ESOP Administration Insights

The Decisions That Will Shape Your Employee Stock Ownership Plan Distribution Policy

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ESOP sponsor company managements typically make many complex decisions regarding the ESOP distribution policy. The timing of distributions, amount of destitutions, and form of payment (i.e., cash or stock) are all elements of the distribution policy that will affect the sponsor company cash flow and other corporate objectives. This discussion will focus on the various elements that comprise the ESOP distribution policy.

Introduction

The benefit distribution policy for an ESOP provides all of the "flesh" designed to cover the bare "bones" of the statutory distribution requirements provided in the ESOP plan document. Typically, an ESOP plan document lists only the outside or maximum statutory distribution rules, leaving all of the details of benefit distribution planning to be fleshed out in the ESOP distribution policy.

In recognition of the special issues confronting ESOPs, such as repurchase liability and funding, Congress has provided companies sponsoring ESOPs with a great deal of flexibility in structuring the timing and form of benefit distributions.

A thoughtfully designed distribution policy will take into consideration desired benefit levels, deduction and contribution limits, the sponsor company's cash flow, and the ownership objectives of any non-ESOP shareholders.

When Will the ESOP Pay?

General ESOP Distribution Timing Rules

ESOPs and other types of qualified retirement plans (e.g., 401(k) or profit sharing plans), must comply with Internal Revenue Code Section 401(a)(14). Section 401 requires that, unless the participant otherwise elects, the payment of benefits must begin no later than the 60th day after the latest of the close of the plan year in which:

1. the ESOP participant attains the earlier of normal retirement age under the plan or age 65,
2. the 10th anniversary of the date on which the ESOP participant began participating in the plan, or
3. the ESOP participant's termination of service.

Special ESOP Distribution Timing Rules

In addition to (not instead of) the general distribution timing rules listed above, ESOPs also must comply with Section 409(o) which contains special rules generally designed to require ESOPs to distribute benefits earlier than the general distribution timing rules would require. Note, however, that the special ESOP distribution timing rules cannot be used to delay a distribution that would be required by the general distribution timing rules above.

Retirement/Disability/Death

If an ESOP participant's service ends because of retirement, disability, or death, distribution of his vested ESOP benefit must begin not later than the last day of the plan year following the plan year in which his retirement, disability, or death occurs. However, the distribution policy may provide for distributions at an earlier date.

Other Termination of Service

If an ESOP participant's service ends for any reason other than his retirement, disability, or death, the distribution of his vested ESOP benefit must begin not later than the last day of the sixth plan year following the plan year in which his service terminates. However, the distribution policy may provide for distributions at an earlier date.

Exception for C Corporation Leveraged Shares

If the ESOP is maintained by a C corporation and is leveraged, the Section 409(o) provides an exception to the two special ESOP distribution timing rules that allows distributions attributable to any leveraged shares to be delayed until the plan year following the plan year in which the loan incurred to purchase the leveraged shares has been repaid. Note, however, that this exception cannot be used to delay the general distribution timing requirements.

The Flexibility

Although an ESOP can make distributions to plan participants as late as the dates described above, the sponsor company's cash flow and value may dictate earlier dates. For example, plan participants who terminate employment for reasons other than death, disability, or retirement could receive distributions in the third (rather than the sixth) plan year following the plan year in which their service terminates.

Although distributions could be provided even earlier, many ESOP sponsor companies choose not to do so to avoid creating an incentive for participants to terminate employment.

A repurchase liability study is a valuable tool in creating the ESOP's distribution policy, and updates to the study can help determine whether the distribution policy should be modified in future years to accommodate changes in ESOP repurchase obligations.

Timing of QDRO Payments to Alternate Payees

A qualified domestic relations order (QDRO) is a court order, judgment, or decree from a state domestic relations court that awards all or a portion of a participant's ESOP benefit to an "alternate payee." This is because of the participant's divorce, or settlement of a child support or property agreement. The Code defines an alternate payee to be the participant's spouse, former spouse, child, or other dependent.

An order is "qualified" if it satisfies all of the requirements of the Code and the Employee Retirement Income Security Act (ERISA). Once an order is determined to be "qualified," then the alternate payee's interest is transferred to an ESOP account established in his/her name where it is maintained until fully distributed to the alternate payee.

An ESOP can provide that as soon as an order is determined to be qualified, the ESOP can pay the alternate payee his/her ESOP benefit in a lump sum, even though the participant may not currently be entitled to a distribution. This "immediate payment" provision is attractive because many companies do not want to share information about the company and the ESOP with a non-employee.

