SHINING AN ESOP LIGHT ON TAX AND ACCOUNTING NEWS

Nov. 15, 2017
Your presenters

Anne Bushman
Senior Manager
Compensation & Benefits, Washington National Tax

Becky Miller
Senior Director
Employee Benefits, Assurance

Emily Hubert
Manager
Valuation Services

Brian Marshall
Partner
Assurance
<table>
<thead>
<tr>
<th>Topic</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax updates and reminders</td>
<td>15 minutes</td>
</tr>
<tr>
<td>Status of tax reform and compliance requirements</td>
<td></td>
</tr>
<tr>
<td>Takeaways from regulator activity</td>
<td>15 minutes</td>
</tr>
<tr>
<td>Current areas of focus and controversy</td>
<td></td>
</tr>
<tr>
<td>Newly applicable accounting standards</td>
<td>20 minutes</td>
</tr>
<tr>
<td>Goodwill and revenue recognition</td>
<td></td>
</tr>
</tbody>
</table>
TAX UPDATES AND REMINDERS

Status of tax reform and compliance requirements
Tax reform implications

- Lower rates, fewer deductions
- 2018 instead of 2017?
- Nothing ESOP-specific, BUT....
<table>
<thead>
<tr>
<th>Impacted party</th>
<th>Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>C and S corporations</td>
<td>Net interest expense deductions limited to 30 percent of adjusted taxable income; small taxpayer exception – <em>interest paid after Dec. 31, 2017</em></td>
</tr>
<tr>
<td>C corporations</td>
<td>Alternative minimum tax repealed – <em>dividends paid to ESOP</em></td>
</tr>
<tr>
<td>C and S corporations</td>
<td>Lower tax rates – <em>more employees? Comparison to other transactions? Value of benefit expense?</em></td>
</tr>
<tr>
<td>Selling shareholders</td>
<td>No changes specified to capital gains, section 1042 or interest income</td>
</tr>
<tr>
<td>Retirement plan contributors</td>
<td>No major changes to qualified plans – <em>deferred compensation planning may change</em></td>
</tr>
</tbody>
</table>
Tax reminders and considerations

• A deduction today is worth more than one tomorrow

But beware S corporations with an ESOP that can’t accrue expenses payable to employees!
TAKEAWAYS FROM RECENT REGULATOR ACTIVITY

Current areas of focus and controversy
Common Dept. of Labor and IRS exam issues

• Plan level
  – Higher percentage selected for exam
  – Significant transactions, new debt
  – Valuation
  – Collateral release on leveraged ESOPs
  – Distribution processes
    • Cashing out small balances
    • Sending diversification notices timely
Common IRS exam issues

• Corporate level
  – Deduction timing for accrued expenses (S corporations)
    • *Petersen, Steven M. et ux. et al. v. Commissioner* (148 T.C. No. 22)
    • Determining which employees and when employees have an interest in shares to become related parties
  – Employment tax
    • Applies even to 100 percent S corporations
Litigation

• Dept. of Labor and First Bankers Trust Services settlement agreement
  – If the trustee approves a transaction with unaudited financial statements of the sponsor, any officer, member or manager of the board of directors who is a selling shareholder must compensate the ESOP for any losses or harm caused by inaccurate information

• Lee v. Holden Industries Inc., N.D. Ill., No. 1:15-cv-6405 (Nov. 16, 2016)
  – Distributions made several months after year-end can use prior year-end value based on statute and plan language
  – Good controls and consistent timing are important

• Class action suits being filed by former ESOP participants
NEWLY APPLICABLE ACCOUNTING STANDARDS

Goodwill and revenue recognition
## Changes to goodwill impairment testing

### EXISTING

- **Two step goodwill impairment test**
  - Step 1 – Compare the carrying amount of the reporting unit with its fair value, if greater than its fair value then proceed to Step 2
  - Step 2 - Determine the implied fair value of goodwill and compare it with the carrying amount of that goodwill
  - Recognize impairment for the excess of the carrying amount of goodwill over its implied fair value

### AMENDED

- **Eliminates Step 2 of the goodwill impairment test**
  - Compare the carrying amount of the reporting unit with its fair value
  - Recognize impairment for the amount by which the carrying amount exceeds the fair value of the reporting unit
  - Any loss recognized should not exceed the total amount of goodwill allocated to that reporting unit
Changes to goodwill impairment testing

Effective date for calendar year-ends

- **PBE - SEC filer**
  - 2017: Permitted
  - 2020: Permitted
  - 2021: Permitted
  - 2022: Required

- **PBE - Non SEC filers**
  - 2017: Permitted
  - 2020: Permitted
  - 2021: Permitted

- **Other entities**
  - 2017: Permitted
  - 2020: Permitted
New revenue recognition guidance

• ASU 2014-09, Revenue from Contracts with Customers (Topic 606), issued in May 2014 with intent of providing a principles-based framework for addressing revenue recognition

• Core principle
  – Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services
Industries impacted by change

• Construction
• Business and professional services
• Technology
• Healthcare
• And more

Our industry-specific analysis and reviews can be found at Revenue recognition: Industry insights
Five step model

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) each performance obligation is satisfied
New revenue recognition guidance

• New framework for analyzing revenue contracts
• Requires more judgment, estimation and disclosure
• Potential changes include the following among many others:
  – Timing of revenue recognition
  – Allocation of revenue in multiple deliverable arrangements, including estimating standalone selling prices
  – Capitalization of costs related to customer contracts
  – Significantly expanded disclosure requirements
### New revenue recognition guidance

<table>
<thead>
<tr>
<th>Effective date of ASC 606</th>
<th>Calendar year-end entities</th>
<th>June 30 year end entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public entities*, quarter and year beginning…</td>
<td>Jan. 1, 2018</td>
<td>July 1, 2018</td>
</tr>
<tr>
<td>Other entities, year ending…</td>
<td>Dec. 31, 2019</td>
<td>June 30, 2020</td>
</tr>
<tr>
<td><strong>Early adoption of ASC 606</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowed for both public entities and other entities…</td>
<td>As early as Jan. 1, 2017</td>
<td>As early as July 1, 2017</td>
</tr>
</tbody>
</table>

* Public entities include PBEs, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. SEC announced at the July 2017 EITF meeting that they would not object to the use of non-PBE adoption dates for a PBE that meets the definition of a PBE only because of inclusion of their financial statements or financial information in another company’s filing with the SEC.
Considerations for ESOP sponsors

• Impact on loan covenants
  – Coverage ratios
  – Debt to equity ratios
  – Measurement of EBITDA

• Will there be a difference between book and tax?

• Consistency of information provided to appraiser
Impact on valuation

• Changes to goodwill impairment testing
  – If goodwill is impaired, the removal of Step 2 should not impact the share price of the company
Impact on valuation, cont.

• New revenue recognition guidance
  – Changes in revenue may impact the valuation of all companies including ESOPs
    • Biggest impact in the first and second year after reporting becomes effective
    • Some industries more than others
  – Additional analysis/discussion may be needed to compare past, current, and future financial results and share prices
  – Projections may need additional development
Impact on valuation, cont.

• Valuation takeaway
  – Work with your valuation professional to make sure they have a thorough understanding of these changes so they can incorporate them early in the valuation process
THANK YOU FOR YOUR TIME AND ATTENTION