Show Me the Money!
ESOP DISTRIBUTION RULES...AND THEN SOME

David A. Guadagnoli, Esq.
Sullivan & Worcester LLP
617-338-2938
dguadagnoli@sandw.com

Barbara Clough, QPA, QKA
VERISIGHT, Inc.
515-318-6220
Barbara.Clough@verisightgroup.com

Peter Preovolos
PenChecks, Inc.
619-600-0667
ppreovolos@penchecks.com

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Overview

- Distribution options vary based on ESOP design
- From the participant perspective, ESOP distributions raise
  - Portfolio diversification considerations (should you continue holding employer stock?) and
  - Tax and retirement planning considerations (should you “cash out” and pay any applicable taxes or roll the ESOP distribution over in order to defer taxes?)
**Timing**

- Most plans permit an employee to take distributions immediately after end of employment
  - Small balance cashout (not more than $5,000)
- Terminated employees can typically defer until age 70½
  - Required minimum distribution rules (post 70½) then kick in (installments over life expectancy)
- Some plans offer in-service distributions (hardship, age 59½, etc.)
**TAX CONSEQUENCES: TAXABLE DISTRIBUTION**

- Generally subject to tax at ordinary income rates
- Withholding at a required 20% federal rate; may also be state withholding
- 10% excise tax on “early” distributions; key exceptions –
  - Distribution after age 59½
  - Distribution after 55 and separation from service (qualified plan only; not IRA)
TAX CONSEQUENCES: ROLLOVER

• Roll distribution over to a traditional IRA or another retirement plan

• Direct rollover (avoids withholding) or indirect rollover (must complete the rollover within 60 days; some portion of distribution will have been withheld)

• Tax deferred until there is a later distribution

• Distributions eventually subject to tax at ordinary income rates

  › Withholding at a “mandatory” 10% federal rate; may also be state withholding
**TAX CONSEQUENCES: ROLLOVER (cont’d)**

- Must begin to take distributions from traditional IRA shortly after 70½, even if still working

- 10% excise tax on “early” distributions from traditional IRA; key exceptions –
  - Distribution after age 59½
  - Series of substantially equal periodic payments
What Is Different About ESOP Distributions?

- Cash vs. stock (unless “S” corporation or ownership limited to qualified plans and employees)
- Tax law vs. plan design
- Lump sum vs. installment
- “Net unrealized appreciation” tax benefit
Timing Of ESOP Distributions Following End Of Employment

- Immediate distributions
  - Retirement
  - Death
  - Required minimum distributions (beginning shortly after age 70½)
  - Small balances (typically)

- Deferred distributions
  - Up to six years following a non-retirement/death end of employment
  - Tax law generally permits distributions to be deferred while ESOP debt is outstanding (helps the employer manage its liabilities associated with the ESOP)
  - ESOP can pay distributions in installments over a period of up to five years (plus one additional year (up to another five) for each $210,000 of value above $1,070,000)
ESOP In-Service Distributions

- Two-year/Five-year rule
- Diversification
- Required minimum distributions
  - Unusual, unless participant is also a “5%-owner”
- Hardship
  - Unusual
- May be subject to 10% early distribution excise tax if not at least age 59½
Taxation Of ESOP Distributions: Cash

- Taxable at ordinary income rates
  - Subject to mandatory withholding – 20% federally (and possibly state taxes)
- May be subject to 10% early distribution excise tax if not at least age 59½
- Tax can be deferred by rolling over distribution (directly or indirectly) to an IRA or other retirement plan
Can take taxable distribution or defer tax by rolling over distribution (directly or indirectly) to an IRA or other retirement plan

- Not always easy to find an IRA provider willing to hold stock of a privately-held company
- Amounts in IRA subject to required minimum distribution rules (whether or not retired)
- Tax benefit of net unrealized appreciation is forever lost; ordinary income (and potentially the 10% excise tax) will apply to amount eventually distributed
• Tax consequences if “lump sum distribution”
  › Total distribution of account within a single year
  › “Basis” of employer stock in hands of trustee taxable at ordinary income rates
    • Subject to mandatory withholding – 20% federally (and possibly state)
  › “Net unrealized appreciation” is taxed at long-term capital gain rates, and only when the shares are ultimately sold
    • NUA: the difference between the value at distribution and the amount the trustee paid for the shares
  › Further appreciation is taxed at short-term or long-term capital gains rates, depending on the holding period in the hands of the distributee
Taxation Of ESOP Distributions: Stock

• Tax consequences if “lump sum distribution” (cont’d)
  › Amount subject to ordinary income may be subject to 10% early distribution excise tax if not at least age 59½ (but net unrealized appreciation portion may never be subject to the 10% excise tax)
  › Net unrealized appreciation not avoided at death
Taxation Of ESOP Distributions: Stock

