Action Items

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a newsletter for ACI's clients and their advisors

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Pat Byrnes To Receive the 2005 EIDSON Award

What is the Eidson Award? This award was created in 1995 in memory of American Society of Pension Professionals & Actuaries (ASPPA) founder Harry T. Eidson, FSPA, CPC. The Harry T. Eidson Founders Award recognizes exceptional accomplishments and contributions to organizations or the pension industry. Recipients of this award are chosen for their contributions over time who have delivered "above and beyond reasonable expectations". This award is ASPPA's most prestigious honor.

Pat Byrnes, a former president of ASPPA who initiated the first joint IRS/ASPPA Los Angeles Benefits Conference will be awarded the ***2005 Harry T. Eidson Founders Award*** in early November. Pat organized the initial Los Angeles Benefits Conference in 1992 at the suggestion of the IRS, which has been successfully repeated regularly since. He has dedicated over 20 years to building collaborative relationships between those who offer pension services and Government agencies that regulate them. He has helped bring together the service and private sector benefits community with the goal of improving cooperation and the level of voluntary compliance in the pension plan arena.

In 2004, Pat received the ***Internal Revenue Service Commissioner's Award*** for his sustained effort to enhance voluntary compliance within the retirement system. This is the highest honor bestowed on a private citizen from the Department of the Treasury.

Please join us in congratulating Pat on a well deserved award.

What is ASPPA? Founded in 1966, ASPPA is a national organization of retirement plan professionals dedicated to the preservation and enhancement of the private pension system in the United States. Its 5,400 members provide consulting and administrative support to more than half the private pension plans in America. ASPPA's purpose is to educate retirement plan and benefits professionals; and also preserve and enhance the private pension system. They are a non-profit organization. They work closely with the Government and keeps members updated on all legislative activities that would affect pension plans.

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Solving the ESOP Riddle

by Paul Gurrola, BBC Capital
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What do Allied Steel, Round Table Pizza, Dunn-Edwards, Volvo (North America), Lowe's Home Improvement, Pixar, Parnelli Jones and CB Richard Ellis have in common? They are all ESOP owned companies that have solved the ESOP riddle of "When is an ESOP more than just an employee benefit plan?"

Literally hundreds of companies across the country are discovering the power and advantages of ESOPs. ESOPs provide tax-favorable strategies for shareholder liquidity, acquisitions and enhanced cash-flow to sponsoring corporations. While the main purpose of an ESOP is to provide benefits for eligible participants and beneficiaries, an ESOP is much more. For example, an ESOP is a liquidity tool that enables current shareholders to sell highly appreciated closely held stock and defer (and perhaps eliminate) capital gains tax on their life's work.

Some Important Facts about ESOPs

1. Under internal revenue code Section 1042, shareholders of a closely held C corporation can defer, and possibly avoid entirely, capital gains taxes if the following requirements are met:

    a. The ESOP must own at least 30% of the company's stock immediately after the sale

    b. Proceeds from the sale must be reinvested by the selling shareholders in "Qualified Replacement Property" (QRP) within a 15 month period, beginning three months before the sale to the ESOP and ending 12 months after the sale to the ESOP. *(In order for a security to qualify as QRP, it must be a purchased security of a domestic operating corporation. Many U.S. stocks and bonds qualify. Treasury securities, municipal securities, mutual funds, real estate investment trusts (REITS), do not qualify as QRP.)*

    c. Shareholders must have held the stock for at least three years. *(In a ruling dated 10/25/2002, the IRS affirmed that a limited liability company that is taxed as a partnership may also elect a Section 1042 rollover)*

2. An ESOP is the only form of qualified retirement plan that is permitted to borrow money to acquire assets.

3. Principal payments on ESOP debt are tax deductible to the sponsoring corporation. An ESOP is the only vehicle in the Internal Revenue Code that permits the deductibility of principal payments on corporate debt.

4. TRA 1997 permitted S corporation ESOPs. S corporation ESOPs pay no state or federal income taxes. The S corporation ESOP also pays no unrelated business income tax (UBIT). The net result is a tremendous increase in cash-flow to the ESOP owned company.

