MENKE & ASSOCIATES, INC.
ESOP ADVISORS AND INVESTMENT BANKERS

To: All Clients

From: Menke Legal Department

Date: April 15, 2020

Subject: ESOP-Related Provisions of CARES Act and FFCRA

On March 18, 2020, President Trump signed the **Families First Coronavirus Response Act (the "FFCRA")** which provides small and midsized employers refundable tax credits for the cost of providing paid sick and family leave wages to their employees for leave related to COVID-19. On March 27, 2020, President Trump also signed the **Coronavirus Aid, Relief, and Economic Security Act ("CARES Act")** which provides additional financial resources for individuals and businesses affected by the COVID-19 crisis. The purpose of this Memorandum is to highlight some of the pertinent provisions of these Acts that apply to ESOP companies and to ESOP participants, as follows:

I. PROVISIONS THAT APPLY TO EMPLOYERS

New Federal Emergency Paid Sick-Leave Act ("EPSLA")

Effective April 1, 2020, FFCRA requires employers with fewer than 500 employees to provide two weeks of paid sick leave if employees are unable to work because they are subject to quarantine or isolation, are experiencing COVID-19 symptoms, are caring for someone who is in quarantine or isolation and/or have children in schools that have closed. However, small businesses that have fewer than 50 employees may qualify for an exemption from the requirement to provide leave due to school closing or childcare unavailability if the leave requirements would jeopardize the viability of the business as a going concern. Emergency paid sick leave is capped at $511 per day (and $5,110 in the aggregate) when used for the employee's own well-being and at $100 per day (and $2,000 in the aggregate) when used for family or childcare.

Expansion of Family and Medical Leave Act ("FMLA")

Effective April 1, 2020, FFCRA expands the existing provisions of FMLA to require that employers with fewer than 500 employees provide eligible employees with up to 12 weeks of job protected "public health emergency leave" when needed to care for a son or daughter under 18 years of age if the child's school or place of class has closed, or the child's child care provider is unavailable as a result of a COVID-19 health emergency declared by a Federal, State, or local authority. To qualify, however, employees must be unable to work or telework while caring for the child. If an employee qualifies, the first 10 days

of such family leave are unpaid; thereafter, the employee must be paid for the reminder of their leave in an amount that is not less than two-thirds of their regular rate of pay, multiplied by the number of hours they would normally work, but capped at $200 per day and $10,000 in the aggregate.

Impact of EPSLA and FMLA on Employer

FFCRA authorizes employer **tax credits** for EPSLA and FMLA wages paid to eligible employees. Such tax credits will be applied against the employer's portion of Social Security taxes for 2020.

For more detailed information regarding employer tax credits, click **HERE** for a copy of the IRS publication *COVID-19-Related Tax Credits for Required Paid Leave Provided by Small and Midsize Businesses FAQ.*

Impact of EPSLA and FMLA Payment on ESOP Participation

The Menke plan document typically includes all forms of **paid** compensation, including sick pay and family leave pay, as "covered compensation". In addition, the hours associated with such pay are included when determining a participant's years of service for purposes of vesting and for determining whether a participant has incurred a break-in-service.

For more detailed information on how EPSLA and FMLA affects both employers and employees, click **HERE** for a copy of the DOL publication *Families First Coronavirus Response Act: Questions and Answers.*

Employee Retention Tax Credit

Separate and apart form the tax credit provisions provided under EPSLA and FMLA for sick leave and family leave payments to employees, the CARES Act provides a refundable and advanceable payroll tax credit against the employer's portion of Social Security taxes for 2020 if the business is fully or partially suspended pursuant to a governmental order related to COVID-19, or experiences during the period from March 13, 2020 through December 31 ,2020 a reduction of 50% or more of gross receipts from the same quarter in 2019. This tax credit is equal to 50% of the qualified wages - up to $10,000 paid to each employee during 2020. For eligible employers with 100 or fewer full-time employees, the tax credit applies to all employee wages. If, on the other hand, the employer has more than 100 full-time employees, the tax credit only applies to wages paid to employees when they are not working due to a governmental order related to COVID-19. **Note**: The Employee Retention Tax Credit is not available if the employer claims the FFCRA credit for sick leave and/or family leave, or if the employer receives a small business interruption loan under the SBA's Paycheck Protection Program .

