

RETIREMENT PLANS: ESOP, REGULATORY UPDATES & ERISA COMPLIANCE

TCVSCPA - SPECIALIZED KNOWLEDGE DAY
November 2, 2022



Introduction

BDO's Retirement Plan Services

BDO's Retirement Plan Services practice works collaboratively with our clients to tailor plans for their unique business. We assess resources, competitive standing, industry trends, and long-term goals to help each client give its employees the best possible retirement benefit.

ERISA CONSULTING & ADMINISTRATION



Qualified retirement plans are regulated under the Employee Retirement Income Security Act of 1974 (ERISA).

Our professionals provide comprehensive design, administration and operational support for all qualified retirement plans, including 401(k) Profit Sharing, ESOPs, Health & Welfare, traditional defined benefit pension, and cash balance plans.

We perform annual compliance testing, prepare plan documents and government filings, including Form 5500, as well as assist clients with plan corrections under IRS and DOL programs including self-correction and voluntary compliance filings.

Our team also provides plan compliance reviews and due diligence related to mergers and acquisitions.

ACTUARIAL SERVICES



A key step in designing effective employee benefit plans is to measure and manage risk. We provide actuarial services to cash balance and other tax-qualified defined benefit plans in addition to retiree health/welfare and non-qualified plans.

We design employer-tailored cash balance plans and support them with implementation and annual administration.

Our team is also a resource for long- and short-term planning, funding, accounting, termination, and mergers and acquisitions related to these plans.

EMPLOYEE STOCK OWNERSHIP PLANS

What Is an Employee Stock Ownership Plan (ESOP)?

EMPLOYEE STOCK OWNERSHIP PLANS

An ESOP is a qualified, defined contribution employee benefit plan, much like a traditional profit-sharing plan, that invests primarily in the sponsoring employer's stock.

An ESOP is unique among qualified benefit plans in its ability to borrow money and may be used as a technique of corporate finance.



Approximately 6,624 ESOPs
in place in the U.S.
covering 14.2 million
employees



Many ESOP companies have
other retirement plans to
supplement their ESOP



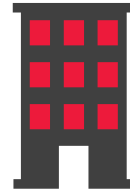
Total assets owned by U.S.
ESOPs are estimated to be
over \$1.3 trillion as of
September 2019

Benefits of an ESOP



SELLER

- Receive fair market value
- Favorable tax treatment on sale
- Flexibility; can sell any % of company
- Preserve legacy as independent company
- Reward management and employees



COMPANY

- Tax-advantaged financing
- Potential for income tax-free entity (100% ESOP-owned S corporation)
- Repay debt more quickly with enhanced cash flow
- Potential for productivity gains and reduced turnover



EMPLOYEES

- Valuable (free!) retirement benefit
- Ability to participate in value they help create
- Continued employment
- Rewarding and motivational
- Incentive for management



Company Benefits

- Employee Ownership is now firmly established in the US economy and has a proven track record of performance.
- The National Center for Employee Ownership (NCEO) has tracked the benefits of ESOP ownership over many years, and study reports are remarkably consistent. For example:
 - **Better corporate performance** - adjusting for changes in overall industry growth, ESOP companies grow about 2.5% per year faster in sales, employment, and productivity after they set up an ESOP than what would have been expected if they had not set up an ESOP.
 - **Offer better pay and benefits** - employee-owners earn 5% and 12% more in median wages compared to employees in matching non-ESOP companies, 2.5x more in retirement savings, and 20% more in financial assets overall than employees in matching non-ESOP companies.
 - **Survive longer and are less likely to lay people off** in a downturn - one study found that ESOP companies were only half as likely as non-ESOP firms to go bankrupt or close, and three-fifths less likely to disappear for any reason.
 - **Provide greater opportunity for young workers** - a recent survey, which looked at workers' economic circumstances over time, compared people age 28 to 34 with ESOP benefits to their peers without. The study found that those ESOP employees enjoyed 92% higher median household wealth, 33% higher income from wages, and 53% longer median job tenure.
- Significant tax benefits to Company, resulting in increased cash flow.
- A management incentive plan that rewards only selected team members can exist alongside an ESOP.
- Employees view ESOPs far more favorably than M&A.

