ESOP “Age 55 Distributions” and Diversification

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Presented By

Steve Wilt
CAPTrust Financial Advisors
steve.wilt@captrustadvisors.com

Deb Groban Olson
Law Offices of Deborah Groban Olson
dgo@esoplaw.com

Wendy Lankes
RK Schaaf Associates, Inc.
wendy@rkschaaf.com

Tina Fisher
SES Advisors
tfisher@sesadvisors.com
ESOP Diversification Rules for Private Companies - IRC Sec. 401(a)28

Diversification of a portion of employer stock, contributed to an ESOP after 12/31/86, must be offered to:

A “Qualified Participant” (“QP”) - who

• Must be age 55 with 10 years of “Plan Participation” During the “Qualified Election Period” (the “QEP”)

• 6 year period beginning the plan year a person becomes a QP and continuing after termination of a QP’s employment
Meaning of “employee” in IRC § 401(a) 28 –

“Qualified Participant” means any employee who has completed at least 10 years of participation under the plan and has attained age 55.” IRC §401(a)28 (B)(iii)
When does “employee” mean “participant”? IRC §401(a)28 (B)(iii)

- Company X literally interpreted “employee” to mean that a QP lost QP status upon retirement or termination

- IRS VCR – Company had to go back and figure out diversification for all those not offered it during QEP years after termination

- Once a participant becomes a QP - gets 6 years of QEP regardless of employment status
10 Years of “Plan Participation”

• “Years of Participation” = Years in the Plan

• ≠ “Years of Service” – although permissible

• Can include participation in a predecessor plan, and must if prior plan assets used to purchase ESOP stock
Must QP meet both 55 and 10 requirements while employed?

Examples:

A participant who has terminated at age 59 without completing 10 years of service, who achieves 10 years of plan participation due to an undistributed account balance while a participant but no longer an employee?

A participant has 10 years of service and terminates at age 53, but remains in the plan until after age 55.
IRS “Interim Position” on QP and YP
- 11/3/2009

IRS “interim position” provided in “Response from Andrew Zuckerman (EP Rulings) to Technical Assistance Request from Dan Jones (EP Determinations) to on how an ESOP may define “qualified participant” (QP) and “year of participation” (YP) are:

• QP may be defined as a “participant or former participant” instead of as an “employee”.
• P who has age 55 but < 10 YP may become a QP after he has attained 10 years with a plan account balance after severance.
IRS “Interim Position” con’t.

• YP can be any year in which a P has assets in an ESOP account regardless of employment status.
• P who has 10 or more YP or “Years of Service“(YS), but is < age 55, may become a QP upon attaining age 55 while s/he has an account balance after severance.
• ESOP may use YS instead of YP provided that no more than 1,000 “hours of service” (HS) per year are required to obtain a YS or YP and that the HS required for a YP are no more than HS required for a YS.
• Plan need not require any HS to acquire a YP.
IRS Interim Position con’t.

• Plans which currently have more restrictive language may keep that language or adopt less restrictive language.

• However, existing plan language cannot be made more restrictive. Examples:
  • Plan that now requires 1,000 HS to qualify for YS or YP, may keep that requirement –
  • But a plan that now defines a YP as any year in which a P has an account balance, cannot add additional requirements such as being an employee or having HS
Best Practice – Clarity in Plan

ESOP should have definitions of “qualified participant” and “year of participation” that use any of the approved definitions set forth in the 11/3/09 TAM.

However, if your plan already includes less restrictive definitions, you cannot make them more restrictive.
Excess Diversification

• Employer can be more generous than required by law, but not less - “excess diversification” is permitted
  – 401(a)28 covers stock contributed to plans after 12/31/86, but may include earlier stock contributions
  – Can be expanded to extend to all years after age 55, not limited to 6 years
  – Can begin earlier than age 55
• Excess diversification complicates repurchase liability planning
Annual Diversification Amounts

- **1st 5 Years** - QP may require diversification **up to 25%** of account balance

- After **1st** election, in years before 6th election amounts, can only total **cumulative 25%** of account balance – generally from increases in account balance

- **Last (6th) Year of QEP** - Up to **50%** of total account balance may be diversified, including the earlier 25%
Election Timing

