ESOP Distribution and Diversification Practices

Presented by:

Renee Stadtmueller
Blue Ridge ESOP Associates
154 Hansen Rd. Suite 102
Charlottesville, VA 22911
(434)202-5827
Rstadtmueller@BlueRidgeESOP.com
Agenda

- Distribution Rules
- Distribution Policies
- Distribution Policy Example
- Statutory Diversification Rules
- Statutory Diversification Example
- Expanded Diversification
Distribution Rules

- Distribution timing requirements under IRC Section 409(o)
- Applies to Stock acquired by an ESOP after 1986
- Retirement, death or disability
  - End of the plan year following the plan year in which the event occurs
- Other termination
  - End of the sixth plan year following the plan year in which employment terminates (unless reemployed)
Distribution Rules

• Notice Requirements
  • Notice provided between 30 and 180 days before the date of distribution
  • 30 day waiting period can be waived

• Consent Requirements
  • For any distribution before the later of age 62 or the plan’s normal retirement age, if vested balance exceeds $5,000
  • If vested balance exceeds $1,000 automatic rollover rules apply (unless plan limits cash-out amount to $1,000)
Distribution Rules

- **Lump Sum**
- **Installments**
  - Must occur in a substantially equal series of installments (not less frequently than annually)
  - Over no more than 5 years (can be as many as 6 installments)
  - Extension for large balances
    - One additional year (but not more than 5 additional years) for each $215,000 or fraction thereof by which the participant’s balance exceeds $1,080,000 (indexed)
Distribution Rules

• Cash

• Stock- a participant has a right to demand stock
  • Exceptions
    ● Charter or bylaw provision that restricts substantially all stock ownership to the ESOP or current employees
    ● S corporation
      ● May still distribute employer securities subject to the requirement that the shares be immediately resold to the employer or ESOP
    ● Banks

• Put Option
Distribution Policy

• An ESOP “Distribution Policy” is the specific rules developed by the Plan Sponsor and/or ESOP Committee that describe when and how distributions from the plan will occur
  ● May be included within the plan document or in a separate distribution policy document
  ● IRS may request distribution policy document as part of a determination letter review process
Distribution Policy

- Establishes when distributions will commence and how they will be made
- Congruent with terms of the Plan, but generally more specific as to when distributions will begin and how payments will be made
- May be modified from time to time
- Considers a company’s strategic objectives and long-term goals for the plan
Distribution Policy

• Update Repurchase Liability Study
• Review short and long-term cash flow projections
• S corporations – Analyze impact on 409(p) testing
• Consider general non-discrimination and fiduciary requirements
• Review/analyze HR considerations
• Provide advance notice of changes to plan participants
Distribution Policy Example #1

• Goal #1 – Commence distributions to pay terminated participants as soon as feasible in the year following termination
• Goal #2 – Maintain current ESOP ownership
• Goal #3 – Utilize allocated cash in the trust to fund distributions
Distribution Policy Example #1

**Timing:**
- **Death:** distributable as soon as practicable following the participant’s death
- **Disability, Retirement and other Termination:** distributable as soon as practicable following the end of the plan year in which the participant’s employment ceased

**Form:**
- Distribution of the vested participant account balances will be made in the form of cash unless a participant requests distribution in the form of Employer Securities

**Method:**
- All distributions made in a lump sum
Distribution Policy Example #1

Possible Issues:

• Ensuring sufficient cash in the plan to fund lump sum distributions
  • Company contributions (subject to 415 limits)
  • Dividends/S corp. distributions
• Getting the stock back into the plan if a participant elects a stock distribution

Employee Ownership as a Brand Advantage
Distribution Policy Example #2

• Goal #1 – Control and manage company cash flow
• Goal #2 – Commence installment distributions within a reasonable time frame
• Goal #3 - Discourage employment termination due to size of ESOP account balances (distribute large balances more slowly)
Distribution Policy Example #2

• Timing:
  • Death, Disability and Retirement: Begin in the year following the year of termination
  • Other Termination: Begin in the 3rd year following termination

• Form:
  • Since the ESOP is sponsored by a company that is an S Corporation, all distributions will be paid in cash
Distribution Policy Example #2

Method:

- If the Plan Administrator does not have sufficient cash in the ESOP to make lump sum distributions, the following installment provisions will apply:
  - Vested balances of $10,000 or less – paid in lump sum
  - Vested balances of $10,001 - $20,000 – paid in 2 installments
  - Vested balances of $20,001 - $30,000 – paid in 3 installments
  - Vested balances of $30,001 - $50,000 – paid in 4 installments
  - Vested balances above $50,000 – paid in 5 installments
Distribution Policy Example #2

Possible Issues:

• Terminated participants continue to hold stock for up to 8 years following termination
  • Receive increases in stock value
  • May be receiving Sub S-distributions
  • Segregation may be a possible solution
Statutory Diversification Rules

- Requirement for ESOPs to allow diversification of a **qualified participant’s** employer securities during the **qualified election period**.
- Qualified Participant – a participant who has reached age 55 and completed 10 years of participation in the ESOP.
- Qualified election period – six year period beginning with the first year a participant becomes a qualified participant.
Statutory Diversification Rules

• May elect to diversify 25% of employer stock in years 1 through 5 and 50% in year 6.

• Eligible diversification amount is cumulative.

• Satisfied by:
  • Cash or stock distribution
  • Transfer to a “sister” qualified plan
  • Offer three or more investment alternatives within the ESOP
Statutory Diversification Rules

- Election must be made within 90 days after end of plan year in which participant becomes eligible to diversify and each of the next 5 years
- Distribution/transfer must be completed within 90 days after end of participant’s 90-day election period
- Participant may revoke, modify or submit new diversification election any time during 90-day election period
Statutory Diversification Rules

• New language issued by the IRS in the ESOP Listing of Required Modifications (LRM)

• IRS stated the plan may provide for an election period ending LATER than the 90-day period

• Example: the election period can end 90 days after the date that the year-end stock value is provided to participants

• Diversifications must be processed within 90 days following the end of the election period.
### Diversification Example

<table>
<thead>
<tr>
<th>YR</th>
<th>BEGIN SHARES</th>
<th>+ NEW SHARES</th>
<th>+ PREV DIVRS</th>
<th>= SUB TOTAL</th>
<th>x 25%</th>
<th>- PREV DIVRS</th>
<th>= AVAIL FOR DIVRS</th>
<th>DIVRSFY</th>
<th>DIVRS SHARES</th>
<th>END SHARE BAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>760</td>
<td>40</td>
<td>0</td>
<td>800</td>
<td>200</td>
<td>0</td>
<td>200</td>
<td>Y</td>
<td>200</td>
<td>600</td>
</tr>
<tr>
<td>2</td>
<td>600</td>
<td>40</td>
<td>200</td>
<td>840</td>
<td>210</td>
<td>200</td>
<td>10</td>
<td>N</td>
<td>0</td>
<td>640</td>
</tr>
<tr>
<td>3</td>
<td>640</td>
<td>40</td>
<td>200</td>
<td>880</td>
<td>220</td>
<td>200</td>
<td>20</td>
<td>Y</td>
<td>20</td>
<td>660</td>
</tr>
<tr>
<td>4</td>
<td>660</td>
<td>40</td>
<td>220</td>
<td>920</td>
<td>230</td>
<td>220</td>
<td>10</td>
<td>N</td>
<td>0</td>
<td>700</td>
</tr>
<tr>
<td>5</td>
<td>700</td>
<td>40</td>
<td>220</td>
<td>960</td>
<td>240</td>
<td>220</td>
<td>20</td>
<td>N</td>
<td>0</td>
<td>740</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>x 50%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>740</td>
<td>40</td>
<td>220</td>
<td>1,000</td>
<td>500</td>
<td>220</td>
<td>280</td>
<td>Y</td>
<td>280</td>
<td>500</td>
</tr>
</tbody>
</table>
Expanded Diversification

• Beyond the Six Year Statutory Period
• Permit Diversification Earlier Than
  • Age 55
  • 10 Years of Participation
  • Or Both
• May Allow Diversification % Greater Than 25/50
• May Allow Diversification of Pre-1986 Shares
• Non-discrimination testing may be needed!
Expanded Diversification

Examples in practice:
• All active participants may diversify 1% of their account balance
• Participants are eligible to diversify 20% of their stock account after 7 years of service
• Eligible participants may continue to diversify 50% after year 6
• Participants who have reached age 50 may diversify 5% in year 1, 10% in year 2, etc.
Questions?

Renee Stadtmueller
Blue Ridge ESOP Associates
154 Hansen Road, Suite 102
Charlottesville, VA 22911
(424)202-5827
Rstadtmueller@BlueRidgeESOP.com