

## Chapter 8

# Employee Stock Ownership Plans (ESOPs), Including S Corporation ESOPs and Anti Abuse Measures

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INTERNAL REVENUE SERVICE  
TAX EXEMPT AND GOVERNMENT ENTITIES

### Overview

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#### Purpose

This chapter is designed to assist the determination specialist understand what an Employee Stock Ownership Plan is and how it works. The chapter also describes the various qualification provisions for ESOPs in order to issue a favorable determination letter. While the main focus is on the qualification provisions under Code §4975(e)(7) and the applicable regulations, the chapter also discusses current problems and issues pertaining to Sub S Corporation ESOPs. Finally, the chapter discusses changes made by EGTRRA.

The following examination topics are beyond the scope of this chapter and have not been included:

- (i) examination steps for ESOPs,
- (ii) deductible limits on contributions and dividends (except as appropriate in order to review an ESOP);
- (iii) the partial interest exclusion (which was eliminated by EGTRRA) and;
- (iv) valuation issues.

For information on these excluded topics, please see Chapter 8 of the 2003 EP Examination CPE.

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**Overview, Continued**

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**Objectives**

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

1. Identify the characteristics of an ESOP and why they are attractive to certain entities.
2. Determine whether an ESOP is leveraged or non-leveraged.
3. Describe the different application forms for a determination letter.
4. Identify the closing caveats to be used to issue a favorable determination letter.
5. Determine whether an ESOP meets the requirements under Code §4975(e)(7) and the applicable regulations.
6. Identify the issues and abuses surrounding an S Corporation ESOP.
7. Identify the changes made to ESOPs by EGTRRA.

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**Overview, Continued**

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## Background

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### Introduction

ESOPs have been around for a long time, approximately since the 1950's, but it wasn't until the passage of ERISA in 1974, that these types of plans became more widely accepted. The basic purpose of an ESOP is to transfer ownership of employer stock to the employees without having to resort to the sale of the business to outside persons. Many professionals have argued that transferring ownership in this manner increases motivation and productivity, which in turn leads to increased corporate performance. Because an ESOP is also a retirement program, which invests most if not all of its assets in employer stock, the ESOP is designed to provide participants with income at retirement or at termination of employment while still giving certain tax advantages to the sponsoring employer.

As you will learn from the chapter an ESOP may also be designed to provide certain tax benefits to shareholders who sell their stock to the ESOP. Today there are about 11,000 ESOPs covering approximately 8.5 million employees. Publicly traded corporations as well as closely held companies of every size have ESOPs, but most have more than 15 employees due to the cost involved.

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### Description of an ESOP

A qualified ESOP is generally a plan that meets the requirements under Code §401(a) as well as under §4975(e)(7), Regulations §54.4975-7 and §54.4975-11 and certain portions of Code §409. The basic element of an ESOP is that of a Stock Bonus Plan, which is a type of Profit Sharing Plan. An ESOP **must** contain this Stock Bonus feature.

A "Stock Bonus Plan" is defined in the regulations under Code §401(a) as a plan established and maintained to provide benefits **similar** to those of a Profit Sharing Plan, **except** that benefits are distributable in stock of the employer. A Stock Bonus Plan is subject to the same general qualification requirements as a Profit Sharing Plan, and either plan can provide for discretionary employer contributions.

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## **Background, Continued**

**Distinction  
between a stock  
bonus and a  
profit sharing  
plan**

The basic distinctions then between a Stock Bonus Plan and a Profit Sharing Plan are:

- Contributions to a Stock Bonus Plan will usually be made, largely (or exclusively) in stock of the employer. Note: When cash contributions are made, they are typically used to buy more employer stock.
- A Stock Bonus Plan is exempted from any “fair return” requirement on employer stock. Revenue Ruling 69-65, 1969-1 C.B. 114.
- Benefits from a Stock Bonus Plan **must be** “distributable” in whole shares of employer stock, although the value of any fractional shares may be paid in cash. However, a Stock Bonus Plan may include the “cash distribution option” available to ESOPs under Code §409(h)(2), subject to the participant’s right to demand that distributions be made in stock. Distributions of non-publicly traded stock, from a Stock Bonus Plan are also subject to the put option requirement that applies to an ESOP. The put option requirement for a Stock Bonus Plan applies to stock acquired after December 31, 1986.
- The voting rights requirement of Code §409(e) applies to a Stock Bonus Plan for those employers whose stock is not publicly traded, while Profit Sharing Plans are not subject to this requirement.
- A Stock Bonus Plan may be designed as an ESOP, while a Profit Sharing Plan cannot be designed as an ESOP.

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## **Background, Continued**

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### **How a Non-Leveraged and a Leveraged ESOP Works**

The following diagrams reflect differences between a leveraged and a non-leveraged ESOP. The availability of the exempt loan is what distinguishes the diagram of a Non Leveraged ESOP from a Leveraged ESOP. The use of the exempt loan allows the trustees of the leveraged ESOP to borrow money from an outside lender (such as a bank) to buy employer stock. The acquired stock is then placed in a **suspense account** until the employer makes contributions each year to repay the loan. As contributions are made by the employer to repay the loan, a portion of the stock in the suspense account is released and allocated to the participants' accounts in accordance with the allocation formula in the plan. Distributions of stock from the ESOP are made as participants leave, retire, or die. A plan that invests in and distributes employer securities, but does not have all of the exempt loan **language** is considered to be a Stock Bonus Plan.

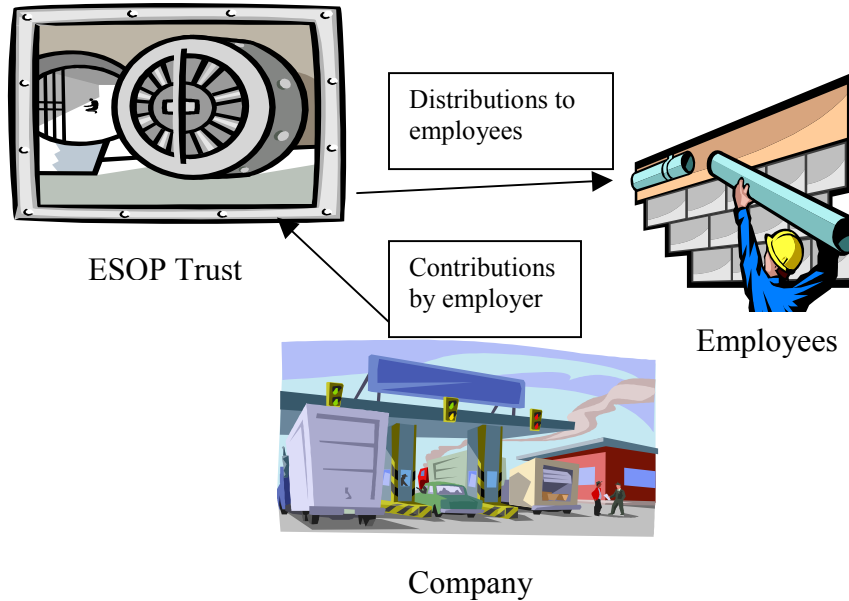
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## Diagram of Non Leveraged ESOP

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**Introduction** The following diagram shows how a non-leverage ESOP works.

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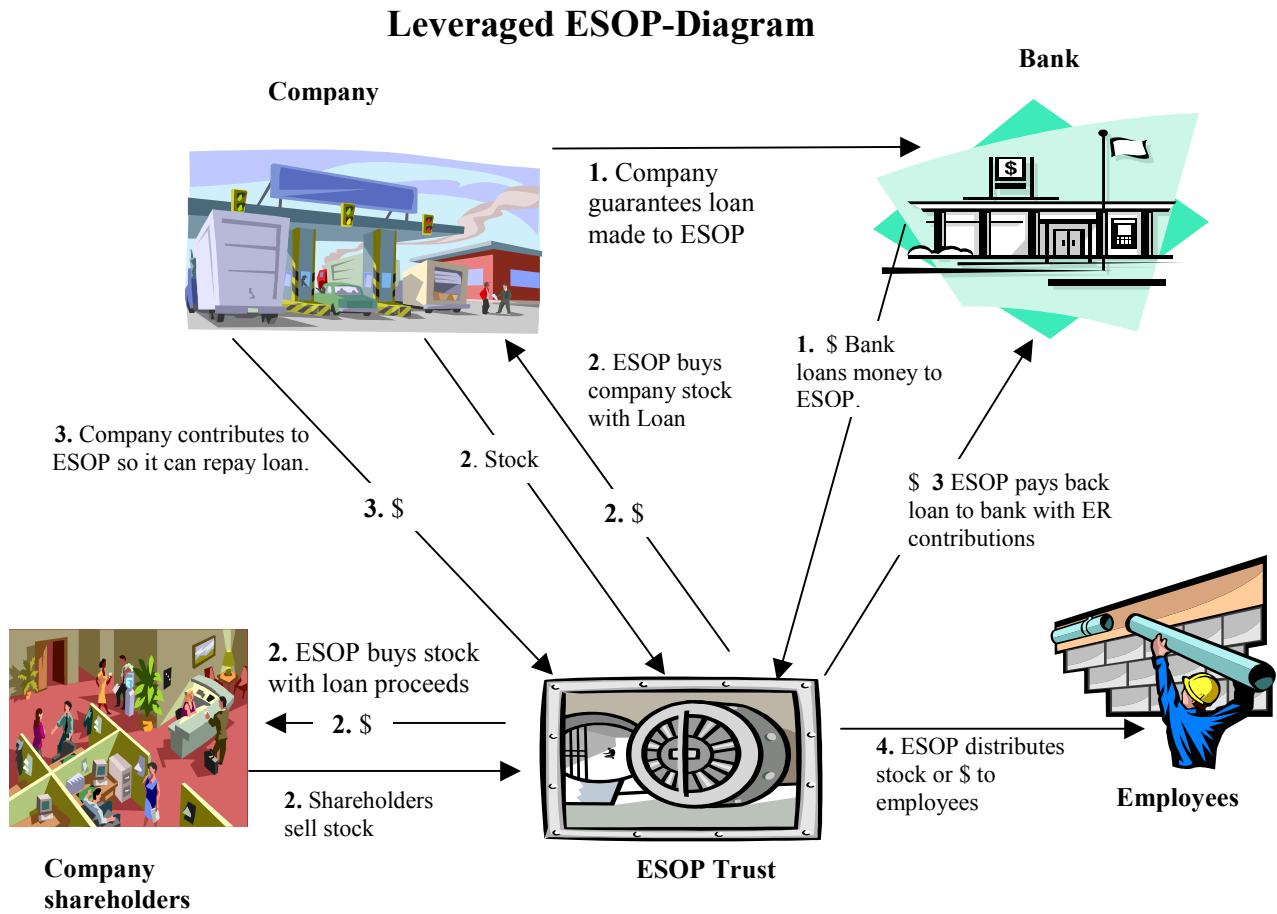
**Explanation of diagram** Each year the company contributes either stock or cash to the ESOP, which holds the stock. The stock is then allocated to the participant's account, based on the formula in the plan.

The Company must notify the participant's how much they own and how much the stock is worth. Because this type of arrangement does not involve an employer loan (see below) to acquire the stock, it is generally referred to as a stock bonus plan.

Employees receive distribution in stock or cash when they leave the company or retire, according to the plan's vesting schedule.

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## How a leveraged ESOP works



### Explanation

1. Bank loans money to ESOP by promissory note, which is guaranteed by Company.
2. ESOP uses the proceeds from the loan, to buy stock from the (i) company, or (ii) existing shareholders.
3. Company makes contribution to ESOP trust to repay the loan. ESOP trustees make repayment of loan according to loan schedule.
4. Participant's receive stock or cash when they retire or leave the company

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## **Why ESOPs are attractive**

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**Why are ESOPs attractive to certain entities?**

The introduction already mentions one of the reasons why ESOPs are attractive to certain entities - to transfer ownership of employer stock to employees, tax-free. The company pays no tax on this transfer since the stock is placed in a tax-exempt trust. But why would a company want to transfer stock ownership to their employees? Here are a few answers:

- In public companies, as a defense for a takeover. Once stock is transferred to the ESOP and allocated to the employees, the employees of the company in essence become the owners, thereby preventing this stock from being acquired in the open market.
- To motivate and reward employees.
- In closely held companies, to buy shares of a departing owner. Since there is no ready market for stock in a closely held company, the company can make deductible **cash** contributions to the ESOP to buy the departing owner shares. The ESOP could also borrow the money and then use the proceeds to buy the shares of the departing owner.
- Also in closely held companies, the ready market mentioned above, is helpful in estate planning. This in-house market for corporate stock makes it possible for existing shareholders to sell their stock during their lifetime, upon retirement or in the event of death.

Another reason why ESOPs are attractive is that they provide a financing tool for the company. That is, the company can sell their stock to the ESOP and in turn use the cash to either acquire other companies, pay off debt, or for capital improvement. Closely held companies, which may be unwilling or unable to raise capital through a public offering of stock, may especially find this option attractive. The costs of public underwriting and the expenses of operating a publicly traded company would be avoided through the use of ESOP financing. Existing owners and management may prefer to build ownership through their own employees rather than going public and opening ownership to outsiders.

