Chapter 8

Examining Employee Stock Ownership Plans (ESOPS), including new developments

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

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Overview

Introduction

This lesson provides guidance pertaining to the examination of both leveraged and non-leveraged employee stock ownership plans. This chapter describes the qualification requirements under IRC sections 401(a) and 409, as well as the additional requirements for ESOPs under IRC section 4975(e)(7) and the applicable regulations, related to both leveraged and non-leveraged ESOPS. This chapter also covers other issues pertinent to ESOPS, such as the IRC section 404(k) deduction rules, IRC section 1042 transfers, the partial interest exclusion and special rules pertaining to Sub S ESOPS. Finally, this chapter discusses recent changes made by EGTRRA.

Objectives

At the end of this lesson, you will be able to:

1. Determine whether the ESOP is operated in a qualified manner.
2. Determine that the ESOP is properly invested in qualifying employer securities (QES), as defined by IRC section 409(l).
3. Determine that distribution requirements are properly satisfied (timeliness and form).
4. Determine that the applicable put options are properly applied.
5. Determine that the QES is properly valued.
6. Determine whether the employer's contributions, including dividends, are deductible.
7. Determine if the premature repayment of an exempt loan by selling the QES in the suspense account is appropriate.
8. Determine whether allocations in the ESOP are valid for a S Corp.

ESOP Requirements-definition of an ESOP

Definition of ESOP

An Employee Stock Ownership Plan, by definition, is a qualified retirement plan consisting of either a stock bonus or a stock bonus/money purchase combination plan, which is designed to invest primarily in qualifying employer securities. See IRC section 4975(e)(7)(A). An ESOP must satisfy the requirements of IRC section 4975(e)(7) and Reg. § 54.4975-11, certain portions of Code section 409 and the plan as a whole must meet Code section 401(a). Further, any use of exempt loans with respect to an ESOP, generally referred to as a leveraged ESOP, must comply with the rules relating to exempt loans contained in Regulation § 54.4975-7.

To qualify as an ESOP, the plan must be formally designated as such within the plan document. See Reg. § 54.4975-11(a)(2). Normally, the entire plan is formally designated as an ESOP. However, it is permissible for a plan to provide that only a portion of a qualified plan is an ESOP. As such, an ESOP may form a portion of a plan, the balance of which includes a qualified pension, profit sharing, or stock bonus plan, which is not an ESOP. See Reg. § 54.4975-11(a)(5). Plan terms should clearly state if an ESOP only pertains to a portion of the plan, and clearly identify that portion of the plan that is intended to comprise the ESOP. This portion of the plan is subject to all ESOP requirements, both in form and operation.

If a plan fails to qualify as an ESOP under IRC section 4975(e)(7), it may still be a qualified plan (such as a stock bonus plan) under IRC section 401(a). See Reg. § 54.4975-7(b)(1)(i).

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ESOP Requirements-definition of an ESOP, Continued

Example

The following is an example where only a portion of the plan constitutes an ESOP. The preamble to this plan provides that the plan is intended to be a stock bonus ESOP with a 401(k) feature. Plan terms provide that the matching and discretionary contributions constitute the ESOP portion of the plan, whereas the 401(k) contributions constitute the non-ESOP portion of the plan. Plan terms clearly provide for separate ESOP accounts for the matching and discretionary contributions and a separate 401(k) account (to hold non-ESOP elective contributions and earnings and losses thereon).

In this instance the ESOP accounts are, per plan terms, designed to invest primarily in QES, while the 401(k) accounts are not subject to such investment requirements. The plan provides that participants have the right to elect the form of investment with respect to their own elective contributions contained in their 401(k) accounts (in various designated investment vehicles). Finally, the ESOP requirements (and special rules), including the right to demand distribution in QES, apply only to the ESOP portion of the plan, not to the 401(k) accounts.

Prohibited transaction exemption

Introduction

The use of loans to acquire qualifying employer securities would be a prohibited transaction if the plan were not an ESOP. This is because the general rule provides that the direct or indirect lending of money or other extension of credit between a plan and a disqualified person, such as the employer, is a prohibited transaction under IRC section 4975(c)(1)(B). In addition, the general prohibition would result in an improper extension of credit to the plan as a result of the employer's guarantee to the lender that a plan would repay the loan. See Reg. § 54.4975–7(b)(1)(ii).

There is a statutory exemption to the prohibited transactions for loans to a leveraged ESOP. See IRC sections 4975(d)(3) and 4975(e)(7). The loan to the ESOP is not a prohibited transaction if the loan is:

1. Primarily for the benefit of plan participants, and
2. at a reasonable interest rate, with any collateral which is given to a disqualified person by the plan consisting only of qualifying employer securities.

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Prohibited transaction exemption, Continued

4975(d)(13)

IRC section 4975(d)(13) provides a statutory exemption from the prohibited transactions with respect to any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b)(12).

ERISA 408(e) and 408(b)(12)

ERISA Act section 408(e) provides for a statutory exemption relating to the acquisition or sale by the plan of qualifying employer securities provided that such acquisition or sale by the plan:

1. Is for adequate consideration, at a price not less favorable to the plan than the price determined under ERISA Act section 407(e)(1),
2. no commission is charged with respect thereto, and
3. the plan is an eligible account plan.

ERISA Act section 408(b)(12) is a rule allowing for the disposition of certain stock that at the time of acquisition constituted qualifying employer securities under Title I, but due to a change in definition are no longer qualifying employer securities.

Operational aspects and advantages of ESOPs-

Introduction-ESOP distinguished with other plans

Like other qualified plans, ESOPS enjoy the normal tax advantages available to qualified plans. However, ESOPS also enjoy other tax advantages peculiar to ESOPS, such as increased deduction limits, deduction of IRC section 404(k) dividends, expanded IRC section 415 annual additions, and other special tax advantages.

For the plan sponsor, ESOPS provide a method of corporate financing not available to other qualified plans through the use of exempt loans. For participants, ESOPS provide a retirement vehicle that confers an increased level of corporate ownership through investment of qualified employer securities by the plan.

ESOP used as a financing tool

Leveraged ESOPs provide the employer with a vehicle as a financing tool, through the borrowing of money involving the ESOP. This leveraged transaction involves the acquisition of qualifying employer securities (QES) from the employer or other shareholders, using debt-financing to acquire the employer securities.

ESOPs uses exempt loans and suspense accounts

This use of exempt loans and the suspense account is another advantage of ESOPS. It permits a larger amount of stock to be acquired initially by the ESOP from the employer or disqualified person than the amount that could be acquired by other types of plans (due to contribution and 415 restrictions). Stock acquired by an ESOP though the use of an exempt loan is initially not allocated, but placed in a suspense account.

This permits the employer to spread out deductible contributions over a period of years as contributions are made to service the debt, with a delayed allocation through release of the stock from such suspense account in subsequent years as payments are made on the exempt loan. This is one of few permitted uses of suspense accounts permitted in defined contribution plans.

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Operational aspects and advantages of ESOPs-, Continued

ESOPs can invest in employer securities

Generally, qualified plans are not permitted to acquire or hold employer securities or employer real property with a fair market value in excess of 10% of plan assets. See ERISA Act sections 406(a)(1)(E), 406(a)(2) and 407(a)(2).

Eligible individual account plans are specifically exempted from the 10% limitation and the investment diversification rules. See ERISA Act sections 407(b)(1), 404(a)(1)(C), and 404(a)(2). Because ESOPs are eligible individual account plans under ERISA Act section 407(d)(3), ESOPs can invest in employer securities without regard to the 10% limitation. An ESOP must provide, by its terms, that the ESOP is designed to invest primarily in qualifying employer securities.

Special tax rules for ESOPs

In addition, special tax rules, such as qualifying IRC section 1042 transfers, permit non-recognition of gain by the seller of qualifying employer securities sold to the ESOP, while at the same time transferring substantial ownership interests in stock of the company to the plan.

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Operational aspects and advantages of ESOPs-, Continued

Example of an Exempt Loan

Assume an employer has need for $10,000,000 in corporate financing. The ESOP can be used to acquire such funds through the use of an exempt loan. The ESOP secures a loan for such amount from an outside lender, such as a bank. The ESOP signs a promissory note for the amount of the loan, with such loan then guaranteed by a third party (generally the employer). (In a back-to-back loan, the employer receives the loan and then loans the proceeds to the ESOP to acquire employer securities for the ESOP).

The ESOP would then purchase $10,000,000 in qualifying employer securities from employer (or from another shareholder). The result is that the employer (or shareholder) receives $10,000,000 in cash, and the ESOP receives the equivalent value in qualifying employer securities, with an equal amount of debt owned to the outside lender (i.e., bank). The loan can be and is generally secured by a pledge of the stock acquired by the ESOP. The stock is then held unallocated in a suspense account, until contributions are made to release the shares.

Under the prohibited transaction exemption involving the use of exempt loans, the employer is now obligated to make sufficient contributions to the ESOP in order for the ESOP to make timely payment to the bank on the debt. See GCM 39747, March 14, 1986, S. Rep. No. 94-36, 94th Cong., lst Sess., 58-59 (1975). Each year, the employer makes a tax-deductible payment to the ESOP sufficient to enable the ESOP to make its annual debt payments to the bank. The ESOP is also permitted to repay the acquisition indebtedness from earnings on contributions received, as well as dividends received on the stock. However, pre-existing plan assets should not be used to service the debt. Since the employer's contributions to the ESOP are deductible within the IRC section 404(a)(9) limits, a leveraged ESOP allows the company to repay the entire loan on a tax-favored basis.

The stock is initially held unallocated by the ESOP in the suspense account (encumbered stock). As payments are made on the debt, a proportional amount of stock is released from the suspense account pursuant to one of two specific release formulas (provided for in the plan) and the released stock is then allocated to participants in a nondiscriminatory manner.

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Operational aspects and advantages of ESOPs-, Continued

Examination Steps

The basic pre-examination planning instructions are contained in IRM section 4.71.1. As part of the pre-examination planning:

1) Analyze the return to determine if the plan is designated as an ESOP. Often, the plan name includes a specific reference to the plan as an ESOP.
2) Review the Form 5500 Pension Benefit Codes. These codes include separate designations for leveraged ESOPS, non-leveraged ESOPS and Sub S ESOPS.
3) Review the Form 5500, Schedule H (Financial Information) and/or Schedule I (Financial Information- Small Plan) for identified investment in employer securities. Also, review the answers on these forms to any questions relating to investment in excess of certain percentages in any one type of investment.
4) Review the Form 5500, Schedule H (Financial Information) for liabilities that could reveal the existence of an exempt loan, in conjunction with the investment in employer securities. The amount of the exempt loan liability would normally be entered under Liabilities as Acquisition Indebtedness or as Other Liabilities.
5) Review Schedule I (Financial Information- Small Plan) for disclosure of a substantial amount for liabilities in relation to plan assets.
6) Review the prior favorable determination letter for any reference to a ruling on the ESOP (i.e., an IRC section 4975(e)(7) or IRC section 409 caveat).
7) If the prior determination file or application can be secured, review the application to determine if a Form 5309 (Application for Determination of Employee Stock Ownership Plan), an attached schedule to the Form 5300 application, was filed. This Form 5309 is used to request a determination with respect to either a tax credit ESOP under IRC section 409 and/or a leveraged or non-leveraged ESOP under IRC section 4975(e)(7). This Form 5309 should result in the applicable IRC section 409 or IRC section 4975(e)(7) caveat on the favorable determination letter.

Qualifying employer securities

Introduction

An ESOP must invest primarily in qualifying employer securities. See IRC section 4975(e)(7). There is no specific percentage that defines the term "primarily," however, the term generally would require at least 50% of the ESOP assets to be invested in qualifying employer securities. In actuality, it is a flexible term that takes into account facts and circumstances such as the investment performance of the qualifying employer securities.

An ESOP can sell qualifying employer securities or refrain from purchasing additional securities based on the investment performance of the securities. This would be consistent with the fiduciary duties under Title I of ERISA. The Department of Labor (DOL) stated in Advisory Opinion 83–6A (1/24/83) that there may be instances where the investment of more than 50% of plan assets in qualifying employer securities would not satisfy the fiduciary responsibility requirements of Title I. The DOL Advisory Opinion concluded that the "primarily" requirement must be satisfied over the life of the ESOP

Definition of qualifying employer security under section 4975(e)(8)

IRC section 4975(e)(8) defines a "qualifying employer security" as an employer security within the meaning of IRC section 409(l). IRC section 409(l) provides that qualifying employer securities consist of the following:

1) Common stock issued by the employer, or by a corporation within the same controlled group, which is readily tradable on an established securities market.

2) If there is no readily tradable common stock, closely held common stock of the employer (or by a corporation which is a member of the same controlled group) which has a combination of voting power and dividend rights equal to or in excess of the class of common stock of the employer (or of any other such corporation) having the greatest voting rights and the greatest dividend rights.

3) Noncallable preferred stock if the stock is convertible at any time into stock which meets the requirements of a) or b) above (whichever is applicable), and if the conversion price is reasonable as of the date the ESOP acquired the preferred stock.

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Qualifying employer securities, Continued

Qualifying security definition for an ESOP is different than for plans

Note that the statutory definition of qualifying employer securities with respect to an ESOP is more stringent than the definition of qualifying employer securities used for non-ESOP plans. Refer to ERISA Act section 407(d)(5).

For example, the definition of qualifying employer securities for non-ESOPS under ERISA Act section 407(d)(5) would include any stock, including non-voting stock, and other marketable obligations.

Special definition of controlled group for ESOPs

For purposes of IRC section 409(l), a "controlled group of corporations" is defined at IRC section 1563(a), but without regard to the insurance company rule at IRC section 1563(a)(4) and without regard to the exception to the attribution from trusts rule at IRC section 1563(e)(3)(C).

This special rule applies to the determination of the definition of qualified employer securities under Code section 409(l). This special rule does not extend the definition of the determination of the controlled group for qualification purposes, such as coverage and nondiscrimination testing.

Special circumstances for a first tier subsidiary under section 409(l)

IRC section 409(l)(4) provides special circumstances in which a first tier subsidiary may be considered to be includable in a controlled group of corporations for purposes of IRC section 409(l), even where the parent owns less than 80% of the first tier subsidiary. The effect of this provision is to permit the acquisition of the controlling corporation's stock by an ESOP maintained by the first tier subsidiary (or vice versa).

If a corporation owns directly stock possessing 50% of the voting power in all classes of stock and at least 50% of each class of non-voting stock in the first tier subsidiary, then the first tier subsidiary (and all other corporations below it in the chain which would meet the 80% test of IRC 1563(a) if the first tier subsidiary were the parent) is considered to be an "includable corporation" for IRC section 409(l) purposes.

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Qualifying employer securities, Continued

Special circumstances for a second tier subsidiary

IRC section 409(l)(4) provides special circumstances in which a second-tier subsidiary may be considered to be includable in a controlled group of corporations for purposes of IRC section 409. The effect of this provision is to permit the acquisition of the controlling corporation's stock by an ESOP maintained by the second-tier subsidiary (or vice versa).

If a corporation owns directly stock possessing all of the voting power in all classes of stock and all of the non-voting stock of a first-tier subsidiary, and if the first-tier subsidiary owns stock possessing at least 50% of the voting power of all classes of stock and at least 50% of each class of non-voting stock of the second-tier subsidiary (and all other corporations below it in the chain which would meet the 80% test of IRC section 1563(a) if the second-tier subsidiary were the common parent) is considered to be an "includable corporation" for purposes of IRC section 409(l).

Example

An ESOP under examination was reviewed with respect to its investment in QES. The preamble to the plan designated the entire plan as the ESOP and provided that the plan was designed to invest primarily in QES. The trust document provided that the plan trustee was responsible for the investment of trust funds. The plan had been in existence for ten years, and the trust assets were currently invested in 8 distinct investment funds, one of which was a fund investing in QES. The breakdown of the investments revealed that the largest single investment was 20% (of total assets) invested in the QES fund, with the remaining seven funds invested between 10% to 15% (of total assets) each.

Upon further investigation, the agent determined that the ESOP had been invested in QES over the ten year life of the ESOP for each year since inception at around the 20% level and that the employer and fiduciary could not provide an adequate explanation as to the failure to invest a larger percentage of plan assets in QES.

In this instant case, consideration should be given to addressing the failure of the ESOP to comply with IRC section 4975(e)(7) as the plan has operationally failed to meet the requirement that the ESOP is designed to invest primarily in QES.

Examination steps

Examine ESOP investment accounts

Examine the ESOP's investment accounts to verify it is investing primarily in qualifying employer securities, as defined in IRC section 409(l).

For ESOPs with closely held stock

If the ESOP holds closely held common stock of the employer, check that neither the employer (nor any member of the controlled group) has readily tradable common stock. This information may have to be requested from the employer. If there is readily tradable common stock, then the ESOP cannot hold the closely held stock.

