

ESOPS - VIVE LA DIFFERÈNCE!

Indiana Benefits Conference

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Van Olson

Van Olson Law Firm, LLC

Overview

- Part I – ESOP Basics for Administration
- Part II – Common Areas of ESOP Administration Errors
 - The ESOP Difference

Part I

ESOP Basics for Administration

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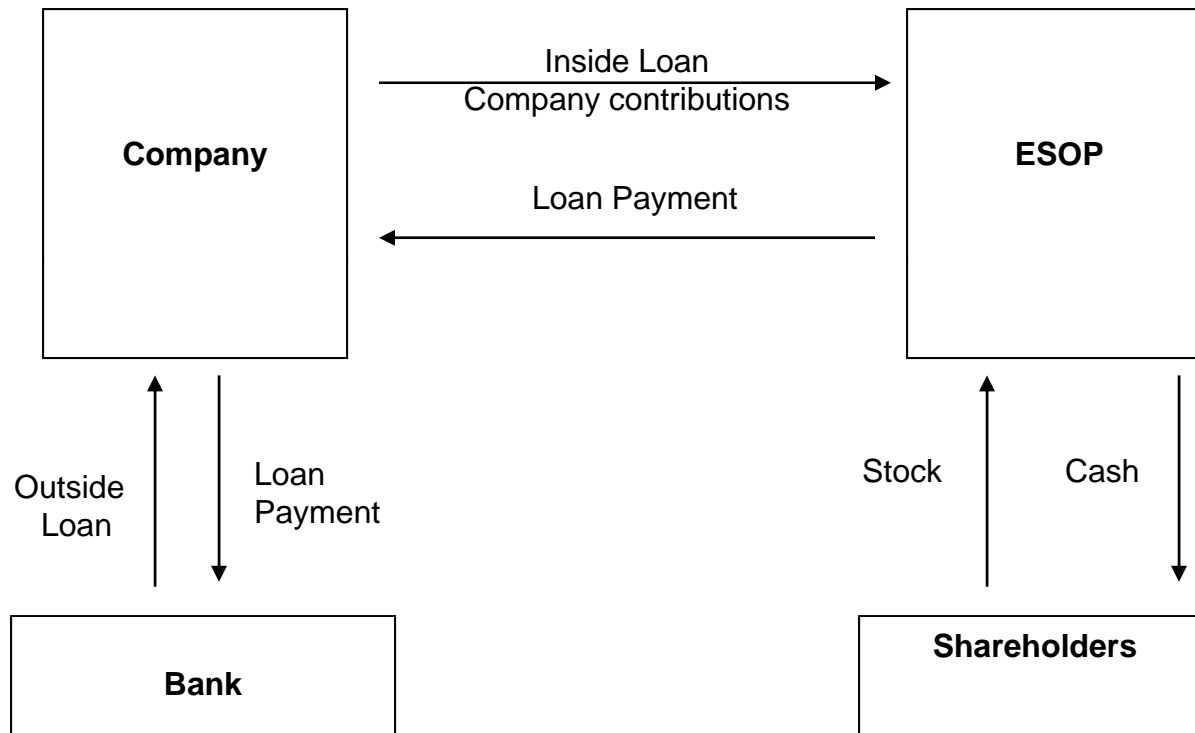
Focused on Employee Stock Ownership Plans

What is an ESOP?

- An ESOP is a tax-qualified retirement plan under section 401(a) of the Internal Revenue Code (**IRC**).
- An ESOP is a defined contribution, individual account plan, which is a stock bonus or stock bonus and money purchase plan.
 - Designed to invest primarily in the shares of the company sponsoring the ESOP, with
 - Individual accounts for each participating employee to share in the ownership of the company.

See IRC §4975(e)(7) and Treas. Reg. §§54.4975-7 and -11.

The Basic ESOP Structure



The Basic ESOP Structure

- The company sets up the ESOP.
- The company then borrows money from the Bank - the outside loan - then lends that money to the ESOP.
- The Loan proceeds borrowed by the ESOP from the company - the inside loan - are then used by the ESOP to purchase the company shares from the owners.
 - The company shares purchased by the ESOP are held as collateral for the company's inside loan to the ESOP.

The Collateral Suspense Account

- Shares acquired by the ESOP with a loan – the “inside” loan, are placed in a collateral “suspense” account within the ESOP trust.
- The shares are then released from serving as collateral, and released from the collateral suspense account, as the ESOP pays down the inside loan each year.
- The shares released from collateral each year are then allocated to eligible participants for that year.