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## Procedures for Obtaining a Determination Letter

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**Use of Form 5300, 5307 and 6406.**

Form 5300, Application for a Determination Letter is used to request a favorable determination letter for an initial or ongoing ESOP. Form 5307 or Application for Determination for Adopters of Master Prototype or Volume Submitter Plan, cannot be used at this time to request a ruling on an ESOP because they cannot be pre-approved as either a Volume Submitter or a Master/Prototype. Form 6406, Application for Determination Letter on Plan Amendments, may be used to request a ruling on minor amendments made to a plan. This form however, should not be used to amend a plan to become an ESOP.

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**Form 5309**

Form 5309, Application for Determination of Employee Stock Ownership Plan, is an attachment to Form 5300 series and is used to request a ruling on an ESOP under Code Section 4975(e)(7). This form is used to request rulings on ongoing plans as well as terminating plans. Items on the form address specific areas of qualification needed for compliance with Code §409 and §4975(e)(7).

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**Form 5310**

Form 5310, Application for Determination for Terminating Plan, is used to request a favorable determination letter on a plan that is terminating. An employer usually terminates the ESOP when the company is going out of business, or when the owners retire. Terminating an ESOP requires the full vesting of all participants and the making of distributions as soon as administratively feasible. Distributions from an ESOP will be discussed later.

Terminating an ESOP however, is distinguished from an employer that simply freezes an ESOP. In a frozen plan, the employer makes no further contributions, but the plan continues to operate. Freezing a plan is usually accomplished by board resolution or by plan amendment. An employer is not required to fully vest participants or make distributions when a plan is frozen.

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## **Procedures for Obtaining a Determination Letter, Continued**

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### **User Fees**

User fees for ESOPs are the same as for any other determination letter application. Section 620 of the Economic Growth and Tax Reconciliation Act of 2001, Pub. L. 107-16 provided for the elimination of user fees with respect to certain requests for determination letters submitted by plan sponsors. Agents are responsible for determining the appropriateness of user fees prior to closing of the case.

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### **Closing letter caveats**

The following caveats should be used on the favorable determination letter for an ESOP that meets the requirements of Code §409 and §4975(e)(7):

- Form 5300 – use caveat 51 when the attached Form 5309 indicates that the employer is requesting a ruling on a **leveraged** ESOP. On 835 letter - caveat 51 – “This plan satisfies the requirements of Code section 4975(e)(7).”
  - Form 5310 – for a plan that is terminating (not just freezing the plan), you will need to use caveat 44 to rule on the ESOP. On 1132 letter - caveat 44 – “This plan satisfies the requirements of Code section 4975(e)(7).”
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## General ESOP Qualification Requirements

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**Plan must meet 401(a)** Because an ESOP is a Defined Contribution Plan, the ESOP is subject to all of the rules and regulations under Code §401(a). However, because an ESOP must, by definition, be a Stock Bonus Plan, a plan that fails to qualify as an ESOP, may still be qualified under Code Section §401(a), as a Stock Bonus Plan. See Reg. §54.4975-7(b)(1)(i). Operational issues may arise however, as a result of a plan failing to qualify as an ESOP, but these will not be discussed further here.

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**Money Purchase ESOP** A Money Purchase Plan can be combined with an ESOP. The Money Purchase Plan which forms a part of an ESOP will generally be subject to all of the requirements applicable to a Money Purchase Plan (except the 10% limit on investments in employer stock under ERISA §407(a)), as well as the special requirements that applies to an ESOP under Code §4975(e)(7) and the regulations there under.

In the past, employers could only deduct 15% of compensation on any one defined contribution plan and therefore could not obtain the full 25% of compensation limit on annual additions without adopting a second plan (i.e. a Money Purchase Plan that provided for a 10% of compensation contribution). This was the primary reason for including a money purchase plan, as part of an ESOP. EGTRRA however, increased the deductible limit to 25% of compensation (from 15%), making the need for a second plan unnecessary.

**Caution:** This increase in the deductible limit does not apply to an ESOP of an S Corporation. Code §404(a)(9)(C)

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## General ESOP Qualification Requirements, Continued

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**Joint &  
Survivor  
Exception**

There is also an exception to the Joint and Survivor rules for Money Purchase Plans that are part of an ESOP. Code §401(a)(11)(C) provides that the Qualified Joint and Survivor Annuity (QJSA) and Qualified Pre-Retirement Survivor Annuity (QPSA) rules do not apply to that portion of a participant's accrued benefit in an ESOP to which 409(h) applies (i.e. right to demand employer securities; put option). Code §409(h) is discussed later in the chapter. A plan that is part Money Purchase and part ESOP would not be required to provide a QJSA or a QPSA. The rationale for this exception is that an ESOP is designed to allow employees to share in the growth of the company through stock ownership and this includes the ability to demand distributions in the form of employer securities and the right to "put" the stock to the employer.

What language must a plan have in order to take advantage of this exception? The same language that applies to all Profit Sharing Plans that do not wish to be subject to Code §401(a)(11). That is:

- a. The plan must provide for full vesting on death of the participant, and;
- b. The plan must provide that the entire account balance is payable to the participant's surviving spouse (unless a prior designation is in place, which was made with participant and spousal consent)

In addition, the plan must not be a transferee plan (i.e. a defined benefit plan or another defined contribution plan, subject to Code §412).

See Income Tax Regulation 1.401(a)-20, Q&A 3(c) and Code §401(a)(11)(C)(ii)

**Plan must  
formally be  
designated as  
an ESOP**

Regulation §54.4975-11(a)(2) requires that in order to be an ESOP, the plan document must have language that **specifically** makes this designation. Normally, the entire plan is designated as an ESOP. However, Regulation 54.4975-11(a)(5) allows a plan to provide that only a **portion** of a qualified plan is an ESOP. For example, part of the ESOP could be Profit Sharing Plan, or, part of the ESOP could be a Money Purchase Plan.

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## General ESOP Qualification Requirements, Continued

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**ESOP must be designed to invest in employer securities**

An ESOP that is intended to satisfy the requirements for qualification must also be designed to invest in “qualified employer securities”. We will later learn what “qualified employer securities” are, but you should look for plan language that **specifically** states that the ESOP is “primarily designed to invest in employer securities”. Regulation §54.4975-11(b)

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**Sample Plan Language – Designation as ESOP and designed to invest in employer securities**

*WHEREAS, the Employer heretofore established an Employee Stock Ownership Plan effective January 1, [            ], (hereinafter called the "Effective Date") known as the Employee Stock Ownership Plan (herein referred to as the "Plan") in recognition of the contribution made to its successful operation by its employees and for the exclusive benefit of its eligible employees; and*

*WHEREAS, under the terms of the Plan, the Employer has the ability to amend the Plan, provided the Trustee joins in such amendment if the provisions of the Plan affecting the Trustee are amended; and*

*WHEREAS, contributions to the Plan will be made by the Employer and invested primarily in the capital stock of the employer.*

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*(a) The plan is designed to invest primarily in Company Stock.*

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## Voting Rights

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**Voting rights –  
For registration  
type class of  
securities**

If the employer has a class of securities that:

- are required to be registered under Section 12 of the Securities and Exchange Act of 1934 (“the Exchange Act”) or
- would be required to be registered except for the exemption from registration provided by Section 12(g)(2)(H) of the Exchange Act,

Code §409(e)(2) states that the ESOP **must** provide each participant with the right to direct the voting of securities allocated to their account on **all** corporate matters.

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**Voting rights –  
If employer  
does not have  
registration  
type securities**

If the employer does not have registration type securities, Code §409(e)(3), requires that an ESOP allow the participants to vote the shares in their account, **but only** with regard to the following issues:

1. any corporate matter involving mergers, or consolidations
  2. the sale of all or substantially all of the corporation’s assets
  3. re-capitalizations
  4. reclassifications
  5. liquidations
  6. dissolutions
- 

**Right to direct  
plan to vote  
shares depends  
on applicable  
state law**

The Service ruled in TAM 9705004 that in the case of **non-registration** type securities, applicable state law would govern with respect to the right to direct the plan to vote allocated shares. Therefore, state law must provide for shareholder voting on those corporate matters before voting rights are passed through to the participants.

In addition, Code §409(e)(5) provides for a special 1 vote for each participant rule for **non-registration** type class securities. This special rule allows each participant 1 vote with the trustee voting the shares held by the plan in proportion to the votes received.

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## **Voting Rights, Continued**

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**Failure to receive instructions on how to vote shares & voting of unallocated Shares**

For either registration class or non- registration class of securities, the plan may provide that, if the plan trustee does not receive instructions on how to vote the particular shares, the trustee will vote those shares. See Revenue Ruling 95-57, 1995-2 C.B. 62

In addition, it is not uncommon for plan provisions to not “pass through” voting rights on unallocated shares (shares still in the suspense account). The plan could provide for the trustee to vote these shares. The plan could also provide that unallocated shares as well as allocated shares are voted in proportion to the allocated shares for which directions have been received. The Department of Labor has held that responsibility for voting unallocated shares should rest with plan trustees. Trustees however, may follow plan provisions only to the extent permitted by ERISA §404(a)(1)(D) (i.e. insofar as plan provisions are consistent with Titles I and IV of ERISA).

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## Voting rights-Sample Plan language

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**Sample plan language –  
Voting Rights**

*The Trustee shall vote all Company Stock held by it as part of the Plan assets. Provided, however, that if any agreement entered into by the Trust provides for voting of any shares of Company Stock pledged as security for any obligation of the Plan, then such shares of Company Stock shall be voted in accordance with such agreement. If the Trustee does not timely receive voting directions from a Participant or Beneficiary with respect to any Company Stock allocated to that Participant's or Beneficiary's Company Stock Account, the Trustee shall vote such Company Stock.*

*Notwithstanding the foregoing, if the Employer has a registration-type class of securities, each Participant or Beneficiary shall be entitled to direct the Trustee as to the manner in which the Company Stock which is entitled to vote and which is allocated to the Company Stock Account of such Participant or Beneficiary is to be voted. If the Employer does not have a registration-type class of securities, each Participant or Beneficiary in the Plan shall be entitled to direct the Trustee as to the manner in which voting rights on shares of Company Stock which are allocated to the Company Stock Account of such Participant or Beneficiary 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 any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as prescribed in Regulations. For purposes of this Section the term "registration-type class of securities" means: (A) a class of securities required to be registered under Section 12 of the Securities Exchange Act of 1934; and (B) a class of securities which would be required to be so registered except for the exemption from registration provided in subsection (g)(2)(H) of such Section 12.*

*If the Employer does not have a registration-type class of securities and the by-laws of the Employer require the Plan to vote an issue in a manner that reflects a one-man, one vote philosophy, each Participant or Beneficiary shall be entitled to cast one vote on an issue and the Trustee shall vote the shares held by the Plan in proportion to the results of the votes cast on the issue by the Participants and Beneficiaries.*

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## Right to Demand Stock

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**Plan must provide that a participant has the right to demand stock**

Because distributions from an ESOP may be made entirely in employer securities or in cash, or a combination of cash and securities, the participant must be given the right to demand that their entire distribution be in the form of employer securities. However, benefits distributed from the portion of a plan that **is not** an ESOP are only subject to the requirements imposed under Code §401(a). For example, the Stock Bonus or Money Purchase portion of the plan could provide for a distribution of cash, while the ESOP portion would provide for a distribution of stock. Code §409(h)

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**Exceptions to right to demand distribution**

Code Section §409(h)(2)(B) provides that if the employer's corporate charter (or bylaws) restricts ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan, the participant does not have to be given the right to demand a distribution in the form of employer securities.

