



CLIENT ALERT

ESOP FUNDING AND DISTRIBUTION BEST PRACTICES – PART II

Written by: Brian Wurpts, Principal and Vice President

ESOP benefit distribution policies and procedures are the source of many questions and confusion for ESOP sponsors. This article is Part II of the article from the August 2011 *Client Alert* in which we discussed forms of benefits, forms of funding, timing of benefits, recycling and reshuffling. Here we will address share redemption and share re-leveraging as other strategies to manage plan funding decisions, and their implications on repurchase obligation.

Redemption Strategy

Share redemption is common under four scenarios: 1) the ESOP sponsor finds itself facing a particularly large repurchase obligation that can't be funded because of compliance limits, or the sponsor feels that the funding level needed would be an unreasonably high contribution amount; 2) the sponsor wants to cleanse and recycle shares that previously carried Section 1042 restrictions (meaning they couldn't be allocated to >25% shareholders or to participants who elected 1042 and their family members); 3) the ESOP sponsor wants to reduce the ESOP Trust's ownership percentage (i.e., shrink the ESOP); and 4) the ESOP

sponsor wants to execute a re-leverage transaction (more on this in the next section).

Executing a share redemption requires some additional administrative complexity and/or expense. There are two ways to accomplish a redemption. First, the company and the ESOP Trustee can negotiate a price and enter into a redemption agreement. This approach involves a transaction

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between the ESOP and a party in interest, so care must be taken to avoid a prohibited transaction. Generally, the ESOP Trustee should engage in the same type of due diligence that he or she would for any purchase or sale of ESOP stock. The ESOP should have a financial advisor (typically the independent appraiser) and should get an opinion that the company's offer is at least adequate consideration. The norm for these types of transactions is to notify the independent appraiser that the ESOP and the company

intend to engage in a redemption transaction immediately after the appraiser issues its report on the year-end stock valuation. The appraiser then reviews the interim financials between the date of the stock valuation and the transaction date and advises the Trustee if any price adjustment is needed. The ESOP Trustee should take care in ensuring that the redemption is in the best interests of plan participants and that the ESOP Trust does not give up voting control of the company as a result of the redemption.

The second approach to executing stock redemptions is to distribute stock directly from the ESOP to the participants. This avoids the need for an appraisal update and for negotiation between the company and the ESOP Trustee. The distributed stock can be sold back to the sponsor utilizing the put option features of the ESOP stock (either elective for the participant, or automatic if the sponsor is a S corporation or a C corporation with a bylaw or charter restriction). Stock distributions permit ESOP participants to take advantage of capital gains treatment if the

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distribution is made in a lump sum payment. Capital gains treatment greatly reduces the potential tax bill if there is significant appreciation in the distributed ESOP stock.

There are two downsides to the stock distribution approach. First, stock distribution forms are complicated and often cause confusion for plan participants. Tax withholding on stock distributions is limited to the cash portion of the participant's account. So, unless the participant's account is made up of at least 20 percent cash, a participant who receives a direct stock distribution may have little or no tax withholding deducted from his or her payment. This can result in bad news at tax time if the participant does not plan ahead. The second downside is uncertainty if the distribution is not subject to an automatic put to the company. It's possible that the participant would elect not to sell his or her shares back to the company in either of the two 60-day put option periods. This introduces the possibility that the ESOP stock distribution could create a nuisance shareholder for the company.

Stock redemptions can be a useful tool in managing plan funding decisions and repurchase obligation. One important element of a stock redemption strategy is the impact on the sponsor company's value. Redemption transactions are usually value-neutral in the short run. The value distributed from the sponsor company's balance sheet to fund the redemption (cash or debt) is proportionately offset by the reduction in the number of shares outstanding, whereas contributions or dividends to fund recycling are a company expense and typically reduce value per share.