Paycheck Protection Program ("PPP") – Forgivable Loans for Small Employers

The Paycheck Protection Program ("PPP"), in effect, allows a company with 500 or fewer employees to obtain an SBA guaranteed loan for an amount that is equal to 2.5 times its **average** monthly "payroll expense", plus an additional amount of up to 25% of payroll expense for certain other expenses payable during the 8 week period after the loan is made. Loan proceeds can be used only for purposes of paying payroll expenses and these additional specific expenses. Subsequently, if certain conditions are met, part or all of the loan is forgiven.

- Lenders may begin processing applications starting April 3rd.
- Loans will be made in amounts of up to $10 million at an interest rate of 0.5%.

- You can apply through any existing SBA 7(a) lender or through any federally insured depository institution, federally insured credit union, or Farm Credit System institution that is participating.
- Other regulated lenders will be available to make these loans once they are approved and enrolled in the program. You should consult with your local lender as to whether it is participating in the program.
- Click **HERE** to view a copy of the SBA's *Borrowers Information Sheet* and the SBA's PPP Application Form.

The maximum amount that can be borrowed by any one company is 2.5 times "payroll costs", including employee benefits, plus up to an additional 25% of the amount of payroll costs for the following costs:

- Interest on mortgage obligations incurred before February 15, 2020;
- Rent, under lease agreements in force before February 15, 2020; and
- Utilities for which service began before February 14, 2020.

Payroll costs consist of two separate components – cash compensation and non-cash employee benefits. Cash compensation includes salary, wages, commissions, tips, vacation pay and sick pay, and is capped at $100,000 on an annualized basis for each employee. Non-cash employee benefits include payments for group health care benefits including insurance premiums; **retirement benefit costs;** and state and local taxes assessed on compensation (i.e. employer taxes for unemployment insurance).

The amount that any one company can borrow, subject to the maximum limit of $10 million, is calculated as follows:

1. Determine the company's **average monthly cash payroll expense** based on the 12 months immediately prior to the loan application, and based upon a cap of $100,000 per employee. The company can then borrow 2.5 times this amount.
2. Determine the company's **average monthly non-cash employee benefits expense** based upon the 12 months immediately prior to the loan application. In calculating **average retirement benefit costs**, the company can include all of the company's 401(k) matching contributions paid during the past 12 months, as well as the company's most recent annual ESOP contribution paid during the past 12 months. The company can then also borrow 2.5 times the amount of the total of **average monthly non-cash employee benefit costs.**
3. Lastly, the company can borrow an additional amount that is up to 25% of the sum of the amounts calculated items 1 and 2 to the extent the company will owe money for interest on qualifying mortgage obligations, rent, and utilities payable during the 8 week period after the loan is made.

Assuming that the company maintains the same number of average full-time equivalent employees during the period from February 15, 2020 through June 30, 2020, the maximum amount of the PPP loan that will be forgiven is the total of the eligible payroll costs and the total of the eligible rent, utilities and interest that is paid by the company during the eight-week period following the date of the loan. As this amount may be slightly more than or less than the amount of the original loan, the loan may be totally forgiven or only partially forgiven, depending upon the circumstances.

Economic Injury Disaster Loans (EIDL)

Companies that have 500 or fewer employees can also apply for a loan under the Disaster Loan Program ("DLP"). The DLP is a program which provides loans directly from the Federal government without the need for a local SBA-approved lender. Unlike PPP loans, DLP loans do not have a restriction on the purpose for the loan. Hence DLP loans can be used, for example, to repay existing loans or to finance ESOP distribution and/or diversification payments. However, unlike PPP loans, these loans are not forgivable.

- The online application for EIDLs is open right now and you can find it **HERE** on the SBA's website.
- A DLP loan offers disaster assistance of up to $2 million with interest rates of 3.75% for small businesses and 2.75% for nonprofits.
- You can request an immediate advance of up to $10,000.
- The repayment of DLP loans can be delayed for one year from the date of the loan.

Note - Businesses can apply for and receive both an EIDL and a PPP loan; however, both loans cannot be used for the same purposes.

