ESOP | Report

November 2018 | The Voice of The ESOP Association | *Serving the Entire ESOP Community*

Inside this issue:

A Month to Remember

ESOP Association Members and the Public Demonstrate Even Greater Interest in Celebrating Employee Ownership Month

Every year we are humbled and impressed with the groundswell of support our members exhibit for each other and for the ESOP community during October's Employee Ownership Month activities.

The time and effort our members put in to Employee Ownership Month helps everyone—including elected officials and the media—better understand why ESOPs are vital in their communities.

Public Leaders Support ESOPs

This year the governors of Indiana and New Hampshire issued formal proclamations recognizing October as Employee Ownership Month—joining a list of proclamations issued in recent years by the governors of Vermont, Iowa, and Nebraska. Having the support of state leaders is a testament to the broad based support ESOPs garner.

Employee owners at Burns & McDonnell engage in a rousing game of trivia over lunch as part of their Employee Ownership Month celebration.

In Congress, pro-ESOP legislation received two new co-sponsors during Employee Ownership Month. Also, a powerful letter was sent to President Trump seeking to curb unfair ESOP enforcement by the DOL.

These shows of public support are proof that our efforts are being noticed, acknowledged, and reinforced.

Record Setting Engagement

This month was one of the most successful Employee Ownership Months we have ever had. From BBQs to breakfasts and from trivia contests to talent shows, we saw tons of creative and exciting ways to share the ESOP spirit.

We also set some records with engagement from the public. Here is a quick snapshot of this activity:

- We had more than 59,000 page views of our website content during Employee Ownership Month—a new record!
- Our social media content was viewed more than 64,000 times—another new record!
- Nearly 1,000 people searched our website for the term, "How Do ESOPs Work?"
- Our blog articles were read more than 1,400 times during Employee Ownership Month.
- More members than ever shared their Employee Ownership Month photos and videos using our hashtag **#EOMESOP**. (Please visit us on Twitter to see the full array of photos, videos, and tweets.)

Thank you to all who participated in this year's celebration. Only 11 months until we get to do it all again!

ESOP Companies Continue Long Streak of Outstanding Financial Performance

Economic Performance Survey results once again show high profits for companies and great rewards for employee owners.

The results of this year's Economic Performance Survey (EPS) show that, once again, companies belonging to The ESOP Association have experienced positive corporate performance.

Just as importantly, the EPS once again shows that when companies perform well, employee owners share in the rewards. And this year, new data reveal a new facet of how ESOP companies distribute those rewards.

Employee Owners Share the Rewards

For the first time ever, this year's survey included questions on pay increases. The results show that 75 percent of responding companies increased wages at or above the national average of 2.7 percent, and 29 percent increased wages by 4 percent or more.

In addition, 55 percent of responding companies contributed to their ESOPs an amount equivalent to 11 percent or more of their employee owners' pay—far surpassing the typical 401(k) match.

Sharing the wealth with employee owners is a fundamental aspect of ESOPs and one that helps align the efforts of all employee owners with the performance of the company.

Profits Rose More than Revenue

The engagement of employee owners may help to explain a noteworthy trend: Companies responding to our survey realize profits that grow more than revenue.

Ever since we started asking for more detail on revenue and profits in 2016, ESOP companies have reported profit margins that rose higher than the highest increases in revenue. The only explanation we can find is that these companies excel at managing costs, which is consistent with businesses that engage their employees and seek better, more efficient ways to operate.

Not every employee can contribute to greater sales or revenue. But every employee—especially those engaged in the business and who stand to benefit from its improved performance—can help reduce waste and improve efficiency.

A History of Strong Performance

Since the EPS was launched in 2000, the majority of responding companies have reported increases in profits for every year but two (2002 and 2010), and increases in revenue for every year but one (2010).

The exceptions noted above reflect the nationwide economic downturns of the prior years (2001 and 2009).

Get Your Copy

The full report of this year's Economic Performance Survey is online, free to members, online at: www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters

ESOP Report

The Voice of The ESOP Association

The *ESOP Report* is published on a monthly basis by The ESOP Association, the national non-profit association of employee-owned companies and ESOP practitioners, located at:

