

# FOR YOUR BENEFIT

A newsletter on current legal issues impacting employee benefits and executive compensation

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## Retirement Plan Participants Reap Some Benefit From Tax Reform

By Susan Foreman Jordan, Esq.

After a long period of relative stability enjoyed by sponsors of qualified retirement plans, several significant modifications have been made by the Bipartisan Budget Act of 2018 (Act), following closely on the heels of changes enacted by the Tax Cuts and Jobs Act of 2017 (Tax Cuts Act), particularly as affecting hardship withdrawal from 401(k) plans. Effective for plan years beginning after December 31, 2018, the Act substantially liberalizes the restrictions on a participant's access to his or her account in order to address financial hardship.

First, the regulations previously required that a participant be prohibited from making elective deferral contributions for a period of six months following a hardship withdrawal. The Act removes that six-month suspension requirement, allowing participants to resume deferral contributions immediately after receiving a hardship withdrawal.

Second, a participant may receive a hardship distribution without first taking any available loan under the plan. A participant, of course,

must establish financial need and show that other options have been exhausted, but that no longer includes the requirement that the participant first seek the maximum plan loan available.

Third, participants now may access qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs), in addition to elective deferral contributions, in the event of hardship, as well as earnings on all three types of contributions. Traditionally, hardship distributions were limited to the aggregate of the participant's own deferrals.

While these changes provide welcome relief to many participants, an earlier change effected by the Tax Cuts Act narrows, slightly, the circumstances under which a participant may request a hardship withdrawal. Under the 401(k) regulations, hardship withdrawal is available only to satisfy an immediate and heavy financial need. Such a need may be established through a facts and circumstances analysis, but most plans rely upon the six safe harbor needs recognized in the regulations, one of which is casualty damage to the participant's principal residence. The Tax Cuts Act modified Code Section 165(h) to limit casualty loss deductions for tax years 2018 through 2025 to those occurring

in a federally declared disaster area. As a result, for those 401(k) plans that rely on the safe harbors, hardship withdrawal will be available for casualty losses only when those losses are sustained in federally declared disaster area.

Apart from the statutory changes affecting hardship withdrawal, the Tax Cuts Act extends the deadline for rolling over plan offset amounts until the participant's tax filing deadline, including extensions. This applies when a participant separates from service (or a plan terminates), and the unpaid balance of an outstanding plan loan is reported as a deemed distribution. The participant now may repay the loan balance to the original plan for purposes of effectuating a direct rollover or may use other funds to contribute as a rollover to an IRA (or another qualified plan) by that extended deadline. Previously, the deadline to effectuate the rollover was the 60th day after the loan offset. The change applies to plan years beginning after December 31, 2017.

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# The Solution to Managing the Repurchase Liability Challenge: A Defined Benefit Plan

By Harvey M. Katz, Esq. and Paul R. Bonsee\*

Undoubtedly, the sponsors of mature ESOPs face numerous challenges that only become apparent after the ESOP has been implemented and has been in operation several years. These challenges include implementation of a seamless leadership transition program as the founding shareholders reduce their role as active managers, as well as effective incentivizing of the workforce through education and well-planned participant communication efforts.

As the most senior workforce begins to retire, other challenges usually arise, many of which are related to the use of the ESOP as the primary retirement vehicle for the company that sponsors the arrangement. This includes the lack of diversification due to reliance on company stock as a retirement benefit, the need by many employees for guaranteed lifetime income and the relative lack of flexibility regarding distributions and withdrawals from ESOPs.

However, the most significant problem facing the “mature” ESOP company is managing its repurchase liability. Part of the problem is that the success of the company exacerbates repurchase liability approaches. As the ESOP company becomes more successful, the drain on cash flow to pay out

retiring and terminated participants can increase exponentially. Without proper financial planning, an ESOP company can be thrown into a financial crisis.

One of the most frustrating aspects of managing repurchase liability is that much of it is beyond the employer’s control. Indeed, the company has little control over employee demographics, the timing of retirements and diversification elections. These variables can play havoc with the most carefully drawn plan to fund ESOP repurchase liability.

