

ESOP Diversification Requirements

John P. Prodoehl
Bradley E. Henschen
Tina M. Fisher

THE REQUIREMENT FOR DIVERSIFICATION stems from the Tax Reform Act of 1986 (“TRA ’86”), which requires that an ESOP must offer an eligible participant the right to elect to diversify up to 25% of his or her post-1986 stock account for five years after meeting eligibility requirements, a percentage that rises to 50% of the stock account with a final election in the sixth year.

This chapter focuses on the “traditional” or “statutory” diversification rights required of ESOPs pursuant to the qualification requirements of section 401(a)(28)(B) of the Internal Revenue Code. Recently, however, Congress enacted the Pension Protection Act of 2006 (the “PPA”), which implements new diversification rights applicable to defined contribution plans of publicly traded companies holding employer securities, which also may affect certain ESOPs and/or KSOPs, i.e., combination 401(k) and ESOP plans, of publicly traded companies. While the PPA refers to the new rules as “diversification,” the new rules require the portion of a plan holding publicly traded employer securities to be subject to participant direction effective for plan years beginning in 2007. Note: ESOPs will be subject to either (1) the “traditional” or “statutory” diversification rules or (2) the new PPA diversification rules, but not both. ESOPs of publicly traded companies are not subject to the new PPA diversification rules if the ESOP holds no employee (before-tax or after-tax) contributions and the ESOP is not integrated with a 401(k) plan.

Broadly speaking, the PPA requires that defined contribution plans holding publicly traded employer securities allow participants the

ability to direct the investment of the portion of their account holding employer securities among at least three other diversified investment choices on at least a quarterly basis. Participant contributions (before-tax or after-tax) that are invested in employer securities are subject to participant direction immediately. Employer contributions that are invested in employer securities are subject to the new rules after the participant has attained three years of vesting service. There is a phase-in transition rule for implementation of investment direction for employer securities acquired with employer contributions prior to the first plan year beginning in 2007. Participants are also required to be notified of their diversification rights at least 30 days prior to their eligibility to diversification.

The remainder of this chapter addresses the “traditional” or “statutory” diversification requirements of ESOPs where the PPA is inapplicable.

Overview

Who Is Eligible for Diversification?

Participants who have 10 years of plan participation *and* who have attained age 55 are eligible to diversify. There is a considerable difference of opinion regarding whether years of plan participation include all plan years in which a participant has an account balance (including terminated employees with deferred vested benefits under the ESOP), or only plan years in which a participant is eligible for contributions and forfeitures. The best way to handle this difference of opinion is to take a position, incorporate *specific* language in the plan document, submit the plan document to the IRS for approval, and apply the rules on a consistent, non-discriminatory basis.

When Is the Diversification Election Made?

The participant election must be made within 90 days after the end of the plan year in which the participant becomes eligible to diversify. The ESOP trustee has 90 days from the end of the election period to actually satisfy or implement the participant’s election.

Once a participant has elected to diversify, the amount of stock eligible for any subsequent diversification is reduced by any previous

diversification elections. If the post-1986 stock account value is less than \$500, diversification is permissible but not required (the de minimis rule).

How Does an ESOP Satisfy the Diversification Requirements?

The requirements of diversification can be satisfied by offering one or more of these options:

- Offer three or more alternative investment funds for the liquidated shares within the ESOP.
- Offer a transfer to a sister qualified plan that offers three or more alternative investment funds.
- Distribute cash equal to stock value.
- Distribute stock (subject to the put option in a closely held company).

Amounts distributed can be rolled over to an IRA, in which case the otherwise applicable 10% early withdrawal tax on distributions before age 59½ will not apply. All current IRA rollover (including direct rollover), trustee-to-trustee transfer, and withholding rules apply.

Should a Plan Sponsor Extend Diversification Beyond What Is Required by Law?

Extending diversification options to participants for stock accounts beyond that which is required by TRA '86 is a concept known as "excess diversification."

In-service distributions that are not specifically authorized by law can jeopardize the qualified status of the plan.