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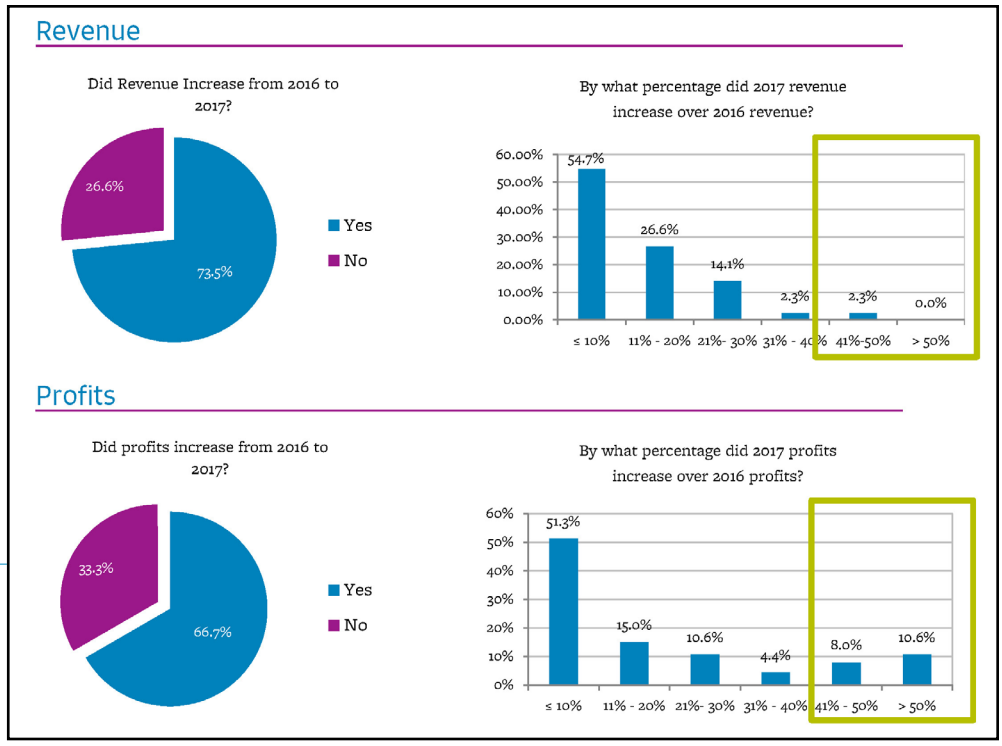
The articles within represent the views of the authors and may not be the views of The ESOP Association.

Even in those challenging economic times, 29 percent or more of ESOP companies responding to our survey reported that profits and/or revenue *increased*.

These results align with recent academic research that found employee-owned businesses surpass conventionally-owned companies at riding out tough economic times. (See *How Did Employee Owned Firms Weather the Last Two Recessions?* by professors Fidan Kurtulus and Douglas Kruse.)



Foundation Furthers ESOP Research

The Economic Performance Survey is sponsored each year by the Employee Ownership Foundation, which is dedicated to researching ESOPs and employee ownership.

The Foundation sponsors a variety of efforts, including the Kelso Fellowships—a program that conducts academic research on employee ownership and is administered by The Institute for the Study of Employee Ownership and Profit Sharing, at Rutgers University.

The Foundation also sponsors questions in the General Social Survey that have shown that companies with employee stock ownership retain employees at a rate seven times higher than conventionally owned firms.

For more information on the Employee Ownership Foundation, or to donate and support its efforts, visit www.employeeownershipfoundation.org.

Finally, we offer a heartfelt thanks to the 186 Corporate Members that shared their time and information with us. This survey is an invaluable source of data for policy makers, elected officials, academics, and the press, and is possible thanks to you.

Valuation Viewpoint

Communicating Valuation Issues to Participants

By Jeffrey A. Szczypinski, ASA, and Daniel P. Callanan, ASA

An ESOP can provide a tremendous retirement benefit to ESOP participants while simultaneously aligning employee incentives with company-wide goals. High-performing employees lead to higher profitability, which drives share value, which in turn motivates employees to be ever more efficient. This circular system facilitates stability and should lead to long-run participant account appreciation.

Critical to that system is an employee's ability to connection his or her individual performance directly to their benefits.

However, other factors often have as large—if not a larger—impact on a company's performance in any given year. These factors threaten to deteriorate the link between employees' effort and reward if not adequately explained to employee owners.

Cash Flow May Not Be King

Even the best run companies grow unevenly. Years of accelerated growth often can be followed by moderate advances, or even declines.

As part of the ESOP valuation process, an appraiser's duty is to assess the company's overall growth trajectory, including past and future performance. ESOP appraisers typically like to focus on long-run performance over a three- to five-year window.

As such, a 30 percent improvement in cash flow in any one year may not directly translate to a 30 percent improvement in an ESOP's share price. Likewise, a single year 30 percent decline in cash flow does not necessarily translate to a 30 percent reduction in ESOP accounts.

Other company-specific factors can cause fluctuations in ESOP stock values, and can include:

- Changes in key customer retention.
- Growth prospects through new customer additions.
- Innovative product development.
- Workforce efficiency.
- Overall business risk.

