

Know The Numbers (2011)

ESOP Account Balance	\$985,000
Covered Compensation	\$245,000

STOCK BONUS PLANS

Stock bonus plans are defined contribution profit sharing plans that allow employers to contribute stock to a qualified plan on behalf of their employees. As with all qualified plans, earnings within a stock bonus plan are tax deferred until the stock, its value in cash, or other securities are distributed from the plan. Because stock bonus plans are not subject to mandatory funding, contributions can and generally are made on a discretionary basis. However, when contributions are made, they must be made to participant's accounts on a nondiscriminatory basis. The contributions cannot discriminate against the **rank-and-file employees** for the benefit of shareholders, officers, and highly compensated employees. Thus, a stock bonus plan is a variation of a profit sharing plan yet has some distinct differences from other profit sharing plans.

Generally, stock bonus plans must satisfy the following requirements:³

- Unlike profit sharing plans, stock bonus plan participants must have pass through voting rights on employer stock held by the plan.⁴
- Participants must have the right to demand employer securities on plan distributions.
- Participants must have the right to demand that the employer repurchase the employer's securities if they are not publicly traded (the put option).⁵
- Distributions must begin within one year of normal retirement age, death, or disability, or within five years for other modes of employment termination.
- Distributions must be fully paid within five years of commencement of distributions.⁶

ADVANTAGES AND DISADVANTAGES OF STOCK BONUS PLANS

Stock bonus plans are profit sharing plans for which an employer makes contributions of employer stock on behalf of a participant to a qualified plan as part of the employee's overall compensation package. Similar to profit sharing plans, stock bonus plans are designed to provide benefits to both employers and to employees. The fair market value of contributions of employer stock are tax deductible to the employer, which can result in decreased income tax costs for the corporation. The contributions are not required to be fixed in amount as there is no annual mandatory contribution requirement for stock bonus plans, which allows the corporation flexibility in funding. Stock bonus plans also promote productivity within the corporation because participants, as shareholders, have a vested financial interest in the growth and success of the corporation (although this does not always lead to an increase in stock prices).

3. IRC Sections 401(a)(22) and 401(a)(23).

4. IRC Section 409(e).

5. IRC Section 409(h).

6. IRC Section 409(o).

Disadvantages to the Employees

While the advantages of stock bonus plans are attractive, stock bonus plans do have drawbacks. To the employee, there is the risk associated with the non-diversified investment portfolio. The employee earns income from the employer and also has an investment in the stock of the employer. In other words, if the corporation were to fail, the entire value in the employee retirement accounts may be lost as well as the employee's job and source of income (wages).

Disadvantages to the Employer

One disadvantage to the employer is that the ownership and control of the corporation is diminished or “**diluted**” as shares are granted to the employees. This has a greater impact on smaller, closely held corporations.

With stock bonus plans, the required “**repurchase option**” (**put option**) could deplete the cash of the corporation. A repurchase option allows a terminating employee the choice to receive the cash equivalent of the employer's stock if the stock is not readily tradeable on an established market. If the repurchase occurs at an unexpected time (e.g., upon the death of participant), the forced sale of stock back to the corporation may drain the corporation's cash flow as well as result in a costly appraisal of the stock to determine the value to pay the employee-participant's heirs. In such a situation, the strain on the cash flow of the employer may have a negative impact on the corporation as a whole.

FEATURES OF STOCK BONUS PLANS AS COMPARED TO PROFIT SHARING PLANS

As discussed above, stock bonus plans are a particular type of profit sharing plan and have many profit sharing characteristics. The features of stock bonus plans will be discussed in relation to profit sharing plans in order to identify the similarities and differences between the two types of plans.

Contributions and Deductions

As with all qualified plans, stock bonus plans and profit sharing plans must be established by December 31st of the year for which the employer will be contributing to the plan. Meanwhile, contributions can be made to the plan as late as the due date of the income tax return, including permitted extensions.

Contributions to stock bonus plans and profit sharing plans are **discretionary** but must meet the general profit sharing plan requirement of “**substantial and recurring.**” While most contributions to stock bonus plans are tied to the corporation's profitability, there is no requirement that a corporation must contribute to the plan in a year in which it has earnings nor




Key Concepts

Underline/highlight the answers to these questions as you read:

1. List the requirements of a stock bonus plan.
2. What are the advantages and disadvantages of a stock bonus plan?
3. What are the main differences between a stock bonus plan and a profit sharing plan?
4. Why are valuations performed for stock bonus plans?

is there a prohibition against contributions to the plan in years in which the corporation has losses.