5. An ESOP pays fair market value and provides an immediate and ready buyer.

Most 100% ESOPs acquire stock in a "leveraged" manner. In other words, the ESOP borrows money to finance the purchase of stock from the sponsoring corporation. The most common method of financing a 100% ESOP stock purchase is for the sponsoring corporation to arrange for a third-party loan, usually from a commercial bank. The bank loan will represent a portion of the total purchase price, perhaps 40%, with the selling shareholder(s) taking the remaining balance of 60% in the form of a note that will also include warrants. The warrants allow the selling shareholders to participate in the future appreciation of the company.

Case Study – ABC Company

ABC Company is a service company with minimum tangible assets. The company is a C corporation with $25 million dollars in revenues with $5 million dollars in EBITDA (earnings before interest taxes depreciation and amortization). The company has a valuation of approximately $25 million dollars ($5 million in EBITDA with a 5 multiple). The transaction type is a 100% ESOP stock purchase.

ABC Company has one shareholder, Jack, who has close to a zero tax basis in his company's stock. Jack lives in a state with a 10% capital gains tax and coupled with the federal capital gains tax rate of 15%, would pay a total capital gains tax of approximately 25%. If he sold his stock to the corporation in a traditional manner or to an outside buyer, he'd pay approximately $6.25 million in federal and state capital gains taxes. Conversely, if Jack sold his stock to an ESOP for $25 million and elected a section 1042 rollover, he would pay no capital gains taxes and would have $25 million to reinvest in a diversified portfolio of publicly traded securities.

To achieve this tax advantage, ESOP sale proceeds must be reinvested in "qualified replacement property" within a 15 month period, beginning three months before the sale to the ESOP and ending 12 months after the sale to the ESOP. "Qualified replacement property" is generally defined as securities (either debt or equity) issued by a domestic operating corporation (either publicly traded or closely held).

At the completion of the transaction, Jack would receive the following:

1. $25 million dollar QRP portfolio.
2. $7.5 million dollars cash – capital gains tax deferred (potentially forever).
3. 8-9% annual interest income on the seller note to the company.
4. Warrants in the company that will allow Jack to participate in any upside appreciation of the company.
5. Employment contract with the company at market level compensation for approximately three years.

See "ESOP" on page 3

ESOP, continued from page2

6. Capital gains tax savings of approximately $6.25 million dollars

The Characteristics a company should have to be a good ESOP Candidate are:

Company Status

- Strong financial condition
- Limited exit options:
  - Service companies
  - Companies with limited hard assets
- 30 or more employees

Shareholder Goals

- Gain liquidity
- Realize the current value of the company and still participate in the future appreciation
- Defer capital gains tax on the sale
- Provide employee ownership and accountability

The ESOP transaction is not suited for every business owner but where it aligns with the business owner's goals, objectives and risk tolerance, it is the most powerful and tax efficient transaction on the planet.

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Editors Note: ACI does not administer ESOPs. We periodically publish articles that are submitted to us when we feel that the content may be of interest to our readers. ACI expresses no opinion on the views taken by the author.

ACI Welcomes Christine Hough, Consulting Actuary

ACI is proud to announce the addition of Christine Hough to our team as a Consulting Actuary. She will assume substantial roles in the areas of valuations, technical training and internal consulting, as well as being a consultative resource for our clients.

Christine brings 20 years of experience to ACI. As a consultant at both Towers Perrin HR Services and Mercer Human Resource Consulting, she was responsible for serving as primary client contact, project manager and quality assurance reviewer for plans with up to 25,000 participants. Christine spent time training and mentoring junior consultants and analysts, and was also responsible for the supervision of other consultants and analysts.

Christine has an MS in Electrical Engineering and a BS in Computer Science and Engineering from California State University, Long Beach. She is a Fellow of the Society of Actuaries and an Enrolled Actuary.

We welcome Christine and expect that many of you will be meeting and working with her as she assumes a wide-ranging technical and consultative role. We hope you are as pleased as we are to have her compliment our technical staff.