Enterprise Value vs. Equity Value

Furthermore, a company's equity value may increase even if the value of the company, or enterprise value, decreases.

What do these terms mean?

The value of a company's stock, or equity value, is equal to the enterprise value less net debt.

Enterprise value is the value of the total company (i.e. before considering the claim of debt holders/bank financing).

Net debt generally is defined as total outstanding debt, less cash and non-operating assets since cash can be used to pay down debt and non-operating assets could be converted to cash to further reduce debt (without impairing the company's operations).

For example, assume the value of a company is $100 and it has $30 of debt with no cash. The value of the company's equity is $70. If a buyer were to purchase the equity, the total purchase would be $70, but to own the entire company (and, thus, the right to all cash flows), the buyer would have to purchase the entire enterprise of $100 (purchasing the existing stock for $70 and repaying all existing debt of $30).

Due to the direct effect of cash, changes to the enterprise value may not entirely correlate with changes in equity value.

> *Herein lies the communication problem: Holding all else constant, does a stock value increase reward employees in a year that the company lost a key customer?*

Continuing with our example above, assume the company loses a key customer that leads to a decline in anticipated future cash flow resulting in a decline in enterprise value from $100 to $98.

However, the company retained $5 of cash during the past year. So, while the enterprise value declined, net debt decreased—causing the value of the company's equity to rise to $73.

Herein lies the communication problem: Holding all else constant, does a stock value increase reward employees in a year that the company lost a key customer?

The short, simple answer is: Yes. The stock value increased from $70 to $73. Yet this short answer needs significant qualification.

The value of a company incorporates a broad spectrum of risks. Within those risk expectations include possible company-specific events, such as losing a customer. In isolation, this event may not harm equity value, but what if it continues? If the company shows a trend of losing major customers, the overall risk of the business undoubtedly will increase—likely at an accelerated pace.

Further customer reductions will likely reduce the cash flow created (previously assumed to be $5); eventually that cash flow will be unable to offset declines in enterprise value.

Offering Context

When discussing ESOP stock values to participants, it often is a best practice to contextualize the change in value in overall company risk.

The company's previous year is not the complete story of long-term cash flow expectations. It may be the most recent data point, yet it remains a single data point.

While one particular event—such as a key customer loss—occurred last year, the likelihood of a similar occurrence can typically be low. In our example above, the value increased due to an increase in cash. In other years, cash may decline from a significant internal investment, such as a new plant.

Naturally, cash is much less risky than stock, thus a larger percentage of the equity value being tied directly to cash can

Update: Search for New CSO Continues

Recruiting for New Association Leader Moving to Next Stage

The search for a new Chief Staff Officer is moving into a new phase. Applications from new candidates will be accepted until Friday, Nov. 30. After that date, the search committee will move into the interview stage.

To review the job description for this position, see the Oct. 22 news item at www.esopassociation.org/news-landing.

If you have questions about this process, please contact either Gary Shorman (gary.shorman@goeaglecom.net) incoming Chair of The ESOP Association's Board and head of the Search Committee, or Jim Zaniello (jim.zaniello@vettedsolutions.com) of Vetted Solutions, the firm retained to co-ordinate recruitment for this position.

lower the risk profile of the stock. Albeit, long-term cash flow growth prospects may be more moderate in this situation.

The Influence of Public Markets

Finally, the value of a company, even a privately held business, is still affected by the value of external factors, such as publicly traded companies.

The ultimate pool of hypothetical willing buyers in ESOP stock have the option of investing in publically traded companies and privately held companies alike. If investors show a willingness to pay 10.0 times cash flow this year vs. 7.0 times cash flow last year, the value of your privately held ESOP company may go up—even if the company's three-year average cash flows decreased.

Communicating to Participants

Overall, communication to ESOP participants is a vital component of an ESOP's success.

To help your ESOP participants understand an appraiser's viewpoint, frame changes that occur from one year to the next in the context of: 1) long-term company performance, 2) the overall risk profile of the business, and 3) the company's value relative to macro-level indicators will convey the viewpoint held by the appraiser.

Note: In our next article, we will expand on external (non-company specific) forces that affect the value of stock and how to communicate those drivers to ESOP participants.

Calendar of Deadlines and Important Dates

Feb. 1	Deadline for Entering AACE and Employee Ownership Month Poster
Feb. 8	ESOP Professionals' Forum
May 22	ESOP Association Annual Awards Banquet
May 23-4	Annual Conference

To see all national and chapter meetings, visit us online at: www.esopassociation.org.

Legal Update

New Way of Settling Claims for Defendants with Insufficient Assets

By Scott S. Morrisson, Partner, Krieg DeVault LLP

The Department of Labor (DOL) has moved into entirely new ground when it comes to structuring settlement claims against ESOP trustees who lack the means the pay the full claim.

