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Managing Diversification

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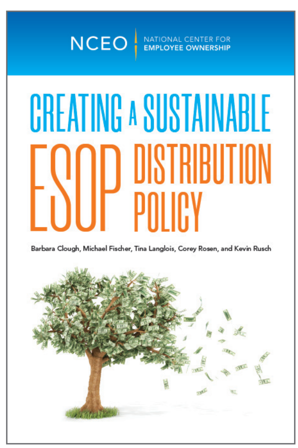

CHAPTER 3

Managing Diversification

Barbara Clough

SECTION 401(a)(28)(B) of the Internal Revenue Code (the "Code") provides an opportunity for ESOP participants who have attained age 55 and completed 10 years of participation in the plan ("qualified participants") to diversify a portion of their stock assets acquired after 1986 over a six-year period. Participants always ask why this provision is offered in their ESOP. Essentially, this provision allows plan participants who are approaching retirement the ability to move their stock from the ESOP to a non-stock investment to have more control over these assets. Plan participants are required to be notified that they are eligible to diversify within the first 90 days following the close of the plan year. The participant must be offered the opportunity to receive their diversification payment no later than 180 days after the close of the plan year. This provision creates timing complexities for plan sponsors, who may not have their stock value within 180 days of the plan year-end. A recent listing of required modifications (LRM) from the IRS allows plan sponsors to amend their plan and adopt a provision under which no preliminary notice is required, and payment must be made within 90 days of receipt of the plan's fair market value.

Plan participants are given the opportunity to diversify up to 25% of their cumulative stock account for five years and increase their election to up to 50% of their cumulative stock account in year six (the "diversification period"). Once this period has expired, the diversification window is considered closed. During the election period, the participant may be allowed to receive the fair market value of their stock in one of three ways: (1) a rollover to the employer's 401(k) plan or a rollover to an IRA account set up by the participant; (2) a cash payment subject to withholding taxes (federal and state) and an additional 10% early withdrawal tax if under age 59½ at the time of the payment; or (3) three distinct investment options within the ESOP. Option (3) is rarely offered because there are fiduciary concerns related to the choice of investment options as well as the quarterly distribution of participant statements.

In the first year of diversification, assuming that all shares were acquired after 1986, a participant could diversify any amount between zero and 25% of their share balance. For example, see table 3-1. In this example, the participant may diversify between 0 and 250 shares.

Table 3-1. First year of diversification

Share balance	Diversification precentage	Shares eligible	Market value @ $40/share
1,000	25%	250	$10,000

In year two, assuming the participant elected a full diversification in year one, the calculation would be as in table 3-2. In year two, the participant can diversify between 0 and 50 shares.

Table 3-2. Year two of diversification where participant elects a full diversification in year one

Shares at beginning of year	750
Current-year additions	200
Previously diversified shares	250
Adjusted shares (BOY + additions + previously diversified)	1,200
Diversified percentage (25%)	.25
Adjusted diversification shares	300
Less previously diversified shares	-250
Shares currently eligible for diversification	50

Alternatively, if the participant chose not to diversify in year one, the calculation would be as in table 3-3. In this scenario, the participant can diversify between 0 and 300 shares.

Table 3-3. Year two of diversification where participant does not diversify in year one	
Shares at beginning of year	1,000
Current-year additions	200
Previously diversified shares	0
Adjusted shares (BOY + additions + previously diversified)	1,200
Diversified percentage (25%)	.25
Adjusted diversification shares	300
Less previously diversified shares	0
Shares currently eligible for diversification	300

Assuming the participant fully diversified each year they were eligible, the account would progress as in table 3-4.

Table 3-4. Diversification progress to year six

	Beginning balance	New additions	Shares diversified
Year 1	1,000	0	250
Year 2	750	200	50
Year 3	900	200	50
Year 4	1,050	200	50
Year 5	1,200	200	50
Year 6	1,350	200	550

The diversification at 50% in year six could be any amount between 0 and 550 shares (table 3-5). Under the statutory diversification rules, this is the final opportunity for the participant to receive a diversification payment.