The “Plan” Documents Rule

- The Federal pension laws, commonly known as “ERISA”- the Employee Retirement Income Security Act- require:
 - Written plan and trust documents, and a plan administrator, a plan trustee and plan fiduciaries... ERISA §§ 402 and 403.
- Basic Plan Administration Rule: Follow the plan document terms.
- Corollary Rule: If you have an administration question, the first place to look for an answer is the plan document.

The “Plan” Documents Rule

- Failure to follow the plan document terms is a breach of fiduciary duty:

“ A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries...In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of...[ERISA].” ERISA § 404(a)(1)(D).

The “Plan” Documents Rule

- For ESOP administration, the Plan documents include:
- Plan and Trust Documents, *plus*
- Documents for the Basic ESOP Structure and ESOP Transaction
 - Stock Purchase Agreement
 - Loan Agreement
 - Promissory Note
 - Stock Pledge Agreement

Part II

Common Areas of ESOP Administration Errors - The ESOP Difference

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Release of Shares from Collateral

- The “suspense” Collateral Account is unique to ESOPs and a common area for errors.
- Shares must be released from the Collateral Account as the ESOP loan is paid down.

See Treas. Reg. §54.4975-7, and DoL Reg. §2550.408b-3

- The method of release is typically addressed in both the ESOP plan and the ESOP deal documents – typically in the ESOP Loan and Stock Pledge Agreements.
 - Hopefully these documents are consistent, but be sure to establish this.

Release of Shares from Collateral

- Stock must be released from the collateral suspense account each year as the ESOP “inside” loan is paid down:

General rule – release is based a fraction, where:

numerator = current year principal + interest

denominator = numerator + (future principal + interest)

Special rule - release is based on a fraction, where:

numerator = current year principal

denominator = numerator + future principal

Note: Regulations generally limit this to a 10 year loan.

Release of Shares from Collateral

- The release calculation is a common area of ESOP administration error, including such errors as:
- The fraction that applies for the current year release, whether under the general or special rule, is not correctly calculated.
 - Basic math errors occur.
 - Errors in calculating the interest for the year.
 - Confusion on how much was paid on the loan.
 - Confusion on what the employer paid to the ESOP which the ESOP then paid on the inside loan.

Release of Shares from Collateral

- How is the “interest” calculated – variable, daily, a 360 or 365 day year or fixed with no days’ calculation? The ESOP Promissory Note should typically spell this out.
- How are prepayments handled – applied to interest first, principal, other? Plan document and/or ESOP loan documents should spell this out.
- Employer contribution confusion:
 - Are the dollars paid into the ESOP during the year employer contributions or a distribution of “dividend” earnings with respect to the ESOP shares?
 - Are the dollars reported as paid that year the dollars paid on the inside loan or the outside loan?

Allocating Released Collateral Shares

- Shares released from the collateral suspense account for a year generally are allocated on the same basis as employer contributions to a qualified profit sharing plan – in proportion to the “plan compensation” of eligible participants.
- But there are some different rules for ESOP allocations under certain circumstances.
 - Special Code §415 allocation rules may apply.
 - Special Code §409(p) allocation rules may apply.
 - Special C corporation dividend rules may apply.
 - Special S corporation “dividend” rules may apply.

Allocating Released Collateral Shares

- C and S corporation “dividend” rules – allocating company distributions of earnings with respect to ESOP shares.
- Dividends paid on collateral account shares are typically used to pay down the ESOP’s inside loan – but that is not required.
 - Shares released from collateral due to dividends may be allocated as trust earnings in proportion to account balances, but sometimes are allocated on the same basis as employer contributions (pro rata plan compensation).
- The plan documents should detail this.
- More on C corporation dividends below under ESOP Deduction Rules.

Allocating Released Collateral Shares

- For C and S corporation dividends:
 - Dividends paid on shares allocated to participant accounts may be used to help pay down the ESOP's inside loan – but only if:
 - The shares released from collateral and allocated to the participant's account are at least equal to the dividend paid. For example: If the dividend was \$100 on the participant's account shares, then additional shares worth at least \$100 must be allocated to the participant's account.

See IRC §404(k)(5) and 4975(f).