What We Know About Roth 401(k)'s Today

by Tobi Cogswell, Director, Client Services
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Roth 401(k) provisions will be effective beginning January 1, 2006. It allows people to make two kinds of deferrals:

1. Traditional pre-tax deferrals that remain tax-deferred until distribution; and
2. After tax deferrals that will be distributed tax free

With regard to distributions, while traditional pre-tax deferrals may be rolled into an IRA or another qualified plan, Roth 401(k) accounts may only be rolled to a Roth IRA or another qualified plan that allows Roth 401(k) contributions.

Distributions from Roth 401(k) accounts are subject to the same withdrawal restrictions as traditional 401(k) accounts, i.e., death, disability, termination of employment, termination of the plan, attainment of age 59 ½ (if so elected in the plan document)

3. The determination of how much will be traditional, and how much will be Roth, is a determination that must be elected each year by the participant
4. Recordkeepers will have to account for these two sources separately
5. Payroll vendors will have to account for these two sources separately
6. Deferrals deposited into a Roth 401(k) source are still subject to ADP testing. Total deferrals are still limited to $15,000 (in 2006).
7. If your plan contains matching provisions, the match may apply to the Roth deferrals.
8. The Roth 401(k) provision is set to expire in 2010 unless it is extended by Congress

What We Don't Know About Roth 401(k)'s Today

9. Exactly how we go about putting this provision into your plan. We expect guidance on how the IRS decides to handle plan amendments shortly.

Please contact your ACI plan administrator if you are interested in adding a Roth 401(k) provision to your plan and we will be happy to assist you with documenting this provision prior to January 1, 2006.

Mergers and Acquisitions:
Qualified Plan Considerations

by Tobi Cogswell, Director, Client Services
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Mergers and acquisitions can be an exciting time, both for a buying company and for the selling company. There are many things that need to be done, and little time in which to do them. Often the retirement plans are not given the attention they deserve during this pressure-filled time.

The following is a partial list of things to be considered. It is not exclusive but should get you thinking about the retirement plans and how they should be handled.

1) Is the acquisition an asset purchase or a stock purchase?
2) What is the future of the seller's Plan? How will it be determined to either terminate it or merge it inot the acquirer's plan?
3) If it is being terminated, does the termination have to occur before the acquisition?
4) If it is being terminated, will the existing Third Party Administrator prepare all termination documents and entity resolutions, and will they submit the plan for a favorable determination letter from the IRS on the plan termination?
5) If it is being merged, are the assets going to change to a new recordkeeper?
6) Are the assets going to be "mapped", or are the acquired participants going to be newly enrolled?
7) If the assets change, who will shepherd the transition and deal with such matters such as the Sarbanes-Oxley notifications and so forth?
8) Is the seller's plan fully in compliance with all current tax laws? How do you know?
9) Does the acquiring plan need to be amended to add a special entry date for the acquired employees?
10) If the seller's plan is a Defined Benefit plan, are there sufficient assets to cover the plan's liabilities?
11) Is the acquiring plan on a prototype document? If so, the definition of "Employer" may require that the acquired employees participate immediately. If not, the definition of "Employer" may allow both plans to operate separately until the end of the IRC 410(b) transition period (the year following the year in which the acquisition occurs.)
12) Do the reps and warranties in the deal agreement spell out the due diligence necessary with respect to the plan and has that due diligence been completed?
13) Are there any cultural differences between the two plans that need to be resolved and havethe appropriate plan design changes been made?

Involving your ACI plan administrator early will allow you to be pro-active in your treatment of the plans and may allow you the ability to do some planning and re-design to meet all the needs of both companies. We are happy to help you.

Action Items is published quarterly.
If you would like to receive future publications of the newsletter, please visit our website at ***www.acibenefits.com****, or contact* ***information@acibenefits.com*** *for a brochure.*

Mandatory Cash Outs Procedures under 2005-5

As we get closer to the end of the year it is important to remember that calendar year plans must have an amendment in place by December 31, 2005 regarding how terminated participants with account balances of $5,000 or less are going to be treated.