The disadvantage of an "immediate payment" provision is that it accelerates the ESOP's repurchase liability. Also, because a sponsor company does not control when an order is submitted to the ESOP, it is hard to plan for these QDRO distributions.

Alternatively, the ESOP can postpone payment to an alternate payee until the participant terminates service. At that time, the alternate payee can receive his/her ESOP benefit in accordance with the distribution policy, like any other ESOP participant.

The Code provides an exception to this general rule: If the order provides for this provision and the participant continues working for the sponsor company after attaining age 50, the alternate payee can insist that payment be made (or installments commence) during the plan year following the plan year that includes the participant's 50th birthday.

What Form of Payment Will Be Used?

Form of Payment Rules—Lump Sum versus Installments

Distributions may be made in a lump sum or in six substantially equal annual payments over a period that does not exceed five years. The first installment is paid in the year that the distribution begins. And, then, an additional payment is made once each year for the following five years.

The period over which installments may be distributed may be extended an additional year (up to an additional five years) for each $180,000 or fraction thereof by which a participant's benefit exceeds $915,000. The Service may adjust these dollar amounts periodically for cost of living increases.

Benefits paid in installments will continue to be invested in the sponsor company stock during the payment period. Therefore, each annual installment payment will be based on the then current fair market value of the sponsor company stock.

The Flexibility

A sponsor company can design its ESOP distribution policy to accommodate corporate cash flow requirements and ESOP repurchase obligations by using a combination of the lump sum and installment payments.

For example, ESOP participants who terminate due to death or disability can be paid in lump sums. Retirees can be paid in installments of at least $50,000 over a period of years not to exceed five years. And, other terminated ESOP participants can be paid in installments of at least $25,000 over a period of years not to exceed five years.

Will the ESOP Distribute Cash or Stock?

The Medium of Distribution Rules—Stock versus Cash

The ESOP distribution policy may be designed to distribute benefits in the form of sponsor company stock, cash, or a combination of both. ESOP participants, however, have the right to demand that their benefits be distributed entirely in whole shares of sponsor company stock, with only the value of any fractional share paid in cash.

The Flexibility

S Corporations

If the sponsor company is an S Corporation for federal income tax purposes, the distribution of a participant's ESOP benefit may be made entirely in cash without granting him the right to demand distribution in shares of company stock. Alternatively, sponsor company stock may be distributed subject to the requirement that it be immediately resold to the sponsor company.

C Corporations

If the sponsor company is a C Corporation for federal income tax purposes and the charter or bylaws of the corporation restrict the ownership of "substantially all" outstanding employer stock to current employees and the ESOP, the distribution of a participant's ESOP benefit may be made entirely in cash without granting him the right to demand distribution in shares of sponsor company stock.

Alternatively, sponsor company stock may be distributed subject to the requirement that it be immediately resold to the sponsor company.

Put Options

As long as sponsor company stock is not readily tradable on an established market, the company must provide the participant/beneficiary with the right to require the company to repurchase the shares of company stock that are distributed to him. This right, the "put option," may be exercised during two 60-day periods.

The first 60-day period begins on the distribution date of the benefit. The second 60-day period begins on the date the value of the company stock is determined for the following plan year. The sponsor company may permit, but cannot require, the ESOP to purchase any shares of company stock that are tendered under the put option.

If the ESOP participant/beneficiary elects to exercise his put option and the sponsor company (or the ESOP) purchases his shares, a check or checks should be prepared and given to the participant/beneficiary for the price of the repurchased shares and the value of any fractional share. If the participant/beneficiary receives his distribution in installments and exercises his put option with respect to any installment, the payment amount should be paid within 30 days after the exercise of the put option with respect to that installment.

If the participant/beneficiary receives his distribution of company stock in a single lump sum and exercises his put option, payment should begin within 30 days after the exercise of the put option. The sponsor company (or the ESOP) may pay for such repurchased shares in a single lump sum payment or with a secured promissory note providing for up to six installment payments over a period not exceeding five years. The promissory note must be "adequately" secured and must bear interest at a reasonable rate.

To be "adequate," the security must consist of more than the company stock being purchased (e.g., a surety bond or an irrevocable letter of credit). And, if the ESOP, rather than the sponsor company, repurchases shares using a secured promissory note, the sponsor company must provide the security and guarantee the ESOP's payment under the note.

