

ESOP Vesting, Diversification
& Other Administrative Issues
Important in a Downturn
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Partial Plan Terminations

- Tough economic times mean –
 - Lay-offs, plant closings or similar reductions in force – RIFs.
 - RIFs may result in a “partial termination” under a tax-qualified retirement plan.
 - Full vesting is required for “affected participants” in a partial termination, regardless of years of service. Code Section 411(d)(3)

Partial Plan Terminations

- Partial terminations have a long and convoluted history of IRS rulings and court cases.
- In 2007, the IRS issued new guidance on partial terminations. Rev. Rul. 2007-43.
- Rev. Rul. 2007-43 is helpful, but does not answer important questions.
- *Rev. Rul. 2007-43 general rule:*

There is a rebuttable presumption that a partial termination has occurred if the “turnover rate” is at least 20% during the “applicable period” for testing.

Partial Plan Terminations

- Partial termination questions:
 - If the turnover rate is under 20%, is there a presumption no partial termination has occurred?
 - Can this presumption be rebutted?
 - See, Matz v. Household Int'l Plan, 388 F.2d 570 (7th Cir. 2004) (presumption exists); and, Halliburton v. Com'r, 100 T.C. 216 (1993) (egregious facts may rebut).

Partial Plan Terminations

- The partial termination “turnover rate” is determined as:
 - (i) the number of participants who had an *employer-initiated* severance during the applicable period;

divided by,
 - (i) the number of active participants at the start of the applicable period, *plus* new participants added during the applicable period.

Partial Plan Terminations

- For this turnover rate testing:
- The turnover rate is based on all active participants whether or not fully vested
- Employer-initiated severance includes severance other than on account of death, disability, or retirement on or after normal retirement age
- An employer may verify an employee's severance is not employer-initiated (e.g., through personnel files).
- *Question:* Are participants terminated "for cause" excluded from the numerator of this test?

Partial Plan Terminations

- The partial termination “applicable period” is:
- *General rule:* The plan year.
- For a short (less than 12-month) plan year, the period includes the short plan year and the preceding plan year.
- The applicable period may be longer if “there are a series of related severances.”
- *Question:* How much longer? Does this mean, for example, that a series of layoffs over a 3 or 4-year economic down-cycle that eventually reaches 20% results in a partial termination? Retroactive vesting back to the initial layoffs?

Partial Plan Terminations

- Other potential partial termination issues/questions:
- Who has to be fully vested? Rev. Rul. 2007-43 uses the term “affected participant” in a manner that could be read to include voluntary and for cause terminations during the applicable period.
- Is there an issue if the administrator incorrectly determines there is a partial termination; or, the company just decides to be the “Good Guys” and vest all terminating participants?
 - *Possible?* – If under the plan terms forfeitures are allocated to the remaining active participants, can they argue their benefit is wrongfully reduced? Is there a breach of fiduciary duty here? How to resolve?

Changing the ESOP's Distribution Options to Preserve Cash

- In hard economic times: **Cash is king!**
- The ability to preserve cash can mean the very survival of an ESOP company.
- The sooner the ESOP accounts are payable, the sooner the resulting cash demands on the company.
- Lump sum and/or early payout options often trigger faster (and perhaps bigger) repurchase obligations.
- *Possible solution:* Amend the ESOP to take out lump sum and early payout options.

Changing the ESOP's Distribution Options to Preserve Cash

- Potential Dilemma: The Code's "anti-cutback" rules.
- Code Section 411(d)(6) imposes the so-called anti-cutback limitations on all tax qualified retirement plans, including ESOPs.
- Code Section 411(d)(6) provides that a plan cannot be amended to
 - Decrease the accrued benefit of a participant; and
 - An amendment that eliminates an optional form of benefit or timing of a benefits is such a prohibited cutback

Changing the ESOP's Distribution Options to Preserve Cash

- Potential Solution: The Code's exception for ESOPs.
- Code Section 411(d)(6) also provides that an ESOP does not violate the anti-cutback rules "merely because it modifies distribution options in a nondiscriminatory manner."
- IRS regulations provide an ESOP sponsor may eliminate or retain the discretion to eliminate single sum or installment optional forms of benefits –
 - so long as such elimination is consistent with the Code Section 409(o) ESOP distribution requirements. Treas. Reg. §1.411(d)-4, Q&A 2(d)(1)(i),
- See *also*, Lee v. The Builder's Supply Co., Inc. Employee Stock Ownership Plan, 19 EBC 2318 (D. Neb. 1995), where the court held that an ESOP could be amended to both delay payments and eliminate the lump sum option, subject to the Code Section 409(o) requirements.

