

NCEO

NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

Plan Operations during COVID-19



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Big Picture – Issue Clusters

- Too many for this short webinar
- Corporate liquidity
- Fiduciary exposure
- Plan document fixes
- Valuation dates and costs
- Administration impacts
- Participant expectations
- Managing costs

Corporate Cash Crunch

- Peaking stock price and repurchase liability, reverses and potentially plunges = a reverse cash crunch
- Share movement always trends with liquidity challenges up or down. It's never easy
- How to protect officers, directors, and multiple hat wearers?
- How to protect the golden goose and be fair to current and future P&Bs?
- Lets avoid the “last one out is a rotten egg” predicament!
- Focus on all ESOP triggers and levers – be proactive
- Handle ESOP and handle an escalating crisis! It can be done cost effectively

Fiduciary Exposure

- Insiders with multiple hats?
- Outside trustees response times that require outside counsel?
- There are ways to segregate exposure and take high ground = more clearly define roles between corporate and trust
- Limit “hat overlap”
- Get the document to make it less haphazard
- Communicate openly

Plan Document Fixes and Protections

- Who's on first – who does what?
- Discretion to reset value for current payouts?
- Hard-wired plan = no fiduciary discretion?
- Declare in advance? Or wait?
- Must follow document = unless clearly contrary to ERISA
- Legal opinions re “anti cutback rules”; potential ERISA contract claims”; “timing of distribution rights enforceability”
- Lack of case law, but history from last recession

Valuation Handling

- Valuation dates and costs
- Two reports? Or one report and a letter?
- What will they charge? When do they start what?
- What is required? Not always a report.
- IRC section 170 = annual reporting; vs ERISA 3(18) & proposed regulations for transactions
- No prohibited transaction exposure for these valuations
- Facts decide the timeline

Normal Valuation Process

Valuation Process for December 31, 2019

- Same as normal valuation process
- Known or knowable
- Public market pricing
- Projection challenge

Update Valuation – Required or Prudent

- Who decides if an update valuation should be conducted
- When is effective date of update valuation
- Update valuation process & challenges

Bring-down value vs. full valuation analysis

Potential Concerns Related to Staff Reduction

Failed Minimum Coverage Test:

The minimum coverage test requires that the NHCE benefit percentage must be at least 70% of the HCE's benefit percentage

- If layoffs/terminations or a long period of shut down or slower ramp up of business operations occurs enough employees may not be credited with significant hours to receive the Employer Contribution

Reduction in Eligible Compensation:

The Maximum Deductible Contribution Limit is 25% of Eligible Compensation

Eligible Compensation is the compensation for each employee who will receive the employer contribution.

Maximum compensation for 2020 is \$285,000 as defined by the IRS.

Leveraged ESOPs with required loan payments :

- C Corporations: Principal only counts towards limit
- S Corporations: Principal PLUS Interest count towards limit
- Cash contributions, Employer Matching contributions and stock contributions also count

Safe Harbor Contributions

Many ESOPs fund their Matching Contributions within the ESOP by use of the annual share release.

Discretionary Matching Contributions which are set in a Board Resolution may be changed at any time.

Plans with fixed matching contribution formulas (in their plan document) must be formally amended.

Safe Harbor Matching or Non-Elective contributions may be reduced or suspended if one of the following criteria are met:

- Plan sponsor is operating under an economic loss as defined in §412(c)(2)(A) for the year OR
- Plan sponsor's annual safe harbor notice specifies the right to suspend or reduce contributions midyear

§409(p) – S Corporation Anti-Abuse Testing

The anti-abuse test ensures that a S Corporation ESOP provides broad based ownership

Failure of the anti-abuse test is not an option, there is no retroactive correction for failed §409(p) tests

The penalties related to a failed test are draconian

The challenge:

- Cash-based equities such as funded deferred compensation plans are converted to shares based upon the fair market value at year end
- Annuity deferred compensation plans will be affected as well based upon lowered interest rates

Partial Plan Terminations

A reduction of 20% or greater in the number of participants in a plan is considered a Partial Plan Termination. Under Revenue Ruling 2007-43 the IRS established that a 20% or greater turnover rate during the applicable period establishes a rebuttable presumption that a partial termination occurred.

In the event of a partial plan termination all affected individuals including voluntary terminees will become 100% vested

The turn-over rate is:

The number of *participating employees* who had an employer initiated severance from employment during the Plan Year



The sum of all *participating employees* at the **start** of the Plan Year **plus** any employees who became participants during the Plan Year

Employer Initiated Severance – Any severance from employment other than on account of death, disability or normal retirement. Also includes severance outside of the employer’s control, such as layoffs as a result of the COVID-19 epidemic.

