

# CLIENT ALERT

## IS REBALANCING AN OPTION FOR YOUR PLAN?

Written by: Diane Fanelli, Principal and Senior ESOP Administrator

**T**he ESOP community has long been aware of the concepts now officially christened by the IRS as “rebalancing” and “reshuffling.” This article discusses rebalancing. We will focus on reshuffling in the next Client Alert.

Let’s look at how rebalancing works.

It’s simple in concept. The IRS has defined rebalancing as “the mandatory transfer of employer securities into and out of participant plan accounts, usually on an annual basis, designed to result in all participant accounts having the same proportion of employer securities.” In other words, in a plan where the assets consist of employer securities and other investments, each participant at the end of the allocation period, after all activity has been posted, has a ratio of employer securities and other investments that is identical to the ratio for other participants and to the plan in total. In the example on the next page, employer

securities represent 80% of total plan assets. Before the rebalancing, each participant’s percentage of employer securities to account balance differs. The rebalancing results in each participant having 80% of his/her balance comprised of employer securities.

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**If your company’s ESOP is intended to motivate “employee owners” to increase profitability, why not rebalance in an effort to create a measure of equality among participants?**

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### **Why rebalance?**

Several reasons actually. Rebalancing can help alleviate the “haves vs. have-nots” problem that frequently arises in ESOPs. If, for example, your plan is leveraged and all of the trust shares have been allocated, you may be contributing cash to fund future repurchases. New employees

will have little opportunity to have shares allocated to them. The only way for them to receive shares is through reallocation of forfeitures.

If you are an S corp ESOP, rebalancing may assist in preventing a future 409(p) test failure by allocating (usually) more cash to those who have the majority of the shares and may be or become “disqualified persons” under the plan. Please note that rebalancing may not be used as a remedy if a failure occurs but only as a preventive measure.

Rebalancing also provides some measure of diversification for all participants regardless of age or length of service.

Finally, if your company’s ESOP is intended to motivate “employee owners” to increase profitability, why not rebalance in an effort to create a measure of equality among participants?

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# Is Rebalancing An Option For Your Plan?

ABC Company ESOP	ABC Stock	Other Investments	Total
Trust balances (@ the end of the year)	\$400,000 80%	\$100,000 20%	\$500,000 100%
<b>Participant Balances (pre-rebalance)</b>			
John Doe	\$130,000 78.80%	\$35,000 21.20%	\$165,000 100.00%
Jane Doe	\$250,000 96.20%	\$10,000 3.80%	\$260,000 100.00%
Rosetta Stone	\$20,000 26.70%	\$55,000 73.30%	\$75,000 100.00%
<b>Participant Balances (post-rebalance)</b>			
John Doe	\$132,000 80.00%	\$33,000 20.00%	\$165,000 100.00%
Jane Doe	\$208,000 80.00%	\$52,000 20.00%	\$260,000 100.00%
Rosetta Stone	\$60,000 80.00%	\$15,000 20.00%	\$75,000 100.00%

ments) the shares converted to cash in the diversification cannot later be considered in the rebalance. Again, there is additional work to perform.

In addition, your plan will have to be amended to include rebalancing provisions. The plan must clearly direct the plan administrator as to the number of shares or the amount of cash to transfer in or out of accounts. It must also clearly state the valuation date and the manner in which the transfers will be effectuated.

## Downside?

There could potentially be fiduciary issues concerning the investment on non-stock assets. But this problem would exist in any plan that is accumulating cash whether or not rebalancing is in place. Perhaps the biggest negative could be participant perceptions especially if the employer stock is substantially under-performing or over-performing the

other investments.

There can be an increase in the cost of administration that may or may not be significant. If some participants are excluded from certain allocations due to 1042 elections, the calculations get trickier. Also, if you are providing the mandated diversification within your plan (by offering the three requisite invest-

SES Advisors would be pleased to discuss with you whether rebalancing might be a good option for your plan and any possible amendments to your ESOP documents to include rebalancing provisions.

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Replay Diane Fanelli's and Brian Wurpts' webcast on Rebalancing & Reshuffling on our website:  
[www.sesadvisors.com/ESOP\\_webcasts](http://www.sesadvisors.com/ESOP_webcasts)

## Client Q & A

*Edited by: Steven B. Greenapple, Esq., Principal*

**Q: Can an ESOP company be sold in a stock sale without a pass-through vote?**

**A: In a stock sale, there is no shareholder vote. Therefore, there is no vote to pass through.**

Here's how it works: The ESOP is a shareholder. The participants are not shareholders; rather, they are beneficiaries of an ERISA qualified trust.

Under each state's corporate law, shareholders get to vote on certain issues, such as electing the board of directors. In extraordinary circumstances, shareholders vote on major corporate decisions like merger, recapitalization, reorganization, sale of substantially all assets, liquidation and dissolution. These extraordinary events are all corporate decisions, governed by state corporate law.

When there is a vote of the shareholders, the ESOP trustee, as shareholder, votes the shares of the corporation owned by the ESOP. When the ESOP trustee votes those shares on routine matters (like electing the board of directors), the trustee will exercise its own discretion. However, when the trustee votes those shares on extraordinary matters, it must pass through to the ESOP participants the power to direct the trustee how to vote the shares (thus, the term "pass-through voting"). Technically, the ESOP trustee is the shareholder and still votes the shares. However, unless the participants direct the trustee to vote the shares in a way that would

violate ERISA, the trustee is bound to follow their directions. (The ESOP plan may provide for pass-through voting on a broader range of matters than is required by ERISA, but most ESOP plans do not.)