• First election period begins in the Plan Year following the Plan Year when a participant became a QP – considerably later than 55th birthday

• Employer must notify QPs of right to make election w/in 90 days after close of their eligible Plan Years

• QP makes election during 90 day election period

• Employer must make distribution within 90 days after end of election period.
Timing Exceptions when Plan Year Valuation is not yet Available

• How does participant decide within 90 days if no valuation?
  - Company provides 2nd 90 day election opportunity after valuation is completed
• How is distribution process completed within 180 days –if valuation is not ready?
  - 180 rule is extended to a “reasonable time” after the valuation is completed
Forms of Distribution

- By end of 180 day period Employer must make distribution in:
  - Cash
  - Transfer to IRA or another plan, or
  - Offer at least 3 investment options in ESOP/KSOP
  - Stock (subject to put option rule)

- 10% excise tax on participant if taken before age 59 1/2 unless rolled over to another plan
Public Companies – PPA 2006
IRC§ 401(a) 35

- Pension Protection Act of 2006 requires diversification rights for all DC plans in publicly traded companies that hold company stock in 401(k) plans, including KSOPs – but not ESOPs that are not integrated with 401(k) plans

- Diversification is required under either the PPA rule or “traditional” IRC 401(a) 28 – not both
Public Companies – PPA 2006
IRC § 401(a)35

• Where the PPA rule applies – companies must offer 3 diversified investment options to all “affected participants” every quarter
• “Applicable participant” has 3 yrs of service
• Participant contributions invested in employer securities are immediately subject to participant diversification
• Notice must be provided to participants at least 30 days before eligibility to diversify
Timing of Notice and Elections

• Initial notice to participant must be provided as close to the beginning of the 1st 90-day election period as possible.
  – Example: Participant attains both age 55 and 10 years of participation during 2010 of a calendar year plan. First election window is 1/1/2011 to 3/31/2011.

• Every effort should be made to provide the notice of eligibility to participants as close to 1/1/2011 as possible.

• Participants can revoke or modify their election during their 90-day period, so it is advisable for trustee to wait until expiration of this period before implementing participant’s instructions.
ESOP DIVERSIFICATION MEMO

Date: January 1, 2011
To: Participant Name
From: The Plan Committee
Re: Plan Name Employee Stock Ownership Plan
Plan Year Ended: Plan Year End

The Tax Reform Act of 1986 provided certain ESOP participants with the right to elect to diversify a portion of their Company Stock Accounts. Participants with ten or more years of plan participation who have reached age 55 will have the right to elect to receive a distribution of up to 25% of the shares acquired by the ESOP on their behalf after December 31, 1986. This opportunity will be available once each year for five years, and one final time in the sixth year when the diversifiable amount will be 50% of those shares.

What this means is that ESOP participants who meet those requirements will be given an opportunity each year to either leave their account intact or receive a distribution of a portion of their shares even though they may still be employed. Distributions under this provision will be treated as all other distributions in that the participant will be entitled to receive the value of the shares as determined by the most recent appraisal, and amounts which are distributed will be subject to tax unless the participant makes a timely rollover into an IRA or another qualified plan.

You are eligible to diversify (receive a distribution of) as much as twenty-five percent (25%) of your eligible shares of Company Stock (your stock account balance as of Plan Year End less any pre-1987 stock, plus any Year End allocation of stock).

At this time, you may elect (1) not to diversify, or (2) to diversify after the Plan Year End ESOP participant statements are completed.

Please complete the diversification election form below and return it to the ESOP Committee by 90 days following Plan Year End (insert 90th day here).

We strongly suggest that you consult your tax advisor before making your decision.

ESOP DIVERSIFICATION ELECTION

NAME: Participant Name
SOCIAL SECURITY NUMBER: XXX-XX-XXXX

(Initial your choice and sign below)

____ I do not wish to diversify for the plan year ended Plan Year End.

____ I want to make my diversification election after I receive my ESOP participant statement for Plan Year End. I understand that the ESOP will send another diversification election form for me to complete and return.

