How to Create an ESOP Distribution Policy

Documenting Timing, Form, & Method for ESOP Participant Distributions

A Distribution Policy is Essential to Every ESOP

The benefit of an employer-paid retirement plan is just one way ESOPs help companies attract and retain satisfied, loyal employees. After all, ESOP distributions have the potential to help your plan participants achieve greater financial security in retirement. That's why it's vital to take extraordinary care when developing and documenting your distribution policy.

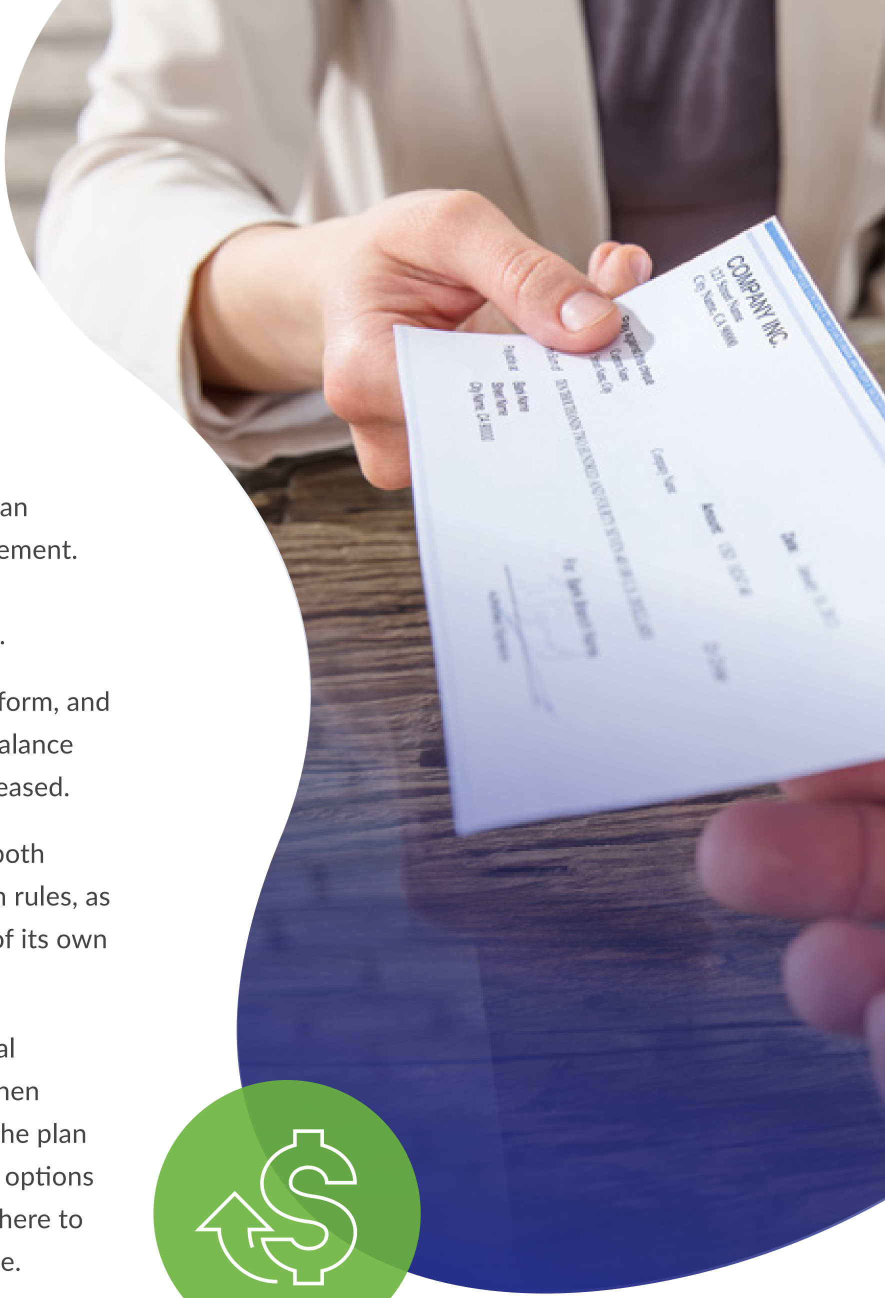
Your ESOP distribution policy articulates the timing, form, and method in which participants receive their account balance when they retire, leave the company, or become deceased.