Internal Revenue Code Section 401(a)(28)(B), added by TRA '86, requires diversification of employer stock acquired by an ESOP after December 31, 1986. Plan sponsors may apply diversification to stock acquired before December 31, 1986. Another example of excess diversification is to extend the diversification period to all years before retirement but after age 55, as opposed to just a six-year period; yet

another example is to extend diversification to younger or less senior people. Permitting excess diversification is normally done to reduce the recordkeeping requirements and costs associated with tracking pre-1987 and post-1986 stock separately, or to discourage employees from terminating to lock in gains on stock. Unfortunately, permitting excess diversification does not lower administrative costs; it can actually increase costs. The major disadvantages associated with excess diversification are:

- The repurchase obligation is accelerated. However, where the stock value is increasing, this can actually reduce the repurchase obligation on a long-term basis (this is not a factor in publicly traded companies).
- What is subject to diversification and what is not must be tracked.
- Excess diversification amounts get added back when determining subsequent eligible diversification amounts, but those same amounts may not reduce the current eligible amount.
- An amendment to the ESOP is normally required.
- Participants can still demand stock.

The following discussion provides examples of how the diversification requirements work, as well as forms and procedures for implementing the diversification requirements.

What Is Required for Diversification

ESOPs are required to offer annual diversification elections to all qualified participants. A qualified participant is an employee who has attained age 55 and completed at least 10 years of participation in the ESOP. A participant becomes a qualified participant when he or she satisfies both the age and participation requirements.

The qualified election period begins when a participant becomes a qualified participant and lasts for six years, regardless of the participant's age when he or she first becomes a qualified participant. Participants who have not yet completed 10 years of participation at the time they

attain age 55 will become qualified participants as soon as they complete 10 years of participation.

A terminated participant who meets the age 55 and 10 years of participation requirements will be eligible for diversification. However, it is still unclear whether years of participation must continue after an employee terminates employment. Members of the legal community do not agree with the IRS or each other on this issue. There is a lack of direction from the IRS, and the choice of how to handle the post-termination crediting of service issue is important. Until this issue is clarified by regulations, plan sponsors should write the plan to incorporate the provision they want to use, and then seek an IRS determination letter.

Participation in a predecessor plan must also generally be considered, particularly when the assets of the prior plan were used to purchase employer securities. As mentioned above, in these areas that are not clear, it is important to work with legal counsel to draft the plan language in accordance with the way you decide to administer the plan.

Example 1: Determination of Qualified Participant

Facts

- The plan year is the same as the calendar year.
- A participant completes 10 years of participation before age 55 and attains age 55 in 2004.

Analysis

- The participant becomes a qualified participant in the plan year beginning January 1, 2004.
- The participant will first be eligible to diversify during the 90-day election period beginning January 1, 2005.
- The participant remains eligible to diversify during the annual election periods in 2006, 2007, 2008, 2009, and 2010.

Example 2: Determination of Qualified Participant

Facts

- The plan year is the same as the calendar year.
- A participant completed 10 years of participation in 2004 when the participant's attained age was 58.

Analysis

- The participant becomes a qualified participant in the plan year beginning January 1, 2004.
- The participant will first be eligible to diversify during the 90-day election period beginning January 1, 2005.
- The participant remains eligible to diversify during the annual election periods in 2006, 2007, 2008, 2009, and 2010.

More Rules

The annual diversification elections must be offered for six consecutive plan years. The first election period begins in the plan year following the plan year in which the participant first becomes a qualified participant.

Participants must be allowed to make a diversification election within 90 days following the end of each plan year during the six-year election period. Elections may be modified or revoked, or a new election may be made, anytime during the 90-day election period. The trustee has 90 days after the participant's 90-day election period expires in which to implement the participant's election. Since participants' elections may be revoked or modified, or a new election filed, during the first 90 days after the end of the plan year, plan sponsors are encouraged to wait until after the initial 90-day period has expired before acting on any elections.

For the first five years, each qualified participant must be permitted to diversify up to 25% of his or her eligible shares. The diversification election applies to amounts allocated as of the last day of the prior plan year. In the participant's sixth and final election year, the amount subject to diversification increases to 50%. However, the plan may allow participants to diversify more than the 25% or 50% minimums. (See the comments above regarding excess diversification.)

The amount subject to diversification in any year is reduced by the amounts diversified in prior years. This is illustrated in the diversification examples below.

There is a de minimis exception to the diversification rules. The exception states that post-1986 stock allocated to a participant's ac-

count with a fair market value of \$500 or less is not required to be subject to diversification. For purposes of this de minimis rule, all ESOPs maintained by a controlled group must be aggregated to determine the participant's account value. The plan document must contain the de minimis rule language to use the exception. If the document contains the de minimis rule language and the value of post-1986 shares is \$500 or less, the plan sponsor may choose not to give the participant the right to diversify.

