BASIC ESOP ADMINISTRATION

ESOP Invitational at Pinehurst
Carolinas and Mid-Atlantic Chapters
March 24-26, 2013

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Overview

- What is an ESOP?
- Data Gathering
- Plan Eligibility
- Allocations
- Compliance Testing
- Distributions and Diversifications
- Government Filings
- Participant Reporting

What is an ESOP?

- An ESOP is a tax-qualified, defined contribution employee benefit plan.
- ESOPs are required to invest primarily in employer securities.
- ESOPs are unique in the fact that they can borrow money in order to purchase employer securities
- ESOPs are governed by the Internal Revenue Code and are subject to Employee Retirement Income Security Act (ERISA) of 1974.
- ESOPs are required to have a written plan document.

Plan Document

- Plan Document
  - Amendments
- Trust Document
- Leverage ESOP Documents
  - Stock Purchase Agreement
  - Stock Pledge Agreement
  - Loan Agreement
  - Promissory Note

Planning Your Annual Allocation

- Create a timeline
- Know your deadlines
- Know the parties involved
  - ERISA Council
  - Appraiser
  - Third-Party Administrator
  - Auditor

Data Gathering – Census

- Information is needed on all employees who worked for the company during the plan year.
  - Social Security Number
  - Name
  - Date of Birth
  - Date of Hire
  - Date of Termination
  - Status – Active, Terminated, Terminated due to death or disability
  - Rehire Information
  - Hours Worked
  - Gross Compensation
  - Plan Defined Compensation
  - Employee 401(k) Deferrals
  - Employer 401(k) Match or Other Contributions
  - Employee Classification – Leased, Union, etc.
  - List of Corporate Officers
  - Shares Held Outside of the ESOP
  - Certain Family Relationship Information
  - Synthetic Equity Held

Participation

- Eligible employees become participants in the plan after completion of the plan's eligibility requirements.
- Maximum Plan Entry Provisions:
  - Age 21
  - One Year of Service
    - Year of Service is defined as 1,000 hours in a 12-month period, regardless of employment
    - Two Years of Service can be required if the participants are fully vested immediately.

Participation – Entry Dates

- Once satisfying the plan’s eligible an employee will enter the plan the plan’s pre-defined entry date.
- Maximum entry date is the earlier of:
  - First day of the plan year which begins after the date the employee completes the eligibility requirements.
  - Six months following the date the employee completes the eligibility requirements.

Rehires

- If a participant had a vested benefit in the plan before they terminated they will enter the plan on the date they are rehired.
- If a participant did not have a vested benefit in the plan before they terminated then the rule of parity is used to decided if their prior service counts for eligibility purposes.
  - Rule of Parity – credit for prior years of service is excluded if the consecutive breaks in service are greater than:
    - Five or
    - The aggregate number of pre-break years of service
- If an employee terminates employment and is rehired before they incur a break in service then their prior service is counted for eligibility purposes.
- If an employee terminates employment and is rehired after they incur a break in service then their prior service is not counted for eligibility purposes.
- Break in service is generally defined as a year with 500 or less hours.

Vesting

- A participant’s non-forfeitable account balance.
- Maximum Vesting Schedules (post PPA)

Years of Service	6 Year Graded	3 Year Cliff
1 Year	0%	0%
2 Years	20%	0%
3 Years	40%	100%
4 Years	60%	100%
5 Years	80%	100%
6 Years	100%	100%

Vesting

- Year of Service – generally 1,000 hours in a plan year.
  - The hour requirement can be less than 1,000
  - Years of Service can be based off of elapsed time
  - Years of Service prior to the effective date of the plan can be excluded or partially counted
  - Years of Service prior to age 18 can be excluded

Vesting Exceptions

- Certain types of contribution are always 100% vested:
  - Employee elective deferrals
  - Rollover contributions
  - Designated Roth contributions
  - After-tax employee contributions
- A participant must be 100% once they reach Normal Retirement Age (NRA)
  - Maximum NRA is the later of age 65 and 5 years of participation in the plan
- Generally plans will fully vest the accounts of participants who terminate due to death or disability although it is not required.

Gathering Trust Information

- ESOP bank account information– bank statements and/or check register
- Contribution amounts, including accruals
- Dividend amounts, including accruals
- Loan payments
- Distribution and Diversification information
- Information regarding new stock transactions

Share Release

- Principal Only Method

$$\frac{\text{Current Principal Payments}}{\text{Current and Future Principal Payments}} \times \text{Shares in Suspense}$$

- Principal and Interest Method

$$\frac{\text{Current Principal and Interest Payments}}{\text{Current and Future Principal and Interest Payments}} \times \text{Shares in Suspense}$$

Allocation – Contributions

- Participants may be eligible to receive a portion of the year's contributions in any plan year in which they met certain requirements.
  - Generally a participant will be eligible for a contribution if they:
    - Work 1,000 hours in the plan year and are actively employed at the end of the plan year.
      - Plans cannot require more than 1,000 hours.
    - Terminate employment due to retirement, death, or disability
      - Plan are not required to provide these exceptions.
- Employer Contributions are typically allocated in a pro-rata manner to all eligible participants based on their eligible compensation or points.