IRC §1042 Prohibited Allocations

- Code §1042 allows a shareholder selling shares to an ESOP to defer and potentially not pay any capital gains tax on the sale proceeds, subject to a number of rules, including:
- Cannot allocate any such shares to the accounts of such shareholder and his/her spouse, siblings, lineal ascendants and descendants, any 25% shareholder and any other shareholder involved in the transaction, except –
 - lineal descendants of §1042 seller may receive aggregate maximum of 5% of seller's shares. See Code §409(n).
- Code §4979A imposes a 50% tax penalty on the employer if the 1042 prohibited allocation occurs.

Special ESOP Vesting Rules

- The faster Pension Protection Act of 2006 vesting schedules are delayed for an ESOP with an ESOP loan in place on September 25, 2005.
- The PPA'06 vesting schedule is delayed until the earlier of:
 - the first Plan Year beginning after the Plan Year in which the Exempt Loan is fully repaid; or
 - the first Plan Year starting after the date when the Exempt Loan was initially scheduled to be fully repaid
 - This prevents modifying the loan to delay vesting schedule; but, discourages prepayment of loan.

See PPA'06 §904(c)(4).

Special ESOP Vesting Rules

- Watch out: New ESOPs typically (but not always) give no credit for years of service before the ESOP is established
 - Prior years of service required if an employer plan terminated within 5 years. IRC §411(a)(4)(C).
- Employer securities purchased with an ESOP loan must be forfeited only after other assets in the terminated participant's account.; and
 - If the participant has been allocated more than one class of stock, forfeitures must be in proportion to each such class.

See Treas. Reg. § 54.4975-11(d)(4).

ESOP Benefit Distribution Rules

- Error of omission: The “tax basis” for employer shares must be determined for C and S corporation ESOPs.
- Employer shares distributed as a plan benefit are eligible for special tax treatment, where the basis is taxed at distribution as ordinary income but the “NUA” - net unrealized appreciation - is taxed at capital gain rates and not until later sale. See IRC §402(e)(4).
- For an S corporation ESOP, the basis must be adjusted for employer pass-through earnings. See IRS Rev. Rul. 2003-27.

ESOP Benefit Distribution Rules

- The IRC §409(o) distribution rules are another common area of administration errors.
- For stock acquired after 1986, unless the participant elects a later start date, benefit payments must start not later than 1 year after the close of the plan year
 - in which the participant terminates on or after the plan's normal retirement age or due to disability or death, or
 - the 5th plan year after the year in which the participant otherwise terminates.

ESOP Benefit Distribution Rules

- Stock acquired with an unpaid ESOP loan may be delayed until such loan is repaid in full, with certain critical exceptions.
 - Many (most?) ESOPs provide additional exceptions.
See IRC §§409(o) and 401(a)(9) or (14).
- Benefits, once payable, must be made in at least annual installments over a period not to exceed 5 years, except
 - accounts over \$985,000 for (2010/2011) may be extended.
See IRC §§409(o)(1)(C).

ESOP Benefit Distribution Rules

- C Corporation ESOPs may require and must offer employer stock as the benefit distribution (with certain exceptions such as where ownership is limited to employees).
- If shares are distributed as the benefit form, the Participant must have right to "put" stock (sell to employer and receive cash) within the 60 day periods after the date of distribution and during the following plan year.
- For partial distributions, the employer has 30 days to make payment on the "put" to the company.

See IRC §409(h).

ESOP Benefit Distribution Rules

- For a total distribution of shares, employer can pay in substantially equal installments at least annually over a period not to exceed 5 years, beginning 30 days after exercise of put.
 - The participant receives an employer promissory note for the balance, the note must provide for a reasonable rate of interest, and the employer must provide adequate security for the note. See IRC §409(h)(5) and (6).
- The ESOP can be designed to allow the put to the ESOP but cannot require the ESOP to buy back the shares. Treas. Reg. §54.4975-7(b)(10).
- S Corporation ESOPs are not required, but may, offer or require employer stock as the benefit distribution and the same put option rules apply. See IRC §409(h)(5) (2).

ESOP Benefit Distribution Rules

- ESOPs sponsored by a company with no publicly traded shares must offer investment diversification for “Qualified Participants.”

See IRC §401(a)(28) and IRS Notice 88-56.

See also the series of 5 technical advice memorandums from December 2009 to October 2010, the IRS National Office advised the Cincinnati District Office on certain ESOP determination letter issues for ESOPs (“**D. L. TAMs**”), which can be found on the IRS website.