For terminees who do not elect to take a distribution, you have several options available:

1) Amend the plan to eliminate mandatory cashouts entirely.
2) Amend the plan to allow for the implementation of the new automatic rollover rules. This means that for a mandatory distribution of over $1,000 but less than $5,000, you must have procedures in place to roll this distribution into an IRA. You must: 1) have a written agreement with an IRA custodian; 2) Notify the terminated participant of this agreement; and 3) Process all mandatory cashouts by December 31, 2005.
3) Amend the plan to reduce the mandatory cashout amount to $1,000 or less. This means that you will still have to process all mandatory cashouts by December 31, 2005, but you can withhold the 20% Federal Withholding and send the terminated participant a net check with no requirement that an IRA be set up.

Whatever you do today can be changed in the future, but we urge you to get this amendment in place sooner rather than later to give you enough time to act on it. Your ACI plan administrator will be contacting you to discuss your choice but do not hesitate to call them first if you know which provision you would like to put in place.

REMINDERS

Timing of Deferral/Loan Repayment Deposits
401(k) Elective Deferral Contributions and Loan Repayments, if applicable, must be deposited as soon as administratively possible but no later than 15 business days following the end of the month in which the pay date fell. Note that the 15 business day maximum is not a safe harbor and cannot be relied upon if it is possible to deposit the monies earlier. If the average timing of your deposits is 3-5 days and one or more deferral deposits are deposited later than the average, they could be considered late, even if it is still less than the 15 business day deadline. Any late deposits are required to be reported on the Form 5500 tax return. Lost earnings will be owed to the participants and a 15% excise tax will be incurred.

Change in Ownership
Any change in ownership of the company or relatives of owners who begin working for the company could affect the results of the compliance tests and employer contribution amounts. It is important to notify your Third Party Administrator in advance of any ownership changes to the plan in order to determine what effect, if any, it might have on the plan design.

Bond
All qualified retirement plans are required to have a bond for at least 10% of the total plan assets at the beginning of the year. If more than 5% of the plan assets are considered "non-qualified" or are not regularly valued, the amount of the bond must cover the total non-qualified assets in order to avoid a small plan audit conducted by a qualified accountant. Please contact your insurance agent to obtain a bond or to increase the amount of your current bond.

Required Minimum Distributions
All participants who have reached the age of 70 ½ and either own more than 5% of the company or are terminated but still have an account in the plan are required to start receiving minimum distributions from their account. Please make sure that anyone who falls into this category is receiving their minimum required distribution.

Safe Harbor 401(k) Plan
Your plan may have a safe harbor provision in order to avoid having to perform the ADP/ACP testing each year. If you have a calendar year plan, you must provide notices to your employees by December 1, 2005. Depending upon what type of safe harbor plan you have, you may be required to provide both a confirmation notice for the 2005 year end and a notice for the 2006 year end.

Katrina Victims Able to Access Pension Assets

by Laura Mitchell, Consulting Actuary
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The Internal Revenue Service and Congress are working to give Hurricane Katrina victims easier access to retirement assets and alleviate the penalties

The IRS has liberalized loan and hardship procedures for victims of Hurricane Katrina. A plan does not need to have loan or hardship language or provide in-service distributions to provide these distributions. However any plan providing these options for Katrina relief would need to be amended by end of first plan year beginning after December 31, 2005. This means a participant could take a loan or hardship distribution up to the statutory limits from their retirement plan. Plans that require documentation for a hardship distribution may relax this requirement.

Who is eligible? Employees or former employees who had a primary residence or place of employment on August 29, 2005 in the Hurricane Katrina designated disaster areas or whose spouse, parents, children, grandparents or other dependents had a principal residence or place of employment in the Hurricane Katrina disaster area. To qualify the distribution must be made between August 29, 2005 and March 31, 2006.

On the Congressional front, the House and Senate have passed the Katrina Emergency Tax Relief Act (KETRA), and the President was expected to sign it at the time this article went to print. If signed, the retirement–related provisions of this Act would among other items waive the 10% excise penalty for disaster related early distributions, tax the distribution as regular income but waive the automatic 20% withholding, raise the loan limit to the lesser of 100% of the account balance or $100,000, suspend loan repayments for up to 1 year, and allow repayment of disaster-relief distributions.