Your policy should effectively protect the plan from both regulatory noncompliance with IRS ESOP distribution rules, as well as possible unintended financial consequences of its own plan rules.

An ESOP submits its distribution policy to the Internal Revenue Service as a section of its plan document when initially requesting a new plan determination letter. The plan document provides for the timing, method, and form options that are allowed under the ESOP's rules and must adhere to the regulations set forth in the Internal Revenue Code.

Why a separate distribution policy document? It's a recommended best practice that allows your ESOP to describe the distribution policy more broadly in the plan document, yet detail how distributions from the ESOP will be processed in the distribution policy. A separate policy document provides the flexibility to make occasional amendments to the distribution policy to meet evolving objectives of the company, to manage cash flow, and to control the employee benefit level.

Even with the flexibility to make policy amendments, it's always essential that your distribution policy remains consistent with your plan document and summary plan description (SPD).



Whether or not an ESOP has a **written distribution policy**, if it has paid a distribution just once, it has **established precedent**.

Every ESOP distribution policy must address these three key elements of participant account distributions:

- **TIMING**
- **FORM**
- **METHOD**

Internal Revenue Code Section 409 is the definitive authority on the requirements ESOPs must meet to achieve and maintain qualified plan status. Details on distribution and payment regulations are found in IRC Section 409(o); distribution policies must comply with the statutory minimums published in the IRC.

Beyond the framework of satisfying minimum regulatory requirements, different ESOPs may benefit from different distribution policy aspects such as lump-sum versus installments, delay periods, etc. What matters perhaps above all is that distribution policies are applied in a non-discriminatory manner.

Timing

When participants’ distribution payments commence

ESOP accounts are distributed to plan participants at separation from service due to retirement, death, disability, or termination (whether voluntary or involuntary).

IRC Section 401(a)(28) stipulates that plan participants meeting certain qualifications (age 55 and 10 years of ESOP participation) must be given the opportunity to receive a distribution for the purposes of account diversification.

IRC Section 409(o)(1)(A) describes distribution requirements post-separation, requiring that ESOPs offer to commence payouts no later than one year after the close of the plan year which follows:

1. **The plan year during which the participant terminates employment due to retirement, disability, or death; or**
2. **The fifth plan year after the plan year during which the participant is otherwise separated from service (quits or is terminated from employment)**

Examples Assuming a December 31 Plan Year End

Retirement, Death, or Disability

Participant retires after meeting plan retirement provisions, becomes disabled, or passes away in August 2022.

Participant (or designated beneficiary) must begin receiving payments after the plan-year end allocation is completed (during the following year).

Payment must commence by December 31, 2023

Other Employment Termination

Participant resigns or is terminated in August 2022.

Participant must begin receiving payments no later than one plan year after the end of the fifth plan year after the year of termination.

Participant must begin receiving payments after the 2027 allocation is completed (in 2028).

Payment must commence no later than December 31, 2028.

Diversification

Participant attains age 55 with 10 years of plan participation.

Participant may elect to diversify up to 25% of their account balance during the first five years of the diversification period, and up to 50% by the end of the final (sixth) year of diversification eligibility.

Exception for Outstanding ESOP Loans

IRC Section 409(o)(1)(B) provides an exception that allows ESOPs to defer distribution payouts until the close of the plan year in which the loan is paid in full.

The **loan exception** means that in some cases, **employees who quit or are terminated** can be required to wait **for their ESOP account distribution** to be completed.

Exception to the Exception?

The language used in the IRC exception clause is cause for some controversy for S corporation ESOPs, since it references only C corporation ESOPs and their deduction limits described in Section 404(a)(9).

Some S corp ESOPs still utilize the loan exception and gain greater comfort by incorporating the loan exception language into their ESOP plan document, which is submitted to the IRS for the plan's determination letter.

