Employee Stock Ownership Plan Design and Compliance

A Lexis Practice Advisor® Practice Note by Gregory K. Brown, Polsinelli P.C.

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This practice note addresses the issues related to employee stock ownership plan (ESOP) design and administration. An employer considering adoption of an ESOP, whether as a supplemental employee benefit plan or as a means of corporate financing in a tax-advantaged manner, should first conduct a feasibility analysis to determine whether an ESOP would be financially and culturally appropriate for the company. After making the decision to adopt an ESOP, there still is substantial work to be done, including designing the ESOP before adoption and administering the plan after adoption.

This practice note addresses the following topics related to the design and administration of an ESOP:

- General Mechanics of an ESOP
- Designing an ESOP
- Distinctive Provisions of an ESOP
- ESOP Operation and Administration
- Distribution of ESOP Shares and Diversification
- Valuation of ESOP Shares and "Adequate Consideration"
- Pass-Through of ESOP Voting Rights
- Fiduciary Duties in ESOPs
- Reducing Risk Associated with Holding Employer Securities
- ESOP Document Precedents

For annotated ESOP form documents, see Employee Stock Ownership Plan (Private Company) and Employee Stock Ownership Plan (Public Company). For discussion of ESOPs in the M&A context, see Employee Stock Ownership Plans in Corporate Transactions. For material relating to plans offering employer securities generally, see Employer Stock in Retirement Plans Resource Kit. For an additional discussion regarding ESOPS, see ALI-ABA Course of Study Materials "ESOPS: Current Twists and Turns" (Jul. 2004).

General Mechanics of an ESOP

Whatever the primary reason that an ESOP is established, all ESOPs generally will operate, as follows:

- **Obtaining loan from outside lender.** The ESOP commonly will often, but not always, obtain a loan from an outside lender, such as a bank. The ESOP signs a promissory note for the money. In a back-to-back loan, the employer receives the loan and lends the proceeds to the ESOP to acquire employer securities.
- **Written guarantee to the bank.** The employer provides a written guarantee to the bank promising that the ESOP will repay the loan. Each year the employer will pay the ESOP enough money to permit the ESOP to make its annual loan repayment.
- **Stock acquisition.** The ESOP uses the money from the loan to buy stock from the employer or a shareholder. Thus, the employer has received new capital. The loan is secured by the pledge of the stock acquired by the ESOP.
- **ESOP suspense account.** The stock is held in an ESOP suspense account. The stock is released annually for allocation to participant accounts as the loan is repaid with

funds contributed to the ESOP by the employer and/or by the use of dividends on employer securities in the ESOP.

- **Tax-deductible payment to the ESOP.** Each year, the employer makes a tax-deductible payment to the ESOP sufficient to enable the ESOP to make its annual debt repayment. As the debt is repaid, employer securities in the ESOP suspense account are released and allocated to participants' accounts. The employer can repay the acquisition indebtedness of the ESOP out of the earnings from its new capital.
- **Loan repayments deductible.** Since the employer's contributions to the ESOP used to repay the loan are deductible within the I.R.C. § 404(a)(9) limits, a leveraged ESOP allows the company to repay the entire loan on a tax-favored basis. See Internal Revenue Manual Section 4.72.4.

Designing an ESOP

Designing an ESOP takes great care and thought with respect to the delivery of appropriate benefit levels to participants over time and doing so in a vehicle which can be administered effectively and efficiently. Thus, the two functions are closely related. Designing an ESOP that presents too many administrative challenges may present significant problems in delivering benefits to participants. Similarly, designing an ESOP that provides for substantial administration must still allow for efficient and effective benefit delivery to ESOP participants.

The ESOP's design flexibility allows it to accomplish a variety of corporate and/or shareholder objectives. These objectives may vary to include:

- Providing employees with a supplemental employee benefit plan and employer ownership
- Providing a means of corporate financing
- Establishing an anti-takeover devise –or–
- For a private company, like an S corporation, providing a tax-efficient vehicle for the purchase of the shares of a departing owner

Finding the design that best achieves these objectives is central to the decision to adopt the ESOP. This flexibility is the rationale for the ESOP. Utilizing this advantage enhances its value.

An ESOP which merely meets the IRS requirements for tax qualification may fail to meet corporate objectives. In addition to designing the ESOP to meet legal requirements and satisfy corporate objectives, you should adapt plan design to simplify ESOP administration.

Design issues will vary from company-to-company. A factor considered merely routine for one company may be pivotal to the ESOP at another company. Thus, you should perform a design study.

Aspects of the ESOP Design Study

Options to Address in ESOP Design

Various options that you should address in an ESOP design study include, but are not limited to:

- Eligibility
- Payroll systems
- Compensation
- Vesting schedules
- Timing and form of benefit distributions
- Forfeitures
- Contribution levels
- Allocation formula
- Post-service credit
- Early retirement policies –and–
- Charter or bylaw provisions that may restrict stock ownership to employees

Questions to Answer When Designing an ESOP

Consider the following additional key questions:

- Who will participate in the ESOP?
- How much should the ESOP borrow?
- Will I need an independent appraiser to determine the value of the employer securities?
- Must the ESOP distribute stock to employees at retirement or other required distribution dates?
- Which divisions or subsidiaries should be included or excluded?
- Who will vote the ESOP stock and under what circumstances?
- Should the ESOP be combined with a 401(k) plan?
- Who will act as trustee(s)?
- For a public company, will I need a Form S-8 to register additional shares for the plan or will the offering qualify for an exemption?

ESOP Design Requirements

At a minimum, the ESOP must be designed to satisfy the following specific requirements:

- The plan must be formally designated as an employee stock ownership plan
- The plan must be designed to invest primarily in employer securities (see "Invested Primarily in Employer Securities" in Distinctive Provisions of an ESOP below)
- The plan must meet the requirements of I.R.C. § 409(e) if it has a registration-type security (see "Voting Rights" in Distinctive Provisions of an ESOP below)
- The plan must meet the requirements of I.R.C. § 409(h), regarding the right to demand that benefits be distributed in the form of employer securities, or purchased by the employer, where the securities are not readily tradeable (see Distribution of ESOP Shares and Diversification) –and–
- The plan must meet the requirements of I.R.C. § 409(o), addressing when distributions must commence (see "ESOP Distributions" in Distinctive Provisions of an ESOP, below)

I.R.C. § 4975(e)(7); Treas. Reg. § 54.4975-11.

Design Choices

Eligibility

Eligibility service may be as short as one hour of service but cannot exceed two years. A plan may also require that an employee must be at least age 21 years to participate. I.R.C. § 410(a).

If eligibility service exceeds one year, vesting must be full and immediate upon entry into the plan. I.R.C. § 410(a)(1)(B). One year of service and age 21 are very typical with entry into the ESOP retroactively for an entire plan year or prospectively from the date the service and age requirements are met.

Some plans have very liberal eligibility requirements in the first year of the plan (*i.e.*, one hour of service in that year to maximize the eligible payroll for deduction purposes) and thereafter require stricter eligibility (one year of service and minimal age 21 requirement).

If the employer has a pre-existing 401(k) plan, it is typical to have the same eligibility requirements in the ESOP to simplify ESOP communication and administration. However, the entry dates for an ESOP usually do not follow the multiple entry dates that most 401(k) plans use. Instead of immediate or monthly dates, ESOPs often provide semi-annual entry dates (e.g., in a calendar year plan, January 1 and July 1).

Allocation of Contributions Based on Compensation

Allocation of contributions to an ESOP based on relative compensation is typical, although what is included in the definition of compensation is quite variable. Compensation-based allocations are used for ESOPs because the "safe harbors" for qualified plan discrimination testing are not available for ESOPs. Treas. Reg. § 1.401(a)(4)-1(b)(ii)(A). Thus, allocations that use a factor other than compensation, such as length of service, are rarely used for ESOPs. Very few ESOPs allocate contributions on a per capita basis.

The challenge here is defining "compensation." Some ESOP sponsors limit or exclude non-basic compensation (such as bonuses, commissions or overtime) from compensation for allocation purposes. However, most ESOPs use W-2 compensation (including 401(k) deferrals) in the allocation base. The plan sponsor should be careful to test for discrimination for any exclusions from compensation which may have a bigger impact on non-highly compensated employees than highly-compensated employees (such as overtime, production bonuses, etc.).

For more information on plan definitions of compensation, see Compensation Definition Rules for Qualified Retirement Plans.

Vesting Schedules

The optimal choice for vesting schedules is different for most ESOPs. Most defined contribution plans (such as 401(k) plans that are not safe harbor plans) use a six-year "graded" vesting schedule requiring 20%-per–year vesting beginning with the participant's completion of three years of service. Some use a three-year "cliff" vesting schedule vesting 100% after completing at least three years of service. Most ESOPs use the graded schedule. I.R.C. § 411(a)(2).

Some ESOPs, however, use the three-year cliff schedule because participants do not vest at all until they have three years of vesting service, at which time they become fully vested. That schedule typically favors longer-service employees at an ESOP employer. Participants whose service terminates before earning three years of vesting service forfeit their unvested ESOP balances to the longer-service employees. Cliff vesting is also easier to administer than graded vesting because there are no partially vested interests that need to be carried over for vested terminees.

Service Crediting

When adopting a new ESOP, an employer may choose to credit service earned prior to the effective date of the ESOP. This recognition of service for eligibility allows for maximum participation in the initial year of the ESOP. You can draft the

plan document to provide a "one year of service" requirement to new employees.

Vesting credit is different—an ESOP may provide for no credited service for vesting purposes that is earned before the effective date of the ESOP. This will not be the case where the company has terminated an existing defined contribution plan within five years of ESOP adoption or where the ESOP is created by amending an existing non-ESOP plan. In these cases, the ESOP will be treated as a "successor plan" that is required to credit prior service for eligibility and vesting service.

Further ESOP Design Options

An ESOP can be prepared as a simple qualified stock bonus plan with ESOP provisions. I.R.C. § 401(a)(22). The ESOP also may be combined with (as a component of) a qualified profit sharing plan. That plan may or may not have a cash or deferred arrangement (401(k) plan). Treas. Reg. § 54.4975-11(a)(5). Where combined with a 401(k) plan, an ESOP is sometimes referred to as a KSOP, particularly in plans where employee salary deferrals can be used to purchase employer securities (and make payments on an ESOP loan).

ESOPs are subject to the same general qualification requirements under I.R.C. § 401(a) as other qualified defined contribution plans. They are however, subject to several distinguishing features.

