

CLIENT ALERT

LONG TERM ESOP FUNDING STRATEGIES

Written by: Brian D. Wurpts

If you attend a national meeting of The ESOP Association or the National Center for Employee Ownership, you will find two common themes on the agenda for mature ESOP companies: ESOP Sustainability and the “Have/Have Not” problem. The ESOP Sustainability sessions deal with strategies for managing the repurchase obligation to ensure that the obligation doesn’t become too burdensome for an ESOP company. The Have/Have Not sessions describe a common situation where leveraged ESOPs create two employee classes: the “Haves,” who participated during a substantial funding phase (usually while the ESOP’s debt was being repaid), and the “Have Nots,” who came later and missed the substantial allocation of shares during this period. This article discusses how an ESOP company’s funding decisions may exacerbate the Have/Have Not problem and may alleviate the ESOP Sustainability concerns.

Life Cycle of a Typical ESOP

ESOPs are unique among qualified retirement plans in that they often serve three distinct roles.

Three Roles of an ESOP

- 1** They are a corporate finance tool intended to create a liquidity event for shareholders of the sponsoring company on a tax advantaged basis.
- 2** They are intended to be a retirement benefit for their participants. (These benefits may be thought of as the quid pro quo for the tax advantages the company and selling shareholders receive.)
- 3** And finally, many ESOPs are intended to be an employee incentive program.

By their nature, ESOPs align the interests of the company and its employees by linking employee actions to a long-term economic reward.

When a company first adopts an ESOP, the primary motivation is usually to facilitate the purchase of shares by the ESOP from one or more shareholders. The company borrows money to fund the transaction, usually resulting in the ESOP owning 30 - 100 % of the company. During the debt repayment phase the company is usually mo-

tivated by two factors: (1) the tax shelter created by ESOP contributions and (2) retirement of the transaction debt. Often the ESOP company will make large contributions (15–25% of company payroll) during this five to ten year period in order to match its tax deductions to the debt service. The company is further motivated to amortize the company/ESOP debt quickly because it generates tax deductions without creating a cash burden (contributions made to the ESOP are returned to the company as debt payments). After the debt is paid, ESOP contributions typically drop off dramatically until there is another leveraged purchase transaction or a substantial benefit distribution from the plan.

After the debt service period ends, most ESOP companies will begin to look at repurchase obligation. An ESOP sponsor will often hire a repurchase consultant to prepare a study or purchase software to help them quantify the obligation. They will use this information to begin budgeting for future repurchase obligations, setting aside funds earmarked for this purpose. Some ESOP sponsors ignore the repurchase obligation for too long and may find themselves in a situation where they are not prepared to make the contributions necessary to fund the obligation. In a small minority of cases, ESOP sponsors must turn to other solutions such as sale or liquidation of the company. Many will make erratic contributions to the ESOP determined only by the size of that year’s repurchase obligation.

While the short-run behaviors of an ESOP company are understandable, a long-run strategy will lead to a much more predictable cash flow stream for the company and a fairer result for non-ESOP shareholders and ESOP participants.

Long Term ESOP Funding Plan: A Better Way

We recommend that you make a plan for your ESOP funding based on a budget of four components: i) a retirement plan contribution; ii) profit sharing contribution; iii) debt service funding contribution; and iv) repurchase funding contribution. Breaking the contribution and/or dividend funding into these component parts is the first step in creating a funding plan that meets your plan’s obligations while

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avoiding the pitfalls created by erratic funding decisions.

i) Retirement Plan Contribution
Typically 1-5% of pay

Think of this portion of a contribution as the contribution a company would make if it had no ESOP. Consider the contributions (matching or profit sharing) the company made to its 401(k) plan before it adopted the ESOP. Evaluate the retirement plan contributions the company's competitors make and the general expectations of the company's employees regarding retirement contributions. This portion of the contribution should be fixed for long periods. From the perspective of management, the board of directors, and the non-ESOP shareholders, this contribution should be considered a cost of doing business.