For ESOPs with preferred stock

If the ESOP holds preferred stock, determine whether the conversion price is reasonable. Look at the conversion formula in the corporate charter documents. Also look at the answer to the question concerning the conversion formula on Schedule E, ESOP Annual Information. If the conversion formula does not allow participants to share in any appreciation in the value of the common stock, the conversion price is not reasonable.

> Note: A conversion price that is based on the common stock's fair market value as of the date the ESOP acquired the preferred stock is reasonable because it permits participants to share in all of the appreciation in the value of the common stock. A formula that includes a conversion premium is permitted if the conversion premium is reasonable.
>
> The reasonableness of a conversion premium is determined on its facts and circumstances. Generally, a reasonable conversion premium will be in the 20% to 30% range.

Special rule under section 409(l)(4)

The special rule under IRC section 409(l)(4) which expands the definition of a controlled group of corporations, as applied to the determination of qualifying employer securities, applies to controlled corporations, but does not apply to partnerships or sole proprietorship. See PLR 9236042 and GCM 39880.

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Examination steps, Continued

Determine whether the stock is readily tradeable

Determination of whether the stock is "readily tradable on an established securities market" should have the same meaning as the term "publicly traded" as defined in Regulation § 54.4975-7(b)(1)(iv). This regulation provides that a security listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 or quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act is "publicly traded". Refer to PLR 9529043 for an example of this interpretation.

Common stock

Common Stock quoted on the NASDAQ SmallCap Market, a separate market on the NASDAQ system, is classified as an established security system, making common stock traded on it as IRC section 409(l) stock. Refer to PLR 9529043.

Verify types of shares held by ESOP

It is permissible for an ESOP to hold and acquire qualifying employer securities (as more liberally defined under Title I of ERISA per Act sections 407(a)(1) and 407(d)(5)). For example, in addition to investing primarily in IRC section 409(l) qualifying employer securities, the plan could also invest in stock as defined under ERISA Act section 407(d)(5), such as in non-voting class B stock.

However, notwithstanding other plan investments, the examiner should verify, for example, that the ESOP was investing primarily in IRC section 409(l) shares, that participants were given the right to demand distribution entirely in IRC section 409(l) stock, and that all stock acquired with exempt loan proceeds was IRC section 409(l) stock.

If plan fails to satisfy ESOP requirements

If a plan fails to qualify as an ESOP under IRC section 4975(e)(7), it may still be a qualified plan (such as a stock bonus plan) under Code section 401(a). However, consideration should be given to any plan operation that is limited to ESOPS, such as use of exempt loans, 404(k) dividend deductions, and expanded IRC section 415 rules, among others. If any of these apply, then failure to comply with IRC section 409(l) could result in prohibited transactions, deduction and/or qualification issues, depending on the specific statutory violations.

Participation, coverage and nondiscrimination

Introduction

The participation (IRC section 401(a)(26) for years beginning before January 1, 1997), coverage (IRC section 410(b)), and nondiscrimination (IRC section 401(a)(4)) requirements are applicable to an ESOP. These requirements must be satisfied separately by an ESOP.

An ESOP may not be considered together with another plan in order to meet the participation, coverage or nondiscrimination requirements. See Regs.§ 54.4975–11(e)(1), 1.401(a)(26)–2(d)(1)(i), 1.410(b)–7(c)(2) and 1.401(a)(4)–1(c)(4).

IRC section 401(a)(26) is inapplicable to defined contribution plans for years beginning after December 31, 1996.

ESOP may not be aggregated with another plan

An ESOP cannot be aggregated with another plan. For example, the use of matching employer contributions to an ESOP to satisfy the nondiscrimination requirements relating to qualified cash or deferred arrangements (CODAs) (including a cash or deferred arrangement which forms a portion of the ESOP) is not permitted. See Reg. § 1.401(k)-1(g)(11), Reg. § 1.401(k)-1(g)(1)(ii)(B), IRC 401(k)(3) and the Technical Guidance on CODAs in IRM 4.72.2.6.

ESOP cannot satisfy 401(a)(4) with a nondesign based safe harbor

An ESOP cannot satisfy the IRC 401(a)(4) nondiscrimination requirements through the use of a nondesign-based safe harbor formula under Reg. § 1.401(a)(4)–2(b)(3), nor through the use of a cross-testing formula under Reg. § 1.401(a)(4)–8(b).

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Participation, coverage and nondiscrimination, Continued

ESOP cannot be aggregated unless a special rule is met

In addition, an ESOP cannot be aggregated with another ESOP to satisfy coverage or nondiscrimination requirements unless the special rule of Reg. § 54.4975-11(e)(2) is met.

This special rule provides that two or more ESOPS can be aggregated for purposes of IRC sections 410(b) or 401(a)(4) and (5), only if the proportion of qualifying employer securities (QES) to total plan assets is substantially the same for each ESOP and

(i) the QES held by all ESOPS are of the same class or

(ii) the ratios of each class held to all such securities is substantially the same for each plan.

Refer also to Beals Bros. Management Corp v. Comm., U.S. Court of Appeals, 8th Circuit, 300 F.3d 963, 2002 U.S. App., which held that the aggregation of two ESOPS (of related employers in a controlled group) was improper and that the ESOP for management employees failed to satisfy the coverage requirements of IRC section 410(b). The ESOP maintained for the non-management employees received almost no contributions, whereas the ESOP set up for the management employees received more significant contributions.

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Participation, coverage and nondiscrimination, Continued

Example-plan with ESOP and non-ESOP components

A plan provides for both ESOP and non-ESOP components within the plan, along with separate accounting. The plan provides for discretionary contributions only, but provides that the employer will designate such contributions when made as either ESOP or non-ESOP contributions.

The plan allocation formula for the non-ESOP contributions provides for a safe harbor formula utilizing permitted disparity under IRC section 401(l). The plan allocation formula for the ESOP contributions provides for a safe harbor formula (compensation to total compensation), that does not utilize permitted disparity.

A review of the determination application and exhibits reflect a Demo 4, which reflects satisfaction of coverage for each separately disaggregated plan per Reg. § 1.410(b)-7(c)(2) and satisfaction of the non-discrimination in amount requirements by each disaggregated ESOP and non-ESOP plan components per 1.401(a)(4)-1(b)(2).

Besides testing each allocation formula separately, the examiner should verify that the designated ESOP contributions are allocated pursuant to the safe harbor formula without permitted disparity. If eligibility requirements are different for the ESOP and non-ESOP components of the plan, the workpapers should reflect separate analyses for each component with respect to IRC section 410(b).

Example-ESOP fails coverage

An agent is assigned an ESOP for examination. During the course of the examination, the agent determines that the plan benefits only highly compensated employees and does not benefit certain statutorily eligible non-highly compensated employees.

As such, this ESOP appears to fail to satisfy the coverage requirement of IRC section 410(b). Subsequent discussions with the taxpayer's representative reveal that the employer also maintains a profit sharing plan that provides comparable benefits to all non-highly compensated employees. The representative submits documentation that supports that the contributions for the year under examination are non-discriminatory when these plans are aggregated. The agent properly concludes that the ESOP is not qualified. The reason is that an ESOP cannot be aggregated with other plans in order to satisfy IRC section 410(b).

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Participation, coverage and nondiscrimination, Continued

Examination Steps

1. Check that the ESOP satisfies the participation, coverage and nondiscrimination requirements without being aggregated with any other plan. This disaggregation also applies to any non-ESOP portion of the plan of which it is a part.

2. In the case of an ESOP that is part of a CODA, check the terms of the ESOP to ensure that if the employer matches the employees' elective deferrals under the CODA by making contributions to the ESOP, the matching contributions to the ESOP are not taken into account for purposes of meeting the nondiscrimination rules of IRC 401(k). Also, check the CODA's terms. Ensure also that the ESOP matching contributions satisfy IRC section 401(m). See the Technical Guidance on Matching Contributions in IRM 4.72.3.

3. In the case of an ESOP that contains provisions for CODAs and matching contributions, ensure that the ADP and ACP tests are run separately with respect to the ESOP and non-ESOP plans or portions of the plan.

Permitted disparity and right to demand qualified employer securities

Permitted Disparity

An ESOP established after 11/1/77, cannot be integrated with Social Security benefits. ESOP's established and integrated before such date may remain integrated. However, such plans must not be amended to increase the integration level or the integration percentage. See Reg. § 54.4975–11(a)(7)(ii). Such plans may in operation continue to increase the level of integration if under the plan such increase is limited by reference to a criterion existing apart from the plan. Similarly, the permitted disparity rules of IRC section 401(l) do not apply to ESOPs, except for ESOPs which were in existence on 11/1/77, which were integrated. See Reg. § 1.401(l)–1(a)(4).

Distributions – Right to Demand QES

Distributions from an ESOP may be made entirely in qualifying employer securities or may be made in cash, or a combination of cash and stock. However, any distribution from an ESOP is subject to the participant's right to demand that their entire distribution be in the form of qualifying employer securities. See IRC section 409(h).

An employee also has the right to require the employer to repurchase certain employer securities that the employee receives in a distribution (i.e., put option).

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Permitted disparity and right to demand qualified employer securities, Continued

Exceptions to right to demand distribution

Exceptions to the right to demand distribution in the form of qualifying employer securities include:

1. If the employer's corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan, the participant may be precluded from demanding a distribution in the form of employer securities. See IRC section 409(h)(2)(B).

2. TRA '97 provides that an ESOP maintained by an S corporation can preclude the distribution of employer securities to a participant. See IRC section 409(h)(2)(B).

3. Employer stock that was subject to the right of diversification and that the participant had previously elected to diversify per IRC section 401(a)(28)(B) is not subject to the right to demand distribution in the form of qualifying employer securities. See IRC section 409(h)(7) and Notice 88-56, Q&A-11.

If stock distributed to the participant is not readily tradable on established security market, then a put option is required subsequent to distribution.

Distributions, timing and payment requirements

Section 409(o)

IRC section 409(o) provides that an ESOP participant who is entitled to receive a distribution can elect to commence distributions sooner than the periods described under IRC sections 401(a)(14) and IRC 401(a)(9). A participant can elect (if applicable, with the consent of his/her spouse per IRC section 401(a)(11) and IRC 417), to commence the distribution of his/her account balance not later than one year after the close of the plan year

(1) which the participant separates from service by reason of normal retirement age, disability, or death, or

(2) which is the 5th plan year following the plan year in which the participant otherwise separates from service, as long as the participant is not reemployed by the employer before this distribution is required to begin.

When section 409(o) applies

IRC section 409(o) applies only to stock acquired after December 31, 1986. However, the election with respect to this right to elect an accelerated distribution does not apply to any employer securities acquired with the proceeds of an ESOP loan until the close of the plan year in which the loan is repaid in full.

Form of distribution

Unless the participant elects otherwise, the account balance must be distributed in substantially equal periodic payments (at least annually) over a period not to exceed 5 years. If the participant's account balance exceeds $500,000 (adjusted for cost-of-living increases), the distribution period is increased to 5 years plus one additional year (up to 5 additional years) for each $100,000 (adjusted for cost-of-living increases), or fraction thereof, by which the balance exceeds $500,000 (as adjusted). See Notice 2001-84, I.R.B. 2001-53.

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Distributions, timing and payment requirements, Continued

If ESOPs acquires more than one class of employer securities

If an ESOP acquires more than one class of employer securities available for distribution with the proceeds of the loan, the distributee must receive substantially the same proportion of each class. Thus, a distributee may not receive only preferred stock if the loan proceeds were also used to acquire voting common stock. See Reg. § 54.4975–11(f)(2).

1. The above distribution is based on shares allocated to a participant's account and such allocation is proportionate (as to separate classes of stock) with respect to shares acquired with each loan.

2. This rule does not apply when separate loans at separate times are used to buy different classes of stock.

Assets released from a suspense account

Assets:

- released from the ESOP suspense account (related to leveraged ESOPs with exempt loans) and
- allocated to a participant's account

can be forfeited only after other assets have been forfeited. See Reg. § 54.4975–11(d)(4).

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Distributions, timing and payment requirements, Continued

Examination Steps-distributions

1. Make sure the plan gives employees the right to receive their distribution in the form of qualifying employer securities, unless the corporate charter or by-laws restricts stock ownership to employees or to a qualified plan, or unless the ESOP is maintained by an S corporation that precludes the distribution of employer securities to participants.

2. Check the plan to make sure that participants can elect an accelerated distribution under IRC 409(o).

3. Look at the assets allocated to a participant from the suspense account. If securities available for distribution consist of more than one class, check that the participant received substantially the same proportion of each class as reflected in the suspense account assets available for distribution.

4. Check that the released suspense account assets allocated to a participant's account were forfeited after other assets were forfeited. If more than one class of qualifying employer securities has been allocated to a participant's account, make sure the participant forfeits the same proportion of each class.

5. If an ESOP provides for both a Stock Account and an Other Investments Account, ensure that the right to demand qualifying employer securities applies to the entire ESOP plan (all accounts constituting the ESOP), not just the Stock Account, with the exception of stock diversified as required by IRC section 409(h)(7) diversification. See Notice 88-56, Q&A-11. Note that if a plan permits more liberal diversification rights that those required under IRC section 401(a)(28)(B), the right to demand distribution in the form of QES applies to all amounts in excess of the minimum amount required to be diversified under IRC section 401(a)(28)(B).

6. Any delayed distribution attempting to utilize the IRC section 409(o)(1)(B) exception for timing of distributions (i.e., delay distribution until the exempt loan is paid off) does not override the requirement to distribute per IRC sections 401(a)(9) or 401(a)(14). If this rule is utilized, scrutinize terminated participants with deferred distributions to verify compliance with IRC sections 401(a)(9) & (14).

Put option

Introduction

IRC section 409(h) and Reg. § 54.4975–7(b)(10) require an employer security to be subject to a put option if it is not readily tradable on an established market when distributed or if it is subject to a trading limitation when distributed. See also IRC section 401(a)(23).

The put option is a post-distribution right that permits the participant or beneficiary to require the employer to repurchase such distributed stock where there is no ready market in which to sell such stock.

Publicly traded defined

Employer securities are "readily tradable on an established securities market" if they are "publicly traded" as defined under Reg. § 54.4975–7(b)(1)(iv). Refer also to PLR 9529043. "Publicly traded" includes securities that are:

1. listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934, or
2. quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act.

The National Association of Securities Dealers (NASD) is a national securities association registered under section 15A(b). It runs the National Association of Securities Dealers Automatic Quotation System (NASDAQ). Therefore, over-the-counter stocks traded on NASDAQ are publicly traded. Note: Stocks listed on the "pink sheets" are not publicly traded because the "pink sheets" are not a system sponsored by the NASD. See PLR 9036039.

If employer violates federal law by honoring put option

The put option must permit a participant to "put" stock that is not a readily tradable security or is subject to a trading limitation to the employer. However, if the employer will violate Federal or state law by honoring such put option, the put option must permit the security to be put, in a manner consistent with such law, to a third party (other than the ESOP) that has substantial net worth at the time the loan is made and whose net worth is reasonably expected to remain substantial. An ESOP cannot be required to honor a put option, but it can have the right to assume the obligations of the put option.

Continued on next page

Put option, Continued

When put option is exercisable

The put option must be exercisable for at least 60 days following the date of the distribution and for at least an additional 60-day period in the following plan year. See IRC section 409(h)(4).

If the participant receives a total distribution which is required to be repurchased by the employer, the employer must make payments at least as rapid as substantially equal periodic payments (at least annually) over a period beginning not later than 30 days after exercise of the put option and not exceeding 5 years. In addition, the employer must provide adequate security and pay reasonable interest on the unpaid amounts of the total distribution. See IRC section 409(h)(5).

Other requirements

If the participant receives ESOP distributions in the form of installments that are required to be repurchased by the employer, the employer must make full payment for the securities no later than 30 days after the put option is exercised. See IRC section 409(h)(6).

In the case of an ESOP established and maintained by a bank or similar financial institution, which is prohibited by law from redeeming or purchasing its own securities, a special exception applies. For this exception, even where securities are not readily tradable, no put option is required if the participants had the right to elect to receive distributions in cash.

Continued on next page

Put option, Continued

Examination Steps –put options

1) Check that employer securities not readily tradable on an established market can be put to the employer. Note that if the ESOP itself is honoring the put option, check that there is an appropriate fiduciary decision involved with respect to this decision to reacquire the stock, in lieu of the taxpayer making the repurchase.

2) Make sure the put is exercisable for two 60-day periods: This would include 60 days following the date the employer securities were distributed and 60 days in the following plan year.

3) If the employee "puts" the shares to the employer that were received in a total distribution, make sure the employer provides adequate security and pays reasonable interest on the unpaid portion. A put option is not adequately secured if it is not secured by any tangible assets. For example, adequate security may be an irrevocable letter of credit, a surety bond issued by a third party insurance company rated "A" or better by a recognized insurance rating agency, or by a first priority perfected security interest against company assets capable of being sold, foreclosed upon or otherwise disposed of in case of default. Promissory notes, secured by a company's full faith and credit, are not adequate security. See PLR 9438002. In addition, the employer securities themselves that were repurchased cannot be treated as adequate security.