Other Key **Distribution Timing Details** to Address

Latest Commencement Date

In addition to ESOP-specific distribution rules in IRC Section 409(o), ESOPs are subject to distribution rules that apply to all qualified retirement plans. The IRC provides that qualified retirement plan distributions must generally begin no later than the 60th day after the later of:

1. **Age 65 or normal retirement age (if normal retirement age is earlier),**
2. **The 10th anniversary date of the employee's participation in the plan, and**
3. **Termination from employment**

The IRC also provides that if a participant met all of the early retirement plan provisions (if applicable) except for the age requirement, he or she is entitled to the same benefits upon attaining the early retirement age.

Required Minimum Distributions (RMDs)

Generally, participants are required to begin receiving RMDs upon attaining age 72 (or above per the SECURE Act 2.0) and terminating service.

Handling Qualified Domestic Relations Orders (QDROs)

In the case of a divorced participant, depending on plan rules, the ESOP may pay the alternate payee of a QDRO before the plan participant is eligible for a distribution, including immediate distribution to the QDRO in some cases. Rules are specified in IRC Section 414(p).

Mandatory Distributions

Generally, companies cannot force distributions without the writing election of the participant. However, a company can make mandatory distributions to terminated participants with account balances of $5,000 or less. Involuntary cash-out distributions of more than $1,000 must be automatically rolled over to an IRA.

Qualified plan provisions could impact the distribution commencement date — and the qualified plan provisions also supersede the outstanding ESOP loan exception in IRC Section 409(o)(1)(B).

Form

Participants may receive cash, stock, or a combination of both

There can be a degree of flexibility in ESOP distributions' form. In most cases, the plan document indicates that distributions can be made in the form of stock or cash.

Stock Distributions

C corporation ESOPs whose articles or bylaws do not restrict the ownership of employer securities (or who don't meet other limited exceptions described below) are generally required to offer distributions in the form of stock with a put option.

ESOP Put Option

The put option, described in IRC Section 409(h), gives a plan participant the right — but not the obligation — to require **the company** to repurchase the stock in their account under a fair market valuation formula as determined by an independent ESOP appraiser. The company *may permit* the ESOP to purchase shares tendered under the put option, but it *cannot transfer the put option requirement to the ESOP*.

Exceptions to Stock Distributions

The IRC includes exceptions for plan sponsors who are not required to offer distributions as shares of stock in Section 409(h). These exception include the following entities:

- **Corporations** with a charter or bylaws that restrict ownership of substantially all outstanding employer securities to employees or to a qualified plan trust;
- **Banks** that are prohibited from purchasing their own stock; or
- **S corporations** (though an S corp may distribute stock with the requirement that the participant immediate sell the shares to the ESOP or the company)

Plan sponsors that do not meet any of these exceptions must generally offer stock distributions. If a stock distribution is not available to the participant due to one of these exceptions, the participant must have the right to receive the distribution in cash.

Plan sponsors meeting these exceptions may still elect to offer share distributions; they are simply not required to do so.

The Value of a **Sustainability Study**

ESOP-owned companies can get a clearer understanding of their future obligations by performing a repurchase obligation study, also known as an ESOP sustainability study.

Once the company has determined its ESOP repurchase obligation, it will need to determine how to fund the obligation. This is crucial to the success of both the ESOP and the company moving forward.

ESOP Repurchase Obligation

The right to demand securities with the ESOP put option is what creates the company's ESOP repurchase obligation. Whether distributions are paid in stock or cash, the plan sponsor needs to plan for the redemption of stock and/or amass cash in the plan to fund distributions.

Every ESOP company needs to establish an understanding of its short- and long-term financial commitment with regard to satisfying liabilities for future obligations.

Stock Distribution Mechanics

If the ESOP pays distributions in shares as opposed to cash, the distribution policy should dictate which entity repurchases shares, and what will happen to them after repurchase — will they become treasury shares, or will they be re-contributed to the ESOP? Past IRS guidance in a technical advice memorandum (TAM) suggests that a well-articulated policy describing distribution in the form of shares with a put option, proper election form paperwork, and careful documentation of the repurchase by the company — returning the shares to treasury — is essential.

NET UNREALIZED APPRECIATION (NUA)

Properly executed distributions in the form of shares adds the benefit for longer-term plan participants to benefit from NUA treatment on their distribution. To qualify for NUA tax treatment, a participant must take an in-kind lump sum distribution, within one tax year, from the plan. This allows the participant to have long-term capital gains tax, rather than income tax, applied to a portion of the distribution.