Main Street Lending Program

The CARES Act also authorized two lending programs under the Main Street Lending Program for U.S. businesses with up to 10,000 employees or $2.5 billion in 2019 revenues**, including businesses with less than 500 employees.** On April 9th, 2020, the Federal Reserve issued term sheets for two loan facilities that are available under this Program – the Main Street New Loan Facility ("MSNLF") and the Main Street Expanded Loan Facility ("MSELF"). MSNFLs are for loan facilities that originate on or after April 8, 2020. MSELFs, on the other hand, provide for expanded loan facilities for loans that originated prior to April 8, 2020. The terms and conditions that apply to these two loan facilities are as follows:

- Only businesses that have significant operations and a majority of their employees in the U.S. are eligible.
- A company can participate both in the Main Street Lending Program and in the PPP, but it cannot participate in both MSNLF and MSELF.
- The minimum loan amount is $1 million.
- For new loans that originate after April 8, 2020 under MSNLF:
    - No security is required.
    - The maximum loan amount is the lesser of (i) $25 million or (ii) an amount that, when added to the borrower's existing outstanding and committed but undrawn debt, does not exceed four times the borrower's 2019 EBITDA.
- For loans obtained under MSELF:
    - Loans will be treated as an extension of the existing loan and may be secured or unsecured.
    - The maximum loan amount is the lesser of (i) $150 million, (ii) 30% of the borrower's existing outstanding and committed but undrawn debt, or (iii) an

amount that, when added to the borrower's existing and committed but undrawn debt, does not exceed six times the borrower's 2019 EBITDA.

- These loans have a four-year maturity, but payment of principal and interest is deferred for one year.
- The interest rate is the adjustable rate of the Secured Overnight Financing Rate (currently .01%) plus 250 to 400 basis points.
- There is no prepayment penalty.
- Borrowers must certify that:
    - Borrower will not use the proceeds to repay other loan balances.
    - Borrower requires financing due to the exigent circumstances presented by COVID-19.
    - Borrower will make reasonable efforts to maintain its payroll and retain its employees during the term of the loan.
    - Until a date that is 12 months after the date the loan is no longer outstanding:
        - Borrower will not pay dividends or make other capital distributions to shareholders.
        - Officers or employees with total compensation over $425,000 in 2019 will not receive compensation in excess of what they received in 2019.

II. PROVISIONS THAT APPLY TO EMPLOYEES

In recognition that many employees will incur layoffs or will require sick leave, etc., the CARES Act authorizes qualified plans the option of offering new Penalty-Free Withdrawal Rights (in addition to any existing hardship withdrawal provisions in the plan) and expanded Participant Loan Rights. In addition, the CARES Act requires that plan sponsors offer participants the right to waive RMD distributions.

In general, we would not recommend that ESOP clients amend their ESOPs to add the Penalty-Free Withdrawal Rights or expanded Participant Loan Rights as these are provisions that are more appropriate to add to 401(k) plans.

Penalty-Free Withdrawal Rights

Under the CARES Act, a plan sponsor may allow eligible participants to take Coronavirus-related Distributions ("CRDs") from their retirement plan accounts under the following conditions:

- The participant must be a "Qualified Individual"
    - diagnosed with coronavirus disease by a test approved by the CDC; or
    - have a spouse or dependent diagnosed with coronavirus disease by a test approved by the CDC; or
    - have experienced adverse financial consequences as a result of (i) being quarantined, furloughed, laid off, or unable to work due to lack of child care; (ii) having work hours reduced; or (iii) the closure or reduction of hours of their owned or operated personal business due to coronavirus disease.

- The plan sponsor may rely on a participant's self-certification that they are eligible for a CRD.
- The maximum amount available for a CRD may not exceed $100,000 in the aggregate from all plans maintained by the plan sponsor.
- CRDs must be taken during the time period between January 1, 2020 and December 31, 2020.
- CRDs are not subject to the 10% early distribution penalty tax.
- CRDs cannot be rolled over to another plan and thus are not subject to the mandatory 20% withholding.
- CRDs **are** subject to mandatory 10% withholding. **However, the plan sponsor must notify the participant that he or she has the right to waive the 10% income tax withholding. Failure to send this notice can result in substantial penalties being assessed against the plan sponsor.**
- The 10% withholding period must be spread out over a 3-taxable-year period beginning with the taxable year in which the distribution is made.
- Participants may repay CRDs at any time during the 3-year period beginning on the date on which the participant has received a CRD.
- Repayments may be made in one or more installments.
- Repayments shall be treated as though the participant has made a rollover contribution of the distributed funds back into the participant's account.