Tax Benefits

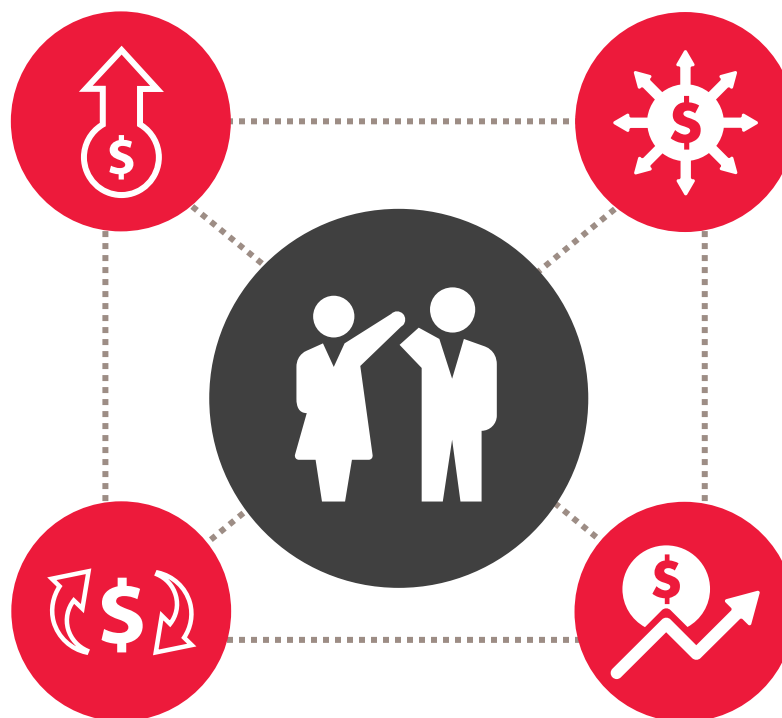
DEDUCTIBILITY OF PRINCIPAL AND INTEREST PAYMENTS

Principal and interest payments of an ESOP loan are considered contributions to a tax-qualified employee benefit plan and therefore, tax deductible. For an S-corporation, the maximum deductible amount is 25% of covered eligible payroll and unlike a C-corporation, both principal and interest are included in the 25% limit.

However, an ESOP is a non-tax paying shareholder, so **an S-corporation that is owned 100% by an ESOP does not pay any federal income tax.**

ESOP ROLLOVER

Shareholders selling to a C-corporation leveraged ESOP, qualify to defer federal income taxes on the gain from the sale by purchasing “qualified replacement property” with the proceeds from the sale.



DEDUCTIBILITY OF DIVIDENDS

In a C-corporation, dividends paid on stock held by the ESOP are tax deductible to the corporation if they are distributed to ESOP participants and do not count towards the 25% limit. These deductible dividends may be used to pay principal and interest on the loan. Dividends are not deductible for S-corporation ESOPs.

STEP-UP IN COST BASIS TO SELLER'S ESTATE

Should a selling shareholder “roll over” their assets in an IRC §1042 transaction, the estate receives a step-up in cost basis on the qualified replacement property at death, eliminating the capital gains tax liability.

