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The Impact of Plan Design and Operations on Ownership Culture

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Bios

Christopher L. McLean, Esq. of Kaufman & Canoles, P.C.

Christopher is an associate in the ESOPs & Employee Benefits Group where he advises clients on a broad range of issues relating to qualified and nonqualified plans and corporate transactions. Christopher's practice focuses primarily on the design, implementation, maintenance and compliance of employee stock ownership plans ("ESOPs") as well as a variety of nonqualified executive compensation plans. Christopher has worked with ESOP Sponsors and ESOP Trustees in a wide range of corporate ownership succession transactions, including leveraged buyouts, corporate stock repurchases and corporate reorganizations. Mr. McLean is a graduate of the University of Virginia and the University of Richmond School of Law, *cum laude*.

Thomas Roback, Jr., CEP, QKA - Managing Director of Blue Ridge ESOP Associates

Tom has worked in the accounting, investment and ESOP industry for over 20 years. He is an expert in the design, implementation and execution of ESOP, stock option, stock purchase and restricted stock plans. Mr. Roback received his MBA from the University of Baltimore and a BS in Accounting from the College of William and Mary. He is a Qualified 401(k) Administrator, Certified Equity Professional and the Immediate Past Chair on the Board of Directors for the National Center for Employee Ownership. Tom is also the Capital Area Regional Vice President of the ESOP Association's Mid-Atlantic Chapter and the Secretary for the Central Virginia Employee Benefits Council. He is a member of The ESOP Association, ESCA and the National Center for Employee Ownership.

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ESOP Plan Design

- Individually Designed Plans
- What are the options?
- How decisions on plan design can impact the ownership culture of your ESOP company

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Structure

- Leveraged ESOP vs. Unleveraged ESOP
- C Corporation vs. S Corporation
- Section 1042?

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Eligibility

- The first thing that impacts an employee owner…
  - Age Requirement
    - Maximum 21 years old
    - Service prior to reaching minimum age can be ignored
  - Service Requirement
    - Maximum is 1 year if using a vesting schedule
    - Can require 2 years with full and immediate vesting
  - Certain classes of employees can be excluded
    - Leased Employees
    - Union Employees
    - Nonresident Aliens

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Plan Entry

- Options
  - Date eligibility requirements are met
  - Dual entry
  - Quarterly
  - Monthly
  - Annually*

* Additional rules may apply

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Vesting

- Maximum Graded Vesting Schedule
  - Years of Service / Vesting Percentage

Years of Service	Vesting Percentage
0	0%
1	0%
2	20%
3	40%
4	60%
5	80%
6+	100%

- Maximum Cliff Vesting Schedule
  - Years of Service / Vesting Percentage

Years of Service	Vesting Percentage
0	0%
1	0%
2	0%
3	100%

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Vesting

- 100% Vesting at
  - Death
  - Disability
  - Normal (or Early) Retirement Age

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Years of Service for Vesting

- Typically a plan year in which a participant works 1,000 hours
  - Can use a small number of hours
  - Can use an equivalency method rather than actual hours
  - Can use elapsed time method
- Include Years of Service prior to implementation of plan?
- Include Years of Service prior to age 21?

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Compensation

- Definition
  - Exclusions
    - Overtime?
    - Bonuses?
    - Commissions?
    - Over a certain limit?
  - Include salary deferrals?
  - Include pre-participation compensation for participants who enter the plan mid-year?

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Who is allocated a contribution?

- Eligible Employees
  - Reached Plan Entry Date
- Service Requirement
  - Typically 1,000 hours of service
- Employment Requirement
  - Typically participants must still be employed on the last day of the plan year
  - Service and employment requirements can be waived for participants who terminate due to death, disability, or retirement

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How are contributions allocated?

- Eligible compensation to total of all eligible compensation
  - Maximum allowable limit: $265,000 (2015)
- Point System based on:
  - Years of Service, and
  - Compensation

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Share Release – Leveraged ESOPs

- Shares are released from suspense as the ESOP Loan is paid off
  - Principal and Interest Method
  - Principal Only Method

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Dividends/S-Corp Distributions

- Allocated based upon share balance rather than compensation

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Reshuffling

- After all allocations are made, the available cash in the plan is used to cash-out the shares in terminated participants' stock accounts and the shares are then allocated to the accounts of active participants

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Rebalancing

- After all allocations are made, all accounts are rebalanced so that every participant holds the same percentage of stock and cash (or other investments) in their accounts