- TRA '97 also provides that an ESOP maintained by an S corporation can preclude the distribution of employer securities to a participant. See the section in this chapter on S Corporations.
  - A right to demand a distribution in the form of employer securities does not have to be given if the securities were subject to the right of diversification and the participant had previously made an election to diversify. Code §409(h)(7) and Notice 88-56, Q&A-14.
  - Code §409(h)(3) provides a special exception for plans that are maintained by a bank (as defined in Code §581). Due to the fact that the law prohibits banks from redeeming or purchasing its own securities, the right to demand distribution in employer securities does not have to be given, if instead, the plan provides for a cash distribution.
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## Error! Not a valid bookmark self-reference.-sample plan language

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**Sample plan language – Right to Demand distribution in stock**

*Distribution of a Participant’s benefit may be made in cash or Company Stock or both. However, if a Participant or Beneficiary so demands, such benefit shall be distributed in the form of Company Stock. Prior to making a distribution of benefits, the Administrator shall advise the Participant or the Participant’s Beneficiary, in writing (or such other form as permitted by the Internal Revenue Service), of such rights.*

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**Sample plan language – Right to Demand distribution in stock**

*If a Participant or Beneficiary demands that benefits be distributed solely in Company Stock, distribution of a Participant's benefit will be made entirely in whole shares or other units of Company Stock. Any balance in a Participant's Other Investments Account will be applied to acquire for distribution the maximum number of whole shares or other units of Company Stock at the then fair market value. Any fractional unit value unexpended will be distributed in cash. If Company Stock is not available for purchase by the Trustee, then the Trustee shall hold such balance until Company Stock is acquired and then make such distribution, subject to Sections [ ]*

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**Sample plan language – Right to Demand distribution in stock**

*Notwithstanding any provision of this Section [ ] to the contrary, if the Employer is electing to be an S corporation, distribution of a Participant's benefit shall be made in cash without granting the Participant the right to demand distribution in shares of Company Stock.*

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**Sample plan language – Restriction to demand stock**

*Notwithstanding anything contained herein to the contrary, if the Employer charter or by-laws restrict ownership of substantially all shares of Company Stock to Employees and the Trust Fund, as described in Code Section 409(h)(2)(B)(ii)(I), the Administrator shall distribute a Participant's Account entirely in cash without granting the Participant the right to demand distribution in shares of Company Stock.*

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## Put Option

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**Put Option Requirements**

Code §409(h) and Regulation §54.4975-7(b)(10) are designed to protect plan participant's from being "stuck" with employer stock where there is no market to sell the stock on an established market. Therefore, an ESOP must provide that once participants receive a distribution of securities from the employer, they must be given the right to "put" the securities back to the employer. That is, the ESOP must allow the employer to repurchase or "put" the securities that are not "readily tradable on an established market" (when distributed or if the stock is subject to a trading limitation when distributed). Also, this regulation requires that stock must be put at fair market value.

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**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). See also 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 also 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.

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## Put Option, Continued

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**If employer violates federal law by honoring the put option**

In cases where the employer would violate Federal or state law by honoring the 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.

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**When is the put option exercisable?**

In accordance with Code §409(h)(4) the ESOP must provide that the put option is exercisable during two periods. The first one is for at least 60 days following the date of distribution and the second one is for at least 60 days in the following plan year.

The plan must also provide that if the participant receives a stock distribution which is repurchased by the employer (“exercises his put option”), the employer must make payments to the participant 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. The employer must also provide adequate security and pay reasonable interest on any unpaid amount. Code §409(h)(5).

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**Nonterminable right**

Another protection required in the plan document is provided in Regulation §54.4975-11(a)(3)(ii). This regulation provides that if the exempt loan is repaid, or if the plan ceases to be an ESOP, the put option requirements must continue to exist with respect to distributions of securities that were acquired with the exempt loan. Also Regulation §54.4975-7(b)(4) requires that securities acquired by an ESOP with an exempt loan may not be subject to a pre-existing put, call or other option, or buy-sell or similar arrangement while held by or distributed from the plan. However, this provision does not override the put option requirement for securities that are not publicly traded (or subject to a trading limitation).

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## Put option-sample plan language

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**Sample plan language – Put Option**

(a) *If Company Stock which was not acquired with the proceeds of an Exempt Loan is distributed to a Participant and such Company Stock is not readily tradable on an established securities market, a Participant has a right to require the Employer to repurchase the Company Stock distributed to such Participant under a fair valuation formula.*

(b) *Company Stock which is acquired with the proceeds of an Exempt Loan and which is not publicly traded when distributed, or if it is subject to a trading limitation when distributed, must be subject to a put option. For purposes of this paragraph, a "trading limitation" on a Company Stock is a restriction under any Federal or State securities law or any regulation thereunder, or an agreement (not prohibited by Section [     ]) affecting the Company Stock which would make the Company Stock not as freely tradeable as stock not subject to such restriction.*

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**Sample plan language – Put Option**

(c) *The put option must be exercisable only by a Participant, by the Participant's donees, or by a person (including an estate or its distributee) to whom the Company Stock passes by reason of a Participant's death. The put option must permit a Participant to put the Company Stock to the Employer. Under no circumstances may the put option bind the Plan. However, it shall grant the Plan an option to assume the rights and obligations of the Employer at the time that the put option is exercised. If it is known at the time a loan is made that Federal or State law will be violated by the Employer honoring such put option, the put option must permit the Company Stock to be put, in a manner consistent with such law, to a third party (e.g., an affiliate of the Employer or a shareholder other than the Plan) that has substantial net worth at the time the loan is made and whose net worth is reasonably expected to remain substantial.*

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*Continued on next page*

**Put option-sample plan language, Continued**

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**Sample plan language – Put Option**  
(continued)

*The put option shall commence as of the day following the date the Company Stock is distributed to the Former Participant and end sixty (60) days thereafter and if not exercised within such sixty (60) day period, an additional sixty day option shall commence on the first day of the fifth month of the Plan Year next following the date the stock was distributed to the Former Participant (or such other sixty (60) day period as provided in Regulations). However, in the case of Company Stock that is publicly traded without restrictions when distributed but ceases to be so traded within either of the sixty (60) day periods described herein after distribution, the Employer must notify each holder of such Company Stock in writing on or before the tenth day after the date the Company Stock ceases to be so traded that for the remainder of the applicable sixty (60) day period the Company Stock is subject to the put option.*

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**Sample plan language – Put Option**

*The put option is exercised by the holder notifying the Employer in writing that the put option is being exercised; the notice shall state the name and address of the holder and the number of shares to be sold. The period during which a put option is exercisable does not include any time when a distributee is unable to exercise it because the party bound by the put option is prohibited from honoring it by applicable Federal or State law. The price at which a put option must be exercisable is the value of the Company Stock determined in accordance with Section [     ]. Payment under the put option involving a "Total Distribution" shall be paid in substantially equal monthly, quarterly, semiannual or annual installments over a period certain beginning not later than thirty (30) days after the exercise of the put option and not extending beyond five (5) years. The deferral of payment is reasonable if adequate security and a reasonable interest rate on the unpaid amounts are provided. The amount to be paid under the put option involving installment distributions must be paid not later than thirty (30) days after the exercise of the put option. Payment under a put option must not be restricted by the provisions of a loan or any other arrangement, including the terms of the Employer articles of incorporation, unless so required by applicable state law.*

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*Continued on next page*

**Put option-sample plan language, Continued**

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**Sample plan language-put option**

*For purposes of this Section, "Total Distribution" means a distribution to a Participant or the Participant's Beneficiary within one (1) taxable year of the entire Vested Participant's Account.*

*(d) An arrangement involving the Plan that creates a put option must not provide for the issuance of put options other than as provided under this Section. The Plan (and the Trust Fund) must not otherwise obligate itself to acquire Company Stock from a particular holder thereof at an indefinite time determined upon the happening of an event such as the death of the holder.*

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**Sample plan language – Non-terminable rights**

*No Company Stock acquired with the proceeds of a loan described in Section [ ] hereof may be subject to a put, call, or other option, or buy-sell or similar arrangement when held by and when distributed from the Trust Fund, whether or not the Plan is then an ESOP. The protections and rights granted in this Section are nonterminable, and such protections and rights shall continue to exist under the terms of this Plan so long as any Company Stock acquired with the proceeds of a loan described in Section [ ] hereof is held by the Trust Fund or by any Participant or other person for whose benefit such protections and rights have been created, and neither the repayment of such loan nor the failure of the Plan to be an ESOP, nor an amendment of the Plan shall cause a termination of said protections and rights.*

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## Distribution Form, Timing, and Period Requirements

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### Timing of Distributions under Code §409(o)

Once employees leave employment, the balance in the employees ESOP account becomes payable. Please note that the account balance might consist of either **cash** or **stock** or **both**. The question then is, how soon will these benefits be paid? Under IRC section 409(o)(1)(A), ESOP participants can generally receive distributions sooner than required by Code §401(a)(14) and §401(a)(9), provided of course that the notice and consent requirements of Code §411(a)(11) and §417(e) are satisfied. However, the regulations make a critical distinction between retiring (or death or disability) and simply terminating employment. Therefore, an ESOP must have language that satisfies the following requirements:

- In the case where a participant retires, becomes disabled, or dies, distributions **must** begin during the plan year following the plan year in which the participant retires, becomes disabled or dies. In other words, **no later than** one (1) year following the event.
- For participants who leave for reasons other than the reasons stated above, the plan does not have to distribute until the sixth plan year after the plan year in which termination occurred (unless the participant is reemployed before then).

Note: The plan can (and probably will) also provide the exception to Code §409(o)(1)(A) under Code §409(o)(1)(B) which allows a leveraged ESOP to further delay payment until the loan is fully repaid.

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## Distribution Form, Timing, and Period Requirements, Continued

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**Period of Distribution under Code §409(o)(1)(C)**

The ESOP also needs to have language to comply with Code §409(o)(1)(C) that limits the distribution period. This provision states that subject to the election of the participant, the account balance will 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 in the same manner as under Code §415(d)), 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).

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**If more than one class of stock in ESOP is available for distribution**

If an ESOP acquires more than one class of employer securities (with the proceeds of the loan) which are available for distribution, the participant must receive substantially the same proportion of each class. Therefore, a participant may not receive only preferred stock if voting stock was also acquired with the proceeds of an ESOP loan. Reg. § 54.4975-11(f)(2).

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**Section 411(d)(6) - modifying the distribution options in the plan**

Please note that Code §411(d)(6)(C) provides a special rule, which allows an employer to modify distribution options in the plan (provided these modification are made in a non-discriminatory manner).  
Reg. § 1.411(d)-4, Q&A-2(d) provides guidance on the elimination of Code §411(d)(6) protected optional forms of benefits for ESOPs. This regulation states that 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 Code §409).

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*Continued on next page*

## Distribution Form, Timing, and Period Requirements, Continued

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**Distribution of Dividend Income** An ESOP may also be designed to allow plan participants to receive a current distribution of dividends instead of allocating those dividends to the participants' accounts. Regulation §54.4975-11(f)(3) states that an ESOP will not fail to meet Code §401(a) merely because it provides for the current payment of income. However, income from a plan that is a Stock Bonus must be held for a two-year period before being distributed.

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## Distribution form, timing and period requirements-sample plan language

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**Sample plan language – Timing of distributions under Code §409(o)** *(c) Unless the Participant elects in writing a longer distribution period, distributions to a Participant or the Participant's Beneficiary attributable to Company Stock, shall be in substantially equal monthly, quarterly, semiannual, or annual installments over a period not longer than five (5) years. In the case of a Participant with an account balance attributable to Company Stock in excess of \$500,000, the five (5) year period shall be extended one (1) additional year (but not more than five (5) additional years) for each \$100,000 or fraction thereof by which such balance exceeds \$500,000. The dollar limits shall be adjusted at the same time and in the same manner as provided in Code Section 415(d).*

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**Sample plan language – Timing of Distributions** *(f) If Company Stock acquired with the proceeds of an Exempt Loan (described in Section [ ] hereof) is available for distribution and consists of more than one class, a Participant, or his Beneficiary must receive substantially the same proportion of each such class.*

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**Distribution form, timing and period requirements-sample plan language, Continued**

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**Sample plan language – Payment of Cash Dividends**

*(e) Notwithstanding anything herein to the contrary, the Administrator may direct that cash dividends on shares of Company Stock allocable to Participants' Company Stock Accounts be:*

- 1) Paid by the employer in cash to the Participants in the Plan or their beneficiaries;*
- 2) Paid to the Plan and distributed in cash to Participants in the Plan or their Beneficiaries no later than ninety (90) days after the close of the Plan Year in which paid;.*
- 3) At the election of Participants or their Beneficiaries with, paid in accordance with paragraph (1) or (2) above, or paid to the Plan and reinvested in Company Stock; provided, however, that if cash dividends are reinvested in Company Stock, then Company Stock allocated to the Participant's Company Stock Account shall have a fair market value not less than the amount of cash dividends which would have been allocated to such Participant's Other Investment Account for the year. This paragraph shall not apply while the Employer has elected to be an S corporation under Code Section 1362(a);*
- 4) Used to make payments on an Exempt Loan the proceeds of which were used to acquire Company Stock (whether or not allocated to Participants' Company Stock Account) with respect to which the cash dividend is paid;*
- 5) Allocated to Participants' Other Investment Accounts.*

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**Distribution form, timing and period requirements-sample plan language, Continued**

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**Sample plan language –  
Timing of distributions under Code §409(o)**

*Upon a Participant's Retirement Date, or as soon thereafter as is practicable, the Trustee shall distribute, at the election of the Participant, all amounts credited to such Participant's Account in accordance with Sections [    ].*

*If elected, distribution shall commence not later than one (1) year after the close of the Plan Year in which such Participant's death occurs.*

*However, at the election of the Participant, the Administrator shall direct the Trustee to cause the entire Vested portion of the Terminated Participant's Account attributable to Company Stock to be payable to such Terminated Participant one (1) year after the close of the Plan Year which is the fifth Plan Year following the Plan Year in which the Participant otherwise separates from service. However, if the Terminated Participant is reemployed by the Employer before distribution is required to commence under this paragraph, distribution shall be postponed. Distribution to a Participant shall not include any Company Stock acquired with the proceeds of an Exempt Loan until the close of the Plan Year in which such loan is repaid in full. Any distribution under this paragraph shall be made in a manner which is consistent with and satisfies the provisions of Sections [    ], including, but not limited to, all notice and consent requirements of Code Section 411(a)(11) and the regulations thereunder.*

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## Allocation Employer Contributions & Forfeitures

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**Definite Allocation Formula**

In order for a plan to be qualified as an ESOP, Regulation §54.4975-11(d)(1) requires that allocations to the individual participant accounts be made under the same rules that apply to a Profit Sharing and Stock Bonus Plan. See also Regulation §1.401-1(b)(1)(ii) and (iii). This means that an ESOP must contain a definite allocation formula that meets Code §401(a)(4). In the Exempt Loan section, you will learn more about the allocation of employer securities, and how unallocated shares get into the participants account.