- Additional rules apply under I.R.C. § 409(n), as applicable, where ESOP securities are received in an I.R.C. § 1042 transaction (see "Prohibition on Allocations of Stock Acquired in an I.R.C. § 1042 Transaction" in ESOP Operation and Administration, below), and under I.R.C. §409(p), regarding allocation of ESOP securities of an S corporation.
- When the ESOP is established as a portion of the plan, the ESOP portion must meet I.R.C. § 4975(e)(7) requirements and certain portions of I.R.C. § 409. Internal Revenue Manual Section 4.72.4.
- In addition to being a qualified stock bonus plan designed to invest primarily in "qualifying employer securities," an ESOP is required to satisfy applicable ERISA regulations. ERISA § 407(d)(6) (29 U.S.C. § 1107(d)(6)).

It is typical to keep private company ESOPs and 401(k) plans in separate documents. This is because these plans operate in very different ways. Where all of the needs of the 401(k) plan and the ESOP are to be accommodated, two documents are simple to operate and communicate to employees. A combined plan can be very cumbersome. For example, there are dual sets of eligibility entry dates, distribution provisions and fiduciary arrangements.

Furthermore, many 401(k) plan administrative forms prefer to use their own volume submitter or prototype plan documents with detailed 401(k) provisions that can be difficult to find in hybrid ESOP/401(k) plan documents. For a discussion regarding ESOPs added to a plan that includes a qualified cash or deferred arrangement (a 401(k) plan), see ALI-CLE Course of Study Materials, "ERISA Fiduciary Duties Regarding ERISA 401(k) and ESOP Investments in Employer Stock" (SU014 ALI-ABA 113).

Distinctive Provisions of an ESOP

Invested Primarily in Employer Securities

When drafting the ESOP document, you must identify, specifically, that the plan is an employee stock ownership plan and that it is designed to invest primarily in employer securities. Treas. Reg. § 54.4975-11(a)(2) and (b). The phrase "designed to invest primarily in employer securities" is not defined. The phrase implies, however, that ESOP trustees hold most plan assets in employer securities. This is consistent with the Department of Labor (DOL) interpretation of ERISA § 407(d)(6) (29 U.S.C. § 1107(d)(6)), although the agency has declined to established a minimum percentage. See DOL, Advisory Opinion 83-6A, 1983 ERISA LEXIS 51 (Jan. 24, 1983).

While an ESOP must be primarily invested in employer securities, an ESOP may still hold liquid assets to:

- Purchase employer securities
- Fulfill the diversification elections of qualified participants –or–
- Provide cash distributions to electing participants

Where a put option will be exercised by a terminating ESOP participant, the employer may provide cash to the ESOP to be accumulated over a short period in order to purchase the terminating participant's interest.

Employer Securities

The term "employer securities" means, either:

- Common stock issued by an employer or a member of its controlled group that is readily tradeable on an established securities market –or–
- If the employer's stock is not publicly-traded, the term means common stock issued by the employer that has a combination of voting powers and dividend rights equal to or greater than the powers and rights of:
    - The class of the employer's common stock that has the greatest voting powers –and–

- The class of the employer's common stock that has the greatest dividend rights

I.R.C. § 409(l); I.R.S. Notice 2011-19.

Where the employer security is that of the employer's parent company or subsidiary, for this purpose, the term "controlled group of corporations" has the meaning given under I.R.C. § 1563(a). However, the parent must own only 50% (not 80%) a first-tier subsidiary's stock for that subsidiary and 80% or more controlled subsidiaries below it to be part of its controlled group. I.R.C. § 401(l)(4).

Non-callable preferred stock qualifies as "employer securities" if such stock is convertible into the qualified common stock pursuant to a reasonable conversion price occurring as of the date of acquisition by the ESOP. I.R.C. § 409(l)(3). Where the choice is made to use convertible preferred stock as the employer security, you will want to work with a valuation group to satisfy the "independent appraiser" requirement to determine if the conversion price is reasonable. I.R.C. § 401(a)(28)(C). Factors to consider in valuation include voting and dividend rights, conversion terms, and liquidation preferences.

Diversification Elections

There is a great deal of variance in ESOP diversification election provisions beyond the basic diversification rights requirement. That requirement allows participants to diversify during a "qualified election period" up to 50% of the participant's ESOP account, provided that the participant has:

- Attained age 55 –and–
- Completed at least 10 years of ESOP participation.

I.R.C. § 401(a)(28)(B)(i) and (iii).

Some plans allow both active and inactive participants to make elections. Other plans require that the participant be actively employed by the company in order to make an election. Also, most plans are administered to reference the number of shares of the employer security in the participant's account in determining the number of shares subject to the election.

In addition, some plans count as years of participation only years in which a participant is eligible to have employer contributions allocated to the participant's account. Other plans count all years in which the participant has an account under the plan (whether employed or separated from service) for this purpose.

Where the employer also has a 401(k) plan, many ESOPs allow the participant to transfer diversified amounts directly from the ESOP to the employer's 401(k) plan or receive those amounts in cash. Where no 401(k) plan is maintained, however, cash distributions are made to the electing participant. Few ESOPs maintain the three required investment options under I.R.C. § 401(a)(28)(B)(ii) for diversification within the ESOP.

For further information on the ESOP diversification requirement, including special diversification rules where the plan holds publicly-traded stock, see Distribution of ESOP Shares and Diversification below.

Voting Rights

The law requires a pass-through of any voting right to participants for shares allocated to each participant's account. I.R.C. § 409(e). The extent of the voting rights pass-through will depend on whether or not the employer holds a registration-type class of security.

- **Registration-type security.** If the employer has a registration-type security, as described under I.R.C. § 409(e)(4), each participant and beneficiary has full shareholder voting rights as to all shares allocated to his or her account.
- **Requirement for other employers.** If the employer does not have a registration-type security (usually a private employer), voting rights as to shares allocated to a participant's or beneficiary's account are limited to corporate matters, where shareholders are voting on a merger, reorganization, liquidation, recapitalization or sale of all or substantially all assets of the employer's trade or business to a third party.

I.R.C. § 409(e)(2) and (3).

Very few private company ESOPs allow participants to direct the ESOP trustee on other issues being voted on by shareholders, such as the election of the company's board of directors. Even fewer provide for a one-person-one-vote allowed under the law.

You should design the plan to provide guidance as to voting of:

- Allocated shares for which no directions are received from participants –and–
- Leveraged shares not yet allocated to participants' accounts (that is, unallocated shares that are still in the suspense account).

Many plans provide that the trustee has complete discretion to vote these shares. Some plans have "mirror" voting provisions which require the trustee to vote such shares in the same proportion as allocated shares for which voting directions are received by the trustee. The ESOP

might also apply the mirror voting provision to unallocated shares. This practice, however, must be assessed in light of ERISA's general fiduciary directive that trustees use their independent judgement when determining what is in the best interest of plan participants. Herman v. Nationsbank Trust Company, 126 F.3d 1354 (11th Cir. 1997), *reh'g denied*, 135 F.3d 1409 (11th Cir. 1998), *cert. denied*, 1998 U.S. LEXIS 4845.

A challenge to the mirror voting provision being applied to unallocated shares is most likely to arise in the context of a tender offer. In this case, you should advocate appointment of an independent trustee to manage the administration of all voting shares. For more information, see Pass-Through of ESOP Voting Rights, below.

ESOP Distributions

ESOP distribution provisions vary greatly from plan-to-plan beyond the legal requirements as to:

- Distribution timing
- Manner of payment –and–
- Mode of payment

I.R.C. § 409(o).

For example, some plans provide for stock-only distributions to participants who, in turn, must exercise their put-option rights with the company in order to receive their cash retirement benefits. I.R.C. § 409(h). Other plans (in private company ESOPs) use special provisions to distribute stock to participants only momentarily where participants are required to immediately put the distributed stock to the employer (i.e., where the company is an S corporation or is substantially employee-owned and its by-laws restrict stock ownership to the ESOP and employees).

Most plans provide that distributions may be made to participants either in a lump sum or installments over five years (more years for certain large distributions). I.R.C. § 409(o)(1)(A) and (C). This allows the company to manage its repurchase liability and avoid the adequate collateral requirement that applies to promissory notes given to participants by the company. Here, a participant who receives a lump sum of vested stock then offers (puts) the stock to the company. However, making installment payments allows former employees to continue to enjoy value improvements after their separation from service dates.

While there are detailed rules as to timing for distributions made on account of normal retirement, death or disability and resignation or dismissal, some flexibility exists and is normally reflected in the plan document. You can reflect in the plan, for example, that:

- Certain distributions will be deferred where an ESOP loan is still outstanding
- Participants who separate from service by reason of resignation or dismissal can be forced to wait up to six years after separation to receive their ESOP distributions –and–
- Participants with large vested balances (inflation-adjusted threshold of $1,130,000 for 2019 and inflation-adjusted threshold of $1,150,000 for 2020) can be made to wait five years following termination of employment for a distribution, plus one additional year (or fraction of a year) for each $225,000 (for 2019) and $230,000 (for 2020) by which the balance exceeds the inflation-adjusted threshold.

I.R.C. § 409(o)(1)(A)(ii), (B) and (C).

Best practice is to draft the distribution provision with maximum flexibility to avoid any anti-cutback rule issues (i.e., under I.R.C. § 411(d)(6)) that may arise if tight distribution provisions need to be amended in the future. See Distribution of ESOP Shares and Diversification below.

Some plans are designed to provide for pre-distribution segregated accounts. Under this design, distributions which are deferred for participants who leave by reason of resignation or dismissal will trigger the automatic use of cash in active participants' accounts to be used to "acquire" the stock balances in the accounts of vested terminated participants. The accounts of such vested terminated participants will be credited with cash and invested in a conservative default fund pending distribution. This prevents such participants from riding up the value escalator after separating from service without requiring the company to repurchase the shares out of current cash flow. The fact that the plan holds some cash for this purpose will not affect the "primarily invested in employer stock" requirement for an ESOP. See DOL, Advisory Opinion 83-6A, 1983 ERISA LEXIS 51.

Rollovers and Treatment of Net Unrealized Appreciation

ESOPS, like all qualified plans, are subject to the direct rollover rules of I.R.C. § 401(a)(31). Thus, ESOP distributions can be rolled over to an IRA or another qualified retirement plan, with some exception for rollover of S corporation stock. I.R.S. Priv. Ltr. Rul. 200122034, 2001 PLR LEXIS 369 (Feb. 28, 2001).

However, a particular tax benefit is available in ESOPs and other plans permitting distribution of employer stock. Where a lump-sum distribution is made from a participant's account upon their separation from service, death, disability, or attainment of age 59½, the amount of the net unrealized appreciation (NUA) (i.e., appreciation of the shares from the

time they were placed in the ESOP trust to the time of the distribution) on the shares distributed is deferred until the distributee actually sells the distributed shares. This results in current income taxation to the employee limited to the value of the shares when first-acquired by the ESOP. I.R.C. § 402(e)(4); Treas. Reg. § 1.402(a)-1(b)(2).