Methods to Comply with the Diversification Requirements

The methodology employed to comply with the diversification requirements is a matter of corporate policy. The purpose of the ESOP and the ESOP's use as a corporate finance tool and/or employee benefit plan will influence the decision on how to comply with the ESOP diversification requirements. Administrative requirements and costs will also influence this decision. Four methods are available to the ESOP company to comply with the diversification requirements. They are as follows:

1. The ESOP can offer at least three investment options other than employer securities. Under this option, the participants eligible to diversify will have to receive a description of the three (or more) alternative investment funds and their relative performance history. In addition, similar information will need to be given to the participants on the employer stock fund, since one of the participant's decisions is whether to stay invested in employer securities. After the required amounts have been determined and upon receipt of fund descriptions, the participant directs the investment among the alternative funds. The employer then liquidates the shares of stock according to plan provisions and transfers the cash amount into the investment options as directed. This method does not delay the company's repurchase obligation. However, the money does stay in the plan and is not considered taxable income to the participant; therefore, the participant (if under age 59½) does not incur the 10% premature distribution tax. In addition, this option does not reduce (via distribution) a participant's retirement account balance.

2. The ESOP can also satisfy the diversification requirements by transferring the required amounts to another plan sponsored by the same employer, which permits the participant to complete self-direction of investments among at least three alternative funds. Once again, the participant must receive detailed descriptions of funds available under the other plan. The same procedures as described above apply for this method, except that the cash is transferred out of the ESOP and into another employer-sponsored plan. Likewise, this method does not delay the company's repurchase obligation. In addition, the money remains in a qualified plan and is not considered taxable income to the participant. Thus, the participant (if under age 59½) does not incur the 10% premature distribution tax. In addition, this option does not reduce (via distribution) a participant's retirement account balance.
3. The ESOP may choose to distribute the amount elected to be diversified in cash. The amount distributed is considered taxable income to the participant and is subject to the normal withholding rules. Thus the participant can roll over the distribution to an IRA or another qualified plan (including via a direct rollover). To the extent not rolled over, the 10% penalty tax on premature distributions will apply if the participant has not attained age 59½. The participant must always elect a distribution to satisfy diversification. In addition, if the plan requires spousal consent on other distributions, then spousal consent is also required on these diversification distributions. If the participant does not make an election and/or spousal consent is not granted, if required, the participant has not elected to diversify for that year, and the plan is deemed to have satisfied the diversification requirements for that year. As with the prior two methods, the company's repurchase obligation is not delayed. Unlike the prior methods, if not rolled into an IRA, a taxable distribution is made to the participant and the 10% premature distribution tax applies if the participant has not attained age 59½.
4. The ESOP can choose to distribute the amount elected to be diversified in stock. If the plan distributes stock, the distribution is considered taxable income and (if under age 59½) is subject to the 10% penalty tax on premature distributions unless the stock is rolled over into an IRA. If the company stock is not publicly

traded, the usual “put option” rules apply to the stock distributed to meet the diversification requirements. Participant consent and spousal consent (if required) must be given before a distribution of stock can be made. If consent is not given, the plan is deemed to have satisfied the diversification requirements for that year. This method is the only method that can delay a company’s repurchase obligation. The company is not required to buy back the stock until the participant exercises the put option; however, the put is usually exercised immediately.

Diversification Example

As explained in IRS Notice 88-56, Q&A 9, the portion of a qualified participant’s account subject to the diversification election in all years in the qualified election period, except the final year, is equal to 25% of the total number of shares of post-1986 employer securities subject to the diversification requirements (as discussed previously) that have ever been allocated to a participant’s account on or before the most recent plan allocation date, less the number of shares of employer securities previously distributed, transferred, or diversified pursuant to a diversification election made after December 31, 1986.

For the final election year, the 25% figure is replaced with 50% in determining the amount subject to the diversification election. The resulting number of shares may be rounded to the nearest whole integer.