Employers and Plan Administrators located in the Katrina disaster area have been provided automatic extensions for filing 5500 Forms until January 3, 2006. Taxpayers should write "Hurricane Katrina" at the top of the forms in red ink to alert the IRS to help identify those eligible for the extension. The IRS has also set up a special disaster hotline, 866- 562-5227 for those with Katrina-related questions.

If you have employees who qualify for Katrina-related loans or hardships please contact your administrator to help keep your plan in compliance.

Note: Just as this article went to print, President Bush signed KETRA on September 26, 2005.

ACI In the News

Speeches

Pat Byrnes spoke at the CalCPA Education Foundation's 2005 Retirement Planning Conference in San Francisco on September 20th, and on September 21th in Los Angeles. His presentation, "*What Plan Fits When*" focused on determining the correct plan for companies. On September 14, Laura Mitchell moderated the Society of Actuaries Webcast on Hybrid Plans. The webcast had an audience of 350-400 people.

Have an Idea for an Article?

Action Items is provided to our clients and their advisors with articles that address relevant, timely issues. If you have a particular topic that you would like us to address, a question you would like answered, or if you would like to submit an article for publication, please let us know. We welcome your feedback and input.

If you have any comments or suggestions regarding *Action Items*, please contact our marketing manager, lace.greene@acibenefits.com.

ACI Client Education Seminars:

2005 401(k) Basic Training: An Introduction to 401(k) Plan Operation
This educational presentation covers items such as non discrimination testing, employee deferrals and employer contributions, loans and distributions and payroll issues. This seminar is open to anyone who would like a better understanding of the administration of 401(k) plans. It will be on Thursday, October 20th from 9:00 AM to 12:00 PM. Please contact Lace.Greene@acibenefits.com to reserve a seat.

ACI Proudly Supports the Following Organizations:

Pediatric Cancer Research Foundation (PCRF)
This is a non-profit organization that is privately supported through donations from individuals, charitable foundations, and businesses that recognize the urgent need to improve treatment and cure childhood cancers. Jack Cross is a member of PCRF's board of directors. For more information, please visit *www.pcrf-kids.com.*

Susan G. Komen Breast Cancer Foundation (www.komen.org)
October is National Breast Cancer Awareness month. Every year, ACI participates in Yoplait's Annual ***Save Lids to Save Lives*** program. Please visit *www.yoplait.com* for more information. On October 7, ACI will participate in the ***Lee National Denim Day***. Lee National Denim Day is the world's largest single-day fundraiser for breast cancer. On this day, ACI employees will slip into their favorite jeans in exchange for a donation to the Komen Foundation. Please visit *www.denimday.com* for more information.

ACI Adopts A Family Program
Every year, ACI adopts a family (or two), who are less than fortunate, for Thanksgiving and Christmas. With donations from ACI and our employees, we are able to provide a family dinner and gifts so that they are able to enjoy a heartwarming celebration during the holiday season. It's a wonderful way to give back to the community.

ACI Makes A Matching Gift Program to the Hurricane Katrina Relief Effort
In September, ACI created a dollar for dollar matching gift program for our employees for the charity of their choice that will aid the victims of Katrina.

Congratulations Natalie DeBruin, Plan Administrator

It is with great pleasure to announce that Natalie DeBruin was promoted to the position of Plan Administrator on August 15. Prior to making Los Angeles County her home, Natalie was a native of Folsom, California (Sacramento County). In 2002, she joined ACI as a receptionist. Having the ability to take on more duties, she began assisting plan administrators in various tasks. She took legal courses on top of her busy schedule and was able to achieve her paralegal certificate in 2004. Natalie held the position as Assistant Document Coordinator until now.

It is remarkable how much Natalie has grown with ACI in such a short time. Many of you have had the opportunity to work with Natalie and were able to experience her dedication in handling your needs. As she assumes a widening role, we hope you are as pleased as we are to have her compliment our administration team. Please join us in congratulating Natalie on her new position.