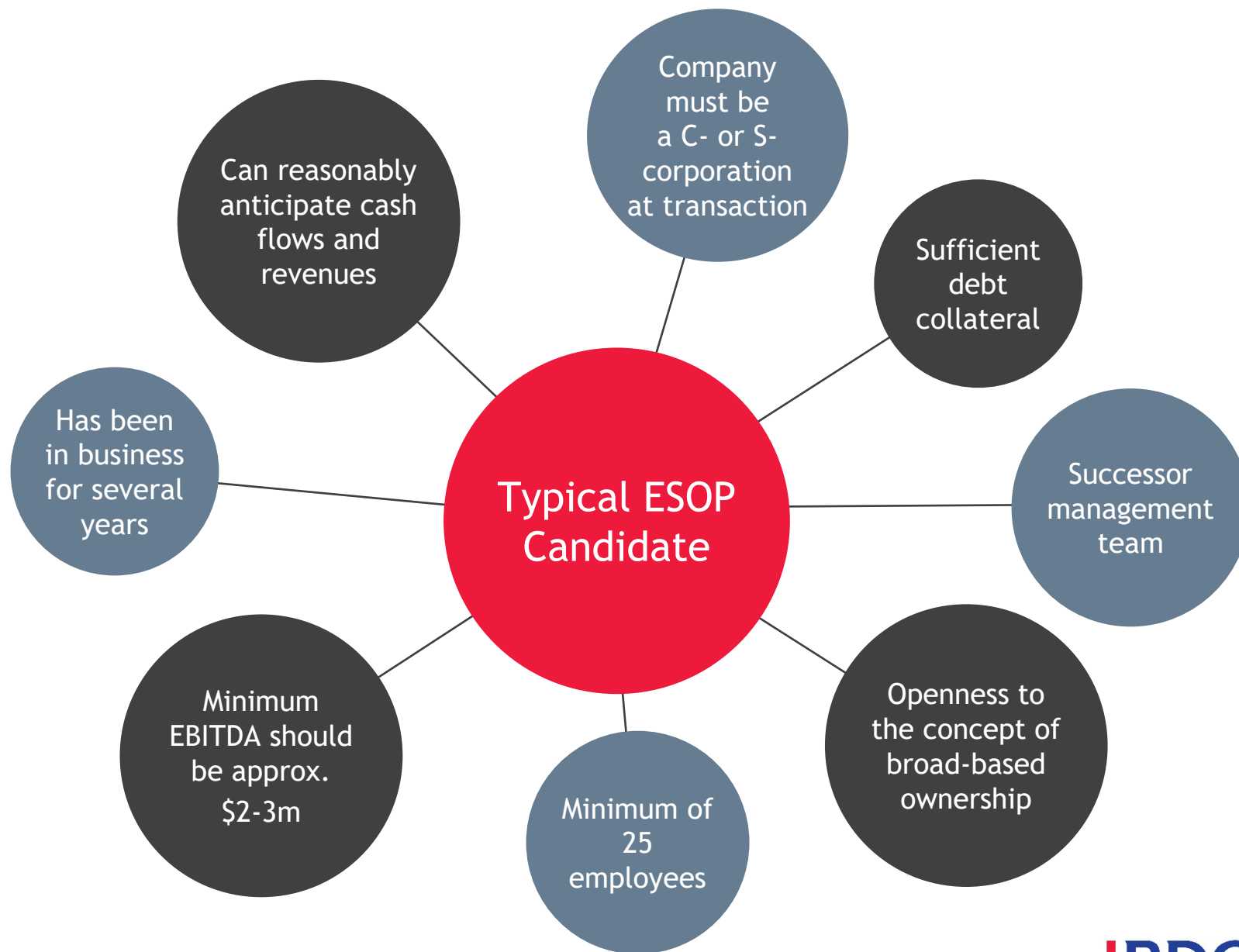
Determining IRC Section 404 Maximum Deductible Contributions

- ▶ 404(a)(3) limits the deductible contribution for plans to 25% of eligible compensation
- ▶ 404(a)(9) applies only to Leveraged ESOPs sponsored by C-Corps
 - Employer contributions applied to repayment of the principal on an exempt loan are deductible up to 25% of eligible participant compensation
 - Then deductions are taken under 404(a)(3) for any amounts not used for loans
 - May also take unlimited deduction for contributions applied to pay interest on an exempt loan.

