

# CLIENT ALERT

## SES ADVISORS OPENS TEXAS OFFICE

On July 27<sup>th</sup>, we announced the opening of our new office in Fort Worth, Texas. The office will include a new 401(k) consulting service that will allow us to better serve all of our ESOP clients' retirement plan needs. Steve Allison, President and founder of SR Allison, Ltd., will manage the Texas office and market all existing SES services, including: ESOP transaction structure and finance; ESOP and 401(k) plan administration and consulting; and repurchase liability analysis and funding consulting.

New DOL regulations have expanded the definition of fiduciary responsibility to require disclosure of fees in connection with 401(k) plans. We now offer a complimentary 401(k) fee disclosure analysis for all clients. If you are interested in this complimentary analysis, please contact your SES or SFE&G professional.

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## ESOP FUNDING AND DISTRIBUTION BEST PRACTICES

Written by: Brian Wurpts, Principal and Vice President

**E**SO benefit distribution policies and procedures are the source of many questions and confusion for ESOP sponsors. This article describes the basic elements of ESOP distributions, some options for funding benefit distributions and the implications of benefit funding decisions on repurchase obligation.

### Form of Benefit

ESOP benefits may be paid in the form of cash and/or employer stock. The form is sometimes left to the

ESOP participant's discretion, but more often is determined by the plan sponsor. Plans sponsored by C corporations must permit stock distributions unless the sponsor's company bylaws or charter restrict stock ownership to employees and the ESOP Trust. Plans sponsored by S corporations are not required to offer stock distributions (though it may be desirable to do so). The decision to offer distributions in the form of company stock is usually motivated by one of three reasons: i) it's mandatory (C corporation with no bylaw restriction); ii) the sponsor

wants to allow participants to take advantage of lower taxation at capital gains rates by offering lump sum stock distributions; or iii) the sponsor plans to redeem some portion of the repurchased stock, either because it wants to cancel or take this stock into treasury, or because it wants to "cleanse" these shares of their Section 1042 restrictions. In cases where the sponsor is not required to offer stock distributions, a stock distribution can be made contingent upon an automatic sale back to the sponsor. If the participant

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# ESOP Funding and Distribution Best Practices

can elect to retain the distributed stock (i.e., a C corporation without a bylaw or charter restriction), the participant has two 60-day windows to put the distributed stock back to the sponsor – the first upon distribution and the second a year later when the stock is revalued.

## Form of Funding

An ESOP sponsor has three basic strategies for funding ESOP benefit distributions: i) recycle shares, utilizing either earnings allocated in the ESOP trust in prior periods or a current year employer contribution or dividend; ii) redeem shares, accomplished through either a stock distribution to eligible participants with the stock immediately resold to the company, or through a redemption transaction directly between the ESOP Trust and the sponsor; or iii) re-leverage shares, accomplished when the plan sponsor first redeems ESOP stock and then sells some or all of that stock back to the ESOP Trust using an ESOP acquisition loan. These three strategies can be combined in any given year and changed from year to year.

## Timing of Benefits

ESOP sponsors may modify elements of their distribution policy periodically. For example, the sponsor may change the form of payment from lump sum to annual installment payments, or set a threshold balance for immediate payout. The sponsor may accelerate the date that terminated participants become eligible to receive a distribution, or offer special one-time distribution or diversification rights to ESOP participants, or even defer the date that participants become eligible to receive a payment in some cases. Distribution policies may also be modified to encourage former participants to consent to a distribution by providing that for-

mer participants who do not elect to begin receiving their plan benefit when the plan first allows distributions must wait until normal retirement age to begin to receive their plan benefit. However, ESOP sponsors should bear in mind that even though the law permits such changes, any modification that defers payment or eliminates options will generally be viewed unfavorably by participants.

## Account Reshuffling (a.k.a. “Segregation”)

Account segregation is the practice of converting a terminated participant’s account balance from company stock to other investments of equal value. Segregation happens before a participant is eligible to receive a distribution and therefore is technically not part of a plan’s distribution policy. However, similar to distribution policy decisions, the decision to segregate impacts repurchase obligation and plan funding strategies. Diane Fanelli’s article on the next page explains segregation in greater detail.

## Recycle Strategy

Share recycling is the most common means of handling repurchase obligations and funding benefit payments. When a plan recycles shares, plan participants are paid out in cash and the shares allocated to their accounts are immediately reallocated among the remaining plan participants. The primary benefits of recycling are: i) administrative simplicity; and ii) tax deductions created by the ESOP sponsor’s contributions to fund the cash recycling distributions to former participants.

Because recycling typically results in a cash distribution from the ESOP Trust, the distribution election forms can be kept relatively simple (no

put option disclosures are needed). The tax withholding procedures are straightforward (essentially the same as a 401(k) plan). The downside to recycling is that unless the sponsor is proactive in planning the funding levels for future repurchase obligation, in some years the ESOP may need to be funded at levels that produce unreasonably high benefit allocations for participating employees. Ideally, a retirement plan sponsor would like to make its funding decision based on the performance of the company and cash availability. However, ESOP repurchase obligations often tend to be lumpy (dependent on retirement or termination decisions of holders of large account balances). This issue is often exacerbated during economic downturns because layoffs or turnover often accelerate repurchase obligation at a time when the sponsor’s board may want to reduce retirement plan funding.

