision reduces the subsequent principal loan payments needed to maintain the term length of the original ESOP note. The inverse-order-of-maturity provision will keep subsequent loan payments in line with the original ESOP Note. It is more common to see loan documents drafted with the inverse order of maturity for loan payments, which will shorten the term of the loan. Alternatively but not as common, some ESOP Notes will direct a re-amortization of all remaining loan payments,



## ESOP LOAN & SHARE RELEASE CHECKLIST

| Executed ESOP Loan Documents on File                                                                                                                                  | Comments |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------|
| ESOP Loan Agreement                                                                                                                                                   |          |
| ESOP Stock Purchase Agreement                                                                                                                                         |          |
| ESOP Stock Pledge Agreement                                                                                                                                           |          |
| ESOP Promissory Note                                                                                                                                                  |          |
| <b>ESOP Loan Amortization Schedule properly reflects</b>                                                                                                              |          |
| Loan start date                                                                                                                                                       |          |
| Frequency of payments                                                                                                                                                 |          |
| Interest Rate                                                                                                                                                         |          |
| Fixed Rate or Variable Rate                                                                                                                                           |          |
| Compounding of Interest                                                                                                                                               |          |
| Year Length (360, 364, or 365)                                                                                                                                        |          |
| Prepayments made on loan:                                                                                                                                             |          |
| Applied in order of maturity                                                                                                                                          |          |
| Applied in inverse order of maturity                                                                                                                                  |          |
| Re-amortize of all remaining payments                                                                                                                                 |          |
| <b>Share Release Method</b>                                                                                                                                           |          |
| Determine release methods allowed in ESOP plan document                                                                                                               |          |
| Determine release method required in ESOP loan documents:                                                                                                             |          |
| General Rule (Principal & Interest Method)                                                                                                                            |          |
| Special Rule (Principal Only Method)                                                                                                                                  |          |
| If Special Rule, do ESOP loan documents:                                                                                                                              |          |
| Provide for annual payments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments of such amounts for 10 years |          |
| Have interest payments computed as would be determined under standard loan amortization tables                                                                        |          |
| Have a loan term not exceeding 10 years (including any renewal, extension, or refinancing)                                                                            |          |

maintaining the original length of the loan but reducing all subsequent payments evenly.

### USING DIVIDENDS FOR LOAN PAYMENTS

C Corporation dividends (and S Corporation distributions) paid on ESOP stock acquired in a leveraged transaction can be used for the respective ESOP loan payments. Since only dividends on shares acquired in that specific transaction can be used for those loan payments, multiple stock accounts and cash transactions should be record kept separately to properly split and track the eligible dividends

for ESOPs with multiple tranches of stock.

As long as it is permitted in the ESOP plan and transactions documents, dividends on allocated shares previously released from the suspense account, as well as the dividends on the unallocated (collateral) shares, can be used for loan payments. To the extent dividends on allocated shares are used for loan payments, participants must receive employer securities from the share release with a fair market value of not less than the amount of the dividend that would have been allocated to the participant in cash. (See IRC §404(k)

(2)(B) for C Corporation ESOPs and IRC §4975(f)(7) for S Corporation ESOPs.) For example, if a participant was allocated \$500 in dividends on her allocated shares and the dividends were used to make loan payments, she must receive a share allocation from the suspense account from those dividends with a current value of at least \$500. The plan document should provide guidance on rectifying issues where the share release does not equal \$500 in this case. One common approach is allocating shares released from the dividends on the unallocated shares to satisfy the fair-market-value rule for the dividends paid and used on the allocated shares.

### CONCLUSION

ESOP loans have multiple facets that must be understood to properly account for them. Just as with nuts and bolts, they are available in all shapes and sizes. A thorough review of the executed ESOP internal loan documents should be completed to ensure the ESOP loan amortization schedule is drafted accurately to compute the correct share release. If designed correctly, the terms of the leveraged transaction will assist the plan sponsor in providing the desired benefit level to the ESOP plan participants. **PC**



*Kevin T. Rusch, CPA, QPA, is a director at Blue Ridge ESOP Associates. He has more than 20 years of experience working closely*

*with plan sponsors, accountants, advisors and legal counsel to provide guidance on ESOP plan design, repurchase obligation analysis, compliance and operation.*