It is important to remember that each year's diversification election will be paid in a lump sum based on the elected amount. This relates to a repurchase obligation funded by the company. Unlike distributions due to an employee's departure from the company, it may be difficult to determine the required cash outflow to pay annual diversification payments.

Table 3-5. Diversification in year six	
Shares at beginning of year	1,350
Current-year additions	200
Previously diversified shares	450
Adjusted shares (BOY + additions + previously diversified)	2,000
Diversified percentage (25%)	.50
Adjusted diversification shares	1,000
Less previously diversified shares	-450
Shares currently eligible for diversification	550

In recent years, there has been increasing interest in allowing participants the opportunity to diversify earlier, extend longer, increase the amounts available for diversification, and even provide one-time windows for payment. Each of these additional opportunities for participants to elect diversification of their stock assets is beyond the statutory requirements of Code Section 401(a)(28).

Extended Diversification

The most prevalent change to diversification is to allow extension beyond the six-year statutory period. Plan sponsors may find extended diversification advantageous if they seek to retain key employees past age 60 and even into their 70s. Extended diversification may be an attractive option for participants who wish to wait until their Social Security retirement age in order to take advantage of other retirement benefits and more favorable distribution rules.

The extended diversification provisions can be very specific, such as extension until the attainment of the plan's retirement provisions or a longer period of time. Another option would be to allow an increasing percentage over an extended period of time. For example, an additional 10% per year for the next five years; year 7 would be 60%, year 8 would be 70%, etc., reaching 100% in year 11, i.e., five years longer. This allows participants the opportunity to control their investments as they approach retirement while providing the company an opportunity to pay the participant a significant portion of their account balance before their actual retirement. Additionally, a plan sponsor will benefit from the knowledge and experience of tenured participants while providing training for younger or newer employees to move into those roles once an individual retires. Table 3-6 illustrates what an extended diversification of this type could look like.

Table 3-6. Extended diversification example

	Beginning balance	New additions	Diversification percentage	Shares diversified
Year 1	1,000	0	25%	250
Year 2	750	200	25%	50
Year 3	900	200	25%	50
Year 4	1,050	200	25%	50
Year 5	1,200	200	25%	50
Year 6	1,350	200	50%	550
Year 7	1,000	200	60%	320
Year 8	880	200	70%	360
Year 9	720	200	80%	400
Year 10	520	200	90%	440
Year 11	280	200	100%	480

Since this process requires the participant to elect a payment versus being required to receive payment, it is possible that the extended diversification provides a more level approach to the repurchase obligation.

Early Diversification

As time has progressed and the number of mature ESOPs has increased, plan sponsors are being faced with very large participant account balances, looming repurchase obligations, and participants who are tenured and loyal looking for access to their ESOP accounts. Accordingly, there is a trend toward early diversification. Early diversification provisions do not remove the company from the requirement of offering statutory diversification payments; however, they do provide an opportunity for participants to access funds earlier than age 55 and 10 years in the plan.

The approach to early diversification design and amendment of the plan document varies greatly from company to company, generally based on geographical location, participant demographics, and the needs of the participants. A plan sponsor with a workforce tenure of 15 to 20 years and ages ranging from 35 to 45 may find that its employees may require access to capital to assist their children with college expenses or the need to remodel their home to provide living space for aging parents.

A plan sponsor could require certain requirements to be met for early diversification. For example, it could require that the age of the participant plus the number of years of employment must equal 65 or greater and that the participant must be 100% vested in their account balance. It could also require that after an early diversification payment, another such payment could be requested only after a five-year wait.

By amending the plan in a manner that does not allow a run on the company finances but allows employees flexibility in accessing a portion of their ESOP stock balance earlier than otherwise would be the case, the company may avoid seeing employees leave employment to access their balances, which could have a negative effect due to, e.g., the knowledge lost with those employees.

Alternatively, a company may decide to implement a provision providing that all employees who are at least age 50 and have reached 100% vesting or 10 years of plan participation may choose to begin diversification. Typically, provisions such as this follow the 25% cumulative diversification rule in Code Section 401(a)(28)(B).

