

CLIENT ALERT

DISTRIBUTION POLICIES

Written by: Mary Beth Gray, Attorney at Law

When companies decide to adopt an ESOP, they are frequently asked to make some decisions about how distributions will be paid to terminated participants. Companies answer some of these questions in a vacuum, without any real context to make decisions that often won't come to pass for many years. There are cultural norms at play, as well as financial and employee benefits decisions that the plan sponsor tries to fit into existing structures. By the time a company is really wrestling with the difficult decisions about how and when to pay participants their ESOP benefits, the plan provisions may be out of date. This is particularly true in companies where there is an inside loan in place and the company is permitted to delay distributions to participants until after the loan is paid off.

The ESOP plan document can be a rigid tool to address all distribution decisions. The plan document is quite long and covers many issues. Using the plan document to address every possible decision on distributions can be cumbersome. Any changes to the plan document require a plan amendment, which requires both board of directors' approval and a new summary plan description. For companies trying to create some flexibility in the timing and manner of distributions, a better solution for defining the terms may be a distribution policy.

A distribution policy exists separate from the plan document and may be amended from time to time by the board of directors without the need for a formal amendment to the plan. The distribution policy may be amended periodically to take into account many factors.

Timing of Distributions

There is not as much permitted flexibility in the timing of distributions as there is in the mode. A plan can provide that participants will not begin to receive distributions until the later of (a) five years

following termination, and (b) the date any inside loan is repaid (this latter event not being an available option in S corporations).

The Internal Revenue Service takes the position that a company that regularly pays distributions immediately following termination cannot later amend the plan to delay distribution of the accumulated account balance. While this position is not clearly supported by the statute and regulations, it needs to be taken into account when a distribution policy is designed. For this reason, many plan sponsors maintain a delayed payout structure

to be sure there is sufficient time to build up cash reserves to pay distributions.

Mode of Distributions

This article focuses on distribution policy alternatives for companies that pay distributions in cash to participants out of the plan. For companies that distribute stock from the plan that is later redeemed by the company, the distribution issues are slightly different and will not be addressed here.

When cash distributions are payable from the plan, there are a number of variables the company can consider in determining the payment stream, or mode of payment, including: (a) whether payments will be made in a lump sum or in installments, (b) if paid in

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Distribution Policies

installments, how many installments, (c) whether there will be a minimum installment payment amount, regardless of the account balance, and (d) whether the policy will treat participants differently depending on the reasons for their termination.

A well designed distribution policy will base the mode of payment on a number of factors, including:

- company cash flow,
- value of accounts,
- participants' need to receive benefits, and
- whether there is some interest in reducing the number of participants.

Note, though, that other than for small balances or for participants who have reached a certain age (later of Normal Retirement Age or age 62), the company cannot pay a distribution to a participant unless the participant consents. Any distribution policy should make clear that the participant's consent is a condition to commencing distribution.

Cash Flow

Cash flow is frequently the most important factor in developing a distribution policy. Available cash flow may provide the upper limit on the amount a company is able to contribute or distribute to the plan to permit the payment of participant distributions. It is not sufficiently precise to adopt a distribution policy that simply states that benefits will be payable to the extent of available cash, but when properly defined in a well drafted distribution policy, available cash may be used to limit annual distributions.

Value of Accounts

Related to the question of available cash flow is the value of the accounts being paid. Companies are permitted to pay very large account balances (i.e., more than \$935,000, indexed) over six, rather than five years. Most account balances, however, must be paid in no more than five years. When a plan document provides that plan balances will be paid in five substantially equal installments, companies could face situations where a participant with a \$6,000 balance stays in the plan for many years to receive a relatively small payment each year. A company may prefer, for example, to adopt a distribution policy that provides that participants will receive installments,

In Our Next Issue

Diane Fanelli discusses the pros and cons of rebalancing and reshuffling.

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but with each installment being the higher of a fixed dollar amount or an equal fraction of the balance. With such a policy, in the case of a participant with a \$6,000 balance, that participant could be paid in one or two years rather than five.

Participants' Desire to Receive Benefits

Some companies may have a cultural or policy interest in paying out participants more or less quickly depending on the reasons for termination. A company may want to pay an older participant who becomes disabled more quickly than a younger participant who leaves to take another job. A carefully drafted distribution policy would facilitate this distinction in distributions.

Number of Participants

A company may have an interest in reducing the number of participants, both for administrative efficiency and, in some instances, to reduce administrative costs. Plans, for example, must be audited when there are 100 or more participants. In companies where the number of participants is close to the audit threshold, there may be value to paying out participants, particularly if the account balances are relatively small.

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Segregation

Related to the issue of a distribution policy is the question of whether participant balances will remain invested in employer securities while the participant is waiting to receive a distribution. Many plan documents provide that the accounts of terminated participants may be converted from company stock to cash. This is called segregation or reshuffling of participant accounts. The issues involved in whether accounts should be segregated are complex and specific to a company's circumstances, and are somewhat outside the scope of this discussion. If you have particular questions about the mechanisms and rules for segregation, please contact us.