COMPANY ABC ESOP		TYPE OF ESOP	MAXIMUM DEDUCTION
Eligible Compensation	\$ 2,000,000.00	C-Corp Leveraged ESOP	404(a)(9) 25% +
Principal Payments	\$ 400,000.00		404(a)(3) 25%
Interest Payments	\$ 50,000.00		\$ 500,000.00
			\$ 500,000.00
			\$ 1,000,000.00
TYPE OF ESOP	MAXIMUM DEDUCTION		
Non-Leveraged ESOP	404(a)(3) 25% limit		
\$2,000,000 * 25%	\$ 500,000.00	Principal + Interest for Loan	\$ 450,000.00
S-Corp Leveraged ESOP	404(a)(3) 25% limit	Maximum Standard	\$ 500,000.00
\$2,000,000 * 25%	\$ 500,000.00	Maximum deduction for Plan	\$ 950,000.00

ESOP Candidate Characteristics

Although views differ on what exactly makes a good ESOP candidate, several characteristics reveal themselves as essential qualifiers. Our list of ESOP candidate characteristics is not exclusive but can be used as a guideline.



Who are the Administrative Players in an ESOP?

TPA - Third Party Administrator

- ❖ Administration
- ❖ Trust Accounting and reconciliations
- ❖ Transactions including contribution allocations, distributions, and diversifications
- ❖ Participant Statements and Annual Notices
- ❖ Government Filings
- ❖ Ongoing Consulting

ERISA Attorney

- ❖ Plan Document preparation and Interpretation
- ❖ Consulting

CPA

- ❖ Annual ESOP Plan Audit if a large plan (>100 participants)

Outside Valuation Firm /Appraiser

- ❖ IRC and ERISA require prudent measures to be taken in valuing stock
- ❖ Fair Market Value based upon corporate financials, industry statistic and other factors

Regulatory Updates

2023 Retirement Plan Limits

The IRS and Social Security Administration recently announced the 2023 COLA adjustments.

To access the full details, see link below for IRS Notice 2022-55:

[N-2022-55 \(irs.gov\)](https://www.irs.gov/notice/2022-55)

IRA limits (not in chart):

- ❖ The limit on annual contributions to an IRA increased to \$6,500, up from \$6,000.
- ❖ The IRA catch up contribution limit for individuals aged 50 and over is not subject to an annual cost of living adjustment and remains \$1,000.

CODE SECTION	2023	2022	2021
401(a)(17) / 404(l) Annual Compensation	\$330,000	\$305,000	\$290,000
402(g)(1) Elective Deferrals	22,500	20,500	19,500
408(k)(2)(C) SEP Minimum Compensation	750	650	650
408(k)(3)(C) SEP Maximum Compensation	330,000	305,000	290,000
408(p)(2)(E) SIMPLE Maximum Contributions	15,500	14,000	13,500
409(o)(1)(C)(ii) ESOP Limits	1,330,000 265,000	1,230,000 245,000	1,165,000 230,000
414(q)(1)(B) HCE Threshold	150,000	135,000	130,000
414(v)(2)(B)(i) Catch-up Contributions	7,500	6,500	6,500
414(v)(2)(B)(ii) Catch-up Contributions	3,500	3,000	3,000
415(b)(1)(A) DB Limits	265,000	245,000	230,000
415(c)(1)(A) DC Limits	66,000	61,000	58,000
416(i)(1)(A)(i) Key Employee	215,000	200,000	185,000
457(e)(15) Deferral Limits	22,500	20,500	19,500
1.61-21(f)(5)(i) Control Employee	130,000	120,000	115,000
1.61-21(f)(5)(iii) Control Employee	265,000	245,000	235,000
Taxable Wage Base for Social Security	160,200	147,000	142,800

Form 5500 Filing Extension Due to Disasters

IRS extended the **2021** Form 5500 filing deadline for affected individuals and businesses (including tax exempt organizations) to **February 15, 2023**.

IRS webpage: [Tax Relief in Disaster Situations](#)
DOL webpage: [Disaster Relief Information for Employers and Advisors](#)

Applies to businesses with address of record in areas covered by FEMA declared federal disaster declarations - including Florida, North Carolina, South Carolina, parts of Alaska and Hinds County, Mississippi.

