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Illustrative Models for Distribution Policies

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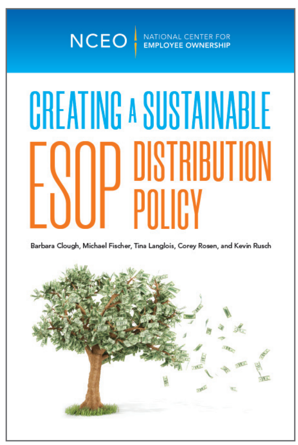

CHAPTER 4

Illustrative Models for Distribution Policies

Kevin Rusch

ESOP PLAN SPONSORS have various options for paying out vested participant account balances and investing the balances in the plan before they are eligible for distribution. As plan participants become eligible for a distribution or diversification of shares from the ESOP, the company (assuming it is closely held) must provide a market to convert those shares into cash. This is known as the ESOP repurchase obligation. Choosing the appropriate distribution policy should take into consideration the available cash flow the company can use to satisfy the ESOP repurchase obligation as well as the benefit levels the company wants to provide to current ESOP participants. Using illustrative examples, this chapter identifies the pros and cons of different distribution policies, segregation, and rebalancing shares in ESOP participant accounts.

Lump-Sum Distributions

If a company seeks a quick and efficient option for processing ESOP distributions, lump-sum distributions should be considered. Lump-sum distributions are generally used in newer ESOPs, such as those six or fewer years old, where the ESOP stock price is still depressed from the debt on the company's balance sheet from the original ESOP leveraged transaction. The account balances of young ESOPs are usually not substantial because a significant number of shares have not yet been allocated, and participants are more likely to be only partially vested in their ESOP balances if they terminate for reasons other than death, disability, and retirement.

As the ESOP matures and account balances in the plan become more substantial due to the increasing stock price and more stock allocations in the plan, lump-sum distributions can get quite costly. The company should determine whether it has sufficient cash flow to continue processing distributions in this manner. If the company's stock price is appreciating at a higher rate than the company can earn with its available cash, it can be in its best interest to continue paying lump-sum distributions. There are mature ESOP companies that continue processing lump-sum distributions, but they have sufficient cash flow and may retire shares to maintain appropriate ESOP benefit levels instead of recycling all the shares, which is discussed later in this chapter.

Installment Distributions

The alternative to lump-sum distributions is paying ESOP vested account balances in installments. As mentioned in chapter 2, ESOP plan sponsors can pay in substantially equal periodic payments (not less frequently than annually) over a five-year period. Many companies pay five installments over a five-year period, as shown in table 4-1. (It is possible to pay six installments over the five-year period by paying the first installment at the inception of the period and then one more for each of the succeeding five years, but the examples in this chapter will use the common method of five installments over five years, three over three years, and so on.)

Paying distributions in installments spreads the cash flow requirement over a period of years, which companies find beneficial as the ESOP participant balances continue to grow as the ESOP matures. In

Table 4-1. Five installment distributions

Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$75,000.00	1	$15,000.00	$60,000.00
2	$63,000.00	2	$15,750.00	$47,250.00
3	$49,612.50	3	$16,537.50	$33,075.00
4	$34,728.75	4	$17,364.38	$17,364.37
5	$18,232.59	5	$18,232.59	$ 0.00
		Total payments	$82,884.47	

* Balance increases 5% per year from stock investment appreciation.

table 4-1, since the participant was not paid a lump-sum distribution of $75,000 in year 1, they continue to share in the investment growth of the assets remaining in the plan, yielding distributions totaling $82,884.47.

Plan sponsors must determine what is more important to them: having a larger repurchase obligation upfront with a lump-sum distribution or having former employees continue to share in stock price appreciation with installment distributions.

Plan sponsors do have options to meet their repurchase obligation needs. They could state in their distribution policy that they will pay in three installments instead of five (table 4-2).

Table 4-2. Three installment distributions

Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$75,000.00	1	$25,000.00	$50,000.00
2	$52,500.00	2	$26,250.00	$26,250.00
3	$27,562.50	3	$27,562.50	$ 0.00
		Total payments	$78,812.50	

* Balance increases 5% per year from stock investment appreciation.