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**Aggregation of ESOP's**

Regulation §54.4975-11(e) prevents an ESOP from being aggregated with another plan in order to satisfy Code §401(a)(4) or §410(b) unless both plans existed on November 1, 1977 or (2) both plans are ESOP's and

- i. both include substantially the same proportion of the various classes of stock,
- ii. the qualifying employer securities held by both ESOP's are all of the same class, or the ratio of each class held to all such securities held is substantially the same for each plan

The rationale for this rule is derived from the broad ESOP objective, which is to promote employee stock ownership. This objective would be thwarted if an ESOP could be established for the highly compensated employees with non-highly compensated employees covered by a “comparable plan”.

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**Use of Non Design Based Safe Harbor & Cross Testing**

Also, an ESOP cannot satisfy the non discrimination rules by using the uniform points safe harbor or by cross testing allocations in accordance with Regulation §§ 1.401(a)(4)-8, 1.401(a)(4)-1(b)(2)(ii) & 1.401(a)(4)-2(b)(3)(i)

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**Allocation in non-monetary units**

Regulation §54.4975-11(d)(4) states that the ESOP must allocate “non-monetary units representing participants’ interest in assets withdrawn from the suspense account.” This simply means that the participant must receive their share of the amount in the suspense account that represents employer securities.

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## Allocation Employer Contributions & Forfeitures, Continued

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**No integration with Social Security**

An ESOP cannot integrate allocations with Social Security, (i.e. Code §401(l)) unless the ESOP was established before November 1, 1977. If an ESOP was established and integrated before this date, it may remain integrated. However, these plans cannot be amended to increase the integration level or the integration percentage. Regulation §54.4975-11(a)(7)(ii) and Regulation §1.401(l)-1(a)(4)(ii).

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**Timing of Forfeitures**

The plan must also provide that stock released from the ESOP suspense account and allocated to a participant's account can be forfeited **only** after other assets have been forfeited. In addition, if the ESOP has more than one class of employer stock that has been allocated to the participant's account, a proportional share of each class of stock must be forfeited. Regulation §54.4975-11(d)(4).

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**Floor Offset Arrangements**

Be aware that an ESOP would generally not be allowed to offset benefits in a defined benefit plan. This is because an ESOP would not be considered an "eligible individual account plan" under ERISA §407(a) and (b), if its benefits are taken into account in determining the benefits payable under any defined benefit plan. See ERISA §407(d)(3)(C). 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 an "eligible individual account plan." Effective December 17, 1987, floor offset arrangements are treated as a single plan, for purposes of the 10% limit, if the benefits of the individual account plan are taken into account in determining the benefits payable under the defined benefit plan. See ERISA §407(d)(9). Therefore, if the ESOP offsets benefits in the defined benefit plan, the 10% limit may be exceeded, causing a prohibited transaction to take place under Code §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 Code §4975(d)(13)).

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## Allocation of Employee Contributions and Forfeitures- Sample plan language

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**Sample plan language –  
Definite allocation formula**

*The Employer shall provide the Administrator with all information required by the Administrator to make a proper allocation of employer contributions for each Plan Year. Within a reasonable period of time after the date of receipt by the Administrator of such information, the Administrator shall allocate such contribution to each Participant's Account in the same proportion that each such Participant's Compensation for the year bears to the total Compensation of all Participants for such year.*

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**Allocation in non monetary units**

*As of each Anniversary Date, the Plan must consistently allocate to each Participant's Account, in the same manner as Employer discretionary contributions pursuant to Section [ ] are allocated, non-monetary units (shares and fractional shares of Company Stock) representing each Participant's interest in Company Stock withdrawn from the Unallocated Company Stock Suspense Account.*

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**Sample plan language –  
timing of forfeitures**

*If a portion of a Participant's Account is forfeited, Company Stock allocated to the Participant's Company Stock Account must be forfeited only after the Participant's Other Investments Account has been depleted. If interest in more than one class of Company Stock has been allocated to a Participant's Account, the Participant must be treated as forfeiting the same proportion of each such class.*

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## Code §415 Limits

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

When the employer stock is first acquired with the loan proceeds, the stock is allocated to a suspense account because the stock is given as collateral for the loan. As repayments are made under the plan (through employer contributions to the ESOP and the use of dividends on employer securities in the ESOP), a portion of stock is no longer necessary to secure the loan and that portion is released from encumbrance and allocated from the suspense account to the participants' accounts.

If stock has been acquired by an exempt loan, annual additions under Code §415(c) can be calculated under either of two methods. Annual additions can be determined either with respect to:

- (1) the amount of employer contributions to the ESOP used to repay a loan,  
or
- (2) the value of the employer securities allocated to participants.

The plan should specify which method it will use to calculate annual additions. 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 Code § 415 purposes. Regulations §§1.415-6(g)(4), & (5), 54.4975-11(a)(8)(ii) and 54.4975-7(b)(8)(iii).

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**If an ESOP is not funded by an exempt loan**

If an ESOP is not funded by an exempt loan, or in the case of a stock bonus plan, 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).

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## Code §415 Limits, Continued

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

Code §415(c)(6) & Regulation §1.415-6(g)(3) provide a special rule that **may** be used in determining annual additions made to an ESOP. The rule provides that 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 Code §414(q)), 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 annual additions. Appropriate language should be found in the ESOP if the taxpayer wishes to use this rule.

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## Code §415 Limits-sample plan language

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**Sample plan language – calculation of annual additions**

*For purposes of applying the limitations of Code Section 415, if Employer contributions are applied to payments on an Exempt Loan, the amount included as an "annual addition" under this paragraph shall be the fair market value of the shares released from the Unallocated Company Stock Account.*

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**Sample plan language – 415**

*(d) For purposes of applying the limitations of Code Section 415, the following are not "annual additions": (1) the transfer of funds from one qualified plan to another and (2) provided no more than one-third of the Employer contributions for the year are allocated to Highly Compensated Participants, Forfeitures of Company Stock purchased with the proceeds of an Exempt Loan and Employer contributions applied to the payment of interest on an Exempt Loan.*

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## **Exempt Loan Requirements**

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### **Introduction to Exempt Loan**

In the earlier diagram of a leveraged ESOP, the ESOP borrowed money from a financial institution (with the company guaranteeing the loan). A plan that has all of the necessary language for this “exempt loan” (i.e. one that meets all of the requirements of Regulation §54.4975-7(b)), along with all other requirements, would qualify under Code §4975(e)(7).

Remember that an exempt loan is a loan to an ESOP by a “disqualified person” or a loan to an ESOP from a third party that is guaranteed by a “disqualified person”. Generally, these kinds of loans are prohibited transactions under Code §4975(c)(1)(B) because they constitute a direct or indirect lending of money or other extension of credit between a plan and a disqualified person. However, Code §4975(d)(3) provides an exemption from the excise tax if the plan meets all of the following:

- a. the loan is primarily for the benefit of participants and beneficiaries of the plan, and
- b. the loan is at a reasonable rate of interest, and any collateral which is given to a disqualified person by the plan consists only of qualifying employer securities (as defined in Code §4975(e)(8)).

The failure of a plan to meet the above does not cause the plan to be disqualified or lose its status as an ESOP. However, the plan would become subject to the excise tax under Code §4975(c).

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## Exempt Loan Requirements, Continued

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**Primary benefit requirement** Regulation §54.4975-7(b)(3) provides that the exempt loan is to be primarily for the benefit of ESOP participants and requires that at the time the loan is made, the interest rate of the loan and the price of the employer securities must not cause the assets of the plan to be drained off. While this is primarily an operational issue, there is some language that you would need to look for that indicates the intention of the plan sponsor to satisfy this requirement.

- The plan should have language to indicate that the terms of the loan must be at least as favorable as the terms of a comparable loan. Regulation §54.4975-7(b)(4).
- There should be language in the plan to indicate that the rate of interest on a loan will not be in excess of a reasonable rate of interest. Regulation §54.4975-7(b)(7).
- The plan should provide that the loan will be for a specific term and will not be payable on demand. Note that the plan does not have to state what the term of the loan will be. The term of an ESOP loan is generally what lenders will accept (normally five to ten years). Regulation §54.4975-7(b)(13).

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**Use of Loan Proceeds** Upon receipt of the loan by the ESOP, Regulation §54.4975-7(b)(4) requires the trustees to use these proceeds within a reasonable time for any or all of the following:

- To acquire qualifying employer securities
- To repay the loan; or
- To repay a prior exempt loan

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## Exempt Loan Requirements, Continued

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### Collateral of Exempt Loan

Regulation §54.4975(b)(5) requires an ESOP to provide that any collateral pledged must be limited to either:

- (i) employer securities purchased with the exempt loan, or
  - (ii) those that were used as collateral on a prior exempt loan and repaid with the proceeds of the current loan.
- 

### Recourse against ESOP

Regulation §54.4975-7(b)(5) also requires that an exempt loan be made **without recourse** against the ESOP. This means “absence of liability”. Therefore, the plan should not be liable for the loan being repaid beyond the unallocated securities in the suspense account. It is the employer’s credit and commitment to make contributions to the ESOP, in sufficient amounts to enable the ESOP loan to be repaid, which secures the loan. In order to satisfy this requirement, the plan must provide that a lender can seek repayment of an ESOP loan **only** out of the following plan assets:

- 1) Assets acquired with the 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 plan should also require that 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.

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## **Exempt Loan Requirements, Continued**

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### **Repayment of Loan & Default**

The use of an exempt loan to acquire employer securities creates an obligation by the employer to make sufficient contributions to repay the loan and release the shares for allocation to the participants. The failure to make sufficient contributions to repay the loan could cause the loan to be non-exempt and therefore subject to excise tax as a prohibited transaction. Regulation §54.4975-7(b)(6)

In order to protect plan participants in the event that there is a default on an exempt loan, the plan must provide:

- If the lender is a disqualified person, the amount that can be transferred from the suspense account must be limited to the amount of the missing payment. This prevents an employer from manipulating the default mechanism in order to use plan assets to repay an exempt loan.
- If the lender is not a disqualified person (i.e. a third party lender) the amount transferred from the suspense account must be limited to the amount of default.

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## Exempt Loan Requirements, Continued

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**Use of Suspense Account & Release of Stock from Suspense Account**

Regulation §54.4975-11(c) requires that the terms of a plan provide for the use of a suspense account to hold unallocated employer stock until released by the employer by making tax-deductible contributions to the ESOP.

This section discusses how that stock is released and allocated and what plan language is required in order to qualify under Code §4975(e)(7).

As an exempt loan is repaid with employer contributions, Regulation §54.4975-7(b)(8) requires that stock be released from the suspense account using one of two methods:

- 1) The first and most common method is based on the principal and interest payments on the loan.
- 2) The second method permits the release of employer securities from the suspense account based solely on principal payments.

The plan must state which method it intends on using to release stock from the suspense account. If the plan incorporates both methods, it should also have language to state that once a method is chosen, it cannot be changed during the period of the exempt loan, except to the extent that method 1 has been violated.

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**Special requirements in order to use Principal Only method**

Note that the principal only method can be used, only if the following conditions are satisfied:

- The term of the loan must be for 10 years or less,
- Interest is disregarded only to the extent that it would be determined to be interest under a standard loan amortization table, and
- 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 cannot extend over 10 years.

