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ESOP Distribution Rules

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Life Stages of ESOP Participant

- During Employment
- Mid-Career Layoff
- Reemployment
- Age 55



Life Stages of ESOP Participant

- Age 59½
- Retirement
- Age 70½
- Death

During Employment

- C Corp dividend payments
 - Paid to plan and distributed
 - Bypass plan and pay participant directly
 - Participant election to reinvest in stock

Section 404(k) dividends. Beginning in 2009, all distributions from an employee stock ownership plan that are section 404(k) dividends must be reported on Form 1099-R. Payments of section 404(k) dividends directly from the corporation to the plan participants or their beneficiaries must be reported on Form 1099-DIV.

- Hardship distributions
 - Not limited to 401(k) definition of hardship
 - May be subject to early withdrawal penalty
 - Cannot be rolled over



During Employment

- In-service withdrawals
 - Becoming more common in ESOPs
 - May be offered to employees so that they don't resign in order to gain access to some of their ESOP funds
 - May be rolled over
 - May be subject to early distribution penalty if made before age 59 ½ (and not rolled over)

Mid-Career Layoff

- Waiting period
 - Up to six plan years
 - May be delayed until ESOP loan is repaid (only shares acquired with same loan)
 - Plan may say pre-1987 stock is subject only to general qualified plan requirements
- Consent requirement
 - If vested balance exceeds \$5,000 (or \$1,000, if elected by employer)



Mid-Career Layoff

- Form of payment
 - Lump sum up to \$X
 - Installments for larger balances over a period “not longer than 5 years”
 - Hybrid: each year will receive the greater of \$X or normally calculated installment
 - May reduce installment period to less than 5 years

Mid-Career Layoff

- Administrative and tax issues
 - Rollover notice
 - Early distribution penalty if terminated before age 55
 - Timing and disposition of forfeitures

Reemployment

- Cash-out/buy-back rule
 - Applies only if:
 - Forfeiture occurred upon distribution of entire vested benefit, and
 - Rehired participant repays full amount of distribution, unadjusted for earnings, and
 - Repayment is completed before the earlier of 5 years after rehire date or completion of 5-year break in service commencing after distribution

Reemployment

- Administrative issues
 - Communicating right to buy back forfeiture
 - Is “full amount” measured in dollars or shares?



Age 55 - Diversification

- Eligible for diversification if participant for 10 years
- Distribution not *required*
 - Transfer to 401(k) or other plan
 - Reinvest within ESOP



Age 55 - Diversification

- ESOP may distribute cash
 - Eligible for rollover
 - Early distribution penalty may apply
- ESOP may distribute stock
 - Immediate sale to company
 - Eligible for rollover
 - Early distribution penalty may apply

Age 55 - Diversification

- Administrative issues
 - Who signs put election or stock power if rolled to IRA?
 - IRS follow-up if rolled to 401(k)
 - May diversification distributions be coordinated with installments?

Retirement

Reward for
Loyalty

Get Good
Tax Advice

Planning



Retirement

- Waiting period
 - ESOP requirement: payment must begin by plan year following year of retirement (or death or disability)
 - General ERISA requirement: within first 60 days of plan year following retirement (if employee participated at least 10 years)
 - Generally no delay if loan has not been repaid

Retirement

- Optional extended installments
 - Balances above \$985,000
 - Add one year for each partial or whole \$195,000 increment
 - Rule may be applied at all times, not just retirement age

Retirement

- Administrative issues
 - How to satisfy 60-day rule if valuation is still pending
 - Consent not required at later of age 62 or plan's normal retirement age
 - ESOPs commonly allow participants to defer distribution after retirement
 - Have participants been adequately informed and educated to wisely handle large distributions?