Formula:

$$\begin{array}{r}
 \text{Post-1986 stock account balance (in shares)} \\
 + \text{ Any previously diversified shares} \\
 \hline
 = \text{ Total shares eligible to diversify} \\
 \times \text{ .25 (substitute .50 for final year)} \\
 \hline
 = \text{ Total shares available for diversification} \\
 - \text{ Any previously diversified shares} \\
 \hline
 = \text{ **Additional shares to be diversified this year**}
 \end{array}$$

The following pages contain a specific example of how diversification works for an ESOP participant known as Paul. Paul’s employer

is an ESOP company whose ESOP is invested primarily in company stock. There is a minimal amount of cash and other investments that have, in the past, been used to provide liquidity for cash distributions of fractional shares. The following example provides for future cash contributions that are slightly in excess of the amount needed for ESOP loan repayments. Therefore, the cash account balance is relatively small and increasing throughout the six-year period covered by this example. The ESOP release method used here is the principal-only method (shares are released from the suspense account and allocated based on principal payments made for the year). The example illustrates the impact of fluctuating stock values on diversification elections. Also, the ESOP is a calendar-year plan, and Paul attains age 55 and completes 10 years of participation during 2004. Paul elects to diversify to the full extent every year. The cost basis of post-1986 stock is \$8.00 per share.

First Election Year

	Cash (in dollars)	Pre-1987 Stock Account (in shares)	Post-1986 Stock Account (in shares)
Account Balance as of 12/31/04:	\$31.50	1,000.0000	1,550.0000
Diversification Election: 25% of the shares acquired after 1986			
Stock Price on 12/31/04:	\$10.00		

$$\begin{array}{r}
 1,550.0000 \text{ shares} \\
 \underline{\times .2500} \text{ (25\%)} \\
 387.5000 \text{ shares to diversify}
 \end{array}$$

Options Available (depending on plan procedures):

1. Paul elects to have \$3,875.00 (387.5 shares x \$10.00 per share) transferred to other investment options under the ESOP; or
2. Paul elects to have \$3,875.00 transferred to other investment options under another employer-sponsored plan; or
3. Paul receives a cash distribution of \$3,875.00; or
4. Paul receives a distribution of 387 shares along with a put option (if privately held) and \$5.00 in cash representing the value of the fractional share amount.

Second Election Year

	Cash (in dollars)	Pre-1987 Stock Account (in shares)	Post-1986 Stock Account (in shares)
Account Balance as of 12/31/04:	\$31.50	1,000.0000	1,550.0000
Fractional Share Sale for Cash	5.00	0.0000	<0.5000>
Diversified Amounts Distributed	<5.00>	0.0000	<387.0000>
2005 Contribution*	3,000.00	0.0000	0.0000
Cash Used to Make Loan Payments	<2,950.00>	N/A	N/A
Shares Allocated as a Result of Principal Loan Payments	N/A	0.0000	368.7500
12/31/05 Balance	\$81.50	1,000.0000	1,531.2500
Diversification Election: 25% of the shares acquired after 1986			
Stock Price on 12/31/05:	\$11.00		

1,531.2500	shares
+ 387.5000	plus 2004 shares diversified
<u>1,918.7500</u>	total shares eligible to diversify
x .2500	(25%)
<u>479.6875</u>	shares to diversify
<387.5000>	shares already diversified
<u>92.1875</u>	additional shares to diversify

Options Available (depending on plan procedures):

1. Paul elects to have \$1,014.06 (92.1875 shares x \$11.00 per share) transferred to other investment options under the ESOP; or
2. Paul elects to have \$1,014.06 transferred to other investment options under another employer-sponsored plan; or
3. Paul receives a cash distribution of \$1,014.06; or
4. Paul receives a distribution of 92 shares along with a put option (if privately held) and \$2.06 in cash representing the value of the fractional share amount.

*Contribution amount shown here excludes interest payments on the ESOP loan.

Third Election Year

	Cash (in dollars)	Pre-1987 Stock Account (in shares)	Post-1986 Stock Account (in shares)
Account Balance as of 12/31/05:	\$81.50	1,000.0000	1,531.2500
Fractional Share Sale for Cash	2.06	0.0000	<0.1875>
Diversified Amounts Distributed	<2.06>	0.0000	<92.0000>
2006 Contribution*	3,500.00	0.0000	0.0000
Cash Used to Make Loan Payments	<3,420.00>	N/A	N/A
Shares Allocated as a Result of Principal Loan Payments	N/A	0.0000	427.5000
12/31/06 Balance	\$161.50	1,000.0000	1,866.5625
Diversification Election:	25% of the shares acquired after 1986		
Stock Price on 12/31/06:	\$13.00		

1,866.5625	shares
+ 479.6875	plus 2004 and 2005 shares diversified
2,346.2500	total shares eligible to diversify
x .2500	(25%)
586.5625	shares to diversify
<479.6875>	shares already diversified
106.8750	additional shares to diversify

Options Available (depending on plan procedures):

1. Paul elects to have \$1,389.38 (106.8750 shares x \$13.00 per share) transferred to other investment options under the ESOP; or
2. Paul elects to have \$1,389.38 transferred to other investment options under another employer-sponsored plan; or
3. Paul receives a cash distribution of \$1,389.38; or
4. Paul receives a distribution of 106 shares along with a put option (if privately held) and \$11.38 in cash representing the value of the fractional share amount.