Allocation - Forfeitures

- The non-vested portion of a participant's account balance is typically forfeited upon the earlier of a 5 consecutive year break in service or a complete distribution of the participant's vested account balance.
  - Deemed Distribution – participants who are zero percent vested are generally deemed to receive a distribution as of the date they terminate.
- Rehire Reinstatements
  - If a participant is rehired before a 5 consecutive year break in service and they pay back their distribution, their forfeited account balance should be reinstated.
  - Reinstatements typically come from current year forfeitures but can also come from Employer Contributions or investment earnings.
- Reallocated forfeitures are typically allocated on the same basis as Employer Contributions.

Allocation – Dividends

- Allocated Stock
  - Generally allocated to participants based on the amount of shares they hold.
- Unallocated Stock
  - Generally allocated to participants based on their eligible compensation or points.
  - Can also be allocated to participants based on their total beginning account balance, including other investments.
- Dividends can be passed through to participants

Allocation – Investment Earnings

- Typically allocated to each participant based on their other investment account.
- Can be allocated to each participant based on their beginning account balance, including employer securities
- Withdrawals and Forfeitures are often excluded from this basis.

Allocation

- Other allocations to consider:
  - Stock Repurchase
  - Stock Purchase
  - Rebalancing/Reshuffling

Highly Compensated Employee (HCE) Determination – 414(q)

- 5% Owner – Any employee who owns more than 5% of the Employer, regardless of compensation, during the current or preceding plan year. Certain family attribution rules apply.
- Top Paid – Employees who receive compensation from the Employer in excess of $115,000 (adjusted for cost of living)
  - Top Paid Group – The number of HCEs can be limited to the top 20% of all employees in the company.
    - This election must be used by all of the Employer's plans and must be written into the plan document.

Key Employee Determination – 416(i)(11)

- 5% Owner – Any employee who owns more than 5% of the Employer, regardless of compensation. Certain family attribution rules apply.
- 1% Owner – Any employee who owns more than 1% of the Employer and whose annual compensation exceeds $150,000
- Officer – Any employee who is an officer and whose annual compensation exceeds $165,000 (adjusted for cost of living)
  - The number of officers is limited

Number of Employees	Maximum Number of Officers
30 or less	3
31-500	10%
501 or more	50

Nondiscrimination Test – 401(a)(4)

- Ensures that benefits do not discriminate in the favor of HCEs.
  - Safe Harbor – If contributions and reallocated forfeitures are allocated pro-rata to compensation and the compensation definition is considered safe-harbor under 414(s) then no testing is required
  - Non-Safe Harbor – if the plan uses compensation that is not a designed safe-harbor or if the plan uses a points method of allocation then the plan must be tested using the general test.

Maximum Deductible Contribution Limit - 404

- Under Section 404(a)(3) the total amount of deductible contributions to all qualified plans cannot exceed 25% of covered compensation.
  - Individual compensation is limited to $255,000 in 2013
  - Compensation is not limited by 'mid-year' compensation election
- Under Section 404(a)(9) leveraged C-Corporations do not have to apply interest payments on exempt loans to the contribution limit.

Minimum Coverage – 410(b)(1)

- Ratio Test – The percentage of covered NHCEs must be at least 70% of the percentage of HCEs who are covered.
  - Example

	Total	NHCE	HCE
Total Employees	157	152	5
Excludable Employees	32	32	0
Non-Excludable Employees	125	120	5
Benefiting Employees	117	112	5
Ratio Percentage	93.33%		

- Average Benefits Test

Maximum Annual Additions – 415(c)

- Limits the annual additions of each participant
- The maximum annual addition is the lesser of:
  - 100% of compensation, or
  - $51,000 (for plan years ending in 2013, adjusted for cost of living)
- Annual Additions
  - Employee 401(k) deferrals
  - Employer contributions
    - If the plan is leveraged, the lesser of fair market value of shares released or the amount of payments may be used.
  - Reallocated forfeitures
- One-Third Test – Reallocated forfeitures of employer securities acquired with the proceeds of an exempt loan and employer contributions applied to interest payments on an exempt loan shall not be applied to the 415 limit if the plan passes the one-third test
  - No More than one-third of the employer contributions applied to principal and interest payments on an exempt loan are allocated to HCEs
  - The employer is a C-Corporation

Top Heavy Test - 416

- A company's defined contribution plans will be considered top heavy if, as of the determination date, the aggregate of the accounts of key employees under the plans exceeds 60% of the aggregate of the account balances of all employees under such plans.
  - Certain balances are excluded
    - Former key employees
    - Participants who terminated in a prior year
    - Unrelated rollovers
  - Certain distributions are added back:
    - Distribution that occurred during the 1-year period ending on the determination date
    - In-Service distributions which occurred during the 5-year period ending on the determination date
- If the plans are considered top heavy there is a required minimum contribution of the lesser of 3% or the highest contribution rate of the key employees.

