

Why Is My TPA Asking for That? Ascertaining S Corporation ESOP Compliance

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February 2005

If you are an S corporation sponsoring an employee stock ownership plan (ESOP), then you may be wondering what has possessed your third party administrator (TPA) lately. Out of the blue, it may seem like they are requesting endless amounts of new and hard to collect data. They want to know things like does Mr. 5% Owner have any cousins working for the company, does Mrs. Top Dog have a severance package, or does Miss CEO have a deferred compensation arrangement? Well, let me try and explain why your third party administrators are asking for this data and why it is essential that you provide them with every scrap of information they request.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased job security for third party ESOP administrators everywhere. One of the items tucked into EGTRRA was Section 409(p) that generally permits an ESOP to hold S Corporation stock provided that the ESOP benefits a sufficiently broad based group of employees. One would think that we might have it all figured out almost four years later; but alas, the IRS continues to issue regulations on how to comply with the Section and with each new issuance of "guidance" third party administrators are guaranteed more job security. The most recent set of "guidance" was issued in late December 2004 as a Christmas present to ESOP professionals. As a result of these proposed regulations, exhaustive data requests were sent out by third party administrators. This article will try to elaborate on the types of information your TPAs are going to need to properly test your ESOP for compliance with IRC Section 409(p).

Your TPA will be asking you for copies of plans or agreements defining all forms of synthetic equity and you may be tempted to say "never heard of it—must not have any." But you may be surprised to learn just what the IRS has defined as synthetic equity. A common form of synthetic equity is stock option plans. Keep in mind that these plans do not have to be qualified and offered to all employees. If your company has issued options to only key management persons—this still counts as synthetic equity and your TPA needs to know about it. Other forms of synthetic equity include warrants and certain kinds of buy-sell agreements. Phantom stock plans are often used to offset restrictions on plan participation by selling shareholders and their family members who elected Section 1042 (back in your C Corporation days). Phantom stock is synthetic equity. Stock appreciation rights, SERP (Supplemental Executive Retirement Plan) plans, severance packages, traditional cash deferred compensation plans, and employment agreements that provide for compensation or benefits to be paid more than two and half months after a person's employment ceases are all synthetic equity in the eyes of the IRS,

although some deferred compensation arrangements in effect on the date the regulations issued are "grandfathered" and do not count as synthetic equity. Synthetic equity can even be a split dollar life insurance arrangement where premiums and benefits are split between the employer and the employee. And to further complicate this definition, synthetic equity also includes rights to acquire stock or similar interests in any related entity of the S Corporation. Because of the confidentiality of some of these benefits—the human resource department may not know about incentives issued to key employees. To be safe, the human resource department should have senior management verify that all forms of synthetic equity are indeed being reported to the TPA.

Who is family? Most of you in the ESOP world are familiar with family grouping, more cryptically known as family aggregation pursuant to IRC Section 318. Not only does IRC Section 409(p) utilize this definition of aggregation it also expands the definition of family for part of the testing process. The expanded definition of family is very inclusive and requires the human resource department to track family relationships not normally monitored. For example, do you know if Sue is married to John's nephew? Well, you might say who cares—but thanks to this IRS regulation, S Corps sponsoring ESOPs care since Sue and John might be grouped together as family for part of the testing process. The expanded definition of family includes the person, the spouse of that person, ancestor or lineal descendants of that person or the spouse, siblings of the person or the spouse, the lineal descendants of those siblings, and the spouse of any person listed above.

Failing this test is something most companies cannot do and stay solvent—it is that intense. Section 4979A imposes a 50 percent excise tax on any allocation during a non-allocation year and any synthetic equity owned by a disqualified person during the non-allocation year. But it gets worse. If there is a non-allocation year, the 50% excise tax applies to all deemed owned shares (includes allocated and unallocated shares still held in suspense) held by the ESOP for the disqualified persons even if no allocation is made for that year. But it gets even worse. The amount of any prohibited allocation is treated as a distribution to the disqualified person which means the fair market value of their account balance under the ESOP is included in their gross income. Furthermore, if the disqualified person is under age 59 1/2 additional income taxes will apply. And it gets even worse. If there is a non-allocation year and there are prohibited allocations in that year, the plan fails to satisfy the requirements of section 4975(e) which in simple terms means it ceases to be an ESOP. This means the plan could lose its prohibited transaction exemption for loans to an ESOP under ERISA and the Code. The plan would owe income tax with respect to S Corporation stock held by the plan as well as excise taxes for the prohibited transactions. And just when you thought it could not get any worse; it does. Your plan document has surely been amended to prohibit allocations during a non-allocation year, so the plan could lose its tax qualification status for failure to operate the plan in accordance with its terms. This is one regulation that really packs a serious punch if your ESOP violates the provisions.

So in summary, cooperate fully with your TPA so that your test can be performed accurately. If you do not have a TPA you should consult with your ERISA counsel on the nuances of IRC Section 409(p) to ensure you are properly performing the test in-house. If you are contemplating any change in corporate structure, issuing or changing any form of synthetic equity, or hiring family

members—check with your TPA or ERISA counsel before implementing such changes. Most S corporations sponsoring ESOPs will have no problems with IRC Section 409(p)—but have the test done every year to be sure you remain in compliance.

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