ESOP Law Blog

Posted at 6:25 PM on May 3, 2010 by Sheppard Mullin

The IRS Wants to Review Your ESOP Distribution Policy

For the first time, the IRS is requiring that detailed ESOP distribution rules be provided to the IRS as part of the ESOP's determination letter submission.

Profit sharing plans and 401(k) plans are required to have fixed distribution rules stated in the plan documents--ESOPs are not subject to this requirement. In recognition of the special issues confronting ESOPs, however, such as repurchase liability and funding, Congress provided companies sponsoring ESOPs with a great deal of flexibility in structuring the timing and form of benefit distributions as long as the policy complied with the statutory limits on deferral periods.

Typically, an ESOP plan document states the longest permissible deferral periods for distributions, leaving the details of benefit distribution planning to be spelled out in the ESOP distribution policy.

For example, the ESOP plan document would provide the IRC Section 409(o) rules regarding the maximum periods allowed for ESOP distributions: if a participant's service ends because of retirement, disability or death, distribution of his vested ESOP benefit must begin *not later than* the last day of the plan year following the plan year in which his retirement, disability or death occurs--if a participant's service ends for any reason other than his retirement, disability or death, distribution of his vested ESOP benefit must begin *not later than* the last day of the sixth plan year following the plan year in which his service terminates.

Although an ESOP can make distributions to participants as late as the dates described above, the company's cash flow and employee benefit objectives may dictate earlier distribution dates, which would be detailed in the distribution policy. For example, the distribution policy could provide that participants who terminate employment for reasons other than death, disability or retirement could receive distributions in the third (rather than the sixth) plan year following the plan year in which their service terminates. And, this timing might later need to be changed to provide for payments during the fourth or fifth year.

The ESOP plan document also would provide the IRC Section 409(o) rules regarding the form of distribution payments: distributions may be made in a lump sum or in up to six substantially equal annual payments over a period that does not exceed five years. Again, although the plan document sets out the maximum timing for installment payments, the company 's ESOP distribution policy would be designed to accommodate corporate cash flow requirements and ESOP repurchase obligations and could provide for a combination of the lump sum and installment payments. For example, participants who terminate due to death or disability could be paid in lump sums; retirees could be paid in three equal annual installments; and other terminated participants could be paid in five installments.

Until this year, the IRS reviewed the ESOP plan document to verify that the maximum statutory distribution provisions were contained in the plan, but did not require submission of the ESOP's distribution policy details. Now, however, the IRS has decided to review the detailed distribution provisions of each ESOP. While this new requirement might make you think about incorporating the detailed distribution rules into the plan document, a separate distribution policy likely remains the best approach because this document can more easily be modified as needed to accommodate the company's cash flow and employee benefits objectives.

Regardless which terms and provisions form the ESOP distribution policy, the company's cash flow requirements and repurchase liability planning likely will require changes to the distribution policy throughout the life of the ESOP. While each change to the ESOP distribution rules could be made in the form of a formal amendment to the ESOP plan document, changes to the ESOP distribution policy (which usually is only 1-3 pages in length) generally are much simpler and can be made much more easily. For this reason, most plan sponsors have elected to make use of a distribution policy separate from the plan document.

Whether your ESOP distribution rules are detailed in the plan document or in a separate policy, the new IRS requirement will mean that the detailed ESOP distribution rules, must now be provided to the IRS as part of the ESOP's determination letter submission.

Now is a good time to make sure your distribution rules accurately reflect your current distribution practice. And, if you have been putting off developing detailed distribution rules for your ESOP (perhaps awaiting a repurchase liability study), now is the time to put a distribution policy into writing. Keep in mind that the distribution policy generally can be amended as necessary in the future, so long as the modification is nondiscriminatory.

And, whether creating a new distribution policy or making changes to an existing policy, plan sponsors should consult with their ESOP counsel to ensure that the ESOP distribution policy provisions do not inadvertently violate the qualified plan nondiscrimination rules.