Joint and survivor rules

Introduction-certain ESOP benefits not subject to QJSA

IRC section 401(a)(11)(C) provides an exception to the qualified joint and survivor annuity (QJSA) and qualified pre-retirement survivor annuity (QPSA) requirements for certain ESOP benefits. The statute provides that the QJSA and QPSA rules do not apply to that portion of a participant's accrued benefit in an ESOP to which the IRC 409(h) rules apply. Remember that IRC section 4975(e)(7) requires an ESOP to satisfy IRC section 409(h).

Therefore, this exception applies not only to a stock bonus ESOP, but also a stock bonus/money purchase combination ESOP, as defined in IRC section 4975(e)(7).

Rationale for this exception

The reason for this exception is that an ESOP's primary purpose is to enable a participant to share in the growth of the employer through ownership in the company, which includes the ability to demand distribution in the form of qualifying employer securities.

When exception is applicable

This exception is applicable where the plan provides that the ESOP participant's vested benefits are payable to the spouse on death, where the participant does not elect a life annuity, and where the ESOP is not a transferee plan of assets from a defined benefit plan or a defined contribution plan subject to IRC 412 minimum funding standards. See also Reg. 1.401(a)–20, Q&A 3(c).

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Joint and survivor rules, Continued

Examination Steps--QJSA

1. Verify that the ESOP complies with Code section 409(h), with respect to the participant's right to demand distribution in the form of qualifying employer securities. Unless an exception applies under IRC section 409(h) with respect to the right of the participant to demand qualifying employer securities, this right should override the QJSA and QPSA requirements. For example, the participant should not be precluded from electing a distribution in the form of qualifying employer securities, merely because consent of the participant's spouse has not been secured.
2. Verify that the ESOP satisfies the conditions contained in the IRC section 401(a)(11)(C) exception to the QPJA or QJSA language, both in form and operation.
3. If the ESOP permits a participant to elect a life annuity, ensure the QJSA and QPSA requirements are satisfied, in form and operation (again, this language should not override the 409(h) right of a participant to demand distribution in the form of qualifying employer securities).
4. If only a portion of a plan is designated as an ESOP, ensure that the non-ESOP portion of the plan satisfies the QJSA and QPSA requirements, if applicable.

Floor offset arrangements

ESOP cannot be used to offset benefits under a DB plan

Generally, under the prohibited transaction rules of ERISA, a plan may not invest more than 10% of its assets in qualifying employer securities. However, this limitation does not apply to eligible individual account plans. See ERISA Act sections 407(a) and (b).

An ESOP is an eligible individual account plan, unless its benefits are taken into account in determining the benefits payable to a participant under any defined benefit plan. See ERISA 407(d)(3)(C). This means an ESOP cannot be used to offset the benefits under a defined benefit plan in a floor-offset arrangement, effective with respect to arrangements established after 12/17/87. After that effective date, a floor-offset arrangement is treated as a single plan for purposes of the 10% limit. Where the 10% limit is exceeded, a prohibited transaction has taken place under IRC 4975(c)(1)(A) due to the sale or exchange of employer securities between a plan and a disqualified person which is not exempt under IRC 4975(d)(13), if there is a transaction with a disqualified person.

In addition, Regulation § 1.401(a)-20, Q&A –5 provides that any plan that would not otherwise be subject to the survivor annuity requirements of sections 401(a)(11) and 417 whose benefits are used to offset benefits in a plan subject to such requirements is subject to the survivor annuity requirements with respect to those participants whose benefits are offset. Thus, there is a question as to whether any benefit provided by an ESOP can be used to offset a defined benefit without violating either IRC section 401(a)(11) or 409(h) requirements, due to QJSA and QPSA requirements of the offset portion in the ESOP in contravention of the ESOP requirement to permit the participant to be able to demand their distribution entirely in qualifying employer securities.

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Floor offset arrangements, Continued

Examination Steps-floor offset

1. Determine whether the employer maintains any defined benefit plans.

2. If yes, determine whether the benefits provided by the defined benefit plan are reduced by benefits under the ESOP in an arrangement established after 12/17/87.

3. Determine whether the value of the employer securities exceeds 10% of the combined assets of the ESOP and the defined benefit plan.

4. If yes, impose the prohibited transaction tax on the fair market value of the employer securities that exceeds 10% of the assets of the combined plans, if there is a transaction with a disqualified person.

5. If yes, also consider the potential qualification issues under IRC sections 401(a)(11), 417 and 409, based on the QJSA/QPSA requirements of Regulation § 1.401(a)-20, Q&A –5 and the conflicting ESOP requirements contained in IRC section 409(h).

Valuation and independent appraiser

Valuation and Independent Appraiser

Since ESOPs are designed to invest primarily in employer securities, the examination of this type of plan necessitates that you be able to determine the fair market value of qualified employer securities.

TRA '86 enacted IRC section 401(a)(28)(C) which provides that employer securities acquired by an ESOP (whether by contribution or purchase) after 12/31/86 that are not readily tradable on an established securities market must be valued by an independent appraiser (within the meaning of IRC section 170(a)(1)). Valuation by an independent appraiser is not required in the case of employer securities that are readily tradable on an established securities market. See IRM 4.72.8, Technical Guidance on Valuation Assets for a detailed discussion of the independent appraiser rules for non-publicly traded shares held by an ESOP.

Valuation must be made in good faith

Regulation § 54.4975-11(d)(5), *Valuation*, provides that the valuation must be made in good faith and based on all relevant factors for determining the fair market value. In the case of a transaction involving the plan and a disqualified person, the value must be determined as of the date of the transaction. For all other purposes, the fair market value must be determined as of the most recent valuation date under the plan.

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Valuation and independent appraiser, Continued

Examination Steps-valuation

1. The balance sheet on Form 5500 provides information such as whether investments are in employer securities, acquisition indebtedness, other liabilities (indicates leverage), and/or party-in-interest transactions.

   In smaller plans, determine whether a valuation was made by adding the assets at the beginning of the year to the contributions and receipts less the disbursements during the year and comparing the total to the assets at the end of the year. If the total equals the assets at the end of the year, a valuation probably has not been made because the total only reflects the receipts and disbursements.

2. When reviewing the income statement, note any non-cash contributions as these may also indicate the acquisition of employer securities.

3. Where stock is publicly traded, examine stock confirmation slips, trust receipt and disbursement accounts, and market records to verify the fair market value of security transactions.

4. Review the applicable question on the Form 5500 series return concerning independent appraisers to determine whether employer securities held in an ESOP that are not readily tradable on an established securities market were valued by an independent appraiser. Secure and analyze the appraisal report.

5. Where stock is not publicly traded, ensure that for stock acquired after 12/31/86 that such stock is valued by an independent appraiser, as required by IRC section 401(a)(28)(C). If the transaction does not involve a disqualified person, the fair market value must be determined as of the plan's most recent valuation date. Examine the records used to value the stock at the last valuation date in order to determine whether the assigned value is comparable to the value of comparable non-publicly traded companies. See Reg. § 54.4975–11(d)(5). The stock held by the plan should be valued at least annually, as required for qualified plans. See Rev. Rul. 80-155.

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Valuation and independent appraiser, Continued

Examination Steps-valuation (continued)

6. Where stock is not publicly traded and the transaction involves a disqualified person, the fair market value must be determined as of the transaction date. Secure the appraisal report, if any, and use it as a basis for verifying the adequate consideration rules. If possible, request both the prior and subsequent appraisals for comparison purposes.

   If the appraisal method is not consistently applied, inquire as to the reason for the change. In addition, determine whether any projections used were reasonable estimates of what has actually occurred. In addition, consider the presence and/or absence of assumptions used in the appraisal such as discounts due to lack of marketability and/or minority ownership. Note: Particular attention should be given to subsequent events that could have been foreseen and have an impact on value. See Rev. Rul. 59-60, 1959-1 C.B. 237. The independent appraisal will not in itself be a good faith determination.

   Also, examine the capital stock accounts of the employer to substantiate transactions of similar stock. Another source of information related to stock sales might include a review of corporate minutes. If there is a problem with the stock valuation, use Form 5202, "Request for Engineering Service" to request assistance from the Examination engineer.

Effect of improper valuation

Fiduciary is responsible for proper valuation

The fiduciary is responsible for determining that employer securities are properly valued. It is not enough for a fiduciary to rely in good faith on a third party valuation to establish that adequate consideration was paid. A fiduciary must make his/her own prudent investigation of value and determine that the underlying assumptions on which the valuation was made have not changed at the time the ESOP purchases the shares. See Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983) and Revenue Ruling 59–60.

A PT occurs if an ESOP pays a disqualified person too much

There is a prohibited transaction if an ESOP pays a disqualified person too much for employer securities. This may occur due to an improper valuation of employer stock that is closely-held. See Eyler v. Commissioner, No. 95-2482, U.S. Court of Appeals, 7th Circuit, 88 F.3d 445.

If stock is overvalued

Where stock contributed to the plan is overvalued at time of contribution, the result could be a partial disallowance of the deduction taken. If the stock contributed is undervalued, the effect could be a potential violation under IRC section 415 (depending on the amount of stock contributed and allocated).

Example

For the plan year ended December 31, 1999, the plan sponsor contributed 10,000 shares of employer securities to their plan, valued at $15 per share. A deduction of $150,000 was taken on the Form 1120 for the tax year ended December 31, 1999 with respect to such contribution.

Upon examination, the agent determined that no independent appraisal had been performed and that the value was an estimate made by the CEO. Subsequent development in the case resulted in a determination that the fair market value of the shares contributed was actually closer to $10 per share. The result was a disallowance of $50,000 for the Form 1120 for the tax year ended December 31, 1999.

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Effect of improper valuation, Continued

Example

Same facts as previous example, except that the fair market value of shares contributed was subsequently determined to equal $30 per share. Note that the employer still only deducted $150,000 based on their valuation. In addition, based on a fair market value of $30 per share, one HCE received an allocation for 1999 of $60,000.

The maximum deductible limit under IRC section 404 (taking into consideration IRC section 404(j)) was determined to be $200,000 for the tax year ended December 31, 1999. The result is that a nondeductible contribution of $100,000 was made ($200,000 – (10,000 shares X $30/share)). As a result, a Form 5330 with excise tax of $10,000 is due under IRC section 4972 (10% of $100,000). In addition, as one participant's allocation exceeded the IRC section 415 limits by an amount of $30,000, this operational failure affecting plan qualification should also be addressed and corrected. Finally, based on the revised valuation, the employer is entitled to an additional deduction of $50,000 for the tax year ended December 31, 1999 (assuming plan retains qualified status).

Unless exception applies, pt occurs for transaction between a plan and a DP

There is a prohibited transaction if there is a sale of any property between a plan and a disqualified person (e.g., an employer) unless the prohibited transaction exception below applies. See IRC sections 4975(e)(2)(C) and 4975(c)(1)(A).

Exception-adequate consideration

The prohibited transaction exception applies where the sale is for "adequate consideration". See IRC section 4975(d)(13) and ERISA Act section 408(e). Adequate consideration is defined as the fair market value of the security as determined in good faith by the plan trustee or named fiduciary. See ERISA Act section 3(18).

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Effect of improper valuation, Continued

Potential exclusive benefit violation-RR 69-494

In addition to a prohibited transaction occurring due to an improper valuation of stock acquired or sold, an exclusive benefit violation may occur if an ESOP acquires stock **for more** than its fair market value, (e.g., the stock is acquired from a shareholder). A decision to pursue an exclusive benefit violation, in addition to prohibited transactions, should be considered only when the scope of the transactions are substantial in relation to total plan assets and should be determined based on the relevant facts and circumstances.

Revenue. Ruling 69–494, 1969–2 C.B. 88, provides guidelines for determining whether a plan investment is consistent with the exclusive benefit rule. These guidelines, as applied to ESOPs, require a determination of whether the amount paid for the stock exceeds its fair market value at the time of acquisition. (All requirements of Rev. Rul. 69–494 do not apply to stock bonus plans and ESOPs.)

An exclusive benefit violation should be considered only where there is a significant depletion of plan assets.

Examination steps-valuation

Determine whether fair market value was used

Determine whether fair market value was utilized in the acquisition, sale or non-cash contribution of employer stock.

If the stock is not publicly traded, request copies of the most recent independent appraisals of employer securities. Consideration should also be given to requesting prior and subsequent years' appraisals for comparison purposes.

Failure to value non-publicly traded stock by utilizing an independent appraiser is a qualification failure under IRC section 401(a)(28)(C) that should be pursued. Corrective options include requiring the taxpayer to secure the services of an independent appraiser to make the appropriate appraisals for the pertinent periods or dates of transactions.

Review valuation report

Look at the valuation report on the company's shares. See if the company that makes products has share prices that rise and fall with its earnings. If the company's earnings have fallen but the report says the price per share has risen, it may indicate an incorrect valuation. Also check the correlation between earnings and stock price if there is no valuation report.

Check employer's audit report and documentation

Check the employer's audit report to see if the company's earnings have fallen after the valuation report was written. If they have, it is likely the shares' value should also have fallen. The plan fiduciary can no longer rely on the price per share from the valuation report because the facts on which it was based have changed.

Ask to see documentation of the fiduciary's prudent investigation to ensure the underlying assumptions have not changed since the last valuation.

Determine whether stock appraisal reflects certain factors

Determine whether the stock appraisal reflects the appropriate factors for determining value contained in Rev. Rul. 59-60, including an adjustment to the stock value due to lack of marketability and/or minority ownership (by the ESOP), if applicable.

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Examination steps-valuation, Continued

Evaluate stock purchases for exclusive benefit violation

Evaluate stock purchases for exclusive benefit violations by applying the fair market value rules of Rev. Rul. 69–494 at the time of the initial purchase and again at the time of any subsequent purchase. Even if the initial purchase did not violate the exclusive benefit rule, a subsequent purchase may have resulted in a violation.

Although technically an exclusive benefit violation, a violation of the exclusive benefit rule generally should not be pursued where it appears employer securities were acquired at an inflated price but the stock subsequently increased in value with the result that a benefit to plan participants has occurred.

If such stock was acquired from a disqualified person, imposing the excise tax under IRC section 4975 would still be appropriate.

If stock purchased at FMV, but later declines in value

Note that neither a prohibited transaction nor a violation of the exclusive benefit rule will occur merely because employer securities acquired at fair market value later decline in value.

Ask for engineering assistance

If you have concerns about the validity of a stock appraisal, consideration should be given to requesting Engineering Assistance.

Voting rights

If employer has registration type class of securities

Employer securities held by an ESOP must meet the IRC section 409(e) requirements pertaining to voting rights.

If the employer has a "registration-type class of securities," each participant must be entitled to direct the plan as to the manner in which employer securities, allocated to the account of such participant, are to be voted. A registration-type class of securities means a class of securities required to be registered under section 12 of the Securities Exchange Act of 1934.

If employer does not have registration type class securities

If the employer does not have a registration-type class of securities, each participant must be entitled to direct the plan as to the manner in which voting rights under employer securities, allocated to the account of such participant, are to be exercised with respect to any corporate matter which involves the voting of such shares with respect to the:

- approval or disapproval of a corporate merger or consolidation,
- recapitalization,
- reclassification,
- liquidation,
- dissolution, or
- sale of substantially all assets of a trade or business.

Right to direct plan as to voting depends on applicable state law

The right to direct the plan as to the voting of allocated securities in the above instances exists only if the applicable state law also provides for shareholder voting in those instances. IRC section 409(e)(5) also provides for a special "1 vote participant' rule for non-registration-type class of securities. This special rule permits the voting of an issue with each participant allowed 1 vote with respect to the issue, with the trustee voting the shares held by the plan in proportion to the votes received.

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Voting rights, Continued

Voting rights and unallocated shares

The voting rights above do not have to be passed through to the participant with respect to unallocated shares. It is not uncommon for plan provisions to provide for the voting of unallocated shares in the same proportional manner as the directions received by the fiduciary for the voting of the allocated shares. However, the Department of Labor has held that the responsibility for voting unallocated shares should rest with the plan trustee. The plan trustee may follow plan provisions only to the extent permitted by ERISA Act section 404(a)(1)(D), i.e., insofar as such plan provisions are consistent with the provisions of Titles I and IV of ERISA. See DOL Advisory Opinion Letter (unnumbered) dated 2/23/89.

If plan trustee does not receive voting instructions

If a plan trustee does not receive voting instructions on employer securities allocated to a participant's account, the plan can provide that the trustee will vote those shares. See Rev. Rul. 95–57, 1995–35 I.R.B. 5.