Expanded Participant Loan Rights

Under the CARES Act, a plan sponsor may also allow "Qualified Individuals", as defined above, to take larger participant loan amounts ("PLAs") from their retirement plan accounts than are allowed under current law under the following conditions:

- Under current law, PLAs are limited to 50% of a participant's vested account balance or $50,000, whichever is less.
- Under the CARES Act, PLAs have been increased to 100% of a participant's vested account balance or $100,000, whichever is less.
- The new PLAs only apply to loans made in the 180-day period beginning March 27, 2020.
- For loan payments that are due between March 27, 2020 and December 31, 2020, "Qualified Individuals" may delay such loan payments for up to one year.
- A one-year delay may extend the general 5-year participant repayment period.
- If the plan allows a repayment delay, later repayments must be adjusted for the interest accrued during the delay and during the extended repayment period.

Waiver of Required Minimum Distributions for 2020

- The CARES Act waives the requirement for defined contribution plans to make required minimum distributions ("RMDs") for RMD payments that are due by April 1, 2020 and for RMD payments that are to be made by December 31, 2020.
- Any RMD payments that are distributed to a participant in 2020 are eligible for a rollover back into the ESOP, i.e. a repayment by the participant who received the RMD back into their account.

Plan Amendments

If you have any questions about the penalty-free withdrawals, expanded participant loans or waiver of the 2020 RMDs, please contact your Menke legal consultant. While these operational changes could become effective in the 2020 plan year, ultimately the plan document will need to be amended to reflect any CARES Act operational changes. The deadline to amend a qualified plan to provide for the mandatory amendment for waiver of RMDs and for the optional amendments for penalty-free withdrawal rights and/or expanded participant loan rights is the first plan year beginning on or after January 1, 2022.

III. OTHER COMPLIANCE AND OPERATIONAL ISSUES

Extended IRS Filing and Payment Deadlines

In response to the COVID-19 emergency, the IRS announced in Notice 2020-18 the following extended filing and payment deadlines:

- Any individual, unincorporated business entity or corporation that has a federal income tax return or payment due on April 15, 2020, may delay the filing and/or payment due date to July 15, 2020.
- This provision does not apply to federal income tax returns and payments due on any other date; S corporations do not qualify, for example, since they have a tax due date of March 15th.
- If the July 15th deadline for filing the return cannot be met, an automatic extension to October 15, 2020, will be granted if the request is made by July 15, 2020 and the 2019 tax liability has been properly estimated and paid by July 15, 2020.
- Second quarter estimated income tax payments are still due on June 15, 2020.
- For calendar year S corporations, the deadline for making retroactive 2019 contributions to their ESOPs is March 15, 2020, unless the filing of the corporate tax return is extended to September 15, 2020.
- For calendar year C corporations, the deadline for making their retroactive 2019 contributions to their ESOPs is extended to July 15, 2020, unless the filing of the corporate tax return is extended to October 15, 2020.
- The deadline for filing the 2019 Form 5500 remains unchanged.

Suspending or Reducing Employer Matching Contributions in Non-Safe Harbor Plans

If you need to suspend your matching contributions to your 401(k) plan or to your ESOP in order to conserve cash flow during the COVID-19 pandemic, you will need to take the following actions:

- If your plan contains a formula for determining the amount of your matching contributions, you will need to amend your 401(k) plan to change the formula. Please contact your 401(k) plan advisor to make this plan amendment.
- Please note that any plan amendment will only be effective prospectively for contributions for which the employees have not satisfied the conditions to receive the matching contributions.
- Please contact your 401(k) recordkeeper and/or payroll vendor as soon as possible to determine how much lead time they will need in order to make this change.
- Notify all employees of this change as soon as possible so that they will have an opportunity to change their elective deferrals.