Paying in fewer installments still spreads out the cash flow needs and reduces the total repurchase obligation versus five installments because former participants have less time to share in stock price appreciation.

Installment Thresholds

Plan sponsors can also set installment thresholds so that vested balances at or below a certain dollar amount are paid in lump-sum distributions but balances over that amount are paid in installments.

For example, a distribution policy may state a $25,000 installment threshold. A participant with a $22,000 balance would be paid in one lump-sum distribution. Another participant with a $75,000 vested balance would be paid in installments, as shown in table 4-1 or table 4-2, depending upon the current distribution policy used in that ESOP.

Installment thresholds allow the plan sponsor the ability to pay out smaller balances that do not have a significant impact on company cash flow while also protecting it from the repurchase obligation of larger account balances that the sponsor would like to pay out over a period of years.

Minimum Installments

Plan sponsors may be hesitant to pay out all balances over three installments, especially in cases where they have some significant account balances that they would rather pay in five installments instead of three. A solution could be to apply a minimum amount, allowing smaller balances to be paid over a shorter period and not being bound to three installments, for example, for larger account balances. Tables 4-3, 4-4, and 4-5 show the benefit of using a $25,000 minimum installment in a distribution policy with a maximum of five installments for participants with balances of $45,000, $75,000, and $120,000.

Table 4-3. $25,000 minimum installment distribution, two installments

Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$45,000.00	1	$25,000.00	$20,000.00
2	$21,000.00	2	$21,000.00	$ 0.00
		Total payments	$46,000.00	

* Balance increases 5% per year from stock investment appreciation.

Table 4-4. $25,000 minimum installment distribution, four installments				
Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$75,000.00	1	$25,000.00	$50,000.00
2	$52,500.00	2	$25,000.00	$27,500.00
3	$28,875.00	3	$25,000.00	$ 3,875.00
4	$ 4,068.75	4	$ 4,068.75	$ 0.00
		Total payments	$79,068.75	
* Balance increases 5% per year from stock investment appreciation.				

Table 4-5. $25,000 minimum installment distribution, five installments				
Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$120,000.00	1	$ 25,000.00	$95,000.00
2	$ 99,750.00	2	$ 25,000.00	$74,750.00
3	$ 78,487.50	3	$ 26,162.50	$52,325.00
4	$ 54,941.25	4	$ 27,470.63	$27,470.62
5	$ 28,844.15	5	$ 28,844.15	$ 0.00
		Total payments	$132,477.28	
* Balance increases 5% per year from stock investment appreciation.				

Minimum installments take the benefit of using installment thresholds one step further. In addition to paying a lump-sum distribution for any balance less than $25,000 in this example, this provision will distribute balances larger than $25,000 in two to five installments as warranted. This eliminates paying the participant in multiple small installments that the company would rather pay out over a shorter period.

Extension for Large Account Balances

As chapter 2 discusses, plan sponsors can increase the number of installments paid to participants with large account balances up to an additional five years. Each year the Internal Revenue Service (IRS) announces the updated limits when it issues the costofliving adjustments affecting dollar limitations for benefit plans. For example, the 2025 calendar year eligible account balance must be more than $1,415,000, and an additional installment can be added for each $280,000 more than the $1,415,000 minimum balance. For example, if an ESOP participant terminates in 2025 and has an account balance of $2,250,000, the plan sponsor could pay out the participant in nine installments instead of five, starting in 2026 (table 4-6).

Table 4-6. Computation of additional installments allowed

2025 account balance	$2,300,000
2025 ESOP large balance limit	$1,415,000
Difference	$ 885,000
ESOP installment factor	$ 280,000
Difference divided by ESOP installment factor	3.16
Additional installments allowed, rounded to next whole number, maximum of 5	4

While adding additional installments is allowed in these cases, it can result in a significantly larger cash outflow depending on the stock appreciation. In tables 4-7 and 4-8, the 5% stock growth increases the cash outflow by over 10% when the balance is paid over 9 years compared to only five years. Many plans do not incorporate this provision into their distribution policy because of the increased repurchase obligation.