Examination Steps

1) Check the plan terms to make sure participants are entitled to vote employer securities allocated to their accounts.

2) Check the summary plan description to make sure participants are aware of their right to vote allocated employer securities in accordance with IRC section 409(e).

3) Check the corporate minutes to determine whether any events occurred that entitle participants to pass-through voting. If yes, then verify that the participants were given the right to the vote on the applicable issue.

Diversification

Introduction

For employer securities acquired after 12/31/86, IRC section 401(a)(28)(B) provides that each qualified participant in a plan may elect, within 90 days after the close of each plan year in the qualified election period, to direct the plan with regard to the investment of at least 25% of the participant's plan account.

The account balance subject to the diversification election increases to 50% in the final year of the election period.

Determining the number of shares subject to diversification

Q&A–9 of Notice 88–56, 1988–1 C.B. 540, provides that the portion of a qualified participant's account subject to the diversification election in all years of the qualified election period (other than the final year) is equal to

(1) 25% of the number of shares of employer securities acquired by the plan after 12/31/86, that have ever been allocated to a qualified participant's account, less

(2) the number of shares of employer securities previously diversified pursuant to a diversification election made after 12/31/86.

Defining qualified participant, years of participation and qualified election period

A "qualified participant" is any employee who has completed at least 10 years of participation in the plan and has attained age 55.

In determining years of participation in the plan, include years the employee participated in a predecessor plan.

The "qualified election period" is the 6 plan year period beginning with the later of the first plan year

(1) in which the individual first becomes a qualified participant, or

(2) beginning after 12/31/86.

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Diversification, Continued

Three methods to satisfy diversification

There are three methods by which a plan can satisfy the diversification requirement. The first two are statutory and appear in IRC section 401(a)(28)(B)(ii).

- First, the plan can provide that the portion of the participant's account subject to the diversification election is distributed within 90 days after the period in which the election can be made.
- Second, the plan can offer at least three investment options to each participant making the diversification election, and within 90 days after the election period ends, the plan invests the portion of the amount in accordance with the diversification election.
- Third, the plan can offer a participant the option to direct the plan to transfer the portion of the account subject to the diversification election to another qualified defined contribution plan of the employer that offers at least three investment options. This transfer must be made no later than 90 days after the end of the election period. See Notice 88–56, Q&A–13.

Example

Participant A, who participates in the ABC Corp ESOP, attains age 55 with 10 years of participation in the plan year ended December 31, 1999. Participant A has 200 shares of stock, valued at $25 per share, which were contributed after December 31, 1986 as of the end of this plan year.

Participant A is a qualified participant entitled to elect diversification of up to 50 shares in the 90-day election period beginning January 1, 2000 (25% of 200 shares).

In addition, Participant A will be eligible to elect diversification during the subsequent election periods in 2001, 2002, 2003, 2004 and 2005 (50% in the election period in 2005).

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Diversification, Continued

Example

Same facts as previous example. For the plan year ended December 31, 2000, an additional allocation of 40 shares of stock is allocated to Participant A's account.

Assuming that Participant A only elected diversification of 20 shares in the 1st election period, Participant A would be eligible to elect diversification of an additional 40 shares in the 2nd 90-day election period beginning January 1, 2001 (25% of 240 cumulative shares minus 20 shares previously diversified).

Examination Steps

1) Determine which plan participants meet the age (55) and service (10 years of participation) requirements to qualify as "qualified participants," if any.

2) Inquire about any potential predecessor plans, to determine if additional years of participation should be considered in the determination of the "qualified participants."

3) Check that the plan provides a diversification election for employer securities acquired after 12/31/86. Ensure that all qualified participants were given the right to diversify, and that such right was handled within the prescribed time frames.

Non-terminable ESOP provisions and 411(d)(6)

Introduction

After an ESOP ceases to be an ESOP (such as when the plan is amended and converted into a non-ESOP plan), an employee's right to put non-readily tradable employer securities to the employer must continue to apply. It is a non-terminable right described at Reg. § 54.4975–11(a)(3)(ii). However, a plan that is no longer an ESOP is not required to be primarily invested in employer securities because the right to a particular form of investment is not an IRC section 411(d)(6) protected benefit.

Section 411(d)(6)

IRC section 411(d)(6) and the regulations thereunder provide that a plan will not satisfy the requirements of IRC 411 if the accrued benefit, early retirement benefit, retirement-type subsidy or optional forms of benefits of participants are eliminated or reduced by a plan amendment. IRC section 411(d)(6)(C) provides an exception to the IRC section 411(d)(6) prohibitions for ESOPs with respect to modifying distribution options (provided the modification is made in a non-discriminatory manner per the regulations).

Reg. § 1.411(d)–4, A–2(d) provides guidance on the elimination, with respect to all participants, of IRC section 411(d)(6) protected optional forms of benefits applicable to ESOPs. It is not an impermissible cutback if the employer eliminates, or retains the discretion to eliminate, the lump sum or installment option with respect to all participants, provided such elimination is consistent with the distribution and payment requirements applicable to such plans (e.g., those required by IRC section 409).

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Non-terminable ESOP provisions and 411(d)(6), Continued

Right to employer stock can be eliminated in certain situations

If the employer becomes substantially employee-owned, or the employer is an S corporation (for taxable years of the employer beginning after December 31, 1997), the right to demand a distribution in employer stock, with respect to all participants, can be eliminated and cash can be substituted instead.

Where employer securities become readily tradable, the employer can eliminate the right to demand a distribution in cash and instead provide that the distribution will be made in the form of employer securities.

Where employer securities cease to be readily tradable, a distribution in the form of employer securities can be eliminated and cash can be substituted instead.

If the employer securities continue to be readily tradable, but substantially all of the employer stock or assets of the employer's business are sold, a distribution in the form of employer securities can be eliminated and cash can be substituted instead. Although the Commissioner can provide additional rules and exceptions in revenue rulings, notices and other documents of general applicability, this has not been done at this time.

Examination Steps

1) In an ESOP amended to become a non-ESOP, make sure the right to put non-readily tradable employer securities to the employer is not eliminated.

2) Determine whether optional forms of benefits that have been eliminated comply with the exceptions for ESOPs under Reg. § 1.411(d)–4, Q&A 2(d).

3) If during the year of examination, a plan eliminates the right to receive lump sum distributions and instead just provides for installment distributions, please review the plan operation to ensure that the criteria in Reg. § 1.411(d)-4, Q&A 2(d)(i) is satisfied. Such elimination of the lump sum distribution must result in plan terms and operation providing that the remaining distribution options are consistent with ESOP requirements (such as the right to demand QES and the IRC section 409(o) rights). In addition, the elimination of the lump sum option should apply to <u>all participants</u>, not just a certain group.

Section 415 limits

Stock acquired in an exempt loan—how annual additions are calculated

An ESOP may be funded through an exempt loan (a leveraged ESOP) or may be funded directly by employer contributions (non-leveraged ESOP).

Employer securities held by a leveraged ESOP are released from the suspense account and allocated to participants' accounts by reason of employer contributions to the ESOP to repay the loan and by reason of the use of dividends on employer securities in the ESOP to repay the loan.

If stock has been acquired in an exempt loan, annual additions under IRC section 415(c) can be calculated under either of two methods. The annual additions can be determined either with respect to

(1) the amount of the employer contributions to the ESOP used to repay a loan, or

(2) the value of the employer securities allocated to participants. Plan terms should specify the method used. See Reg. § 1.415-6(g)(4) and Notice 87-21, Q&A 11.

If the annual additions are calculated with respect to employer contributions, appreciation in the stock's value from the time it entered the suspense account will not be counted for IRC section 415 purposes. See Regs. § 1.415-6(g)(4), 54.4975–11(a)(8)(ii) and § 54.4975–7(b)(8)(iii).

If ESOP not funded by an exempt loan

If an ESOP is not funded by an exempt loan, the fair market value of the employer securities on the date they were contributed to the ESOP is treated as an annual addition. See Reg. § 1.415–6(b)(4).

Continued on next page

Section 415 limits, Continued

Special rule for determining annual additions—415(c)(6)

IRC section 415(c)(6) provides for a special rule in determining annual additions made to an ESOP. If not more than one-third of the employer contributions to an ESOP for a plan year are allocated to the accounts of participants who are highly compensated employees, within the meaning of IRC 414(q), then all forfeitures of leveraged stock and all employer contributions used to pay interest on a leveraged loan which are charged against the participant's account are eliminated from the computation of the annual addition. This should be stated in plan. This is called a broad-based ESOP.

Court Cases that have sustained the Service's position with respect to excess annual additions made to ESOPS include Steel Balls, Inc. v. Commissioner, Docket No. 13492-93R, U.S. Tax Court, T.C. Memo 1995-266, Howard E. Clendenen, Inc. v. Commissioner, No. 98-4183, U.S. Court of Appeals, 8th Circuit, 207 F.3d 1071 and Roblene v. Commissioner, No 21576-95R, U.S. Tax Court, T.C. Memo 1999-161.

Continued on next page

Section 415 limits, Continued

Examination Steps

1) Determine whether the ESOP is funded by an exempt loan or by direct employer contributions.
2) If the ESOP is not funded by an exempt loan, ensure the fair market value of stock on the date it was contributed to the ESOP is treated as an annual addition.
3) If the ESOP is funded by an exempt loan, determine whether annual additions are calculated based on employer contributions to repay the loan, or based on the fair market value of the employer securities when allocated to participant accounts. Review the terms of the plan to determine the method used when testing for the IRC section 415 limits.
4) If annual additions are calculated based on employer contributions to repay an exempt loan, a separate computation will be necessary to arrive at each participant's share of the contribution used by the ESOP to repay the loan.

   Analyze the encumbered stock account and the liability accounts of the trust to determine the number of shares released from encumbrance and the employer contribution, so that a contribution per released share can be determined. Then, multiply the number of released encumbered shares allocated to a participant's account by the cost per released share in order to arrive at an amount to be used to verify compliance with IRC section 415. Do not include shares released due to the payment of dividends. Also, if you are examining a broad-based ESOP, do not include shares released due to the payment of loan interest. The formula is:

   <u>TOTAL CONTRIBUTION TO PAY LOAN</u>
   TOTAL NUMBER OF RELEASED SHARES
   = COST PER RELEASED SHARE

5) Determine whether more than 1/3 of employer contributions to a leveraged ESOP were allocated to the accounts of highly compensated employees. If yes, check that annual additions include forfeitures of employer securities and employer contributions used by the ESOP to pay interest on loans to acquire employer securities.
6) Check the plan document to see if it permits the plan to use the special ESOP rules under IRC section 415(c)(6).

Tax credit ESOPs

Tax Credit ESOPS

Prior to 1987, the statutes provided for two other types of ESOPS. Taxpayers were allowed tax credits, as well as deductions, for contributions made to Tax Reduction Act Stock Ownership Plans (TRASOPS), which were subsequently replaced by the Payroll Based Stock Ownership Plans (PAYSOPS). However, as both the PAYSOP and TRASOP rules have been repealed for several years, they will not be covered by this chapter. If you need information relating to these types of ESOPS, refer to IRM 4.72.4.1.3.

Deduction Limits

Deduction Limits – Leveraged ESOP Deductions

There are special deduction rules for contributions to an ESOP used to repay principal and interest on a loan to an ESOP. See IRC section 404(a)(9).

Under the general rule of IRC section 404(a)(3), an employer's deduction for contributions to a stock bonus or profit-sharing plan is limited to 15% of the participants' compensation. Under the general rule of IRC 404(a)(7), where an employer maintains one or more defined contribution plans and one or more defined benefit plans, an employer's deduction for contributions for all plans is the greater of 25% of compensation or the amount necessary to meet the minimum funding standards of IRC section 412. See IRC section 404(a)(7).

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Deduction Limits, Continued

Exception to use to pay back ESOP loan

IRC section 404(a)(9)(A) provides that notwithstanding the provisions of IRC sections 404(a)(3) and (a)(7), an employer's deduction for contributions paid to an ESOP to repay the principal on a loan used to acquire qualifying employer securities can be as high as 25% of the ESOP participants' compensation.

In addition, there is no limit on the employer's deduction with respect to contributions to an ESOP applied toward the payment of interest on the exempt loan. The ESOP must actually use the employer contributions to repay the exempt loan by the due date of the employer's return (including extensions) to take advantage of these increased limits.

Company M maintains a leveraged ESOP. For the 1997 plan year, Company M makes a contribution of 30% of the participants' compensation to repay principal and interest on the ESOP loan: 25% of compensation was used to repay the principal on the loan and 5% of compensation was used to repay the interest on the loan. The entire 1997 contribution is deductible under IRC section 404(a)(9).

Deduction Limits – IRC section 404(k) (dividend deduction) – Pre-EGTRRA (prior to 2002)

In addition to the deduction permitted under IRC sections 404(a)(3) or 404(a)(9), a C Corporation may deduct dividends (called applicable dividends) under IRC section 404(k) paid on employer securities held by an ESOP if such dividends are

(i) paid in cash to the participants or their beneficiaries,

(ii) paid to the plan and distributed in cash to the participants or their beneficiaries within 90 days after the close of the plan year in which the dividends are paid to the plan, or

(iii) used to repay an ESOP loan. Note that this deduction for dividends is not allowed for S Corporations.

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Deduction Limits, Continued

If dividends used to repay loans

If dividends on allocated stock are used to repay a loan, the fair market value of employer securities released from suspense and allocated to participants' accounts must equal or exceed the amount of such dividends. This allocation due to the use of dividends is in addition to the allocation due to the loan repayment.

[Note: The stock released due to use of dividends on allocated shares should be allocated to the respective participant's stock account associated with the applicable dividend].

If employer securities paying dividends were acquired after 8/4/89

If the employer securities paying the dividends were acquired after 8/4/89, such dividends are deductible under IRC section 404(k)(2)(A)(iii) only if they are used to repay a loan the proceeds of which were used to acquire the employer securities that are paying the dividends.

However, dividends on employer securities that were not acquired in an exempt loan, but were acquired by an ESOP before 8/5/89, can be used to repay a loan the proceeds of which were used to acquire employer securities and deducted under IRC section 404(k).

Example-facts

Company M maintains an ESOP that acquired qualified employer securities in an exempt loan in 1994. Also in 1994, Employer M terminated a profit-sharing plan and permitted participants to have a direct transfer of their profit sharing plan accounts to the ESOP. The cash transferred from the profit-sharing plan to the ESOP is reinvested in employer securities. The exempt loan obtained by the ESOP is repaid with contributions made by Company M and with cash dividends paid on the qualified employer securities held by the ESOP which were purchased with the exempt loan proceeds.

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Deduction Limits, Continued

Example-analysis

Company M can claim a dividend deduction under IRC section 404(k) for the dividends paid on the securities acquired in the exempt loan that are used to repay the loan.

Company M cannot claim a dividend deduction under IRC section 404(k) to the extent the exempt loan was repaid with cash dividends paid on employer securities purchased with the funds transferred from the terminated profit-sharing plan. This is because, although these employer securities were acquired by the ESOP after 8/4/89, they do not relate to employer securities acquired with the proceeds of the exempt loan.

Disallowing a deduction

Disallow an IRC section 404(k) dividend deduction if the dividend constitutes, in substance, an evasion of taxation or is not a dividend as defined in IRC section 316. See IRC section 404(k)(5)(A). This determination will depend on the facts and circumstances relating to the declaration and issuance of dividends.

Example

Amounts paid that exceed accumulated and current earnings and profits may not constitute a dividend. Amounts that constitute the payment of unreasonable compensation, or are not reasonable dividends, are an evasion of taxation and cannot be deducted as dividends under IRC section 404(k). An example of a reasonable dividend is one that is at a rate normally paid by the employer in the ordinary course of business.

Example

Company M repays an exempt loan with dividends on employer securities acquired with exempt loan proceeds. Company M claims a dividend deduction under IRC section 404(k). You ascertain the dividend rate is 70%, and that this is an extraordinary dividend that is greatly in excess of the dividend Company M can reasonably be expected to pay on a recurring basis. These dividends are not reasonable and are not deductible under IRC section 404(k).

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Deduction Limits, Continued

Redemptions of stock are not dividends

Corporate payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants do not constitute "applicable dividends" under IRC section 404(k)(5)(A) and are not deductible. See Rev. Rul. 2001–6, 2001–6 I.R.B. 491.

Moreover, any deduction for such payments in redemption of stock is barred under section 162(k).

Examination Steps

1) Cancelled checks, payroll records, trust receipts and disbursement records, and participant's accounts should be examined to determine whether the IRC section 404 limits have been exceeded. Problems could also arise if the number of participants decreased so as to lower the deductible limits.
2) Look at the applicable question on Schedule E, ESOP Annual Information, of Form 5500, to find out whether the employer repaid the exempt loan using dividends on employer securities.