Suspending or Reducing Employer Matching Contributions in Safe-Harbor Plans

- If the Safe-Harbor Notice previously given to employees included a statement that the plan could be amended during the plan year to suspend or reduce the safe-harbor contributions, the Plan Sponsor can amend the plan to change the safe-harbor contributions, subject to the following conditions:
    - Employees must receive a Supplemental Notice that gives (i) an explanation of the consequence of reducing or suspending safe-harbor contributions, (ii) describes the procedures for employees to change their deferral election, and (iii) states the effective date of the amendment.
    - The amendment cannot take effect earlier than the later of (i) the date the plan is amended or (ii) 30 days after the date the Supplemental Notice is provided to all eligible employees.
- If the Safe-Harbor Notice previously given to employees did not include a statement that the plan could be amended, the plan can still be amended mid-year to reduce or suspend the amount of the safe-harbor contribution if the employer is operating at an "economic loss" within the meaning of IRC Sec. 412(c)(2)(A).
- **Caveat**: When an employer amends a safe-harbor plan mid-year to reduce or suspend employer contributions, the plan will lose its safe-harbor status for the entire plan year and the amendment must provide that the plan will be subject to nondiscrimination testing for the entire plan year.
- **Further caveat**: Safe harbor **suspensions** cannot be indefinite. However, a plan sponsor may suspend contributions for three out of five plan years without the suspension being treated as a permanent discontinuance of contributions.

Partial Plan Terminations

Under the provisions of Rev. Rul. 2007-43, if during the course of a plan year employer-initiated terminations of employment (i.e. severances from employment other than severances on account of death, disability, retirement on or after the normal retirement age, or voluntary separations) constitute 20% or more of the employer's workforce, the IRS can treat these terminations as triggering a "partial plan termination". On the other hand, if the layoffs occur on a gradual or sporadic basis throughout the plan year rather than as a result of a specific event, such as the closing of a specific plant or business location, these layoffs may not necessarily result in there being a partial plan termination. Determining whether a partial plan termination has occurred is based on the facts and circumstances of each particular case. If a partial plan termination occurs, the resulting consequence is that terminated employees**, as well as those who voluntarily terminated during the year**, will have their accounts fully vested. If this becomes an issue at yearend in your ESOP, your Menke Recordkeeping Consultant and/or your Menke Legal Advisor will consult with you to determine whether the facts and circumstances in your case require complying with the vesting requirements of Rev. Rul. 2007-43.

Refinancing of ESOP Loans

Depending upon how long various states maintain their shelter-in-place orders, some ESOP companies may incur serious cash-flow problems and may not be able to make the necessary principal and interest payments on their ESOP loans. This raises the question of whether, under ERISA, a plan sponsor is permitted to skip or defer an ESOP loan payment for a year or two until the COVID-19 crisis has subsided and economic conditions have improved.

The only guidance we have on this issue is that set forth in the DOL Field Assistance Bulletin 2002-1 issued on October 17, 2002. Click **HERE** for a copy of this DOL Field Assistance Bulletin.

Based upon the issues discussed in DOL Field Assistance Bulletin 2002-1, ESOP fiduciaries and plan sponsors should keep the following factors in mind when deciding whether to skip or defer an ESOP loan payment:

- In the eyes of the DOL, any extension or delay of an ESOP loan payment constitutes a loan refinancing.
- To the extent that an ESOP fiduciary has funds available to make a loan repayment, any failure to make that repayment is a fiduciary decision that must be made on the best interests of the plan participants.
- In most cases, the plan document designates the plan sponsor as the "Plan Administrator". Accordingly, to the extent the Plan Sponsor fails to provide the funding needed for the ESOP to make a loan repayment, the Plan Sponsor may be liable as a fiduciary for failing to administer the plan for the "exclusive benefit" of the participants.
- Whether a fiduciary has acted appropriately, and whether an ESOP loan continues to qualify as an "exempt loan", are factual determinations that must be based on all of the facts and circumstances.
- As ESOP loans present various fiduciary issues, we would strongly recommend that you discuss any changes to your ESOP loan repayments with your Menke recordkeeping representative.