If you are relying on one of these announced special extensions, check the appropriate box on Form 5500, Part I, line D, and enter a description of the announced authority for the extension.

D Check box if filing under:

☐

Form 5558

☐

automatic extension

☐

the DFVC program

☒

special extension (enter description)

Plan Amendments and Required Restatements

POST PPA Cycle 3 Restated Plan Documents were due by 7/31/2022 - *pre-approved plans*

IRS extends due date for several required plan amendments to 12/31/2025

- ❖ Originally due by last day of plan year beginning on or after 1/01/2022
- ❖ SECURE Act - all law changes for both retirement plans and IRAs
- ❖ CARES Act
 - DOES extend due date for amending for 2020 RMD suspensions in qualified plans
 - Originally did not extend the deadline for expanded distribution & loan options due to COVID but IRS recently announced that this is also extended to the 12/31/2025 date

Important to note:

- ❖ *Regardless of when the plan is amended, it must be operated as if the amendment applied as of the original effective date of the applicable change in the law.*
- ❖ *Regardless of any IRS relief for plan amendment deadlines, retirement plans must be updated for all relevant changes in the law before they are terminated.*

SECURE Act - Lifetime Income Illustrations (LIIs)

Requires all DC plans to provide participants with an annual benefit statement showing hypothetical lifetime income disclosures:

- ❖ illustrating the hypothetical amount a participant would receive if their plan provided a lifetime annuity benefit
 - estimates the monthly annuity income payments if the account balance was used to purchase a qualified joint and survivor annuity (QJSA) and a single life annuity (SLA)
 - *It is not required for a plan to provide annuity benefits but DOL encouraging*
- ❖ For participant-directed plans - required in statements beginning with quarter-end June 30, 2022
- ❖ For non-participant directed plans - required in October 2022 benefit statements

<https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/pension-benefit-statements-lifetime-income-illustrations>

SECURE Act - 401(k) Plan Automatic Enrollment Provisions

Increased Auto-escalation Contribution Cap

- ❖ Plan sponsors using a Qualified Automatic Contribution Arrangement (QACA) Safe Harbor design must default the employee's contribution to at least 3% of the employee's pay with an annual increase of 1% to at least 6%.
 - *If the auto deferral starts at 6%, auto escalation is not required*
- ❖ The automatic escalation of the employee's contribution previously was capped at a maximum of 10%, but the SECURE Act **increased that limit to 15%**.
- ❖ Plan sponsors can choose to stop the auto-escalation at an amount lower than 15%, however, as this increase is not a required change.
- ❖ This higher limit could be especially helpful in enhancing the retirement readiness of employees who tend to put their retirement savings on autopilot.

SECURE Act - Extension of Time to Adopt New Plan

Employers can now adopt a retirement plan up until their tax return due date, plus extensions.

For tax years beginning back in 2020, employers can retroactively adopt a new qualified retirement plan as late as the employer's extended federal income tax filing deadline.

Important items to consider:

- ❖ timing for salary deferrals with new plans as deferrals can only be made prospectively
- ❖ the new plan can be retroactively effective as of the beginning of the tax year for which the tax return is being filed
- ❖ may allow for full year employer profit sharing, subject to plan eligibility and allocation conditions

Tax Status	Filing Deadline	Extended Deadline
S-Corporation (or LLC taxed as S-Corp)	March 15	September 15
Partnership (or LLC taxed as a part)	March 15	September 15
C-Corporation (or LLC taxed as C-Corp)	April 15	October 15
Sole Proprietorship (or LLC taxed as sole prop)	April 15	October 15



SECURE Act - Long Term, Part-Time Employees in 401(k) Plans

New requirement for 401(k) plans to allow long-term, part-time (LTPT) employees to make salary deferrals starting Jan 1, 2024

Employers must be tracking hours of service starting back to Jan. 1, 2021 to determine eligibility for this new rule