Unlike benefits paid from the ESOP in installments (with each annual installment payment based on the then current value of the company stock), the value of a distribution of stock paid in a lump sum and repurchased with a secured promissory note is determined at the time of the lump sum distribution of stock. And, the amount of each annual payment under the note is not affected by any subsequent changes in the value of the company stock.

If the participant/beneficiary does not elect to exercise his put option during the first 60-day period, he will be required to sign a "Stock Transfer Agreement" before receiving the certificate for his employer stock shares. This Stock Transfer Agreement provides that the sponsor company has the right of first refusal to buy the employer shares if a third party offers to buy the shares from the participant/beneficiary.

The sponsor company then should notify the participant of his second opportunity to exercise his put option right when the value of sponsor company stock has been determined in the following plan year. This notification should include an election form for him to elect to exercise his put option during the second 60-day period.

If he elects to exercise his put option during the second 60-day period, he must tender his stock certificate with the second put option election form. And, the procedure outlined in connection with the exercise of the put option during the first 60-day period should be followed.

Tax Consequences Related to the Medium of Distribution

ESOP participants are generally taxed at ordinary income tax rates on the value of the distributions received. In addition, if the ESOP participant terminated service before age 59½, he will be subject to an additional 10 percent penalty tax for early distribution from the ESOP. ESOP participants may avoid these taxes by rolling over their distributions to an IRA or another tax-qualified plan.

Net Unrealized Appreciation

If a participant receives a distribution in shares of company stock, rather than a distribution of cash, the participant is taxable only on an amount equal to the ESOP's "cost basis" in the stock. Any growth in value in the shares while held by the ESOP (the "net unrealized appreciation") is taxed to the ESOP participant only when he sells the shares.

For example, if employer stock were contributed to the ESOP when the stock was worth $100 and the stock is worth $120 when distributed to the participant, the participant would not have to pay tax on the $20 gain until he later sells the stock. The gain will be taxed as long-term capital gain no matter how long the ESOP held the shares.

However, this special benefit is only available if the employer shares were distributed to him in a qualifying lump sum distribution, and the ESOP participant does not request a direct rollover or roll over the distribution to another eligible retirement plan.

Will Former ESOP Participants Remain Invested in Sponsor Company Stock?

If a sponsor company believes that only actively employed participants should bear the risk of changes in the value of the company stock, a sponsor company can invest the account balances of former participants in assets other than company stock. The advantage of this approach is that former participants receive a more stable investment return and are not subject to changes in the stock value.

First, the disadvantage of converting account balances from sponsor company stock to cash is that the conversion accelerates the repurchase liability. At termination of employment, each account balance that is not currently payable will have to be converted to cash, based on the most recent valuation. Second, the ESOP fiduciaries must follow their ERISA responsibilities and invest this cash for the benefit of the former participants.

Because the ESOP needs participant consent to make a distribution before the participant reaches the ESOP's normal retirement age (or age 62, if the ESOP retirement age is earlier than age 62) if the benefit is valued at more than $1,000, this cash may be held by the ESOP trust for several years.

Consequently, the investment of this cash fund will have to be monitored and evaluated annually, if not more frequently. If the total value of former participants' accounts is substantial, it may be worthwhile to follow the requirements of ERISA Section 404(c) and establish different investment funds within the ESOP trust and allow former participants to direct the investment of their accounts, like in a 401(k) plan. ERISA Section 404(c) relieves plan fiduciaries from the losses that are a direct result of participant investment directions.

When Will Benefit Distributions Be Processed?

The value of sponsor company stock for purposes of distributions is determined by the most recent valuation. A best practice would be to process all distributions for the year as soon as the new value is determined, thereby making all distributions within the first several months following the end of the plan year. This avoids distributions based on a stale employer stock valuation and simplifies plan administration by offering distributions only once per year.

For example, a distribution policy could provide that distribution requests received by the end of the fourth month following the end of the plan year will be based on the fair market value of the sponsor company stock determined as of the last day of the preceding plan year, and that requests received after this deadline will be postponed until the value of the company stock has been updated.

Alternatively, the policy could provide that all distribution requests received at any time during a plan year will be made based on the valuation as of the last day of the preceding plan year. This policy has the disadvantage of possibly making a distribution on a stale stock valuation.

Summary and Conclusion

Each company sponsoring an ESOP will have a unique set of corporate and stock ownership objectives. But, with careful attention to each of the elements that make up the ESOP benefit distribution policy, it is possible to design a policy that will help meet the sponsor company's corporate objectives while providing a valuable benefit, at the desired level, for the ESOP participants.

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