This treatment also generally results in the distributee benefiting from lower capital gains-tax rates on the eventual sale of the shares. NUA treatment is unavailable, however, if the distributee:

- Does not take a lump sum distribution of his or her plan benefit
- Fails to receive distribution of the shares "in-kind" –or–
- Rolls or transfers the shares to an IRA

The fact that a distributee rolls part of a total plan distribution to an IRA will not disqualify the distribution of employer stock from being recognized as part of a lump sum distribution. I.R.S. Private Letter Ruling 200202078.

Distribution of ESOP Shares by an S Corporation

The rollover rules apply similarly to an ESOP that holds S corporation stock. The ESOP must permit participants to elect a direct rollover of any distribution of S corporation stock thatf is an eligible rollover distribution into an eligible retirement plan specified by the distributee. However, an IRA trustee or custodian is not a permissible S corporation shareholder. Rev. Proc. 2004-14.

ESOP Operation and Administration

An ESOP may be leveraged or unleveraged. In an unleveraged ESOP, the employer contributes to the plan its employer securities or cash to purchase its employer securities, for allocation to participant accounts. No gain or loss is recognized by the corporation on the contribution of its own stock to an ESOP. In a leveraged ESOP, the plan borrows money to purchase the employer securities. The loan may be from a third-party or from the employer. These transactions are unlike those permitted under other defined contribution plans.

ESOP Leveraging: the ESOP Loan Exemption

Prohibited Transaction Exemption for ESOPs

The I.R.C. and ERISA prohibited transaction rules enable an ESOP established under I.R.C. § 4975(e)(7) to acquire a loan to purchase employer securities. ERISA § 408(b)(3) (29 U.S.C. § 1108(b)(3)) and I.R.C. § 4975(d)(3). Without this exemption, the leveraged ESOP could not exist since the related party-in-interest (under ERISA § 3(14) (29 U.S.C. § 1002(14)) would be prevented from participating in the direct or indirect money lending or other credit extension that occurs between an ESOP and a party in interest, such as the plan sponsor or trustee. ERISA § 406(a) (29 U.S.C. § 1106(14)).

By applying the exemption, an ESOP may borrow money to acquire employer securities from a party in interest, by the use of:

- A direct loan
- A loan guarantee –or–
- An installment sale

The acquisition loan exemption differentiates an ESOP from other qualified plans that invest in employer stock, and from other individual account plans, as defined under ERISA § 3(34) (29 U.S.C. § 1002(34)), which are subject to the 10%-of-fair-value-limit when holding employer securities. ERISA § 407(b) (29 U.S.C. § 1107(b)).

How Does an ESOP Loan Qualify for a Prohibited Transaction Exemption?

To qualify for the prohibited transaction exemption, you should direct that the ESOP loan satisfies the following requirements:

- **Primarily for benefit of ESOP participants.** The loan must be primarily for the benefit of ESOP participants and their beneficiaries. Treas. Reg. § 54.4975-7(b)(3)(i); 29 C.F.R. § 2550.408b-3(c).
- **Loan proceeds used within reasonable time.** The loan proceeds or other extension of credit must be used within a reasonable time after their receipt by the borrowing ESOP for any or all of the following reasons:
    - For the acquisition of employer stock
    - To repay a loan –or–
    - To repay a prior exempt loan (Treas. Reg. § 54.4975-7(b)(4); 29 C.F.R. § 2550.408b-3(d))
- **Loan interest rate and purchase price of ESOP stock.** At the time the loan is made, the interest rate on the loan and the purchase price of the ESOP stock acquired with the loan proceeds must not be so high that plan assets may be drained off. Treas. Reg. § 54.4975-7(b)(3)(ii); 29 C.F.R. § 2550.408b-3(g).
- **Loan terms.** The loan terms must be as favorable as the terms that could be achieved from arm's-length negotiations between independent parties. Treas. Reg. § 54.4975-7(b)(3)(iii); 29 C.F.R. § 2550.408b-3(g).

- **Loan interest rate.** The interest rate on the loan cannot exceed a reasonable rate of interest, considering all relevant factors. Treas. Reg. § 54.4975-7(b)(7); 29 C.F.R. § 2550.408b-3(g).
- **Collateral pledged.** Any collateral pledged by the ESOP (whether or not it is pledged to an ERISA party in interest) must be limited to the shares of employer stock acquired with the ESOP loan proceeds and those applied as collateral on any prior exempt loan (that has been repaid or eliminated from encumbrance with the proceeds of the current exempt loan). I.R.C. § 4975(d)(3); ERISA § 408(b)(3) (29 U.S.C. § 1108(b)(3)); Treas. Reg. § 54.4975-7(b)(5); 29 C.F.R. § 2550.408b-3(e).
- **Formula for collateralization of ESOP loan.** Even where the stock is not pledged, shares of employer stock that collateralize an ESOP loan must be released from pledge on a pro rata basis as the loan is repaid, according to this formula:
    - Based on principal and interest payments –or–
    - Solely on principal payments (Treas. Reg. § 54.4975-7(b)(8); 29 C.F.R. § 2550.408b-3(h))
- **ESOP loan repayment liability.** The ESOP's loan repayment liability must be limited to:
    - The collateral provided for the loan
    - Contributions in a form other than employer securities made to the ESOP for loan repayment purposes
    - Earnings on the contributions and collateral (Treas. Reg. § 54.4975-7(b)(5); 29 C.F.R. § 2550.408b-3(e))
- **Payments on the exempt ESOP loan.** Payments on the exempt ESOP loan during a plan year must not exceed an amount equal to the sum of (1) the ESOP contributions, and (2) the earnings on the ESOP contributions and collateral to the extent that such contributions and earnings were not used for loan payments in prior years. Where an ESOP loan is refinanced in a manner that changes the original ESOP loan terms, the new loan's terms should be used to calculate release of the remaining securities from the loan suspense account. The rate of release from the suspense account must follow one of the two methods specified in regulations. Treas. Reg. §§ 54.4975-7(b)(5) and (b)(8)(i); 29 C.F.R. § 2550.408b-3(e)), and see "Allocation of Shares Purchased with an Exempt Loan," below.
- **Accounting of contributions and earnings received by ESOP.** Contributions and earnings received by the ESOP must be accounted for separately in the ESOP books and records until the loan is repaid. Treas. Reg. § 54.4975-7(b)(5); 29 C.F.R. § 2550.408b-3(e).
- **Fixed term of ESOP loan.** The ESOP loan must be for a fixed term. This term may be extended on refinancing and may not be payable on demand of the lender except for default, and is subject to satisfaction of certain default requirements including a party in interest lender may not accelerate payments in the event of default. Treas. Reg. § 54.4975-7(b)(7) and (13); 29 C.F.R. § 2550.408b-3(g).
- **Put option.** The ESOP's distribution must be subject to a put option where the shares distributed are those of a non-publicly-traded employer security that was purchased with the proceeds of an exempt loan or that are subject to a trading restriction on distribution. Treas. Reg. § 54.4975-7(b)(10); 29 C.F.R. § 2550.408b-3(j).
- **No additional put, call or other option.** The employer stock purchased by an ESOP with an exempt loan generally may not be exposed to any additional put, call, or other option or any buy-sell or similar arrangement except as required under securities laws. Treas. Reg. § 54.4975-7(b)(4); 29 C.F.R. § 2550.408b-3(d).

Excise Tax

A prohibited transaction excise tax may apply if the ESOP fails to satisfy the exempt loan rules. The tax is enforced on a disqualified person (within the meaning of I.R.C. § 4975(a)) that extends credit to the ESOP. The excise tax initially equals 15% of the amount involved, increasing to 100% if the loan is not modified or the transaction unwound within the applicable taxable period. I.R.C. § 4975(a) and (b).

Refinancing the ESOP Loan

The DOL has addressed the refinancing of ESOP loans under ERISA for exemptions from prohibited transactions. In determining whether to cause an ESOP to engage in a refinancing, a fiduciary must make a careful assessment of the costs and benefits conferred upon the ESOP and the likely consequences of a failure to refinance, and ensure that the transaction is "arranged primarily in the interest of participants and beneficiaries". DOL, Field Assistance Bulletin 2002-1 (Sept. 26, 2002).

ESOP Loan Design and Loan Suspense Account

Employer securities purchased by an ESOP (ESOP stock) are used as collateral for the ESOP loan with the ESOP stock held initially in a suspense account and withdrawn from the suspense account as payments are made on the ESOP loan. Treas. Reg. § 54.4975-11(c). These shares of ESOP stock are then:

- Released from the suspense account as the loan is repaid –and–

- Allocated to eligible participant accounts applying the allocation mechanism set forth in the plan (see "Allocation of Shares Purchased With an Exempt Loan" below).

While plan language regarding the ESOP loan suspense account is normally quite general in nature, describing the release of suspense account shares on either the principal-and-interest method or the principal-only method (where suitable), the particulars of the ESOP loan amortization are key to the delivery of benefits to participants. The longer the amortization period, the slower will be the release of suspense account shares and the build-up of repurchase liability to the employer (i.e., in a private ESOP the plan liability that results when a terminated participant exercises his or her put option rights under I.R.C. 409(h)).

Many employers constrict the ESOP loan amortization with great care, taking into account:

- Total payroll of eligible employees
- The estimated annual allocation of stock value as a percentage of participant compensation
- Participant turnover rates
- Employee ages
- The plan vesting schedule
- Distribution provisions and policy –and–
- Build-up and timing of the repurchase liabilities account

Often, principal amortization rises modestly over the amortization period, rather than applying a straight-line principal amortization. Balloon payments in the later years of the amortization period are generally avoided. By this design, the employer is attempting to "normalize" the amount of share allocations to participants. This normalization allows the ESOP to mimic a profit sharing allocation, retain participants, and to reduce turnover without "over-benefitting" participants. The latter result might otherwise incent participants to separate from service earlier than expected and trigger repurchase liability bulges.

Projected growth rate on the employer stock is key, but often elusive over a long period of time. Thus, it's best to make conservative assumptions with respect to the variables listed above. While there are many other ways to manage repurchase liability such as distribution timing and mode of distribution, the design of the ESOP loan amortization schedule is very important and requires careful thought and design.

Allocation Rules and Limitations

Allocation of employer securities acquired by an ESOP are generally the same as the rules that apply to allocations in other types of qualified defined contribution plans. However, special limitations prohibit allocations to certain individuals under ESOPs. Special rules apply in a leveraged ESOP whereby the plan acquires employer securities with the proceeds of an exempt loan.