- Some possible solutions to this problem are the following:
  - In cases where the ESOP loan is an "internal loan" between the ESOP and the Plan Sponsor, the Plan Sponsor can simply "forgive" that year's annual payment of principal and interest on the internal loan. Since the loan forgiveness does not require any net outlay of cash, there is no detriment to the company's cash flow. The loan forgiveness, however, will result in the usual release and allocation of ESOP suspense shares, thus meeting the requirement that the plan be operated for the exclusive benefit of participants. The Plan Sponsor is then free to defer or not defer payments to the outside bank lender or to the seller note holder without violating ERISA fiduciary obligations. (Please note, however, that the term "loan forgiveness" is a shorthand way of describing the process of contributing cash to the ESOP and then simultaneously using this cash to make a payment on an internal company loan. The IRS requires a simultaneous exchange of cash; it does accept a cashless loan forgiveness as being a valid ESOP contribution.)
  - In those cases where the seller holds a seller note directly from the ESOP, the Plan Sponsor should endeavor to make the necessary contribution to the ESOP, and the ESOP should make the normal note payment to the seller. The seller can then lend the money back to the Plan Sponsor if the Plan Sponsor cannot otherwise afford the cash outlay.
  - In those cases where the cash flow issues are severe, the ESOP and the Plan Sponsor may have no alternative other than to skip or defer making an ESOP loan payment. In these cases, the Plan Sponsor may, as suggested by the Field Assistance Bulletin, need to offer the ESOP a special inducement as consideration for the ESOP not receiving a current contribution.

Using an Interim Valuation Date

One of the fundamental principles of valuation procedures is that company stock valuations must be based entirely on facts known or knowable as of the valuation date in question. Since the events related to the COVID-19 pandemic were not known or knowable as of December 31, 2019, virtually all ESOP appraisers are taking the position that their December 31, 2019 appraisals cannot take into account any of the potential financial impacts of COVID-19. Consequently, ESOP participants will receive 2019 benefit statements that will not reflect any negative impact the company suffers in 2020 as a result of COVID-19. Depending on how significantly the company's financial position is impacted by the COVID-19 crisis, the value of participants' accounts reflected on their 2019 benefit statements could show stock values that are significantly higher than the value that would be shown if the COVID-19 impact were taken into account. As you may know, the provisions of your ESOP plan document provide that when participants receive their distribution and/or diversification elections later in 2020, those distributions will be made on the basis of the 2019 yearend value of the company stock. This then raises the question of whether the ESOP is overpaying participants who receive payouts in 2020 based upon 2019 yearend valuations. It also raises the question of whether, in some cases, the company will be able to fund its 2020 repurchase obligation if it uses the 2019 yearend valuation. If not, it also raises the further question of whether the Plan Sponsor and/or the Plan Trustee can request that the ESOP appraiser

provide an updated appraisal as of an interim valuation date so as to reduce or minimize the impact of the 2020 repurchase obligation.

The short answer to the first question is that ERISA has always required the use of an annual, yearend valuation for purposes of calculating participant allocations and distributions. Given this fact, it will almost always be the case that the value of the company stock as of the distribution date will be different than the valuation as of the yearend date. Nevertheless, under the provisions of ERISA, the fiduciaries will not incur any fiduciary liability for using valuations determined as of the prior yearend date.

The answer to the second question is that it depends upon two factors. First, does the plan document specifically authorize the plan fiduciary to use an interim valuation date for purposes of making participant distributions and offering participant diversification elections? Most plan documents, including the standard Menke plan document, permit the plan to obtain “additional valuations”, but do not specifically authorize the use of interim valuation dates for purposes of participant distributions and participant diversification elections. The question then becomes, can the plan be amended to specifically authorize interim valuations for these purposes? Unfortunately, there is only one court case, *Pratt v. Petroleum Production Management*, that has considered this issue, and this case held that under both ERISA and general contract principles, the plan could not be amended to include this language with respect to those participants who had already terminated as of the yearend valuation date. Under these circumstances, you will generally be advised to consult with your legal counsel as to whether your plan can be amended. However, in view of the lack of court rulings on this matter, it is unlikely that your law firm will be willing to give a legal opinion on this matter.

The second factor to be considered is whether amending the plan to provide for an interim valuation date is prudent from a fiduciary point of view. In general the plan fiduciaries, which typically include the Plan Sponsor, the Plan Committee and the Plan Trustee, must administer the plan for the exclusive benefit of participants and thus cannot take any actions that would benefit the Plan Sponsor at the expense of the plan participants. Based upon this principle, it seems fairly clear that the plan fiduciaries should not request an interim valuation unless the yearend valuation would cause the company’s repurchase obligations to be so severe as to jeopardize the company’s solvency or the continued sustainability of the ESOP.