Since the early diversification provisions are not legally mandated, a plan sponsor may choose any arrangment it finds suitable and nondiscriminatory to determine the percentage available to diversify, as well as whether these amounts use the cumulative calculation or not.

See the example in table 3-7.

Table 3-7. Early vs. statutory diversification

					A	B	C = A+B	D = C * %					
Payment type	Age	Years of participation	Beginning balance	New additions	Total shares	Plus previously diversified shares	Total diversification-eligible shares	Diversification calculated shares	Less prior diversification	Diversification shares eligible for payment	% available	Shares diversified	Cumulative diversified shares
Early diversification	50	5	1,000.00	0.00	1,000.00		1,000.00	250.00		250.00	25%	250.00	250
Early diversification	51	6	750.00	200.00	950.00	250.00	1,200.00	300.00	-250.00	50.00	25%	50.00	300
Early diversification	52	7	900.00	200.00	1,100.00	300.00	1,400.00	350.00	-300.00	50.00	25%	50.00	350
Early diversification	53	8	1,050.00	200.00	1,250.00	350.00	1,600.00	400.00	-350.00	50.00	25%	50.00	400
Early diversification	54	9	1,200.00	200.00	1,400.00	400.00	1,800.00	450.00	-400.00	50.00	25%	50.00	450
Statutory diversification	55	10	1,350.00	200.00	1,550.00	450.00	2,000.00	500.00	-450.00	50.00	25%	50.00	500.00
Statutory diversification	56	11	1,500.00	200.00	1,700.00	500.00	2,200.00	550.00	-500.00	50.00	25%	50.00	550.00
Statutory diversification	57	12	1,650.00	200.00	1,850.00	550.00	2,400.00	600.00	-550.00	50.00	25%	50.00	600.00
Statutory diversification	58	13	1,800.00	200.00	2,000.00	600.00	2,600.00	650.00	-600.00	50.00	25%	50.00	650.00
Statutory diversification	59	14	1,950.00	200.00	2,150.00	650.00	2,800.00	700.00	-650.00	50.00	25%	50.00	700.00
Statutory diversification	60	15	2,100.00	200.00	2,300.00	700.00	3,000.00	1,500.00	-700.00	800.00	50%	800.00	1,500.00

In-Service Withdrawals

A small percentage of ESOPs offer in-service withdrawals. Typically, these are offered in lieu of a formal early diversification provision. As with all distributions, in-service provisions must be included in the plan document. The provisions relating to eligibility for in-service withdrawals can vary from plan to plan. It is very common for plan sponsors to allow in-service withdrawals only to participants who have attained age 59½ years of age; this eliminates the requirement of paying a 10% early withdrawal penalty on their distribution. However, this could significantly limit the number of still-employed individuals who are eligible to request payment. One key difference with in-service withdrawals is that often, when an account has accumulated cash, those funds are available for distribution as well as stock, or sometimes only the non-stock account balance is available. Generally, these payments are not considered diversification; accordingly, they do not play into the calculation of previously diversified shares, although they do count toward previous distributions; see the calculations in the example in table 3-8.

As illustrated in the early diversification example in table 3-7, the cumulative diversification payments reduce the available current diversification amount. When comparing this with classifying the payment as an in-service withdrawal, the cumulative available distribution plus diversification election amounts increase significantly (table 3-8).

Another approach to in-service withdrawals is to offer them only to those who have attained the plan's normal retirement age. This provision is often designed to allow participants who have reached normal retirement but do not want to stop working the ability to begin receiving their payments "as if" they had terminated employment. This provides the participant payments over five years while remaining in the workforce and continuing to accumulate ESOP allocations and stock growth. One important consideration for those electing payment is that they have the ability to roll their account balance into the 401(k) plan and direct their investments or alternatively roll the payment into an IRA investment of their choice. The rollover allows