ESOP Benefit Distribution Rules

- A Qualified Participant is an ESOP participant who has attained at least age 55 and completed at least 10 years of participation. See IRC §401(a)(28)(B)(iii) and D. L. TAMs.
- The Qualified Participant, over a 6-year period, may elect –
 - 25% of the number of shares for first five years of eligibility period, and
 - 50% of the number of shares in the sixth year of the eligibility period.
- Prior diversification amounts reduce the amount eligible in the current year.

ESOP Benefit Distribution Rules

- The eligible diversification amount can be distributed out of the ESOP in cash or in stock, the ESOP itself can include diversified investment options (offering at least 3 diverse investment options), or transfer such amount to another employer plan such as a §401(k) plan with participant directed investments.
- Another issue is determining who is a Qualified Participant.
 - What constitutes 10 years of participation?
 - Does this apply to terminated participants who are no longer employees?

See IRS' D. L. TAMs referenced above.

ESOP Benefit Distribution Rules

- These diversification requirements are a common area of administration error, including –
 - not implementing the option when first applicable to the ESOP,
 - Failing to determine who are Qualified Participants,
 - not providing proper and timely notice for election, and
 - determining the incorrect number of shares eligible for the diversification election.

ESOP Annual Addition Rules

- General IRC §415(c) rules apply to both C and S corporation ESOPs: The Annual Addition cannot exceed lesser of –
 - 100% of §415 compensation, or
 - \$49,000 for 2010/2011.
- The “Annual Addition” includes employer contributions (whether used to pay principal or interest on the ESOP loan), employee contributions and forfeitures.

See IRC §415(c)(2) and Treas. Reg. §1.415-1(f)(2)(i).

ESOP Annual Addition Rules

- Generally, for S or C corporation leveraged ESOPs, the Annual Addition can be determined with respect to shares released from collateral, on the lesser of:
 - the fair market value of the shares allocated to participant accounts, or
 - the employer contributions that resulted in those shares' release from collateral.
- What does the ESOP plan document provide?
See, Treas. Reg. §1.415-1(f)(2)(ii), IRS Audit Manual for ESOPs, and PLR 9625045.

ESOP Annual Addition Rules

- IRC §415(c)(6) includes the special “1/3 Rule” for C Corporation leveraged ESOPs that applies if the HCE-participants in the ESOP for a limitation year do not receive more than 1/3 of the allocation of the employer contribution applied to principal and interest on the ESOP loan for the year.
- If the ESOP passes the 1/3 Rule for a limitation year, then:
 - Interest payments are disregarded in determining the Annual Addition for that year, and
 - Forfeitures of employer stock acquired with the exempt loan are disregarded for that year.

See also, Treas. Reg. §1.415-1(f)(3).

- Does the plan document provide for special allocation rules here?

ESOP Deduction Rules

- For both S and C corporation ESOPs, the IRC §404 General Deduction Limit is 25% of covered compensation – generally the compensation of the plan participants.
- For leveraged C corporation ESOPs:
 - Contributions used to pay the ESOP loan principal is limited to 25% of covered compensation, and
 - There is a separate full deduction for employer contributions used to pay interest on the ESOP loan. IRC §404(a)(9)
- The deduction limit cannot exceed the IRC §415 limit. See IRC §404(j).

ESOP Deduction Rules

- Potential errors here:
 - the annual contribution required to satisfy ESOP loan payments for the year exceeds the 404 deduction limit, resulting in a 10% penalty tax, even if its an S corporation ESOP. See IRC §4972.
 - What are S corporation employer contributions vs. “dividend” distributions,
 - What is determinative for the §4972 penalty?
 - How allocated?

ESOP Deduction Rules

- Another administration issue: Dividends paid on ESOP shares are deductible under IRC §404(k) by a C Corporation if:
 - Paid in cash directly to participants and beneficiaries,
 - Used to make payments on an ESOP loan used to acquire the employer securities,
 - Paid to the ESOP and distributed in cash to participants and beneficiaries within 90 days after the close of the plan year in which paid, or
 - Paid in cash or to the participant or ESOP with the election of the participant to have such amounts reinvested in employer stock under the ESOP.

ESOP Deduction Rules

- Another potential issue? S corporation deduction is limited to 25% of covered compensation.
 - However, there appears to be no limit on S corporation “dividend” distributions of earnings with respect to ESOP shares.
- Caution: The IRS has the authority to re-characterize “abusive” dividends as annual additions. *See* Treas. Reg. §1.415(c)-1(b)(4); and, Steel Balls, Inc. vs. Com’r, TCM 1995-266, 19 EBC 1583, aff’d 89F.3d 841 (8th Cir. 1996).
 - If re-characterized as employer contributions, this would also impact the 404 deduction limits.