Part-time employees who have at least 500 hours of service in each of 3 consecutive 12-month periods must be allowed to enroll in the employer's 401(k) plan and make salary deferrals

No employer contributions are required, not even a match on salary deferrals for LTPT employees

SECURE Act - Required Minimum Distributions

Let's start with original proposed regulations:

- ❖ Changed the required beginning date (RBD): now generally April 1 of the calendar year following the calendar year the participant attains age 72.
- ❖ Limited the duration of many RMDs to beneficiaries to 10 years after death. Code §401(a)(9)(H),
 - applies to defined contribution plans, including 403(b) and 457(b) plans as well as IRAs
- ❖ For most plans, the new limitation on beneficiary distributions applied to deaths after December 31, 2019.
- ❖ For governmental plans and many collectively bargained plans, the new limitation was effective for deaths after December 31, 2021.

In February 2022, the IRS issued detailed proposed regulations addressing the new RMD rules. Under the proposal, the regulations, once finalized, would be effective January 1, 2022, and a reasonable, good faith interpretation of SECURE would suffice for 2021.

SECURE Act - Required Minimum Distributions

New Guidance issued October 7, 2022:

- ❖ Proposed regulations, when finalized will not be effective before January 1, 2023
- ❖ The primary source of confusion relates to certain beneficiaries of participants who died after the SECURE Effective Date and on or after their RBD.
 - *Eligible Designated Beneficiaries, Other Designated Beneficiaries, and other recipients (ex. Trusts, estates)*
- ❖ Notice 2022-53 provides that, for 2021 and 2022, there is no operational failure and no penalty tax for failure to pay “specified RMDs”.
 - If someone has already paid the penalty tax, they can file for a refund.
 - However, if a beneficiary has already taken the 2021 or 2022 RMD, they cannot pay it back to the plan or roll it over to an IRA.
- ❖ The definition of “specified RMD” is tailored to address this situation. A 2021 or 2022 RMD is a specified RMD qualifying for this relief if it meets all of the following conditions:
 - The RMD is a life expectancy payment due from a defined contribution plan or an IRA.
 - The RMD is due to a designated beneficiary following the death of a participant.
 - The participant died in 2020 or 2021, after the SECURE Effective Date, and after the participant’s RBD.
 - The designated beneficiary is not taking life expectancy distributions.

Retirement Plan Start-up Costs - Tax Credits

Employers may be able to claim a tax credit of up to \$5,000, for three years, for the costs of starting a SEP, SIMPLE IRA or 401(k) Plan.

Which Employers are eligible?

- ❖ 100 or fewer employees who received at least \$5,000 in compensation from you for the preceding year;
- ❖ at least one plan participant who was a non-highly compensated employee (NHCE); AND
- ❖ In the three tax years before the first year you're eligible for the credit, your employees weren't substantially the same employees who received contributions or accrued benefits in another plan sponsored by you, a member of a controlled group that includes you, or a predecessor of either.

Retirement Plan Start-up Costs - Tax Credits

Amount of the credit

The credit is 50% of your eligible startup costs, up to the greater of:

- ❖ \$500; OR
- ❖ The lesser of:
 - \$250 multiplied by the number of NHCEs who are eligible to participate in the plan, or
 - \$5,000

Auto-enrollment tax credit

- ❖ Additional tax credit of \$500 per year for a 3-year period by adding an auto-enrollment feature

<https://www.irs.gov/retirement-plans/retirement-plans-startup-costs-tax-credit>

Important Timing Considerations

When can I adopt a new 401(k) plan if I currently have a SIMPLE IRA in place?

All SIMPLE IRAs operate on a calendar year basis. Replacing one with a 401(k) plan takes some planning due to the following IRS rules:

- ❖ A SIMPLE IRA must be the sole retirement plan in effect for the calendar year.
- ❖ SIMPLE IRAs cannot be terminated mid-year.
- ❖ For a SIMPLE IRA to be terminated at year-end, participants must be notified at least 60 days in advance (November 2).