- **Assets released from suspense account.** As of the end of each plan year, the ESOP must consistently allocate to participants' accounts non-monetary units (i.e., ESOP stock) representing participants' interests in assets released from the suspense account.
- **Income.** Income with respect to ESOP stock acquired with the proceeds of an exempt loan must be allocated as income of the plan except to the extent that the ESOP provides for the use of income from such securities to repay the loan.
    - This limitation is subject to the special rule that applies to dividends on allocated ESOP stock (see "Dividends" below).
- **Forfeitures.** If a portion of a participant's account is forfeited, allocated ESOP stock must be forfeited only after other assets. If interests in more than one class of ESOP stock have been allocated to the participant's account, the participant must be treated as forfeiting the same proportion of each such class.

Treas. Reg. § 54.4975-11(d).

Tax Deduction of ESOP Contributions Based on Exempt Loan Payments

In a leveraged ESOP, employer contributions are made in the form of payments to service the exempt loan. In an unleveraged ESOP, contributions are made in the form of employer stock, or cash provided for its purchase by the plan.

An employer's deduction for contributions to a qualified defined contribution plan is limited, generally, to 25% of the compensation of eligible participants. I.R.C. § 404(a)(3). However, special deduction rules apply for ESOP contributions used for the repayment of principal and interest on an exempt ESOP loan. I.R.C. § 404(a)(9). These rules permit an employer to claim a deduction:

- Of up to 25% of eligible participant compensation for ESOP contributions that are used for the repayment of the principal on an ESOP acquisition loan and allows the employer to disregard the deduction limitations set forth in I.R.C. §§ 404(a)(3) and (7). I.R.C. § 404(a)(9)(A).
    - By comparison, if an ESOP owns an S corporation's stock, that S corporation may not deduct any accrued expenses for any ESOP participant, including retirement plan contributions based on accrued

compensation. S Corp. Deduction of ESOP Accrued Expenses.

- In addition, a C corporation employer is not subject to a deduction limit for its ESOP contributions used to repay interest on an ESOP acquisition loan. I.R.C. § 404(a)(9)(B).
    - This rule does not apply to an S corporation. Thus, contributions made by an S corporation and used to pay ESOP loan interest will count against the 25% of compensation deduction limit. If an employer exceeds the deduction limits, I.R.C. § 4972 imposes a 10% excise tax.

IRS has stated that the I.R.C. § 404(a)(9)(A) ESOP contribution deduction is separate from the I.R.C. § 404(a)(3) deduction. The I.R.C. § 404(a)(3) deduction allows deduction of employer contributions to a profit-sharing plan up to 25% of eligible payroll. Private Letter Ruling 200436015, PLR 200436015.

This means that a C corporation employer can take:

- A 25%-of-eligible-compensation deduction under I.R.C. § 404(a)(9)(A) where its ESOP contributions are used to make principal repayments on an exempt loan –and–
- A 25%-of-eligible-compensation deduction in the same plan year, under the general rule of I.R.C. § 404(a)(3) for contributions to another defined contribution plan

Total annual additions for participants in the plans must still comply with I.R.C. § 415 limits (see "Special I.R.C. 415 Limitations Considerations," below).

I.R.C. § 415(f)(1)(B).

Planning the Size of the ESOP Loan

Selecting the size of the ESOP loan is central to ESOP design and administration. The loan should not be so large that the anticipated employee benefit, in the form of annual employer stock allocations to employee accounts, exceeds the intended benefit as a percentage of employee compensation. Thus, in determining the size of the ESOP borrowing a balancing is required among several factors, primarily:

- The employer's borrowing requirements
- The size of the employer's payroll
- Anticipated growth and fluctuations in the payroll
- Anticipated change in the value of the employer stock
- The term of the ESOP loan –and–
- The anticipated annual employee benefit

Several additional factors may apply which may influence the size of the ESOP borrowing:

- **I.R.C. § 404 tax-deduction limits.** Employer contributions toward annual ESOP loan payments must not exceed 25% of the annual (or prorated) compensation of participating employees. Operation of this rule effectively places an upper limit on the amount of employee benefit the employer will want to provide through ESOP allocations. I.R.C. § 404(a)(3)(A)(i)(I), 404(a)(9)(A).
- **The One-Third Rule.** Where the employer is a C corporation, if the one-third rule is satisfied (see "The One-third Rule" in Special I.R.C. § 415 Limitations Considerations, below) contributions to satisfy interest payments when servicing the ESOP loan are not counted towards the I.R.C. § 415 limit. I.R.C. § 415(c)(6).
- **Dividends.** Dividends on the shares held by the ESOP (both allocated and unallocated shares) can be used to repay the ESOP loan or, for dividends on allocated shares, may be paid directly or indirectly to the employee. Employers will want to optimize tax deductibility and cash preservation in choosing the best application of dividends (see the "Dividends" subsection, below). That choice will impact planning on the size of the ESOP loan since dividends offset the amount the employer will require to satisfy the annual loan obligation. I.R.C. § 404(k).

Allocation of Shares Purchased with an Exempt Loan

Mechanics of Administering an ESOP: Principal-and-Interest Method and Principal-only Method

The mechanics of administering an ESOP require that employer securities that the ESOP acquires with the proceeds of an exempt loan be placed, initially, in a suspense account. Treas. Reg. § 54.4975-11(c). As principal and interest on the exempt loan are repaid, a pro rata amount of securities is released from the suspense account. The released shares are then allocated to the accounts of eligible participants for such plan year following a schedule. This schedule must be at least as rapid as one of the following schedules:

- The principal-and-interest method –or–
- The principal-only method

Treas. Reg. §§ 54.4975-7(b)(8)(i) and (ii).

According to the principal-and-interest method, the number of shares released is equal to the total number of shares in the suspense account multiplied by a fraction:

- The numerator: the principal and interest paid during the year –and–
- The denominator:
  - The sum of the numerator plus
  - The total remaining principal and interest to be paid over the life of the loan This assumes that in the case of a variable interest rate, the rate in effect at the year-end remains in effect for the loan duration)

Treas. Reg. §§ 54.4975-7(b)(8)(i).

Illustration 1: Principal (P) + Interest (I) Release Method

$$\frac{\text{Year X P + I}}{\text{Year X P + I + Remaining P and I}} \times \text{Number of shares in ESOP suspense account} = \text{Number of shares to be released for Year X}$$

Under the principal-only method, interest is excluded from both the numerator and the denominator of the fraction. The ESOP loan must also satisfy special requirements. Treas. Reg. § 54.4975-7(b)(8)(ii).

Illustration 2: Principal (P)-Only Release Method

$$\frac{\text{Year X P}}{\text{Year X P + Remaining P}} \times \text{Number of shares in ESOP suspense account} = \text{Number of shares to be released for Year X}$$

Based on relative compensation, ESOP shares normally are allocated to the ESOP accounts of participants who satisfy the allocation eligibility rules under the plan and who are not prohibited from receiving an allocation in a particular year (as described above). However, as with other defined contribution plans, the plan sponsor has some flexibility in establishing the plan's allocation criteria.

For example, to receive an allocation for the final year of employment, you may design the plan to:

- Provide that a participant must be employed on the last day of the plan year –or–
- Impose a minimum hours of service requirement

These requirements raise no issues under the non-discrimination rules for tax-qualified plans. Treas. Reg. § 1.401(a)(4)-2(b)(4)(iii). Regardless of the approach selected, you must reflect the allocation criteria in the plan document and the criteria must be applied in ESOP administration. The plan administrator should verify from year-to-year that contributions to the ESOP and allocations to individual participants are within the limitations described above, particularly where the participant headcount or aggregate compensation has been reduced.

You should advise the plan sponsor to keep in mind the deduction limits under I.R.C. §§ 404(a)(3) and 404(a)(9) and the annual addition limits under I.R.C. § 415 when designing

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the ESOP document and any ESOP loan amortization schedule.

Allocation of Shares in an ESOP that is Combined with a Profit Sharing/401(k) Plan

A common plan design is to include an ESOP as an element of a larger qualified plan. This usually includes a profit-sharing plan that may or may not be combined with a cash or deferred arrangement (i.e., a 401(k) plan).

Depending on design choice, the plan sponsor may enter into an ESOP financing that aligns plan design, like a matching contribution, with payments on an ESOP loan that requires release of shares from the ESOP suspense account to be allocated to participant accounts. If released shares are to be allocated, in part or in whole, as a matching contribution to employee elective contributions under a 401(k) plan, specific provisions should be included in the ESOP document detailing the allocation rules and a cross-reference thereto should be included in any companion 401(k) plan (which likely is part of an integrated plan document).

In addition, careful planning is required to coordinate compensation levels with the ESOP loan amortization schedule and the resulting release of shares to assure that a sufficient number and value of shares are released for allocation for a particular plan year. Shares that are released that exceed the amount necessary for matching contributions are typically allocated on the basis of participant compensation.

In this case, in addition to application of I.R.C. § 401(a)(28), the diversification requirements of I.R.C. 401(a)(35) will apply to the plan if the employer has publicly-traded securities. Generally, these rules will require that participants be permitted to diversify their ESOP shares after completing three years of service. See Distribution of ESOP Shares and Diversification.

Special I.R.C. § 415 Limitations Considerations

I.R.C. § 415(c)(1) generally provides that contributions that may be credited as "annual additions" to a participant's defined contribution plan account in a limitation year may not exceed the lesser of:

- An inflation-adjusted cap ($56,000 for 2019 and $57,000 for 2020) –or–
- 100% of the participant's compensation

A participant's annual addition is determined as the sum of employer contributions, employee contributions, and forfeitures to the participant's account for a year. This takes into account all defined contribution plans sponsored by an employer. I.R.C. § 415(c)(2).

I.R.C. § 415 annual additions in an ESOP normally include principal and interest payments that the employer makes to service the ESOP loan and not the value of securities allocated to participants' accounts. Treas. Reg. § 54.4975-11(a)(8)(ii). Two special rules apply that may limit the amount of employer contributions to the ESOP that will count as an I.R.C. § 415 annual addition.

The One-third Rule

The first special rule applies to leveraged ESOPs sponsored by C corporations. This rule provides that:

- Where no more than one-third of the employer ESOP contributions to the ESOP are allocated to highly compensated employees (HCEs, as defined in I.R.C. §414(q)), the I.R.C. § 415 "annual addition" to a participant's ESOP account for the year then excludes:
    - Employer contributions to the ESOP used to pay interest on the ESOP loan –and–
    - The amount of reallocated forfeitures of employer securities that were acquired with the proceeds of the loan

I.R.C. § 415(c)(6). For this purpose, the employer may choose to adopt the top 20% rule reflected in I.R.C. § 414(q)(3) to limit the allocations to HCEs.

The Regulatory Rule

The second special rule provides that I.R.C. § 415 annual additions under an ESOP may be calculated based on the lesser of:

- Employer contributions used to repay an exempt loan –or–
- The fair market value of the employer securities allocated to participant accounts

Given the mechanism of an ESOP, whereas payments on the ESOP loan release ESOP shares from a suspense account for allocation to participant accounts, this rule provides an advantage to ESOPs whose employer stock has appreciated since the date that the stock was first purchased by the ESOP trust and placed in its suspense account. This can be a significant employee benefit considering that a leveraged ESOP's lifespan is, generally, in excess of 10 years. Treas. Reg. § 54.4975-11(a)(8)(ii).