Table 4-7. Five installment distributions

Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$2,250,000.00	1	$ 450,000.00	$1,800,000.00
2	$1,890,000.00	2	$ 472,500.00	$1,417,500.00
3	$1,488,375.00	3	$ 496,125.00	$ 992,250.00
4	$1,041,862.50	4	$ 520,931.25	$ 520,931.25
5	$ 546,977.81	5	$ 546,977.81	$ 0.00
		Total payments	$2,486,534.06	

* Balance increases 5% per year from stock investment appreciation.

Table 4-8. Nine installment distributions

Year	ESOP balance*	Installment #	Installment distribution	Remaining ESOP balance
1	$2,250,000.00	1	$ 250,000.00	$2,000,000.00
2	$2,100,000.00	2	$ 262,500.00	$1,837,500.00
3	$1,929,375.00	3	$ 275,625.00	$1,653,750.00
4	$1,736,437.50	4	$ 289,406.25	$1,447,031.25
5	$1,519,382.81	5	$ 303,876.56	$1,215,506.25
6	$1,276,281.56	6	$ 319,070.39	$ 957,211.17
7	$1,005,071.73	7	$ 335,023.91	$ 670,047.82
8	$ 703,550.21	8	$ 351,775.11	$ 351,775.10
9	$ 369,363.86	9	$ 369,363.86	$ 0.00
		Total payments	$2,756,641.08	

* Balance increases 5% per year from stock investment appreciation.

Timing of Distributions

ESOP distributions can be delayed until the sixth plan year following the plan year of termination for participants that terminate for reasons other than the attainment of normal retirement age under the plan, disability, or death. The plan sponsor can pay earlier than the sixth year and may find that approach more favorable because the participant does not continue to share in stock price appreciation. Paying distributions earlier can have a cash flow savings, especially in the earlier years of an ESOP when the stock price can increase rapidly as the debt on the company's balance sheet from the original ESOP leveraged transaction is repaid. Table 4-9 reflects how an ESOP account balance of $25,000 can grow to over $50,000 during a six-year delay period at a 15% annual stock value growth rate.

Many plan sponsors opt to pay distributions earlier for smaller account balances as opposed to distributing more than double the value of the account six years later.

Distribution policies can be written to state that balances less than a defined amount will paid in the year following termination of employment to get the balances distributed earlier. Balances greater than the stated amount could still apply a distribution delay to give the

Table 4-9. Distribution proceeds based on different distribution timing

Year	One-year delay	Six-year delay
1	$25,000.00	$25,000.00
2		$28,750.00
3		$33,062.50
4		$38,021.88
5		$43,725.16
6		$50,283.93

* Balance increases 15% per year from stock investment appreciation.

plan sponsor more time to fund the repurchase obligation as needed. Other plan sponsors may only impose a three-year delay for larger account balances, for example, to disincentive the employee to terminate employment to get access to their funds. The plan sponsor still has time to plan for the repurchase obligation, but with continued stock value appreciation, the obligation will be less than it would be if delaying for the full six years.

Cash Distributions

Companies that desire to keep company stock in the ESOP and reallocate the shares to active ESOP participants in the current plan year generally use cash distributions. This process is known as recycling shares, which is the most common approach to satisfying the ESOP repurchase obligation for younger ESOPs.

The company satisfies the repurchase obligation by depositing cash into the plan. Recycling uses cash in the ESOP trust to convert participants out of their stock position at the time of distribution. Cash is generally deposited to the trust as a discretionary employer contribution or a dividend/S corporation distribution on company stock held in the ESOP. Participants receiving a cash distribution exchange their stock balance in return for cash from other participants in the plan. The participants who exchanged their cash for shares now have those shares allocated to their ESOP accounts. The net effect on the overall shares held in the trust is zero since recycled shares do not leave the trust.

Stock Distributions

Participants can be paid their ESOP account balances in stock and then "put" the shares back to the company; this is also known as redeeming or retiring the stock.

