MORGAN LEWIS · ON ESOPs

A NEWSLETTER FROM THE ESOP TEAM AND THE EMPLOYEE BENEFITS PRACTICE ■ www.morganlewis.com

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NEW ESOP LEGISLATION INTRODUCED

Legislation entitled the ESOP Promotion and Improvements Act of 2005 has been introduced in Congress. The proposed legislation would provide enhanced benefits to ESOPs, particularly S corporation ESOPs. Among other things, it would (i) allow sellers of S corporation stock to elect Section 1042 tax-deferred rollover treatment on a sale to an ESOP, a benefit that is currently limited to C corporation shareholders, (ii) eliminate the 10% penalty tax on S corporations for distributions from current earnings that are passed through to ESOP participants, and (iii) permit ESOP participants to make early withdrawals from the ESOP for first-time home purchases and college tuition payments, subject to certain restrictions. The proposed legislation would also expand the definition of qualified replacement properties in Section 1042 transactions to include mutual funds invested in U.S. operating companies.

The primary sponsor of the bill in the House (H.R. 3111) is Representative Nancy L. Johnson, and the primary sponsor of the bill in the Senate (S. 1319) is Senator Blanche L. Lincoln. ■

IRS RULES THAT USE OF PROCEEDS FROM SALE OF ESOP SHARES TO REPAY ESOP LOAN DID NOT VIOLATE THE EXEMPTION

In Private Letter Ruling 200514026, the IRS ruled that the cash proceeds from the sale of shares held by an ESOP sponsored by a company, identified as “Company B,” could be used to repay an ESOP loan. The ESOP trustee was an independent and discretionary trustee of the ESOP trust. When the ESOP was created, the trustee purchased shares of Company B’s common stock with funds borrowed from Company B. The loan was secured by a pledge of the shares, which were allocated to a suspense account. The shares were subject to release from the pledge as the loan was paid down. The loan qualified as an “exempt loan” – a loan that was exempt from the general prohibition on related-party transactions involving employee benefit plans.

When the loan was entered into, Company B anticipated that the ESOP would continue in existence at least until the loan was repaid, by which time all shares in the suspense account would be allocated to the participants. Each month after the ESOP was established, Company B made sufficient contributions to the ESOP to enable it to make all ESOP loan payments on a timely basis. Several years after the ESOP was established, Company C, an unrelated corporation, acquired all of the issued and outstanding stock of Company B for cash. The purchase price was an amount

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The Department of Labor
Revises Its Voluntary Fiduciary Correction Program

The DOL has proposed several revisions to its Voluntary Fiduciary Correction Program (VFCP). The revisions are intended to make it easier for plan sponsors to correct certain violations of ERISA, expand the types of transactions that can be corrected under the VFCP and simplify the methods for making corrections. The DOL has also proposed amendments to the prohibited transaction exemption applicable to certain transactions under the VFCP.

In general, the VFCP establishes the rules and conditions with which an employer and other plan fiduciaries must comply in order to correct a fiduciary breach before the DOL's Employee Benefits Security Administration (EBSA) initiates an audit or an investigation. If the VFCP requirements are satisfied, the applicant receives relief from enforcement action and from certain penalties.

History of the VFCP

Title I of ERISA sets forth the standards that a plan fiduciary must follow. Specifically, ERISA Section 409 provides that a fiduciary who breaches his or her duties under Title I will be personally liable for restoring any losses to the plan, including any profits derived from the use of the plan's assets.

In 2000, the DOL established the VFCP, implemented on a temporary basis, to respond to requests for a correction program for fiduciary violations. In 2002, the DOL permanently adopted the program and included a class exemption that provided excise tax relief for specific situations. Effective as of April 6, 2005, the DOL proposed to simplify the program and expand the prohibited transaction exemption to cover additional transactions. The most prominent changes to the VFCP are discussed below.

Reduced Documentation

Under the revised VFCP, the documentation requirements for two items would be reduced as follows: the requirement that an applicant provide certain information relating to a plan's fidelity bond has been eliminated from the application procedures; and applicants correcting breaches with respect to delinquent participant contributions or loan payments under the VFCP may provide summary documentation (instead of detailed records) for transactions that involve either (i) amounts less than $50,000, or (ii) amounts greater than $50,000 that were remitted within 180 calendar days after receipt by the employer.

Simplification of Correction Amount

Under the revised VFCP, plan officials would be able to calculate the lost-earnings (and interest, if any) and restoration-of-profits components of the correction amount using the factors provided under Revenue Procedure 95-17, 1995-1 CB 556. The factors also are shown on EBSA's website in a tabular format and incorporate daily compounding of an interest rate over a set period of time. Applicants either may use the on-line calculator to facilitate the calculation of the lost-earnings and restoration-of-profits amounts or may perform the calculations manually. In either case, information sufficient to verify the correctness of the amounts to be paid to the plan must be included as part of the VFCP application.