Under each special rule and when applying I.R.C. § 415 generally to ESOPs, dividends paid on employer securities held by the ESOP are treated as plan earnings and do not count against the I.R.C. § 415 annual addition limits. However, the IRS is authorized to recharacterize amounts that an employer designates as dividends if it determines that such dividends should be treated as annual additions, and that total annual additions violated I.R.C. § 401(a)(16).

Prohibition on Allocations of Stock Acquired in an I.R.C. § 1042 Transaction

Where a C corporation sponsors an ESOP and the sale of shares by individual shareholder(s) results in the ESOP owning at least 30% of outstanding employer securities, the selling shareholder(s) may defer the gain on the sale if certain conditions are met. One such condition is that the selling shareholders and certain others may not participate in the allocation of the shares sold to the ESOP.

Section 409(n) of the Internal Revenue Code states that no portion of the assets attributable to or allocable in lieu of employer securities acquired in a transaction to which the I.R.C. §1042 tax deferral provisions apply may be allocated to certain employees:

- During a nonallocation period to a selling shareholder who renders a I.R.C. § 1042 election or to any person related to that electing selling shareholder (as defined in I.R.C. § 267(b)) –or–
- At any time to a more-than-25% shareholder as determined by application of the I.R.C. § 318(a) attribution rules

I.R.C. § 409(n)(1).

A de minimis exception does apply to the prohibited allocation rule for a selling shareholder's (but not for a more-than-25% shareholder) lineal descendants. This exception states that allocations that otherwise would be prohibited may be permissible for lineal descendants when the aggregate amount of allocated stock does not exceed 5% of the amount sold by the selling shareholder in the § 1042 transaction.

Under the Section 409(n) prohibited allocation rules, an employer is prevented from making special contributions or allocations of other assets under an ESOP for the benefit of participants who cannot receive allocations under the rule. However, an exception does apply when additional contributions are made to other participants in an amount sufficient to satisfy both applicable coverage and non-discrimination requirements. Special contributions under any aggregated plan will be considered in applying the rule. The prohibited allocation rule is not applicable to allocations of employer securities or cash contributions made to a non-qualified deferred compensation plan.

A nonallocation period applies to I.R.C. § 1042 sellers and persons related to them (but not to 25% shareholders). The nonallocation period is the period beginning on the date of the Section 1042 transaction and ending on the later of:

- The date that is 10 years after the date of the transaction –and–
- The date of the plan allocation resulting from the final payment on the loan used to purchase the § 1042 shares.

Thus, for 25% shareholders, the nonallocation period is perpetual. Failure to comply with the prohibited allocation rule is an ESOP qualification issue. I.R.C. § 4975(e)(7).

A violation of the nonallocation rule by the employer will subject them to tax liability under I.R.C. § 4979A that is equal to 50% of the amount of the prohibited allocation. Also, the ESOP will be treated as having distributed the prohibited allocation to the participant. The participant must generally include the corresponding amount in his or her taxable income for the year. I.R.C. § 409(n)(2).

Prohibition on Allocations to Disqualified Persons in an S Corporation ESOP

Special rules apply to an ESOP established by an S corporation to prevent the plan from being used as an abusive tax shelter. No portion of the assets of an ESOP established by an S corporation that are attributable to (or allocable in lieu of) employer securities of the S corporation can accrue or be allocated, directly or indirectly, under any qualified plan maintained by the S corporation for the benefit of a disqualified person during a so-called nonallocation year. The consequences of a violation are catastrophic, including disqualification of the plan, the ESOP, and S corporation status, along with excise tax penalties. The Section 409(p) nonallocation year rules are briefly described below. For more information, see I.R.C. § 409(p); Treas. Reg. § 1.409(p)-1, and I.R.S., Issue Snapshot – Preventing the Occurrence of a Nonallocation Year under Section 409(p).

Nonallocation Year

Generally, a nonallocation year is any plan year of an ESOP that holds S corporation employer securities where, at any time during the plan year, disqualified persons own or are deemed to own at least 50% of the number of outstanding shares of the S corporation. I.R.C. § 409(p)(3)(A). For this purpose, stock ownership is attributed as required under I.R.C. § 318, with three modifications (as further described below):

- Special family attribution rules include additional family members.
- Special rules for synthetic equity apply in lieu of Section 318 stock option attribution rules.

- Shares held by the ESOP are treated as deemed-owned by the participants to whom they are allocated or would be allocated (based on the prior allocation under the plan).

I.R.C. § 409(p)(3)(B).

Disqualified Persons

For the nonallocation year rules, a disqualified person means either of the following:

- **Deemed 10% shareholders.** An individual is a deemed 10% shareholder if he or she:
    - Is not a member of a deemed 20% shareholder group (described below) –and–
    - Is deemed to own shares representing at least 10% of the total deemed-owned ESOP shares (or whose deemed-owned shares plus synthetic equity shares (described below) represent at least 10% of the sum of the total deemed-owned ESOP shares plus the individual's synthetic equity shares)
- **Member of a deemed 20% shareholder group.** An individual is a member of a deemed 20% shareholder group (along with each family member) if the individual and all his or her family members are deemed to own shares representing at least 20% of the total deemed-owned ESOP shares (or which group's deemed-owned shares plus synthetic equity shares represent at least 20% of the sum of the total deemed-owned ESOP shares plus the group's synthetic equity shares), where an individual's family members include the:
    - Spouse of the individual
    - Ancestors or lineal descendants of the individual and of his or her spouse
    - Siblings of the individual and of his or her spouse, along with any lineal descendant of the siblings
    - Spouse of any such ancestor, lineal descendant, sibling, or sibling's descendant (unless legally separated)

I.R.C. § 409(p)(4).

Deemed-Owned Shares

Deemed-owned shares include both:

- ESOP stock allocated to the account of an individual –and–
- An individual's share of the unallocated stock held by the ESOP

I.R.C. § 409(p)(4)(C).

An individual's share of the unallocated stock equals the amount of unallocated stock that would be distributed to such person if the unallocated stock were distributed to all participants in the same proportion as the most recent stock allocations under the plan. If there have been no previous allocations under the ESOP, then a reasonable estimate of such an allocation is used. Treas. Reg. § 1.409(p)-1(e)(2).

Deemed-owned shares do **not** encompass shares owned outright by an individual in his or her own name.

Synthetic Equity Shares

Synthetic equity shares taken into account for the nonallocation year rules include a number of shares attributable to an individual who has any of the following rights:

- Right to receive S corporation stock pursuant to a stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right (e.g., stock-settled SAR), stock purchase right, or similar equity rights, whether or not then vested, exercisable, or in-the-money
- Right to a future payment (in a form other than S corporation stock) based on the value of S corporation stock (e.g., cash-settled SAR)
- Right to acquire interests in or assets of the S corporation or a related entity (to the extent of the S corporation's ownership in that entity)
- Right to certain nonqualified deferred compensation payments with respect to services provided to or on behalf of the S corporation

Treas. Reg. § 1.409(p)-1(f).

For equity rights in the S corporation's stock, you generally attribute 100% of the shares subject to the equity right to an individual for purposes of determining the number of their synthetic equity shares (regardless of any exercise price, base price, or purchase price). If the rights are in stock of a related entity, the number is adjusted based on the S corporation's interest in that entity. In other cases, the number of synthetic equity shares is generally determined based on the value of the underlying right and the fair market value of the S corporation stock at the time.

Effect of Prohibited Allocation during Nonallocation Year

Prohibited allocations to a disqualified person during a nonallocation year include (1) any accrual under the ESOP (e.g., distributions on allocated shares or allocated proceeds from the sale of ESOP shares) to the disqualified person's account or (2) any contribution, other annual addition, or other benefit is made to the disqualified person's account. All of the following can result from the occurrence of a prohibited allocation in a nonallocation year:

- The plan ceases to qualify as an ESOP for failing to satisfy the prohibited transaction exemption requirements of I.R.C. § 4975(e)(7) and ERISA § 408(b)(3) (29 U.S.C. § 1108(b)(3)), triggering an excise tax on any ESOP loan under I.R.C. § 4975(d)(3).
- The plan ceases to be a qualified plan under I.R.C. § 401(a) (and, consequently, its S corporation status).
- The plan is treated as having made a deemed distribution in the amount of the prohibited allocation to the disqualified person, who must then include the amount in their gross income.
- The S corporation becomes liable under I.R.C. § 4979A(a) for an excise tax equal to 50% of the amount of the prohibited allocation plus 50% on any synthetic equity interest that is owned by any disqualified person.

Treatment of Dividends on ESOP Stock

Dividends or distributions paid on employer securities held by the ESOP may be used by the ESOP trustee to make payments on the ESOP loan. It will not matter if the dividends are paid on allocated or unallocated shares. Treas. Reg. § 54.4975-11(d)(3). However, while there is an economic benefit of using dividends to meet loan servicing obligations, the employer will want to optimize the benefit by also satisfying tax-deductibility rules.

Tax-deductibility of Dividends

While corporations generally do not receive an income tax deduction for dividends paid to shareholders, special dividend deduction rules apply to C corporations on dividends generated by ESOP stock. A C corporation may deduct all "applicable dividends" paid on employer securities held by an ESOP maintained by the corporation or its controlled group member.

- On allocated shares, regardless of whether or not the allocated shares were actually acquired with the proceeds of the loan that is being repaid
    - This includes dividends on shares attributable to a refinanced loan. I.R.C. § 404(k)(2)(A)(iv) –and–
- On unallocated shares

I.R.C. § 404(k).

For this purpose, an "applicable dividend" is any dividend paid on an employer security held by the plan, provided that the dividends are:

- Paid in cash directly to plan participants or their beneficiaries
- Paid to the plan in cash and distributed to plan participants or their beneficiaries within 90 days of the plan year end in which the dividends were paid
- At the **election** of the participant or beneficiary:
    - Paid to the participant or beneficiary in cash, directly or indirectly, as provided above –or–
    - Reinvested in employer securities –or–
- Used to repay an ESOP loan
    - Dividends used to repay an ESOP loan are deductible only if:

      — **Sourcing.** The shares generating the dividends were acquired with the proceeds of that loan (or its refinancing) –and–

      — **FMV requirement.** The plan must provide that employer securities having no less value than the fair market value of the dividend will be allocated to the participant's account (in the same year that the dividend would have been allocated)

I.R.C. § 404(k)(2)(A); I.R.S. Notice 2002-2.