The company satisfies the repurchase obligation by paying cash to retire stock. In this process, company stock does leave the ESOP trust as a stock distribution to the former ESOP participant. Generally, the steps are as follows:

1. The ESOP distributes stock to plan participants.
2. The plan participants sign a "put" option to sell stock back to the company.
3. The redeemed shares are retired to the company's treasury account, where they are no longer considered outstanding stock for valuation purposes.

When an ESOP matures and the repurchase obligation from recycling shares with cash contributions provides benefit levels higher than the company's goals, stock distributions can be a great option.

The benefit level equals the summation of the fair market value of shares released from ESOP loan payments, cash or stock contributions, and reallocated forfeitures divided by eligible payroll. The benefit level is often stated as a percentage of eligible compensation. Once that value is known, the plan's distribution policy and repurchase obligation strategy can be modified as needed to assist the company in meeting its benefit level goals for ESOP participants.

For example, if the desired benefit level is lower than the projected repurchase obligation in a given plan year, processing stock distributions would be a better solution for the company to achieve its desired benefit level. Instead of the ESOP covering the full repurchase obligation by recycling all the shares, the company can decide how many shares the ESOP would buy back in the case of stock distributions, with the company buying back the remaining shares and retiring them to the corporate treasury account. This approach reduces the benefit level and provides the company more control of how many shares are reallocated in the ESOP. Table 4-10 shows how using stock distributions can be used to meet benefit level goals.

Table 4-10. Using stock distributions to achieve an 8% contribution benefit level

	Cash distributions	Stock distributions
Total repurchase obligation	$5,000,000.00	$5,000,000.00
Stock price per share	$ 80.00	$ 80.00
# of shares to fund	62,500.0000	62,500.0000
Eligible payroll	$37,500,000.00	$37,500,000.00
8% contribution goal	$ 3,000,000.00	$ 3,000,000.00
Contribution to recycle shares	$5,000,000.00	$3,000,000.00
Stock redemption	$ 0.00	$2,000,000.00
Funds used to satisfy repurchase obligation	$5,000,000.00	$5,000,000.00
Shares recycled in the plan	62,500.0000	37,500.0000
Shares redeemed (retired)	0.0000	25,000.0000
	62,500.0000	62,500.0000
Benefit level (contribution to recycle shares divided by eligible payroll)	13.33%	8.00%

In this example, the plan sponsor has an 8% contribution benefit level goal. If all the shares are recycled in the plan with cash contributions, the benefit level exceeds 13% of eligible compensation. Alternatively, if the distributions are processed as stock distributions, the plan sponsor can contribute $3 million to the ESOP to achieve the 8% benefit level goal. The $3 million contribution will put 37,500 shares back into the plan to be allocated to the eligible participants. The company will fund the remaining $2 million of repurchase obligation by directly purchasing the shares from the participants receiving a stock distribution. Those shares are not returned to the ESOP, being retired for the time being.

Alternatively, the plan sponsor can meet its contribution goals by retiring all the distributed shares and then contribute stock to the plan. The contribution value is determined based on the stock price on the date of the contribution multiplied by the number of shares contributed.

Segregation

There may be a benefit to include a segregation provision in the ESOP distribution policy. Segregation, also known as reshuffling, is the process of converting company stock balances of terminated ESOP participants to assets other than company stock so they do not continue to share in stock price appreciation.

To be used, segregation must be included in the ESOP plan document. It can be added with an amendment if it is currently not in the plan document. Most plans are written to state segregation occurs only to the extent the ESOP trust has cash available to complete the segregation of stock. The company maintains discretion on the amount of cash to put in the ESOP to fund segregation. The plan document should indicate how segregation will be done if there are insufficient other investments in the plan to fully segregate all the stock held in terminated participant accounts. There should also be an investment policy referenced in the plan document that directs how the segregated balances should be invested. The segregated balances could also be transferred to the plan sponsor's sister 401(k) plan, which could allow the former employee to invest the segregated account balances as they wish.