Example

- Hank has been a participant in his employer’s ESOP since Day 1, when the ESOP bought stock at $40/share
- Hank retires and requests a complete distribution of his account, consisting of 1,251 shares, at a time when the shares are worth $100/share
- Assume Hank is in a 35% bracket for ordinary income and 15% for long-term capital gains
Absent a rollover –

- Hank will be immediately subject to tax at ordinary income rates on $50,040 (1,251 shares x $40/share)
- Hank has net unrealized appreciation of $75,060 (1,251 shares x ($100/share - $40/share))
- The $75,060 will be taxed at long-term capital gain rates when the shares are eventually sold
- If two months later Hank sells all of the shares for $110/share
  - He will pay tax at long-term capital gain rates on $75,060
  - He will pay tax at short-term capital gain rates on $12,510 (1,251 shares x ($110/share - $100/share))
**Total Taxes**

<table>
<thead>
<tr>
<th>No rollover</th>
<th>$33,152</th>
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</thead>
<tbody>
<tr>
<td>Rollover/withdrawal</td>
<td>$48,163</td>
</tr>
<tr>
<td>Savings</td>
<td>($15,011)</td>
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</tbody>
</table>

**Bottom Line:** If **NOT** deferring taxes by rolling over to an IRA, why not reduce taxes by requesting a distribution in shares and immediately selling them back to the employer?
Methods for liquidating stock after distribution

- Participant has a right to sell (or “put”) the shares back to the employer during a 60-day period following distribution and again a year later
  - Stock can be sold for a note if there is adequate security and a reasonable rate of interest
  - Note must generally be repaid within five years
- If distributee does not “put” the shares during one of these two periods, no further right to force a purchase by the employer or the ESOP
- Shares distributed may be subject to a right of first refusal
DIVERSIFICATION
Traditional ESOP Rules: Basics

- Qualified participant has the right to elect to diversify up to 25% of the number of shares in his/her post-1986 ESOP stock account for the first five years and up to 50% of the number of shares in his/her post-1986 ESOP stock account for the sixth year after satisfying the diversification eligibility requirements.
  - “Qualified participant”: age 55 and 10 years of ESOP participation
- Election opportunity not required (but still permitted) if shares in stock account have market value of $500 or less.
Diversification Alternatives

- Cash distribution
  - Taxed as ordinary income
  - Subject to 10% penalty for pre-age 59½ distributions
- Stock distribution (subject to put option if closely held company)
  - Taxed as ordinary income
  - Subject to 10% penalty for pre-age 59½ distributions
- Transfer to company’s 401(k) or profit-sharing plan
- Rollover to IRA
- Offer three or more investment alternatives in ESOP
<table>
<thead>
<tr>
<th>Requirement/Task</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Identify participants eligible for diversification</td>
<td>• Six months before year end (target: July for calendar year plan)</td>
</tr>
<tr>
<td>• Send preliminary diversification forms to participants eligible for diversification</td>
<td>• Within 90 days after year end (preliminary elections should be made by March 31 for calendar year plan)</td>
</tr>
<tr>
<td>• Send final diversification forms to participants eligible for diversification</td>
<td>• As soon as possible after updated stock valuation and current allocations are complete</td>
</tr>
<tr>
<td>• Complete diversification distributions or transfers for participants who elected to diversify</td>
<td>• Within 180 days after plan year end (target: June 30 for calendar year plan)</td>
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</table>
## Traditional: Example

<table>
<thead>
<tr>
<th>YR</th>
<th>BEGIN SHARES</th>
<th>+ NEW SHARES</th>
<th>+ PREV DIVRS</th>
<th>= SUB TOTAL</th>
<th>x 25%</th>
<th>- PREV DIVRS</th>
<th>= AVAILABLE FOR DIVRS</th>
<th>DIVRSFY?</th>
<th>DIVRS SHARES</th>
<th>END SHARE BAL</th>
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<tr>
<td>1</td>
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<td>40</td>
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<td>800</td>
<td>200</td>
<td>0</td>
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<td>240</td>
<td>220</td>
<td>20</td>
<td>N</td>
<td>0</td>
<td>740</td>
</tr>
</tbody>
</table>

\[ \text{= SUB TOTAL} \times 50\% \]

| 6  | 740          | 40           | 220          | 1,000       | 500   | 220          | 280                   | Y        | 280          | 500           |
Traditional: Diversification Mishaps

- Failure to notify qualified participants of their right to diversify
  - Provide diversification notice and election form as soon as possible
  - Make-up contribution may be necessary to make participants whole if the share value has decreased
  - Implement administrative procedures for annual notices

- Pending plan operational corrections – correct stock account balance not available
  - Implement diversification election based on current stock account balance (with later true-up, if appropriate) or
  - Notify participant that diversification distribution will be delayed and permit new election when the plan operational corrections are complete
• Specifically, how is 10 years of participation defined?