Changing the ESOP's Distribution Options to Preserve Cash

- Code Section 409(o)'s ESOP requirements – Generally:
 1. Distributions must start not later than 1 year after the close of the plan year (i) in which the participant terminated service by reason of attaining normal retirement age under the plan, disability, or death, or (ii) that is the 5th plan year following the plan year in which the participant otherwise terminates service;
 2. The distribution of any part of a participant's account balance that consists of employer securities acquired with the proceeds of an ESOP loan may be delayed until such loan is repaid in full; and
 3. Distributions must be made in periodic payments at least annually over a period not to exceed 5 years (excepts for certain large account balances).

Changing the ESOP's Distribution Options to Preserve Cash

- Conclusion:
- There appears to be a sound legal basis for amending an ESOP to reduce the immediate cash demands on the company,
- *Caution, however, is necessary.*
 - ESOP companies should carefully consider with their advisors the scope, timing and application of the amendment, and the plan's procedures required for amendment.
 - Further, careful consideration should be given to both required and advisable notices to and communications with your ESOP participants.

Basics of Eligibility and Government Limits

- Age/Service Requirements
- Age – Plan cannot impose an age requirement greater than 21
- Service – Plan cannot impose a service requirement greater than 1 Year of Service*
 - * exception, a Plan that is not a 401(k) can impose a 2 Years of Service requirement, provided there is full and immediate vesting

Basics of Eligibility and Government Limits

- What is a Year of Service
- 12 month computation period during which employee has 1,000 hours of service
- Plan year during which employee has 1,000 hours of service
- Elapsed time
- Plan document should include definition

Basics of Eligibility and Government Limits

- Entry Date into the Plan
- Date of Satisfaction of Eligibility Requirements
- 1st of Month following
- 1st of Quarter following
- 1st Day of 1st month or 7th Month following

Basics of Eligibility and Government Limits

- Coverage Testing
- All Plans must pass one of the following two tests
- Ratio percentage test – the percentage of non-highly compensated employees covered under the Plan must be at least 70% of the percentage of highly compensated employees covered
- Average Benefits Test – complicated analysis of rate of benefits provided

Basics of Eligibility and Government Limits

- Allocations to Participants
- Allocation Date – generally the last day of the Plan Year
- Plan can impose an hours requirement and/or last day requirement
 - Exception may be made for those retired, deceased or disabled
- Allocation of Contributions – generally based on compensation (as defined in Plan)
 - Participation compensation may be used

Basics of Eligibility and Government Limits

- Dividends and Earnings Distributions (S Corp)

- Allocated Shares
 - Based on share balance on record date – unusual
 - Based on beginning shares less distributions and forfeitures

- Unallocated Shares
 - Eligible compensation
 - Share balances

Basics of Eligibility and Government Limits

- Government Limits
- Deductibility – 25% of eligible compensation
 - For a C-Corporation, the amount of contributions to pay interest are not included in the 25% limit
- Compensation – limited to \$230,000 in 2008 and \$245,000 in 2009 (indexed annually)
- Annual Additions – lesser of 100% of compensation or \$46,000 for 2008, \$49,000 in 2009

Basics of Eligibility and Government Limits

Share Release Formula

Principal-only Method (special rule)

$$\frac{\text{Current Principal Payment}}{\text{Current + Future Principal Payments}} \quad * \text{ \# Shares Outstanding}$$

The Principal-Only Method can only be used if the term of the loan does not exceed 10 years and the loan does not include any balloon payments

Principal-and-Interest Method

$$\frac{\text{Current P\&I Payments}}{\text{Current + Future P\&I Payments}} \quad * \text{ \# Shares Outstanding}$$

Basics of Eligibility and Government Limits

- Diversification
- Participants have a 6 year window to defer a portion of their stock account balance into alternate investments
- Eligibility – Participants Age 55 and 10 Years of Participation in the Plan
- Eligible Participants can elect to defer 25% of their stock account balance during each of the 1st five years of their election period
- The 25% for the 1st five years is a cumulative percentage
- In the 6th year, up to a total 50% can be diversified