*Quick
Quiz 6.1*

Highlight the answer to these questions:

1. A stock bonus plan is a particular type of profit sharing plan, so they share many characteristics.
 - a. True
 - b. False
2. A valuation of an employer's securities is performed only at the creation of the stock bonus plan.
 - a. True
 - b. False
3. A stock bonus plan may require an employee to attain six years of service before considering the employee eligible.
 - a. True
 - b. False

True, False, False

Like profit sharing plans, stock bonus plans have a deductible contribution limit of 25 percent of covered compensation (limited to \$245,000 for 2011) per employee.⁷ When stock is contributed, the fair market value of the stock, as determined by a qualified appraiser, is deductible. In some instances, an employer may contribute more than the permitted 25 percent, in which case the employer would deduct the 25 percent and could carry forward the amount which exceeds the 25 percent limit and deduct the excess in a future year. However, the amount carried forward when added to the contribution made for the future year cannot exceed 25 percent, and the employer must pay a 10 percent excise tax on the portion of the contribution that exceeds 25 percent of covered compensation for the current year.⁸

Valuation of Employer Stock in Stock Bonus Plans

An important area of plan administration for a stock bonus plan is the valuation or appraisal of the employer's securities. Valuations are performed to determine the value of the contribution for the corporation's income tax deduction purposes and the corporation's

financial statements. Valuations are also completed to periodically inform the participants of the stock's value. The employer will track the value of the contributions and therefore the amount of ordinary income that the employee will have to recognize upon distribution. A valuation also allows the employee to determine the sales price of the stock if he is exercising the repurchase option (put option).

For private or closely held corporations, determining the value of securities is often difficult. The law requires valuations of employers' securities and if those securities are not readily tradable on an established securities market, then these valuations must be undertaken by independent appraisers.⁹ The appraiser must be an uninterested, independent party. The valuation must be done in good faith and must be based on all factors relevant to determining the securities' fair market value.¹⁰ The valuation therefore involves an assessment of what a willing buyer would

7. IRC Section 404(a)(3).

8. IRC Section 4972(a).

9. IRC Section 401 (a)(28)(C).

10. Regulations Section 54.4975-11(d)(5). See also *Donovan v. Cunningham* 541 ESOPs 246 (S.D. Texas 1982).

pay to a willing seller for the securities or business.¹¹ These valuations are used on an annual basis to determine the value of the securities, that, for example, were contributed by the employer for tax deduction purposes or that were subjected to a repurchase option of a departing employee.

Eligibility

Stock bonus plans are subject to standard eligibility rules discussed in Chapter 3, the same as other qualified plans, including profit sharing plans. The standard eligibility of age 21 and one-year of service generally applies to stock bonus plans. As discussed before, plan sponsors could make the eligibility requirements less restrictive.

Like other qualified plans, stock bonus plans may require a two year waiting period before the employee is eligible. However, if the employer requires a two year waiting period, then all contributions must be 100 percent vested after the two year waiting period.

Allocation Methods

The allocation methods for contributions to participants' accounts in stock bonus plans are the same as those for profit sharing plans. The difference is that normally employer stock is contributed to the stock bonus plan rather than cash.

The standard allocation method for a stock bonus plan is to allocate contributions based on a percentage of each employee's compensation. Whenever stock is contributed, the stock must be valued by a qualified appraiser as discussed previously. Cash is generally only contributed when the plan expects cash distribution elections or the plan needs cash to meet its obligation to provide a market for the stock.

The percentage of compensation method is not the only acceptable allocation method for stock bonus plans. The formulas discussed for profit sharing plans based on age and past service also apply to stock bonus plans, as does the new comparability plan based on the employees' respective classifications in the corporation. These methods apply as long as they do not discriminate in favor of highly compensated employees. As discussed in Chapter 5, stock bonus plans are also permitted to use the technique or method of permitted disparity, also known as Social Security Integration, which allocates plan contributions to employees' accounts and provides greater contributions to those employees whose earnings exceed the Social Security wage base.

