

# ADVISORY COMMITTEE ON ADMINISTRATION

## ESOP Distribution Policies --- Importance and Recommended Content By: Lynn DuBois, Partner, ESOP Law Group, San Francisco, CA

Believing that the devil is in the details, the IRS now requires each ESOP to have a written ESOP distribution policy with detailed provisions that leave no room for plan sponsor discretion. The IRS mantra is “definitely determinable” by which the IRS means that (1) the distribution policy must not contain any discretionary provisions and (2) anyone reading the distribution policy will be able to determine exactly when and how ESOP distributions will be made. The distribution policy must be submitted to the IRS each time the plan is submitted for a new determination letter (every five years).

### ***“WHAT’S OUT” AND “WHAT’S IN” FOR 2013?***

In connection with processing determination letter requests over the past couple of years, the IRS issued technical advice memoranda on a number of topics with a common theme. Section 1.401-1(b)(1)(ii) of the Treasury Regulations requires an ESOP to provide a definite predetermined formula for all allocations and distributions under the plan. “What’s Out” for distribution policies are provisions that, while complying with Internal Revenue Code Section 409(o), allow plan sponsor discretion in making benefit distributions. “What’s In” are distribution provisions that, you guessed it, are definitely determinable and non-discretionary. Below are key components for a distribution policy and recommendations for complying with the IRS “definitely determinable” requirements.

### ***PAYMENT TIMING***

**WHAT’S OUT:** “If a participant’s service ends because of retirement, disability or death, distribution of his vested ESOP benefit will begin no later than the last day of the plan year following the plan year in which his retirement, disability or death occurs.” *This provision allows distribution to begin either in the plan year of termination or in the plan year following the plan year of termination.*

**WHAT’S IN:** “If a participant’s service ends because of retirement, disability or death, distribution of his vested ESOP benefit must begin during the plan year following the plan year in which his retirement, disability or death occurs.” *This provision states the only year that distribution will begin. Note that the provision could instead provide that payment will begin during the plan year of termination.*

**WHAT’S OUT:** “If a participant’s service ends for any reason other than his retirement, disability or death, distribution of his vested ESOP benefit will begin no later than the last day of the sixth plan year following the plan year in which his service terminates.” *This provision allows distribution to begin in any one of six plan years.*

**WHAT’S IN:** “If a participant’s service ends for any reason other than his retirement, disability or death, distribution of his vested ESOP benefit must begin during the third plan year following the plan year in which his service terminates.” *This provision states the only year that distribution will begin. Note that the provision could instead provide that payment will begin during any year from the plan year of termination to the sixth plan year following the plan year of termination.*

## ***PAYMENT FORM***

**WHAT'S OUT:** "Distributions may be made in a lump sum or in six substantially equal annual payments over a period that does not exceed five years."

**WHAT'S IN:** "If a participant's account balance is \$50,000 or less, the company will pay the benefit in a single lump sum. If a participant's account balance is more than \$50,000, the company will pay the benefit in substantially equal annual installments over a period of five years."

## ***PAYMENT MEDIUM—STOCK OR CASH***

**WHAT'S OUT:** "So long as the company is an S corporation, 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, company stock may be distributed subject to the requirement that it be immediately resold to the company."

**WHAT'S IN:** "So long as the company is an S corporation, distribution of a participant's ESOP benefit will be made entirely in cash without granting him the right to demand distribution in shares of Company Stock." *Note that the distribution policy instead could provide for distribution of shares, but one option or the other must be elected and set forth in the distribution policy.*

## ***INVESTMENT OF ACCOUNT FOLLOWING TERMINATION***

**WHAT'S OUT:** "Provided the Company determines that sufficient cash is available, the accounts of former participants may be diversified and converted into other investments within the plan."

**WHAT'S IN:** "Following a participant's termination of service for any reason, his company stock account will not continue to be invested in company stock and instead will be converted to cash as of the valuation date for the plan year of termination and will be invested as determined by the Trustee until the plan year of distribution. Transfers of company stock from the accounts of terminated participants to the accounts of active participants will occur pro rata based on the cash held in the account of each active participant." *As required by the IRS, this provision provides a definite formula, including the timing and valuation date for the transfer, by which employer stock will be transferred from terminated participant accounts into the accounts of active participants. These types of transfers are sometimes referred to as "segregation" or "conversion" provisions; the IRS refers to these transfers as "reshuffling."*

## ***DIVERSIFICATION***

**WHAT'S OUT:** "Diversification distributions will be made in cash or shares of company stock or by transferring cash representing that portion of the participant's company stock account with respect to which a "diversification" election is made to a subaccount under the ESOP for investment by the participant (so long as at least three investment funds other than company stock) are made available."

**WHAT'S IN:** "Diversification distributions will be made in cash." *Note that any one of the three choices listed above can be made, but only one.*

## **OTHER PROVISIONS**

**WHAT'S OUT:** Silence.

**WHAT'S IN:** Reviewing all of the elements of benefit distributions and setting forth in writing the administrative rules and procedures your ESOP will follow. Some examples are below:

— Consent and Forced Payments. “If the distribution is payable to a death beneficiary, the participant has reached retirement age under the plan, or the participant’s vested account is \$5,000 or less, a distribution will be made without the participant’s consent.” *Note that some plans do not force a payment to participants who have reached retirement age.*

— Distribution Processing. “Distribution requests received within forty-five days of notification of eligibility for distribution will be based on the Fair Market Value of the company stock determined at the last day of the preceding Plan Year. (Notification will be made within thirty days of receipt of an accurate allocation statement.) Requests received after this deadline will be postponed until the following Plan Year.” *Note that this avoids distributions based on a stale valuation and simplifies plan administration by offering distributions only once per year.*

— QDROs. “If a domestic relations order is determined to be a Qualified Domestic Relations Order (“QDRO”), payment to the alternate payee will begin when the participant is entitled to a distribution. If the QDRO provides, and if the participant continues working past age 50, the ESOP can distribute or begin distributions to the alternate payee in the Plan Year following the Plan Year in which the Participant reaches age 50 (in accordance with the other provisions of this Benefit Distribution Policy).” *Note that the alternate payee’s ESOP benefit may be paid immediately after the determination that a domestic relations order is qualified, even though the participant may not currently be entitled to a distribution.*

## **PLAN SPONSOR FLEXIBILITY REMAINS**

Although the distribution policy cannot contain “wiggle room,” plan sponsors retain a great deal of flexibility in structuring the timing and form of benefit distributions. The distribution policy, whether incorporated into the plan document or a standalone policy, is an integral part of the ESOP plan document and as such can be amended by the plan sponsor so long as the amendment(s) do not result in impermissible discrimination. This means that while a distribution policy cannot contain an “either or” provision, the policy can provide for “option A” now and then later be amended to change the policy to provide for “option B” that better meets the plan sponsor’s changed repurchase liability/cash flow objectives of the plan sponsor.

*The author reviewed this article with Committee Chair Pete Schuler, Crowe Horwath LLP, Columbus, OH.*

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