Signed: ___________________________ Date: ________________________
Timing of Notice and Elections

• The 2\textsuperscript{nd} 90-day window is when distribution should be made to participant.

• Since the value of the stock may not be available during the 1\textsuperscript{st} 90-day window, sponsor can offer to extend the decision to the 2\textsuperscript{nd} 90-day window.
  – Example: If the 1\textsuperscript{st} 90-day window ends 3/31/2011, the 2\textsuperscript{nd} 90-day window ends 6/29/2011.

• If the value is not available after the 2\textsuperscript{nd} 90-day window, the distribution may be extended to a “reasonable time” after the valuation is completed.
ESOP DIVERSIFICATION MEMO

Date: July 15, 2011
To: Participant Name
From: The Plan Committee
Re: Plan Name Employee Stock Ownership Plan
Diversification Election for Plan Year End Plan Year End

Previously you were notified of your right to diversify a portion of your stock accounts in the ESOP. You were asked to let us know whether (1) you did not wish to diversify or (2) wanted to make your diversification election once your most recent ESOP statement was available.

Now that your ESOP statement has been made available to you and you wanted to wait until this time to make your diversification election, please let us know whether or not you would like to diversify and, if so, how much. Distributions under this provision will be treated as all other distributions in that the participant will be entitled to receive the value of the shares as determined by the most recent appraisal, and amounts which are distributed will be subject to tax unless the participant makes a timely rollover into an IRA.

Our records indicate that you are entitled to diversify up to Number of share shares (the current Fair Market Value is $FMV per share). In order that we may process your distribution in a timely manner, please complete the diversification election form below and return it to the ESOP Committee as soon as possible (or insert 180th day here). We strongly suggest that you consult your tax advisor before making your decision.

<table>
<thead>
<tr>
<th>Date</th>
<th>Value Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/08</td>
<td>$15.00</td>
</tr>
<tr>
<td>12/31/09</td>
<td>$17.50</td>
</tr>
<tr>
<td>12/31/10</td>
<td>$20.00</td>
</tr>
</tbody>
</table>

ESOP DIVERSIFICATION ELECTION

NAME: Participant Name
SOCIAL SECURITY NUMBER: XXX-XX-XXXX

(Initial your choice and sign below)

_____ I hereby elect not to exercise my right to receive a distribution of a portion of my ESOP Account

_____ I hereby elect to exercise my right to receive ___% (up to 25% / 50%) of my ESOP account as explained above. I have competed the Participant Election and Authorization Form indicating whether I want the distribution paid directly to me or rolled over to an IRA.

_____ I hereby elect to exercise my right to receive ___% (up to 25% / 50%) of my ESOP account as explained above. I have competed the Participant Election and Authorization Form indicating whether I want the distribution paid to the Plan Name 401(k) Plan. (Note: only include this option if document provides.)

Signed: ___________________________ Date: ___________________________
Timing of Notice and Elections

• Check with your ERISA professional as to your options regarding payouts after the 180 days have lapsed.

• Sponsors may be required to use their most educated guess at the stock value for determining distribution amount.

• Sponsors may be required to use “EPCRS” (Employee Plans Compliance Resolution System) to self correct.
  – Although EPCRS is intended to address inadvertent or unintentional errors, the issue of ESOP diversifications have not been specifically excluded from EPCRS.
Calculations – Determine Class of Eligible Stock

- Shares purchased by ESOP prior to 1987
- Shares purchased by ESOP after 1986
- Plan document will determine if both classes of stock are eligible for diversification
Calculations – Election Window

- Election window opens upon meeting diversification eligibility requirement

- Election window open for 6 years

- Election window closes after 6 years
## Calculations – Diversification Percentages

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>25%</td>
</tr>
<tr>
<td>Year 2</td>
<td>25%</td>
</tr>
<tr>
<td>Year 3</td>
<td>25%</td>
</tr>
<tr>
<td>Year 4</td>
<td>25%</td>
</tr>
<tr>
<td>Year 5</td>
<td>25%</td>
</tr>
<tr>
<td>Year 6</td>
<td>50%</td>
</tr>
</tbody>
</table>

If the value of the company stock account has a value of $500 or less, diversification is not required.
## Sample Calculation A