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**Exempt Loan Requirements, Continued**

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**Sample plan language - Primary Benefit Requirement**

*All purchases of Company Stock shall be made at a price which, in the judgment of the Administrator, does not exceed the fair market value thereof. All sales of Company Stock shall be made at a price which, in the judgment of the Administrator, is not less than the fair market value thereof. The valuation rules set forth in Article VI shall be applicable.*

*The loan must be at a reasonable rate of interest;*

*The loan must be for a specific term and may not be payable at the demand of any person, except in the case of default;*

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**Sample plan language – Use of Loan Proceeds**

*The Plan may borrow money for any lawful purposes, provided the proceeds of an Exempt Loan are used within a reasonable time after receipt only for any or all of the following purposes:*

- (1) To acquire Company Stock*
  - (2) To repay such loan*
  - (3) To repay a prior Exempt Loan*
- 

**Sample plan language – Collateral for Exempt Loan**

*Any collateral pledged to the creditor by the Plan shall consist only of the Company Stock purchased with the borrowed funds;*

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**Exempt Loan Requirements, Continued**

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**Sample plan language – Use of suspense account**

*All Company Stock acquired by the Plan with the proceeds of an Exempt Loan must be added to and maintained in the Unallocated Company Stock Suspense Account. Such Company Stock shall be released and withdrawn from that account as if all Company Stock in that account were encumbered.*

*Company Stock acquired by the Plan with the proceeds of an Exempt Loan shall only be allocated to each Participant's Company Stock Account upon release from the Unallocated Company Stock Suspense Account as provided in Section [ ] herein. Company Stock acquired with the proceeds of an Exempt Loan shall be an asset of the Trust Fund and maintained in the Unallocated Company Stock Suspense Account.*

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**Sample plan language – Recourse against ESOP**

*Under the terms of the loan, the creditor shall have no recourse against the Plan except with respect to such collateral, earnings attributable to such collateral, Employer contributions (other than contributions of Company Stock) that are made to meet Current Obligations and earnings attributable to such contributions;*

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**Sample plan language – Repayment of Loan & Default**

*In the event of default upon an Exempt Loan, the value of the Trust Fund transferred in satisfaction of the Exempt Loan shall not exceed the amount of default. If the lender is a disqualified person, an Exempt Loan shall provide for a transfer of Trust Funds upon default only upon and to the extent of the failure of the Plan to meet the payment schedule of the Exempt Loan;*

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**Exempt Loan Requirements, Continued**

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**Sample plan language –  
Release of stock  
from suspense  
account**

*Such Company Stock shall be released and withdrawn from the Unallocated Suspense Account as if all Company Stock in that account was encumbered. For each Plan Year during the duration of the loan, the number of shares of Company Stock released shall equal the number of encumbered shares held immediately before release for the current Plan Year multiplied by a fraction, the numerator of which is the amount of principal and interest paid for the Plan Year and the denominator of which is the sum of the numerator plus the principal and interest to be paid for all future Plan Years. As of each Anniversary Date, the Plan must consistently allocate to each Participant's Account, in the same manner as Employer discretionary contributions pursuant to Section [ ] are allocated, non-monetary units (shares and fractional shares of Company Stock) representing each Participant's interest in Company Stock withdrawn from the Unallocated Company Stock Suspense Account. However, Company Stock released from the Unallocated Company Stock Suspense Account with cash dividends pursuant to Section [ ] shall be allocated to each Participant's Company Stock Account in the same proportion that each such Participant's number of shares of Company Stock sharing in such cash dividends bears to the total number of shares of all Participant's Company Stock sharing in such cash dividends.*

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## Valuation of Employer Securities

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### Introduction

There are a number of issues that can arise in operation regarding the valuation of employer stock. Because this chapter is devoted to looking at what plan language is needed in order to make the ESOP qualified, these issues will not be discussed further here. Instead, refer to Chapter 8 in the 2003 CPE for additional information with regard to valuation issues in examination cases.

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### Independent Appraiser

In closely held companies, Code §401(a)(28)(C) requires all stock transactions to be valued by an independent, outside appraiser. The plan must provide, therefore, 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)).

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### Sample plan language - Independent Appraiser

*Valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities. In the case of a transaction between a Plan and a disqualified person, value must be determined as of the date of the transaction. For all other Plan purposes, value must be determined as of the most recent Valuation Date under the Plan. An independent appraisal will not in itself be a good faith determination of value in the case of a transaction between the Plan and a disqualified person. However, in other cases, a determination of fair market value based on at least an annual appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any party to the transaction will be deemed to be a good faith determination of value. Company Stock not readily tradeable on an established securities market shall be valued by an independent appraiser meeting requirements similar to the requirements of the Regulations prescribed under Code Section 170(a)(1).*

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## **Right of First Refusal**

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**Right of First Refusal**

A right of first refusal is a right of the employer to match any offer the participant may receive (from a third party) on distributed stock that is not publicly traded. A plan **may** but is **not** required to utilize the provisions of Regulation §54.4975-7(b)(9). However, if a sponsor chooses to use this provision, the plan must provide for the following:

- (1) The right of first refusal must be in favor of the employer, the ESOP or both in any order of priority.
- (2) The securities must not be publicly traded at the time right is exercised.
- (3) The right may not be extended in favor of other stockholders.
- (4) The right of first refusal must lapse within a 14-day period after the security holder gives written notice of intent to transfer such stock.
- (5) The selling price and other terms under the right must not be less favorable to the seller than the terms of a good faith offer to purchase such shares from an unrelated third party or the value of the shares determined under Regulation §54.4975-11(d)(5), whichever is greater.

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## Right of First Refusal, Continued

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**Sample plan language -  
Right of First Refusal**

*If any participant, his Beneficiary or any other person to whom shares of Company Stock are distributed from the Plan (the "Selling Participant") shall, at any time, desire to sell some or all of such shares (the "Offered Shares") to a third party (the "Third Party"), the Selling Participant shall give written notice of such desire to the Employer and the Administrator, which notice shall contain the number of shares offered for sale, the proposed terms of the sale and the names and addresses of both the Selling Participant and Third Party. Both the Trust Fund and the Employer shall each have the right of first refusal for a period of fourteen (14) days from the date the Selling Participant gives written notice to the Employer and the Administrator (such fourteen (14) day period to run concurrently against the Trust Fund and the Employer), to acquire the Offered Shares. As between the Trust Fund and the Employer, the Trust Fund shall have priority to acquire the shares pursuant to the right of first refusal. The selling price and terms shall be the same as offered by the Third Party.*

*Except as provided in this paragraph (d), no Company Stock acquired with the proceeds of an Exempt Loan complying with the requirements of Section [ ] hereof shall be subject to a right of first refusal. Company Stock acquired with the proceeds of an Exempt Loan, which is distributed to a Participant or Beneficiary, shall be subject to the right of first refusal provided for in paragraph (a) of this Section only so long as the Company Stock is not publicly traded. The term "publicly traded" refers to a securities exchange registered under Section 6 of the Securities Exchange Act of 1934 ((15 U.S.C 78F) or that is quoted on a system sponsored by a national securities association registered under Section 15A(b) of the Securities Exchange Act (15 U.S.C 780). In addition, in the case of Company Stock which was acquired with the proceeds of a loan described in Section [ ], the selling price and other terms under the right must not be less favorable to the seller than the greater of the value of the security determined under Section [ ], or the purchase price and other terms offered by a buyer (other than the Employer or the Trust Fund), making a good faith offer to purchase the security. The right of first refusal must lapse no later than fourteen (14) days after the security holder gives notice to the holder of the right that an offer by a third party to purchase the security has been made. The right of first refusal shall comply with the provisions of paragraphs (a),(b) and (c) of this Section, except to the extent those provisions may conflict with the provisions of this paragraph.*

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## Diversification Requirements

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### Introduction

As ESOP participants near retirement age, and the value of the ESOP stock account becomes increasingly susceptible to decline (in the event there is a down turn in the market, or if the financial status of the company worsens), their livelihood is at risk. Because an ESOP is also a retirement program, the value of the ESOP stock account could be an important part of their livelihood. For this reason, the Tax Reform Act of 1986 provided that for employer securities acquired after December 31, 1986, each “qualified participant” **must** be given the right to diversify their account. That is, they must be given the right to move some or all of the shares of stock into other investments (other than employer securities) or to receive an in service distribution. This section deals with the provisions of Code §401(a)(28)(B) and plan language requirements.

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### Code §401(a)(28)(B)

This code section requires that each “qualified participant” in a plan may elect, within 90 days after the close of the 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 is increased to 50% in the final year of the election period.

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 percent of the number of shares of employer securities acquired by the plan after December 31, 1986, 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 December 31, 1986.

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## Diversification Requirements, Continued

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**Definition of  
“Qualified  
Participant”**

A “qualified participant” is any employee who has completed at least 10 years of participation in the plan and has attained age 55. Included in determining years of participation in the plan, is years of service with a predecessor plan.

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**Definition of  
“Qualified  
Election  
Period”**

The “qualified election period” is the six (6) plan year period beginning with the later of:

- (1) the first plan year in which the individual first becomes a “qualified participant”, or
  - (2) the first plan year beginning after December 31, 1986.
- 

**Ways in which  
a plan can  
satisfy Code  
§401(a)(28)(B)**

There are three methods by which a **plan** can satisfy the diversification requirements of Code §401(a)(28)(C). The first two are statutory and appear in Code §401(a)(28)(B)(ii).

- (i) 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.
  - (ii) Second, the plan **must** 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.
  - (iii) Q&A 13 of Notice 88-56 provides a third method by which a plan can satisfy the diversification election. The plan can offer a participant the option to direct the transfer of a 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.
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**Diversification Requirements, Continued**

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Sample plan  
language –  
Code  
§401(a)(28)(B)

*Each “Qualified Participant” may elect within ninety (90) days after the close of each Plan Year during the “Qualified Election Period” to direct the Trustee in writing as to the investment of 25 percent of the total number of shares of Company Stock acquired by or contributed to the Plan that have ever been allocated to such “Qualified Participant’s” Company Stock Account (reduced by the number of shares of Company Stock previously invested pursuant to a prior election). In the case of the election year in which the Participant can make his last election, the preceding sentence shall be applied by substituting “50 percent” for “25 percent.” If the “Qualified Participant” elects to direct the Trustee as to the investment of the Company Stock Account, such direction shall be effective no later than 180 days after the close of the Plan Year in which such direction applies. In lieu of directing the Trustees a to the investment of the Participants’ Company Sock Account, the “Qualified Participant” may elect a distribution in cash of the portion of the Participant’s Company Stock Account covered by the election within 90 days after the last day of the period during which the election can be made. Furthermore, the Participant must be given a choice of at least three distinct investment options.*

*Notwithstanding the above, if the fair market value (determined pursuant to Section[ ] at the Plan Valuation Date immediately preceding the first day on which a “Qualified Participant” is eligible to make an election) of Company Stock acquired by or contributed to the Plan and allocated to a “Qualified Participant’s” Company Stock Account is \$500 or less, then such Company Stock shall not be subject to this paragraph. For purposes of determining whether the fair market value exceeds \$500, Company Stock held in accounts of all employee stock ownership plans (as defined in Code Section 4975(e)(7) and tax credit employee ownership plans (as defined in Code Section 409(a)) maintained by the Employer or any Affiliated Employer shall be considered as held by the Plan.*

*(e) For purposes of this Section the following definitions shall apply:*

*(1) “Qualified Participant” means any Participant or Former Participant who has completed ten (10) Years of Service as a Participant and has attained age 55.*

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## Diversification Requirements, Continued

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Sample plan language Code §401(a)(28)(B) (continued)

(2) “Qualified Election Period” means the six (6) Plan Year period beginning with the later of (A) the first Plan Year in which the Participant first became a “Qualified Participant,” or (B) the first Plan Year beginning after December 31, 1986.

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## Qualified Employer Securities

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### Introduction

Earlier you learned that an ESOP must have language to provide that it is primarily intended to invest in qualified employer securities. While there is no specific percentage that defines the term “primarily”, the term generally requires at least 50% of the ESOP assets to be invested in employer securities. In actuality however, facts and circumstances would need to be taken into account, such as the investment performance of the securities.

It should be noted that 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.

This section will indicate what language is needed in a plan document to comply with the definition of “Qualifying Employer Securities” under Code §4975(e)(8) and Code §409(l) as it applies to ESOPs, which is different from how this same term applies to other plans.

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## Qualified Employer Securities, Continued

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**Definition of “Qualifying Employer Securities” under Code §4975(e)(8)**

Code §4975(e)(8) defines “qualifying employer securities” as employer securities within the meaning of Code §409(l). This code section provides that qualifying employer securities shall 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.

Code §409(l)(4) applies special rules to the definition of “qualifying employer securities” for plans of controlled groups of corporations. The effect of this code section is to expand the definition of controlled groups to determine employer securities, but not to expand the definition of controlled group for other qualification purposes. See Chapter 8 of the 2003 CPE for further information on the application of Code §409(l)(4).

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**Definition of “Qualifying Employer Securities” is different for other plans.**

Originally the definition of employer securities for ESOPs was the ERISA definition in §407(d)(5). The Revenue Act of 1978 made the definition more restrictive to generally mean common stock of a corporation or of a controlled group member that covers the ESOP participants. Therefore, a Stock Bonus Plan (other than an ESOP) may define employer securities using the broader definition found in ERISA §407(d)(5) while an ESOP (intended to satisfy Code §4975(e)(7)) must use the stricter definition in Code §409(l).

