Session 2B
Benefit Distributions

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Agenda

- Legal Framework for ESOP Benefit Distributions
- Benefit Distribution Policies
- Practical “Mechanics” of Processing Distributions

Distribution-The Basic Concept

- Applies to all qualified plans and involves Internal Revenue Code, ERISA, and plan document
- Special distribution rules apply to ESOPs in addition to those that apply to other plans (IRC §§401(a)(28) and 409(h) & (o))
- As to an ESOP, it will primarily involve the value and quantity of employer securities
  - Employer must purchase its securities under “fair valuation formula” per Section 409(h) regardless of whether or not there is a take and “put”
  - Adequate consideration rules apply under ERISA Sections 404(a) and 408(e)

Timing – Legal Framework

- When must the ESOP offer participants distributions?
  - Death, disability, retirement: Within 1 year of plan year end event occurred
  - Other termination: Within 1 year after the fifth plan year end following the plan year end in which termination occurs (i.e., 2015 for 2009 termination)
  - For stock acquired prior to 1987, distribution can be postponed until death, disability, retirement
  - See IRC §409(o)

Timing – Legal Framework

- When must the participant take the distribution? (§401(a)(11))
  - Vested balance of $5,000 or less
    - Plan Document can stipulate that participants will be paid out immediately or at some other specific time – participant's consent is not needed
    - However – if balance exceeds $1,000, the distribution must be rolled over to an IRA (§401(a)(31))
  - Vested balance exceeds $5,000
    - Participants with vested balances greater than $5,000 cannot be paid without participant's consent until the later of age 62 or the Plan's definition of normal retirement age (usually age 65)
    - Plan may allow the participant to postpone the distribution further, but does not have to – can pay out without consent

Timing – Legal Framework

- Are there any other limitations with regard to the timing of distributions?
  - Distributions of financed shares may be postponed until ESOP acquisition loan is fully repaid for C-Corps, unclear for S-Corps
    - Cannot delay diversification or RMD payments to retired participants
    - Delay only applies to shares purchased by that loan
  - Often referred to as the “Financed Securities Exception” or “ESOP Loan Delay.” See IRC §409(o)(1)(B).

Timing – Alternatives

- The ESOP can offer timing choices…
  - Distributions may be paid out sooner than legal framework but not later
  - For example:
    - Immediate distribution
    - Anything sooner than 6th plan year end following plan year of termination
- …and place limits on those choices:
  - For example:
    - Threshold limit: Distributions under $10,000 may be paid immediately, larger balances wait 5 years

Timing – Cultural Implications

- Long wait for distributions
  - The ESOP may lose some of its employee goodwill – "Joe's been gone for three years, and he still doesn't have his money. What kind of ownership is that?"
  - Terminated employees can get a free ride on the backs of current employees
- Quicker distributions
  - Employees may quit to get their cash
  - Gets stock/company value back into hands of current employees

Timing – Cash Flow/Repurchase Obligation

- Faster distribution generally results in higher repurchase obligation because the shares are purchased quicker than otherwise required by law
- Are there better uses of excess corporate cash?

Cash v. Stock – Legal Framework/Alternatives

- What form can distributions take?
  - Cash or stock
    - Publicly traded companies need not offer cash
    - Participants must have the right to demand stock, unless
      - Charter or bylaws of the corporation restrict ownership to active employees or to a qualified plan
      - S-Corp
      - Sponsored by certain banks not permitted to repurchase their own securities
    - Diversification under the plan does not include the option to demand stock

Cash v. Stock – Legal Framework/Alternatives

- Stock Distributions and the Put Option
- Definition: In general, the contractual right to sell a security at a set price/time
- With regard to ESOPs:
  - Seller is the distributee
  - Buyer is the company, but the ESOP can assume the put
  - Price is the latest FMV
- Privately-held companies that allow stock distributions must provide put options
- If a plan is not required to distribute stock but does, the immediate repurchase of those shares can be required, making put provisions unnecessary.

