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Working with Your Third Party Administrator to Avoid Common Administrative Errors

Annual Spring ESOP Conference of the Michigan Chapter of the ESOP Association

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Overview

- Required IRS Restatement Schedule
- Starting with the Basics – Condition of Plan and Related Documents
- Common Mistakes in Plan Operation
- Plan Qualification Errors
- The Potential Pain

Required IRS Submission Restatement Dates

Submission Procedures for Individually Designed Plans - 5-Year Remedial Amendment Cycle

Last digit of plan sponsor's EIN	Exceptions to EIN rule for	Cycle	Submission period opens and ends	Cumulative List	Second 5-year cycle began
1 or 6	Controlled group or affiliated service group	A	02/01/2011 - 01/31/2012	Notice 2010-90 (2010 CL)	02/01/2007
2 or 7	Multiple employer plans	B	02/01/2012 - 01/31/2013	Notice 2011-97 (2011 CL)	02/01/2008
3 or 8	Governmental plans	C	02/01/2013 - 01/31/2014	Notice 2012-76 (2012 CL)	02/01/2009
4 or 9	Multi-employer plans	D	02/01/2014 - 01/31/2015	Notice 2013-84 (2013 CL)	02/01/2010
5 or 0	Governmental Plans	E	02/01/2015 - 01/31/2016	Notice 2014-77 (2014 CL)	02/01/2011

See Revenue Procedure 2007-44 for details on the cycle system.
See Initial Five-Year Cycles (EGTRRA) for the remedial amendment cycles that began 2/1/2001- 2/1/2006 and ended 1/31/2007 - 1/31/2011.

Required IRS Submission Restatement Dates (cont'd.)

- **New plans**

A new individually designed plan will be treated as filing an on-cycle application if their on-cycle submission period ends at least two years after the end of the off-cycle period in which the application is received. A plan will be treated as a new plan if it is submitted by the due date of the employer's tax return (with extensions).

- **Groups, mergers and other transactions**

Groups generally file using the parent's EIN. The highest level entity in the U.S. that has an EIN will be used for making alternative elections.

See Revenue Procedure 2007-44, Section 11, for details on determining a plan's cycle in cases of mergers, acquisitions, changes in plan sponsorship, plan spin-off, or other events. In general:

  - **Controlled group election** - Controlled or affiliated service group (including parent/subsidiary) that maintains more than 1 plan – can make a Cycle A Controlled Group Election.
  - **Merger** – Use the EIN of employer maintaining the merged plan.
  - **Acquisition** – Use the EIN of employer that acquired the plan.
  - **Spin off** – Use the EIN of the employer that maintains the spun off plan.

List of Plan and Related Documents

- Plan
- Trust
- Summary Plan Description (SPD)
- Summary of Material Modifications (SMM)
- IRS Determination Letter
- Plan Amendments (Legally Required and Design)
- Distribution Policy
- Distribution Forms
- Diversification Forms
- Beneficiary Designation Forms
- Qualified Domestic Relations Orders (“QDROs”)
- Appraisal Report

Plan Document

- IRS Required Language
- Important Provisions
  - Eligibility
  - Vesting
  - Compensation
  - Allocation – Employer Contributions and Dividends/Distributions
  - Diversification
  - Distribution Language
  - “C” Corporation or “S” Corporation – different rules

Summary Plan Description

- Layman Description of Plan Terms
- As Bob Seger once said: “What to Leave In – What to Leave Out”
- Pay Close Attention to Description of the Topics Discussed Today
- Required to be Provided to Participants
- Summary of Material Modifications (“SMM”) if Plan is Amended

Distribution Policy

- Do You Have One?
- In Writing?
- IRS Paying More Attention?
- Can it be Amended?

Distribution Forms

- Comply with Plan Provisions
- 30 Day – 90 Day Window Period
- Stock vs. Cash
- Timing of Distributions with Appraisal Report

Beneficiary Designation Forms

- On File for Everyone?
- Plan Default Language
- Spouse Consent for Non-Spouse Beneficiary
- Impact of QDRO
  - Important since many ESOP distributions take longer to pay out than 401(k) distributions

Common Mistakes In Plan Operation

Plan Entry

- Maximum entry provision

  - Age 21 and One Year of Service
    - Could be two Years of Service, if immediate vesting
    - Year of Service – Generally, 12-month period with at least 1,000 hours worked

  - Members of certain classes can be excluded – e.g. union employees excluded per collective bargaining agreement

Plan Entry

- Common Error
  - Having employees enter too soon or too late
  - Handling of rehires