### Sample Diversification Calculation

**Date Become Qualified Participant: 12/31/2010**

**Assumption: Election to receive full diversification each year for six years**

<table>
<thead>
<tr>
<th>(A)</th>
<th>(B)</th>
<th>(C)</th>
<th>(D)</th>
<th>(E)</th>
<th>(F)</th>
<th>(G)</th>
<th>(H)</th>
<th>(I)</th>
<th>(J)</th>
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</thead>
<tbody>
<tr>
<td>Value of Shares</td>
<td>Add</td>
<td>Shares</td>
<td>Diversified Shares</td>
<td>Shares</td>
<td>Diversified Shares</td>
<td>Shares</td>
<td>Eligible Value</td>
<td>Shares</td>
<td>Eligible For Share Distribution</td>
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<tr>
<td><strong>Election Period 1</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/1/11 - 3/31/11</td>
<td>2,600,000</td>
<td>+</td>
<td>0.000</td>
<td>=</td>
<td>2,600,000</td>
<td>x</td>
<td>25%</td>
<td>=</td>
<td>650,000</td>
</tr>
<tr>
<td>Election Period 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/1/12 - 3/30/12</td>
<td>2,450,000</td>
<td>+</td>
<td>650,000</td>
<td>=</td>
<td>3,100,000</td>
<td>x</td>
<td>25%</td>
<td>=</td>
<td>775,000</td>
</tr>
<tr>
<td>Election Period 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/1/13 - 3/31/13</td>
<td>2,825,000</td>
<td>+</td>
<td>775,000</td>
<td>=</td>
<td>3,600,000</td>
<td>x</td>
<td>25%</td>
<td>=</td>
<td>900,000</td>
</tr>
<tr>
<td>Election Period 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/1/14 - 3/31/14</td>
<td>3,450,000</td>
<td>+</td>
<td>900,000</td>
<td>=</td>
<td>4,350,000</td>
<td>x</td>
<td>25%</td>
<td>=</td>
<td>1,087,500</td>
</tr>
<tr>
<td>Election Period 5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/1/15 - 3/31/15</td>
<td>3,763,000</td>
<td>+</td>
<td>1,087,500</td>
<td>=</td>
<td>4,850,500</td>
<td>x</td>
<td>25%</td>
<td>=</td>
<td>1,212,625</td>
</tr>
<tr>
<td>Election Period 6</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/1/16 - 3/30/16</td>
<td>4,338,000</td>
<td>+</td>
<td>1,212,625</td>
<td>=</td>
<td>5,550,625</td>
<td>x</td>
<td>50%</td>
<td>=</td>
<td>2,775,313</td>
</tr>
</tbody>
</table>

**CAPTRUST Financial Advisors**
A Business of CapWealth Financial Partners, LLC

**Deborah Groban Olson**
**RKSchaaf Associates, Inc.**

**SES Advisors**
## Sample Diversification Calculation

**Date Become Qualified Participant:** 12/31/2010

**Assumption:** Election to postpone full diversification until Year Six

<table>
<thead>
<tr>
<th>Period</th>
<th>Shares</th>
<th>Months</th>
<th>Diversified Shares</th>
<th>Cumulative Shares Diversified</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/11 - 3/31/11</td>
<td>2,600,000</td>
<td>25%</td>
<td>650,000</td>
<td>0.000 * 650,000 = 650,000</td>
<td>$20.00 * 650,000 = $13,000.00</td>
</tr>
<tr>
<td>1/1/12 - 3/30/12</td>
<td>3,100,000</td>
<td>25%</td>
<td>775,000</td>
<td>0.000 * 775,000 = 775,000</td>
<td>$22.50 * 775,000 = $17,437.50</td>
</tr>
<tr>
<td>1/1/13 - 3/31/13</td>
<td>3,600,000</td>
<td>25%</td>
<td>900,000</td>
<td>0.000 * 900,000 = 900,000</td>
<td>$25.00 * 900,000 = $22,500.00</td>
</tr>
<tr>
<td>1/1/14 - 3/31/14</td>
<td>4,350,000</td>
<td>25%</td>
<td>1,087,500</td>
<td>0.000 * 1,087,500 = 1,087,500</td>
<td>$28.00 * 1,087,500 = $30,450.00</td>
</tr>
<tr>
<td>1/1/15 - 3/31/15</td>
<td>4,850,500</td>
<td>25%</td>
<td>1,212,625</td>
<td>0.000 * 1,212,625 = 1,212,625</td>
<td>$30.00 * 1,212,625 = $36,378.75</td>
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<tr>
<td>1/1/16 - 3/30/16</td>
<td>5,550,625</td>
<td>50%</td>
<td>2,775,313</td>
<td>0.000 * 2,775,313 = 2,775,313</td>
<td>$32.50 * 2,775,313 = $90,197.65</td>
</tr>
</tbody>
</table>