In *Acosta v. Potts, et al.*, (Case No. 2:16-cv-00612-JLG-TPK, S.D. Ohio, October 17, 2018), the trustee was denied fiduciary insurance coverage and lacks the ability to fully pay the claim or judgment. The actual amount to be paid by the trustee is much less than the amount of the consent judgment. Further, the amount is conditioned on the trustee's income over the next several years, with the remainder of the consent judgment payable only if the trustee's fiduciary insurance carrier later provides payment through settlement or a judgment.

> ***The actual amount to be paid by the trustee is much less than the amount of the consent judgment.***

Background

The case initiated straight out of the Department of Labor's (DOL) standard playbook. The agency filed a complaint on June 27, 2016, alleging the trustee violated Title I of ERISA in connection with the ESOP's 2011 purchase of stock from the company's shareholders. The DOL alleged the trustee's approval of the ESOP transaction was based on a flawed valuation that caused the ESOP to purchase the stock at a "significantly overvalued" price.

In September 2016, the trustee's fiduciary liability carrier intervened in the action. The carrier sought a determination that the professional liability policies the carrier had issued the trustee did not obligate the carrier to defend or indemnify the trustee against the DOL's claims. The carrier was allowed to intervene, but the court stayed the insurance declaratory judgment issues.

Meanwhile, the trustee and the ESOP plan sponsor continued to litigate the ESOP stock valuation issue. On October 17, all the parties except the insurance carrier agreed to a settlement of the ERISA claims and filed a 14-page consent order and proposed judgment detailing the settlement. The trustee and insurance carrier have not yet reached any settlement regarding their claims and counterclaims related to insurance coverage.

Settlement Terms with the Trustee

The settlement and judgment amount is for $2,475,000. Of that amount, $2,250,000 is to be paid to the ESOP; a statutory ERISA Section 502(l) penalty of $225,000 is

Trustee's Income for Calendar Year	Adjustment to Payment
less than $75,000	100% reduced and deferred
$75,000-$100,000	75% reduced and deferred
$100,000-$150,000	50% reduced and deferred
$150,000-$300,000	no adjustment
$300,000-$350,000	10% increased
$350,000-$400,000	20% increased
$400,000-$450,000	30% increased
$450,000-$500,000	40% increased
$500,000 or more	50% increased

payable to the DOL. (The fee was reduced from 20 percent to 10 percent).

This is where it gets interesting. The consent judgment says the trustee "demonstrated a current inability to pay" the $2,475,000 settlement, absent contribution by the trustee's insurance carrier. To confirm this, the trustee provided a sworn declaration of his financial status, as well as his federal and state tax returns.

The DOL thus agreed to forebear execution against the trustee of the total amount of the consent judgment, conditioned on payment pursuant to the following novel payment program:

- The trustee and DOL agreed that the trustee will pay $456,500 (of the $2,475,000), with payments to be made over time, as follows:
  - A first payment of $72,727 to the ESOP and $7,272.70 to the DOL by November 1, 2018.
  - Beginning on November 1, 2019, and annually thereafter, annual installments of $48,896.15 to the ESOP and $4,889.62 to the DOL until the full $456,500 is paid (a total of $415,000 to the ESOP and $41,500 to the DOL).
- All future payments by the trustee may be increased, reduced, or deferred based on the trustee's future income. The trustee's $48,896.15 and $4,889.62 future annual payments may be altered as outlined in the box above.

If the trustee is not obligated to make any payment in a particular year due to income limitations, the total obligation is deferred—but not reduced. Conversely, if the trustee is required to make an accelerated payment due to extra income, the total obligation is not increased.

The consent order defines the trustee's "income" to mean Adjusted Gross Income (AGI) as defined by the Internal Revenue Service, including income attributable to his ownership of an S corporation (and excluding the trustee's spouse's income).

The trustee is required to provide the DOL with his federal and state tax returns each year. In short, the trustee still pays a large amount "out of pocket," but escapes payment of the far more substantial amount claimed by the DOL and has some form of relief if his income does not reach agreed-upon levels in any given year.

Money Received from the Insurance Carrier

The consent judgement then deals with payments the trustee may receive from his insurance carrier, whether through settlement or judgment. The judgment uses a method that encourages the trustee to pursue the claims so that he may receive the benefit of some of the insurance proceeds, but with the majority to still be paid to the ESOP and DOL to complete payment of the consent judgment.

The payment obligation depends on whether money is received from the carrier through settlement, or through an actual judgment.