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DIVERSIFICATION: WHAT WAS THE FINAL ANSWER?

Written by: Tabitha Croscut, Attorney at Law

Do you have a plan that was held hostage by the Internal Revenue Service in the past couple of years? One reason for the delayed processing of ESOP determination letters was a disagreement between the IRS and advisors over the diversification language in plans. In 1986, as part of the Tax Reform Act, a diversification requirement was added to the Internal Revenue Code that applied specifically to employee stock ownership plans. The diversification requirement in Code Section 401(a)(28)(B) requires that an ESOP allow each “qualified participant” to elect within 90 days after the close of each plan year in the “qualified election period” the diversification of a certain percentage of their Company stock account under the ESOP. “Qualified participant” is defined by the Code as any employee who has completed at least 10 years of participation under the plan and has attained age 55. A “qualified election period” is defined by the Code as the six plan year period beginning with the later of (i) the first plan year in which the individual first became a qualified participant, or (ii) the first plan year beginning after December 31, 1986. Company stock acquired prior to January 1, 1987 is not subject to the diversification requirements.

Over the years the term “qualified participant” has been defined and interpreted by plans in two primary ways:

- i) a participant or former participant, and not just an employee, or
- ii) an employee who has completed at least 10 years of *service* instead of 10 years of *participation*.



**"Participation"
or
"Service"**

While ESOPs have been implementing the required diversification of accounts for over 20 years, in the past few years the IRS has decided to focus on the plan language defining “qualified participant.”

As part of the relatively new five-year determination letter cycling program, the IRS focused on these alternative definitions of the term “qualified participant” and began asking that plans be amended to ensure that only years in which a participant was employed by the plan sponsor were counted in determining whether a participant had sufficient credit to qualify as “10 years of participation under the plan.” Those plans that counted “years of participation” in the absence of ongoing employment and were not willing to amend the language of their plan were held back by the reviewing field agents pending issuance of guidance in response to the agents’ Request for Technical Assistance.

Finally, on November 3, 2009, the IRS issued a Technical Assistance Memorandum with respect to the request for guidance on diversification and adopted an *interim* position. For purposes of defining “qualified participants,” plans are permitted to count any

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Diversification

year in which an individual has assets in an account under the ESOP as a year of service, regardless of whether the individual is employed by the employer at such time and regardless of whether the individual has completed 1,000 hours of service (or such other number required for a “year of service” under the plan).

Plans that currently have more restrictive language may keep that language or adopt less restrictive language. However, plans are not permitted to make their existing language more restrictive. For example, if a plan requires 1,000 hours of service to be credited with a “year of participation” (therefore just having an account is insufficient), the plan can retain that language or adopt a less restrictive requirement. In contrast, a plan that requires only that an individual have an account balance to be credited with a year of participation cannot be amended to add more requirements, such as requiring 1,000 hours of service to receive credit for a year of service.

Going one step further, some companies have adopted a more lenient definition of “qualified participant” that is more favorable to participants by defining a “qualified participant” as a participant who has attained age 55 but completed fewer than 10 years of participation in the plan, or a participant with 10 or more years of participation but who has not yet attained age 55. In other words, these plans offer their participants the ability to become a “qualified participant” on terms more favorable to participants than those set forth in Section 401(a)(28)(B). Although plans are permitted to offer more favorable diversification rights on a voluntary basis, the IRS has indicated that this type of provision will not make a participant a “qualified participant” for purposes of the mandatory diversification that must be offered under the statute. Therefore, any additional diversification rights offered voluntarily will not count toward a qualified participant’s statutory rights and will expand

the total percentage of the participant’s account that is eligible to be diversified.

In addition, the Technical Assistance Memorandum makes it clear that the diversification requirements apply to employees who have separated from service. If a participant who is credited with 10 years of participation (as defined in the plan consistent with the above requirements) separates from service before attaining age 55, the former employee must be treated as a “qualified participant” once he/she attains age 55.

What does all of this mean? First, it means that if your ESOP was submitted for a determination letter and the IRS was holding the plan hostage based on the diversification language, your plan can be “released” and the determination letter can be issued. Second, it means that most plans will not need to amend their diversification provisions because the IRS is accepting a definition of “qualified participant” based on either a year of “participation” or a year of “service,” which will cover most plans. If you have any questions about how this might affect your plan(s), we would be happy to review the diversification language and consult with you on your options.

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In response to your inquiries, SES has created a consulting group focused specifically on the issues facing "mature" ESOPs. Our services include:

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- Development and/or Modification of ESOP Distribution Policies
- Modeling and Guidance Related to ESOP Loan Modifications
- Design and Implementation of Second Stage ESOP Transactions
- Modeling of Plan Funding and Design Strategies
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Brian Wurpts has led the SES Plan Administration team and consulted on administration, policy, funding and plan design strategies for over twelve years. For more information, please contact Brian at 215.508.5640 or bwurpts@sesadvisors.com.