IRC §409(p) Prohibited Allocations

- IRC § 409(p) applies only to S corporation ESOPs.
- A 409(p) prohibited allocation occurs if “Disqualified Persons” (DQPs) own 50% or more of the ESOP company, with ownership tested on the basis of direct ownership and deemed ownership → 409(p)’s “Deemed Owned Shares”.
- DQPs include individuals who own or are deemed to own 10% or more of all “Deemed Owned Shares” or are part of a “Family” that owns or is deemed to own 20% or more of all Deemed Owned Shares.
 - Family is broadly defined under 409(p) and the IRS’s 409(p) regulations.

IRC §409(p) Prohibited Allocations

- Deemed Owned Shares include –
 - Allocated ESOP shares, plus
 - A pro rata portion of the unallocated collateral suspense account shares based on current year allocation percentages, plus
 - “Synthetic Equity” which generally includes most forms of non-qualified deferred compensation.
See Treas. Reg. §1.409(p)-1 *et. seq.*

IRC §409(p) Prohibited Allocations

- Violation of the 409(p) results in significant penalties in the 1st year of the prohibited allocation –
 - a 50% tax payable by the S Corporation on the FMV of all Deemed Owned Shares and Synthetic Equity attributable to DQPs. See IRC §4979A(a) and (e).
 - Treating all Deemed Owned Shares as a taxable distribution to the DQPs. See, IRC §409(p)(2).
- If the company survives the above penalties, there are additional 50% penalty taxes on any further prohibited allocations. See, IRC §4979A(a) .

IRC §409(p) Prohibited Allocations

- For preventing 409(p) prohibited allocations, see:
 - Final 409(p) regulations and the preamble to those regulations. See Treas. Reg. 1.409(p)-1 et seq. issued December 20, 2006.
 - See the D. L. TAMs referenced above, particularly the memos issued December 9, 2009, January 5, 2010, and October 2010.
- **For those performing 409(p) Tests** → "The day before me is fraught with God knows what horrors."
A Confederacy of Dunces, John Kennedy Toole.

IRC §409(p) Prohibited Allocations

- Just some of the critical error areas of 409(p):
 - The complexity of the 409(p) rules, aggravated in no small part by the complexity of the IRS regulations, just begs for errors.
 - Establishing “Family” members often is difficult.
 - Establishing who has what Synthetic Equity in the S corporation can prove very difficult.
 - Establishing the value of Synthetic Equity.
 - Plan design issues can promote 409(p) failures, e.g., stock distributions from the ESOP with company redemptions.

ERISA Fiduciary Bond for ESOPs

- ERISA Requires all retirement plans including ESOPs to have a bond protecting plan assets against fiduciary misdeeds
- Bond must be at least greater of \$1,000 or 10% of plan assets, but
- Need not be greater than \$500,000 except the cap for plans with employer securities including ESOPs is \$1,000,000.
- See ERISA §412(a) as amended by PPA'06.

Safe Harbor 401K Plans

- Safe-Harbor 401(k) Plans require “safe harbor” contributions which may be made to an ESOP – even if a separate plan.
- Administration issues arise with respect to:
 - How to determine the amount of “safe harbor” actually contributed : Is it dollars contributed or value of shares released from collateral and allocated?
- If 401(k) prohibits withdrawal of safe harbor accounts, how are the ESOP investment diversification rules satisfied for the Qualified Participants (the 55 + 10 years group)?
- What does the plan document say?

Rebalancing/Reshuffling Shares

- Rebalancing and reshuffling are terms of art in the ESOP industry and refer to different methods for the reallocation of already allocated shares under an ESOP.
- In the D. L. TAMs referenced above, the IRS analyzes and provides guidance on these ESOP administration terms and procedures.
 - Observation: The D. L. TAMs, although not binding, may well result in creating retroactive administration errors. Careful consideration of past and current reallocation practices is required here.

Questions

Van Olson – Van Olson Law Firm, LLC

Focused on ESOPs

Van Olson Law Firm, LLC

8500 Keystone Crossing, Suite 540

Indianapolis, IN 46240

(317) 202-0443

Van.Olson@vanolsonlaw.com

Van Olson Law Firm, LLC

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