*Contribution amount shown here excludes interest payments on the ESOP loan.

Fourth Election Year

	Cash (in dollars)	Pre-1987 Stock Account (in shares)	Post-1986 Stock Account (in shares)
Account Balance as of 12/31/06:	\$161.50	1,000.0000	1,866.5625
Fractional Share Sale for Cash	11.38	0.0000	<0.8750>
Diversified Amounts Distributed	<11.38>	0.0000	<106.0000>
2007 Contribution*	3,540.50	0.0000	0.0000
Cash Used to Make Loan Payments	<3,430.50>	N/A	N/A
Shares Allocated as a Result of Principal Loan Payments	N/A	0.0000	428.8125
12/31/07 Balance	\$271.50	1,000.0000	2,188.5000
Diversification Election:	25% of the shares acquired after 1986		
Stock Price on 12/31/07:	\$11.00		

2,188.5000	shares
+ 586.5625	plus 2004, 2005 and 2006 shares diversified
<u>2,775.0625</u>	total shares eligible to diversify
x .2500	(25%)
<u>693.7656</u>	shares to diversify
<586.5625>	shares already diversified
<u>107.2031</u>	additional shares to diversify

Options Available (depending on plan procedures):

1. Paul elects to have \$1,179.23 (107.2031 shares x \$11.00 per share) transferred to other investment options under the ESOP; or
2. Paul elects to have \$1,179.23 transferred to other investment options under another employer-sponsored plan; or
3. Paul receives a cash distribution of \$1,179.23; or
4. Paul receives a distribution of 107 shares along with a put option (if privately held) and \$2.23 in cash representing the value of the fractional share amount.

*Contribution amount shown here excludes interest payments on the ESOP loan.

Fifth Election Year

	Cash (in dollars)	Pre-1987 Stock Account (in shares)	Post-1986 Stock Account (in shares)
Account Balance as of 12/31/07:	\$271.50	1,000.0000	2,188.5000
Fractional Share Sale for Cash	2.23	0.0000	<0.2031>
Diversified Amounts Distributed	<2.23>	0.0000	<107.0000>
2008 Contribution*	3,500.00	0.0000	0.0000
Cash Used to Make Loan Payments	<3,482.00>	N/A	N/A
Shares Allocated as a Result of Principal Loan Payments	N/A	0.0000	435.2500
12/31/08 Balance	\$289.50	1,000.0000	2,516.5469
Diversification Election: 25% of the shares acquired after 1986			
Stock Price on 12/31/08:	\$9.00		

2,516.5469	shares
+ 693.7656	plus 2004, 2005, 2006, and 2007 shares diversified
<u>3,210.3125</u>	total shares eligible to diversify
x .2500	(25%)
<u>802.5781</u>	shares to diversify
<693.7656>	shares already diversified
<u>108.8125</u>	additional shares to diversify

Options Available (depending on plan procedures):

1. Paul elects to have \$979.31 (108.8125 shares x \$9.00 per share) transferred to other investment options under the ESOP; or
2. Paul elects to have \$979.31 transferred to other investment options under another employer-sponsored plan; or
3. Paul receives a cash distribution of \$979.31; or
4. Paul receives a distribution of 108 shares along with a put option (if privately held) and \$7.31 in cash representing the value of the fractional share amount.

*Contribution amount shown here excludes interest payments on the ESOP loan.