- How to Prevent
  - Know the Plan Document
    - Who is eligible?
    - What are the eligibility requirements?
    - Break in service rules for rehires
  - Maintain full employment history for employees

Eligible Compensation

- Employer contributions and reallocated forfeitures are generally allocated based on eligible compensation but can also be allocated on a combination of points and service
  - In either case, compensation is an important component

- ESOPs generally require participants to meet requirements each year in order to receive an allocation:
  - Employment requirement (last day)
  - Hours requirement
  - Either or both can be and often are waived if a participant’s employment ends due to death, disability, or retirement

Eligible Compensation

- Contributions, forfeitures, released shares

Eligible Participant	Wages	% of Total Wages	Contribution/ Forfeiture
Brown	$30,000	30%	$3,000
Smith	$40,000	40%	$4,000
Jones	$30,000	30%	$3,000
Totals	$100,000	100%	$10,000

Eligible Compensation

- Common Error
  - Not using correct definition of compensation
  - Not excluding appropriate amounts
  - Section 414(m) test

- How to Prevent
  - Know the Plan Document
    - Different compensation definitions for different purposes
  - Know the starting base of compensation
  - "Map" compensation buckets in payroll system

Allocation Eligibility

- Common Error
  - Missing or erroneous people getting allocation
- How to Prevent
  - Know the Plan Document
    - Different rules for different plan components
    - Exceptions to the rules
    - “S” vs “C” Corps
  - Make sure able to track hours and employment history in timely fashion

Section 1042 Elections

- Capital gain taxes on sale of shares to ESOP can be deferred or avoided if:
  - Owner sells stock issued by a domestic, non-publicly traded C corp to ESOP
  - ESOP owns at least 30% of stock after sale
  - Seller reinvests proceeds in “qualified replacement property” (QRP), which are securities of domestic operating companies
  - Seller and seller’s family do not receive allocations of the stock in the ESOP for 10 years; 25% owners never receive allocations of the stock

Section 1042 Elections

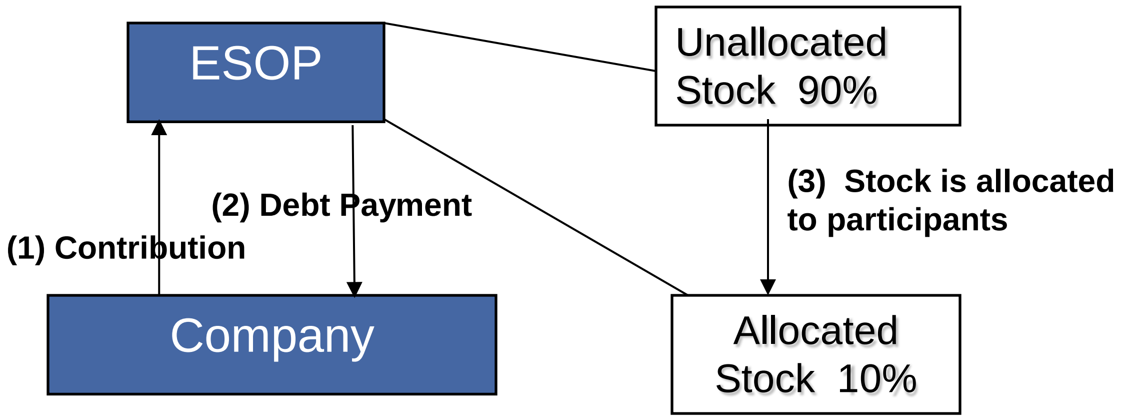
- 1042 Exclusions
  - Selling shareholder
  - Members of selling shareholder family (IRC 267(b))
  - 25% shareholders
  - No other “make up” contributions inside qualified plan
  - Applies even if company goes from C Corp to S Corp status
  - Family may receive allocations based on 5% deminimus rule
  - May share in Non 1042 Allocations
  - Note: there are varying practitioner views on who may receive 1042 forfeitures

Section 1042 Elections

- Common Error
  - Not excluding people who elected 1042
  - Not excluding related employees of those who elected 1042
  - Not excluding 25% owners (outside and inside ESOP)

- How to Prevent
  - Know if people who sold shares elected 1042
  - Know relationships among employees who elected 1042 and 25% owners

Release of Suspense Shares



(1) The Company makes a tax deductible contribution to the ESOP.

(2) The ESOP makes its debt payment back to the Company.

(3) Stock is released from suspense (and as collateral) and allocated to participants as debt is repaid.