Table 3-8. In-service withdrawals vs. statutory diversification

					A	B	C = A+B	D = C * %							
Payment type	Age	Years of partici-pation	Beginning balance	New additions	Total shares	+ previously distributed & previously diversified	Total diversification-eligible shares	Diversification calculated shares	Less prior diversi-fication	Diversification shares eligible for payment	% available	Shares distributed	Cumulative distributed shares	Shares diversified	Cumulative diversified shares
In-service withdrawal	50	5	1,000.00	0.00	1,000.00						25%	250.00	250.00	0	0
In-service withdrawal	51	6	750.00	200.00	950.00						25%	237.50	487.50	0	0
In-service withdrawal	52	7	712.50	200.00	912.50						25%	228.13	715.63	0	0
In-service withdrawal	53	8	684.38	200.00	884.38						25%	221.09	936.72	0	0
In-service withdrawal	54	9	663.28	200.00	863.28						25%	215.82	1,152.54	0	0
Statutory diversification	55	10	647.46	200.00	847.46	1,152.54	2,000.00	500.00	0.00	500.00	25%		1,152.54	500.00	500.00
Statutory diversification	56	11	347.46	200.00	547.46	1,652.54	2,200.00	550.00	-500.00	50.00	25%		1,152.54	50.00	550.00
Statutory diversification	57	12	497.46	200.00	697.46	1,702.54	2,400.00	600.00	-550.00	50.00	25%		1,152.54	50.00	600.00
Statutory diversification	58	13	647.46	200.00	847.46	1,752.54	2,600.00	650.00	-600.00	50.00	25%		1,152.54	50.00	650.00
Statutory diversification	59	14	797.46	200.00	997.46	1,802.54	2,800.00	700.00	-650.00	50.00	25%		1,152.54	50.00	700.00
Statutory diversification	60	15	947.46	200.00	1,147.46	1,852.54	3,000.00	1,500.00	-700.00	800.00	50%		1,152.54	800.00	1,500.00

the employee to avoid taxation until a later time when they withdraw the funds during retirement.

One-Time Window

Plan sponsors often open a one-time diversification window. This is often used to provide for a significant buyback of previously allocated shares to releverage the ESOP and work toward a strategy to provide additional share allocations over time. Often, a window such as this may have a limit on the capital expenditure—e.g., $5 million. The plan sponsor allows, in a nondiscriminatory manner, participants to request a distribution under this window. If the elections exceed the offering, the plan sponsor prorates the distributions paid to plan participants.

Strategies such as the one-time window may have an impact on compliance testing, such as the 409(p) S corporation anti-abuse test. It is important that whenever significant plan provisions are implemented, careful coordination of the sponsor, legal counsel, and TPA are initiated to avoid future testing issues.

Conclusion

There are many reasons for an ESOP plan sponsor to implement plan provisions that expand the diversification or withdrawal provisions of the ESOP. Before adding or amending provisions, plan sponsors should work closely with their legal counsel and TPA and also examine the cash flow effect immediately and over time to ensure no unexpected results emerge. When properly structured, these provisions can be a win-win for both the company and plan participants.

About the Author

Barbara Clough is a vice president at Blue Ridge Associates, where she specializes in ESOP design, implementation, administration, and consulting. With over 25 years of experience in the employee benefits and ESOP industries, Barbara has a deep understanding of the complexities involved in managing ESOP companies and advising clients ranging from small businesses to large enterprises. Her expertise includes navigating tricky administration and compliance issues, with a particular focus on Section 409(p) testing and distribution policy design. Barbara holds a BS in chemistry from the University of Massachusetts, Dartmouth. She is a designated Qualified Pension Administrator (QPA), Qualified 401(k) Consultant (QKC), and Qualified 401(k) Administrator (QKA). Barbara is an active member of the ESOP Association (TEA), NCEO, and ASPPA. She is a past chair of TEA's Administration Advisory Committee and is an executive committee member of TEA's Public Policy Council. Barbara is also the vice president of advocacy for TEA's New England chapter and has served as an NCEO board member. She is a frequent speaker and author, sharing her knowledge and insights with industry professionals and organizations.