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## Qualified Employer Securities, Continued

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**Sample plan  
language –  
Qualifying  
Employer  
Securities**

*"Company Stock" means common stock issued by the Employer (or by a corporation which is a member of the controlled group of corporations of which the Employer is a member) which is readily tradeable on an established securities market. If there is no common stock which meets the foregoing requirement, the term "Company Stock" means common stock issued by the Employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of: (A) that class of common stock of the Employer (or of any other such corporation) having the greatest voting power, and (B) that class of common stock of the Employer (or of any other such corporation) having the greatest dividend rights. Noncallable preferred stock shall be deemed to be "Company Stock" if such stock is convertible at any time into stock which constitutes "Company Stock" hereunder and if such conversion is at a conversion price which (as of the date of the acquisition by the Trust) is reasonable. For purposes of the preceding sentence, pursuant to Regulations, preferred stock shall be treated as noncallable if after the call there will be a reasonable opportunity for a conversion which meets the requirements of the preceding sentence.*

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## Code §1042 Transfers

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### Introduction

Code §1042 allows an individual shareholder to elect to sell certain qualified securities to an ESOP, purchase “qualified replacement property”, and to defer recognition of capital gain, until these new securities are sold. Capital gain would then be recognized to the extent that the amount realized on the sale exceeds the cost of the “qualified replacement property”. Securities that are acquired by an ESOP in this type of transaction are also subject to the allocation restrictions under Code §409(n).

However, 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.

A plan that violates these provisions would be subject to the excise taxes under Code §4978 and §4979A.

A plan **may** but is not required to provide for this provision. Form 5309 should indicate whether a plan sponsor is requesting a ruling with regard to Code §1042. If the question on Form 5309 is answered in the affirmative, look for appropriate plan language. Note however, Code §1042(c)(7) provides that the non-recognition treatment does not apply to gain on the sale of qualified securities which are includible in the gross income of a **C Corporation**. In addition, a **shareholder** of an S Corporation **may not** utilize this provision because the definition of qualified securities for purposes of the non-recognition of gain treatment is limited to C Corporations (unless S-election is terminated; see PLR 200003014).

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**Code §1042 Transfers, Continued**

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**Definition of  
“Qualified  
Replacement  
Property”**

“**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.
- 

**Definition of  
“Qualified  
Securities”**

“**Qualified securities**” are employer securities, defined in Code §409(l), issued by a domestic corporation that has no outstanding stock that is readily tradable on an established securities market, and have not been received by the taxpayer as a distribution from a qualified plan or pursuant to the exercise of a stock option.

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**Definition of  
“Replacement  
Period”**

Code §1042(c)(3) defines the replacement period as the period which begins 3 months before the sale of the qualified securities and ends 12 months after the date of such sale. The taxpayer must have held the qualified securities for at least 3 years as of the time of the sale.

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## Code §1042 Transfers, Continued

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**Manner and  
Statement of  
election**

In order to take advantage of this benefit, the selling shareholder must make a “statement of election” which is 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 was made. The election once made, is irrevocable.

The “statement of election” must provide that the taxpayer elects to treat such sale of securities as a sale of qualified securities under Code §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 sale of the qualified securities;
- 3) The adjusted basis of the qualified securities;
- 4) The amount realized from 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, the name, TIN, and number of shares sold by other taxpayers would need to be included; and
- 7) If qualified replacement property was purchased at the time of the election, a “statement of purchase” should be attached describing the qualified replacement property, date of purchase, cost, and declaration that such property is to be qualified replacement property. The 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, the notarized statement (along with the required information noted above) must be attached to the subsequent income tax return.

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**Code §1042 Transfers, Continued**

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**Manner and Statement of election – (continued)**

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 any authorized officer of the eligible worker cooperative), consenting to the application of Code §4978(a). This code section generally imposes a 10% excise tax on any corporation that disposes of qualifying employer securities acquired in a sale to which Code §1042 applies, before the expiration of a 3 year period after the date the ESOP acquired any qualified securities and –

- (1) immediately after the disposition, the total number of shares held by the plan is less than the total number of employer securities held after the sale to the company, or
- (2) the value of the qualified securities held by the plan is less than 30% of the total value of all employer securities.

Regulation. §1.1042-1T, Q&A 2 & 3 and Code §4978.

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**Code Section 409(n)**

Code §409(n) is designed to prevent shares of stock that have been acquired in a Code §1042 transaction from being allocated for the benefit of:

- 1) The selling shareholder;
- 2) Relatives of the selling shareholder (as defined in Code §267(c));
- 3) Any other person who, after the application of the attribution rules under Code §318(a) owns, more than 25% of any class of outstanding stock of the corporation or of any controlled group member (as defined in Code §409(l)(4)), or more than 25% of the total value of any class of outstanding stock of any such corporation.

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## Code §1042 Transfers, Continued

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**Code Section  
409(n)  
(continued)**

Allocations of Code §1042 securities cannot be made during the non-allocation period. The non-allocation period is the period beginning when the securities are sold to the plan under Code §1042 and ends on the later of:

- 1) 10 years after the date of sale, or
  - 2) if the plan borrowed money to purchase the securities, the date the loan is repaid.
- 

**Sample plan  
language –  
Code §1042 and  
§409(n)**

*(a) No portion of the Trust Fund attributable to (or allocable in lieu of) Company Stock acquired by the Plan in a sale to which Code Section 1042 applies may accrue or be allocated directly or indirectly under any plan maintained by the Employer meeting the requirements of Code Section 401(a):*

*(1) during the Nonallocation Period for the benefit of:*

- (A) any taxpayer who makes an election under Code Section 1042(a) with respect to Company Stock,*
- (B) any individual who is related to the taxpayer (within the meaning of Code Section 267(b)); or*

*(2) for the benefit of any other person who owns (after application of Code Section 318(a) applied without regard to the employee trust exception in Code Section 318(a)(2)(B)(i)) more than 25 percent of:*

- (A) any class of outstanding stock of the Employer or Affiliated Employer which issued such Company Stock, or*
  - (B) the total value of any class of outstanding stock of the Employer or Affiliated Employer.*
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**Code §1042 Transfers, Continued**

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**Sample plan language – Code §1042 and §409(n) – (continued)**

*(b) Except, however, subparagraph (a)(1)(B) above shall not apply to lineal descendants of the taxpayer, provided that the aggregate amount allocated to the benefit of all such lineal descendants during the Nonallocation Period does not exceed more than five (5) percent of the Company Stock (or amounts allocated in lieu thereof) held by the Plan which are attributable to a sale to the Plan by any person related to such descendants (within the meaning of Code Section 267(c)(4)) in a transaction to which Code Section 1042 is applied.*

*(c) A person shall be treated as failing to meet the stock ownership limitation under paragraph (a)(2) above if such person fails such limitation:*

- (1) at any time during the one (1) year period ending on the date of sale of Company Stock to the Plan, or*
- (2) on the date as of which Company Stock is allocated to Participants in the Plan.*

*(d) For purposes of this Section, "Nonallocation Period" means the period beginning on the date of the sale of the Company Stock and ending on the later of:*

- (1) the date which is ten (10) years after the date of sale, or*
- (2) the date of the Plan allocation attributable to the final payment of the Exempt Loan incurred in connection with such sale.*

*(e) Notwithstanding any provision of this Section to the contrary, a sale to which Code Section 1042 applies shall not be made during the period in which the Employer has elected to be an S corporation under Code Section 1362(a).*

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## **Sub S Corporation ESOPs and Anti Abuse Measures**

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### **Background**

An S Corporation is a form of business which does not pay tax on its earnings. Instead, the earnings of the S Corporation flow through to the owners who pay tax on their proportionate share of the company's earnings at their own individual tax rates. In some instances, the S Corporation will pay a distribution to these owners equal to the amount of tax they owe. When ownership in an S Corporation is sold, the owner (seller) pays capital gain tax on the earnings, which is adjusted upward for any distributions they received and decreased by any allocations on which they paid taxes. This avoids the double taxation on corporate earnings that applies to C Corporations, where the company pays taxes on profits, and the owners pay taxes when profits are distributed.

Prior to 1997, a Sub S Corporation could not establish an ESOP, because an S Corporation would lose its status upon funding of the ESOP. Basically, S Corporations could not have an ESOP own stock in the company because the exempt trust pays no taxes and therefore a portion of the S Corporation earnings would go untaxed. However, effective for tax years after December 31, 1997, Code §1361(c) was changed to allow various trusts, including ESOPs to own stock of the S Corporation. The ESOP (and other trusts) however, would be responsible for their share of corporate earnings as "unrelated business income" because of the flow-through of an S Corporation's income to the ESOP.

The law changed with TRA 97, to make ESOPs even more appealing to S Corporations by exempting ESOPs from the unrelated business income tax thereby essentially making all of the income attributable to an S Corporation stock tax free.

For example, if an ESOP owns 40% of the S Corporation, and the company had \$100,000 in earnings, \$60,000 of the earnings would be taxable to the shareholders of the S Corporation (whether or not the shareholder takes an actual distribution from the company) but 40% would go to the ESOP and therefore, not be taxed. But, if in the above example, the ESOP owned 100% of the S Corporation, none of the earnings would be taxable to the shareholders.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Differences in  
plan provisions  
for S  
Corporation  
ESOP's**

Agents reviewing ESOP plan documents of an S Corporation should be aware of the following law changes:

- 1) Dividends paid on S Corporation stock may be used to repay the exempt loan **only** to the extent of the dividends were paid on **unallocated** shares (i.e. shares held in the suspense account). Therefore, an ESOP maintained by an S Corporation could not provide that dividends paid on **allocated** shares will be used to repay the exempt loan. This is based on the interpretation of Regulation §54.4975-7(b)(5) in PLR 199938052, which concluded that the use of dividends on allocated shares would cause the plan to fail to satisfy the prohibited transaction exemption under Code §4975(d)(3). This is because Regulation §54.4975-7(b)(5) permits the exempt loan to be repaid with earnings on the collateral (i.e. amount in the suspense account, not earnings on allocated shares). Note: Although Code §404(k) allows dividends paid on allocated shares to be deducted, this is not available to an S Corporation, because 404(k) specifically applies to C Corporations.
- 2) Due to the statutory limit on the number of shareholders under §1361, Code §409(h)(2)(B)(ii) allows an S Corporation to provide for a cash distribution in lieu of the right to demand a distribution from the ESOP in the form of qualifying employer securities. An ESOP maintained by an S Corporation may permit distributions of employer securities, but is not required to do so.
- 3) An ESOP of an S Corporation may not utilize the expanded Code §415(c)(6) rule, which allows certain forfeitures and interest payments to be disregarded as annual additions, because this code section limits the exclusion to contributions which are deductible under Code §404(a)(9). The 1997 legislation does not allow an S Corporation to deduct ESOP interest payments (under Code §404(a)(9)), and therefore, interest cannot be disregarded as an annual addition. It is unclear at this time whether this interpretation also applies to forfeitures.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Differences in plan provisions for S Corporation ESOPs – (continued)**

- 4) Code §1042, which allows the deferral of gain on the sale of qualified securities to an ESOP, is not available to an ESOP maintained by an S Corporation. This is because Code §1042(c)(1)(A) limits the definition of qualified securities for purposes of the non-recognition of gain treatment to C Corporations.
- 

**Introduction to S Corp Anti Abuse Measures**

When Congress opened the door to allow an S Corporation to be owned by an ESOP, the intent was to give rank and file employees a meaningful stake in the S Corporation. However, after the 1997 law was passed, a few abusive S Corporation ESOPs were developed and promoted that benefited only a few highly compensated employees. Congress added Code §409(p) in order to close some of these loop holes so that an S Corporation ESOP would not inure for the benefit of just a few shareholders. Treasury and IRS continue to focus on S Corporations and possible abuses.

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**Code §409(p)**

In general, Code §409(p) provides that no portion of the assets of an S Corporation ESOP attributable to (or allocable in lieu of) employer securities may, during a “non-allocation year” accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any “disqualified person”. Therefore, the anti abuse measures are triggered if a “**disqualified person**” receives a “**prohibited allocation**” during a “**non-allocation year**” in a Sub S ESOP.

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**Definition of “Non-allocation Year”**

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.

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**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.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Definition of  
“Prohibited  
allocation”**

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

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**Definition of  
“Disqualified  
Person”**

Under §409(p)(3)(A), a disqualified person is one who is either:

- 1) a member of a "deemed 20% shareholder group", or
  - 2) a "deemed 10% shareholder".
- 

**Definition of a  
“deemed 20%  
shareholder  
group”**

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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**Definition of 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.

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**Definition of  
“deemed owned  
shares”**

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

- 1) stock allocated to the account of an individual by the ESOP, and
- 2) an individual's share of unallocated stock held by the ESOP.

It is important to note the impact of the 2<sup>nd</sup> part of this definition. Essentially, for purposes of this definition, a participant is considered owning their own proportionate share of unallocated qualified employer securities held in the leveraged ESOP's suspense account. Code §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.

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*Continued on next page*

## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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

Family members include:

- (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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**Definition of "Synthetic Equity"**

The determination of whether someone is a "disqualified person" and whether a plan year is a non-allocation year, includes "synthetic equity" attributable to that person.

"Synthetic equity" is defined as 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. This 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 its value.

