Timing Problems and Solutions for ESOP Diversification Elections
2.20.07

ESOP Diversification

The January 1, 2007 effective date of the new investment diversification rules for ESOPs with publicly traded stock got us thinking about the diversification rules that extend to companies whose stock is not publicly traded. These rules include some rather difficult timing requirements for most ESOP companies.

The Internal Revenue Code ("IRC") requires that "Eligible Participants" be given an election to diversify up to 25% of their Company Stock Account balances each year during a five year "Election Period" and up to 50% of their Company Stock Account balance in the 6th and final year of the Election Period. An Eligible Participant is one who is at least age 55 and has completed at least 10 years of participation in the ESOP.

The IRC requires that Eligible Participants be given an election to diversify during the first 90 days of the plan year. In addition, the IRC requires that any elections to diversify in the first 90 days be implemented, that is, the change in investment or the distribution, must occur, within a second 90-day period.

Two problems will arise for most ESOP companies:

First, the Company will likely not have completed its allocations for the prior year and the Trustee will not have received the new annual valuation from the appraiser before the end of the first 90-day period. So, an election form that is sent to Eligible Participants asking for their investment instructions will not inform them of: (a) the number of shares eligible for the diversification election, or (b) the fair market value that will be used to convert shares to cash. Two critical pieces of information needed for an informed decision!

Second, a significant number of ESOP companies will not have completed their annual valuations even by the end of the second 90-day period, and will not be able to convert electing participants' accounts to cash in time to meet the second deadline.

What to do?

Let's say your calendar year company's December 31 valuation is not ready until July 15 of the following year. You've sent the first revocable notice out as described above. Now, the Company sends a second notice out around July 31, giving participants 30 days to elect a distribution. The ESOP is now in technical violation of IRC 401(a)(28)(B). For a possible solution, we look to the IRS correction program, known as the Employee Plans Compliance Resolution System ("EPCRS"). EPCRS provides taxpayers with the ability to self correct qualification defects in their plans without risking loss of the plan's tax-qualified status under Section 401(a) of the IRC.

The correction principles of EPCRS would first look to place participants into the position they would have been in had the qualification defect not occurred. That is, as if the company had followed the terms of the ESOP plan document requiring implementation of elections by June 30th (for a calendar year company). Since the company's stock value is determined only once per year, the amount of the distribution the participant should have received on or before June 30th is the same as the actual distribution he received on August 31st. One could argue that the only additional action required of the company is to provide the participant with the lost earnings opportunity for the period from July 1st to August 31st. While EPCRS does not specifically address, the situation, it does provide guidance on determining lost earnings for other purposes.

EPCRS does not provide a complete solution, because EPCRS looks to address inadvertent or unintentional errors that occurred for a plan, despite the plan having in place adequate procedures to guard against such errors. In the case of ESOP diversification, the IRS might take the position that the lateness of the election is not inadvertent or a violation of the plan's regular operating rules. The good news, however, is that the violation does not appear to be one that is specifically excluded from EPCRS. For example, EPCRS specifically states that it is not available for egregious violations, such as for a plan that is providing excessive benefits to the highly compensated employees.

Conclusion

The first timing problem identified above can readily be addressed by using a two-step revocable election form process. The second timing problem can also readily be solved by completing the stock valuation within the first 4 to 5 months of the new year. For companies unable to work within that time frame, the ESOP company can look to the EPCRS model for a workable resolution. Perhaps, given the commonality of this problem, the IRS will one day provide additional guidance to ESOP companies.