Sixth Election Year

	Cash (in dollars)	Pre-1987 Stock Account (in shares)	Post-1986 Stock Account (in shares)
Account Balance as of 12/31/08:	\$289.50	1,000.0000	2,516.5469
Fractional Share Sale for Cash	7.31	0.0000	<0.8125>
Diversified Amounts Distributed	<7.31>	0.0000	<108.0000>
2009 Contribution*	3,750.00	0.0000	0.0000
Cash Used to Make Loan Payments	<3,735.00>	N/A	N/A
Shares Allocated as a Result of Principal Loan Payments	N/A	0.0000	466.8750
12/31/09 Balance	\$304.50	1,000.0000	2,874.6094
Diversification Election:	50% of the shares acquired after 1986		
Stock Price on 12/31/09:	\$12.00		

2,874.6094	shares
+ 802.5781	plus 2004, 2005, 2006, 2007, and 2008 shares diversified
<u>3,677.1875</u>	total shares eligible to diversify
x .5000	(50%)
<u>1,838.5938</u>	shares to diversify
<802.5781>	shares already diversified
<u>1,036.0157</u>	additional shares to diversify

Options Available (depending on plan procedures):

1. Paul elects to have \$12,432.19 (1,036.0157 shares x \$12.00 per share) transferred to other investment options under the ESOP; or
2. Paul elects to have \$12,432.19 transferred to other investment options under another employer-sponsored plan; or
3. Paul receives a cash distribution of \$12,432.19; or
4. Paul receives a distribution of 1,036 shares along with a put option (if privately held) and \$0.19 in cash representing the value of the fractional share amount.

*Contribution amount shown here excludes interest payments on the ESOP loan.

Other Issues

Administrative Issues

The employer's recordkeeping system must be able to distinguish between stock acquired before January 1, 1987, and after December 31, 1986. This can be quite complex. A plan cannot avoid this requirement simply by extending diversification to all stock because excess diversification is not treated exactly like amounts required to be subject to diversification (i.e., the right to subsequently demand employer securities). If a plan does not track pre-1987 and post-1986 stock separately, it is presumed that a participant's account consists first of employer securities acquired by or contributed to the plan after December 31, 1986, and second of employer securities acquired or contributed before January 1, 1987.

As described below, the 90-day requirement and 180-day requirement may need to be extended if the current stock appraisal is not available or if allocations or contributions are not determined. The procedures listed below reflect a two-step approach to first allow participants to make an election within the required 90-day period, thus complying with the requirements, and second to allow participants to change or revoke their elections once the appraisal is completed. At this point, given the lack of formal guidance, this is believed to be an attempt at good-faith compliance.

Document Issues

If your ESOP plan document does not address which one or more of the four options will be used to satisfy the diversification requirements, a plan amendment will be needed. The amendment must be adopted no later than during the first year in which the ESOP becomes subject to diversification.

Communication Issues

There are several communication issues involved with diversification. These issues can best be explained by the following questions and answers. The first set of questions is from a plan participant's perspective. The second set is from a plan sponsor's perspective.

Participant Questions

What is diversification? Diversification means to spread the ESOP account balance among different investments so as to minimize your potential loss. By diversifying into a range of investments, should one investment's value decrease, the other will be somewhat independent and may or may not decrease in value. However, the opposite is also true. If one investment increases in value, the others may or may not increase. In short, diversification allows you to avoid "having all your eggs in one basket."

When can I diversify? You are eligible to diversify after the end of the plan year in which you turn age 55 and complete 10 years of participation. You will then be offered an option to diversify up to 25% of eligible shares as of that plan year-end. You can make your election anytime after the end of the plan year, up to 90 days following the plan year-end. For example, let us assume you are a participant in a plan with a year-end of December 31 and you become eligible to diversify (attain age 55 and complete your 10th year of participation) during the plan year 2004. You will be entitled to make an election to diversify up to 25% of your eligible shares anytime from January 1, 2005, to March 31, 2005. In addition, you will have the opportunity to diversify every year for the next four years (2006, 2007, 2008, and 2009). Then, in 2010, you will be eligible for your final diversification election of up to 50% of your eligible shares.

How much can I diversify? As described in the preceding question and answer, you can diversify up to 25% (50% in the final diversification election year) of the shares of company stock allocated to the ESOP account that are considered eligible for diversification. Shares are eligible for diversification if the plan purchased or received those shares after December 31, 1986. The plan sponsor will notify you of the amount of eligible shares.

Can I change my election? Can I un-diversify? You can change or revoke your current election provided you do so before the 90-day period expires. To change or revoke a previous election, you should notify the

plan administrator. You can only change the current year's election. Thus, you cannot elect to diversify in Year One and then elect to un-diversify in year two. Once the shares of company stock are diversified, you cannot make an election to regain them.