Transactions Currently Covered

The VFCP is only available for the correction of fiduciary breaches that are specifically listed by the DOL, which currently include:

- delinquent participant contributions to a qualified retirement plan
- below-market interest rate loan with a party in interest
- fair-market interest rate loan with a party in interest
- purchase of assets by a qualified retirement plan from a party in interest
- sale of assets by a plan to a party in interest
- purchase of assets from a non-party in interest at a price above market value
- sale of assets to a non-party in interest at a price below market value
- benefit payments based on improper valuation of plan assets
- payment by a plan of duplicate, excessive or unnecessary compensation
- payment of dual compensation to plan fiduciaries

New Covered Transactions

Illiquid Assets. The revised VFCP allows a plan to sell an illiquid asset (e.g., a limited partnership interest, real estate or collectibles) to a party in interest where the plan fiduciary has determined that continued holding of the asset is not in the best interests of

The Department of Labor
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the plan or the plan's participants and beneficiaries and, following reasonable efforts to dispose of the asset, the only available purchaser is the party in interest (e.g., the employer). If certain conditions are satisfied, the required correction allows the sale of the illiquid assets to the party in interest. In addition to this new covered transaction, the DOL is now proposing to add the sale of illiquid assets to the existing VFCP class exemption.

Participant Loans. The new covered participant loan transaction involves situations in which a plan extends a loan (i) to a party in interest based solely on his or her status as an employee, and (ii) either the amount or the duration of the loan exceeds applicable limits. Under the revised VFCP, correction of a loan that exceeded the limitation amount requires that:

- the participant pay back to the plan the excess amount of the loan;
- plan officials reform the loan to amortize the remaining principal balance as of the date of correction over the remaining duration of the original loan, making any required adjustments to the monthly repayment amount; and
- plan officials otherwise continue to enforce all other terms of the original loan agreement.

To correct a loan that exceeded the duration limitation under the VFCP, plan officials must reform the duration of the loan to complete repayment within the maximum term permitted under the plan loan provisions.

Delinquent Participant Loan Repayments. In Advisory Opinion 2002-02A, the DOL issued guidance regarding correction of delinquent participant loans. The DOL has now expanded the VFCP to specifically include delinquent participant loan repayments as eligible for correction.

Modification of Term "Under Investigation"

Eligibility to participate in the revised VFCP is conditioned on neither the plan nor the applicant being "under investigation." For purposes of the revised VFCP, EBSA has expanded this definition to include investigations or examinations by other federal agencies, whether of a criminal or a civil nature, as well as notice of a federal agency's intent to conduct an investigation (since the parties to the transaction may actually be on notice of an agency's intent to conduct an investigation well in advance of the beginning of the actual investigation). However, the applicant or plan sponsor will be considered "under investigation" only if the investigation or examination at issue is in connection with an act or transaction involving the plan.

Modification of Penalty-of-Perjury Statement

The revised VFCP reflects a simplified required penalty-of-perjury statement to conform with the VFCP's revised criteria. However, the statement continues to require a declaration that the application and all supporting documents, based on knowledge and belief, are true, correct and complete.

Effective Date of Changes

Although EBSA is requesting comments on the proposed changes to the VFCP, the revised VFCP is available to applicants immediately. VFCP applicants may also continue to pursue relief under the original VFCP until final changes are adopted by the DOL.

Conclusion

The VFCP is a valuable correction tool for employers and other plan fiduciaries involved in any of the fiduciary breaches described above. Plan sponsors should review their plans' operations to determine whether any transactions have occurred that may be eligible for correction under VFCP. If full correction of the transactions is not implemented, the DOL may take enforcement action, including imposition of civil penalties. ■

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend herein, please see www.morganlewis.com/circular230.

Transers to ESOPs from Terminating Defined Benefit Plans

The sponsor of a defined benefit plan is obligated to provide a specified amount of retirement income for each plan participant, usually computed as an average of the compensation the participants earned while working for the plan sponsor. The employer makes contributions to the plan in amounts calculated by actuaries to enable it to satisfy its obligations under the terms of the plan, taking anticipated earnings and distributions into account. The employer contributions are invested until retirement income is paid out to the plan participants. If the investments of the contributed funds perform well, the plan may become "overfunded" because the value of its assets may exceed the amount necessary to satisfy obligations to plan participants.