ii) Profit Sharing Contribution
Typically 0-10% of pay

If you want to use the ESOP as an incentive plan, base a portion of the ESOP contribution on profitability and advertise it! Set a range of possible contributions and tie it to a tangible revenue or net income metric. Follow through on the plan, presenting the contribution as a separate line item on the ESOP benefits statements, and communicate the concept to employees. Management, the board, and the non-ESOP shareholders should evaluate this program like any management incentive or profit-sharing plan.

iii) Debt Service Contribution
Typically 10-15% of pay

During the loan repayment period the amounts described above are usually included in the debt service contribution and the entire ESOP contribution is then used to service debt. Because debt service repayment has a much different goal and motivation than the retirement plan and profit sharing contributions described above, it should be evaluated under different criteria. Management, the board and any non-ESOP shareholders should weigh the tax benefits of this contribution against the costs for other stakeholders. For example, if the level of debt service contributions (after factoring in the tax shield) creates unreasonable compensation for the employees, the company may want to avoid acceleration of the debt repayment or consider extending the term of the loan to the ESOP. From a benefits perspective, management and the board should evaluate the impact of dropping this portion of the contribution after the debt repayment period.

iv) Repurchase Funding Contribution
Typically 5-15% of pay

This portion of the contribution typically does not begin until the ESOP debt is repaid. This contribution is very much like the debt service contribution in that it funds a liquidity event for shareholders, but in this case we're funding the eventual exit of ESOP participants. The first step in evaluating an appropriate funding level is to measure future repurchase obligation. A reasonable rule of thumb is that an ESOP's assets turn over every 15 to 25 years (meaning you need 4 - 7% of the value of the ESOP's stock in liquid assets at any given time). A repurchase obligation study is

an even better approach. After the repurchase obligation is estimated, the company should set an annual funding budget that ensures that the Trust will meet its obligations. As with the debt service contribution, the entire ESOP contribution may be used to fund repurchase obligation. Again the intention of this category is to define the level of funding necessary to close any gap between the funding need and the normal retirement plan and profit sharing contributions. This type of contribution should be evaluated for fairness, recognizing the tax benefits of ESOP contributions or ownership. For most profitable ESOP companies, the tax benefits outweigh the funding costs. For example, let's assume an ESOP sponsor creates \$100 of profit SERP attributable to the ESOP's ownership. This profit translates into roughly \$40 of tax savings and \$500 of company value. The liquidity funding need created by this profit is \$20 to \$35.

Funding Cash in the ESOP after Debt Repayment Period

Contributions to an ESOP after the debt repayment period are perhaps the most neglected aspect of ESOP funding. Most ESOP companies are naturally conservative. They emerge from a highly-leveraged period (the debt repayment phase) and are motivated to preserve cash. However, we recommend a long view. It's important to set a cash funding budget both to ensure that new employees are incentivized through the ESOP and to provide sufficient cash to the ESOP to fund its repurchase obligation. Cash contributions to the ESOP also provide some diversification and protection from creditors for the ESOP participants.

Tools for Solving the Have/Have Not Problem

There are tools for undoing a Have/Have Not situation. Those ESOP companies that aggressively funded during the debt repayment phase and then substantially dropped the contribution level have the option of adopting a plan rebalancing provision. Plan rebalancing is the practice of making intra-trust exchanges among the plan participants such that after the execution of the exchanges each ESOP participant holds the same proportion of company stock and other investments in their account. Rebalancing addresses situations where new employees hold substantial cash balances, but there is not enough repurchase or forfeiture activity for the new employees to obtain significant stock balances. Rebalancing has the added benefit of making every participant equally diversified. One needs to understand however, that rebalancing without funding through cash contributions accomplishes nothing. Contributions and forfeitures are the only actions that build significant benefit balances in the accounts of new employees. As another tool to put more stock in the accounts of newer employees, companies may consider account segregation. Similar to rebalancing, segregation is an exchange of cash for stock within the trust. The difference is that the exchange takes place exclusively between active participants and terminated participants. Segregation results in termi-

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nated participants holding non-stock assets, while active participants hold as much company stock as possible. Segregation has several benefits: (1) it diversifies the terminated participant's account; (2) it ensures that those benefiting from company stock appreciation are those who are contributing most to the outcome (active employees); (3) it pre-funds the repurchase obligation; and (4) it provides shares to new employees.