Prohibited Allocation Rule – 1042 – 409(n)

- If company stock is sold to the ESOP by a shareholder who elected Section 1042 tax treatment certain participants cannot receive an allocation of assets attributable to those shares
  - During the non-allocation period the selling shareholder and certain family members cannot receive an allocation of assets attributable to 1042 shares
  - Shareholders holding more than 25% of company stock and certain family members cannot receive an allocation of assets attributable to 1042 shares.

Prohibited Allocation in S-Corporations – 409(p)

- Ensures that if an ESOP holds shares of company stock in an S-Corporation that no assets attributable to the company stock are allocated to disqualified person in a non-allocation year.
- Non-Allocation Year is a year in which disqualified person own at least 50% of the company stock.
- Disqualified Persons
  - 10% Individual Rule – any person who is deemed to own 10% or more of company stock
  - 20% Family Rule – any person who, along with certain family members, is deemed to own 20% or more of company stock
- Synthetic Equity
- 24/7 test

Diversification – 401(a)(28)

- Age 55 and 10 year of participation
- 6 Election Periods
  - Periods 1-5 – 25% of eligible stock
  - Periods 6 – 50% of eligible stock
- Eligible to diversify a ‘cumulative’ percentage of stock
- Applies only to post 1986 stock
- Diversification is satisfied through:
  - Distribution directly to the participant
  - Transfer to another qualified plan (401(k)) that has at least three investment options
  - Keeping the assets in the ESOP but offering at least three investment options for the participants.
- Due Date:
  - Notice must be provided within 90 days after the close of the plan year
    - Preliminary Notice
  - Assets must be diversified no later than 180 days after the close of the plan year.

Distributions

- Distribution Policy
- Types of Distributions
  - Due to Termination
  - Required Minimum Distributions (age 70 ½)
  - In-Service Distributions
  - Hardship Withdrawals
  - Participant Loans

Distributions

- Distribution Timing
  - Death, Disability, or Normal Retirement – generally the plan year following termination
  - Termination for other reason – may be delayed until five years following the year of termination
- Forms of Distributions
  - Cash
  - Stock
- Types of Distributions
  - Lump Sum
  - Installments

Distributions

- Required to give participants at least 30 days to elect a distribution
- Special tax notice
- Required Federal and State tax withholding
- Distributions without consent
  - Less than $1,000 in cash
  - $1,000 to $5,000 transfer to an IRA

Form 5500 – Annual Return/Report of Employee Benefit Plan

- Information Return that must be filed electronically.
- Large vs. Small Plans – 80-120 Participant Rule
- Due Date:
  - The end of the 7th month following the last day of the plan year
  - Form 5558 – Extension of Time
    - Gives an additional 2 ½ months
    - Must be filed before the original Form 5500 due date
- Open to public inspections
  - www.efast.dol.gov

Form 8955-SSA

- Annual registration statement identifying separate participants with deferred vested benefits
- Used to report terminated participants who have not been paid their vested balance.
- Not open to public inspection
- Due Date:
  - Same as the Form 5500 including applicable Form 5558 extension

Form 1099

- Form 1099-R
  - Records distributions and diversifications paid to participants during the year
  - Records 404(k) pass through dividends from the ESOP paid directly to participants
- Form 1099-DIV
  - Records pass through dividends that are not run through the plan
- Due Date:
  - To participants by January 31st
  - To the IRS by February 28th or March 31st if filed electronically

Form 945

- Used to report federal income tax withheld during the year.
- Deposit Schedules
  - Monthly
  - Semi-Weekly
  - Under $2,500
- Due Date:
  - January 31st
- Different states have different withholding and reporting requirements

Participant Statements

- All participants and beneficiaries must be given a statement at least annual or, if the plan has self-direct accounts, quarterly.
- Needs to include:
  - Account balance
  - Vested portion
  - Value of each investment as of the most recent valuation
  - Additional details required on quarterly statements.
- Due Date:
  - Annual - on or before the date the Form 5500, including extension, is filed.
  - Quarterly – at least 45 days after the end of each quarter

Summary Plan Description (SPD)

- Provides the provisions of the plan document in layman's terms.
- Due Date:
  - For new ESOPs – 120 days after the plan is adopted or 120 days after the plan is effective, whichever is later
  - For new participants – 90 days after becoming a participation
  - For beneficiaries – 90 days after first receiving benefits.
- Summary Material Modification (SMM) – amendment to the SPD

Summary Annual Report (SAR)

- Provides a summary of the Form 5500 to plan participants and beneficiaries.
- Due Date:
  - 9 months after the plan year end or
  - 2 months after the due date of the Form 5500, including extension, if later

Questions

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