3) Look at the question on Schedule E with regard to whether any dividends used to repay an exempt loan were not generated by employer securities acquired in that exempt loan. If the answer is yes, find out if the employer securities paying those dividends were acquired after 8/4/89. If yes, disallow the deduction.

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Deduction Limits, Continued

Examination Steps (continued)

4) Determine whether the amount of dividends paid exceed the employer's current or accumulated earnings or profits under IRC section 316. Review the question on Schedule E of Form 5500 for this information. If yes, disallow the deduction.

5) Check whether the dividends paid on employer securities held by the ESOP are reasonable. A reasonable dividend does not include an unusually large dividend used to repay ESOP debt, which is greatly in excess of the dividend the ESOP sponsor can reasonably be expected to pay on a recurring basis. A reasonable dividend is one that is at a rate normally paid by the sponsor in the ordinary course of business.

6) Determine whether any corporate redemptions of ESOP stock were deducted under IRC section 404(k). If yes, disallow the deduction. Refer to Rev. Rul. 2001-6, I.R.B. 2001-6 for an example and description of an improper deduction of a corporate redemption of stock from the ESOP.

Deduction limits—EGTRRA (Post 2001)

Change by EGTRRA

IRC section 404(k)(2), relating to the deduction of applicable dividends to an ESOP, was expanded by EGTRRA, effective for tax years beginning after 12/31/01. The law was liberalized to permit the deduction of applicable dividends of an ESOP, where the applicable dividends, in accordance with plan terms, are either:

1) Paid in cash directly to the participant or beneficiary,

2) Paid to the plan and later distributed in cash to either the participant or beneficiary no later than 90 days after the close of the plan year in which paid,

3) At the election of the participant or beneficiary, the dividends are paid to the ESOP and reinvested in employer securities. This preceding election is only permitted where the plan also provides that the participant can alternatively elect that the dividends be paid in cash as described in (1) or (2) above (plan can offer one or both options, as described in Notice 2002-2, Q&A-2), or

4) Used to make payment on an exempt loan, the proceeds of which were used to acquire employer securities (whether or not allocated to participants) with respect to which the dividend is paid. Note that this rule is still subject to the IRC 404(k)(2)(B) limitation if the dividends arise from allocated shares (i.e., employer securities released and allocated to the participant must have FMV no less than amount of dividends used).

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Deduction limits—EGTRRA (Post 2001), Continued

Applicable dividends must be fully vested, 404(k)(7) if election to pay dividends to ESOP

Applicable dividends that are deducted by the corporation must be fully vested if the participant makes the election to pay such dividends to the ESOP and reinvest them in employer securities. See Notice 2002-2, Q&A 9 and IRC section 404(k)(7).

> Therefore, an ESOP must provide that a participant is fully vested in any dividend with respect to which the participant is offered the election under IRC section 404(k)(2)(A)(iii).

Under prior law, with respect to dividends retained by the plan, these dividends constituted applicable dividends under IRC section 404(k) only if used to make payments on an exempt loan.

The EGTRRA law change will now permit the deduction of dividends paid to the ESOP, even if not used to service the exempt loan, if the plan also permits the participant the option to elect to have the dividends paid in cash pursuant to either election (1) or (2) above.

Timing of deduction

For the rules relating to the timing of the deduction, refer to Notice 2002-2, I.R.B. 2002-2, 285 (January 14, 2002). In general, the new deduction rules permit a deduction for the dividend for taxable years beginning on or after 1/1/02. With respect to dividends that are reinvested in the ESOP, the deduction is allowed under the new rules if the later of the date on which the dividend is reinvested in employer securities or the date on which the participant's election becomes irrevocable occurs in 2002.

The timing of the deduction is such that the applicable dividend becomes deductible in the later of the taxable year of the corporation in which the dividend is reinvested in employer securities or the date on which the participant's election becomes irrevocable. Dividends paid to the plan and distributed to participants within 90 days after the end of the plan year are deductible in the taxable year of the corporation in which the dividend is paid or distributed to the participant. See Q&A-4 of Notice 2002-2.

Refer to Notice 2002-2 for additional guidance, such as conditions related to the manner of election by the participant, the impermissible designation of a plan as an ESOP (must be an ESOP as of the record date for the dividend), and examples of the new deduction rules.

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Deduction limits—EGTRRA (Post 2001), Continued

Secretary may disallow deduction if dividend constitutes an avoidance of taxation etc.

EGTRRA also amended IRC section 404(k)(5)(A) to provide that the Secretary may disallow the deduction for any dividend under IRC section 404(k)(1) if the Secretary determines that the dividend constitutes, in substance, an avoidance or evasion of taxation. This includes the authority to disallow a deduction for unreasonable dividends.

With respect to dividends reinvested under §404(k)(2)(A)(iii), a dividend paid on common stock that is primarily and regularly traded on an established securities market (within the meaning of §54.4975-7(b)(1)(iv) of the Excise Tax Regulations) is presumed to be a reasonable dividend.

In the case of a corporation with no outstanding common stock (determined on a controlled group basis) that is primarily and regularly traded on an established securities market, a determination regarding whether the dividend is reasonable is made by comparing the dividend rate on the stock held by the ESOP with the dividend rate for common stock of comparable corporations whose stock is primarily and regularly traded on an established securities market.

Whether a closely held corporation is comparable to a corporation whose stock is primarily and regularly traded on an established securities market is determined by comparing relevant corporate characteristics such as industry, size of the corporation, earnings, debt-equity structure, and dividend history. See Notice 2002-2, I.R.B. 2002-2, Q&A 11.

Exempt Loans

Definition of Exempt Loan

This section describes the requirements for an exempt loan. The failure of a plan to follow these rules will result in the loan failing to be exempt under Code section 4975 and subject to the prohibited transaction excise tax. Failure to follow these rules does not cause the plan to become non-qualified.

An exempt loan is a loan that meets the requirements of Reg. § 54.4975–7(b). A non-exempt loan is a loan that fails to satisfy the requirements of Reg. § 54.4975–7(b).

An exempt loan is a loan made to an ESOP by a disqualified person or a loan to an ESOP from a third party that is guaranteed by a disqualified person. See Reg. § 54.4975–7(b)(1)(ii). Generally, these kinds of loans are prohibited transactions under IRC section 4975(c)(1)(B) because they constitute the direct or indirect lending of money or other extension of credit between a plan and a disqualified person. IRC section 4975(d)(3) provides that if the requirements for that section are met, such loans to an ESOP are exempt from the prohibited transaction rules.

The failure of a plan to follow the exempt loan rules results in the loan being non-exempt and subject to the prohibited transaction tax. Such failure to follow the rules does not cause the plan to be disqualified or lose its status as an ESOP.

Examination Steps

If during the course of an examination of an ESOP with exempt loan provisions, you determine that the loan is non-exempt, treat as a prohibited transaction under IRM 4.72.11, Prohibited Transactions. The effect is that the direct or indirect extension of credit applicable to the exempt loan would no longer be exempt.

Other issues that may arise include the loss of certain special deduction rules for leveraged ESOPS, as well as the loss of the certain interest and forfeitures applicable to the exempt loan that would now be considered annual additions under IRC section 415(c)(6).

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Exempt Loans, Continued

Primary Benefit Requirement

An exempt loan must be primarily for the benefit of the ESOP participant and their beneficiaries. All the surrounding facts and circumstances should be considered in determining this requirement.

At the time an exempt loan is made, the interest rate for the loan and the price of securities acquired with the loan proceeds should not be such that the plan assets might be drained off.

The terms of the loan must be at least as favorable as the terms of a comparable loan resulting from an arm's-length negotiated transaction between independent parties.

The loan should be for a specific term and not payable on demand. See IRC section 4975(d)(3) and Reg. § 54.4975-7(b)(3), (b)(7) and (b)(13).

Examination Steps

1) Secure a copy of the loan documents related to the existing exempt loan. The loan document should be scrutinized to determine whether the terms of the loan were reasonable as of the date the loan was made and of the date that the qualified employer securities were purchased. Determine whether the interest rate for the loan and the price paid for the securities would have had the effect of draining off plan assets. The prime interest rate, rates for similar transactions, rates charged by banks, and rates charged by other financial institutions should be used as a measuring device to determine an acceptable interest rate.

2) Scrutinize the loan against prior loans of the same nature and loans to other entities to determine whether arms-length dealing existed. Items to be compared are interest, cost of assets purchased, collateral, pre-payment penalties, and any other provisions or restriction in the terms of the loan.

3) For purposes of determining whether fair market value was paid for the securities, refer to the earlier chapter segments, relating to valuation of employer securities.

4) Any other facts and circumstances relating to the loan can be used to substantiate compliance with or violation of the primary benefit requirement.

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Exempt Loans, Continued

Use of Loan Proceeds

Exempt loan proceeds must be used by an ESOP within a reasonable amount of time after their acquisition by the ESOP:

1) to acquire qualifying employer securities;

2) to repay the loan; or

3) to repay a prior exempt loan.

Securities acquired with exempt loan proceeds may not be subject to a put, call, or other option, or buy-sell or similar arrangement while held by the ESOP or when distributed from the ESOP, other than the right of first refusal and the IRC section 409(h) put option. See Reg. § 54.4975–7(b)(4).

Examination Steps

1) Examine the buy and sell slips, receipt records, and loan contracts to determine the exempt loan proceeds were used to:

   a) purchase qualifying employer securities;

   b) repay such loans; or

   c) repay a prior exempt loan.

2) Examine the securities to ensure there is no call, put, other option, buy-sell arrangement or any other restriction on the securities while in the trust or upon distribution, other than those provided in Regs. § 54.4975–7(b)(9) and (10).

Collateral for Exempt Loans

The collateral pledged by the ESOP with respect to any exempt loan must be limited to the qualifying employer securities purchased with such exempt loan or the qualifying employer securities that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan. See Reg. § 54.4975-7(b)(5).

Continued on next page

Exempt Loans, Continued

Liability of ESOP for Exempt Loan

An exempt loan should be without recourse against the ESOP. A lender can seek repayment of an ESOP loan only out of the following plan assets:

1) Assets acquired with exempt loan proceeds that are collateral for the loan;

2) Collateral used in a prior exempt loan repaid with exempt loan proceeds;

3) Contributions made to the ESOP to meet plan exempt loan obligations;

4) Earnings on collateral or the contributions noted in 3) above.

The payments made with respect to an exempt loan by the ESOP during the year must not exceed an amount equal to the sum of contributions and earnings received during or prior to the year less payments in prior years. The purpose of the preceding requirement is that pre-existing plan assets prior to the exempt loan should not be used to service the debt. Also, these contributions and earnings must be accounted for separately on the books of accounts of the ESOP until the loan is repaid. See Reg. § 54.4975–7(b)(5).

Examination Steps

1) Examine the ESOP, the assets and the exempt loan contract to ensure that any recourse by the lender does not exceed the assets of the ESOP as stated above.

2) Request an accounting that supports that the exempt loan is not repaid with any pre-existing plan assets.

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Exempt Loans, Continued

Default

If the loan is secured by the employer securities held in the suspense account and there is a default on the loan, a lender who is a third party and not a disqualified person can have suspense account assets transferred to the extent of the remaining loan amount.

If the lender is a disqualified person (e.g., the employer), then the amount that can be transferred on default is the amount of the missed payment. This prevents an employer from manipulating the default mechanism in order to use plan assets to repay an exempt loan.

A default can cause a loan to be a non-exempt loan. See Reg. 54.4975–7(b)(5)&(6). The use of exempt loans to acquire QES creates an obligation by the employer to make sufficient contributions to service the debt and release the shares for allocations to participants.

The failure to make sufficient contributions to pay the debt could cause the loan to be non-exempt and thus subject the taxpayer to prohibited transaction liability.

Examination Steps

1) Determine whether there has been a default in repaying the loan.

2) If there has been a default, check whether the shares in the suspense account are collateral for the loan. Ensure that the plan does not transfer any plan assets in the event of default to any third party in excess of the lesser of the 1) the amount of the default or the 2) the collateralized stock.

3) If the stock in the suspense account is collateral for the loan and the employer is the lender, ensure that the employer does not use suspense account assets greater in value than the missed payment to repay the loan.

4) Determine whether the default has caused the loan to become non-exempt. The agent should review all the facts and circumstances relating to the default to determine whether to pursue such default as a prohibited transaction.

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Exempt Loans, Continued

Release of Stock from Suspense Account

Employer securities acquired with exempt loan proceeds are required to be placed in a suspense account to be allocated to participants' accounts as the loan is paid off by employer contributions.

Methods by which exempt loans are paid

An exempt loan is repaid and qualifying employer securities are released from the suspense account based on one of two methods.

The first and most common method is based on principal and interest payments.

The second method (special rule) permits the release of qualifying employer securities from a suspense account based solely on principal payments, if certain conditions are met. See Reg. § 54.4975–7(b)(8). This second method results in low allocations of securities in the early years of the loan, when mainly interest is being paid off. Sometimes employers will renew loans in which securities are released based only on principal payments in order to keep allocations low.

Requirements to use the principal only method

However, in order to utilize the principal only method, the exempt loan must provide:

- for level annual payments over 10 years or less,
- with interest disregarded only to extent that it would be determined to be interest under standard loan amortization tables, and
- that by reason of renewal, extension or refinancing, the sum of the expired duration of the exempt loan, the renewal period, the extension period, and the duration of the new exempt loan can not extend over 10 years.

Stock released from a suspense account

Stock released from the suspense account must be allocated to participants' accounts in shares of stock or other non-monetary units, rather than by dollar amounts. Reg. § 54.4975-11(d)(2).

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Exempt Loans, Continued

Example

XYZ Corporation establishes an ESOP that borrows $10,000,000 from a bank, which it uses to acquire 200,000 shares of XYZ stock (QES). XYZ guarantees the exempt loan, which is for 10 years at 7% and is payable in level annual payments of $1,423,775. Total payments on the loan equal $14,237,750.

The plan uses the first method to release shares from suspense (i.e., the principal and interest method), with the number of shares to be released the first year equaling 20,000 shares. This is based on calculation of $1,423,775/$14,237,750 X 200,000 shares.

If all loan payments are made as originally scheduled, the number of securities released each year will also equal 20,000.

Example

Same facts as above, except that the release from suspense is based on the special rule (release based on principal payments only). The level annual payments are $1,423,775. Total payments on the loan over the 10-year term equal $14,237,750.

In the first year, the annual payment of $1,423,775 involves a $723,775 principal payment and a $700,000 interest payment. The number of shares to be released the first year is equal to 14,476 shares. This is based on a calculation of $723,775/$10,000,000 X 200,000 shares.

If loan payments are made as originally scheduled, the number of securities released in subsequent years will increase, as the portion of the loan payment representing the principal payments increases.

Examination steps-exempt loans

Refer to Schedule E, ESOP annual information

Refer to the question on Schedule E, ESOP Annual Information, which determines the method the employer uses to repay the loan.

Analyze loan contract and other information

Analyze the loan contract and its repayment provisions to verify that as the loan is repaid, stock is released from the suspense account and allocated to participant accounts.

Analyze the loan contract, the encumbrance account, the allocation schedule, and the receipts and disbursements accounts to substantiate compliance with the regulations.

Also, if you encounter a situation where contributions have been missed for a period of years, or where there are large repayments to the lender, additional analysis should be undertaken to determine if the effect of such non-payment or large payments proves to be a violation of the exclusive benefit requirement or the anti-discrimination provisions of the Code.

Failure to make sufficient contributions to make timely payments on the debt could also, based on the facts and circumstances, cause the loan to be non-exempt.

Example

Assume an employer originally entered into an exempt loan and acquired qualified employer securities with an exempt loan that required substantially level annual payments over 10 years. The necessary contributions were made the first two years to make the required loan payments due and the requisite shares were released for allocation. However, no contributions were made the next four years, with no action taken by the fiduciary with respect to such non-payment.

If no valid business reason exists to support non-payment of contributions necessary to service the debt, considerations should be given to treating the exempt loan as non-exempt under IRC 4975(c)(1)(B).

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Examination steps-exempt loans, Continued

Determine method of repayment-principal and interest, or principal only

Determine whether the loan is structured so that securities are being released from the suspense account based on principal and interest or by reference to principal payments only.

If the principal only method is used, ensure the plan document permits the release of shares from the suspense account based on the principal only method. If so, determine whether the loan period, and any renewal, extension, or refinancing period exceeds 10 years. The release of employer securities from a suspense account must revert to the principal and interest method when the loan period (including extensions) exceeds 10 years. See Reg. § 54.4975-7(b)(8)(ii).

Verify that one of the two release formulas are properly applied to release shares from the suspense account as contributions are made and payments are made on the exempt loan. Recommend that the agent request a copy of the workpapers for the plan year under audit related to the release formula that was used by the plan administrator. The agent should determine that the proper amount of shares were released from the suspense account as a result of the loan repayment.

