ESOP BRIEF #18

ESOP Distributions

By The ESOP Association

A guide to the rules surrounding ESOP distributions including an overview of The Put Option.

A primary goal of an ESOP is to provide employees with retirement benefits from their ownership stake. Therefore, ESOP participants and their employers should have a clear understanding of the manner and method in which ESOP benefits are distributed to ESOP participants after they have left their employer.

ESOP distributions are governed by Internal Revenue Code 409(h). In most instances, benefits must be distributable in the stock of the employer corporation; however, participants do not have the right to demand stock from an ESOP that holds stock of an S corporation or a C corporation with restrictive bylaws. Closely held companies are required to extend a put option to repurchase the shares from the distributee.

Public companies with an existing market for their shares are exempt from this requirement.

With respect to stock acquired by an ESOP after December 31, 1986, distribution of a participant's account balance must commence no later than:

- One year after the close of the plan year in which the participant separates from service by reason of attainment of normal retirement age under the plan, disability or death.
- The fifth plan year following the year in which the participant resigns or is dismissed, unless the participant is reemployed before such date.

Thereafter, distribution of the balance must be made in substantially equal periodic payments over a period not longer than five years (up to 10 years for certain balances in excess of $1,070,000).

Thus, an employer's planning opportunities to level out its repurchase liability by deferring and lengthening ESOP distributions are restricted. (For more on repurchase liability, see ESOP Brief #20 Repurchase Obligation.) Subject to these limitations, an employer retains discretion as to the form and timing of more rapid distributions—so long as the distribution options do not favor highly compensated employees and are clearly communicated to ESOP participants through amendments to the plan document or written distribution policy.

Leveraged Stock

The foregoing distribution requirements are not applicable to that part of a participant's account consisting of employer securities acquired with the proceeds of an ESOP acquisition loan until the end of the plan year in which the entire loan is repaid, if the ESOP sponsor is structured as a C corporation. This exception may require separate accounting within a participant account for allocations from ESOP loans that become due at different times and for non-leveraged shares.

To illustrate, assume that the participant left the company in January 2009, five years before final payment of the ESOP loan. The loan was paid off in January 2014. Those shares that had been allocated to the participant account prior to his departure would not be eligible to be distributed during the five-year period that the loan was being paid off.

For participants who resign, are fired, or terminate their employment for any other reason prior to reaching normal or early retirement age, distributions may be further delayed until the close of the fifth plan year following the plan year in which the loan is repaid (i.e. close of plan year in 2019). In the case of those who terminate because of death, disability, or those who reach normal or early retirement age, distributions must begin within a year of the close of the plan year in which the loan is paid off (i.e. close of plan year 2014).

The Stock Election

The ESOP may make the distributions in either stock or cash provided that the participant is given the option to demand the distribution in employer stock. This right must be communicated at the time a distribution is payable.

If, however, the sponsoring employer's corporate charter and bylaws restricts ownership of substantially all outstanding employers' securities to current employees or to a trust qualified under Sec. 401(a), the ESOP may distribute all benefits in cash without granting participants the right to demand stock.

Alternatively, the plan may distribute employer securities subject to a requirement that the securities be resold to the employer under terms that meet the put option payment requirements. Substantially all is not defined in law or regulation. Many feel 80 percent meets the test, others 75 percent or 70 percent. Everyone agrees “substantially all” means significantly more than 50 percent.

Also, if an S corporation sponsors the ESOP, the distribution may be restricted to the cash value of the stock in the departing employee’s account.

The Put Option

The put option requirement applies to all shares of employer securities acquired if the shares are not ”readily tradable” on an established market. This requirement serves to create a market for the stock of closely held companies that normally have no market.

Companies with publicly traded stock are not required to extend the put option to their participants; they may simply distribute the stock to departing employees. The put option must permit the distributee to require the employer to repurchase shares of employer stock under a fair valuation formula, which will be determined by an independent appraiser.

For this purpose, fair market value as of the preceding valuation date under the ESOP generally may be used. The put option period must be for a period of at least 60 days following the date of distribution.

If the put option is not exercised during that period, the employer is required to extend the same 60 day option again one year from the date the first option was extended. The option may not bind the ESOP to repurchase the stock, but may permit the ESOP to purchase stock tendered to the employer.

If a participant takes a total distribution of employer securities in his account and exercises his option, the employer must pay the option price in a single sum or in substantially equal annual installments over a period that begins no later than 30 days after the distribute exercises the option and extends no longer than five years.

The employer also must provide adequate security for the unpaid amounts and must pay a reasonable rate of interest thereon. There remains uncertainly as to what precisely constitutes ”adequate security,” but the IRS has made clear that pledging the repurchased shares as security for the unpaid amounts is insufficient. If an employee exercises a put option under an installment distribution, the employer must pay the option price within 30 days of the exercise.

Caution: No area of ERISA plan administration is as complex as distribution of employer securities from a defined contribution plan, such as an ESOP. Often, an experienced administrator and/or attorney needs to be consulted to arrive at the proper handling of an ESOP distribution.

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