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ESOP Account Benefit Distribution Alternatives, Issues & Implications

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Tim Jochim
Jochim Co., L.P.A.
Columbus, OH
(614) 444-1190
tjochim@jochim-law.com

Melissa W. Spencer
Swerdlin & Company
Atlanta, GA
(678) 775-5525
mspencer@swerdlin.net

Pete Shuler
Crowe Chizek and Co. LLC
Columbus, OH
(614) 280-5208
pshuler@crowechizek.com

Distribution-The Basic Concept

- Applies to all qualified plans and involves Internal Revenue Code, ERISA and plan document
- As to ESOP, 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 of the fifth plan year end following the plan year end in which termination occurs (i.e. 2012 for 2006 termination)
  - For stock acquired prior to 1987, distribution can be postponed until death, disability, retirement

Timing – Legal Framework

- When must the participant take the distribution?
  - Vested balance $5,000 or less
    - Plan Document can stipulate that participants <u>will be</u> paid out immediately or at some other specific time – participant's consent is not needed
  - Vested balance exceeds $5,000
    - Participants with vested balances greater than $5,000 cannot be paid without participant's consent until 60 days after the latest of:
      - PYE in which participant attains normal retirement age
      - PYE which includes the 10^{th} anniversary of participation
      - PYE in which the participant terminated employment
    - 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 other limitations with regard to the timing of distributions?
  - Distributions may be postponed until ESOP acquisition loan is fully repaid for C-Corps, unclear for S-Corps
    - Cannot delay diversification or RMD or payment to retired participant who has 10 years of participation
    - Delay only applies to shares purchased by that loan

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 5th 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
  - ESOP may lose some of its firepower– “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 more times over a given period

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-Corps
      - Sponsored by certain banks not permitted to repurchase their own securities
      - Diversification under the plan does not include the option to receive 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 ESOP's:
  - 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

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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

- Put Option Process

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, secured note, bearing a "reasonable interest rate" must be issued to 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
    - Pro's and con's:
      - Pro: Selling to external market requires no cash outlay from the Company;

        Shares repurchased by Company can later be re-contributed to the Plan
      - Con: Reduces ESOP ownership, possibly affecting stock value

Cash v. Stock – Redeem/Recycle

- Cash Distributions
  - Recycle the shares within the ESOP
    - the ESOP must have cash in order to do so
      - Source of funds: existing cash, company contributions, dividends paid on stock
    - cash in participants' accounts is used to "purchase" shares from the terminating participants
    - Pro's and con's:
      - 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

Cash v. Stock – Mechanics

- Cash Distribution Example
  - Assume: FMV at December 31, 2005 is $12 per share

At December 31, 2005	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, 2005 is $12 per share

At December 31, 2005	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+($420/$12)shares+(0.3 shares*$12)

  =935 shares <u>and</u> $3.60

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, 2005 is $12 per share

At December 31, 2005	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 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
- Stock distributions allow redemption of shares without valuation update
- Stock distributions can offer significant tax advantages to the recipient

Cash v. Stock – Stock Dist Tax Advantages

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

Cash v. Stock – Stock Dist 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 Dist Tax Advantages

- Federal Tax Differences:

	Taxes on	Total Taxes
Stock Distribution	($1,000 Cost basis * 28%) + ($500 NUA * 15%)	$355
Cash Distribution	$1,500 FMV * 28%	$420
Difference		$65

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 $885,000 (as indexed for inflation). This is increased by 1 year for each $175,000 (or any part thereof) over $885,000, 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
    - Fixes the price of the shares so that the participant does not share in the future increase in share value, but get some interest income
  - Installment Distribution of Shares
    - Price paid for each installment is based on most recent FMV, so the distributee shares in future increase 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

Single Payment v. Installments – Cash Flow

- Installments smooth out spikes in repurchase obligation by spreading them over 5 years
- If combined with immediate distribution, generally provides middle ground between immediate, single payment distribution and 5-year wait, installments with regard to the repurchase obligation

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: Spousal beneficiaries - yes, non-spousal beneficiaries – no
        - » RMD’s cannot be rolled over
        - » Hardship distributions cannot be rolled over

Lump Sum or Rollover – Legal Framework

- What form can distributions take?
  - 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 tax liability 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
- Generally, 10% withholding on distributions <u>not</u> eligible for rollover (i.e. RMD, hardship), unless payee elects out

Lump Sum or Rollover – Cash Flow

- Premature distribution penalty is separate from withholding:
  - 10% of the total distribution if the participant is less than 59½
  - Exceptions: Separation from service after 55, disability, deductible medical expenses, death, QDRO, corrective distributions, dividends paid on employer securities, NUA
  - No exception for hardship distributions
  - Distribution penalty is not withheld from distribution, but participant may elect to increase withholding to cover penalty

Lump Sum or Rollover – Cash Flow

- Cash Lump-Sum Distributions
  - Full amount generally taxed as ordinary income at the payee's personal income tax rate
  - 20% withholding
  - Withholding Example:

$11,223.60 X 20% = $2,244.72

Lump Sum or Rollover – Cash Flow

- Combination Cash and Stock Lump Sum Distribution

Item	Calculation	Result
Cost-Basis (CB)	100 shares * $10/share	$1,000
FMV Stock @Distribution	100 shares * $15/share	$1,500
NUA	100 shares * ($15 - $10)/share	$500
Cash		$150
Total FMV of Distribution	$1,500 (FMV stock) + $150 (cash)	$1,650

Lump Sum or Rollover – Cash Flow

- Cash and Stock Lump Sum Distribution: Withholding

Cost-basis + Cash	*	20%	=	Withholding
($1,000 + $150)	*	20%	=	$230

- However, there is only withholding to the extent that the participant's distribution also includes cash.
- Cash portion of distribution does not equal 20% of the distribution; total withholding required in this instance is limited to the total cash portion: $150

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 RMD's?
  - 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 RMD's begin due to 5% ownership, then RMD's continue even if ownership changes
- Plans <u>may</u> allow non-5% owners who turn 70½ and who are not terminated to receive RMD's

Required Minimum Distributions

- Timing of RMD's
  - Must receive RMD by 4/1 following the end of the calendar year in which requirements are first met
  - Must receive RMD by 12/31 for each subsequent year
  - Two payments in first year – one by 4/1, one by 12/31
- Taxation of RMD's
  - 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 RMD's
  - 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
  - RMD must be paid from each plan in which the participant participates

Diversification

- Allows participants 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 QP wishes to diversify, must make the election within 90 days of 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 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 inservice 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:

12/31/2005 is 2nd diversification year

Shares diversified during 2005: 50.00 shares (200 shares * 25%)

Balance at 12/31/2005 : 190.00 shares

Calculation:

190.00 shares in account at 12/31/2005

\+ 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 12/31/05 diversification

Qualified Domestic Relations Orders

- Exception to the anti-assignment rules for qualified retirement plans

- Requirements
  - Must be a judgment, decree or order made pursuant a state's domestic relations law and relating to child support, alimony or marital property rights
  - Must identify participant, alternate payee, plan

Qualified Domestic Relations Orders

- Requirements (continued)
  - Must state the amount or percentage of the participant's benefits to be paid to alternate payee
    - Will generally "separate" the alternate payee's interest in the account as of a specific date and then call for the calculation of earnings from that point in time
  - Must specific the payment method to the alternate payee, which is often accomplished by deferring to the plan's distribution provisions
- Plan Document must have QDRO provisions
  - Determination of whether an order is a QDRO
  - Distribution provisions for QDRO's