Unfortunately, many of the typical solutions employed by ESOP plan sponsors often worsen the problem they seek to solve. This usually occurs because of the natural reaction of finance executives in attempting to smooth out the significantly fluctuating year-to-year liabilities by accumulating cash reserves. The problem with cash reserves is that such reserves are usually counted as a balance sheet asset, while the associated repurchase liability is not. This mismatch has the effect of artificially increasing the value of the company, and, as a result, the associated repurchase liability. Further, and as a practical matter, creation of a reserve is usually only

a partial measure, as few companies have sufficient resources to create a reserve sufficient to fund the entire liability.

## The Solution

At first blush, having an ESOP company adopt a defined benefit pension plan may seem counter-intuitive. After all, why add an obligation to fund a second plan to a company already challenged to fund liabilities associated with its primary retirement vehicle? The reality is quite different, however, because the costs associated with funding the defined benefit plan reduce the value of the company and the associated repurchase liability. Further, the employees do not lose value. Their benefit will be paid to them from the defined benefit plan upon retirement.

There are several other advantages in using a defined benefit plan to pre-fund repurchase liability. Defined benefit plans can be overfunded and any excess cash is not counted as an asset when determining company value. Thus, the company can create a reserve to fund repurchase liability without engaging in the counter-productive step of increasing the value it seeks to fund. Additionally, the company can use the excess cash

directly to purchase stock from retiring participants. ERISA and the Internal Revenue Code both allow a defined benefit plan to invest up to 10 percent of its assets in employer securities. Otherwise, the excess can be quickly consumed by skipping or reducing a contribution to the plan, thereby freeing up cash for share redemptions.

There are other benefits to the use of a defined benefit plan in conjunction with an ESOP. By substituting a pension benefit for the value that would have otherwise have been paid through an ESOP, each employee will receive a fixed, predictable pension based upon his or her salary, age and service with the company. The employer's cash flow can be improved by requiring benefits from the defined benefit plan to be paid as an annuity based upon the participant's life. It is the employer's choice as to whether to offer lump sum and installment payment options as forms of benefit.

The concept is best illustrated through the following example. Assume a 100 percent, ESOP-owned company is worth \$2,000,000 before adoption of any defined benefit plan and that, upon retirement, Participant A will be entitled to five percent of the value of the company, or \$100,000. Further, assume that the company adopts a defined benefit plan that will provide benefits costing \$300,000. The obligation to fund

those benefits is a liability of the company; all things being equal, that obligation will reduce the company's value by \$300,000 to \$1,700,000. Accordingly, the value of Participant A's ESOP account would decrease to \$85,000. Assuming that our "average" participant is also entitled to a pension with a value of five percent of the total value of the defined benefit plan, his pension would be worth \$15,000. Thus, his total benefit would not change; it would simply be divided between the ESOP and the pension plan.

In addition, the company could choose to put \$500,000 into the pension plan, without increasing the value of the plan benefits. All things being equal, the additional \$200,000 would be plan overfunding, which can serve as a reserve for the payment of repurchase liability. These additional funds cannot be withdrawn from the plan absent termination of the plan or unusual circumstances. Further, it would not be counted in determination of the value of the company, as would be the case if held as part of the company's general corporate assets.

This structure also addresses one of the principle objections raised by the Department of Labor and others regarding the use of an ESOP as a retirement vehicle: lack of diversification. By dividing each employee's retirement

benefit between ESOP and defined benefit components, a degree of diversification can be achieved. More importantly, the Pension Benefit Guaranty Corporation insures a significant portion of the benefit payable to every defined benefit participant. This provides an additional layer of "downside" protection for employees in the event that the company encounters serious financial problems.

It is not uncommon for an ESOP company to maintain a 401(k) plan alongside or as part of its ESOP. Arguably, the 401(k) plan addresses the diversification issue as well. However, 401(k) benefits can vary greatly depending upon employee participation and do not provide the government insured, predictable fixed payout provided by a defined benefit plan. They also do not provide a mechanism to accumulate reserves to address repurchase liability concerns available with a defined benefit plan.