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Release of Suspense Shares

- Principal-only Method

$$\frac{\text{Current Principal Payment}}{\text{Current + Future Principal Payments}} \quad * \quad \text{Shares in Suspense}$$

- Principal-and-Interest Method

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

Release of Suspense Shares

<u>$100,000 principal payment</u>

$1,000,000 current+future principal payments

*

100,000 shares in suspense

=

10,000 shares release

Release of Suspense Shares

Year	Principal Payment	Shares Release	Suspense Account
0	$100,000	10,000	100,000
1	$100,000	10,000	90,000
2	$100,000	10,000	80,000
3	$100,000	10,000	70,000
4	$100,000	10,000	60,000
5	$100,000	10,000	50,000
6	$100,000	10,000	40,000
7	$100,000	10,000	30,000
8	$100,000	10,000	20,000
9	$100,000	10,000	10,000
10	$100,000	10,000	0
Totals	$1,000,000	100,000	

Release Of Suspense Shares

- Common Error
  - Not using proper release method
  - Not using proper interest rate/calculation
  - Not using proper funds for loan payments
  - Impact of refinancing
  - Principal only release is limited to 10 years
- How to Prevent
  - Know the Plan and Loan Documents
    - Release method and interest rate calculations
  - Tracking of available sources in trust and participant accounts
- Possible to have several ESOP loans

Vesting

- Vesting refers to the amount of time an employee must work before acquiring a nonforfeitable entitlement to his or her benefit.
- Employees who leave the company before being fully vested will forfeit their benefits to the extent they are not vested in them.

Vesting

- Vesting is based on years of service:
  - Hours method – 1,000 hours in a plan year
  - Elapsed Time Method – 12 month period

- May disregard
  - Service before the plan's effective date
    - Could give partial credit before the effective date
  - Service before age 18

Vesting

6-Year Graded

Years	Vested %
0	0
1	0
2	20
3	40
4	60
5	80
6	100

3-Year Cliff

Years	Vested %
0	0
1	0
2	0
3	100

More generous vesting schedule can be used.

100% Vested

- Fulfill requirements of vesting schedule
- Retirement
- Death (optional)
- Disability (optional)
- Partial plan termination
- Plan termination or complete discontinuance of contributions

Vesting

- Common Error
  - Not using proper periods to determine vested service
  - Not determining proper vested percentage

- How to Prevent
  - Know the Plan Document
    - How is vested service determined? (elapsed time vs. year of service)
    - When does vested service start?
    - What is the vesting schedule and exceptions?

Forfeitures

- Employee terminates employment before reaching 100% vesting

- Forfeiture event
  - After 5 consecutive breaks in service
  - Entire vested account balance distributed

- Forfeiture proceeds
  - Reinstate previously forfeited balances
  - Allocated to eligible participants
  - Pay plan expenses

Forfeitures

- Common Error
  - Forfeitures happening too soon or too late
  - Not forfeiting accounts on proper hierarchy
  - KSOP's – not taking all balances into account

- How to Prevent
  - Know Plan Document
    - Timing and hierarchy definitions
  - KSOP's - Need to coordinate with other plan balances

Dividends Used For Loan Payments

- Common Error
  - Not using allowable dividends for loan payments
  - Not meeting the fair market value rule
  - More than one loan?

- How to Prevent
  - Properly tracking accounts at participant level
  - Only dividends paid on shares acquired with the loan can be used to pay down that applicable loan
  - The fair market value of shares released with dividends on allocated shares must at least equal the dividend the participant would have received

Match in the ESOP

- Common Error
  - Not including correct participants
  - Not using correct compensation
  - Not complying with match terms (cash vs. value)
  - No one doing ACP testing
- How to Prevent
  - Know Plan Document
    - Could have different definitions between ESOP/401(k)
  - Know who is responsible for testing

Tracking Accounts

- Common Error
  - Not tracking accounts separately for plan purposes
- How to Prevent
  - Track accounts separately for:
    - Section 1042 elections
    - Leveraged vs. Non-leveraged
    - Specific diversification or distribution rules
    - Different money sources (match, deferrals, money purchase)
    - Different vesting provisions

Tracking Cost Basis

- Common Error
  - Paying distributions in shares and not tracking cost
  - Incorrect NUA if lump sum distributions
- How to Prevent
  - Track cost basis for each share account per participant
  - Know original cost and also adjust for S corporations

Section 409(p) Testing

Incredibly simplified description of a very complex test:

Disqualified Persons (DP's) cannot own more than 50% of S-Corporation ESOP shares, non-ESOP shares and Synthetic Equity