If *settled*, the first $1,176,471 of settlement proceeds received by the Trustee will be allocated as follows:

- 60 percent paid to the ESOP.
- 6 percent paid to the DOL.
- 30.9 percent paid to the ESOP, up to the amount that remains outstanding on the $415,000 payment the trustee owes over time.
- 3.09 percent paid to the DOL, up to the amount that remains outstanding on the $41,500 payment.

If there are any settlement proceeds left above the $1,176,471 payment level:

- 54.5 percent shall be paid to the ESOP.
- 5.45 percent shall be paid to the DOL.
- 40 percent shall be paid to the trustee—but this payment will be capped at the total amount of attorneys' fees and costs paid by the trustee in the lawsuit. If any settlement proceeds remain after the trustee has repaid his attorneys' fees and costs, the remainder is to be paid to the ESOP and the DOL in specific percentages.

Thus, in sum, if there is a settlement with the trustee's insurance carrier, no insurance money would ever be paid directly to the trustee, although the settlement amount can reimburse the trustee's attorney's fees and expenses and reduce the amount he must pay out of pocket toward the $456,500 settlement amount.

If the trustee is awarded a *judgment* against the carrier—by summary judgment or trial—then the following payment structure is to be followed:

- If the judgment is equal to or greater than $2,475,000, $2,250,000 must be paid to the ESOP (less any amounts the trustee has already paid to the ESOP)

and $225,000 will be paid to the DOL (less the amount already paid).

- If the proceeds of the judgment against the carrier are less than $2,475,000, the proceeds will be allocated in the same manner as if they were awarded in a settlement, discussed above.
- If the proceeds of the judgment exceed the amounts due to the ESOP and the DOL, the trustee is permitted to keep the additional amount—thus the motivation to pursue the carrier.

Should the trustee fail to timely make any payment as required or violate the consent order's terms, the unpaid amount is accelerated and immediately due and payable.

Interestingly, the trustee is required to resign as trustee for the ESOP at issue, but is apparently *not* required to resign as trustee for *all* ESOPs, as the DOL has requested of some other ESOP fiduciaries.

What Next?

Is this the new norm in similar circumstances or where a defendant actually has insurance coverage but not sufficient coverage from the DOL's perspective? That remains to be seen.

This is a truly unique settlement. In fact, the author of this article has never seen a consent judgment in this format agreed to by the DOL.

Further, the DOL has 10 separate regional offices, each of which have their own regional director and their own unique characteristics. This consent judgment was agreed to by the Cincinnati, Ohio regional office, located in Ft. Wright, Kentucky, and signed by the Solicitor's office in Cleveland, Ohio. Only time will tell if the agency's other regional offices adopt this approach in similar circumstances.

Washington Report

When Old Friends Leave Capitol Hill, New Friends Must Be Made

By J. Michael Keeling, President, The ESOP Association

At first glance, the midterm elections were not kind to the ESOP community: The retirement and defeat of key ESOP advocates in Congress—primarily in the House, where tax law originates—means challenging days ahead for positive ESOP laws.

Today, in the 115th Congress, the majority of members on the House Ways and Means Committee (which is responsible for tax legislation) are proven, consistent supporters of ESOPs. But when the 116th Congress begins in January, nearly 33 percent of those ESOP advocates will not return to office, due to retirement or defeat. That reality does not trigger positive thoughts for the 2019-2020 Congressional bills focused on tax law, retirement savings, or ERISA plans.

Tax Incentives at Risk

There is a strong move afoot to increase tax incentives for ERISA plans that are not ESOPs. Like any tax incentive, these measures will lower Federal tax revenue, and the Democrats—who will control the House of Representatives and its committees—will likely insist on balancing that lost revenue by reducing tax incentives in other ERISA areas.

Is it possible that Congress would reduce ESOP tax incentives? Yes, it is.

Four years ago, our potential concern would have been lessened because ESOP incentives did not deprive the federal treasury of that much revenue—according to the Congressional Joint Committee on Taxation (JCT), which is responsible for these estimates. But the JCT has dramatically changed its findings over time and now estimates that ESOP incentives may cost the treasury $40 billion over a 10-year span.

These new estimates raise the profile of ESOP tax incentives, making them more noticeable—and potentially more vulnerable.

In the past, the tax committees had little to gain by reducing the ESOP tax incentive. But today, cutting ESOP benefits can provide significant cost "savings" that members of Congress can use to pay for some other initiative.