Stock acquired through a redemption transaction can be held and contributed in later years in order

to achieve better matching between the desired funding level and the repurchase obligations. The sponsor benefits from tax deductions in the year the contribution is made based on the fair market value of the stock contributed. Of course, the ESOP participants and the other shareholders incur some stock dilution cost if the shares are later taken from treasury and contributed to the plan. It's also important to bear in mind that redemption transactions do not create ESOP benefits for new employees. If the sponsor pursues a redemption strategy exclusively, it potentially sets up two classes of ESOP participants (often referred to as the "have/have not" problem).

Re-leverage Strategy

Re-leveraging transactions start with a stock redemption as described above. The difference is that instead of retiring or later re-contributing the redeemed ESOP stock, the stock is immediately resold to the ESOP in exchange for a note. The shares sold to the ESOP are put into a loan suspense account, just as they are in any traditional leveraged ESOP sale. This approach gives the ESOP sponsor a few advantages. First, repurchase liability is typically reduced in re-leverage transactions because, unlike the redemption only strategy, the redeemed shares end up as outstanding. The sponsor's value is reduced by the cash or debt outlay to fund the repurchase, and that reduced value is spread over a higher number of shares outstanding. In essence, the re-leverage approach is very similar from a stock value perspective to a recycle strategy. Second, and more importantly, the re-leveraged shares end up in loan suspense for the term of the loan (often 5-10 years). The shares held in loan suspense are allocated to ESOP participants only as

the debt is repaid. This means that the unallocated shares are not "aging" with the employee population and are not part of the normal account turnover which creates repurchase obligation. We have studied this effect in potential re-leveraging transactions and found that it can reduce repurchase obligations over the term of the loan by as much as 35 percent.

The second benefit of re-leveraging transactions is that they provide a pool of benefits to new employees. The sponsor has control over the rate in which the loan suspense shares are allocated. This is an excellent means of creating a pool of shares for new employees while creating some diversification for long term employees (via the redemption proceeds).

Re-leveraging transactions require some expense (valuation update, redemption agreement, and loan documents). They also create some administrative complexity (creating another loan tranche to track). However, for some mature ESOPs they can be an excellent tool for managing repurchase obligation and benefit funding.

An ESOP sponsor should quantify the plan's repurchase obligation and should consider all of these tools and their effects on future repurchase obligations and employee benefit allocations. Your ESOP advisors can help you understand the interaction between these decisions and the implications of each strategy.

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NEW ADMINISTRATION FORMS

Written by: Mychelle Holloway, Principal and Senior ESOP Administrator

Form 8955-SSA

Form 8955-SSA has been created by the IRS to collect data previously reported on Schedule SSA and filed with Form 5500. This information is now filed separately, directly with the IRS, not using the EFAST2 system.

Information reported on the form is provided to the Social Security Administration which forwards the information to participants when they file for Social Security benefits. Form 8955 provides data regarding terminated participants eligible for future benefits and also previously reported participants who have received payment of their benefits.

For 2009 and 2010 there was no form to report the SSA data. With the creation of Form 8955-SSA, data for both years will be reported, simultaneously in most cases. The due date for the 2009 and 2010 plan year SSA data is the later of (1) January 17, 2012 or (2) the due date that applies for the filing of the plan's 2010 Form

5500. Penalty for not filing can be steep: \$1 per participant not reported per day up to a maximum of \$5,000. The form is not required to be filed in years where no information is required to be provided. It is unclear how the IRS will ascertain whether a Form 8955-SSA was required to be filed and not filed, which triggers the penalty assessment, or whether there was simply no Form 8955-SSA required to be filed for that plan year.

Form 8955-SSA is filed by mailing the completed form to Ogden UT 84201-0024 (different zip code than the Form 5558). There is also a system called FIRE (Filing Information Returns Electronically) that allows for electronic filing. The 2009 Form 8955-SSA could have been used to report both the 2009 and 2010 data, with the 2010 data being considered voluntarily reported. Instructions stated to mark the form with the beginning and ending dates for the 2009 plan year. It is vague how the IRS will know that 2010 data was

reported on the 2009 form since there is no place on the form to indicate the year which the data relates. It would be prudent to file the 2009 and the 2010 forms separately with the related data for each plan year as to avoid any confusion.