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Rebalancing - Example

Allocated Share Value: 4,000,000 80%

Cash/Investments: 1,000,000 20%

Total Allocated Assets: 5,000,000

- The account value of each participant will be made up of 80% stock and 20% cash

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Distributions

- What is distributed?
  - Vested Balance
  - Cash or Stock?
  - Forfeitures

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Distributions

- When?
  - Termination due to death, disability, or retirement
    - No later than the plan year following the event
  - Other termination
    - No later than sixth plan year after the plan year of termination
    - Can be delayed further with leveraged ESOPs in some cases

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Distributions

- How?
  - Installments:
    - Substantially equal payments
    - No longer than five years (can be six installments)
    - Can be extended if balance exceeds threshold—one year for each $210,000 by which balance exceeds $1,070,000 (2015)
  - Lump Sum

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What happens to the shares?

- Recycling
- Redemption
- Re-Leveraging

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Diversification

- Age 55
- Ten years of participation
- Option over six years
  - 25% of shares eligible in years 1-5
  - 50% of shares eligible in year 6

  - Calculation is cumulative
  - Plan can provide for more liberal diversification

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Voting of Shares

- When is a pass-through vote required?
  - Sale of "all or substantially all" of the company's assets
  - Merger
  - Liquidation
  - Recapitalization of company
  - Reclassification
  - Dissolution of company
  - Consolidation of company
- Plan can provide for more events, such as sale of stock
- How should a pass-through vote be managed?

ESOP Implementation

- What is an ESOP Committee?
- Issues of independence when an appraiser works for the ESOP Committee and then later for the Trustee?
- Should the Trustee be internal or external?
- Should the Trustee be directed or discretionary?
- Should the company have some independent board members?

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Potential Issue #1: Haves and Have Nots

- Length of internal ESOP Note
- Shares to the ESOP in steps
- Rebalancing
- Recycling vs. Redeeming
- Re-leveraging
- Segregation
- Distribution Policy

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Potential Issue #2: Repurchase Obligation

- Distribution Policy
- Diversification
- Segregation
- Cash inside vs. outside of the plan

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Potential Issue #3: Compliance

- Code Section 409(p) Issues → S-Corporations
- Code Section 404/415 Issues → Contribution Limits

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401(k) and ESOP

- Almost all employee-owned companies offer 401(k) Plans so their employees can save for their retirement in a tax-efficient manner.
- It is the prudent thing to do because the future value of ESOP accounts are uncertain and 401(k)s offer diversified investment opportunities.

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401(k) and ESOP

- The first decision for the company is can we afford to fund a 401(k) match or non-elective contribution in addition to the ESOP contribution?
- If the company can afford this, there are several 401(k) formulas that can incent employees to participate and be satisfied with their benefits.
- Some of these formulas are beneficial to the plan sponsor by eliminating the normal ADP/ACP testing and pesky after-tax refunds that annoy highly compensated employees.

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401(k) and ESOP

- Common "safe harbor" 401(k) formulas that prevent ADP/ACP testing, but are 100% vested immediately:
  - The basic match is dollar for dollar on the first 3% of compensation deferred by a participant plus 50% of the next 2% of compensation contributed. For a participant deferring 5% or more of compensation, the maximum match is 4% of compensation.
  - An enhanced match of 100% of the first 4% deferred by the participant is another option.
  - 3% (or greater) of each participant's compensation. This is called a non-elective contribution and it can be limited to just non-highly compensated employees.

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401(k) and ESOP

- There are also some newer alternatives for companies that feel 100% vesting immediately is too generous.
- Under a qualified automatic contribution arrangement (QACA) the company contributions do not have to be fully vested until after two years.
- The safe harbor contributions under this arrangement are coupled with an automatic enrollment feature to prod employees to save for their retirement on a default basis.
- QACA arrangements are similar to traditional safe harbor formulas, but the basic match is different.

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401(k) and ESOP

- Basic QACA match is dollar for dollar on the 1% of compensation deferred, plus 50% of the next 5% of compensation deferred by the participant.
- For a participant deferring 6% or more of compensation, the maximum match is 3.5% of compensation.
- Automatic enrollment can start at 3% or more of compensation and must escalate by 1% a year until reaching 6%, but not more than 10% of pay.
- In order to avoid a rash of payroll questions each year, some HR Managers prefer to set the default rate at 6% when the employee starts work so there is no change in net pay each year.
- Employees have the capability to reduce or suspend these deferrals, but they need to take the initiative themselves.

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Thank You and Questions

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