Section 409(p) Testing

- Disqualified Person (DP)
  - Individual who owns 10% of all Deemed-Owned shares
  - Member of family owning 20% of all Deemed-Owned shares
  - Deemed-Owned shares include:
    - ESOP Shares – actual and pro-rata portion of suspense
    - Synthetic Equity
    - NOT shares held outside the ESOP

Section 409(p) Testing

- Failure is not an option:
  - Prohibited Allocations include:
    - Stock and stock-related allocations made to DPs during the year of failure and
    - Stock and stock-related balances in DP accounts at the beginning of the year
  - Prohibited Allocations are treated as distributions to the DP, including taxes and early withdrawal penalties
  - Corporation pays:
    - 50% excise tax on Prohibited Allocations
    - 50% excise tax on the FMV of Synthetic Equity held by a DP

Section 409(p) Testing

- Common Error
  - Not doing test timely
  - Not doing test correctly

- How to Prevent
  - Do projected test prior to major ownership structure change or share transactions within the ESOP
  - Know and track important data that impacts test
    - Family groups
    - Outside Ownership
    - Synthetic Equity

Maximum Annual Additions

- Annual Additions cannot exceed the lesser of $53,000 (for 2015) or 100% of gross wages
- Annual Additions consist of:
  - Employer contributions to the ESOP and to any qualified plan sponsored by the employer (profit sharing, MPP, etc.)
  - Employer matching contributions
  - Reallocated forfeitures of cash and stock (at year end fair market value) in the ESOP; reallocated forfeitures in other plans
  - 401(k) pre-tax salary deferrals, reduced by catch-up contributions
  - Employee after-tax contributions
- For C-Corps, if not more than 1/3 of contributions used to pay principal on the ESOP loan are allocated to HCEs, then can exclude the following from Annual Additions:
  - Contribution used to pay interest on ESOP loan
  - Reallocated forfeitures of leveraged stock

Maximum Annual Additions

- Plan document can specify that, instead of counting employer contribution ($) as Annual Additions, cost-basis or FMV of released shares is used
- Corrections to failures:
  - Generally, return employee deferrals first, then reallocate excess amounts
- It is best to have your 401(k) recordkeeper supply Annual Additions under that plan/component to the ESOP recordkeeper, so that the ESOP recordkeeper can use the method that yields the best results (and is permissible under the plan)
- If 401(k) plan and ESOP have separate plan years, this test must be performed at each plan year end, based on the Annual Additions for that plan year

Maximum Annual Additions

- Common Error
  - Not calculating ESOP annual additions properly
  - Not doing a combined test (Does Company maintain separate 401(k) Plan?)
  - Not correcting excess additions properly

- How to Prevent
  - Use annual additions from all plans in the test
  - Know all Plan Documents

Diversification

- Qualified participant has the right to elect to diversify up to 25% of the number of shares in his/her post-1986 company stock account for the first 5 years and up to 50% of the number of shares in his/her post-1986 company stock account for the 6th year after satisfying the diversification eligibility requirements
  - "Qualified participant": age 55 and 10 years of ESOP participation
- Election opportunity not required (but still permitted) if shares in stock account have market value of $500 or less

Diversification

- Common Error
  - Not calculating participation correctly
  - Not calculating diversification amount correctly
  - Not satisfying diversification timely

- How to Prevent
  - Know Plan Document
  - Make sure tracking “counter” for 10 year requirement
  - Make sure tracking Pre 87 shares separately from Post 86 shares
  - Make sure doing cumulative calculations
  - Need to make good-faith effort to adhere to 90/180 day rule

General ESOP Distribution Rules

- If separation from service is due to normal retirement, death or disability, a benefit payable under the Plan may be postponed to a date not later than one year after the close of the plan year in which the individual retired, became disabled or died.
- If separation from service occurs for reasons other than retirement, death or disability, a payment may be postponed to a date not later than the close of the sixth plan year after the plan year in which the participant separated from service (i.e., quit or got fired).
- If distributions are made in installments, the participant's Employer Stock account can be converted to cash or remain in Employer Stock. If left in the Employer Stock, such stock will be valued annually as the annual distribution installments are made.

Recycling v. Redeeming

- ESOP law permits the Employer to "recycle" or to "redeem" the shares when making a distribution to a former employee.

- Recycling:
  - Briefly stated, involves the Employer making a cash contribution to the Plan, and such contribution would be used to make cash distributions to those entitled to a distribution.
  - Keeps the number of shares in the ESOP the same.
- Redemptions
  - The shares are distributed to the participant and pursuant to an "automatic put option" are immediately purchased by the Employer.
  - Number of shares in the ESOP continue to dwindle as each distribution is made.