Dividends that are paid or reinvested as provided in I.R.C. §404(k)(2)(A)(iii) are not treated as:

- I.R.C. § 415(c)annual additions
- I.R.C. § 402(g)elective deferral
- A § 401(k) elective contribution –or–
- A § 401(m) employee contribution

Use of the Participant Election in Plans with Old ESOP Stock

The participant election, above, can be a useful method of preserving tax-deductibility of a dividend payment on ESOP stock. I.R.C. § 404(k)(2)(A)(iii). Best practices indicates that using the participant election is most appropriate to obtain a deduction for dividends generated on:

- Old ESOP stock where a New ESOP Loan is outstanding:
    - Where one ESOP loan has been repaid, dividends generated on employer securities purchased with the old ESOP loan (old ESOP stock) can't be applied automatically toward payments on a new ESOP loan (by virtue of the sourcing limitation under I.R.C. § 404(k)(2)(iv)) (see above). Employers will want the dividend on the old ESOP stock to be applied toward payment of the current ESOP loan, where one is outstanding. The participant election overrides the sourcing rule of I.R.C. 404(k)(2)(A)(iv)
- Where the ESOP isn't leveraged and the employer wishes to allow participants to reinvest their dividends toward the purchase of additional employer securities
- In a plan that has an employer stock fund in which the dividends may be reinvested in additional shares of units of the employer security

Foreign Corporation Stock

An IRS Private Ruling held that dividends paid by a foreign corporation subject to U.S. taxes can be considered for the ESOP dividend-deduction. However, proposed regulations would not permit a deduction to a U.S. subsidiary of a foreign parent for dividend payments made by the parent. I.R.S., Priv. Ltr. Rul. 200237026, 2002 PLR LEXIS 824 (June 18, 2002). In addition, the IRS can deny a dividend deduction that amounts to an avoidance or evasion of taxation. I.R.C. § 404(k)(5)(A).

Default Election

Where participants are provided the dividend election under I.R.C. § 404(k)(2)(A)(iii), you can design the ESOP to designate one of the alternatives to be the default election for participants who fail to select a method of dividend-delivery. Thus, consider designing the plan so that, when a participant's fails to make a dividend election, the dividends are reinvested in additional ESOP shares within the plan. I.R.S. Notice 2002-2, Q&A-3.

Fully-vested Shares

Where ESOP dividends are paid-out or reinvested within the plan, at the participant's election, the issue arises as to whether it makes sense if the underlying ESOP shares are not yet fully-vested. The problem arises because an ESOP participant must be fully vested in any dividends for which an election is available under I.R.C. § 404(k)((2)(A)(iii). I.R.C. § 404(k)(7).

You may design the ESOP document to allow the dividend election, without regard to whether the participant is vested in the underlying stock. Alternatively, you can design the ESOP to offer the election only to vested participants, provided the feature is non-discriminatory. I.R.S. Notice 2002-2, Q&A-9; Treas. Reg. § 1.401(a)(4)-4(b)(2)(ii)(2)(B). A third option is to vest the dividend, but not the underlying ESOP stock. This option may prove difficult to administer.

Reasonable Opportunity to Elect

For dividends subject to a participant election to be considered "applicable dividends" that may be deducted under I.R.C. § 404(k)(2)(A), the participant dividend election must satisfy all of the following requirements:

- Participants must be provided with a reasonable opportunity to make the election before the dividend is paid or distributed.
- Participants must be provided a reasonable chance to change their dividend elections at least once a year.
- Participants must be given a reasonable opportunity to make elections under any new plan terms that govern the manner in which dividend payments are made or distributed to participants before the date on which the first dividend subject to the new plan terms is paid or distributed.

I.R.S. Notice 2002-2, Q&A-3.

Dividends on ESOP Stock in S Corporations

Because I.R.C. § 404(k) does not cover an S corporation, any S corporation dividend-distributions that are passed through the ESOP are treated as plan distributions. Unlike dividend distributions from a C corporation, dividend distributions from an S corporation ESOP:

- Qualify as "eligible rollover distributions" under I.R.C. § 402(c)(4)
- May be subject to the I.R.C. § 72 10% early distribution tax –and–
- May require participant consent under I.R.C. § 411(a)(11) rules, before distributed

Also, in the case of dividends paid on ESOPs in S corporations, to avoid the violation of the plan qualification and prohibited transaction rules, the plan must provide that the ESOP allocate to participant accounts, employer securities that have a fair market value at least equal to the amount of the dividends or distributions. The allocation should be made for the year when the dividends/distributions would have been paid to the participants. I.R.C. § 4975(f)(7).

Dividends on Employer Securities in Employer Stock Fund

The dividend deduction under I.R.C. § 404(k) does not apply to ESOPs, alone, and will apply, similarly, to dividends on employer securities held within an employer stock fund (whether represented as shares or as units) maintained as an investment in a 401(k) plan.

Dividends on Allocated and Unallocated ESOP Stock Used to Make ESOP Loan Payments

As discussed above, a C corporation that maintains a leveraged ESOP will almost always choose to apply dividends, on both allocated and nonallocated ESOP stock, toward payment of principal and interest due on an outstanding ESOP loan.

This application is subject:

- To the sourcing requirements of I.R.C. § 404(k)(2)(A)(iv) for dividends on both allocated and unallocated shares –and–

- To the fair market value requirement of I.R.C. § 404(k)(2)(B) for allocated shares (see "Tax Deductibility of Dividends" above

Where an ESOP loan has been refinanced, dividends or distributions on shares acquired with the original loan may be deducted and eligible for the qualification and prohibited transaction relief if they are used to pay the refinanced debt. Otherwise, dividends on old ESOP shares (that is, acquired with old ESOP debt) are not deductible if used to make payments on new ESOP debt. You should draft the plan to permit the election method of I.R.C. § 404(k)(2)(A)(iii) to preserve the tax deduction. I.R.C. § 404(k)(2)(A).

Dividends Paid on Appreciated ESOP Stock

You may consider the economic advantage to the employer of drafting a plan which satisfies only the minimum fair market value requirement of I.R.C. § 404(k)(2)(B), and not more. Under conditions where the fair market value of the employer security has appreciated since the ESOP trust first acquired the shares, dividends applied to pay an ESOP loan may release ESOP stock of greater value than the fair market value of the dividends required to be allocated.

The shares released which are not required to satisfy the fair market value requirement may be applied for other plan purposes, for example:

- Where the ESOP is a component of a 401(k) plan, allocating the "excess" released shares to satisfy the employer's matching contribution obligation (all or part of which may be required in the form of employer securities).
- Allocating the "excess" released shares to all participants, pro rata, based on compensation

Tax Year of the Deduction

The corporation paying the dividends may take a deduction in the year in which the ESOP participants or beneficiaries have a corresponding income inclusion.

- If dividends are paid in cash directly to ESOP participants, the deduction is permissible in the year that dividends are paid.
- If dividends are paid in cash to the ESOP and then distributed by the plan to participants not later than 90 days after the plan year close, the deduction is permitted in the employer's taxable year when the dividends were distributed from the ESOP to its participants.

The following special rules also apply to ESOP dividends paid to participants and their beneficiaries:

- Cash dividends are exempt from the 10% early distributions-penalty tax. I.R.C. § 72(t)(2)(A)(vii).
- Cash dividends are not eligible for tax free rollover to an IRA or other eligible retirement plan. Treas. Reg. § 1.402(c)(2), Q&A-4(e).
- Participants must be fully-vested in dividends for which the C corporation claims a tax deduction. I.R.C. § 404(k)(7).
- Distribution may be made without the participant's consent. I.R.C. § 411(a)(11)(C).
- Tax withholding is not required. I.R.C. § 3405(e)(1)(B)(iv).
- ESOP dividends paid are not eligible for the 15% tax rate on qualified dividends. I.R.S. Publication 550.

Use of the Dividend Deduction in a Combined ESOP/401(k) Plan

This mechanism can also be used where the ESOP is part of a larger plan, like a 401(k) plan, which offers participants an opportunity to invest in an employer stock fund. While dividends or distributions attributable to the employer securities held in that fund will not be tax-deductible if applied to make payments on an outstanding ESOP loan, the plan can preserve the tax deduction by providing for payment of these dividends in the manner provided in I.R.C. § 404(k)(2)(A).

Distribution of ESOP Shares and Diversification

Right to Demand Employer Securities /Put Option

Where ESOP stock is readily tradeable, benefits generally must be distributable in whole shares of employer stock. The value of any fractional share may be paid in cash. I.R.C. § 409(h). Therefore, as a qualification issue, an ESOP must offer a participant the right to receive a distribution in the form of employer securities. I.R.C. § 401(a)(23). If a terminated participant or beneficiary does not desire a stock distribution then, where the plan provides, benefits may be distributed in cash.

However, where the ESOP sponsor is:

- An S corporation –or–
- A C corporation required by its corporate charter or by-laws to:
    - Restrict ownership of "substantially all" outstanding employer securities to employees –or–
    - To a trust qualified under I.R.C. § 401(a),

then the ESOP may distribute all benefits in cash without granting participants the right to demand stock.

Alternatively, the ESOP may distribute employer securities subject to a requirement that they be resold immediately to the employer to satisfy the put-option payment requirements. However it is the employer, not the ESOP that is required to satisfy the put-option payment requirement to repurchase distributed employer securities under a fair market valuation formula. The fair market value for the stock subject to this put option should be defined by an independent appraiser in accordance with I.R.C. § 401(a)(28)(C).

In order to satisfy the put option requirement, the ESOP generally may use the fair market value of the employer securities as of the immediately preceding valuation date under the ESOP. The put option period must cover at least 60 days following the distribution date. The put option requires the employer to pay the option price in a one sum, or substantially equal payments to extend no more than five years, with interest and "adequate security." I.R.C. § 409(h)(5); I.R.S. Memorandum, EP Determinations #2 (Nov. 3, 2009). While the put option may not bind the ESOP to repurchase the stock, it may allow the ESOP to buy stock tendered to the employer. Treas. Reg. § 54.4975-7(b)(10). I.R.S. Memorandum, EP Determinations #1 (Mar. 6, 2009).

ESOP Diversification

ESOPs are required to invest "primarily in employer securities. Treas. Reg. §54.4975-11(b). This is unlike the assets of most other qualified plans. Most other qualified plans usually invest in a broad range of investment alternatives or with other "individual account plans," as defined under ERISA § 3(34) (29 U.S.C. § 1002(34)). These are typically invested as the participant elects among designated investment alternatives.

Notwithstanding the requirement that ESOP assets be invested primarily in employer securities, an ESOP must provide an opportunity for "qualified participants"—those who are at least age 55 and have at least 10 years of participation in the plan—to "diversify" their plan holdings consisting of employer securities (limited to those acquired by the ESOP after 1986). I.R.C. § 401(a)(28)(B)(iii).