In summary, using an interim valuation date for participant distributions and participant diversification elections seems fairly safe if (i) the plan document specifically authorizes such interim valuations, and (ii) not using an interim valuation date would jeopardize the company’s solvency. In all other cases, using an interim valuation date poses a substantial risk of both legal and fiduciary liability.

That said, there are other options that are available to help alleviate the Company’s repurchase obligations. For example, if distributions are typically made in a lump sum, one option that can be used is to switch distribution payouts from lump sum to five annual installments.

If a company does decide to use an interim valuation date, one fact to keep in mind is that the company will still need to provide participant benefit statements, both as of the plan yearend date and also as of the interim valuation date. In the alternative, the company can wait until the participant accounts have been updated with the interim date stock value and then provide participants with a combined

statement that shows their account balances as of both dates. In either case, it is not necessary that the company file a second Form 5500 or an amended Form 5500 as of the interim valuation date.

As there are numerous issues involved regarding the use of an interim valuation, we would strongly recommend that you discuss this matter with your Menke legal representative.

IRC Sec. 409(p) Violations

Under the S corporation anti-abuse provisions of IRC Sec. 409(p), an S-corporation will lose its income tax exemption if “disqualified persons” wind up owning **on any day of the year** more than 50% of the company’s outstanding equity, including both common stock equity and any synthetic equity.

Synthetic equity consists of either **stock-based** synthetic equity (stock options, warrants, restricted stock, deferred issuance stock rights or similar stock rights) or **cash-based** synthetic equity (stock appreciation rights, aka “SARs”, phantom stock units, dollar amounts of deferred compensation, and the economic benefit of split dollar-life insurance).

If the value of your Company Stock declines during 2019 or 2020 because of the COVID-19 crisis (or for any other reason) and you have only **stock-based** synthetic equity, this valuation decline will have no impact on your company’s ability to meet the Sec. 409(p) anti-abuse provision.

On the other hand, if the value of your Company stock declines during 2019 or 2020 and you have any outstanding **cash-based** synthetic equity, this valuation decline may have a major impact on your company’s ability to meet the Sec. 409(p) test. For example, if you have $1,000,000 worth of cash-based synthetic equity outstanding and your Company Stock was appraised at $20 per share at the end of 2018, this synthetic equity would convert into 50,000 shares of common stock for purposes of calculating the 50% test during 2019. If the value of your Company Stock is later appraised at $10 per share at the end of 2019, this synthetic equity will convert into 100,000 shares of common stock for purposes of calculating the 50% test at the end of 2019 and during 2020. These additional shares of synthetic equity may then cause the plan to fail the 50% test under Sec. 409(p).

CAVEAT: If your company has **cash-based** synthetic equity and only passed the Sec. 409(p) test by a small margin at the end of 2018, and you anticipate that the value of your Company Stock will fall as of December 31, 2019, or as of an Interim Valuation Date in 2020, you should immediately contact your Menke Legal Advisor or your Menke Recordkeeping Consultant to determine (i) whether you are in danger of failing to pass the test in 2019 and in 2020, and (ii) what steps can be taken to avoid this result.

FURTHER CAVEAT: If you company has **cash-based** synthetic equity and only passed the 409(p) test by a small margin at the end of 2019 and you anticipate that the value of your Company stock has fallen subsequent to December 31, 2019, you should be sure to have your Menke Recordkeeping Consultant run a Sec. 401(p) projection **before deciding to implement an Interim Valuation Date** for your ESOP in 2020. An Interim Valuation Date would typically result in an even lower value for your Company Stock and thus would make it even more difficult to pass the 50% test under Sec. 409(p).

IV. CONCLUSION

We hope that the foregoing provisions will be helpful to you in navigating through the numerous issues you will need to consider in administering your ESOP for the year ended 2019 and for the 2020 plan year due to the COVID-19 pandemic. Please feel fee to call or email your Menke Legal Advisor and/or your Menke Recordkeeping Consultant if you have any questions about these or any other issue affecting your company during this challenging period of time.