If a person owns synthetic equity in an S Corporation, the shares of stock in the corporation on which the "synthetic equity" is based will generally be treated as outstanding stock in the corporation, and as "deemed-owned" shares of that person, if the treatment of synthetic equity results either in the treatment of any person as a disqualified person or a year as a non-allocation year.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Effective Date of Code §409(p)** If the S Corporation ESOP was in existence on March 14, 2001, Code §409(p) is not effective until the first plan year beginning on or after January 1, 2005. If the S Corporation ESOP was not in existence on that date, the effective date is plan years ending after March 14, 2001. If a corporation that maintained an ESOP makes an election after March 14, 2001 to be taxed as an S Corporation, Code §409(p) becomes effective as of the first plan year ending after March 14, 2001. Thus, any change to an S Corporation after March 14, 2001 immediately subjects the plan to these rules. This is true even if the S election is made retroactive to a date before March 14, 2001. See Q&A-15 of Notice 2002-2.

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**Plan Amendments** Notice 2001-42 provides that “good faith” amendments must be adopted to reflect these prohibited allocation rules no later than the last day of the plan year in which they are first effective, or, if later, the last day of the GUST remedial amendment period. Due to the delayed effective date for many plans, the amendment deadline will generally be after the end of the GUST remedial amendment period. For the plan year in which the prohibited allocation rules are first effective, good faith amendments may need to be adopted before the end of the year in order to prevent a violation of Code §411(d)(6).

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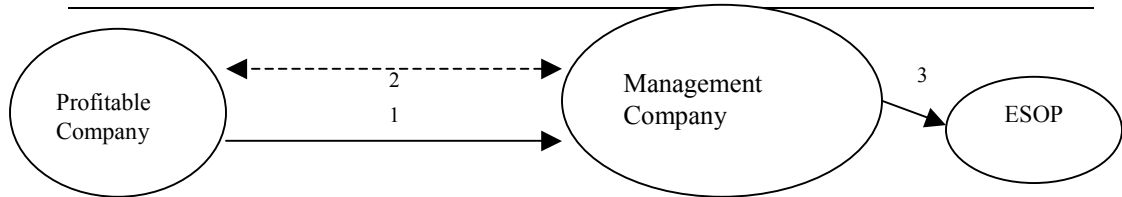
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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Management  
Company  
Transactions**

In spite of the passage of Code §409(p), some promoters devised schemes which allowed employers to avoid the impact of Code §409(p), but still use the combination of S Corporation status and ESOP to provide benefits for shareholders instead of rank and file employees. One variation of such scheme worked as follows:



**Scheme**

1. A Profitable Company creates a Management Company and the owner employees of the Profitable Company become employees of the Management Company
2. The Management Company contracts with the Profitable Company to receive a management fee that in essence drains off the profits of the Profitable Company.
3. The Management Company elects to be taxed as a Sub S Corporation and establishes an ESOP. All of the stock in the Management Company is sold to the ESOP at a nominal price. At the same time, the management company adopts a generous non-qualified deferred compensation plan (e.g. rabbi trust) for its employees who happen to be the shareholders of the Profitable Company, plus a few others to make this appear legitimate.

The above arrangement allows the Profitable Company to deduct the fee paid to the Management Company. The fee received by the Management Company is then used to fund the non-qualified deferred compensation plan for the owner employees of the previously Profitable Company. Although the monies used to fund the non-qualified deferred compensation plan are not deductible by the Management Company, the Management Company is an S Corporation that is wholly owned by the ESOP and therefore, is not adversely affected by the loss of deduction, since it pays no federal income tax on its taxable income. Although the employees of the Management Company participate in the ESOP, the benefits they receive are generally minimal because the profits from the Management Company are used to fund the non-qualified deferred compensation plan for the owner employees.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Management  
Company  
Transactions  
(continued)**

The above diagram was an attempt to circumvent Code §409(p) because not all non-qualified deferred compensation was treated as “synthetic equity” under the statute. The regulations, however, remedied this by expanding the definition of synthetic equity to include all non-qualified deferred compensation, even if not payable in stock.

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**Delaying the  
effective date of  
Code §409(p)**

Another scheme was an attempt to claim eligibility for the delayed effective date of Code §409(p). A person in the business of providing advice to other companies or individuals sets up an S Corporation, that has no substantial assets or business, along with an ESOP, before March 14, 2001,.

The ESOP covers employees of the S Corporation (actually the law firm that is setting these plans up), but there is no reasonable expectation that these individuals will accrue more than insubstantial benefits under these plans or more than insubstantial shares in the ownership of the S Corporation.

The S Corp and ESOP are then marketed to C Corporations as a way of getting around paying taxes. The owner of the C Corp spins himself off into the S Corp and then, for a fee (which is usually not nominal), gives “management assistance” back to the C Corp, basically performing the same function that he had been as owner of the C Corp. Although the ESOP still has the earlier participants, they are no longer “employees” for purposes of the new sponsor of the ESOP and therefore accrue no further benefit, leaving the sole participant of the plan to be the owner.

The Service ruled in Revenue Ruling 2003-6 that for purposes of Code §409(p) these ESOPs are not considered established on or before March 14, 2001 and therefore not entitled to the delayed effective date in 2005.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Related entities  
of S  
Corporations -  
Revenue Ruling  
2004-4**

Although the Proposed and Temporary Regulations under Code §409(p) expanded the definition of synthetic equity to include all non-qualified deferred compensation, it did not address situations where there were related entities of the S Corporation. A number of independent businesses (Qsubs) could be combined under a single parent (S Corp) with **stock options** being provided for in the Qsub, to avoid the 10% and 50% tests under Code §409(p) and the regulations. Prior to the issuance of Revenue Ruling 2004-4, **none** of the executives who hold stock options in the Qsub would be “disqualified persons, and their options would **not** constitute “synthetic equity”.

Revenue Ruling 2004-4 provides the first guidance on these types of entities. The revenue ruling describes 3 different situations where **subsidiary** stock options are used to enable certain individuals to obtain tax benefits associated with S Corporation status, while limiting profits from going into the ESOP. In all three situations this revenue ruling determined that:

- (i) the structures are considered to result in non-allocation years for the ESOP under Code §409(p);
- (ii) the managers holding stock options in the Qsubs are considered to be disqualified persons; and
- (iii) Qsub stock options are treated as synthetic equity in the S Corporation.

The consequences in each case would be that in a non-allocation year, each company would be subject to a 50% excise tax on the value of the Qsub stock **and** underlying synthetic equity.

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Penalties associated with violations of the anti abuse measures**

If a “disqualified person” receives a “prohibited allocation” during a “non-allocation year” the following penalties would be imposed:

- (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**. Code §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). Code §4979A.
  - (3) An excise tax is imposed on the S Corporation with respect to any synthetic equity owned by a disqualified person. Code §4979A.
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**Determination Processing**

Screening alerts were issued on July 22, 2002 and August 7, 2002, that required suspicious S Corporation or Management type ESOPs to be sent to and suspended in Cincinnati. However, pursuant to Determination/Screening Alert (FY 2004-4) dated March 3, 2004, these types of cases are no longer to be sent to Cincinnati since guidance has now been issued in Revenue Rulings’ 2003-6 and 2004-4 and the temporary and proposed regulations under Code §409(p). These suspended cases have now been returned to the group and are being worked by determination agents.

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**Sub S Corporation ESOPs and Anti Abuse Measures, Continued**

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**Sample plan language – S Corporations**

(a) *No portion of the Trust Fund attributable to (or allocable in lieu of) Company Stock in an S corporation may, during a "nonallocation year," accrue (or be allocated directly or indirectly under any plan maintained by the Employer meeting the requirements of Code Section 401(a)) for the benefit of any "disqualified person."*

(b) *For purposes of this Section:*

(1) *The term "nonallocation year" means any Plan Year if, at any time during such Plan Year,*

(i) *the Plan holds Company Stock consisting of stock in an S corporation, and*

(ii) *"disqualified persons" own at least fifty percent (50%) of the number of shares of stock in the S corporation.*

(2) *Attribution rules. For purposes of subsection (b)(1),*

(i) *the rules of Code Section 318(a) shall apply for purposes of determining ownership, except that:*

(A) *in applying paragraph (1) thereof, the members of an individual's family shall include members of the family described in subsection (c)(4), and*

(B) *paragraph (4) thereof shall not apply.*

(ii) *Deemed-owned shares. Notwithstanding the employee trust except in Code Section 318(a)(2)(B)(i), an individual shall be treated as owning "deemed-owned shares" of the individual.*

*Solely for purposes of applying subsection (c)(5), this subsection (b)(2) shall be applied after the attribution rules of subsection (c)(5) have been applied.*

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*Continued on next page*

**Sub S Corporation ESOPs and Anti Abuse Measures, Continued**

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**Sample plan language – S Corporations**

(c) *For purposes of this Section:*

(1) *The term "disqualified person" means any person if,*

*(i) the aggregate number of "deemed-owned shares" of such person and the members of such person's family is at least twenty percent (20%) of the number of "deemed-owned shares" of stock in the S corporation, or*

*(ii) in the case of a person not described in subsection (c)(1)(i), the number of "deemed-owned shares" of such person is at least ten percent (10%) of the number of "deemed-owned shares" of stock in such corporation.*

(2) *Treatment of family members. In the case of a "disqualified person," any member of such person's family with "deemed-owned shares" shall be treated as a "disqualified person" if not otherwise treated as a "disqualified person" under subsection (c)(1).*

(3) *Deemed-owned shares:*

(i) *The term "deemed-owned shares" means, with respect to any person,*

*(A) the stock in the S corporation constituting Company Stock which is allocated to such person, and*

*(B) such person's share of the stock in such corporation which is held by the Plan but which is not allocated under the Plan to Participants.*

*(ii) Person's share of unallocated stock. For purposes of subsection (c)(3)(i)(B), a person's share of unallocated S corporation stock held by the 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*

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**Sub S Corporation ESOPs and Anti Abuse Measures, Continued**

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**Sample plan  
language – S  
Corporations**

*(4) Member of family. For purposes of this subsection (c), the term member of the family means, with respect to any individual,*

*(i) the spouse of the individual,*

*(ii) an ancestor or lineal descendent of the individual or the individual's spouse,*

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

*(iv) the spouse of any individual described in subsection (c)(4)(ii) or (iii).*

*A spouse of an individual who is legally separated from such individual under a degree of divorce or separate maintenance shall not be treated as such individual's spouse for purposes of this subsection (c)(4).*

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## Sub S Corporation ESOPs and Anti Abuse Measures, Continued

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**Sample plan language – S Corporations**

*(5) Treatment of synthetic equity. For purposes of subsections (b) and (c), in the case of a person who owns "synthetic equity" in the S corporation, except to the extent provided in Regulations, the shares of stock in such corporation on which such "synthetic equity" is based shall be treated as outstanding stock in such corporation and "deemed-owned shares" of such person if such treatment of "synthetic equity" of one (1) or more such persons results in,*

*(i) the treatment of any person as a "disqualified person," or*

*(ii) the treatment of any year as a "nonallocation year."*

*For purposes of this subsection (c)(5), "synthetic equity" shall be treated as owned by a person in the same manner as stock is treated as owned by a person under the rules of paragraphs (2) and (3) of Code Section 318(a). If, without regard to this subsection (c)(5), a person is treated as a "disqualified person" or a year is treated as a "nonallocation year," this subsection (c)(5) shall not be construed to result in the person or year not being so treated. The term "synthetic equity" means, any stock option, warrant, restricted stock, deferred insurance 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*

***(d) Effective date. The provisions of this Section [ ] apply to Plan Years ending after March 14, 2001.***

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## EGTRRA Changes

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### Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 made a number of changes to retirement plans. This section is not intended to discuss all of the changes made by this act, only the few that may have a direct impact on the qualification of an ESOP.

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### Change by EGTRRA to Sub S Corporations

The one change that had a very significant impact on ESOPs, which has already been discussed, was with regard to the anti abuse measures for Sub S Corporations. As was previously mentioned, the provision was intended to prevent a few shareholders from reaping the majority of benefits while diluting the value of the ESOP stock. The provision called for excise taxes to be assessed on several items (including, principally, allocations to certain participants) in any non-allocation year. See the section entitled Sub S Corporations and Anti Abuse Measures for further information.

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### Change by EGTRRA to Code §404

For C Corporations, EGTRRA revised Code §404, effective in 2002 to allow the plan to pay a dividend and offer the participant the right to have the dividend reinvested in qualifying employer securities in the 401(k) portion of an ESOP. Prior to the change of Code §404K by EGTRRA, dividends retained by the plan were deductible only if used to make payments on an exempt loan. These dividends now will be fully deductible by the corporation even if not used to service the loan, but only if the **plan** provides that the participant is fully vested in these dividends. See Notice 2002-2, Q&A 9 and Code §404(k)(7).

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### Change by EGTRRA to Code §404K

In addition, Notice 2002-2, Q&A-2 provides that the election (to have the dividend reinvested) is permitted only where the plan also provides that the participant can alternatively elect that the dividends be paid in cash, or, paid to the plan and later distributed in cash to either the participant or to the beneficiary, no later than 90 days after the close of the plan year in which the dividend is paid. The plan can offer one or both of these options.