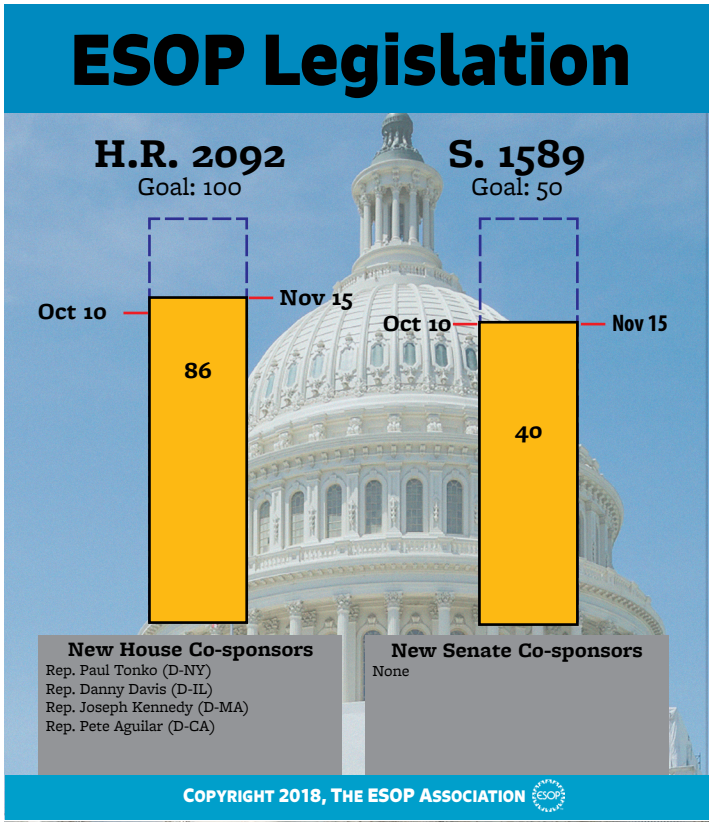
Fewer Friends in High Places

The higher estimated costs of ESOP incentives potentially are more worrisome for another reason: Some of our key advocates in the House Ways and Means Committee won't be around next session.

Representatives Erik Paulsen of Minnesota and Peter Roskam of Illinois have been major, effective, influential members of the House tax committee and strong supporters of ESOPs. Both were defeated this November.

Another strong ESOP supporter and senior member of the Ways and Means Committee—Rep. Dave Reichert of Washington State—retired from public office and won't return to Washington, D.C.

Another committee of great importance to our community is the House Committee on Education and Workforce,



which has jurisdiction over the Department of Labor. This committee has been a tremendous ally to our community and has worked to tamp down the DOL's unreasonable legal assault on ESOPs.

While many of the pro-ESOP members of the committee will return in 2019, Republican Rep. Virginia Foxx—a staunch supporter of ESOPs—will lose her role as committee chair.

On the Senate side we lost far fewer supporters, in part because only one third of all Senate seats are up for re-election at any given time. Even so, some strong ESOP advocates won't be returning in 2019 to lend us their support.

In the Senate Committee on Finance—which is the upper chamber's key tax committee and is expected to be involved in changes to ERISA—three ESOP champions will not return. Senators Dean Heller of Nevada and Claire McCaskill of Missouri both lost their re-election bids; Sen. Orin Hatch of Utah will retire.

Sen. Hatch also serves on the Senate committee with jurisdiction over the Department of Labor, so his loss will be felt there too.

On the positive side, both of these Senate committees retain a majority of members who are proven ESOP champions.

What Do We Do?

Does the ESOP community wring its hands and say, "Woe is me?"

Of course not. We have a story to tell to every new member of the House and Senate, and that story is too good to be silenced. It is about how ESOPs benefit the companies where they are instituted, and the employee owners who work there.

That story is bolstered by great data that include the following:

- Our participation in the General Social Survey (thanks to funding from the Employee Ownership Foundation) shows that companies with employee stock ownership are 7.3 times less likely to lay off employees than conventionally owned firms.
- A 2014 analysis (again, funded by the Employee Ownership Foundation) showed that by laying off fewer employees, ESOP companies saved the federal government $1.9 billion.
- The latest results from the Economic Performance Survey (sponsored by—you guessed it—the Employee Ownership Foundation) offer striking evidence that our member companies excel at producing profits and at sharing those profits with employee owners. (See page 2 of this newsletter for a summary of the survey's findings.)

Past Is Prologue

The story of the powerful benefits that ESOPs can provide has been retold each and every time a new batch of elected officials has descended upon Washington. And with each retelling, we gain new friends and supporters for our community.

ESOP champions have left Congress voluntarily or been defeated in elections many times since ESOPs were sanctioned by Congress in 1975.

Sen. Russel Long, the father of ESOP laws, retired at the end of 1986.

Sen. Max Baucus stopped negative ESOP proposals from the House in the late 1980's and left Congress to become the U.S. Ambassador to Japan.

Rep. Beryl Anthony stopped negative ESOP proposals in the early 1990's in Ways and Means before being defeated in 1992.