Cash v. Stock – Legal Framework/Alternatives

- Put Option Process
  1. Stock is distributed to the participant
  2. Distributee has two "put periods": 1st period: 60 days commencing with distribution date; 2nd period: 60 days beginning when the next valuation is completed and communicated
  3. The company pays for the shares immediately or over a period not exceeding 5 years

Cash v. Stock – Legal Framework/Alternatives

4. Price paid for shares is fixed at the FMV determined as of the date the put is exercised
5. If the company does not pay immediately, a secured note bearing a "reasonable interest rate" must be issued to the distributee for balance due
   - Security must be tangible:
     - Priority interest in assets of the company
     - Surety bond
     - Letter of Credit

Cash v. Stock – Redeem/ Recycle

- Cash Distributions
  - How do you generate the cash necessary to pay the participant out?
  - Sell the shares to:
    - External markets – NYSE, NASDAQ, AMEX, OTC, etc., if possible
    - The company (redeem)
      - If company is privately held and stock is sold to company, valuation must be updated at time of sale
  - Recycle shares

Cash v. Stock – Redeem/Recycle

- Cash Distributions - Recycling
  - Source of funds: existing cash, company contributions, cash dividends paid on stock
  - Cash in participants' accounts is used to "purchase" shares from the terminating participants
  - Pros and cons:
    - Pro: Serves as a source of stock to allocate to new plan participants, thus giving them ownership
    - Con: Company may be required to come up with cash when it is not readily available
    - Con: Benefit levels can be volatile and unpredictable – low in some years, very high in others.

Cash v. Stock – Mechanics

- Cash Distribution Example
  - Assume: FMV at December 31, 2013, is $12 per share

At December 31, 2013	Employer Stock Account	Other Investments Account
Ending Balance	1,500.5000	$700.00
Vesting %	60%	60%
Vested Balance	900.3000	$420.00

- Distribution= (900.3 shares * $12) + $420 = $11,223.60

Cash v. Stock – Mechanics

- Stock Distributions
  - Cash in participant account is used to purchase as many whole shares as possible
  - Vested shares are transferred to name of distributee
  - Value of vested fractional shares is paid in cash

Cash v. Stock – Mechanics

- Stock Distribution Example
  - Assume: FMV at December 31, 2013, is $12 per share

At December 31, 2013	Employer Stock Account	Other Investments Account
Ending Balance	1,500.5000	$700.00
Vesting %	60%	60%
Vested Balance	900.3000	$420.00

- Distribution = $11,223.60 ÷ $12/sh = 935.3 shares.
  - Distribute 935 whole shares, plus 0.3 sh x $12 or $3.60 cash

Cash v. Stock – Mechanics

- Combination Distribution – Stock and Cash
  - Generally, vested stock account is paid as stock, vested cash account as cash
  - Fractional shares paid as cash

Cash v. Stock – Mechanics

- Combination Distribution Example
  - Assume: FMV at December 31, 2013, is $12 per share

At December 31, 2013	Employer Stock Account	Other Investments Account
Ending Balance	1,500.5000	$700.00
Vesting %	60%	60%
Vested Balance	900.3000	$420.00

- Distribution = 900 shares + (0.3 shares * $12) + $420

  = 900 shares and $423.60

Cash v. Stock – Cultural Implications/Cash Flow

- Generally little cultural difference because the result is quickly the same – cash to terminee
- Little difference in repurchase obligation to the company because stock is generally sold back to the company quickly
- In the long run, stock distributions followed by redemption tends to benefit participants with larger stock account balances. Recycling tends to benefit participants with more current compensation.
- Stock distributions allow redemption of shares without valuation update
- Stock distributions can offer significant tax advantages to the recipient

Cash v. Stock – Stock Distribution Tax Advantages

- Stock Lump-Sum Distributions
  - Cost-basis of stock is taxed as ordinary income at the payee's personal income tax rate in year of distribution
    - 20% withholding on the cost-basis, but shares are not sold to satisfy withholding requirement
    - 10% early withdrawal penalty if payee is under 59½
  - Net unrealized appreciation (NUA) = FMV - cost-basis
    - Generally taxed as a long-term (LT) capital gain in year of share sale
  - Appreciation above NUA is taxed as an LT or ST capital gain in year the distributee sells stock, depending on the holding period

Cash v. Stock – Stock Distribution Tax Advantages

- Example of NUA Calculation:

Item	Calculation	Result
Cost basis	100 shares * $10/share	$1,000
FMV@Distribution	100 shares * $15/share	$1,500
NUA	100 shares * ($15 - $10)/share	$500

Cash v. Stock – Stock Distribution Tax Advantages

- Federal Tax Differences:

	Taxes on	Total Taxes
Stock Distribution	($1,000 Cost basis * 28%) + ($500 NUA * 20%)	$380
Cash Distribution	$1,500 FMV * 28%	$420
Difference		$40

Single Payment v. Installments – Legal Framework/ Alternative

- What form can distributions take?
  - Single-sum or installments
    - Single-Sum Payments: Full payment of accrued benefits within one taxable year
    - Installment Payments: Payment of accrued benefit in a series of payments over more than one taxable year
      - Maximum payment period, unless distributee elects longer, is 5 years for balances not greater than $1,050,000 (as indexed for inflation). This is increased by 1 year for each $210,000 (or any part thereof) over $1,050,000, not to exceed a total of 10 years.
  - Plan can offer form choices and place limits on those choices
    - Example: Lump sum distributions for balances under $10,000; larger balances paid in installments

Single Payment v. Installments – Legal Framework/ Alternative

- Points to consider:
  - Lump-Sum Distribution of Shares
    - Company (or Plan) purchases shares from the distributee at the FMV at time of distribution, but may pay for the shares in installments (subject to providing "adequate security").
    - If a rollover is desired this is more complicated and expensive – need to find a willing IRA custodian.
    - Fixes the price of the shares so that the participant does not share in the future increase in share value, but gets some interest income. Can also allow for NUA treatment.
  - Installment Distribution of Shares
    - Price paid for each installment is based on most recent FMV, so the distributee shares in future increase or decrease in share value
    - Shares remaining in the plan receive proportionate share of dividends
    - Terminated participant retains beneficial interest in the Company

Single Payment v. Installments – Cultural Implications

- Long wait, installments:
  - Can compound the cultural problems of delaying distributions
- Immediate distribution, installments
  - Discourages employees quitting to get their cash, because it takes them a while to get it all – split up the “jackpot”
  - Still gets stock/company value back into hands of current employees fairly quickly
  - Doesn’t have same negative cultural issues that may come with a 5-year wait
- What about account segregation/liquidation/reshuffling?

Lump Sum or Rollover – Legal Framework

- What form can distributions take?
  - Lump-sum or rollover
    - Rollover
      - Tax-free transfer of vested benefits to another qualified plan, an IRA, a 403(b) plan, or a governmental Section 457 plan
      - What can be rolled over?
        - Most single-sum payments or installments paid over less than 10 years
        - Death Benefits
        - RMDs cannot be rolled over
        - Hardship distributions cannot be rolled over

Lump Sum or Rollover – Legal Framework

- Lump-Sum
  - Payment of vested benefits directly to participant or beneficiary
  - Subject to taxation as ordinary income/capital gain
  - 20% withholding (if over $200)
  - 10% early withdrawal penalty if under 59½ years old, subject to certain exceptions
- Installment Distributions: Plan may allow rollover/lump sum election for each installment or initial election governs until changed

Lump Sum or Rollover – Cash Flow

- No tax withholding on distributions rolled over directly from qualified plan to another qualified plan or IRA
- 20% withholding on all distributions eligible to be rolled over that are not rolled over
- Exception:
  - No withholding if <u>total</u> distribution to the participant is less than $200;
  - Stock does not need to be sold in order to satisfy withholding requirement.
- 20% applied to participant's taxable distributions for the year. Actual tax paid on the distribution will be based on payee's personal income tax rate and, if stock is in the distribution, the capital gains tax rate

Required Minimum Distributions

- Theory:
  - Qualified plans are meant to be a retirement tool, not an estate planning tool
  - Benefits are meant to be paid out over the life of the participant

Required Minimum Distributions

- Who Receives RMDs?
  - First Step: Participant attains age 70½
  - Second Step:
    - Participant is terminated from employment; or
    - Participant is a 5% owner
      - Attribution rules of Code Section 318 apply
      - If RMDs begin due to 5% ownership, then RMDs continue even if ownership changes
- Plans <u>may</u> allow non-5% owners who turn 70½ and who are not terminated to receive RMDs