Segregation provides diversification for terminated participants and provides stock appreciation rewards for those who contribute to the ongoing success of the business (i.e., current employees). There is no requirement that all the balances of former participants be fully segregated, so the plan sponsor can contribute cash to the plan or pay C corporation dividends or S corporation distributions to a level it wishes to achieve the desired benefit levels and cash flow amounts it can afford.

Segregation does not change any participant's total account balance, but it does change the assets that make up the participant's account balance, as table 4-11 shows.

Table 4-11. Effect of segregation

	Samantha	Jacob	
	(Active participant)	(Terminated participant)	Total balances
Pre-segregation			
Cash balance	$4,000.00	$ 0.00	$4,000.00
Stock balance	$ 0.00	$3,500.00	$3,500.00
Total balance	$4,000.00	$3,500.00	$7,500.00
Post-segregation			
Cash balance	$ 500.00	$3,500.00	$4,000.00
Stock balance	$3,500.00	$ 0.00	$3,500.00
Total balance	$4,000.00	$3,500.00	$7,500.00

Another form of segregation is mandatory diversification. Mandatory diversification generally applies to participants who have reached a certain age, such as age 61. If the participant did not elect to receive their diversification or distribution from the ESOP, the plan will automatically diversify a percentage of their stock balance. This process will reallocate shares to less-tenured participants in the plan and lock in the stock price for the mandatory diversification amount, which can be beneficial for companies with rising stock values. However, mandatory diversification is not a common plan provision because it requires additional plan compliance testing to ensure it does not discriminate in favor of current and former highly compensated employees.

Rebalancing

Second to segregation, rebalancing helps with the "have and have not" problem in which less tenured ESOP participants have very few shares in their ESOP account and have a large percentage of cash investments of their total balance. According to the IRS, rebalancing is the "mandatory transfer of employer securities into and out of participant plan accounts having the same proportion of employer securities." The goal of rebalancing is to ensure all balances of active participants have the same percentage of stock vs. cash in their accounts. Rebalancing normally applies after segregation is processed, and the active participants still have a mix of cash and stock investments. As with segregation, the participant's total account balance does not change, but it does change the assets that make up the participant's account balance, as table 4-12 shows.

Like segregation, rebalancing must be a provision in the ESOP plan document. It is recommended to incorporate rebalancing in the plan document as early as possible, so more tenured active ESOP participants do not feel slighted when a portion of their stock investments are converted into other investments.

Table 4-12. Effect of rebalancing

	Henry		Sally			
	(Active participant)	% of account balance	(Active participant)	% of account balance	Total balances	% of account balance
Pre-rebalance						
Cash balance	$6,000.00	93.0%	$ 7,500.00	8.1%	$13,500.00	13.6%
Stock balance	$ 450.00	7.0%	$85,000.00	91.9%	$85,450.00	86.4%
Total balance	$6,450.00	100.0%	$92,500.00	100.0%	$98,950.00	100.0%
Post-rebalance						
Cash balance	$ 879.99	13.6%	$12,620.01	13.6%	$13,500.00	13.6%
Stock balance	$5,570.01	86.4%	$79,879.99	86.4%	$85,450.00	86.4%
Total balance	$6,450.00	100.0%	$92,500.00	100.0%	$98,950.00	100.0%

About the Author

Kevin Rusch is a vice president and co-head of ESOP consulting services at Blue Ridge Associates. He has over 30 years of experience providing administration and consulting advice to ESOP clients. He is a CPA as well as a QPA. Mr. Rusch is a member of the ESOP Association's Administration Advisory Committee and is a frequent speaker on ESOP administration topics for both the ESOP Association and the NCEO. He works with plan sponsors, accountants, advisors, and legal counsel to provide guidance on plan design, repurchase obligation studies, compliance, and operation. He is a member of the ESOP Association, ASPPA, and the NCEO. He has served as the subject matter expert on ESOPs for ASPPA's Education and Examination Committee. Mr. Rusch received his bachelor of business administration in accounting from the University of Wisconsin-Madison.