Rep. Nancy Johnson added the law that permitted S corporations to sponsor ESOPs in 1996, and was defeated for re-election.

Sen. John Breaux perfected the S ESOP law tax benefits in the late 1990's, before voluntarily stepping down.

In the early 21st Century, Rep. Jim Ramstad stopped in its tracks a proposal from the Clinton Administration that would have negatively affected ESOPs.

Others on Capitol Hill have come and gone—and in between they helped us grow and become an ever stronger force for economic fairness.

Despite that turnover, ESOP incentives survive. Only one incentive ever was repealed and that was in 1989—nearly 30 years ago.

You Are the Difference

Why have ESOPs fared well? Because of you, the men and women who work in ESOP companies and who invite members of Congress to see for themselves what makes ESOP companies unique.

How do I know? I saw it firsthand in 1980 as the chief of staff for a senior member of the Ways and Means Committee, Rep. J.J. Pickle of Austin, Texas. At the time, House members were skeptical about the value of tax incentives for employee owned companies.

My boss was one of the skeptics.

That is, until he visited an ESOP company for himself and saw with his own eyes that employee ownership can spark a special quality in companies—a quality that must be experienced to be understood.

You and other members like you have provided that experience to elected officials in the House and Senate. Those elected officials have seen it and responded to protect and advance employee ownership, because they understand what you do—that it is worth fighting for.

Bigger Than Any One of Us

Ultimately, employee ownership is bigger than any one person.

As Sen. Long once said to a group of supporters who were bemoaning his impending retirement: "If ESOPs do not survive after I am gone, ESOPs do not deserve to survive."

Those words remain true today.

We will lose many friends on Capitol Hill on January 1, 2019. But that just means we have many new friends to make, new members to greet, and new advocates to win over.

If we continue to invite members of Congress to visit our companies and continue to share the story of how ESOP companies excel, we will generate a new crop of supporters that will help carry us into 2019 and beyond.

Advisory Committee on Administration

IRC Section 409(p): Do's and Don'ts with Your Plan Provisions

By Kevin Rusch, CPA, QPA, Director, Blue Ridge ESOP Associates
Reviewed by Lynn DuBois, Partner, ESOP Law Group, LLP

ESOPs in S corporations must comply with Section 409(p) of the Internal Revenue Code. Until recently, there were concerns that plan language designed to protect against a 409(p) violation might not be approved by the IRS.

IRS Office of Chief Counsel Advice dated September 17, 2017 provides guidance on plan language that can be included in an ESOP plan document to prevent the occurrence of a nonallocation year under Section 409(p). This article highlights the issues and conclusions documented in the memo.

Background

IRC §409(p) states that no portion of the assets of the ESOP attributable to (or allocable in lieu of) the stock in an S Corporation may, during a nonallocation year accrue (or be allocated directly or indirectly under any qualified plan) for the benefit of any Disqualified Person. The purpose of the law is to limit the establishment of ESOPs by S Corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

A nonallocation year occurs when Disqualified Persons own 50 percent or more of the stock in the S corporation, including deemed-owned shares, and the ESOP holds S corporation stock.

A Disqualified Person is one who owns at least 10 percent of all the Deemed-Owned Shares or together with his family, owns at least 20 percent of all Deemed-Owned Shares.

Deemed Owned Shares, with respect to any person, include:

- S Corporation stock that is allocated to that person under the ESOP.
- That person's share of the S Corporation's stock that the ESOP holds but has not yet been allocated to plan participants.
- Net Synthetic Equity held by that person.

Violation of Section 409(p) through the occurrence of a nonallocation year can result in draconian penalties for the participant, the employer, and the ESOP.

The Chief Counsel Advice provided guidance on the three issues outlined below.

Issue No. 1

The question: Can an ESOP include plan language that allows shares to be transferred back from the non-ESOP plan of the employer—or a separate portion of the ESOP that is not an ESOP—if the following conditions are met?

- The ESOP previously transferred the stock to prevent a nonallocation year pursuant to the "transfer method."
- The transfer back to the ESOP will not cause a nonallocation year or prohibited allocation in a nonallocation year for purposes of Section 409(p).

The "transfer method," as noted in the regulations, allows an ESOP to transfer S Corporation stock allocated to the account of a Disqualified Person to the non-ESOP portion of the plan or to another quailed plan prior to the occurrence of a nonallocation year. This process, if written in the plan document, prevents an ESOP from having a nonallocation year and a 409(p) violation.

IRS Conclusion. The exception allowed by the regulations to allow the transfer of securities from an ESOP using the transfer method applies only to shares being transferred from the ESOP. Therefore, any plan language providing for a stock transfer back into the ESOP is not appropriate.