• Participation years are not the same as Years of Service

  › Years of Service are generally defined in the Plan Document
  › Years of Service begin at date of hire and end upon termination
  › May be based on Plan Years, generally have an associated hours requirement
  › May be based upon elapsed time (a/k/a anniversary of hire)
  › Participation years have traditionally not been defined in the Plan Document
  › Count from date of participation until the date a participant has received a complete distribution
Plan may allow participants the opportunity to take both diversification and termination distributions in the same year

- Plan sponsors should be cautious not to over/under pay plan participants
- Amounts distributed under diversification rules are not subject to the right to demand stock, the termination distribution may be (subject to “S” corporation status and by-laws)
- Timing of the portion attributable to diversification is paramount
- Amounts distributed under diversification are not subject to 10% early distribution tax
Diversity, Distribute Or Both?

- Participant terminated employment before 55/10 YOP
- Participant receives first of five installments at age 54/9 YOP
  - One fifth of 500 hundred shares = 100 shares
- Participant balance after first installment: 400 shares
- Year two – the participant will receive second installment equal to one fourth of 400 shares or 100 shares
- Participant is now eligible to diversify
- Diversification in year one is 25% of highest historical stock balance adjusted for amounts previously diversified
  - 500 shares * 25% = 125 shares
- So if participant elects to diversify in addition to the installment the payment would be
  - 100 shares installment PLUS 125 shares diversified – total 225
The method for determining amount to be diversified should be clearly spelled out in either the Plan document or a formal written distribution policy:

- Highest historical or current balance (must be consistent once selected)
- Separate event or in combination with other distribution events
- Definition of Year of Participation
- How terminated participants are treated in the diversification process
Beyond The Statutory Requirements

- Plan sponsors may allow expanded diversification
- Permit diversification beyond the six-year statutory period
- Permit diversification earlier than
  - Age 55 or
  - 10 Years of Participation or
  - Both
- May allow diversification percentage greater than 25%/50%
- May allow diversification from pre-1986 shares
Field Assistance Bulletin 2014-01

October 2, 2015

Presented by: PenChecks, Inc.
Peter Preovolos

Distributions Made Simple.
Fiduciary Duties and Missing Participants in Terminated Defined Contribution Plans
How can the fiduciaries of terminated defined contribution plans fulfill their obligations under ERISA to locate missing participants and properly distribute the participants’ account balances?
Under the Internal Revenue Code, a plan administrator must distribute all of a plan’s assets as soon as administratively feasible. The prior FAB 2004-02 addressed the same issues...

What are the key differences between the bulletins?

- IRS and SSA Letter-Forwarding Services
- Enforcement of Safe Harbor
How does the FAB assist with the termination of DC plans?

In our opinion, assistance comes from the more practical and bright-line guidance contained in FAB 2014-01...
The FAB appears to be directed at terminating defined contribution plans...

Do the provisions of FAB 2014-01 apply to terminated defined benefit plans?

This guidance does not apply to missing participants in a terminated defined benefit plan insured by the PGBC. In certain instances when the plan is not insured, it may be possible.
Under FAB 2014-01, the following are the search requirements for missing participants...

- Use Certified Mail
- Check Related Plan and Employer Records
- Check with Designated Plan Beneficiary
- Use Free Electronic Search Tools
What are the options available to a fiduciary if a participant cannot be found?

1. Distribute the missing participant’s account into an IRA per 2550.404a-3

2. Open an interest-bearing federally insured bank account in the name of the missing participant

3. Transfer the account balance to a state unclaimed property fund
In 2006, the Department of Labor published final safe harbor regulations which cover missing participant distributions from a terminated defined contribution plan.

In most cases, the Department of Labor recommends that the best strategy is to distribute the missing participant’s account balance into an individual retirement plan in compliance with the above mentioned 2006 safe harbor regulations.
In the presence of such strong language, it is clear that the rollover IRA is by far the distribution option of choice...
Distributions Made Simple.

PenChecks, Inc.
8580 La Mesa Blvd., Ste.101
La Mesa, CA 91942

Contact:
Peter Preovolos  
619.600.0667  
ppreovolos@penchecks.com

Lydia Jun  
619.600.0054  
ljun@penchecks.com

www.PenChecks.com