PROMISSORY NOTES

Now rarely used, promissory notes allowed some ESOP companies to pay distributions as shares in a lump sum, with shares immediately put to the company in exchange for a promissory note. Reasons for this option include:

- NUA tax treatment on the distribution
- Compliance with share distribution requirements
- Reduction of the number of shares in the trust
- Protections for plan participants against fluctuations in share value after their departure from the company
- Other repurchase planning reasons

Promissory notes must have reasonable interest rates and provide adequate security — not simply the company's full faith and credit. Obtaining adequate security to satisfy IRS requirements has become very difficult, and today the promissory note is rarely used.

Cash Distributions

When participants have cash in their ESOP accounts or the ESOP chooses not to distribute shares, a distribution policy can dictate payment in cash. This requires a plan for acquiring cash for payments, whether using existing cash in the plan, contributing new cash to the plan, paying a dividend or S distribution of earnings, establishing an exempt ESOP loan, or redeeming shares — the latter of which requires a stock valuation as of the redemption date.

Companies that contribute cash must consider whether they have enough "deduction room" within IRC Section 404 requirements to include both the cash for distributions and loan payments (if applicable). Those that pay dividends or S distributions of earnings must satisfy fair market value requirements.

ESOP Reshuffling

Reshuffling occurs when the company buys all (or some) of the shares of the accounts of separated participants, and invests cash in other prudent investments until distribution. This is also known as segregation or cash conversion of accounts. It prevents former employees from sharing in future gains after leaving the company, protects them from sharing in future losses in value, and further diversifies their retirement benefit.

Many companies use reshuffling to manage repurchase obligations, since it enables them to repurchase shares of terminated participants at current fair market value. This speeds the repurchase obligation to the time of segregation. Assuming an increasing stock value, reshuffling accelerates the repurchase obligation in the short term and limits it over the long term. It can also free up more shares for allocation.

RECYCLE OR REDEEM?

One of the most frequently asked questions is whether to recycle or redeem shares. This decision ultimately drives the choice between distribution as cash or shares.

Method

Lump-sum and installment distribution payments

Regulations allow for some flexibility in the method of distribution. Most ESOP plan documents indicate that distributions can be made in lump sums or installments.

Lump Sum

IRC regulations allow an ESOP to pay distributions in a lump sum. This accelerates the company's repurchase obligation, protects former employees against future losses in company value, and keeps the value of potential growth to current employees.

Lump sum distributions generally occur as soon as possible after finalization of the annual stock price valuation. To minimize the administrative burden, many companies process distributions in a window that follows completion of plan year administration. Eligible participants must request their distribution during these windows, or wait until the next plan year's post-administrative window.

Installments

IRC regulations also allow an ESOP to pay distributions in substantially equal payments over a period not longer than five years.

For balances over a threshold ($1,330,000 in 2023), the company can increase the number of installments. For each additional increment past the threshold ($265,000 in 2023), an additional year can be added to the payout period — up to an additional 5 years.

Installment payments allow former participants to continue to participate in the ownership of company stock, to the extent that stock remains in their accounts, which will impact the company's repurchase obligation.

Exercising Flexibility & Amending Policy

ESOP companies can use one or both methods for distribution, depending on the reason for termination (e.g., retirement, disability, death, or other separation). The ESOP distribution policy should clearly define which method applies to which termination type(s), to eliminate uncertainty.

Distribution method can be amended in the policy, and an exception for ESOPs to the anti-cutback rules of IRC Section 411(d)(6) provides flexibility. Even so, changes must be made and exercised in a nondiscriminatory manner, and it's vital to work closely with ESOP legal counsel and/or advisors before making changes that could be perceived as "cut-backs."

Successful **ESOPs** Require **Clear, Compliant Distribution Policies**

Just as every company is unique, so is every ESOP.

Essential to the success and sustainability of every ESOP is a well-developed, forward-looking, clearly articulated and nondiscriminatory distribution policy. Consulting with an experienced team of true ESOP experts can give your stakeholders confidence in your plan and enhance the sense of its value as a benefit.

It's easy to tap into the expertise of the ESOP Partners team.

Take the first step today by

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