As with the prior SSA, Code A is used for newly reportable participants (those terminated in the prior plan year with a remaining vested benefit). Unlike the prior SSA, Code D is now mandatory and is used to indicate when previously reported participants have either been paid out, begun to receive benefits, or had their accounts transferred to another plan. Filing of the final 5500 for a plan mandates that all previously reported participants coded as "A" be reported as "D." This could be problematic when there is a change in recordkeepers as the current recordkeeper may not have access to participants previously reported as Code A. Code B is used to modify previously reported information and Code C is used for amounts transferred into your plan.

Line 8 of Form 8955-SSA requires that the plan administrator confirm that an individual statement reflecting the data reported on the form has been provided to each participant reported on the form. This rule has been around since 1978 but never enforced. It is unclear if providing the annual benefit statement will satisfy this requirement or if there will be sample disclosure / notice wording released. The IRS can impose a \$50 penalty for each failure to furnish such a statement. More guidance is expected.

DO YOU KNOW YOUR FEES?

401(k) plan sponsors have a fiduciary responsibility to understand the value of the services being offered, and must have a process to itemize plan expenses and ensure services are being offered at rates competitive in the marketplace. Beginning in 2012, new Department of Labor regulations will require plan sponsors to understand and communicate fee information to employees. SES would like to offer our clients a complimentary one page fee summary of your current 401(k) plan fees. We can also help you complete the RFP process for 401(k) services to ensure that your plan's services and fees are competitive, and we offer other 401(k) independent advisory services and administration for ESOP companies. For more information, contact your SES Administrator, or call 888.SES.ESOP.

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New Administration Forms

Form 5558

On July 8, 2011 the IRS released the new Form 5558, Application for Extension of Time. This form is most commonly used to extend the filing deadline of Form 5500 for an additional 2 ½ months. For example, most calendar year plans used Form 5558 to extend their 2010 Form 5500 filing deadline from July 31, 2011 to October, 15, 2011. The new Form 5558 will be submitted on paper, not electronically through EFAST2, to Department of Treasury, IRS Center, Ogden UT 84201-0045 (new zip code). To eliminate processing problems it is advisable to submit using some kind of proof of delivery.

The most notable change to Form 5558 is the inclusion of a new line 2 in Part II that specifically refers to Form 8955-SSA. This is a separate line item that extends the filing deadline of Form 8955-SSA by granting 2 ½ months additional time. Another change is that plan sponsors must now sign Form 5558 to receive an extension of time for the Form 8955-SSA. There continues to be no signature requirement to extend Form 5500. However, since the extension of Form 5500 is on the same form, in practice the form will be signed. If the 2010 plan year ends before April 1, 2011, do not use Form 5558 to extend the due date of Form 8955-SSA for the 2009 and 2010 plan years as these returns have been automatically extended until January 17, 2012 and cannot be further extended.

So who can sign Form 5558 when extending the Form 8955-SSA (or Form 5330 which is not covered in this article)? At first it appeared the

list of acceptable signers might be different than in previous years when Form 5558 was required to be signed; however, the IRS has unofficially confirmed they did not intend to change the list. This means Form 5558 can be signed by the plan sponsor, the plan administrator, attorney or CPA qualified to practice before the IRS, or a person holding a power of attorney. Your third-party administrator (TPA) will most likely not be permitted to sign Form 5558 on your behalf unless you have granted them power of attorney.

If you have additional questions about either of these new forms, please contact your recordkeeper at SES Advisors.

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Thank you to all of our clients who were able to join us at Joe's Seafood in Las Vegas on November 3rd. It was a wonderful opportunity to connect face-to-face with people who are spread out across the country, and for ESOP companies to meet each other and share ideas.



From left to right: John Humphrey (Pariveda Solutions & SES Board Member) and Don Slominski (McNaughton-McKay Electric Company)



From left to right: Cindy Cerro (Total Water Treatment Systems, Inc.), Bob Massengill (President of SES) and Cindy Turcot (Gardener's Supply Company)