Satisfying the Diversification Requirement

In order to meet this diversification requirement, the ESOP must permit its qualified participants:

- An opportunity to either:
    - Receive a distribution of ESOP shares (which may be rolled over to another eligible retirement plan) –or–
    - Direct the investment of a certain percentage of the employer securities held in their ESOP accounts into at least three other investment options –and–
- To make the election during the "qualified election period," which is:
    - The six-plan-year period beginning with or after the plan year in which the participant:

        — attains age 55 –and–

        — completes 10 years of plan participation

I.R.C. § 401(a)(28)(B)(i).

Qualified participants are entitled to make their diversification elections during the first 90 days following the plan year that is within the qualified election period.

I.R.C. § 401(a)(28)(B)(i).

The diversification election relates to 25% of the number of shares in the participant's ESOP account for the first five plan years of the six-plan-year election period. This amount rises to 50% in the sixth year. In each case, it is reduced by the number of shares that the participant has diversified under any prior election. I.R.C. § 401(a)(28)(B)(i).

Computation for the diversification is solely based on the number of shares allocated to the qualified participant's account. The computation does not include other assets allocated to the account.

When the employer securities are not readily tradeable, advance valuation by an independent appraiser is required. I.R.C. § 401(a)(28)(C).

Drafting the ESOP Plan Document to Satisfy the Diversification Requirements

In drafting the ESOP plan document to satisfy the diversification requirements of I.R.C. § 401(a)(28), the document may reference:

- "Participant and former participant" instead of "employee" for purposes of identifying qualified participants –and–
- "Year of service" instead of "year of participation" as long as the "year" in either case does not require more than 1,000 hours of service.

I.R.S. Memorandum, EP Determinations #12 (Nov. 3, 2009).

Methods of Diversification

An ESOP may satisfy the diversification requirement in two ways. Within 90 days after the period in which the diversification election may be made, the plan may:

- Distribute to a participant, in stock or cash, the portion of the participant's account subject to the diversification requirement –or–

- Make available to qualified participants at least three diversified investment options (other than employer stock). An option to transfer assets to a plan that permits employee self-direction of investments (such as the employer's 401(k) or profit-sharing plan) satisfies the diversification requirement, but an option to invest in employer securities does not.

I.R.C. § 401(a)(28)(B)(ii).

A participant is not required to accept the diversification opportunity. A participant may choose to keep his or her ESOP account fully invested in employer securities.

Although the diversification requirements of I.R.C.§ 401(a)(28) apply to employer securities acquired by or contributed to an ESOP after 1986, including employer securities purchased by reinvestment of dividend generated on pre-1986 shares, you should discuss with the plan sponsor whether the sponsor prefers treating all ESOP shares as subject to the diversification requirement. I.R.S. Notice 88-58, Q&A-11.

Where the ESOP satisfies the diversification requirement by distributing stock, the put option requirements apply and the stock, which qualifies as an eligible rollover distribution under I.R.C. § 402(c)(4), may be rolled over into an accepting IRA. Here, if the transferred stock is not readily tradable on an established market at the time of the rollover distribution, the IRA retains the put option.

However, if the ESOP distributes cash, the participant may roll the cash over into an IRA or another eligible retirement plan under I.R.C. § 402(c)(8) that accepts rollovers. Any portion of a diversification distribution that is not rolled over is subject to taxation, including the 10% early distribution penalty under I.R.C. § 72(v).

Annual Notification to Qualified Participants

Although the I.R.C. does not set forth specific participant notification requirements regarding the diversification election, you should instruct clients that notification of a diversification election should be provided to qualified participants annually. Notification exclusively in the summary plan description generally is insufficient.

If notice is not provided and the value of the stock declines, the employer must make the participant whole for the diminution of value by applying a true-up to the participant's account, with earnings, to reflect the lost value of the stock. Joint Committee of Employee Benefits Q&A with the IRS (May 11, 2002), Q&A-9.

De Minimis Exception

ESOPs are permitted to avoid providing a diversification election where the fair market value of the employer securities allocated to a participant's account and acquired by or contributed to an ESOP (after 1986) is $500 or less.

In determining fair market value, employer securities held in a qualified participant's accounts in all of the ESOPs maintained by an employer and the members of the controlled group of corporations are aggregated are considered to be held by the same plan.

For this purpose, fair market value is determined as of the valuation date immediately preceding the first day that a qualified participant is eligible to make a diversification election. I.R.S. Notice 88-56, Q&A-7.

Diversification of Employer Securities in an "Applicable Defined Contribution Plan"

Special diversification rights apply to certain defined contribution plan accounts that hold publicly-traded employer securities (regardless of whether they are also ESOPs). These rights entitle participants in an "applicable defined contribution plan" to:

- elect to direct the plan to divest employer stock allocated to the participant's account –and–
- reinvest the sale proceeds in other investment options

I.R.C. § 401(a)(35).

There must be at least 3 other investment options for the participant's investment, each of which is diversified and has materially different risk and return characteristics. The participant must be able to elect such diversification at least quarterly.

For this purpose, an "applicable defined contribution plan":

- Is a defined contribution plan that holds publicly-traded employer stock –and–
- Is not a stand-alone ESOP

I.R.C. § 401(a)(35)(E).

Participants are permitted to diversify their plan investment in employer securities on the following schedule:

- Immediately, for employee (after tax) contributions and elective deferrals (I.R.C. § 401(a)(35)(B)) –and–
- After completing three years of service, for employer contributions to the participant's account (like matching contributions or non-elective contributions that are

automatically invested in employer securities) (I.R.C. § 401(a)(35)(C)(i))

Beneficiaries of deceased participants are also entitled to immediate diversification of employer securities allocated to the participant's account. I.R.C. § 401(a)(35)(C)(ii).

Thus, the diversification requirements of I.R.C. § 401(a)(35) apply, most typically, where the employer has designed an ESOP to be a component of a larger plan, usually a 401(k) plan that provides for a matching contribution and a non-elective employer contribution.

Exception for Stand-alone ESOPs and One-Participant Plans

Only an "applicable defined contribution plan" is subject to the diversification requirement. This includes any defined contribution plan that holds any publicly-traded employer security (or, if the shares are not publicly-traded but a corporation in the sponsor's 50%-controlled group issues a class of securities that is publicly traded). The following plans are excluded:

- An ESOP, provided that:
    - No contributions to the plan are subject to I.R.C. § 401(k) or (m) (no elective deferrals, employee contributions, or matching contributions are made to the plan) –and–
    - The plan is a separate plan (i.e., it is a stand-alone ESOP, and not one combined with a profit sharing or 401(k) plan) for purposes of I.R.C. § 414(l) –and–
- A one-participant ESOP

I.R.C. § 401(a)(35)(E).

For more information on participant diversification requirements for employer securities in an applicable defined contribution plan, see Disclosure Rules for SPDs, Participant-Directed Plans, Employer Securities, and Blackout Notices.

Transition on Diversification Provision

As noted above, there are two different provisions that allow plan participants to require diversification of their ESOP accounts into assets other than employee stock:

- I.R.C. § 401(a)(28) applies to ESOPs of private companies and stand-alone ESOPs sponsored by public companies.
- I.R C. § 401(a)(35) generally applies to defined contribution plans holding publicly-traded employee stock and prescribes stricter rules for amounts attributable to employee after-tax contributions and employee elective contributions than it does for employer matching and discretionary contributions.

However, I.R. C. § 401(a)(35) does not apply if:

- The plan satisfies the requirements for being an ESOP
- There are no contributions to the plan (or earnings thereunder) which are employer salary deferrals or employer matching contributions –and–
- The plan is a separate plan from every other plan maintained by the employer

An ESOP will transition from I.R.C. § 401(a)(28)(B) to I.R C. § 401(a)(35) where, for example, the plan sponsor becomes a publicly traded company as a result of an initial public offering or merger with a publicly-traded company together with a merger with a 401(k) plan. In that case, the plan must eliminate any in-service distribution option that was added to satisfy I.R C. § 401(a)(28)(B)(ii)(1). The IRS has provided relief from the anti-cutback rules of I.R C. § 411(d)(6) to extend time for affected plans to adopt an amendment eliminating this distribution option. I.R.S. Notice 2013-17.

Rebalancing, Reshuffling, and Segregation

Many ESOP plan documents include language that provides for "reshuffling," "rebalancing," or "segregation" of ESOP participant account balances.

The IRS has provided technical assistance to a taxpayer whose ESOP contained these provisions. In this case, the taxpayer questioned whether the provisions violated Treas. Reg. § 1.401-1(b)(1)(i), (ii) or (iii) and Revenue Ruling 80-155, respectively, by ignoring prior allocations to participant accounts of employer contributions, in cash or stock, and earnings on trust assets. I.R.S. Memorandum, EP Determinations #4 (Feb. 23, 2010) (February 2010 EP Memo).

For this purpose, IRS provided the following definitions:

- "Rebalancing" is the mandatory transfer of employer securities into and out of participant plan accounts designed to result in all participant accounts having the same proportion of employer securities.
- "Reshuffling" is the mandatory transfer of employer securities into or out of plan accounts not designed to result in an equal proportion of employer securities in each account.
- "Segregation" is a reshuffling that applies only to terminated employees and treats all terminees the same.

Given these definitions, the February 2010 EP Memo advises as follows:

- **Violation of "definitely determinable" requirement.** If employer or fiduciary discretion is involved with reshuffling, such discretion causes the provision to

violate the "definitely determinable" allocation formula requirements of Treas. Reg. §1.401-1(b)(i)(ii) and (iii) and Rev. Rul. 80-155.

- **Reshuffled stock not eligible for I.R.C. § 401(a)(28) diversification.** Neither reshuffling nor rebalancing violate the diversification requirements of I.R.C. §§ 401(a)(28) or 401(a)(35), but once a participant's shares have been diversified out of stock under those statutory provisions, reshuffling or rebalancing may not be used to reinvest non-stock assets in stock.
- **Trust requirement.** Reshuffling is consistent with the fundamental nature of how trusts under a defined contribution plan are structured and operated.
- **No violation of protected rights.** Reshuffling and rebalancing do not violate any protected rights of participants because there is no right to a particular form of investment, such as employer securities, as long as the benefits, rights and features non-discrimination test is met.
- **No violation of right to particular form of investment.** Reshuffling and rebalancing do not violate the current and effective availability requirements of I.R.C. § 401(a)(4) and the regulations issued thereunder with respect to the right of a participant to a particular form of investment.
- **May reshuffle terminated vested only.** The reshuffling of only terminated vested accounts pursuant to segregation does not violate I.R.C. § 411(a)(ii) where the plan offers immediate distribution and, where the participant elects deferred distribution, the participant is offered sufficient investment options (such as a life cycle or target date fund or three diversified investment alternatives) in order to assure that the loss of the stock investment is not a significant detriment. Otherwise, segregation is permissible where the plan does not permit immediate distribution.

