StatonWalsh

Financial Clarity Through Transparency

Prepared for:

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Stock Bonus Plan

The Basics

Employer contributions to the plan are not dependent upon profits, and the plan may, but is not required to, invest primarily in employer stock.

How It Works

- Employer contributes to the plan.
- Employer contributions are tax deductible.
- Contributions are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging,[1] or, at retirement from the current employer, rolled over to a traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover.
- Except for more than 5% owners, required minimum distributions (RMDs) must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 72, or (b) the year following the year in which the participant retires. More than 5% owners must begin to receive distributions by April 1 of the year following the year they reach age 72.[2]

Additional Considerations

- **Maximum annual deduction:** Up to 25% of covered payroll can be contributed and deducted by the corporation.
- **Individual limits:** In 2023, the allocation of contributions to a participant's account may not exceed the lesser of 100% of includable compensation or $66,000 per year.

[1] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

[2] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

- **Employer contributions:** Most plans are discretionary as to the amount that the employer contributes. If there are profits, the employer is expected to make "substantial and recurring" contributions. See IRS Reg. 1.401-1(b)(2).
- **Excluding persons:** Certain persons can be eliminated on the basis of months of service, age, coverage in a union plan and salary base; for example, persons under age 21 can be excluded from the plan.
- **Investment of plan assets:** Investments must be diversified and prudent. Subject to plan provisions, plan assets can be invested in equity products like mutual funds or stocks; or debt instruments like T-Bills and CDs. Insurance products like life insurance and annuity policies may also be used. Stock bonus plans typically are heavily invested in employer stock. They are not, however, required to invest in employer stock as with an Employee Stock Ownership Program (ESOP).
- **Social Security integration:** Since the employer already contributes to the employee's Social Security retirement benefit, these contributions can be integrated into the contribution formula of the plan.
- **Parties which are favored:** Typically younger participants are favored because they have a longer time for their fund to grow.
- **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures, or forfeitures may reduce future employer contributions.

How Much Will There Be at Retirement?

This will depend upon three factors:

- The frequency and amount of contributions,
- The number of years until retirement, and
- The investment return.

The risk of poor investment returns rests upon the *employee*. However, if the investment results are favorable, the participant will have a larger fund at retirement age.

An Example of What $10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax[1]				
Years	2.00%	4.00%	6.00%	8.00%
5	$52,040	$54,163	$56,371	$58,666
10	$109,497	$120,061	$131,808	$144,866
15	$172,934	$200,236	$232,760	$271,521
20	$242,974	$297,781	$367,856	$457,620
25	$320,303	$416,459	$548,645	$731,059
30	$405,681	$560,849	$790,582	$1,132,832
35	$499,945	$736,522	$1,114,348	$1,723,168

Top-Heavy Plans

If more than 60% of the plan assets are allocated to key employees,[2] the employer must contribute at least as much for non-key participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includible compensation (higher in some instances).

Advantages to Employer

- Contributions are tax deductible.
- Contributions and costs are totally flexible.
- The plan is easy to understand by the employees.
- It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- Since all or substantially all of the assets are invested in employer's stock, this is a good method for raising additional capital without going to the marketplace.

[1] The rates of return used in this illustration are not representative of any actual investment. Typically, an investment will not provide a consistent, unchanging rate of return year after year. Years with a rate of return higher or lower (even negative) than the hypothetical returns shown here can substantially affect the final results.

[2] A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded $215,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

- In effect, the corporation can raise capital with deductible contributions to its plan.
- If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than $5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds $1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than $1,000.

Advantages to Employees

- Annual employer contributions are not currently taxed to the participant.
- Earnings on the account are not currently taxed.
- Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.
- Younger employees can accumulate a larger fund than with a Defined Benefit Plan.
- The forfeited, unvested portion of accounts of former participants may be allocated to the active participants' accounts. This can have a major impact on the future benefits.
- Participant may borrow from the plan within certain guidelines, if provided for in the plan documents.
- Employee participates in employer's growth.
- A potential market is created for stock of deceased shareholders.
- At distribution, the gain on the stock is not taxed until it is sold.
- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.
- Upon distribution, for stock that is not readily tradable, the participant has the right to require the employer to repurchase the participant's stock.

- If participants are given the right to direct any investments, plan sponsors are required to provide certain standardized investment fee and performance data. This information is intended to aid participants in making better-informed investment choices.

Disadvantages to Employer

- The stock bonus plan will generally not produce as large a contribution and deduction for older employees as will a defined benefit plan or other types of defined contribution plans.
- Deductible contribution limits are set at 25% of covered payroll.
- If a firm's stock is not publicly traded, the voting power of the stock must be passed through to the participants on matters requiring a majority vote of the shareholders.
- The cost of re-valuing closely held stock each year may be expensive.
- Future repurchases required by employee distributions may not come at a convenient time for company cash flow purposes.
- If a plan gives participants the right to direct investments, plan sponsors are obligated to provide participants with standardized investment fee and performance information. Failure to comply with these ERISA requirements may result in a breach of fiduciary duty to plan participants, and the loss of ERISA Section 404(c) protection. In this situation, the plan fiduciaries could be held responsible for the results of the participants' own investment choices.

Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risks rest on the *employee*.
- Older participants will not receive as large a benefit as with a defined benefit plan.
- There is no assurance as to the frequency and amount of employer contributions.
- The value of closely held stock may be difficult to determine at retirement age.

- If the founder or other key people die, retire or terminate employment, the company stock may be worth very little.
- The company may not be financially able to repurchase the stock, even though required to do so.
- If the employer's stock is depressed in value at retirement time, there could be a significant loss in the retirement account.

Coronavirus Aid, Relief, and Economic Security (CARES) Act

- **Coronavirus-related distribution (CRD):** One section of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided for a "Coronavirus-related distribution," or CRD. A CRD – optional (not mandatory) for a qualified retirement plan sponsor – was a distribution made from January 1, 2020, through December 30, 2020, from an IRA or qualified retirement plan. A CRD could not exceed $100,000 in aggregate per individual, was exempt from the usual 20% mandatory federal income tax withholding, and must have been made to an individual (or spouse or dependent) who was diagnosed with SARS-CoV-2 or COVID-19, or who experienced an adverse financial consequence as a result of the COVID-19 pandemic. A CRD was exempt from any 10% early withdrawal penalty that may have applied and, unless the individual chose otherwise, the CRD could be included in taxable income ratably over a three-year period. A CRD may be re-paid, without regard to the normal contribution limits, over a three-year period.

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Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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