An ESOP company that wishes to ensure the sustainability of its ESOP and fair results for all stakeholders should take a long view of ESOP funding. A long-term plan smoothes the benefit allocations, provides greater flexibility, helps to keep contribution levels consistent with the company's financial performance, and avoids potential compliance problems arising from funding needs when the repurchase obligation level is high.

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IRS ISSUES NOTICE 2010-6 TO HELP COMPANIES FIX DEFECTIVE NONQUALIFIED DEFERRED COMPENSATION PLANS

Written by: Stephen P. Magowan

In early 2010, the Internal Revenue Service issued Notice 2010-6, which provides a voluntary correction program for certain nonqualified deferred compensation plan document failures that would otherwise cause a violation to occur under Code Section 409A. This program is similar in ways to the Employee Plans Compliance Resolution System for qualified plans. Notice 2010-6 provides for some standard corrections of typical document failures and sets forth a set system of fees for correcting the disqualifying plan document failures. The goal of Notice 2010-6 is to get taxpayers to fix problems with their plan documents.

Background

Congress enacted Code Section 409A in 2004 to prevent abuses of nonqualified deferred compensation plans. Among other things, 409A provides for a rigid set of rules regarding when participants can elect to defer compensation and when and how deferred compensation will be distributed. Failure to comply with Code Section 409A leads to three levels of taxation:

Three Levels of Taxation

- 1 The deferred amount plus earnings, if any, is included immediately in taxable income.
- 2 The deferred amounts are subject to an additional penalty tax of 20% (the "20% Penalty Tax").
- 3 Amounts are subject to another additional tax equal to the underpayment rate that would have been due if the amounts deferred had been included in income when no longer subject to a substantial risk of forfeiture (the "Premium Interest Tax").

The IRS issued a number of notices and proposed final regulations under 409A. Although taxpayers had to comply with 409A generally beginning upon its passage, the form of pre-409A nonqualified deferred compensation documents did not have to come into compliance until December 31, 2008. Notice 2010-6 represents in part

an effort by the IRS to "bring the stragglers into the barn" and get them in compliance.

Basic Structure of the Notice

Notice 2010-6 is rather lengthy and cannot be summed up point by point in a short article. Some key aspects of the notice are: (1) certain commonly used language will not be deemed a violation as long as the plan is operated in compliance with 409A; (2) if the employer fixes certain outlined document failures and there is no effect for one year - meaning there is no additional deferral caused by the change and there is no acceleration of benefit payments either - then *generally* there is no tax due; and (3) if there is an effect within one year (i.e., an additional deferral or an acceleration), then typically tax will be due (at 25% or 50% of the amount affected), plus the 20% Penalty but no Premium Interest Tax.

Eligibility to Use the Provisions of Notice 2010-6 and Impact of Correction

In order to avail yourself of the protective provisions of the Notice, the service recipient company has to demonstrate that the failure in question is one of the listed document failures in Notice 2010-6. Next, the company also has to show that the proposed fix fits within the parameters of the repairs allowed. Third, both the service provider and the service recipient have to report the problem and the fix to the IRS. The service recipient also needs to fix all plans containing similar problems. Finally, no one can avail themselves of the protection offered by this Notice if the service provider or service recipient is under examination or if the failure was intentional or a listed tax shelter type transaction.

What is the impact if the service recipient and service provider

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comply with Notice 2010-6? If you fully correct the document, pay any applicable taxes and undergo all required reporting, then the service provider does not have to include the deferred amount in income and service recipient is not required to report any income under 409A for any year prior to the year of correction.