Basics of Eligibility and Government Limits

- Common alternatives a Plan Sponsor can offer
- Transfer to another Retirement Plan that the Plan Sponsor offers – such as a 401(k) Plan
- Distribution to the Participant – either in cash or a rollover to an IRA
- Establishment of investment choices – usually at least 3, within the ESOP



Basics of Eligibility and Government Limits

- Diversification offered may be more lenient
- Notification to the Participant/Timing

Example 1 – Eligibility to Enter Plan

Issue: Eligibility to enter the plan is defined in the company's plan document as 1,000 hours during an eligibility computation period and upon meeting this requirement, participant enters on the nearest January 1. Sue is hired by the company on September 15, 2008. She works 1,000 hours from September 15, 2008 – September 14, 2009. She is eligible to enter the plan on January 1, 2010, the nearest entry date. However, when the December 31, 2009 statements are completed and distributed to participants in early 2010, Sue expected to receive a statement showing that she has a balance in the ESOP. When she did not receive any such statement, she becomes disillusioned with the ESOP and starts sharing her negative opinions with others.

Example 1 – Eligibility to Enter Plan

Rule:

The document must state the requirements that the employees must satisfy in order to be eligible to participate in the plan, as well as the date(s) the employees are eligible to participate.

Maximum requirements:

- One year of service (a non-401(k) plan could require two years, but then must provide for full and immediate vesting)
- Age 21
- Plan can be more liberal

Defining a year of service for Eligibility (Eligibility Computation Period (ECP)):

- An ECP must be 12 months but the plan does not have to require an ECP for plan entry (for example, can allow entry on date of hire).
- An ECP can only exclude service due to break in service rules (can not exclude prior to effective date or prior to certain age).
- An ECP must start on the first day an employee works an hour of service – then the period can continue based upon DOH or switch to plan year.

Example 1 – Eligibility to Enter Plan

Rule continued:

Once an employee has satisfied the plan's eligibility requirements, employee must be permitted to begin participation no later than the earlier of:

- First day of the next plan year, *or*
- Date which is six months after the date on which the employee satisfied the requirements, unless the employee has terminated employment before such entry date

Solution:

- Distribution of the Summary Plan Description – required when participant is first eligible for plan – should give sooner?
- Hold new hire/participant communication meetings
- Design the plan differently at inception
- Amend the eligibility provision (pros and cons)

Example 2 – Eligibility for Contribution

Issue:

The plan document allows all participants who were employed on the plan's effective date to enter the plan immediately. The plan was effective January 1, 2007. Joe was employed on January 1, 2007 so immediately enters the plan. Joe generally works about 950 hours every year. The plan is also written to require 1,000 hours in order to receive a contribution allocation. So even though Joe is in the plan, he continues to receive a statement showing a \$0 balance.

Rule:

- Becoming an ESOP participant does not guarantee an allocation of employer contributions or forfeitures during the plan year.
- Plans could require that a participant work a certain number of hours (not to exceed 1,000) and/or be employed on the allocation date in order to receive an allocation of employer contributions or forfeitures.
- The hour requirement is based upon the current plan year.
- Plans can always have more liberal requirements.



Example 2 – Eligibility for Contribution

Solution:

- Distribution of the Summary Plan Description – required when participant is first eligible for plan – summarizes eligibility provisions for participant
- Hold new hire/participant communication meetings
- Design the plan differently at inception
- Amend the contribution requirements (pros and cons)

Example 3 – Cash Contribution used for Loan Payment

Issue:

The company makes a cash contribution in the first year of the plan (2008) to prefund for a leveraged transaction which will occur in 2009. Participants receive a 2008 statement reflecting their portion of the cash contribution. Then the participants receive their 2009 statement showing the cash contribution subtracted from their account and a corresponding number of shares released. However, the fair market value of the shares allocated to their account has a much smaller value than the contribution used to release these shares. So the participants balance at the end of 2009 is much less than 2008.

