



R_x FOR SUCCESS

LATEST UPDATE:
UNDERWRITING
INFORMATION

Employee Stock Ownership Plans (ESOP)

An ESOP is a qualified, defined contribution employee benefit plan that invests primarily in the stock of the employer company. Employer-sponsors receive tax benefits in return for meeting certain rules and restrictions. Employer contributions accumulate to produce a benefit that is not defined in advance but is determined by the performance of the underlying company stock, the frequency and amount of contributions and the number of years until distribution. ESOPs are unique among qualified employee benefit plans because of their ability to borrow money to buy employer stock. This feature makes it possible for an ESOP to be used as a market for company stock, as a method of increasing the company's cash flow, as an estate-planning tool for the owner of a closely held corporation, and as a means of financing corporate growth.

ESOPs are also a tax-advantaged way of providing employee benefits using employer dollars. However, because of an ESOP's unique ability to borrow money to purchase employer stock, it can also be utilized as a true corporate finance tool that can be used in a variety of tax effective planning scenarios, such as business succession, financing to purchase capital assets, or refinance existing debt.

ESOP companies must meet the minimum IRS requirements regarding participation. A minimum percentage of employees aged 21 or over, who have completed a year of service that includes 1000 hours must benefit under the ESOP. Participation must be non discriminatory, and shares must be allocated among participants based on their relative compensation or some other formula that does not discriminate in favor of highly compensated employees.

ESOP companies whose stock is not publicly traded face a unique requirement. The Internal Revenue Code requires that the company be prepared to buy back stock at fair market value from participants who receive distributions of stock from the ESOP. This requirement is referred to as the repurchase obligation or the repurchase liability. Also, the Department of Labor requires that participants in an ESOP program receive "worth" or "value" but not actual shares of stock. Life insurance is one of the most economically efficient tools to fund the repurchase obligation since it can provide tax deferred build up of cash value and potentially tax free loans that provide the ESOP with liquidity¹. Additionally, tax favored death benefits help offset liquidity problems the business may face due to the unexpected death of a participant with a very large account balance. Once the repurchase liability has been defined, actuarial calculations are performed to determine the cash flow requirements necessary to provide for payment of future benefits to plan participants. The cash flow requirements are then used to determine how many participants will be insured to fund the plan, and face amounts are determined by the amount of cash accumulation needed to fund the cash flow requirement. Ideally, face amounts will be the minimum amount that will still provide for the targeted cash accumulation over time, not create a Modified Endowment Contract (MEC), and still be flexible enough to allow for future growth.

All cases are fully underwritten with normal age and amount requirements. Typically, the goal will be to insure the youngest, healthiest lives available in order to minimize the mortality expense to the ESOP and maximize the cash accumulation.

¹ Policy loans may have tax and other consequences

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Financial underwriting is unique, since actual face amounts are determined by the funding needs of the ESOP and the specific design structure of the plan. Face amounts should generally not exceed the lesser of \$10 million or 100x incomes. It is expected that the funding will be spread over multiple lives, concentrating on the management pool as the primary source of insured lives. There should be no evidence of anti-selection, with younger, healthier lives being insured in order to maximize the non-MEC cash accumulation opportunity.

As with any financial transaction, there can be potential economic risks. An ESOP is primarily a deferred income plan for participants. The actual value of each participant's account is tied directly to the value of the stock of the business. If the business thrives and grows, the participants' account values will grow proportionately. However, if the business does poorly or fails, there may be insufficient funds (*or no funds at all*) to provide for future income benefits.

The client must sign a disclosure letter that, among other things, specifically acknowledges that the company's role in the transaction is limited to being a product provider only. The client must discuss and sign this disclosure letter with legal counsel prior to delivery of the policies.

After reading the Rx for success on ESOP, please feel free to contact the Advanced Marketing team at 1-800-286-7745 for more information.

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