Types of Problems That Can Be Corrected

A brief summary of the kinds of provisions that can be fixed under the Notice is as follows. The Notice allows for a penalty-free cleaning up of language that provides for payments “as soon as practicable” following a given event (or similar payment language) if the plan has in fact operated in compliance. The Notice gives a roadmap for fixing impermissible definitions of otherwise permissible payment events like “separation from service,” “change in control” or “disability.” The Notice shows how to fix impermissible payment periods following a permissible payment event (i.e., periods longer than 90 days after a payment event). There are also provisions for correcting:

- (1) impermissible payment events and payment schedules (there are six sub-categories of these problems outlined in Part VII of the Notice);
- (2) failures to include the six-month delay (required for certain employees of public companies); and
- (3) impermissible initial and subsequent deferral elections.

Example of a Fix:

Impermissible Definition of Separation from Service

Let’s focus in on one class of failures. Certain failures relating to an impermissible definition of “separation from service” (which is a distribution event) are fixable under the Notice. The correction procedures apply to allow correction of the following incorrect plan provisions: (1) payments that relate solely to change in level of services (i.e., from full to part time); (2) payments due to a change in service provider’s capacity (from employee to contractor); or (3) payments due to the service provider being shuffled around among related companies.

In the instance of these failures, the Notice permits the employer to correct the document (i) before the date that an event occurs that would be a payment event under the plan but not under the Treasury Regulations, and (ii) before the date an event occurs that would be a payment event under the Treasury Regulations but not under the plan. If that timing concern is met, the corrective amendment must satisfy the Treasury Regulations, but cannot: (a) expand the definition to create a payment event that was not there before the amendment, or (b)

narrow the definition of a payment event to eliminate a payment event except as necessary to satisfy the Treasury Regulations. Also, the amendments must be effective immediately.

Want to Learn More?

Replay the May 21 webcast on Nonqualified Deferred Compensation Plans:

www.sesadvisors.com/ESOP_webcasts

However, if within one year following the “date of correction” one of the following payment events occurs: (1) that would have qualified under the plan but not the Treasury Regulations or that is a payment event under the Treasury Regulations but not the old plan, or (2) results in the corrected plan postponing the payment or in making a payment due that would not have otherwise be payable - then 50% of the amount deferred has to be included in income.

Summary

The foregoing is just one of the many ways that Notice 2010-6 operates in a given circumstance. The Notice is important for companies that need to fix their nonqualified deferred compensation plans and employment plans that create deferred compensation. A careful review of all the underlying facts will be necessary to determine whether you can qualify and how you can fix your document under Notice 2010-6.

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SES Advisors and SFE&G

Join Clients on Capitol Hill ★

At The ESOP Association’s annual conference in Washington, D.C., Jim Steiker, Brian Wurpts, Mary Beth Gray, Tabitha Croscut and Steve Fischer joined ESOP companies, including client Herbert, Rowland and Grubic, on Capitol Hill to ask for support for H.R. 5207. This new bill is the most comprehensive pro-ESOP bill introduced to the House in recent years, with provisions that would expand the 1042 tax deferral to S corporations, repeal the punitive 10% penalty on S corporation dividends passed through to ESOP participants in cash, and eliminate a bias against majority-owned ESOPs who were eligible for SBA programs before becoming majority ESOPs.

As a result of the visits, three Congressmen from Pennsylvania, Representatives Tim Holden (PA-17), Todd Russell Platts (PA-19) and Jim Gerlach (PA-6) have signed on as cosponsors of H.R. 5207.

We encourage every ESOP company to contact their legislators and invite them for a company visit this summer while Congress is out of session. We need their support to ensure the future of employee ownership, and you are our strongest advocates. For more information on how to get started, visit www.esopassociation.org and download the Advocacy and Congressional Company Visit Kits under Government Affairs, or contact Alice Simons, Marketing Manager at SES, at 215-508-5639.

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