Rule:

- In a leveraged ESOP, all shares acquired by the ESOP with an ESOP loan are held in a suspense account. They are released from the suspense account as the loan is repaid. The loan documents and possibly the plan document define how the release of shares are calculated.
- The Internal Revenue Code (and corresponding regulations) allow this loan with the ESOP (which would normally be a prohibited transaction) as long as certain requirements are met.
- Company stock must be valued at certain times including: 1) when it is sold to an ESOP and 2) at least once a year, on the allocation/valuation date of the ESOP.



Example 3 – Cash Contribution used for Loan Payment

Solution:

- Statement design
- Communication to employees in 2008 and 2009. Provide a detailed explanation of statement in addition to the actual statement. Discuss how share release is calculated. Discuss common occurrence of post-transaction drop in value.

Example 4 – Dividends used for Loan Payment

Issue:

The company makes a dividend payment in 2009 and uses this dividend to make a payment on the ESOP loan. The shares released on the dividends that are paid on shares already allocated to the participants' accounts are allocated to those participants who own the shares. The shares released on the dividends that are paid on the shares that are still in suspense are allocated based upon eligible compensation. The company is surprised when the third party administrator calls to tell them that because of the drop in share value (see rule below), modifications will be needed to the allocated dividend calculation.

Rule:

- If dividends on allocated shares are used to pay down the loan, the fair market value of the shares released must at least be equal to the dividend used.

Example: Kim should receive a dividend of \$100 on the shares she holds in her ESOP account, based upon the number of shares and the amount of dividend paid. The \$100 dividend is used to make a payment on the ESOP loan. This payment releases 10 shares to Kim's account. The current fair market value of the shares is \$8, so the fair market value of the shares released (\$80) is less than the dividend used (\$100).

Example 4 – Dividends used for Loan Payment

Solution:

- Plan must make up the shortfall or the company must forgo the deduction. Often the shortfall is made up with shares released by dividends on unallocated stock.
- If the company is aware of a possible drop in fair market value - company should make sure that this will not be an issue prior to paying the dividend.

Example 5 – Drop in Fair Market Value of Company Stock

Issue:

The company's ESOP is in its 8th year. For the past several years, the company has shown a consistent increase in fair market value. The 2008 valuation is completed and the company records its first drop in fair market value. The company did not have prior communication to the participants regarding a possible drop in fair market value so while the participants are not completely surprised when they see their 2008 statements (due to downturn in the economy); there is still some surprise over the value.

Solution:

Hold ESOP communication meetings – some possible ideas for discussion: 1) basic facts regarding the valuation including comparing to publicly traded companies, current and future state of the industry, and prospects for the economy as a whole, 2) comparing the results of the 401(k) plan to the ESOP, and 3) discussing ways the employees can work together to increase revenues or decrease expenses to help increase the fair market value in future years.

Example 6 – Synthetic Equity/409(p) in an S corporation

Issue:

Company is an S corporation and therefore required to pass 409(p) testing. The company decides to implement a deferred compensation plan instead of current cash bonuses and do not test the impact of the deferred compensation plan on 409(p) testing. The fair market value drops, so when the deferred compensation plan is converted to synthetic equity shares, the company is surprised by the resulting number of synthetic equity shares and its impact on the 409(p) test.

Rule:

- The Economic Growth & Tax Relief Reconciliation Act of 2001 (EGTRRA) added section 409(p) to the Internal Revenue Code and amended section 4979A.
- The purpose of section 409(p) is to ensure that ESOPs sponsored by S corporations provide broad-based employee coverage.
- The general rule:
“An employee stock ownership plan holding employer securities consisting of stock in an S corporation shall provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person.”

Example 6 – Synthetic Equity/409(p) in an S corporation

Rule continued:

- Simplified description of the test: Disqualified persons cannot own 50% or more of the stock in an S corporation. The following formula determines whether disqualified persons own at least 50% and a nonallocation year occurs:

Disqualified Persons' ESOP shares

- + Disqualified Persons' portion of the unallocated ESOP shares
- + Disqualified Persons' synthetic equity
- + Disqualified Persons' direct ownership
- + Attribution ownership, including above amounts for any family members of Disqualified Persons not already included

All outstanding shares

- + Synthetic equity included in the numerator

Example 6 – Synthetic Equity/409(p) in an S corporation

Rule continued:

- What is synthetic equity – per the Internal Revenue Code
 - Stock options
 - Warrants
 - Restricted stock
 - Deferred issuance stock rights
 - Similar interests that give the holder the right to acquire or receive stock of the S corporation in the future
 - Also includes stock appreciation rights, phantom stock units, or similar right to a future cash payment based on the value of such stock or appreciation in such value
 - Nonqualified deferred compensation
 - Right to acquire interests in a related entity
 - Final regulations - certain rights of first refusal are not synthetic equity

Converting synthetic equity not related to shares (example: deferred compensation) - count number of shares equal to the present value of the synthetic equity

Example 6 – Synthetic Equity/409(p) in an S corporation

Solution:

- Should review all current and proposed executive compensation plans, stock based programs, employment agreements, etc. to determine if any constitute synthetic equity and notify the person responsible for preparing 409(p) testing prior to implementing any new arrangements.
- Should prepare projected testing to be aware of possible future issues.
- Must prevent, not correct – final regulations are clear that any method used must be completed before a nonallocation year occurs. So have prevention methods in your plan document.
- If stock value fluctuation (and its effect on the number of synthetic equity shares) is a concern, consider including language in your plan allowing for an annual or triennial determination date.



Events that Require Distribution

- Death
- Disability
- Retirement
- Termination of Employment
- Required Minimum Distributions
- Diversification Requirements

Death

- **Payment must begin by end of 1st plan year following year of Death**
- **Payout may be made over 5 years**

Disability

- Must be defined in Plan Document
 - **Social Security Awards letter (most common)**
 - **Physician appointed by Plan Trustee Medically determinable physical or mental disorder which renders a participant incapable of performing the duties assigned to him or her by the Employer**
 - Payment must begin by end of 1st plan year following year of Disability
- Payout may be made over 5 years, extended if over statutory limits
- Balances over \$985,000 may be extended for each \$195,000 over limit



Retirement

- Rule – age 65 with five years of plan participation
- Choice – Plan may be more liberal. Must be defined in Plan Document
- Payment must begin by end of 1st plan year following Retirement
- Payment may be made over 5 years, extended if over statutory limits

Termination

- Payment not later than end of 6th plan year following year of Termination
- Payout may be made over 5 years, extended if over statutory limits
- Vesting – Pension Protection Act shortened vesting to minimum of
 - 3 year cliff (3 years/100%)
 - 6 year graded (2 years/20% and 20% each year thereafter)
- Rule – Generally all years of service must be counted. 1000 hours
 - Choices – require less than 1000 hours for vesting service
 - Possible exclusions –
 - Years of service prior to age 18
 - Years of service prior to plan's effective date

Required Minimum Distributions

- Due by April 1 following attainment of age 70 ½
- Delayed until employee terminates employment unless 5% owner
- Distribution amount is based on IRS Life Expectancies
- On December 23, 2008, President Bush signed the Worker, Retiree and Employer Recovery Act of 2009 (the ACT). For 2009, the Act suspends the penalties imposed on those aged 70½ and older who do not take RMDs.

Forms of Payment

- Cash

- Stock
 - Participant has the right to demand distribution in employer stock
 - Put Option
 - Exceptions
 - **S Corporations**
 - **Charter or by-law restrictions**



Method of Payment

- Lump Sum
- Installment
 - Period not exceeding 5 years, extension for large account balances

Put Options

- Definition: In general, the contractual right to sell a security at a set price/time
 - With regard to ESOP's:
 - Buyer is the Company (ESOP can step in and buy the stock)
 - Seller is the distributee
 - Price is the latest FMV
 - Privately-held companies that allow stock distributions must offer put options

Account Segregation Prior to Distribution

- **Transfer vested account balance following termination**
 - **Required to be included in Plan Document Considerations –**
 - **Trustee vs. Participant Directed**
 - **Segregated vs. Pooled**

- **Advantages**
 - **Terminated participant does not share in future increases in stock value or dividends**
 - **Shares can be recycled immediately**

- **Disadvantages**
 - **Fiduciary responsibility for investment decision**
 - **Employee may still be able to demand distribution in stock**



Distribution Policies - Considerations

- Understand your participant mix
 - Age
 - Tenure with Company
 - Account Balances
 - Turnover Rates
 - Compensation
- Understand Plan Provisions
 - Eligibility to Participate
 - Eligibility to Receive Employer Allocation
 - Vesting Schedule
 - Treatment of Forfeitures
 - Contribution Allocation Methodology

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