Required Minimum Distributions

- Timing of RMDs
  - Must receive RMD by April 1 following the end of the calendar year in which requirements are first met
  - Must receive RMD by December 31 for each subsequent year
  - Two payments in first year – one by April 1, one by December 31
- Taxation of RMDs
  - Not eligible for rollover, therefore, not subject to 20% withholding; is subject to 10% withholding unless participant elects out
  - If not paid, participant is subject to a 50% excise tax
  - If a distribution is paid during a year for which an RMD is due, RMD must be calculated first and handled accordingly (i.e., cannot be rolled over)

Required Minimum Distributions

- Calculation of RMDs
  - Account Balance ÷ Life Expectancy Factor = Minimum Distribution
    - Account Balance: At PYE within the calendar year immediately prior to the distribution year
    - Calculation is based on entire account balance, not just vested balance
    - If vested balance is less than RMD, payment is limited to the vested balance
      - Adjustment must be made to future distributions to make up for missed RMD's from prior years as vesting increases

Diversification

- Allows participants the option to reduce investment risk as they approach retirement
- General Rule
  - Qualified Participant must be permitted during the Qualified Election period to diversify a certain percentage of their post-1986 stock account (shares acquired by the plan after 1986)
- Qualified Participant
  - Age 55 and 10 years of participation in the ESOP; these terms can be made more lenient but are then considered in-service distributions
- Participation
  - May include years in a predecessor plan if assets from that plan were used to purchase ESOP shares
  - It is not clear whether years of participation include years after termination of employment, so Plan Document should carefully define years of participation

Diversification

- Qualified Election Period
  - 6-year period beginning with 1st plan year in which the participant becomes a Qualified Participant ("QP")
  - If a QP wishes to diversify, they must make the election within 90 days after the end of each plan year in the Qualified Election Period
- Diversification Amounts
  - Cumulative 25% for the first 5 years, 50% for the 6th year
- Three mechanisms for diversification:
  - Distributing funds directly to the participant
  - Transferring funds into an IRA or employer's 401(k) plan
  - Offering at least three investment options in the ESOP
- Diversification must be completed within 180 days following the end of the plan year

Diversification

- Potential roadblocks
  - What if post-1986 and pre-1986 shares are not kept in separate "buckets"?
    - Draft plan to allow in-service distributions and calculate diversification amounts based on total share balance
  - How do you meet the deadlines for diversification if you don't have your stock value?
    - Provide preliminary diversification election within the 90-day election period based on prior year end information
    - Provide final diversification election when year end work is completed
  - And if the work isn't completed within 180 days following year end...what then?
    - Possible solution: Make preliminary diversification based on a percentage of the shares elected; "true-up" when final work is completed

Diversification – Example Calculation

- Assumptions:
  - 12/31/2013 is 2nd diversification year
  - Shares diversified during 2013: 50.00 shares (200 shares * 25%)
  - Balance at 12/31/2013: 190.00 shares
  - Calculation:

    190.00 shares in account at 12/31/2013
    + 50.00 shares previously diversified
    240.00 total post-1986 shares allocated to account
    x 25% (first five years, 50% for sixth)
    60.00 total shares
    - 50.00 (previously diversified shares)
    10.00 shares eligible for 12/31/2013 diversification

Agenda

- Benefit Distribution Policies

Policy Design Steps

- Determine and prioritize objectives and hurdles
- Determine who is making the decision
- Design policy to meet objectives
- Consider nondiscrimination aspects of design; modify design as needed
- Consider administration issues with policy
- Document policy and procedures
- Communicate policy to participants

Objectives and Hurdles

- Ownership objectives
- Philosophy on terminated employee-owners
- Repurchase liability
- Stock value growth and dividends
- Funding method

Objectives and Hurdles

- Employees leaving to gain access to balance
- S corporation anti-abuse prevention
- Desired benefit levels
- Predictability and volatility of contributions
- IRS limits
- “Haves-and-Have-Nots” prevention
- Bylaw restrictions
- Price protection