Repaying an exempt loan from the proceeds of the sale of unallocated employer securities

Introduction

Employer securities acquired with exempt loan proceeds are placed in a suspense account to be allocated to participants' accounts as the loan is paid off by employer contributions. If unallocated employer securities are used to repay the loan, they will not be available for allocation to participants' accounts.

Exempt loan must be primarily for the benefit of ESOP participants

IRC section 4975(d)(3) and Reg. § 54.4975–7(b)(3) provide that an exempt loan must be primarily for the benefit of the ESOP participants. Thus, neither plan terms nor operation should provide for the sale of qualifying employer securities in the suspense account with the resultant proceeds derived from the sale of the unallocated employer securities to repay the loan.

Whether the primary benefit is violated depends on facts and circumstances

Whether an ESOP in operation violates the primary benefit requirement by repaying an exempt loan with the proceeds from the sale of unallocated securities will be determined based on all the surrounding facts and circumstances.

Among the facts relevant to the primary benefit requirement are whether:

- the transaction promotes employee ownership of employer stock,
- contributions to an ESOP that is part of a stock bonus plan are recurring and substantial, and
- the extent to which the method of repayment of the exempt loan benefits the employees.

All aspects of the loan transaction, including the method of repayment, will be scrutinized to see whether the primary benefit requirement is satisfied.

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Repaying an exempt loan from the proceeds of the sale of unallocated employer securities, Continued

Analysis of published guidance—ESOP did not fail as a result of using proceeds to repay loan

Essentially, employer securities acquired with an exempt loan create an obligation by the employer to make annual contributions to the plan sufficient to meet the plan's obligation of paying interest and principal on the debt. S. Rep. No. 94-36, 94th Cong., 1st session, 58-59 (1975).

If unallocated employer securities are used to repay the loan, they will not be available for allocation to the participants' accounts. IRC section 4975(d)(3) and Reg. § 54.4975-7(b)(3) provide that an exempt loan must be primarily for the benefit of the ESOP participants.

> Thus, a plan that repaid an exempt loan using proceeds derived from the sale of unallocated employer securities held in suspense could cause the exempt loan to become a non-exempt loan.

Although not cited as authority, refer to Private Letter Rulings 8231043, 8231039 and 8044074 for an explanation of scenarios where the Service determined that the use the proceeds from the sale of unallocated employer securities held in a suspense account to repay the loan did not cause the ESOP to fail to satisfy IRC section 4975(d)(3).

In these particular cases, the Service held that the proceeds from the sale of unallocated employer may be used to repay the exempt loan where:

- a tender offer has been made that may result in employer securities no longer being available and
- the price fixed during the tender offer would produce a financial gain to the plan participants.

However, these determinations were based on the relevant facts and circumstances involved.

Continued on next page

Repaying an exempt loan from the proceeds of the sale of unallocated employer securities, Continued

Analysis of Published guidance in which ESOP did fail due to proceeds used to repay exempt loan

Conversely, other PLRs, such as PLR 8828009, have held that, based on a particular set of facts and circumstances, the use the proceeds from the sale of unallocated employer securities held in a suspense account to repay the loan caused the ESOP to fail to satisfy IRC section 4975(d)(3).

GCM 39747, issued 3/14/86, explained, in part, that an ESOP is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees, without requiring any cash outlays on their part, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees. S. Rep. No. 94-938, 94th Cong., 2d Sess., 180 (1976).

The Service has noted that both the securing of capital funds for necessary capital growth and the bringing about of stock ownership by all corporate employees are to be considered part of a leveraged ESOP's exempt functions under section 401(a). See Rev. Rul. 79-122, 1979-1 CB 204.

GCM 39747 went on to provide that while an arrangement whereby securities acquired are thereafter sold for loan repayment may further the corporate finance objective, it does not further the stock ownership objective.

This GCM concluded that a plan that contained blanket language to permit a sale of unallocated shares in suspense to make payments on the loan **was not** an arrangement that is "primarily for the benefit of participants and beneficiaries of the plan" as required by section 4975(d)(3)(A).

Continued on next page

Repaying an exempt loan from the proceeds of the sale of unallocated employer securities, Continued

Unallocated employer securities used to repay loan--possible 415(c) violation

In addition to considerations of the exempt loan requirements of IRC section 4975(e)(7) and applicable regulations, another issue to consider is the potential of an IRC section 415(c) violation.

Earlier positions contained in PLRs issued by the IRS provided that the use of unallocated shares to make repayments on the exempt loan also constituted IRC 415 annual additions, based on a formula that considered the ratio of the cost basis in the stock in relation to the final selling price. See PLRs 9507031, 9417033, 9417032 and 9416043.

However, upon further consideration, the current position is contained in the May 18, 1998 memo from Carol Gold, Director Employee Plans, Subject: Technical Advice Request Concerning Annual Additions under Section 415 of the Internal Revenue Code.

The determination as to whether the proceeds from the sale of unallocated shares constitute earnings or annual additions is now based on:

- the specific facts and circumstances surrounding the sale and
- whether this sale satisfies the primary benefit requirement of Reg. § 54.4975-7(b)(3).

Continued on next page

Repaying an exempt loan from the proceeds of the sale of unallocated employer securities, Continued

Rationale of current position regarding 415 and analysis if this issue is discovered upon examination

This position is based, in part, on Reg. § 1.415-6(b)(2)(i), which provides that the Commissioner may, in appropriate cases, considering all the facts and circumstances, treat certain allocations to participant accounts as giving rise to annual additions.

If this issue is discovered on examination, the examiner should

- analyze the facts and circumstances surrounding the sale (of employer stock in the suspense account) and
- determine whether such sale represents a bona fide sale and whether it satisfies the primary benefit requirement.

If is determined that the sale was not a bona fide sale or that the sale did not satisfy the primary benefit requirement, consideration should be given to recharacterizing those amounts released from the suspense/encumbrance account into annual additions in accordance with Reg. § 1.415-6(b)(2)(i).

Example, using proceeds of sale of stock to repay an exempt loan

An ESOP was established in 1997 and contributions sufficient to make payments on the exempt loan were made in 1997, 1998 and 1999. In 2000, an unrelated third party made a tender offer to purchase all employer stock at a premium. In late 2000, pursuant to a vote of all the shareholders of the employer, all outstanding shares were sold to the unrelated third party. The plan was terminated, with the proceeds from the sale of employer stock previously held in the ESOP's suspense account used to pay off the exempt loan, and the remaining balance of the proceeds allocated as gain among all the eligible participants.

In the instant case, the examiner determined that based on the facts and circumstances surrounding the transactions:

- the premature sale of employer stock did not violate the primary benefit and exempt loan rules of IRC section 4975(e)(7),
- **nor** did the remaining proceeds allocated as earnings constitute annual additions under IRC section 415(c).

Continued on next page

Repaying an exempt loan from the proceeds of the sale of unallocated employer securities, Continued

Examination Steps

1) During pre-planning, refer to Schedule E to the question that inquires as to whether unallocated securities or proceeds from the sale of unallocated shares were utilized to repay any exempt loan. If yes, an explanation of the transaction should be attached to the Schedule E.

2) Request a detailed explanation from the plan sponsor and plan trustee as to the circumstances and decision making that went into the decision to sell unallocated shares in the suspense account to make payments on the exempt loan.

3) The agent should analyze the reasons behind the premature sale of unallocated stock and make a determination as to whether the facts and circumstances support a finding that the primary benefit requirement has or has not been violated. If it is determined that such sale was not for the primary benefit of participants, the loan would be non-exempt.

When qualifying securities can be forfeited

Forfeiture Allocation

Plan terms should provide (and plan operation reflect) that qualifying employer securities are forfeited only after other assets. Reg. § 54.4975-11(d)(4).

If more than one class of qualifying employer securities subject to exempt loan provisions have been allocated to a participant's account, the plan must forfeit the same proportion of each such class. Reg. § 54.4975-11(d)(4).

Example

A participant was 80% vested in their account balance upon termination. Just prior to date of distribution, the participant's Stock Account was valued at $5,100 and the Other Investment Account was valued at $4,900. The plan administrator made a lump sum distribution to the participant in the form of $4,100 in QES and $3,900 in cash. The allocation schedules reflected forfeiture from the Stock Account of $1,000 and a forfeiture from the Other Investment Account of $1,000. This was improper. Even though the participant was only 80% vested, the entire $2,000 forfeiture should have emanated from the Other Investment Account pursuant to Reg. § 54.4975-11(d)(4), with the participant receiving their distribution in the form of $5,100 in QES and $2,900 in cash.

Examination Steps

1) The analysis of distributions made to terminated participants should include not only a determination that the proper vested amount was paid, but should also include a determination that any forfeitures comply with Reg. § 54.4975-11(d)(4).

2) Review the participant's allocation statements immediately preceding the date of plan distribution. Ensure that no forfeitures from a participant's account relate to the stock account until assets from other assets have been forfeited. If the participant's account holds more than one class of IRC section 409(l) shares, please ensure that the plan administrator applies the vesting schedule in such a manner that the same proportionate percentage of forfeiture apply to each such class of stock.

Right of first refusal

Right of First Refusal

Qualifying employer securities acquired with exempt loan proceeds may be, but need not be, subject to a right of first refusal. This is a post-distribution right in favor of the employer or ESOP, or both, that enables an employer to keep shares of closely-held stock which have been distributed to a participant in friendly hands and out of the hands of third parties.

When a participant receives an offer by a third party to buy non-publicly traded securities, the participant must notify the employer or ESOP (whichever holds the right of first refusal) of the written offer by the third party to purchase the securities.

The employer, or ESOP, has 14 days to match the good faith offer (selling price and other terms) by the third party or to pay, if greater, the fair market value of the securities (and match other terms). The right of first refusal should lapse after the 14-day period. See Reg. § 54–4975–7(b)(9).

Continued on next page

Right of first refusal, Continued

Examination Steps

1. Examine the receipt and disbursement records of the ESOP securities and the employer securities accounts to determine if either the trust or the employer has purchased securities which had previously been distributed to a participant and then reacquired from the participant under a right of first refusal provided in the plan. If the securities in question were purchased originally with the proceeds of an exempt loan, then scrutinize the transaction to ensure:

   a) The stock is not publicly traded at the time the right is exercised;

   b) The right only applies to the employer or the trust (ESOP) or both;

   c) The right was only enforceable within 14 days from the date written notice was given to the holder of the right of an offer by a third party; and

   d) The selling price and other terms are the greater of—(i) the fair market value per Reg. 54.4975–11(d)(5), or (ii) the price and terms offered by a buyer, excluding the employer and the trust (ESOP), making a good faith offer to purchase the security.

2. Secure copies of the good faith offer and, if necessary, contact third parties and the former participants to verify the above requirements. Care should be taken to comply with disclosure requirements.

Special ESOP Transactions

Section 1042 Transfers

Introduction

IRC section 1042 provides for non-recognition of gain where an individual shareholder elects to sell qualified securities to an ESOP and defer any gain on such sale by reinvesting the proceeds in another domestic operating corporation. Under IRC section 1042, if a taxpayer or executor elects to sell qualified securities to an ESOP, and the taxpayer purchases qualified replacement property within the replacement period, then any long-term capital gain will be recognized only to the extent the amount realized on the sale exceeds the cost to the taxpayer of the qualified replacement property.

After the sale, the ESOP must own at least 30% of:

1) each class of outstanding stock of the corporation which issued the qualified securities, or

2) the total value of all outstanding stock of the corporation.

The taxpayer must have held the qualified securities for at least 3 years as of the time of the sale. The replacement period is the period that begins 3 months before and ends 12 months after the date of the sale of the qualified securities.

Definitions

"**Qualified replacement property**" is any security issued by a domestic operating corporation which:

1) Did not, for the taxable year preceding the taxable year in which such security was purchased, have passive investment income in excess of 25% of the gross receipts of the corporation, and

2) is not the corporation which issued the qualified securities.

"**Qualified securities**" are employer securities, defined in IRC section 409(l), issued by a domestic corporation that has no stock readily tradable on an established securities market, and not received by the taxpayer from a qualified plan or pursuant to the exercise of a stock option.

Continued on next page

Section 1042 Transfers, Continued

Taxpayer's basis in qualified replacement property

The taxpayer's basis in the qualified replacement property is reduced by the amount of the gain not recognized by reason of the purchase. When the taxpayer disposes of any qualified replacement property, any gain is to be recognized to the extent of the gain that was not recognized due to the purchase of the qualified replacement property. But see the exception at IRC section 1042(e)(3).

Manner of Election

An IRC section 1042 election is not available to a C Corporation or to a shareholder of an S Corporation. See IRC section 1042(c)(1)(A) and 1042(c)(7). In addition, an IRC section 1042 election requires certain written elections to be made by the individual shareholder.

> The selling shareholder's election must be made in a "statement of election" attached to the taxpayer's income tax return filed on or before the due date (including extensions) for the taxable year in which the sale occurs. This election, once made, is irrevocable.

Continued on next page

Section 1042 Transfers, Continued

Statement of election

The "statement of election" shall provide that the taxpayer elects to treat such sale of securities as a sale of qualified securities under IRC section 1042. In addition, the statement should contain the following information:

1) A description of the qualified securities sold, including the type and number of shares;
2) The date of the sale of qualified securities;
3) The adjusted basis of the qualified securities;
4) The amount realized upon the sale of the qualified securities;
5) The ESOP to which the qualified securities were sold;
6) If the sale is part of a single, interrelated sale involving other taxpayers, include the name, TIN, and number of shares sold by other taxpayers; and
7) If qualified replacement property was purchased at the time of the election, attach a "statement of purchase" describing the qualified replacement property, date of purchase, cost, and declaration such property is to be the qualified replacement property. This statement must be notarized by the later of 30 days after the purchase or March 6, 1986. If the qualified replacement property was not purchased at the time of the election, this notarized statement with the required information noted above must be attached to the subsequent income tax return.

Statement of election must be verified by consent of corporation

In addition to the above, the taxpayer's "statement of election" must be accompanied by the verified written statement of consent of the corporation (or corporations) whose employees are covered by the ESOP (or authorized officer of the eligible worker cooperative), consenting to the application of IRC section 4978(a) (relating to excise tax on certain dispositions of employer securities prior to expiration of the three year holding period). Refer to Reg. § 1.1042-1T, Q&A 3.

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Section 1042 Transfers, Continued

IRC section 1042 – Prohibited Allocation

IRC section 409(n) states a plan must provide that the assets of an ESOP attributable to employer securities acquired by the ESOP in a sale to which IRC section 1042 applies (IRC section 1042 securities) cannot accrue for the benefit of the persons specified in IRC section 409(n). Also, the IRC section 1042 securities acquired by the ESOP cannot be allocated to the accounts of the persons specified in IRC section 409(n) directly or indirectly under any qualified plan of the employer. Any stock acquired in a sale to an ESOP will be subject to the restrictions of IRC section 409(n) if any of the sellers elect IRC section 1042 treatment with respect to their sale of employer securities.

Allocations of IRC section 1042 securities cannot be made during the non-allocation period to any taxpayer who makes an IRC section 1042 election, or to anyone who is related to the taxpayer within the meaning of IRC section 267(b), unless the lineal descendant exception of IRC section 409(n)(3)(A) applies. This exception provides that an allocation of IRC section 1042 shares to a relative of the taxpayer who made the IRC section 1042 election is not prohibited if he/she is a lineal descendant of the taxpayer, and the amount allocated to all such lineal descendants during the non-allocation period does not exceed 5% of the employer securities held by the plan attributable to a sale under IRC section 1042 by a person related to such descendants (within the meaning of IRC section 267(c)(4)). The lineal descendant exception does not apply to persons prohibited from allocations because they are treated as 25% shareholders, described below.

Continued on next page

Section 1042 Transfers, Continued

IRC section 1042 – Prohibited Allocation (continued)

The non-allocation period is the period beginning when the securities are sold to the plan pursuant to IRC section 1042, and ends on the later of 1) 10 years after the date of the sale, or 2) the date this indebtedness is repaid, if the plan borrowed money to purchase the IRC section 1042 securities.

Allocations of IRC section 1042 securities also cannot be made, at any time, to a person who owns, after the application of IRC section 318(a), more than 25% of

1) any class of outstanding stock of the corporation which issued the employer securities or of any corporation which is a member of the same controlled group, or

2) the total value of any class of outstanding stock of such a corporation. IRC section 318(a) is applied to the "25% ownership of any class of stock" test without regard to the employee trust exception in IRC section 318(a)(2)(B)(i).

Therefore, stock owned by a qualified plan is attributed to a participant or beneficiary for purposes of (1) above. A person is treated as a 25% shareholder if he/she has the requisite ownership interest at any time in the one-year period ending on the date of the sale to the plan, or the date the securities are allocated to participants in the plan.