When an overfunded defined benefit plan terminates, the employer generally is entitled to recover the amount by which the plan is overfunded after annuities have been purchased to provide retirement income under the plan for the participants. Congress, however, has imposed taxes and penalties on "reversions" in order to discourage employers from terminating their defined benefit plans. Excess pension funds that are paid to a sponsoring employer are subject to both income tax, at rates up to 35%, and a 50% excise tax. However, if an employer transfers an amount equal to 25% of the reversion amount to a "qualified replacement plan" covering the employees who previously had participated in the terminating defined benefit plan, the excise tax rate on the funds received by the plan sponsor is reduced from 50% to 20%, and the amount transferred to the qualified replacement plan is exempt from both excise tax and income tax.

The statutory language is vague as to the tax result if an employer transfers more than 25% of the amount of the overfunding to a qualified replacement plan, for example, if the employer transferred all of the overfund amount of the terminating plan to an ESOP, which, in turn, could invest that amount in employer securities. In several early private letter rulings, the IRS held that, in such a case, only 25% of the overfund amount was exempt from excise and income taxes, and any additional amounts transferred would subject the employer to the taxes, even though the employer never received any assets. However, as a result of litigation on this issue, the IRS reversed its position and, in Revenue Ruling 2003-85, held that the entire amount transferred to the qualified replacement plan would be exempt from both excise and income taxes.

Revenue Ruling 2003-85 is significant in that it allows for an increase in the financing of an ESOP transaction from the excess assets in a terminating defined benefit plan. If you maintain a defined benefit plan that is currently overfunded, a transfer of excess assets to an ESOP may be a tax-effective way to obtain access to funds that otherwise would have to remain in trust or be subjected to confiscatory taxes. ■

Calendar of Events

July 12-14, 2005

Strategic Research Institute

2005 Private Equity Roundup

Waldorf Astoria

New York, NY

John Kober presented on "Case Study: ESOP Private Equity Transactions," with Keith Butcher, executive director and co-head of the Morgan Stanley BusinesScape Business Advisory/ESOP Transaction Services team.

September 15, 2005

7th Annual Repurchase Obligation Seminar

The ESOP Association

Hyatt Regency Hotel Downtown

Chicago, IL

David Ackerman will be discussing the recent case involving the Amsted Industries' ESOP. John Kober will also be making a presentation at this event, titled "Repurchase Obligations Are too LARGE – What Can I Do?"

September 29-30, 2005

The 2005 California/Western States Chapter Conference

The ESOP Association

Hyatt Grand Champions Resort

Indian Wells, CA

Scott Adamson will be making a presentation on "The Role of Trustees and Fiduciaries as Internal or External Guardians of the Tent."

September 6, 2005

Dallas Area Paralegal Association

Family Law Section

The Belo Mansion

Dallas, TX

Jason Ray will be making a presentation on "ERISA Issues in Family Law."

September 20, 2005

Webcast on S Corporation ESOPs

National Center for Employee Ownership

David Ackerman's topic during this webcast will be "Legal Issues."

October 28, 2005

Mississippi Tax Institute

Mississippi Society of Certified Public Accountants

Hilton Jackson

Jackson, MS

Riva Johnson will be making a presentation on ESOPs

IRS Rules that Use of Proceeds from Sale of ESOP Shares to Repay ESOP Loan Did Not Violate the Exemption

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sufficient to enable the trustee to repay the ESOP loan in full, and the trustee applied the proceeds from the sale of the pledged shares to pay off the ESOP loan. A merger of Company B with and into Company C followed the purchase. After the expiration of a five-year escrow period (established to protect Company C from any liability acquired from Company B), the remaining proceeds from the sale of the ESOP's unallocated shares were released and allocated to the ESOP participants' accounts, and the ESOP was terminated.

In order for an ESOP loan to qualify for an exemption from the prohibited-transaction rules set forth in ERISA and in the Internal Revenue Code, the loan must be made primarily for the benefit of the ESOP participants and beneficiaries. The employer has primary responsibility for the repayment of an exempt loan through contributions to the ESOP. However, the IRS has ruled that a loan will not fail to meet the exemption requirements merely because the trustee sells the unallocated suspense account shares and uses the proceeds to pay the exempt loan, provided that the transaction satisfies the primary-benefit requirement based on all the surrounding facts and circumstances.

In the private letter ruling, the IRS ruled that the "primary benefit" test was satisfied because (i) Company B had made sufficient contributions to the ESOP to allow it to make all ESOP loan repayments on a timely basis prior to the sale and (ii) after the sale of the suspense account shares, the portion of the proceeds remaining after repayment of the ESOP loan was then allocated to the ESOP participants' accounts. ■

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