There is another advantage available to employers desiring to provide additional deferred benefits to key executives. In many cases, Internal Revenue Code Section 409(p) restricts or prohibits these additional prerequisites. Because defined benefit plans are qualified plans within the meaning of Section 401(a) of the Internal Code, these plans are exempt from the restrictions imposed by 409(p). Thus, a defined benefit

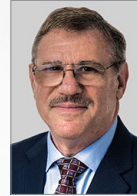


plan designed to favor key and long serviced individuals accomplishes these goals without implicating 409(p).

It is important to note that this article only scratches the surface of addressing the issues discussed above. Both repurchase liability funding and diversification of benefits can be fine-tuned through the combination of the ESOP with a defined benefit plan, 401(k) plan as

well as other types of arrangements that are customized to address each company's specific needs. The specific circumstances of each company, as well as the engagement of experienced advisors familiar with these issues, will help drive the manner in which a company will best address these concerns. However, this option is certainly worthy of consideration by any ESOP company seeking to manage its repurchase liability.

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## ESOP Trustees and Administrators: Draft Your Plans Strategically

By **Harvey M. Katz, Esq.**

One challenge faced by ESOP trustees and administrators in recent years are challenges from the plaintiff's bar in the form of class action lawsuits frequently filed by attorneys representing purported classes of participants in connection with certain ESOP transactions. In light of a recent decision by the Ninth Circuit Court of Appeals, these participant class action lawsuits may pose a more serious threat to plan sponsors, trustees and their business partners.

In a typical scenario, the plaintiff asserts that the ESOP trustees have breached their fiduciary duties as a result of the loss in the stock value without action to divest the shares. These allegations are based upon a line of so-called "stock drop" cases involving public company stock held

by ESOPs and other similar plans. This loss, however, is a necessary part of every leveraged ESOP transaction. In essence, an ESOP transaction is a leveraged buyout of all or part of the company. Debt is placed on the company to finance the sale, as it would be in any management buyout. The debt (and the associated drop in share value) is a normal and expected part of the transaction. The company's intrinsic value does not change – it has merely converted some of its equity into debt.

In many cases however, a successful stock drop claim is not the objective. Rather, the goal is to obtain access to the ESOP's books and records by claiming the loss in share value constitutes a breach in fiduciary duty. From a litigation perspective, factually based allegations are more

problematic because these type of allegations are not easily susceptible to motions to dismiss, which are motions arguing that the plaintiff has no legal claim even if the facts he or she alleges are presumed to be true. Once a fact-based set of allegations survives a motion to dismiss, a plaintiff typically has a right to commence far-ranging discovery. Because the federal discovery rules are liberally construed, it opens the entire operation of the ESOP to examination by the plaintiff, in a very expensive and time-consuming process.

The threat posed to ESOP community is creation of an incentive for the plaintiff's bar to bring multiple lawsuits in the belief that ESOPs may enter into expensive settlements simply to avoid litigation costs. The

ESOP community has responded by adding arbitration clauses to ESOP documents, requiring participants to arbitrate disputes with ESOPs. At minimum, such arbitration language will have a chilling effect on the ability of participant's ability bring a successful challenge to the ESOP transaction. However, these arbitration clauses must be carefully drawn to serve as an effective bar to the litigation threat.

This point was underscored by a decision recently issued in the U.S. Ninth Circuit Court of Appeals entitled *Munro v. Univ. of Southern California*, No. 17-55550 (9th Cir., July 24, 2018). While *Munro* did not involve an ESOP, the fiduciary breach claims at issue parallel those that arise in the plaintiff's lawsuits under ERISA. The arbitration agreements signed by the *Munro* participants did not prevent those participants from bringing their fiduciary breach claims in Federal Court, thereby bypassing the arbitration process.