An exception to the above 90-day requirement exists when the current stock valuation is not completed within the initial 90-day period. When this is the case, you will be given a preliminary election form to be completed within the required 90-day period. After the new stock value is available, you will be given a final election form to be completed. This final election is the one that will be executed by the plan administrator.

Does it matter when I complete my election form within the 90-day period? Does the stock value change, thus changing my account balance, or the amount I will be able to diversify? No. It does not matter when within the 90-day period you complete the election. For stock that is not publicly traded, the stock price that will be used to effect your diversification election will be the price as of the last day of the plan year. The stock price does not fluctuate during the 90-day period. The price is the same one day after the end of the plan year through the end of the next plan year.

What will I receive if I choose to diversify? This will depend on plan procedures. The options available are to receive cash, receive shares of stock via a stock certificate, or receive nothing at this time if diversified amounts are transferred to another plan or transferred within the ESOP. You should contact your plan administrator for more details on what you will receive.

When will I receive the diversified amounts if the plan distributes cash or stock? Again, this will depend on plan procedures. However, you should receive diversified amounts no later than 180 days after the plan year-end. An exception to this 180-day rule is if the stock valuation is not completed within that 180-day period. In this situation, you will receive the diversified amount within a reasonable time after the stock value is available.

What are the disadvantages of diversifying? The following are disadvantages if you elect to diversify and a distribution will be made in either cash or stock:

- The distribution will be considered taxable income during the calendar year in which it is paid to you.
- If you have not yet attained age 59½, an additional 10% early distribution tax will be imposed by the IRS.
- The account balance in the plan will be reduced, thus lowering the amount you will be entitled to receive at retirement.

The above disadvantages do not exist if the amounts are transferred to another plan of the employer or if they are transferred within the ESOP. Also, the diversified amounts will not be considered taxable income and the 10% penalty tax will not apply if the amount is rolled over into an IRA.

Should I diversify? This must be answered by you, the participant. However, the factors to consider are those relating to the past history of the company stock value. Is it on the rise, or is it declining? What does the future look like for the company and the industry as a whole? Are the previously mentioned disadvantages outweighed by the advantage of being diversified, assuming less risk, and not having all your eggs in one basket? You should consult your tax advisor and/or investment manager for further advice.

Plan Sponsor Questions

Who is responsible for communicating diversification issues to participants? The plan sponsor is the party responsible for notifying participants of their eligibility for diversification, their diversification options, and so forth.

When should I notify participants that they are eligible for diversification? Besides notifying participants of their right to diversify within 90 days of the plan year-end for each year that they are an eligible par-

ticipant, there are no legal requirements for notifying participants of their status as an eligible participant. However, for participants to make an informed decision, you may want to notify participants at least one year before they become eligible participants. They should be given information regarding what diversification is, how many election periods they will have, taxation, and penalty taxes. This one-year period should give participants ample time to consider their alternatives, consult their tax advisor, and make an informed decision.

How should I notify participants? Again, there are no legal requirements regarding how to notify participants of their eligibility for diversification. However, a letter to eligible participants or an employee meeting would be advantageous. Both approaches allow the plan sponsor to provide participants with necessary information regarding diversification. A meeting would allow participants to ask questions and may save the plan sponsor from answering the same questions several times.

When should I give eligible participants the diversification election forms? You must give eligible participants a preliminary election form within 90 days of the plan year-end. If the year-end allocation and stock appraisal are completed within 90 days of the plan year-end, you can give them a final election form instead. If a preliminary election form is necessary, a final election form should be given to eligible participants as soon as possible after the allocation and appraisal are completed.

When must participants return their completed forms? If a preliminary election form is necessary, participants should return their completed election forms within 90 days of the plan year-end, and final election forms should be returned as soon as possible after the final allocation and appraisal are completed, but no later than 180 days after the plan year-end. You should encourage participants to return their election forms promptly to allow you ample time to complete their diversification requests within 180 days of the plan year-end.

If a preliminary election form is not needed, the final election form must be returned within 90 days of the plan year-end.

What if a participant does not return his or her completed election form? Every effort should be made to have all eligible participants return a completed election form. This will prevent an employee from claiming he or she never received an election form and will provide you with proof that you complied with the participant's election. If a participant still refuses to return a completed form, he or she has not elected to diversify for that year, and no further action is required by you until next year when the participant may be eligible to elect to diversify again.

How do I execute the participants' diversification elections? This depends on the diversification options offered by the plan and the option chosen by the participant.