- As the issue of repurchase liability is studied further, it may very well be that the Employer decides to redeem in one year and recycle in the next or some variation thereof.

Distributions

- Common Error
  - Not using current fair market value
  - Not paying in correct form
  - Not making payouts timely
  - Not calculating withholding correctly

- How to Prevent
  - Do not pay distributions after plan year end on old value
  - Know Plan Document and/or distribution policy
  - Tracking of cost basis

Plan Qualification Errors

- Plan provision or lack of plan provision that fails to meet 401(a) qualification rules
  - E.g. No diversification provision in the Plan document
- Plan not timely amended for change in law
  - E.g. Definition of spouse in Plan continues to exclude same-sex couples with a valid marriage from another state
- Plan amended in violation of anti-cutback rules

The Pain

- What happens if the IRS and DOL catch your error?

IRS And DOL Have Investigative Authority

- Perform on-site audits
- Require submission of reports, books, and records
- Inspect books and records
- Question individuals regarding investigation
- Subpoena records and testimony in connection with investigation

How Far Back Can They Go?

- DOL - ERISA has 6 year statute of limitations, but generally DOL audits will not go back further than 2-3 years
- IRS - Code generally allows for 3 year statute of limitations

What Penalties Can IRS Assess?

- IRS - Disqualification
  - Loss of tax deductions to ESOP plan sponsor
  - Loss of tax-exempt status of ESOP trust (earnings are then taxable)
  - Participants must include vested allocations as taxable income
  - If disqualification due to ESOP's failure to meet minimum coverage or minimum participation requirements, then each HCE must include all of his or her account balances as taxable income

More IRS penalties?

- IRS - Closing Agreement Program
  - Instead of disqualifying ESOP, IRS will most likely enter into an agreement where ESOP sponsor pays sanction for disqualification defect
- The sanctions are determined by taking the maximum tax liability that would result from disqualification and then give the ESOP sponsor the opportunity to negotiate it downward based on equitable factors

Even More? Yes!

- IRS - Other Penalties
  - Prohibited Transactions - disqualified person is liable for 15 percent of the amount involved (can be increased to 100 percent of amount involved)
  - Over-Contribution to ESOP - 10 percent of the amount contributed to the ESOP that exceeds the maximum contribution limitation for year

DOL Penalties

- DOL - Filing and Disclosure Penalties
  - Assessment of civil penalties for late 5500 filings of up to $1,000/day past filing date (DOL has limited this to $300/day)
  - Form 5500 rejected by DOL because it lacks material information is considered not filed
  - Failure to issue SPDs, SARs, and account statements - $110/day past deadline

You Can Cure What Ails Your ESOP

- IRS's Correction Programs – Employee Plans Compliance Resolution System (EPCRS)
  - Self-Correction Program (SCP)
  - Voluntary Correction Program (VCP)
  - Audit Closing Agreement Program (CAP)

- DOL's Correction Programs
  - Voluntary Fiduciary Compliance Program (VFCP)
  - Delinquent Filer Voluntary Compliance Program (DFVCP)

Questions?

Stephen J. Lowney

- Stephen J. Lowney is a shareholder in the Lansing office of Foster Swift whose legal practice is in the business and tax areas, with an emphasis on ESOPs (employee stock ownership plans), 401(k) plans, other kinds of deferred contribution plans and other forms of equity compensation benefits.
- Steve is a long standing member of the National and Michigan Chapter of the ESOP Association, the National Center for Employee Ownership (NCEO) and has served as a past chairperson of the Employee Benefits Committee of the State Bar of Michigan Taxation Section. Steve regularly speaks on ESOP related subjects to local, regional and national organizations and interested groups. Steve frequently serves as an adjunct professor at Thomas M. Cooley Law School in Lansing, Michigan. He has been listed in ***Best Lawyers® in America*** since 2005. Since 2007, Steve has been selected by his peers for inclusion in the ***Michigan Super Lawyers*** listing. Steve has also presented a number of national webinars for the National Center for Employee Stock Ownership (NCEO).

Pete Shuler

- Pete Shuler is a partner of Crowe Horwath LLP and has 20 years of experience assisting his clients by administering and consulting on ESOPs and other qualified retirement plans. His current responsibilities include managing the administration of over 525 ESOPs; consulting with companies considering ESOP-related transactions; performing feasibility studies; consulting on the termination and merger of ESOPs; forecasting the impact of new legislation on the compliance and operation of ESOPs; and coordinating and reviewing repurchase liability studies.
- Pete frequently speaks and writes on technical topics regarding ESOPs. He has a Bachelor of Business Administration in Finance from the University of Notre Dame.