Notes:
- **CAPTRUST Financial Advisors**
- **Deborah Groban Olson**
- **R K Schaff Associates, Inc.**
Diversification Issues-#1

Diversification vs. Installments - If participant is eligible for both an installment distribution and a diversification distribution, how do you calculate?

Example-Year One:

- Account has $10,000
- 1st Installment payment (assuming 5 total installments) = $2,000
- 1st Diversification payment = $2,500

Do you…

- Distribute $2,500 (larger of the two)
- Distribute $4,500 (both payments)
- Or $4,000 (Make diversification of $2,500. Subtract from account balance=$7,500. One-fifth of $7,500=$1,500. Both=$4,000).
Diversification Issues-#2

Diversification vs. Installments-If a participant has received both a diversification distribution and an installment distribution in a prior year, how does that factor into the current year’s diversification calculation?

Notice 88-56 states that the amount eligible for diversification is calculated by multiplying 25% (or 50% if it is the 6th year of the election period) by the total number of post-1986 shares that have ever been allocated to the participant's account on or before the most recent plan allocation date, less the number of shares of employer securities previously distributed, transferred, or diversified pursuant to a diversification election.
Diversification Issues-#2

According to Notice 88-56, you would:

1) add back into the most recent share balance any shares distributed pursuant to an installment election and any shares distributed pursuant to a diversification election 2) multiply times 25% (or 50%), but then 3) only subtract back out diversified shares to calculate the current number of shares eligible for diversification.

Check the language in your plan document to see if it mirrors the language in Notice 88-56. Some documents may be worded slightly different. For example, the document language may subtract out all distributions that occurred during the election period.
Diversification Issues-#2

It could be possible to have a situation where the amount calculated to be eligible for diversification exceeds the number of shares in the participant’s account. This would occur when the shares distributed due to the installment distributions continue to be added back into the account balance for applying the applicable percentage, but are not considered as employer securities previously distributed, transferred, or diversified pursuant to a diversification election.
Diversification Issues-#3

Diversification vs. Installments-many plans are designed that upon a participant’s election to receive their first installment, they must continue to receive their remaining installments as well. However, age 55/10 years of participation diversification is not mandatory - participants have the option of electing to receive none, some or all of the 6 diversifications offered during their diversification election period. Plans must clearly design their distribution paperwork so that the participant knows what they are electing and the plan administrator knows what they are paying out.
Diversification Issues-#4

Extending diversification beyond that which is required is considered “excess diversification.”

Examples of excess diversification:
• Lowering the age and/or participation requirements for diversification
• Extending the election period beyond 6 years
• Increasing the percentage above 25% (first 5 years) and 50% (6th year)

Plan must contain language to allow for this excess diversification.
Diversification Issues-#4

Notice 88-56 states that “amounts in excess of the minimum amount required to be available for diversification under section 401(a)(28)(B) are not treated as available for diversification or as diversified pursuant to section 401(a)(28)(B).”

The plan may decide to offer excess or early diversification for a variety of reasons including giving participants more flexibility regarding their retirement investments or to discourage employees from terminating to lock in gains on stock.
Diversification Issues-#4

However, there are disadvantages associated with excess diversification such as:

• Participants can still demand stock
• These amounts would be added back into the post-1986 shares allocated to the participant’s account, but they would not be subtracted back out to calculate the amount available for diversification.
• The repurchase liability is accelerated, at least in the short term.