

Morgan Lewis

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DOWNTURN IMPACT ON 409(p)

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- 409(p) Problem Areas
- 409(p) Prevention
- 409(p) Correction

409(p) Problem Areas

- Dollar Denominated Nonqualified Deferred Compensation (NQDC)
 - Synthetic equity under 409(p)
 - If value of S corporation equity drops significantly, the equivalent shares for 409(p) purposes increases sharply
 - Triennial testing may mitigate the effect on 409(p) testing, but only for a relatively short amount of time. If the S corporation equity value does not increase, the increased equivalent shares attributable to the NQDC could create a nonallocation year

- Example
 - Executive enters into a deferred compensation agreement that promises Executive a lump sum payment of \$1,000,000 payable as soon as the Executive completes five years of service for the Company.
 - The Company is valued at \$10M and has 100 shares outstanding. Accordingly, Executive has 10 equivalent shares attributable to the \$1M of deferred compensation. With synthetic equity alone, Executive is deemed to own 9.09% of the Company.
 - In Year 3, the Company's value drops sharply to \$5M. Now, the Executive has 20 equivalent shares attributable to his \$1M of deferred compensation and is clearly a DQP. This situation could create a nonallocation year.

409(p) Problem Areas

- Reduction in Workforce
 - *If layoffs or workforce reductions have occurred, there are fewer people to include for 409(p) testing purposes*
 - **This change may create new disqualified persons or a situation where existing disqualified persons have aggregate ownership that exceeds 50%**

- Example
 - ABC Construction Co. is an S corporation wholly owned by its ESOP with 100 employees. The company is experiencing a decline in business due to the housing crisis. Due to the decline, ABC Construction has to reduce its workforce by 20%. The 20% of employees that were laid off were all NHCEs. Because of the reduced workforce, there is now a smaller denominator for the 409(p) testing and a greater concentration of DQPs in the workforce.

409(p) Problem Areas

- Selling shareholder forecloses upon stock pledged as security for an ESOP loan
 - *This can possibly make an existing disqualified person create a nonallocation year by the increase in their deemed owned shares by the amount of direct ownership that the disqualified person has with the foreclosed upon stock*

ESOP Loan Foreclosure

- Example
 - Three years ago, Executive sold 49% of the company's stock to an ESOP in exchange for a note. The stock sold was pledged as collateral for the loan. Executive participates in the ESOP and has 12% deemed ownership. Two years ago, the company experience a severe downturn in business. The downturn was so severe that the company was not able to contribute to the ESOP and the ESOP was not able to make its debt payments to Executive. Executive forecloses on a portion of the pledged stock to the extent of the default loan amount and now has a 7% direct ownership interest, increasing his total deemed ownership to 19%. Depending on the existence of other DQPs, the foreclosure could create a nonallocation year.

409(p) Prevention

- Transfer to non-ESOP account or Non-ESOP plan
- Reduce contributions for HCEs who may become DQPs
- Provide additional benefits to NHCEs
- Expand ESOP coverage to include all employees
- Mandatory diversification of stock accounts
- Broaden allocation of suspense shares so that it is weighted in favor of NHCEs
- Must prevent a 409(p) occurrence in real time – if it is a correction, 409(p) penalties will apply

Reshuffling vs. Rebalancing

- Targeted reshuffling of the accounts of potential DQPs is discouraged due to potential for violation of the 401(a)(4) nondiscrimination requirements
- A systematic rebalancing may relieve the pressures on the 409(p) testing and not be considered discriminatory.

Correction of Violations

- Correction through plan document
 - ESOP plan document may cap allocations to avoid creating a DQP or a non-allocation year
 - Synthetic equity plan may contain forfeiture provisions with a similar cap
 - Consider “excess allocations” discovered during annual administration and those that are discovered in subsequent plan years

Correction of Violations

- Closing Agreement Program
 - EPCRS not available for correction of excise tax under Section 4979A of the Code
 - EPCRS can only be used to correct the plan disqualification issues
 - Regular closing agreement program could be used for universal settlement of excise tax, income tax, loss of S corporation status of plan disqualification – Equitable resolution

- Statute of Limitations
 - Code Section 4979A delays commencement of statute of limitations until 3 years after “the date the Secretary is notified of such [prohibited] allocation or ownership”
 - Income tax for deemed distribution applies normal 3 year limit (6 years if substantial underpayment)

- New ESOP Task Force
 - Focused on uniform approach to many ESOP plan language issues
 - Concern over 409(p) position
 - Not receptive to self-correction methods other than profit sharing plan transfer
 - Request for inclusion of extensive definitions
 - Need for additional flexibility

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Any Questions?