Who Will Be Decision Maker

- Settlor
- Fiduciary
- Specifics in plan, separate policy or combination

Policy Content

- Timing
  - When distributions will start
- Method
  - Manner of payment (lump sum, installments, annuities)
- Form
  - Cash, stock, combo
- Special exceptions
- Diversification decisions
- Segregation decisions
- Rebalancing

Policy Content – Timing

- ESOP loan delay
- Different timing for different events
- Accelerated timing for small balances
- Force out distributions
- Post termination death, disability, retirement
- General ERISA timing

Policy Content – Method

- Different method for different benefit event reasons
- Separate timing for cash balance
- Minimum installments and lump sum thresholds
- Large balance installment extension

Policy Content – Form

- Recycle vs. redeem
- Know whether offering stock is a must
- Lump sum distribution in stock – can turn ordinary income into capital gains = tax savings for participant

Policy Content – Form

- S corporations
  - Instantaneous sale
  - Watch shareholder limit
- Mechanics – stock distribution with participant selling shares to company vs. ESOP selling shares directly to company

General Tips

- Follow the terms of the plan document!
- Don’t forget to include these decisions:
  - Force-out distributions
  - QDRO alternate payee payouts
  - Post termination death, disability, retirement treatment
  - Coordination with diversification
  - Rehire on installments

Agenda

- Practical “Mechanics” of Processing Distributions

Distribution Mechanics – Who Cuts the Check?

- In-house processing
- Institutional trustee
- Third-party Administrator
- Payment processing service
  - PenChecks
  - Others?
- Regardless of process, take distribution payments seriously! "It's the entire point of the exercise." and the thing that matters most to ESOP participants. A well-planned, organized and executed distribution process will go far to keeping employee-owners happy.

Distribution Mechanics – What needs to be done?

- Properly interpret distribution policy
- Provide distribution election & consent forms, including *Special Tax Notice*
- Collect and properly interpret distribution election forms
  - Investigate non-responders
  - Validate/correct/perfect problems
- Prepare payment batch worksheet, including gross and net amounts, withholdings, 1099-R distribution codes, check payee and payment instructions
- Cut the checks for the net payment amounts

Distribution Mechanics – What needs to be done? *(continued)*

- Remit withheld taxes
  - Federal taxes must be remitted via EFTPS
  - Monthly depositors: 15th day of the month following the payments
  - Semiweekly depositors: Deposit on Wednesday for payments made the previous Wednesday through Friday. Deposit on Friday for payments made the previous Saturday through Tuesday.
  - Deposit schedule is based upon total remittance for the second preceding calendar year. $50K or less – Monthly depositor. $50K+ – semiweekly.
- Each individual state as distinct withholding, remittance, and reporting processes. The state of residency of the <u>participant</u> controls, not the Plan's.
- Report annual distributions on IRS Form 945, generally due January 31 of the following year. Again, watch for state requirements.

Distribution Mechanics – What needs to be done? *(continued)*

- Identify and resolve uncashed and nondeliverable checks
- Prepare Forms 1099-R
  - Due to the IRS by February 28, or March 31 if filing electronically
  - Due to the Participants by January 31
- Tips:
  - Use the ESOP Trust's Tax ID Number for all filings (remittance, 945, and 1099-R). Helps avoid confusion with the Sponsoring company's regular payroll tax transactions and filings.
  - Remit withheld tax the same day that you cut checks even if not required.
  - Mail IRA Rollover checks to the participant, not the custodian. Let them handle delivery to the custodian, as more and more custodians require specific intake paperwork and may reject direct mailings.

Distribution Mechanics - Distribution Policies

- Increasing personal preference for explicit distribution policies that are embedded in the plan document, rather than a separate distribution policy. Why?
  - Easier applications for a Favorable Determination Letter
  - Distribution policy is clearly stated in the Summary Plan Description. Important to ownership culture and credibility.
  - Plan amendment required, forcing ERISA legal counsel oversight and avoiding costly errors and corrections.
  - Less likely that the TPA has an outdated copy