The decision to invest in the corporation's stock is not a corporate decision, and does not require a shareholder vote. Rather, the ESOP trustee - in its capacity as an investor - makes the decision to invest in the stock. Similarly, the decision to sell the corporation's stock is not a corporate decision, and does not require a shareholder vote. The ESOP trustee - again, as an investor - makes the decision to sell the stock.

### Conclusion

How a transaction is structured has a significant impact on who gets to make the decision to engage in the transaction. Corporate law says that in order to do a merger, you need shareholder approval. ERISA says that when an ESOP trust is a shareholder, the shareholder vote on that decision must be passed through by the ESOP trustee to the ESOP participants. In contrast, a stock sale is an investor decision, not a corporate decision. The state corporate law does not dictate how the decision to sell stock will be made. There is no shareholder vote; therefore there is no vote to pass through. M&A (merger and acquisition) transactions in the non-ESOP business world have long followed the same rules.

*Submit your own questions to [asimons@sesadvisors.com](mailto:asimons@sesadvisors.com)*

## PLAN RECORD RETENTION:

### HOW LONG DO YOU NEED TO KEEP RECORDS OR INFORMATION PERTAINING TO YOUR ESOP OR OTHER RETIREMENT PLANS?

Written by: Barbara Krumbhaar, Compliance Specialist

Plan sponsors are generally aware of their responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA) pertaining to reporting and disclosure requirements such as the annual Form 5500 and distribution of benefit statements to participants. ERISA also has requirements regarding retention of plan records.

Both the Internal Revenue Service and the Department of Labor, the agencies that have oversight of retirement plan tax and reporting requirements, require an employer to keep records. For the IRS, records need to be available at all times for inspection by the IRS to support tax deduction or qualification of the plan. For ERISA, sufficient records

need to be maintained to determine benefits due or which may become due, as well as those that support the information reported on the annual Form 5500. The IRS recently provided guidance and tools on its website in the Taxpayer Documentation Guide to assist employers with the documentation needed in the event there is an examination of a plan. The Guide can be found at [www.irs.gov/retirement/article/0,,id=206496,00.html](http://www.irs.gov/retirement/article/0,,id=206496,00.html).

#### How Long to Retain

In the Taxpayer Documentation Guide, the IRS advises that records should be retained over the life span of a retirement plan - whether a defined benefit or defined contribution plan. Retirement plans are designed to be long-term vehi-

cles that allow participants to build up benefits or account balances over time and, as a result, the records of transactions for the plans may cover many years. The ERISA statute requiring maintenance of records similarly applies to records necessary to determine a participant's benefits due under the plan.

For tax purposes, records must be retained for at least 6 years, after which the statute of limitations affords some protection. For ERISA purposes, there is also a specific 6-year statutory retention requirement that applies to records supporting the Form 5500. It does not apply to the records needed in the event of an IRS audit or records needed to determine benefits payable to participants.

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# Plan Record Retention

## Free Webcast:

401(k) Fee Disclosures & Other New DOL Regulations

Thursday, March 17, 1:00 - 2:00 EST

Register now at: [www.sesadvisors.com/ESOP\\_seminars](http://www.sesadvisors.com/ESOP_seminars)

ERISA allows claims for breach of fiduciary responsibility to be filed up to 6 years (and sometimes more) after the breach occurred. For benefit claims, state statutes of limitations apply, so the limitation period for breach of contract under state law also needs to be considered. While statutes of limitation provide some protection against direct participant and/or regulatory suits, there are a

number of situations in which administrative records, in particular, should be retained longer to confirm ERISA compliance.

All in all, there is no simple answer to the question. All records should be kept for at least 6 years, and we recommend that administrative records involving

benefit allocations be retained as long as they are necessary to calculate benefits due participants under the plan.

## What to Retain

In the sidebar is general list of documents that should be retained. An audit of the plan or a request by a participant for information pertaining to his/her benefit or status under the plan can be resolved quickly without sanctions to the plan or disruption of business if complete and accurate records are kept.

## Who Should Maintain the Records?

The employer is responsible for maintaining the records of all retirement plans. Although outside service providers may be retained by the company to do many of the tasks of administering the plan, they are not the ones responsible for record retention.

Service providers and employers alike must be familiar with record retention requirements and should develop a written record retention policy that addresses both paper and electronic transactions.

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## Documents to Retain

1. A dated and executed copy of the plan document, any corporate action taken to adopt the plan, and signed and dated copies of all plan amendments and authorizing Board resolutions
2. Copies of all employee communications including the plan's SPD, any summary of material modifications that describe plan amendment(s), and copies of all plan related materials given to employee or participants and/or their beneficiaries
3. A copy of the most recent IRS determination letter, or if one is pending, the IRS filings
4. Copies of Form 5500 for the last 6 years or since the plan's inception, including any amendments to the filing, all schedules and required audits
5. Copies of payroll records used to determine plan eligibility and contribution
6. Verification of all employees excluded from the plan based on age, service or employment classification
7. Hours of service and vesting determination
8. Copies of Form 1099 information statements with respect to plan distributions
9. Copies of corporate income tax returns (to reconcile the deduction taken)
10. Demonstration of compliance with all applicable coverage and nondiscrimination tests
11. Any other plan-related materials, such as applications to IRS corrections programs, governmental inquiries and resolutions to those inquiries, participant claims against the plan, etc.

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