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Section 1042 Transfers, Continued

Example, prohibited allocation

Individual A of ABC Corporation makes the appropriate IRC section 1042 election and sells his 15% ownership in the company to the ABC ESOP. Assume all conditions for an IRC section 1042 non-recognition of gain are satisfied with respect to such sale, including proper elections and the acquisition of qualified replacement property. Immediately after the sale, the ESOP owns 75% of the sole outstanding stock of the corporation. In addition, Individual B owns 20% of all outstanding shares outside of the plan and owns an additional 10% of stock (allocated to his ESOP stock account). The plan contains necessary language permitting an IRC section 1042 transfer and contains the required language precluding allocation of such securities during the non-allocation period to persons as described in IRC section 409(n).

Based on the terms of the plan and the allocation restrictions of IRC 409(n), neither Individual A (i.e., the person who made the 1042 election) nor Individual B (i.e., the more than 25% shareholder) should receive any allocation of stock pertaining to the IRC section 1042 transfer. With respect to Individual B, note that Code section 409(n) requires the determination of ownership through application of IRC section 318, without regard to the employee trust exception in paragraph (2)(B)(i).

Excise Tax on Prohibited Allocations of IRC section 1042 Employer Securities

If there is a prohibited allocation in violation of IRC section 409(n) of qualified securities acquired in an IRC section 1042 sale, the securities are treated as though they have been distributed to the participant. See IRC section 409(n)(2).

An excise tax under IRC section 4979A is imposed if there is a prohibited allocation of qualified securities acquired in an IRC section 1042 sale. The tax is equal to 50% of the amount involved and is to be paid by the employer sponsoring the plan.

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Section 1042 Transfers, Continued

Early Disposition of IRC section 1042 Employer Securities

IRC Section 4978 Excise Tax - An excise tax under IRC section 4978 can be imposed if, during the 3-year period after the date on which an ESOP acquired any qualified securities in a non-recognition sale under IRC section 1042, the plan disposes any of the securities and:

1) the total number of shares held by the plan after the disposition is less than the total number of employer securities held immediately after the sale, or

2) except to the extent provided in regulations, the value of qualified securities held by the plan after the disposition is less than 30% of the total value of all employer securities as of the disposition.

Determining the amount of the excise tax

The excise tax will be 10% of the amount realized on the disposition if either 1) or 2). above apply. However, the amount realized for this purpose will not exceed that portion allocable to qualified securities acquired in the sale to which the non-recognition of gain provisions applied, determined as if such securities were disposed of:

1) first, from IRC section 133 securities acquired during the 3-year period ending on the date of such disposition;
2) second, from IRC section 133 securities acquired before such 3-year period unless such securities have been allocated to accounts of participants;
3) third, from IRC section 1042 securities acquired during the 3-year period ending on the date of disposition;
4) fourth, from any other employer securities.

The 3-year holding period and excise tax do not apply to any distribution of qualified securities (or sale of such securities) which is made by reason of a participant's:

1) death or disability,
2) separation from service for any period which results in a one-year break in service, or
3) retirement after attaining 59½ years of age.

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Section 1042 Transfers, Continued

Excise tax not imposed on following exchanges or dispositions (continued)

The following are exchanges or dispositions on which the excise tax is not imposed.

1) An exchange of qualified securities in an IRC section 368(a)(1) reorganization for stock of another corporation.

2) An exchange of qualified securities in an IRC section 332 liquidation into an eligible worker-owned cooperative (determined by substituting 100% for 80% everyplace it appears in IRC section 332(b)(1)).

3) The disposition of shares pursuant to a diversification election under IRC section 401(a)(28).

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Section 1042 Transfers, Continued

Examination Steps

1) Review plan terms to determine if the plan is designed to permit the purchase of employer securities under IRC section 1042 and that the plan contains the prohibited non-allocation language with respect to persons described in IRC section 409(n).

2) Verify that after the acquisition of the employer securities, the ESOP owned at least 30% of 1) each class of outstanding stock of the employer corporation, or 2) the total value of all outstanding stock of the corporation.

3) Inspect the taxpayer's income tax return for the year that the sale of the IRC section 1042 shares to the ESOP occurred. Ensure that the proper "statement of election" and notarized "statement of purchase" were attached to the taxpayer's income tax return ("statement of purchase" could be attached to either this or the subsequent income tax return). Scrutinize the particulars with respect to the shares involved in the sale and the identification of the replacement properties. In addition, review the attached verified written statement of consent of the corporation (or corporations) whose employees are covered by the ESOP (or authorized officer of the eligible worker cooperative), consenting to the application of IRC section 4978(a).

4) Check that the employer securities sold to the ESOP were held for at least 3 years by the taxpayer prior to the sale. Refer to the taxpayer's individual or corporate return, if necessary.

5) Determine whether "qualified replacement property" was purchased within the replacement period by the taxpayer. Refer to the taxpayer's individual tax return, if necessary.

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Section 1042 Transfers, Continued

Examination Steps (continued)

6) Determine whether any IRC section 1042 securities are allocated to the persons specified in IRC section 409(n) and whether the allocations occurred during the nonallocation period. If yes, determine if the prohibited allocation is treated as a taxable distribution to the participant. See IRC section 409(n)(2). In addition, request a copy of the Form 5330 to verify that the excise tax under IRC section 4979A is properly reported (equal to 50% of the amount involved and paid by the employer sponsoring the plan).

7) Check whether any IRC section 1042 securities were disposed of within 3 years after the plan acquired them. If they were disposed of within the 3 year period, determine if an exception applies. If not, address the excise tax reportable on Form 5330 under IRC section 4978.

8) If it is determined that the conditions of IRC section 1042 were not satisfied, consideration should be given to making a referral to the appropriate exam function for the income tax adjustment.

Special ESOP transactions, partial interest exclusion

Partial Interest Exclusion

A bank, insurance company, corporation actively engaged in the business of lending money, or a regulated investment company may exclude 50% of the interest received from a securities acquisition loan. See IRC section 133(a). A securities acquisition loan may result in a lower interest rate on a loan to an ESOP.

Note: IRC section 133 was repealed by the SBJPA effective with respect to loans made after 8/20/96, (other than loans made pursuant to a written binding contract in effect before 6/10/96).

Defining a security acquisition loan

A "securities acquisition loan" is:

1) A loan to a corporation (back to back loan) or ESOP (direct loan) to the extent the proceeds are used to acquire employer securities for the ESOP (see IRC section 133(b)(1)(A)), or

2) A loan to a corporation to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the loan proceeds, provided the securities are allocable to participant accounts within one year of the loan (an immediate allocation loan). See IRC section 133(b)(1)(B).

Loan may be treated as a security acquisition loan

A loan to a corporation which is lent to an ESOP is treated as a securities acquisition loan if:

1) The repayment terms are substantially similar to the loans terms to the corporation from the lender (a mirror loan), or

2) The loan from the corporation to the ESOP requires a more rapid repayment of interest or principal (a rapid payment loan), and allocations under the ESOP attributable to this repayment do not discriminate in favor of highly compensated employees (within the meaning of IRC section 414(q)). See IRC section 133(b)(3).

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Special ESOP transactions, partial interest exclusion, Continued

If security acquisition loan is made after 7/10/89

If a securities acquisition loan is made after 7/10/89:

- the term of the securities acquisition loan cannot be greater than 15 years
- and the plan must hold more than 50% of each class of outstanding stock of the employer corporation, or more than 50% of the value of all outstanding stock of the corporation. See IRC section 133(b)(6).

In addition, if the loan is made after 7/10/89, ESOP participants must be able to direct the voting of all allocated securities in the ESOP acquired through a securities acquisition loan in accordance with IRC section 409 (e)(2). The full pass-through of voting rights applies even if the securities are not a registration-type class of securities (i.e., are closely-held). See IRC section 133(b)(7).

Excludable period during which the partial interest exclusion is available

The excludable period during which the partial interest exclusion is available is, in general, the 7-year period beginning on the date of the loan for any original securities acquisition loan (i.e., the direct loan or back to back loan described at IRC section 133(b)(1)(A) or immediate allocation loan described at IRC section 133(b)(1)(B)).

However, if the term of an original acquisition loan described at IRC section 133(b)(1)(A) is greater than 7 years, the excludable period is the term of the loan (which cannot be greater than 15 years).

The excludable period for a rapid payment loan described at IRC section 133(b)(3)(B) or an immediate allocation loan described at IRC section 133(b)(1)(B) cannot be greater than 7 years.

Special ESOP transaction, section 133 excise tax

IRC section 133 Excise Tax

An excise tax is imposed if a taxable event occurs with respect to securities acquired by an ESOP in an IRC 133 transaction. See IRC section 4978B. A taxable event subject to the excise tax occurs where there is any disposition of employer securities acquired in a IRC section 133 transaction within 3 years of their acquisition if:

1) the total number of employer securities held by the plan after the disposition is less than the total number of employer securities held after the acquisition, or

2) except to the extent provided in regulations, the value of the employer securities held by the plan after the disposition is 50% or less of the total value of all employer securities at the time of the disposition.

A taxable event subject to the excise tax also occurs if there is a disposition of employer securities acquired in an IRC section 133 transaction to which a. and b. above do not apply if the disposition occurs before the securities are allocated to participant accounts, and the proceeds of the disposition are not allocated.

1)

Determining the excise tax

The excise tax is equal to 10% of the amount realized on the disposition to the extent allocable to IRC 133 securities, determined as if such securities were disposed of:

1) First, from IRC section 133 securities acquired during the 3-year period ending with disposition, beginning with the securities first so acquired;
2) Second, from IRC section 133 securities acquired prior to the 3-year period, unless such securities (or proceeds from their disposition) have been allocated to participant accounts;
3) Third, from IRC section 1042 securities acquired during the 3 year period ending on the date of the disposition, beginning with the securities first so acquired; and
4) Fourth, from any other employer securities.

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Special ESOP transaction, section 133 excise tax, Continued

Section 133 excise tax does not apply to the following

- The excise tax does not apply to a distribution of IRC section 133 securities which is made due to a participant's:

  1) death or disability,

  2) separation from service for a period which results in a one-year break in service, or

  3) retirement after attaining 59½ years of age.

- The excise tax does not apply to an exchange of IRC section 133 securities in a corporate liquidation under IRC section 4978(d)(3) involving an eligible worker-owned cooperative.

- The disposition of IRC section 133 securities pursuant to a diversification election under IRC section 401(a)(28) will also not be treated as a disposition.

- An exchange of IRC section 133 securities for employer securities of another corporation pursuant to an IRC section 368(a)(1) reorganization will not be treated as a disposition.

- A forced disposition of IRC section 133 securities due to operation of a State law will not be treated as a disposition if the securities were regularly traded on an established securities market at the time they were acquired by the plan.

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Special ESOP transaction, section 133 excise tax, Continued

Examination Steps

1) Look at the applicable questions on Schedule E of Form 5500, ESOP Annual Information, to determine whether the plan has engaged in a securities acquisition loan under IRC section 133. If yes, complete the remaining examination steps in this section.

2) Determine whether the loan is from a qualified lender.

3) Check that the loan qualifies as a securities acquisition loan.

4) For post 7/10/89 loans, determine whether the ESOP held 50% of the stock, or 50% of the value of the stock, after the securities acquisition loan.

5) For post 7/10/89 loans, make sure full pass-through voting rights apply to IRC section 133 securities that have been allocated.

6) Determine whether the partial interest rate exclusion of the lender is available for a period not in excess of the excludable period. This is an item for referral to a corporate tax examiner.

7) Determine whether any IRC section 133 securities were disposed of in a taxable event. If yes, find out whether any of the exceptions to the excise tax apply.

Special ESOP transaction-section 4980 exception

IRC section 4980 Exception

There was an exception to the tax on the amount of any employer reversion from a qualified plan to the extent any of the reversion is transferred to an ESOP. IRC section 4980(c)(3). This exception applied to any amount transferred:

1) after 3/31/85, and before 1/1/89, or

2) after 12/31/88, pursuant to a termination which occurs after 3/31/85, and before 1/1/89.

Within 90 days after the transfer (or longer period as the Secretary may prescribe), the amount transferred, and the income therein, must be invested in employer securities or used to repay an ESOP loan that was used to purchase employer securities.

The amount allocated to participant accounts in the year of the transfer cannot be less than the lesser of the maximum allowable under IRC section 415 or 1/8 of the amount attributable to the securities acquired.

Any portion of the transferred amount which is not allocated to participant accounts in the year of the transfer must be credited to a suspense account (IRC section 4980 suspense account) and allocated from that account to the accounts of participants ratably over a period not greater than seven years. Additional employer contributions to an ESOP cannot be made until the allocation of such amount. When amounts are allocated to participant accounts from the IRC 4980 suspense account, they are treated as employer contributions for IRC section 415 purposes, except the annual addition will not exceed the value of the securities when they were placed in the IRC section 4980 suspense account.

At least half of the participants in the qualified plan from which the reversion is being transferred must be ESOP participants as of the close of the first plan year in which the allocation is required.

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Special ESOP transaction-section 4980 exception, Continued

Examination Steps

1) Check whether the ESOP contains an IRC section 4980 suspense account. If yes, go on to the other examination steps in this section.

2) Make sure the transfer of assets to the IRC section 4980 suspense account took place:

   a) After 3/31/85, and before 1/1/89; or

   b) After 12/31/88, due to a plan termination after 3/31/85 and before 1/1/89. There is no exception to the reversion tax for amounts transferred to an ESOP after these dates.

3) Check that the transferred assets were used within 90 days (or longer, if an extension was granted) to purchase employer securities or to repay a loan.

4) Make sure amounts in the IRC section 4980 suspense account are allocated over a period not greater than seven years.

5) If (2), (3) or (4) are not met, impose the excise tax under IRC section 4980(a) on the amount transferred to the ESOP.

Special ESOP transactions-section 664(g) transfers

IRC section 664(g) – Qualified Gratuitous Transfers

IRC section 664(g) contains a special rule permitting the qualified gratuitous transfer of qualified employer securities to an ESOP provided that certain conditions are met. The qualified employer securities transferred to the ESOP must relate to securities that had previously passed from a decedent dying before 1/1/99 to a charitable remainder annuity trust or charitable remainder unitrust.

Among the requirements contained in IRC section 664(g) is that the plan must provide specific plan language pertaining to

- the qualified gratuitous transfer and
- the handling of such stock, and

In addition, another requirement is that immediately after such transfer, the plan owns at least 60 percent of the corporation.

Refer to IRC section 664(g) for additional rules, including the allocation and suspense account requirements.

Subchapter S Corporation ESOPS

Sub S ESOP Basics

Effective for tax years after 12/31/97, the Small Business Job Protection Act of 1996 (SBJPA) and the Taxpayer Relief Act of 1997 (TRA '97) made amendments that permitted Sub S Corporations to adopt and sponsor ESOPS. See IRC section 1361(c)(6). The ESOP **is treated as a single shareholder** for purposes of the 75-shareholder rule. In conjunction with this law change, certain special rules apply to Sub S ESOPS.

Normally, the flow-through of a Sub S Corporation's income to the ESOP would have constituted unrelated business income (UBI) and would be subject to unrelated business tax income (UBIT). TRA '97 eliminated the UBI provision, with the effect that Sub S corporate income, to the extent owned by the ESOP, is not currently taxable, nor is the income subject to UBIT.

An ESOP is required to adjust its basis in Sub S Corporation stock under IRC section 1367(a) for the ESOP's pro rata share of the corporation's item. Upon the distribution of the Sub S Corporation stock by an ESOP to a participant, the stock's net unrealized appreciation under IRC section 402(e)(4) is determined using the ESOP's adjusted basis in the stock. See, Revenue Ruling 2003-27, 2003-11 I.R.B. (March 17, 2003).

Due to the statutory limits on the number of shareholders permitted for a Sub S Corporation, IRC section 409(h) was modified to allow cash distributions in lieu of the right to demand distribution from the ESOP in the form of qualifying employer securities. See IRC section 409(h)(2)(B)(ii). An ESOP maintained by a Sub S Corporation may permit distributions of employer securities, but is not required to do so.

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Subchapter S Corporation ESOPS, Continued

IRA cannot be a sub S shareholder, but an exception applies if certain requirements are satisfied

Although an IRA is not a permissible Sub S Corporation shareholder, a Sub S Corporation's S election will not be treated as terminated when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover provided that:

1) <u>The terms of the ESOP require that the Sub S Corporation repurchase its stock immediately upon the ESOP's distribution of the stock to an IRA;</u>

2) <u>The Sub S Corporation actually repurchases the Sub S Corporation stock contemporaneously with, and effective on the same day as the distribution; and</u>

3) <u>No income (including tax-exempt income), loss, deduction, or credit attributable to the distributed Sub S Corporation stock under IRC section 1366 is allocated to the participant's IRA.</u>

See, Revenue Procedure 2003-23, 2003-11 I.R.B. (March 17, 2003).

Section 4975(f)

IRC section 4975(f) relates to the general prohibition involving transactions of a shareholder-employee, a member of their family or a corporation in which a shareholder-employee owns 50% or more interest with respect to the sale of qualifying employer securities.