Vesting

Similar to profit sharing plans, the vesting rules for stock bonus plans are the same as for other qualified plans as discussed in Chapter 3. The standard three-year cliff vesting schedules and the



Key Concepts

Underline/highlight the answers to these questions as you read:

1. Define net unrealized appreciation.
2. What is the advantage to an employee of receiving a stock distribution from a stock bonus plan rather than receive the distribution in cash?

11. Revenue Ruling 59-60.

graduated 2 to 6 year vesting schedules for defined contribution plans as required by the Pension Protection Act of 2006 apply unless the employer selects a two year eligibility rule. The plan sponsor may not exceed these vesting requirements yet is always permitted to be more generous if desired.

Portfolio Diversification

Profit sharing plans are generally designed to invest in **diversified investment portfolios**. Consequently, they are not usually invested exclusively in employer stock. Unlike profit sharing plans, stock bonus plans are usually funded with one hundred percent employer stock. Profit sharing plans assist the employee in preparing for retirement through the growth of the individual participant's account with deferred compensation and tax deferral on earnings. As such, these plans are generally well-diversified investment portfolios. In contrast, stock bonus plans are initially "cash free" to the employer as they are predominately funded with the employer's stock in order to provide benefits to employees without the need to use the corporation's cash. The exclusive use of employer stock as contributions results in an undiversified portfolio for the participant.

To the extent that a stock bonus plan is funded with publicly traded stock, the Pension Protection Act of 2006 requires the plan to allow plan participants to diversify their pre-tax deferrals, after-tax contributions, and employer contributions that have been invested in employer securities. Like other defined contribution plans, the plan must offer a choice of at least three investment options, other than employer securities, each of which must be diversified and have materially different risk and return characteristics. This requirement is consistent with that found in ERISA and generally implies that a plan must provide at least one type of stock, bond, and cash fund as investment options. All plan participants must be allowed to diversify the investment of their elective deferrals and after-tax contributions. In addition, plan participants with three or more years of service must be allowed to diversify the investment of other contributions made on their behalf.

PPA 2006 DIVERSIFICATION REQUIREMENTS

EXHIBIT 6.1

	EMPLOYEE CONTRIBUTIONS*		EMPLOYER CONTRIBUTIONS
	Pre-tax Elective Deferrals	After-tax Contributions	
Participant with less than 3 years of service	Immediate right to diversify	Immediate right to diversify	No requirement to diversify
Participant with 3 years or more of service	Immediate right to diversify	Immediate right to diversify	Immediate right to diversify
<i>*Employee contributions typically occur in 401(k) plans and thrift plans, but not in stock bonus plans or ESOPs.</i>			

The investment diversification requirements were phased in over three years, beginning in January of 2007.¹² During 2007, 2008, and 2009, a transition rule applied to amounts attributable to employer contributions invested in employer securities that were contributed prior to January 1, 2007. Under the transition rule, a percentage of employer securities are subject to the new diversification requirements in each year. The applicable percentages are 33 percent in the first year, 66 percent in the second year, and 100 percent in the third year. The applicable percentage applies separately to each class of employer security in an individual’s account. Note that the transition rule did not apply to plan participants who had three years of service and who had attained age 55 by the beginning of the first plan year beginning after December 31, 2005. In other words, employees who had three years of service and had attained age 55 had an immediate right to diversification.

PPA 2006 DIVERSIFICATION REQUIREMENTS - TRANSITION RULE

EXHIBIT 6.2

Plan Year	Applicable Percentage
2007	33%
2008	66%
2009	100%

Voting Rights

If a profit sharing plan consists of employer stock, the plan participant generally does not have voting rights in the stock held by the plan. However, participants in a stock bonus plan must have pass through voting rights on employer stock that is held by the plan on their behalf. “**Pass through**” voting rights mean that the voting rights of the stock pass through from the plan all the way down to the participant. In this case, the participant could vote the shares of stock allocated to his stock bonus plan account. There are exceptions for closely held corporations to limit voting to only those matters that are material. Also, unallocated shares are usually voted by the plan trustee. Unallocated shares are those shares in the trust that have not yet been allocated to individual participants.

12. Pension Protection Act of 2006, Section 901; IRC Section 401(a)(28)(B).