Due to these rules, the soonest you can implement a new 401(k) plan is the January 1 following the year your SIMPLE IRA plan is terminated.

What is the deadline for adopting a new safe harbor 401(k) plan?

- ❖ the first year of a new safe harbor 401(k) plan must be at least 3 months long - to give all plan participants the opportunity to make salary deferrals.
- ❖ The deadline for employers to adopt a new calendar-based plan was October 1.

Important Timing Considerations


What is the deadline for amending a traditional 401(k) into a safe harbor 401(k) plan?

A plan amendment must be executed to convert a traditional (ADP tested) 401(k) into a safe harbor 401(k) plan. The deadline for adopting this amendment will depend upon the type of safe harbor contribution to be made.

- ❖ Safe harbor match - amendment deadline is the last day of year preceding the plan year in which the plan will be safe harbor.
- ❖ However, match-based safe harbor plans must distribute a safe harbor notice to participants sooner - 30-90 days before the start of the plan year.

Safe harbor nonelective - The SECURE Act made the amendment deadline much more flexible for these plans. It depends on the contribution formula elected:

- ❖ *Less than 4%* - up to 30 days before the close of the plan year in which the plan will be safe harbor.
- ❖ *4% or greater* - The last day of the plan year following the plan year in which the plan will be safe harbor.
- ❖ The SECURE Act eliminated the notice requirement for Safe Harbor Nonelective plans.



ERISA Compliance and Administrative Areas of Focus

Qualified Plans & Compliance Testing - WHY IS IT IMPORTANT?

Qualified plans receive preferential tax treatment

- ❖ Employer may deduct employer contributions, subject to limits & timing rules, for tax savings
- ❖ Employees defer income tax and receives some employment tax relief

Nondiscrimination testing ensures plans do not favor highly compensated employees regarding:

- ❖ Plan eligibility
- ❖ Contributions
- ❖ Benefits, Rights and Features

Reference Chart for Most Common Testing

(Common) Type of Test	Applicable to DC Plans	Applicable to DB Plans	Applicable to H&W Plans
Minimum coverage test (IRC Section 410[b])	YES	YES	NA
Nondiscrimination test (IRC Sections 401[a][4] or 505)	YES ^(a)	YES ^(a)	Yes, <i>if</i> funded through a VEBA
Average deferral (ADP) and contribution (ACP) percentage limits (IRC Section 401[k] and [m])	Yes – unless safe harbor design	NA	NA
Top-heavy tests (IRC Section 416)	YES ^(b)	YES ^(b)	NA
Benefit and contribution limits (IRC Section 415[b] and [c])	YES	YES	NA
Employee deferral contribution limitations (IRC Section 402[g])	YES	NA	NA

^(a) Collectively bargained plans are deemed to automatically satisfy this test.

^(b) Plans with no key employees and collectively bargained plans are deemed to automatically satisfy this test.

Important Business Considerations

Controlled and Affiliated Service Groups

- ❖ Must be confirmed before any testing begins
- ❖ Aggregated Testing for related entities - such as 410(b) Coverage and Nondiscrimination

Mergers & Acquisitions

- ❖ Has the business bought or sold an entity?
- ❖ Section 410(b)(6)(c) Transition Rule
 - Subject to certain conditions, allows plans to be tested separately until the end of the first plan year following the year of the business transaction
 - Both plans must satisfy coverage immediately before acquisition **AND**
 - Coverage under the plan has not changed significantly during the transition period or may cause the period to end sooner

Does the Plan Sponsor maintain other plans? Ex. ESOP, Cash Balance Plan

Other Areas of Focus for Plan Sponsors

- ❖ Regular review of Plan Design
 - Growing population
 - Recruiting & Retention- align eligibility with other benefits?
 - Changes in ownership
 - Flexibility in the plan document related to employer contributions
- ❖ Service Providers and their role in the annual compliance testing
- ❖ Automation of processes for efficiency and accuracy
- ❖ Establish Internal Controls and detailed processes
- ❖ Compliance Calendar or Checklists to ensure Plan Sponsor stays on top of deadlines

Common Administrative & Compliance Errors

- ❖ Eligibility determination
- ❖ Incorrect definition of compensation
- ❖ Timely deposit of 401(k) deferrals & loan repayments
- ❖ Vesting
- ❖ Loans & Hardship Distributions
- ❖ Plan Expenses

Annual Plan Audit - When is it Required?