A recycling strategy works best when the ESOP sponsor proactively forecasts future repurchase obligations at least five years in advance and actively funds cash contributions into the ESOP Trust before those repurchase obligations become due. Cash in the ESOP Trust creates a buffer that helps the sponsor match the desired funding level in a particular year to the repurchase obligation in that year. This helps to ensure that new allocations of stock to employees are appropriate, based on company and employee performance. A cash pre-funding and recycling strategy, combined with account segregation, can be a very effective approach to managing ESOP funding and repurchase obligations, particularly when the ESOP sponsor has invested the time and resources to project future obligations.

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# WHAT DOES RESHUFFLING MEAN?

Written by: Diane Fanelli, Principal and Senior ESOP Administrator

In our last Client Alert we examined rebalancing plan assets within an ESOP. This article tackles the ins and outs of reshuffling. Reshuffling, as defined by the IRS, is “the mandatory transfer of employer securities into or out of plan accounts, not designed to result in an equal proportion of employer securities in each account.” Reshuffling is what the ESOP community commonly refers to as “segregation” or “conversion” of accounts.

In simple terms, reshuffling is the exchange, within the plan and among

plan participants, of employer stock for other investments. Key to the concept is the availability of cash or other investments in the plan. This makes reshuffling attractive to more mature plans rather than newer ones. In one sense reshuffling can be thought of as a pre-funding of the repurchase obligation under the plan.

## How it works

In the example below, the plan’s assets consist of \$400,000 worth of employer securities and \$100,000 of other investments (cash). Each participant has

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Free Webcast:  
ESOP Administration Pitfalls  
Wednesday, October 26  
12:30 – 1:30 p.m. Eastern

Register:  
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a different ratio of stock to cash. After reshuffling, the terminated participant’s account was converted to 100% cash through a purchase of her shares by the active participants with the cash in their accounts.

## Reshuffling/Segregation Example

ABC Company ESOP	ABC Stock	Other Investments	Total
<b>Trust balances</b> <i>(@ the close of the allocation period)</i>	<b>\$400,000</b> 80%	<b>\$100,000</b> 20%	<b>\$500,000</b> 100%
<b>Participant Balances (pre-reshuffle)</b>			
<b>John Doe- active</b>	\$130,000 78.8%	\$35,000 21.2%	\$165,000 100.0%
<b>Jane Doe- active</b>	\$250,000 96.2%	\$10,000 3.8%	\$260,000 100.0%
<b>Rosetta Stone- terminated</b>	\$20,000 26.7%	\$55,000 73.3%	\$75,000 100.0%
<b>Participant Balances (post-reshuffle)</b>			
<b>John Doe- active</b>	\$145,556 88.2%	\$19,444 11.8%	\$165,000 100.0%
<b>Jane Doe- active</b>	\$254,444 97.9%	\$5,556 2.1%	\$260,000 100.0%
<b>Rosetta Stone- terminated</b>	\$0 0.0%	\$75,000 100.0%	\$75,000 100.0%

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# What Does Reshuffling Mean?

Since the terminated participant has no employer securities in her account, the sponsoring company will not have to worry about funding the distribution when it occurs - it has been “pre-funded.”

Naturally, there are pros and cons of reshuffling and also rules and regulations that must be adhered to. The plan must contain clear language regarding how the reshuffling works. There must be no discretion as to which accounts will be affected and to the timing of the conversion. No discrimination in favor of “highly compensated” participants is permitted.

## Will the participants be in favor of reshuffling?

That depends. If the share price is rising, those whose accounts were converted out of company stock may feel that they are not getting the return they expected. This perception can be addressed by making sure that the other investments are attractive. On the other hand, if the share price is declining and participants whose accounts had been segregated are doing well, the remaining active participants may feel that they are too heavily invested in poorly performing company stock while terminated participants enjoy increasing accounts.

If reshuffling or segregation is applied consistently and in a non-discriminatory matter, participants’ concerns can be lessened.

## What other issues should the plan sponsor consider?

First, there is fiduciary duty to invest the non-stock funds prudently. The trustees must carefully consider the

type of investments that will be used and should regularly review the investment policy.

Second, the company needs to plan to contribute cash, however limited, consistently to fund the repurchases. The cash should be contributed as early in the plan year as possible - as soon as the prior year’s share price is known.

The entire account balance - not just the vested portion of the account - should be subject to reshuffling. If forfeitures occur immediately, this is not an issue.

If the company cannot contribute sufficient cash to fund all of the repurchases in a given year, it must choose a non-discriminatory method to determine the amounts to segregate. For example, if it funds 75% of the terminated accounts, then each participant eligible for the segregation would

have 75% of his/her balance converted.

## Does reshuffling make sense for your plan?

Yes - if your plan has significant investments other than employer securities, will continue to make cash contributions, and is prepared to institute a prudent investment policy for the reshuffled account balances.

Reshuffling can also work well with rebalancing and with special distribution policies adopted by the plan.

If your plan is relatively new, reshuffling is probably a few years off for you, but it helps to understand what choices you may confront in the future.

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## TABITHA CROSCUT, ESQ. RELOCATES TO VERMONT OFFICE

In order to better serve our clients in the upstate New York and New England areas, Tabitha recently joined fellow SFE&G Partner Steve Magowan in the firm’s Burlington, VT office.

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