Managing Costs

- “Organization” materials are only general – contact your advisors and tell them to get ready with their positions, Have they done this before?
- Have they conferred with their peers? No time for silos. The ESOP community is in it together.
- Your document provider should get amendments cut for all their clients.
- There are only so many variables and issues – challenge is selection
- Valuation firm needs to address these approaches across the board and proactively staff
- Make sure you talk to your service providers about scope of work and related fees– don’t stumble on it as you go

Participant Expectations

- Some will get it – some won't
- Impacted differently due to age tenure and pay status
- Can you make exceptions or adjustments? Do that outside the plan.
- Communicate, clearly but at the right times – multiple times
- Have your ESOP ambassadors and committees do the heavy lifting
- Communicate from the boardroom, not the fiduciary pulpit
- Hopefully avoid Karmageddon

Questions?

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For more on ESOPs during COVID-19...

... see our [COVID-19 Resource Page](#) for more responses from the ESOP community

...find answers to your questions at [COVID-19 Q&A](#) at nceo.org/covid-qa.

...watch our [other COVID-19 webinars](#) on current economic conditions, and communications and culture

...and see annualconference.nceo.org to learn how our annual conference is going virtual.

§409(p) – S- Corporation Anti-Abuse Testing By the Numbers

THE ESOP COMPANY							
Non-Allocation year test - 409(p) as of 12/31/2020							
	Stock Owned in ESOP	Mock Allocations	Synthetic Equity	Direct Ownership	Total Ownership	DQP%	DQP Family %
<u>Disqualified Persons:</u>							
President	15.0000	150.0000	71.4286	0.0000	236.4286	22.07%	
Son of President	6.0000	60.0000	0.0000	0.0000	66.0000	6.60%	28.67%
CFO	10.5000	105.0000	17.8571	0.0000	133.3571	13.10%	
Sales & Marketing NHCE	8.5000	85.0000	20.0000	0.0000	113.5000	11.13%	
Total DQP	40.0000	400.0000	109.2857	0.0000	549.2857		
All Others	60.0000	500.0000	0.0000	0.0000	560.0000		
Total	100.0000	900.0000	109.2857	0.0000	1,109.2857		
Non-Allocation Year Percentage							49.52%
NOT A NONALLOCATION YEAR							
The above test results are based upon the following parameters:							
ESOP Allocated Share Balances:		100.0000					
ESOP Unallocated Share Balances:		900.0000					
ESOP TOTAL Shares:		1,000.0000					
Direct Ownership Shares:		0.0000					
The following Synthetic Equity Items were considered in our determination:							
List types	Participant Name		Funded Value of DC	FMV Shares	# Shares for Testing		
Deferred Comp	President		\$1,000,000.00	\$14,000.00	71.4286		
Deferred Comp	CFO		\$250,000.00	\$14,000.00	17.8571		
Warrants	Sales & Marketing NHCE		n/a		20.0000		

§409(p) – S- Corporation Anti-Abuse Testing By the Projected Numbers

THE ESOP COMPANY							
Projection of 15% drop in Fair Market Value as of 12/31/2020							
	Stock Owned in ESOP	Mock Allocations	Synthetic Equity	Direct Ownership	Total Ownership	DQP%	DQP Family %
<u>Disqualified Persons:</u>							
President	15.0000	150.0000	83.3333	0.0000	248.3333	22.92%	
Son of President	6.0000	60.0000	0.0000	0.0000	66.0000	6.60%	29.52%
CFO	10.5000	105.0000	20.8333	0.0000	136.3333	13.36%	
Sales & Marketing NHCE	8.5000	85.0000	20.0000	0.0000	113.5000	11.13%	
Total DQP	40.0000	400.0000	124.1667	0.0000	564.1667		
All Others	60.0000	500.0000	0.0000	0.0000	560.0000		
Total	100.0000	900.0000	124.1667	0.0000	1,124.1667		
Non-Allocation Year Percentage							50.19%
						!!NONALLOCATION YEAR!!	
The above test results are based upon the following parameters:							
ESOP Allocated Share Balances:		100.0000					
ESOP Unallocated Share Balances:		900.0000					
ESOP TOTAL Shares:		1,000.0000					
Direct Ownership Shares:		0.0000					
The following Synthetic Equity Items were considered in our determination:							
List types	Participant Name		Funded Value of DC	FMV Shares	# Shares for Testing		
Deferred Comp	President		\$1,000,000.00	\$12,000.00	83.3333		
Deferred Comp	CFO		\$250,000.00	\$12,000.00	20.8333		
Warrants	Sales & Marketing NHCE		n/a		20.0000		