EMPLOYEE STOCK OWNERSHIP PLANS AND "REBALANCING"

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What is rebalancing? It is peculiar to Employee Stock Ownership Plans (ESOPs). In its Response to Technical Assistance Request (#4) (http://www.irs.gov/pub/irs-tege/esop_tar4_022310.pdf), issued April, 2009, the IRS has said "… we define *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."

Where is it applicable? First of all, it is only applicable to an ESOP that has "other investments" in *addition* to employer stock. Some plans allocate new shares (or newly released shares as an exempt loan is paid off) to the participants each year. After a while, all the shares are purchased and allocated; and *new* participants only share in the allocation of new cash contributions or forfeitures attributed to other participants terminating employment. The employees who have been with the company since the ESOP was established could be, for example, 95% invested in company stock, while those who have been in the plan only a couple of years might be, for example, only 10% invested in company stock. Anticipating this problem down the road, some employers put a provision in their ESOP so that the allocation of all assets is in a "pooled" approach whereby all participants are invested proportionately the same in company stock. So, for example, there could be a year for which (instead of some people being 95% in company stock and others being 10% in company stock) all participants are 85% invested in company stock.

Advantages: Now that rebalancing is blessed by the IRS, why use it? There are several advantages to such a provision.

It results in all participant balances being proportionately the same. In other words if every participant's account is 85% in company stock and 15% in other investments, then every participant's yield on his prior year-end balance is the same percent. It avoids cases where there can be dramatic differences in yields seen by participants – such as when the company stock increases 25%, the other assets earn only 5%, and rebalancing is *not* being used.

It is sometimes thought of, and communicated to participant as, a forced diversification. So, even though participants will have the right at age 55 with 10 years of participation to start diversifying out of company stock, this provision might create additional diversification at an earlier point in time.

Rebalancing provides an "equal incentive and reward" to all participants, when you look at the yield on their ESOP account balances.

Disadvantages: What are perceived above as advantages from one person's point of view can be seen as a disadvantage from another's point of view.

Unless rebalancing is put in the plan when established and communicated properly, the people who have some shares taken out of their accounts in order to accommodate rebalancing will perceive it as a "take-away" if the company stock consistently performs better than the other assets.

It complicates administration (and communication to participants) to have rebalancing interact with other required provisions – e.g., the rule that at age 55 with 10 years of participation, the participant has some *optional* diversification.

If an ESOP has other assets, would the employer wish, instead, to purchase shares from *former* employees who have not yet been paid their benefits, thus maximizing the company stock held by *current* employees? Of course this could be seen as a disadvantage to the former employee who chooses to leave a balance in the plan until retirement age. However, the IRS has also given its blessing to such provisions, now called "reshuffling".

The only ESOPs that can *preclude* a distribution in company stock are those sponsored by S corporations and those sponsored by companies whose by-laws require that non-ESOP shares can only be held by employees. For other ESOPs, the participant must have the right to a distribution in employer securities. Consequently, even if the funds are taken out of company stock at a participant's termination of employment, the former employee who later requests a distribution could request that it be in the form of company stock.

If RMS can assist you in any way, whether considering an ESOP, or considering changes to an existing ESOP, please don't hesitate to contact us.

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