Forms and Procedures

The following section contains samples of a preliminary diversification election form and a final diversification election form, followed by a diversification procedures timetable.

PRELIMINARY

SAMPLE

**ABC Company Employee Stock Ownership Plan
2004 Diversification Election for John Doe**

You attained the age of 55 and have been a participant of the ESOP for 10 years. You now have the right to diversify a portion of the employer securities held in this ESOP account. You are eligible to receive as a distribution 25% of the shares of stock allocated to the account that were acquired by the ESOP after December 31, 1986.

Because the allocation report and/or stock appraisal has not been completed at this time, the amounts shown below are based on last year's account balance and/or stock price. You will be given a final diversification election form when the allocation/stock appraisal is completed. You may change your preliminary diversification election at that time. Our calculations show that you can elect to receive the value of the following number of shares:

$$206.3962^* \text{ shares of company stock} \times \$19.68^*/\text{share} = \$4,061.88$$

You may elect to receive all or part of the above available value. However, if the post-1986 stock account value is less than \$500, no diversification will be allowed. Please complete the bottom of this form, sign it, and return the entire form to the plan administrator as soon as possible.

You will be offered an annual *cumulative* opportunity to diversify 25% of the stock acquired after December 31, 1986, next year also, with an opportunity to diversify 50% of the stock in your final election year (2009).

If you have any questions concerning this diversification option, please contact the plan administrator.

Historical Market Value

Date	Value per Share
12/31/96	\$5.12
12/31/97	\$7.35
12/31/98	\$9.56
12/31/99	\$11.79
12/31/00	\$13.41
12/31/01	\$15.63
12/31/02	\$17.24
12/31/03	\$19.68

ELECTION (PLEASE CHECK ONE)

- I do not wish to diversify any of the company stock in the account.
- I wish to diversify the company stock in the account (value up to 25% of the ESOP stock).

I understand that I will be given a final diversification election based on the current stock balance and the current stock price when that information is available.

Signature: _____ Date: _____

Address: _____

Social Security Number: _____ Phone Number: _____

*Figures given are as of December 31, 2003.

FINAL

SAMPLE

**ABC Company Employee Stock Ownership Plan
2004 Diversification Election for John Doe**

You attained the age of 55 and have been a participant of the ESOP for 10 years. You now have the right to diversify a portion of the employer securities held in this ESOP account. You are eligible to receive as a distribution 25% of the shares of stock allocated to the account that were acquired by the ESOP after December 31, 1986.

You may have previously completed a preliminary diversification election form based on last year's account balance and/or stock price. The account balance and stock price shown below are current. Our calculations show that you can elect to receive the value of the following number of shares:

$$257.6429 \text{ shares of company stock} \times \$21.33/\text{share} = \$5,495.52$$

You may elect to receive all or part of the above available value. Please complete the bottom of this form, sign it, and return the entire form to the plan administrator as soon as possible.

You will be offered an annual *cumulative* opportunity to diversify 25% of the stock acquired after December 31, 1986, next year also, with an opportunity to diversify 50% of the stock in your final election year (2004).

If you have any questions concerning this diversification option, please contact the plan administrator.

Historical Market Value

Date	Value per Share
12/31/96	\$5.12
12/31/97	\$7.35
12/31/98	\$9.56
12/31/99	\$11.79
12/31/00	\$13.41
12/31/01	\$15.63
12/31/02	\$17.24
12/31/03	\$19.68
12/31/04	\$21.33

ELECTION (PLEASE CHECK ONE)

- () I do not wish to diversify any of the company stock in the account.
- () I wish to receive \$_____ (value up to \$5,495.52 of the ESOP stock). *If you choose this option, you must complete a Request for Benefits form and return it to the plan administrator so the distribution can be processed.*

Signature: _____ Date: _____

Address: _____

Social Security Number: _____ Phone Number: _____

Diversification Procedures Timetable

Description	Due
Begin discussions regarding alternatives to comply and requirements.	Two years before plan is subject to diversification.
Review plan document as it relates to diversification.	One year before plan is subject to diversification.
Send preliminary diversification election forms to participants eligible to diversify. If final allocation report and stock valuation are completed, send final forms instead.	Within 90 days after the plan year-end.
Send final diversification election forms to participants eligible to diversify.	As soon as possible after allocation and stock appraisal are completed.
Complete diversification for those choosing to diversify.	Within 180 days after the plan year-end (provided final allocation and stock appraisal are completed by that date.)