At issue are the two types of participant lawsuits permitted under ERISA. The first is an individual claim for benefits under Section 502(a)(1)(B); and the second is a claim for fiduciary breach under Section 502(a)(2) of ERISA on behalf of the plan. This second type of suit has been analogized to a shareholder's derivative suit, where an individual shareholder brings a suit on behalf of

the corporation (and its shareholders) to remedy a wrong committed by management. The critical distinction is that the ERISA 502(a)(2) action, like a shareholders derivative suit, is not an individual action, but rather brought in a representative capacity on behalf of the plan or the corporation, as the case may be.

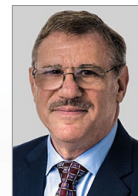
In *Munro*, the participants signed individual arbitration agreements as a condition of participation in the plan. However, their lawsuit, sought financial and equitable remedies specifically on behalf of the plan and all affected participants. The plan moved to compel arbitration, relying on the arbitration agreements. However, both the trial court and the Ninth Circuit declined to enforce the arbitration agreements under the facts presented. While noting the general policy to liberally enforce arbitration agreements, the Court held that arbitration cannot be compelled by the arbitration agreement if its scope is insufficiently broad for the claim at issue.

The Court examined the language of the arbitration agreements and found them to be lacking in this regard. In doing so, it focused on the distinction between individual and representative-based lawsuits such as those authorized under ERISA section 502(a)(2). In focusing upon the fundamental distinction between these actions the Court drew

another analogy: between ERISA 502(a)(2) claims and so-called *qui tam* claims brought under the False Claims Act. In essence, *qui tam* actions are brought by an individual on behalf of the U.S. government to recover damages in cases where the government has been overcharged by contractors. It cited a recent case where a substantively similar arbitration agreement was rejected as a bar to a *qui tam* action.

The *Munro* holding has broad implications for ESOPs if their trustees cannot compel 502(a)(2) plaintiffs to arbitrate their claims. However, we do not read *Munro* so broadly as to impose a blanket prohibition on arbitration agreements involving 502(a)(2) claims. The holding is based upon the limited scope of the arbitration agreement at issue. The decision clearly left the door open to establishing a more targeted arbitration agreement. The lesson to be learned is that arbitration agreements for all ERISA plans, but particularly with respect to ESOPs, must be drafted with extreme care and with an understanding of the available participant causes of action under ERISA.

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## Recent Updates to the IRS Special Tax Notice

By **Seth I. Corbin, Esq.**

Last month, the IRS published Notice 2018-74, which updated the model tax notice that is regularly referred to the “Special Tax Notice” or the “402(f) Tax Notice.” This tax notice is required to participants any time that all or a part of a distribution is eligible for rollover. The previous update to the model tax notice was made in 2014.

The changes to the model tax notice are meant to reflect legislation enacted over the past few years such as the Tax Cuts and Jobs Act of 2017, as well as incorporate other recent IRS guidance since 2014. The updated notices are not a complete overhaul of the 2014 model notices but reflect changes made since that time, including, by way of example, the following updates:

- Information regarding self-certification if a participant

misses the 60-day rollover deadline (as provided in Revenue Procedure 2016-47).

- Changes relative to qualified plan loan offsets (on or after January 1, 2018) and the time a participant has to complete a rollover, including an explanation that participants may have until their tax return due date, including extensions.
- Clarifications that certain exceptions to the 10 percent excise tax on early distributions may not apply to distributions from IRAs.
- Notice to participants that they may have special rollover rights if they were affected by a federally declared disaster (or similar event).

Notice 2018-74, like prior guidance, includes the model notices to be provided whenever distributions are not from a

designated Roth account and for distributions from a designated Roth account. It also includes explanations for plan sponsors that simply want to supplement the 2014 model notice and not necessarily replace it. Regardless of how a plan sponsor wants to incorporate these changes into the materials distributed to participants in connection with distributions, plan sponsors do need to update distribution packages to include the newly required notices. Fortunately, this should not be a particularly onerous task, as the 2014 notices can simply be swapped out for the notices included in Appendix A of Notice 2018-74.

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