Small Plan Audit Waiver

- ❖ < 100 participants on the first day of a plan year
- ❖ Meet the 80 to 120 Participant Rule
- ❖ Indicated on 5500 that plan is claiming the waiver

Large Plan - Audit required

- ❖ > 120 participants on first day of plan year
- ❖ Schedule H must have IQPA attached
- ❖ Continue to file as large plan until < 100 participants on 1st day of plan year

What Triggers an IRS or DOL Audit

Items reported on the Form 5500

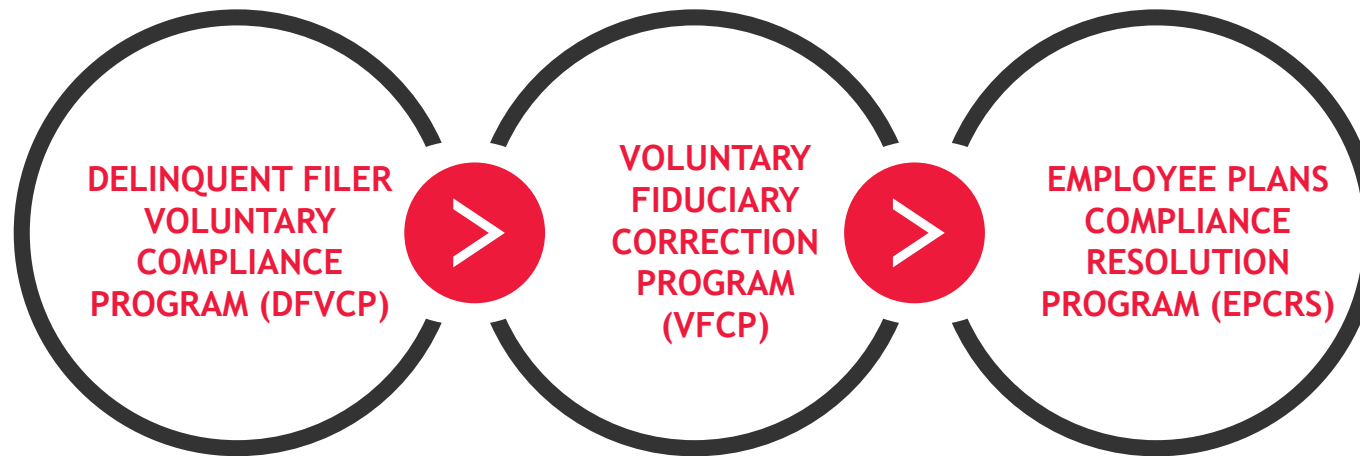
- ❖ Participant Count questions
- ❖ Late 401(k) & Loan Repayments
- ❖ Failure to provide benefits due
- ❖ ERISA Bond coverage not sufficient
- ❖ Plan Termination

W-2cs issued to correct excess deferrals

Employee complaints could trigger both IRS & DOL



Correction Program Services



- ▶ For delinquent filing of Forms 5500, 5500-SF, and 5500-EZ. Includes preparation and filing, as well as consulting and assistance with submission to DOL website.
- ▶ Allows plan sponsors to identify and fully correct certain transactions such as delinquent participant contributions and loan repayments, prohibited purchases, sales and exchanges, improper loans, and improper plan expenses.
- ▶ The Self-Correction Program permits corrections with or without fee or application to the IRS, such as for missed deferral corrections and calculation of QNEC.
- ▶ The Voluntary Correction Program permits corrections, prior to an IRS initiated audit, by paying a fee and applying to the IRS.

Questions?

Please contact me if I can be of any assistance:

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