Distribution Mechanics - Distribution Policies *(continued)*

- Is there a "most common" set of distribution policies? No, not really, but consider:
  - Minimum installment amounts of $5,000 or $10,000 in order to avoid multiple small installment payments. Perhaps a higher threshold for Death/Disability/Retirement
  - Segregated balances paid in a lump-sum. If the account is liquid, what's the point of paying in installments?
  - Be cautious about accelerating the start date. Protected benefit? Does it create an incentive to quit? If you must, consider accelerated start dates only for minimal balances.
  - Carefully consider the implications of recyling vs. redeeming
  - Consider stock distributions to cleanse from a §1042 "taint," even if the ESOP will immediately repurchase/recycle

Distribution Mechanics - Distribution Policies *(continued)*

- Why don't we see more NUA distributions?
  - Especially valuable for large distributions. Most Sponsors are reluctant to distribute large balances in a lump sum for obvious reasons.
    - Consider stock distributions paid for with a secured promissory note.
    - But those who desire a rollover will be burdened with a specialized IRA custodian with higher fees
  - Most participants with large balances wish to roll over to an IRA and continue the tax deferral

Distribution Mechanics - Distribution Policies *(continued)*

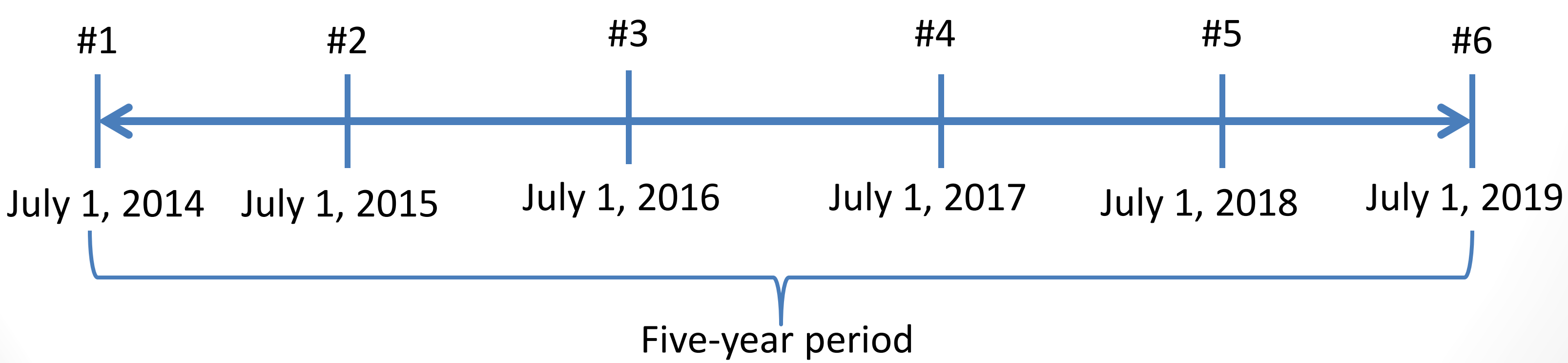
- Do retirees really need to wait for a year before receiving distribution?
  - Example: Monica has a modest wage but earned a $600,000 ESOP account balance. She retires on January 31, 2014 after 30 years of dedicated service. After a splendid retirement party, she asks for her ESOP check.
    - You explain that she won't get paid until the 2014 administration is completed, perhaps as 20 months later – September or October of 2015.
  - Alternative approach: Distribute the first installment at the retirement party – 1/5 (or some lesser percentage) of the known 12/31/2012 account balance. True-ups will be required for future installments, but the participant is obviously happier.

Distribution Mechanics - Distribution Policies *(continued)*

- Financed Securities Exception or ESOP Loan Delay
  - Provides peace of mind and an important safety valve to the highly-leveraged ESOP Sponsor, but
  - ESOP loans are often 20, 30, or even longer.
  - The longer the wait between separation from service and payment, the higher the likelihood of a Missing Participant
  - Highly-leveraged ESOP sponsors also enjoy a temporarily depressed stock value due to the “post-transaction drop in value” – deferring distributions for 10+ years could prove very costly compared to what a “regular” distribution would have cost.

Distribution Mechanics - 5 installments or six?

- IRC §409(o) requires "substantially equal periodic payments (not less frequently than annually) over a period not longer than . . . 5 years . . .
  - So that's five installments, right? Not necessarily (but check your plan document and distribution policy):



Questions

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