Age 70½ - RMDs

- When must required minimum distributions begin?
 - Generally, April 1 of calendar year after year of attaining age 70½
 - Not until actual retirement if do not own more than 5% of employer's stock
 - ESOP stock is not counted toward 5% ownership test

Age 70½ - RMDs

- Form of payment
 - RMD rules only require small fractional payment (less than 4% of account) in first years
 - Plan may only permit payments in “normal” forms (for example, installments over 5 years)



Age 70½ - RMDs

- Administrative and tax issues
 - Communications about RMDs
 - 50% penalty tax on shortfall
 - Will participant double-up payments in first year?
 - If first payment is taken April 1 of following year, second payment is due by December 31 of same year

Death

- Required minimum distributions for beneficiaries
 - Life expectancy rule
 - 5-year rule
 - Option to allow beneficiaries to choose
 - Spouses may be treated differently than other beneficiaries

Death

- Administrative issues
 - Appropriate documentation
 - Proof of death
 - Proof of marriage at time of death (if plan says divorce nullifies designation of spouse)
 - Calculating installments when 5-year RMD rule requires acceleration
 - Multiple beneficiaries

Death

- Administrative issues
 - Trust as beneficiary
 - Must ESOP demand copy of trust before allowing rollover? Or is letter from attorney who drafted it enough?
 - Death of beneficiary
 - Always look to plan document for initial guidance

Tax Withholding

- State withholding varies by state
- Federal withholding on direct distribution of eligible rollover distribution depends on form of distribution:
 - Distribution made in Shares
 - No Withholding Required
 - Taxed at lesser of cost basis or FMV of stock
 - Distribution made in Cash or Cash and Shares
 - Withholding is the lesser of
 - 20% of the taxable value of the total distribution, or
 - Total value of cash distributed

Tax Withholding

- Example:
 - Distribution consists of 100 shs stock with cost basis of \$1,000 and FMV of \$2,000 plus \$100 cash
 - Taxable amount: \$1,100 (cash + cost basis of shares)
 - “Normal Withholding” = \$220 ($\$1,100 \times 20\%$)
 - Actual Withholding = \$100 (total cash distributed)
 - You are not required to sell shares to cover withholding

Distribution Policy

- Approval is a Board action
- Some things to remember in the design and operation of administrative distribution rules include:
 - Policies must be written, clear and communicated
 - They should be followed in a non-discriminatory manner
 - They should not be subject to change without substantiation of the need and statutory conformity
 - They can be more liberal than the plan document, but not more restrictive
 - Control of cash flow requirements should be considered when drafting or revising the policy

Projecting the Liability

- The company can project in the near term what the obligation is by setting up a spreadsheet to project payouts based on:
 - Share price appreciation
 - Allocations
 - Participant age and years of service
 - Distribution rules
- Large groups can:
 - Purchase software
 - Hire a practitioner
 - Should utilize actuarial assumptions
- A coordinated strategy includes
 - A sound distribution policy
 - Periodic evaluation of the repurchase liability

Strategy

- The strategy to meet the repurchase obligation should be an “integrated” one appropriate for performance and culture, coordinating:
 - Financial outlook
 - Independent valuation
 - Participant expectations
 - Fiduciary considerations
 - Cash funding
 - Stock contributions
 - Share recycling and share redemptions

Recycling vs. Redemptions

- Recycling in the plan is an exchange of other investments for employer securities so that payouts are in cash
 - Sources can be current year cash contributions or cash allocated in prior years
 - Checks are written from the ESOP for distributions/withholding
 - The faster the rate of recycle, the higher the repurchase costs. Rate can be slowed when accounts are held in stock for a longer period
 - Share count in the plan does not change
- Redemptions are payments from the corporation to participants to redeem shares allocated in the plan
 - Reduces the number of shares outstanding
 - The shares can be contributed back to the Plan at a later date or not
 - A stock ledger of redemptions should be kept and communicated to the CPA and record keeper each reporting period

Conclusion

- Every ESOP operates under a mixture of all-purpose ERISA distribution requirements and ESOP-specific distribution rules, to which the employer may add its own modifications expanding participant rights.
- Often this amalgamation of rules works well, but sometimes it can become difficult to understand and administer.
- Re-evaluate periodically.



ESOP Distribution Rules

Questions?

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