Issue No. 2

The question: Can an ESOP include plan language designed to prevent a nonallocation year by including one or more of the following provisions, in addition to a provision providing for the transfer method discussed in the previous section (Issue No. 1)?

1. Excluding from allocations only highly compensated employees (HCEs) who otherwise would become Disqualified Persons.
2. Excluding from allocations all HCEs.
3. Expanding allocations to nonhighly compensated employees (NHCEs)—who are not Disqualified Persons—with less than 1,000 hours of service.
4. Expanding allocations to NHCEs—who are not Disqualified Persons—with less than 1,000 hours of service and who were employed on the last day of the plan year.
5. Expanding allocations to NHCEs—who are not Disqualified Persons—who were employed on any day of the plan year.
6. State "Nowithstanding any other provision of the plan to the contrary, no allocation of any company stock whether by reason of any Employer contribution, forfeiture, dividend, or otherwise, shall be made to or on behalf of XX or any member of XX's family that would make XX or such family member a "disqualified person" within meaning of Section 409(p)(4)."

The preamble to the final 409(p) regulations states that an S Corporation may:

- Reduce contributions for HCEs who are or may become Disqualified Persons.
- Provide additional benefits to NHCEs who are not Disqualified Persons.
- Expand coverage to include all employees.

Plan provisions must be written, require a definite predetermined formula for allocating employer contributions to the plan participants, and must not discriminate in favor of HCEs.

IRS Conclusion. Since the provisions listed above either expand allocations to NHCEs or exclude allocations to HCEs, they likely will not discriminate in favor of HCE's, which is prohibited under Section 401(a)(4).

Options 1 and 2 meet the legal requirements as long as they are drafted in the plan document and identify the group of HCEs that are excluded from allocations in a plan year. Options 3, 4, and 5 meet the legal requirements as long as they are drafted in the plan document and identify the group of NHCEs that are included in allocations for a plan year.

If more than one 409(p) failsafe provision is included in the plan document, the plan should state the order in which the provisions will be applied to satisfy the required predetermined allocation requirement.

Regarding option 6, this example also meets the requirement of a written plan and a definite predetermined formula. It would be unlikely that the members of this family group would be NHCEs, alleviating any nondiscrimination issues.

Issue No. 3

The question: Can an ESOP include plan language that includes a methodology that provides for multiple adjustments to participants accounts through incremental reallocations of stock initially allocated to HCEs, with such reallocations continuing until total allocations of stock released from the ESOP loan suspense account to HCE participants, as a percentage of compensation, do not exceed the lowest percentage allocated the account of a NHCE participant.

IRS Conclusion. This provision provides for the reallocation of stock that has already been allocated to participants' accounts. This would result in the forfeiture of accrued benefits and would not be acceptable.

Conclusion

Now that we have the benefit of the Chief Counsel Advice, Plan sponsors should talk with their ESOP attorneys and record keepers to determine what additional language would be best to incorporate into their ESOP documents to prevent the occurrence of a nonallocation year under Section 409(p).

This article was reviewed and approved by the Chair of the Administration Advisory Committee, Dolores Lawrence, Managing Director at Blue Ridge ESOP Associates.

Board Approves Member Dues Increase

Two Percent Increase Will Take Effect on Jan. 1, 2019

Membership dues for The ESOP Association will increase two percent, effective January 1, 2019. While dues went unchanged in 2018, the time had come for a reasonable increase, the Board of Directors determined at its November meeting. Rather than wait a longer period of time and increase dues by a larger amount, the Board decided to increase dues after a smaller interval and by a smaller percentage.

Letters soon will be sent to all members providing additional information.

The increase was warranted, the Board decided, due to a number of factors, most notably, the increase in the cost of doing business overall. (In 2018 alone, the cost of living rose 2.8 percent.) In addition, The Association continues to make significant investments in technology infrastructure to provide an improved experience for its members.

Las Vegas ESOP Conference

Clockwise from top left: Frieda Takaki accepts an award from Employee Ownership Foundation Chair Mark Lomele; eating with 1,700 friends can be fun; Association President J. Michael Keeling provides a lunch update on the effect of the midterm elections on ESOPs; attendees participate in an interactive session.

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Publication Highlight

Your ESOP: It's for All of Us

This brochure is designed to help companies communicate the ESOP concept to employee owners. It includes a plain-language explanation of how ESOPs work and how employee stock ownership can benefit the company and employees alike. This explains concepts such as how stock values can accumulate, the importance of productivity, and the advantages ESOPs provide. Bonus: It also includes answers to nine questions commonly asked by ESOP participants.

Members $1.00 / Non-Members $6.00

Sign in to our website, www.esopassociation.org, or call (202) 293-2971 to purchase.