IRC 4975(f)(6) was amended to repeal this prohibited transaction with respect to the sale of qualified employer securities to an ESOP.

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Subchapter S Corporation ESOPS, Continued

Several ESOP perks not available for Sub S ESOPs

Even with the law change permitting the sponsorship and maintenance of an ESOP by a Sub S Corporation, several ESOP perks are not available for Sub S ESOPS. Unlike a C Corp ESOP, a Sub S ESOP is not permitted to utilize the following special ESOP provisions:

1) The IRC section 404(k) applicable dividend deduction.

2) The expanded IRC section 415(c)(6) increased limit (e.g., the 1/3 HCE rule that permits certain forfeitures and interest payments to be disregarded as annual addition for purposes of the IRC section 415(c) limit).

3) The expanded IRC section 404(a)(9) deduction limit of 25% (an ESOP (stock bonus only plan) maintained by a Sub S Corp is limited to the 15% limit). However, a combination stock bonus/money purchase limit could still take advantage of the 25% limit under IRC sections 404(a)(1) and 404(j).

4) The special exception for the expanded deduction of contributions applied toward interest payments for an exempt loan in an ESOP under IRC section 404(a)(9).

5) To utilize dividends paid on the Sub S Corporation's stock to make payments on an exempt loan with respect to allocated shares. Dividends paid on allocated shares, if used to make payments on an exempt loan, will fail to satisfy the prohibited transaction exception under IRC section 4975(d)(3). See Reg. section 54.4975-7(b)-5 and PLR 199938052. However, dividends paid on unallocated shares would be treated as earnings on the collateral and therefore could be used to service the exempt loan debt (but would still not be deductible under IRC section 404(k) for a Sub S ESOP).

6) The tax deferral of gains received by a shareholder on the sale of qualified securities to an ESOP (an IRC section 1042 transfer). See IRC section 1042(c)(1)(A), which limits the definition of qualified securities for purposes of the non-recognition of gain treatment to C Corporations.

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Subchapter S Corporation ESOPS, Continued

Several ESOP perks not available for Sub S ESOPsEGTRRA passed additional legislation

EGTRRA passed additional legislation to eliminate a perceived abuse by certain closely held Sub S ESOPS, generally effective for plan years effective after 12/31/04, but effective 3/14/01 for newly established Sub S ESOPS. This will be covered later in the chapter.

Examination Steps

1) Determine the type of entity that has adopted the ESOP under examination. If adopted by an electing Sub S Corporation, apply the statutory requirements relevant to Sub S ESOPS. In addition, confirm whether a valid existing ESOP was adopted and effective on or before March 14, 2001. Refer to the next section if an S Corporation makes an "S" election after March 14, 2001 or if the ESOP is started after March 14, 2001, in which event the new anti-abuse provisions of EGTRRA will go into effect. This is covered in the next section.

2) If dividends were declared and issued for the year under audit, confirm that no deduction was taken under IRC section 404(k).

3) Review the allocations made and perform an analysis of the IRC 415(c) limits. Verify that the Sub S ESOP did not attempt to utilize the IRC section 415(c)(6) exception, relating to disregard of certain forfeitures and interest payments as annual additions.

4) Verify that the expanded IRC section 404(a)(9) deduction limit of 25% is not utilized by the S Corporation. A stock bonus ESOP should be limited to the 15% limit, for years prior to January 1, 2002.

5) If an exempt loan is utilized, verify that the expanded deduction of contributions applied toward interest payments per IRC 404(a)(9) is not utilized.

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Subchapter S Corporation ESOPS, Continued

Examination Steps (continued)

6) If an exempt loan is utilized, confirm that dividends paid on allocated shares is not used to service the exempt loan debt.

7) Verify that no IRC 1042 transfers have been made to the Sub S ESOP.

8) Carefully scrutinize any Sub S ESOP, where all, or substantially all outstanding stock of the Sub S, is owned by the ESOP. Please conduct detailed interviews with the taxpayer and/or representative. The operation of the business, business customers and related corporations for which they perform services should be discussed. If it is determined that this Sub S entity is a organization whose principal business is performing, on a regular and continuing basis, management functions for another organization (or for 1 organization and other related organizations), additional development may be needed. It is possible that an affiliated service group may exist under IRC section 414(m)(5).

Prohibited allocations in Sub S ESOPs

Introduction

On June 7, 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 amended IRC section 409 by adding subsection (p). This is a very complex anti-abuse provision. The intent of this law change was to prevent perceived abuse from closely held ESOPS with few employees that established ESOPS to provide a shelter for income generated by the Subchapter S Corporations.

Basically, the **anti-abuse provisions** are triggered if a **"disqualified person"** receives a **"prohibited allocation"** during a **"non-allocation year"** in a Sub S ESOP**.**

There are three tax costs if the anti-abuse rules are triggered. They are:

1) The "disqualified person" will be deemed to have received the amount of allocated stock in the "prohibited allocation" and must include the value of the allocated stock in taxable income. See IRC section 409(p)(2)(A).

2) An excise tax is imposed on the S corporation equal to 50% of the amount involved in the "prohibited allocation" (subject to a special rule in the case of the first "non-allocation year"). See IRC section 4979A.

3) An excise tax is imposed on the S corporation with respect to any "synthetic equity" owned by a "disqualified person." See IRC Section 4979A.

Defining a disqualified person and deemed shareholder group

A disqualified person is one who is either

1) a member of a "deemed 20% shareholder group" or

2) a "deemed 10% shareholder".

A person is a member of a "deemed 20% shareholder group" if the number of "deemed-owned shares" of the person and the person's family is at least 20% of the total S corporation shares held by the ESOP.

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Prohibited allocations in Sub S ESOPs, Continued

Defining "deemed owned shares"

The term "deemed-owned shares" is the sum of:

1) stock allocated to an account of an individual by the ESOP and

2) an individual's share of unallocated stock held by the ESOP. The impact of the 2nd part of this definition is important. Essentially, for purposes of this definition, a participant is considered owning their own proportionate share of unallocated qualified employer securities held in the leverage ESOP's suspense account. IRC section 409(p)(4)(C)(ii) provides that a person's share of unallocated S corporation stock held by such plan is the amount of the unallocated stock which would be allocated to such person if the unallocated stock were allocated to all participants in the same proportions as the most recent stock allocation under the plan.

Defining a deemed 10% shareholder

A person is a "deemed 10% shareholder" if the person is not a member of a "deemed 20% shareholder group" and the number of the person's "deemed-owned shares" is at least 10% of the total S corporation shares held by the ESOP.

318 attribution rules apply

For purposes of determining ownership, the attribution rules of IRC section 318 apply, modified with the exception that the members of an individual's family shall include members of the family described in IRC section 409(p)(4)(D). See IRC section 409(p)(3)(B).

Family members will include the

(i) individual's spouse,

(ii) ancestors or lineal descendant of the individual or the individual's spouse,

(iii) brother or sister of the individual or the individual's spouse and any lineal descendant of the brother or sister, and

(iv) the spouse of any individual described in (ii) or (iii).

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Prohibited allocations in Sub S ESOPs, Continued

Defining nonallocation year

The definition of a "non-allocation year" is any ESOP plan year where, at any time during the year, "disqualified persons" own directly or through attribution, 50% of the number of outstanding shares of the S corporation. The attribution rules of §318 apply in this computation except there are some modifications that will not be addressed here. See IRC section 409(p)(3)(B) for the attribution rules.

Deemed owned shares in ESOP is treated as held by individual

In arriving at the 50% test, the "deemed-owned shares" held in the ESOP are treated as held by the individual that is deemed to own them.

Prohibited allocation defined

A "prohibited allocation" is one that violates the requirement that, during a "non-allocation year", no portion of the assets of the ESOP may be accrued (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit or any "disqualified person". According to the legislative history, a "prohibited allocation" occurs if income on S corporation stock held by an ESOP is allocated to the account of a "disqualified person".

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Prohibited allocations in Sub S ESOPs, Continued

Example

A newly established ESOP is adopted by a Sub S Corporation on November 30, 2001 and is immediately subject to the new EGTRRA requirements related to the prohibited allocations under IRC section 409(p). The ESOP owns all outstanding shares of the Sub S Corporation (totaling 2100 shares). These shares were acquired through the use of an exempt loan in December 2001.

For the plan year ended December 31, 2001, only three participants were eligible to receive allocations. Participants A, B & C each received an allocation of 100 shares of stock for the plan year ended December 31, 2001. The remaining 1800 shares are maintained in the ESOP suspense account (pending subsequent years' contributions and resultant release from suspense).

For purposes of IRC section 409(p), Participants A, B and C are considered owning both the shares allocated to their accounts and their proportionate share of stock in the unallocated suspense account (i.e., treat all unallocated stock as though fully allocated in such year to eligible participants). As such, Participants A, B and C each have "deemed owned shares" of 700 shares for the plan year ended December 31, 2001.

Accordingly, all three participants are "disqualified persons" by reason of being "deemed 10% shareholders." Next, as "disqualified persons" own at least 50% of all outstanding shares, the prohibited allocation rules and restrictions of IRC sections 409(p) and 4979A apply.

> The 100 shares allocated to each participant are subject to inclusion as taxable income per IRC section 409(p)(2)(A).

In addition, any Sub S income that flows through to the ESOP and is attributable to such shares and allocated to such participants, is also taxable to the participants. In addition, the Sub S Corporation is liable for the 50% excise tax under IRC section 4979A.

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Prohibited allocations in Sub S ESOPs, Continued

Other non-allocation situations—including synthetic equity

In addition, IRC section 409(p)(7)(B) states that the Secretary may, by regulation or other guidance, provide that a non-allocation year occurs in any case in which the principal purpose of the ownership structure constitutes an avoidance or evasion of the prohibited allocation rules.

Special rules also apply to "synthetic equity" as to the treatment of any person as a "disqualified person" and as to the treatment of any year as a "nonallocation year."

The term "synthetic equity" means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future.

Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.

Effective dates for ESOPs holding stock in S corporations

Effective Dates of IRC sections 409(p) & 4979A

These provisions enact very strict penalties on ESOPs holding stock in closely held S corporations. Therefore the effective date is very important.

The general effective date is for ESOP years that begin after 12-31-04. This allows the current S corporation ESOP's time to restructure the stock ownership.

The special effective date is for ESOP years ending after 3-14-01. The special effective date applies to corporation that converted to S status or established ESOP's after 3-14-01. In these situations the provisions apply to plan years ending after 3-14-01. Therefore if an S corporation makes an election after 3-14-01 or the ESOP is started after 3-14-01, the ESOP will always be subject to the new anti-abuse legislation.

Special ruling for S corporations established after 3-14-01

There is an interesting ruling dealing with S corporations established after 3-14-01. In Notice 2002-2, Question 15, it was held that the S election had to be filed by 3-14-01 in order to meet the general effective date. Therefore, if a C corporation that has an ESOP elects S corporation status on 3-15-01, effective as of 1-1-01, it will not meet the requirement that it had an S election in effect on 3-14-01.

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Effective dates for ESOPs holding stock in S corporations,
Continued

Rev. Rul. 2003-6

Refer to Revenue Ruling 2003-6, 2003-3 I.R.B. 286, January 21, 2003, which provides guidance with respect to certain arrangements involving the establishment of ESOPS holding securities in Sub S Corporations that the Service determined will not be considered timely established on or before March 14, 2001.

In effect, this ruling provides that the delayed effective date for IRC section 409(p) does not apply in certain circumstances. The facts of this revenue ruling pertain to A, a person in the business of providing advice to other companies or individuals, who arranges for the establishment of a number of S Corporations that have no substantial assets or business and the formation of ESOPs for each of these corporations on or before March 14, 2001. Employees of A are initially covered by these ESOPS, but there is no reasonable expectation that these individuals will accrue more than insubstantial benefits under these plans or more than an insubstantial share in the ownership of the S Corporation. The Sub S Corporations are then marketed to other taxpayers, along with the associated ESOPS, after March 14, 2001. The Service's position is that for purposes of IRC section 409(p), these ESOPs are not considered established on or before March 14, 2001 and therefore, are not entitled to the delayed 2005 effective date.

The Service is developing further guidance to address other abusive arrangements involving Sub S Corporations. See Revenue Ruling 2003-6.

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Effective dates for ESOPs holding stock in S corporations,
Continued

Examples

Example 1: A Sub S Corporation does not elect Sub S status until July 1, 2001. As this date is later than the special effective date of March 14, 2001, the ESOP maintained by this Sub S Corporation is immediately subject to the new anti-abuse provisions of IRC sections 409(p) and 4979A. An analysis of stock ownership will be necessary to determine if any plan participants are "disqualified persons" subject to the prohibited allocation requirements.

Example 2: An examiner is assigned an ESOP adopted by a Sub S Corporation that was created in December 2000 and that adopted an ESOP on January 5, 2001, with an effective date of January 1, 2001. The Sub S only employs two persons, with the ESOP covering both. The company has the unusual name of "Working Woman Five". Based on this date, the ESOP appears to eligible for the general effective date for IRC sections 409(p) and 4979A for years beginning after December 31, 2004. However, based on interviews and further analysis, the examiner determined that both the Sub S Corporation and the ESOP were originally established by a pension practitioner.

Subsequent to March 14, 2001, ownership of both the S Corporation (and the ESOP) was transferred to the current plan sponsor. Based on this information, the agent should apply the special effective date of March 14, 2001, with respect to the potential application of IRC sections 409(p) and 4979A, based on Revenue Ruling 2003-6.

Examination steps-Sub S Corporation

Examination Steps

1) Determine the type of entity that sponsored the ESOP under examination. If adopted by an electing Sub S Corporation, ascertain whether a valid existing ESOP was adopted and effective on or before March 14, 2001. In addition, confirm that a valid "S" election was made on or before March 14, 2001.
2) Before accepting the validity of a timely March 14, 2001 adoption, the agent should consider the potential that the scenario contained in Revenue Ruling 2003-6 applies. If based on interview(s) and/or other case development, it appears that abusive step transactions such as those covered by Revenue Ruling 2003-6 apply, then the agent should pursue the earlier effective date of plan years ending after March 14, 2001, with respect to IRC sections 409(p) and 4979A.
3) If the Sub S ESOP was timely adopted and effective on or before March 14, 2001, the general effective date of plan years beginning after December 31, 2004 will apply with respect to IRC sections 409(p) and 4979A.
4) If not timely adopted by March 14, 2001, the agent should apply IRC 409(p) and 4979A, effective for plan years ending after March 14, 2001.
5) If effective for the year under examination, the agent should analyze the ownership percentages of stock owned by the ESOP to determine if the tax sanctions of IRC section 409(p) and 4979A apply. This analysis should include a determination as to whether any participant(s) in the plan meet the definition of a "deemed 10% shareholder," a "deemed 20% shareholder group" and "disqualified person". The analysis should include consideration of the attribution rules of IRC section 318 and the definition of family member of IRC section 409(p)(4)(D). If exempt loans are involved, the agent should consider such stock as part of a participant's "deemed-owned shares."
6) If during any "non-allocation year", disqualified persons own, directly or through attribution, 50% of the outstanding shares of the S Corporation, then the agent should apply the new anti-abuse provisions of EGTRRA under IRC sections 409(p) and 4979A. Discrepancy adjustments under IRC section 409(p) should be made to the income tax return of the individual "disqualified person", and Forms 5330 should be picked up with respect to the IRC section 4979A excise tax imposed on the S Corporation.

Summary

The lesson covered various form and operational requirements of both leveraged and non-leveraged ESOPS. This lesson described the requirements that an ESOP must satisfy to qualify under IRC sections 401(a), 409 and 4975(e)(7), including the rules related to the use and handling of exempt loans. In addition, this lesson also covered certain special rules related to ESOPS, such as the special IRC section 404 deduction rules, IRC section 1042 transfers, the partial interest exclusion and Sub S ESOPS.

At the conclusion of this lesson, you should have learned:

1) How to determine whether the ESOP operated in a qualified manner.

2) To verify that the ESOP is properly invested in IRC section 409(l) qualifying employer securities.

3) To verify that the appropriate distributions were made to participants and beneficiaries, both as to the form and timeliness.

4) For non-publicly traded stock, how to ascertain that participants were given the appropriate post-distribution rights involving "put" options with respect to distributions of stock.

5) How to determine whether the stock transactions involving the ESOP properly valued the stock at fair market value.

6) How to determine the applicable deductible limits for contributions to both leveraged and non-leveraged ESOPS, including special rules related to IRC section 404(k) applicable dividends.

7) How to consider the impact of a premature sale of QES in the suspense account to pay off the exempt loan, by considering the facts and circumstances surrounding such decision.

8) To determine whether certain allocations in an ESOP sponsored by a Sub S Corporation were subject to the new prohibited allocation requirements with respect to certain disqualified persons.