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## EGTRRA Changes, Continued

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**Other Changes  
made by  
EGTRRA**

Some other changes made by EGTRRA to defined contribution plans are as follows:

- Amount of compensation under Code §401(a)(17) increased to \$200,000.
- The maximum amount of annual additions increased to the lesser of: (i) 100% of compensation or (ii) \$40,000.
- Participant loans to partners and certain S corporation shareholders (currently prohibited) will be allowed in 2002.
- Increase the deductible limit to 25% of compensation (up from 15%).
- Increase in the amount of elective deferrals to \$11,000 in 2002 and then increased by \$1,000 each year until reaching \$15,000 in 2006.
- Compensation used to compute the 404 deduction includes elective deferrals for years beginning after December 31, 2001.
- Repeal of the “multiple use” test for 401(k) and (m) plans.
- Matching contributions will have to vest under one of two schedules: (i) a 3 year cliff or (ii) a 6 year graded.
- Allow participants who are 50 and over to make “catch up” contributions. The amount is \$1,000 in 2002 and will increase by \$1,000 each year until it reaches \$5,000 in 2006. The contribution will then be indexed in \$500 increments thereafter.

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**Sample plan  
language –  
Reinvest of  
dividends**

*At the election of Participants or their Beneficiaries with respect to cash dividends payable on or after [ ], paid in accordance with paragraph (1) or (2) above, or paid to the Plan and reinvested in Company Stock; provided, however, that if cash dividends are reinvested in Company Stock, then Company Stock allocated to the Participant's Company Stock Account shall have a fair market value not less than the amount of cash dividends which would have been allocated to such Participant's Other Investment Account for the year. This paragraph (3) shall not apply while the Employer elected to be an S corporation under Code Section 1362(a).*

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## **Summary**

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The lesson described the various qualification requirements under Code §4975(e)(7), §409, §401(a) and the applicable regulations. It explained how a leveraged ESOP works as well as the differences between a leveraged and non-leveraged ESOP. In addition, the chapter discussed the qualification requirements for a Sub S ESOP and the provisions now applicable for the anti abuse measures. Finally, the chapter mentioned a few of the changes made by EGTRRA and some of the other changes by EGTRRA that may have an impact on the qualification of an ESOP.

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

- How to identify the characteristics of an ESOP and why they are attractive to certain entities
  - How to determine whether an ESOP is leveraged or non-leveraged.
  - The correct application forms for a determination letter on an ESOP.
  - The correct closing caveats to be used on a favorable determination letter for an ESOP.
  - To determine whether an ESOP meets the requirements under Code §4975(e)(7)
  - To identify the issues and abuses surrounding an S Corporation ESOP
  - To identify the changes made to ESOPs by EGTRRA.
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## ESOP Provisions Table

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| ESOP Provisions  | Plan Reference | Yes | No |
|--|----------------|-----|----|
| 1. Does the plan document formally designate the plan as an ESOP & does the plan state that it is designed to invest primarily in qualifying employer securities? Reg. 54.4975-11(a)(2)  |                |     |    |
| 2. Does the plan define “Qualifying Employer Securities” as an employer security which is: (i) stock or otherwise an equity security, or (ii) a bond debenture, note, or certificate or other evidence of indebtedness which is described in paragraphs (1) or (2) and (3) of ERISA §503(e)? Code §4975(e)(8) & §409(l)              |                |     |    |
| 3. Does the plan provide for the allocation of employer securities to participant’s account as provided under Reg. 1.401-1(b)(ii) & (iii) and accounted for as provided under Reg. §1.402(a)-1(b)(ii)?   |                |     |    |
| 4. Does the plan provide that if a portion of the account is forfeited, qualifying employer securities must be forfeited only after other assets? Reg. 54.4975-11(d)(4)  |                |     |    |
| 5. Does the plan provide that securities acquired with the proceeds of an exempt loan will be added to and maintained in a suspense account until withdrawn? Reg. §54.4975-11(c)   |                |     |    |
| 6. Does the plan provide for the release from encumbrance of qualifying employer securities under either the general rule or special rule of Reg. §54.4975-7(b)(8)?  |                |     |    |
| 7. If the employer chooses to exclude forfeitures and interest from the calculation of annual additions, does the plan provide that forfeitures and interest may only be excluded if no more than 1/3 of the employer stock is allocated to a highly compensated employee? IRC 415(c)(6). Note: Not applicable for an S Corporation. |                |     |    |

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**ESOP Provisions Table, Continued**

| <b>ESOP Provisions</b>  | <b>Plan Reference</b> | <b>Yes</b> | <b>No</b> |
|---|-----------------------|------------|-----------|
| 8. Does the plan provide that the only assets that may be given as collateral on an exempt loan are qualifying employer securities of two classes, (i) those acquired with the proceeds of an exempt loan, and (ii) those that were used as collateral on a prior exempt loan and repaid with the proceeds of the current exempt loan? Reg. 54.4975-7(b)(4)   |                       |            |           |
| 9. Does the plan provide that the loan proceeds will be used only for the following purposes: (i) to acquire qualifying employer securities, (ii) to repay such loan, and/or (iii) to repay a prior exempt loan? Reg. 54.4975-7(b)(4)   |                       |            |           |
| 10. Does the plan provide that in the event of default of an exempt loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default? Reg. 54.4975-7(b)(6)  |                       |            |           |
| 11. Does the plan provide that the exempt loan must be made without recourse against the ESOP? Reg. 54.4975(b)(5)   |                       |            |           |
| 12. Does the plan provide that securities acquired with the proceeds of an exempt loan will not be subject to a put, call, or other option, or buy-sell or similar arrangement while held by and when distributed from a plan? Reg. 54.4975-7(b)(4) & Reg. 54.4975-11(a)(3)   |                       |            |           |
| 13. Does the plan provide that no person entitled to payment under the exempt loan, shall have any right to ESOP assets, other than: (i) collateral given for the loan, (ii) contributions (other than of employer securities) that are made under an ESOP to meet its obligations under the plan, and (iii) earnings attributable to the collateral and the investment of such contributions? Reg. 54.4975-7(b)(5) |                       |            |           |
| 14. Does the plan provide that the interest rate on an exempt loan must not be in excess of reasonable rate of interest? Reg. 54.4975-7(b)(7)   |                       |            |           |
| 15. Does the plan provide for the valuation of employer securities, which are not readily tradable on an established securities market are made by an independent appraiser pursuant to IRC 401(a)(28)(C)?  |                       |            |           |

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**ESOP Provisions Table, Continued**

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| ESOP Provisions  | Plan<br>Reference | Yes | No |
|--|-------------------|-----|----|
| 16. Does the plan provide that a participant has a right to demand distributions in the form of employer securities? IRC 409(h)1(A) Note: An S Corporation, may but is not required to give participants the right to demand stock, but if the plan does not give this right to participants, it must allow for a cash distribution instead.   |                   |     |    |
| 17. Does the plan provide that a participant is entitled to elect to commence distribution of his or her account balance after attaining normal retirement age, or after death disability or separation from service no later than required by IRC 409(o)?   |                   |     |    |
| 18. Does the plan provide for the current distribution of income (i.e. dividends) with respect to qualifying employer securities at any time after receipt by the plan to a participant on whose behalf such securities have been allocated? Reg. 54.4975-11(a)(8)(iii). Note: A plan is not required to provide for this provision.           |                   |     |    |
| 19. If the employer's stock is not publicly traded or is subject to a trading limitation, does the plan provide that qualifying employer securities acquired with the proceeds of an exempt loan will be subject to a "put" option? Reg. 54.4975-7(b)(10)  |                   |     |    |
| 20. Does the plan provide that the "put" option must be exercisable for a period of at least 60 days following the date of distribution of stock of the employer? In addition, the plan must also provide an additional 60 days in the following plan year, if the put option is not exercisable in the first period. Reg. 54.4975-7(b)(11)(i) |                   |     |    |

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**ESOP Provisions Table, Continued**

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| ESOP Provisions   | Plan Reference | Yes | No |
|---|----------------|-----|----|
| 21. Does the plan provide that if the employer is required to repurchase the employer securities which have been distributed to a participant which are not readily tradable, the amount to be paid for a total distribution is paid in substantially equal period payments over not more than 5 years after the exercise of the put option; and if the distribution is made in installments, the amount to be paid is paid not later than 30 days after the exercise of the put option? Reg. 54.4975-7(b)(12)  |                |     |    |
| 22. Does the plan provide that the protections and rights regarding the put option and buy-sell arrangements are non-terminable? If the plan holds or has distributed securities acquired with the proceeds of an exempt loan, and either the loan is repaid, or the plan ceases to be an ESOP, these protections and rights must continue to exist under the terms of the plan. Reg. 54.4975-11(a)(3)(ii)  |                |     |    |
| 23. Does the plan allow the employer with the right of first refusal? Qualifying employer securities acquired with the proceeds of an exempt loan, may, but need not be subject to a right of first refusal. Securities subject to such right must be stock, or an equity security, or a debt security convertible into stock or an equity security. Also, the securities must not be publicly traded at the time the right is exercised. The right of first refusal must be in favor of the employer, the ESOP, or both in any order of priority. The selling price and other terms under the right must not be less favorable to the seller than the greater of the value of the security determined under Reg. 54.4795-11(d)(5), or the purchase price and other terms offered by a buyer, other than the employer or the ESOP, making a good faith offer to purchase the security. The right of first refusal must lapse no later than 14 days after the security holder gives written notice to the holder of the right that an offer by a third party to purchase the security has been received. |                |     |    |

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**ESOP Provisions Table, Continued**

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| ESOP Provisions   | Plan<br>Reference | Yes | No |
|---|-------------------|-----|----|
| 24. Does the plan provide that a participant is entitled to diversify a portion of his or her account as required by IRC 401(a)(28) (B)?  |                   |     |    |
| 25. Does the plan give each participant the right to direct the trustee to vote the allocated securities in accordance with IRC 409(e)(3)? If the employer maintains non registered type securities the plan is only required to provide that participants will vote on the corporate matters outlined in IRC 409(e)(3)   |                   |     |    |
| 26. If Form 5309 indicates that the employer is applying for a ruling under Code §409(n), with respect to transactions under IRC 1042, does the plan provide that the assets of the plan attributable to employer securities acquired by the plan in a sale to which section 1042 applies, cannot accrue for the benefit of persons specified in section 409(n) during the non-allocation period? |                   |     |    |

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**ESOP Provisions Table, Continued**

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**EGTRRA**

| <b>ESOP Provisions</b>  | <b>Plan Reference</b> | <b>Yes</b> | <b>No</b> |
|---|-----------------------|------------|-----------|
| 27. For C Corporations Only – If the plan allows participants to elect to reinvest qualifying employer securities in the 401(k) portion of the ESOP, does the plan:<br>(i) make these participants fully vested in the dividends that are reinvested?<br>(ii) give the participant the right:<br><br>(a) To receive cash in lieu of reinvesting the dividends and/or,<br>(b) To be paid to the plan and later distributed in cash to either the participant or the participant’s beneficiary  |                       |            |           |
| 28. For S Corporations Only – If the S Corporation was in existence on March 14, 2001, Code §409(p) does not apply until the first plan year beginning on or after January 1, 2005. For S Corporations that were not effective on March 14, 2001, Code §409(p) is effective for plan years ending after March 14, 2001. Does Code §409(p) apply in this case? If no, do not complete the remainder of this worksheet.<br>See also Revenue Ruling 2003-6 regarding certain entities that are not entitled to the delayed effective date. |                       |            |           |

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*Continued on next page*



**ESOP Provisions Table, Continued**

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| ESOP Provisions   | Plan Reference | Yes | No |
|---|----------------|-----|----|
| 29. Does the plan define the term “disqualified person” in accordance with Code §409(p) and the applicable regulations and guidance?  |                |     |    |
| 30. Does the plan define the term “prohibited allocation” in accordance with Code §409(p) and applicable regulations and guidance?  |                |     |    |
| 31. Does the plan define the term “non-allocation year” in accordance with Code §409(p) and applicable regulations and guidance?  |                |     |    |
| 32. Does the plan define “deemed owned shares” in accordance with Code §409(p)(4)(C)(ii) and the applicable regulations and guidance?   |                |     |    |
| 33. Does the plan define “deemed 10% shareholder” in accordance with Code §409(p) and applicable regulations and guidance?  |                |     |    |
| 34. Does the plan define “synthetic equity” in accordance with Code §409(p) and applicable regulations and guidance?  |                |     |    |
| 35. Does the plan provide that for purposes of determining ownership, the attribution rules of Code §318 will apply, modified with the exception that members of an individual’s family shall include the members of the family described in Code §409(p)(4)(D)?  |                |     |    |
| 36. If the plan provides that dividends will be used to repay an exempt loan, and the employer is an S Corporation, does the plan provide that dividends on only <b>unallocated</b> stock will be used to repay the loan? Dividends on allocated stock in an S Corporation may not be used to repay the exempt loan. Regulation §54.4975-7(d)(5). |                |     |    |

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