FINDLEY perspective

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Take Stock of Your ESOP Distribution Policy

It's plain and simple: if your company's Employee Stock Ownership Plan (ESOP) lacks a distribution policy, there may be no defined rules for when and how participants are paid from the plan. A distribution policy is a key component of an ESOP and should include timing, method, and form of payment.

Committee of Stakeholders

Developing an ESOP distribution policy begins by gathering a committee of company stakeholders – representatives from the executive team, human resources, shareholders and trustees. This policy group should focus on developing a well-written ESOP distribution policy that considers the employee benefit, ownership and corporate objectives, and their relative importance. An ESOP distribution policy:

- Provides details for distribution to participants
- Ensures adherence to legal requirements outlined in the plan document and the Internal Revenue Code (IRC)
- Ensures the method of payment is non-discriminatory and non-discretionary
- Simplifies administration of the plan
- Aligns distributions from the plan with the company's financial objectives
- Supports the company's philosophies and ESOP culture

Ultimately, the committee will set rules related to when and how ESOP participants will be paid from the plan.

Timing of Payment

As the committee weighs the timing of ESOP benefits, one of the guiding factors should be based on your company's overall goals and objectives. Deferring payments until the required deadline:

- Allows for a longer planning horizon
- Slows the reallocation of shares and repurchase obligation
- Reduces the incentive participants may have to quit in order to gain access to their ESOP benefit

The committee may choose to provide immediate payment of ESOP benefits to participants who have terminated employment. Immediate payment allows the organization to:

- Remove stock from accounts of terminated participants
- Allocate shares to newer employees sooner, which addresses "have/have not" concerns typical in more mature ESOPs
- Ease administration of the plan

Whether the committee opts to defer ESOP benefit payments or make them immediately upon the participant's termination, it's important to follow IRC regulations (*IRC §409(o)*) for ESOPs which set specific rules for distributions due to death, disability or normal retirement, as well as termination for any other reason.

In the event of death, disability or normal retirement, participants are entitled to ESOP benefits no later than one year after the end of the play year in which the event occurs. A participant who retires in 2020, is entitled to payment of their ESOP benefit before December 31, 2021.

For participants who terminate employment for any other reason, benefits must be provided no later than six years after the end of the play year in which the event occurs. A participant who terminates employment in 2020, is entitled to their ESOP benefit before December 31, 2026.

There are additional ESOP distribution rules (IRC §401(a)(14)) that must also be applied, including:

- Age 65 or the plan's normal retirement age (if earlier)
- 10^{th} anniversary of the date the participant entered the ESOP

In some instances, a participant's request to delay an ESOP payment may be permissible. For example, an employee may wish to delay receiving their payment under the IRC's required minimum distribution rules (i.e. attainment of age 72), instead of age 65. Rules addressing these delays should also be addressed during formulation of the distribution policy.

Method of Payment

The ESOP distribution policy establishes the method of payment for the benefit: lump sum, installments or alternative options based on the participant's account balance. In accordance with IRC §409(o), installment payments should be:

- Substantially equal payments
- Made at least once per year
- Fully paid within a five-year period (large balances can be paid over an additional five years)

The policy may also provide an option to make lump sum payments for balances that are below a certain threshold (e.g. $10,000 or $20,000) and installments for balances above the threshold.

The committee should consider the company's objectives as it chooses the ESOP payment method.

Installment Payments:

- Help spread the overall distribution funding requirements over a longer horizon
- Contribute to smoother plan benefit levels

Lump-Sum payments:

- Limit terminated participants from receiving future S-distributions/C-dividends
- Help concentrate the shares held in the plan to primarily active employees

Form of Payment

The ESOP distribution policy should also define the form of payment – cash, stock or a combination. IRC 409(h) provides specific distribution rules for ESOPs, including participant rights to demand distribution in the form of employer securities and (if not readily tradable) have the employer repurchase the shares at a fair valuation.

Mandatory cash distributions are permissible in certain instances:

- S Corporation ESOPs
- When an employer's charter or bylaws restrict substantially all ownership to the ESOP or current employees
- Bank ESOPs

Just as the timing and method of the ESOP payment align with the company's objectives, the form of payment should also be set with the organization's goals in mind. When payments are made in stock:

- Shares are distributed and redeemed by the company (Payment is either a lump sum payment or installments backed by a promissory note, which must be adequately secured by the company)

- Participants may be eligible for capital gains treatment on the difference between the market value and their cost basis (net unrealized appreciation (NUA))

If cash is the chosen form of payment, the distribution funding will typically consist of employer contributions to the ESOP or through S-distributions/C-dividends.

Other Considerations

While the ESOP distribution policy committee will focus primarily on the timing, method and form of payment, the group should also address these topics which may impact plan distributions:

- Account segregation
- Qualified Domestic Relation Orders (QDROs)
- Events after termination
- Force out distributions
- Diversification

Questions? Contact the Findley consultant you normally work with or Aaron Geibel at *Aaron.Geibel@Findley.com* or *614.453.4653*