ESOP Phone Forum

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Introduction

Presenters:

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Overview of Topics

- Section 401(a)(35) Final Regulations
- Technical Assistance Requests
  - Background of requests
  - Topics
    - Mandatory repurchase of employer securities under section 409(h)(2)(B)
    - Diversification under section 401(a)(28)(B)
    - Exchange of assets within an ESOP

Section 1.401(a)(35)-1

- Background
- Affected Plans
  - Applicable Defined Contribution Plans
    - ESOP exception
- Definition of publicly traded stock
  - Readily tradable on an established securities market
  - When is a plan treated as having readily tradable stock
    - Control groups
    - Broad investment funds
- Plan contributions

Section 1.401(a)(35)-1

- General Requirements
  - Not less than 3 investment options
  - Opportunity to divest no less frequently than quarterly
  - Restrictions/conditions (direct or indirect) on employer stock divestment may not exceed those on other plan investments
    - exceptions
      - application of securities laws, frozen funds (with transitional rule exception)
      - day-trading, QDIA's
- Definition of readily tradable used in interrelated provisions of the Code

Section 401(a)(28)(B)

- Background
- Basic Definitions
  - “qualified participant”
  - “years of service”
- Plan language

Mandatory repurchase of S corporation stock

- Automatic put options (C & S corporations)

- S corporations
  - Revenue Procedures 2003-23 and 2004-14
  - Section 409(h)(2)(B)(i)

TA-4: Rebalancing & Reshuffling Provisions

- Issue: Whether an ESOP or stock bonus plan can include a reshuffling provision that allows the trustee or administrator to involuntarily exchange employer stock held in participants' accounts for cash or other assets allocated to other participants' accounts.

TA-4: Rebalancing & Reshuffling Provisions

- Conclusion:
  - The right to a particular form of benefit (e.g., investment in employer stock) is not a protected benefit under Code §411(d)(6).
  - Thus, subject to certain limitations, plans may provide for rebalancing or reshuffling.

TA-4: Rebalancing & Reshuffling Provisions

Definitions

- Rebalancing: 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.

- Reshuffling: 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.

TA-4: Rebalancing & Reshuffling Provisions

- Specific areas of concern raised:
  - Definite allocation formula requirements of §1.401-1(b)(1)(i), (ii), and (iii) of the Regulations.
  - Diversification requirements of Code §401(a)(28)(B).
  - Discrimination testing for benefits, rights, and features under §1.401(a)(4)-4 of the Regulations.
  - Asset segregation provisions.

TA-4: Rebalancing & Reshuffling Provisions

<u>Definite written program requirements</u>

- Section 1.401(a)(2) of the Regulations: plan must be a definite written program.

- Section 1.401-1(b)(1)(ii) and (iii) of the Regulations: plan must provide a definite predetermined formula for allocating contributions.

TA-4: Rebalancing & Reshuffling Provisions

Definite written program requirements (cont.)

- Provision must have language that directs the plan administrator as to the number of shares or amount of cash to transfer in or out of plan accounts.
- Provision must state the manner in which the transfers will be effectuated, such as the date of valuation.

TA-4: Rebalancing & Reshuffling Provisions

Benefits, rights, & features testing

- Section 1.401(a)(4)-4 of the Regulations provides that benefits, rights, and features available to any employee under the plan must be provided in a manner that does not discriminate in favor of highly compensated employees ("HCEs")
- The right to a particular form of investment qualifies as a right under §1.401(a)(4)-4.

TA-4: Rebalancing & Reshuffling Provisions

<u>Benefits, rights, & features testing (cont.)</u>

- Two requirements: current availability and effective availability
- *Current availability*:
  - a right under the plan meets the current availability requirement if the group of employees to whom the right is currently available satisfies Code §410(b).
  - Whether a right is "currently available" is based on the current facts and circumstances with respect to the employee.

TA-4: Rebalancing & Reshuffling Provisions

Benefits, rights, & features testing (cont.)

- *Effective availability*: the group of employees to whom the right is effectively available must not substantially favor HCEs.
  - Operational requirement

TA-4: Rebalancing & Reshuffling Provisions

Benefits, rights, & features testing (cont.)

- Reshuffling provisions that raise current availability issues may be considered inappropriate.
  - Not a concern for rebalancing provisions.

- Segregation of assets plan provision
  - Terminated employees comprise a coverage group under §1.401(a)(4)-10.

TA-4: Rebalancing & Reshuffling Provisions

Diversification rights

- Code §401(a)(28)(B) provides that ESOPs must allow participants to direct the investment of at least 25% of their account each year. (In the case of the last election year, 50%).

- In order to comply with §401(a)(28)(B), any rebalancing or reshuffling provision must preclude shares diversified under such section from being mandatorily returned to participants' accounts.

TA-4: Rebalancing & Reshuffling Provisions

- Additional concerns with ESOP asset segregation provisions.

TA-4: Rebalancing & Reshuffling Provisions

Example Plan Language

- Example 1:

  The Trustee may debit a Participant's Company Stock Subaccount with one type of Employer Securities provided the Trustee credits such Participant's Company stock Subaccount with another type of Employer Securities equal in fair market value as determined by the Independent Appraiser as of such date. The Trustee may debit a Participant's Company Stock Subaccount provided the Trustee credits such Participant's Other Investments Subaccount on the date of such debit with assets equal to the fair market value of the Employer Securities debited as determined by the Independent Appraiser of such date.

TA-4: Rebalancing & Reshuffling Provisions

- Example 2:

Required Divestiture for Participants Who Have Attained the Age of 60: The Trustee shall transfer from a Participant's account the Employer stock in such Participants account in accordance with the following schedule:

Attained Age	Fraction of Stock to be Transferred
60	1/8
61	1/7
62	1/6
63	1/5
64	1/4
65	1/3
66	1/2
67	100%

TA-4: Rebalancing & Reshuffling Provisions

- Example 2 (cont.):

  The transfer of the stock in the Participant's account shall be made internally within the Plan or sold by the Plan. The consideration to the Participant's account shall be the fair market value of the stock as of the date of such transfer. Once the transfers take place, the Participant shall be entitled to direct the investment of the Participant's non-stock account in accordance with the provisions of 9.15.

Questions?