Thus, an ESOP may provide for rebalancing, reshuffling or segregation, subject to the following limitations:

- **Definite written program and definite predetermined allocation formula.** The plan must provide for a "definite written program" with a "definite predetermined allocation formula," which states the manner in which the transfers will be accomplished, such as the date of valuation.
- **Rebalancing.** Rebalancing, which treats all participants the same, and segregation of terminated participant accounts out of stock, do not raise issues of current or effective availability.
- **Right to retain stock not protected benefit.** The right to retain stock in an account is not a protected benefit.
- **No significant detriment on right to defer.** Segregation of terminated participant accounts out of stock will not be considered as imposing a significant detriment on the right to defer distribution in an ESOP that permits an immediate distribution if the ESOP offers adequate investment options.

Anti-cutback Rules

As a general rule, a qualified retirement plan:

- May not be amended to decrease the accrued benefit of any participant –and–
- An amendment will be treated as reducing an accrued benefit if it eliminates an optional form of benefit under a plan relating to benefits attributable to pre-amendment service.

I.R.C. § 411(d)(6) and ERISA § 204(g) (29 U.S.C. § 1054(g)).

Further, several protected benefits, to the extent they have accrued, cannot be reduced, eliminated or made subject to employer discretion except under limited situations. These include:

- Early retirement benefits
- Retirement-type subsidies –and–
- Optional forms of benefit, including a distribution form that is available under the plan, including the medium of distribution (e.g., in cash or in kind), and the election rights with respect to such optional forms

Treas. Reg. § 1.411(d)-4, Q&A-2(b)(2).

Regulations generally prohibit employer discretion regarding which optional form of payment will be provided to a participant. Allowing an employer to select an optional form of payment for a participant mirrors an amendment to the plan to eliminate all of the optional forms not selected for that participant. Treas. Reg. § 1.411(d)-4, Q&A-4.

Therefore, a plan generally may not authorize an employer or an employer-selected committee to choose how distributions to a terminated participant are to be made. That is, , in the form of a lump sum or installments, if available under the plan, or whether cash distributions are made or shares of employer securities or the commencement date of a distribution.

Special ESOP Rules on Eliminating Forms of Payment

An exception to the anti-cutback rules applies for ESOPs that modify distribution options in a non-discriminatory manner, limited to the following:

- An employer that is substantially employee-owned or is an S corporation may eliminate or retain the discretion to eliminate distributions in the form of employer securities

and replace such distributions with distributions in the form of cash, as I.R.C. § 409(h)(2) permits.

- An employer with readily tradable e stock on an established market may eliminate or retain the right to eliminate cash distributions and replace them with distributions in the form of employer securities, with respect to benefits pursuant to I.R.C. § 409(h).
- An employer whose stock no longer is readily tradable on an established market or is sold may eliminate or retain the discretion to eliminate distributions in the form of employer securities.
- An employer may eliminate, or retain the discretion to eliminate, a single sum or installment optional form of distribution, provided that the form retained is consistent with the ESOP distribution requirements of I.R.C. § 409(o).

I.R.C. § 411(d)(6)(C) and ERISA §204(g)(3) (29 U.S.C. § 1054(g)(3)); Treas. Reg. § 1.411(d)-4, Q&A-2.

In each case, the amendments and exercise of discretion must satisfy the I.R.C. § 401(a)(4) non-discrimination requirements. In addition, the benefits with respect to which the optional form of benefit is eliminated must have been held in an ESOP and not another plan that is converted into an ESOP or transfers assets to an ESOP for at least five years or for the entire life of the ESOP, if it is less than five years old.

Plan Termination and ESOP Loan Repayment

For all qualified plans, including ESOPs, the plan may be amended following plan termination to substitute distribution in cash for distribution in some other specified form of property, including employer securities. This is permitted as long as the employer doesn't maintain any other plan that provides for distribution in the other specified form of property. Treas. Reg. § 1.411(d)-4, Q&A-2(b)(2)(iii)(C).

This provision also requires that the participant must be given the opportunity to receive the other specified form of property at the time of the plan's termination. Keep in mind that compliance with this requirement will not be possible in the context of most sales of ESOP companies, in which the buyer insists on purchasing 100% of the company stock prior to termination of the ESOP. It could be argued that that following the sale, the ESOP no longer exists and thus, becomes a profit sharing plan that not requiring stock distributions.

Valuation of ESOP Shares and "Adequate Consideration"

All defined contribution retirement plans are required to provide participant account statements at least annually. Plans that permit participants to direct the investment of their account assets must provide account statements at least once each calendar quarter. ERISA § 105 (29 U.S.C. § 1025).

The account statement requirement often is more challenging for ESOPs. This is particularly true if the employer securities held by an ESOP are not publicly traded. A key and challenging aspect of ESOP planning is the valuation of employer securities contributed or sold to an ESOP. Valuations must be made in good faith and must be based on all relevant factors for determining the fair market value of securities. Treas. Reg. § 54.4975-11(d)(5).

However, an ESOP that holds employer securities acquired after 1986 that are not readily tradable on an established securities market must have all valuations of those securities made by an independent appraiser. I.R.C. § 401(a)(28)(C). Improper valuation may result in the loss of some deductions if the valuation is overstated. It could also subject the sponsoring employer to the prohibited transaction excise tax under I.R.C. § 4975. In egregious circumstances, the ESOP could be disqualified.

A guide to valuation of employer securities is available by reference to the ERISA § 408(e) (29 U.S.C. § 1108(e)) or I.R.C. § 4975(d) exemption from a prohibited transaction characterization of an employer's sale of its securities to an ESOP trust. To qualify for the exemption the sale of employer securities must be at a price that represents no more than "adequate consideration." DOL Advisory Opinion 96-08A (June 26, 1996). This term is described in proposed regulations issued by the DOL in 1988. Many practitioners rely on these proposed regulations as the most definitive guidance available regarding the valuation of stock of closely-held companies for ESOP purposes. DOL Prop. Reg. § 2510.3-18, 53 Fed. Reg. 17,632 (May 17, 1988). A fiduciary seeking to invoke the adequate consideration exception must prove the value assigned to an asset both:

- Reflects its fair market value (as determined under DOL Prop. Reg. § 2510.3-18(b)(2)) –and–
- Is the result of a determination made by the fiduciary in good faith (as described in DOL Prop. Reg. § 2510.3-18(b)(3))

I.R.S. Chief Counsel Advice Memorandum 200930038, 2009 IRS CCA LEXIS 118 (June 12, 2009).

Pass-Through of ESOP Voting Rights

Voting right pass-through requirements apply to ESOPs and stock bonus plans of employers whose stock is and for those

whose stock is not, publicly traded. I.R.C. §§ 401(a)(22) and 409(e).

Registered securities. In general, if an employer has a class of securities:

- Required to be registered under Section 12 of the Securities and Exchange Act of 1934 (the "Exchange Act") –or–
- A class of securities that would be required to be registered except for the registration exemption provided by Section 12(g)(2)(H) of the Exchange Act,

then the ESOP must permit each participant to direct the voting of employer securities allocated to his or her account. I.R.C. § 409(e)(4).

Non-registered securities. The voting rights pass-through for an ESOP maintained by an employer that does not have a registration-type class of securities, is required only with respect to any corporate matter that involves the voting of shares for or against a corporate:

- A merger
- A consolidation
- A sale of all or substantially all of the corporation's assets –or–
- A recapitalization, reclassification, liquidation, dissolution, or such similar transaction as the IRS provides

I.R.C. § 409(e)(3).

Voting of Allocated and Non-allocated Shares

For both registration-type securities and those that are not, the voting rights requirements of I.R.C. § 409(e) apply only to shares of employer stock that have been allocated to participant accounts.

When shares in an ESOP that are not allocated such as shares held in the ESOP suspense account or acquired since the last allocation date, the ESOP trustee may exercise its right in voting such shares, unless the plan does not provide this right.

An ESOP sponsored by a corporation that does not have a registration-type class of securities may provide each participant one vote on each issue on which he or she is entitled to direct the trustee to vote without regard to the actual number of shares allocated to his or her account. I.R.C. § 409(e)(5)(A).

The ESOP trustee thus may vote the shares held in the plan (both vested and unvested) in the proportions directed by the participant. Unallocated loan suspense account shares as well as allocated shares for which no direction is received from the participant are either voted, per plan provisions:

- At the discretion of the trustee,
- By direction from the plan committee –or–
- According to a mirror voting provision (described above)

Proxy Voting

The DOL has provided guidance regarding the duties of employee benefit plan fiduciaries in proxy voting situations. 29 C.F.R. § 2509.08-2. The guidance, which generally applies to all defined contribution plans, is particularly relevant to ESOP fiduciaries regarding the general management of voting rights. These rights are treated by the DOL as a plan asset that is subject to applicable fiduciary standards of care under ERISA § 404(a) (29 U.S.C. § 1104(a)).

The DOL guidance provides several instances that might prompt active monitoring and communication by fiduciaries. This includes:

- Investigating the independence and expertise of candidates for the board of directors
- Ensuring that the board of directors has sufficient information to carry out its responsibility to monitor management
- Determining the appropriateness of executive compensation
- Examining corporate policy regarding mergers and acquisitions
- Analyzing the extent of debt financing and capitalization
- Investigating long-term business plans and workforce development –and–
- Assessing financial and non-financial measures of corporate performance

Fiduciaries may carry out their monitoring and communication role through various methods. This includes conducting meetings and corresponding with corporate management and exercising the legal rights of a shareholder.

For information regarding securities required to be registered under Section 12 of the Securities and Exchange Act of 1934, see Registration Requirements under Section 12 of the Exchange Act.

Fiduciary Duties in ESOPs

An ESOP and its fiduciaries are regulated by the general fiduciary rules of ERISA §404(a) (29 U.S.C. § 1104(a)). However, the application of such rules to an ESOP often

differs from the application to other qualified plans. For example, ERISA provides special exemptions for ESOPs regarding the investment diversification requirements and related rules.

Exclusive Purpose and Prudence Rules

Under ERISA, ESOP fiduciaries are responsible for acquiring employer stock for the benefit of participants in a manner demonstrating compliance with the "exclusive purpose" and "prudence" rules that apply to all ERISA plan fiduciaries. ERISA § 404(a)(1)(A) – (D) (29 U.S.C. § 1104(a)(1)(A) – (D)).

For a further discussion on ERISA 404(a) fiduciary duties, see ERISA Fiduciary Compliance for Investment Managers.

While an ESOP is subject to the ERISA "exclusive purpose" and "prudence" requirements that apply to all qualified defined contribution plans, the application of these rules to ESOP fiduciaries must take into account the special nature of an ESOP as a plan "designed to invest primarily in qualifying employer securities."

As such, an ESOP fiduciary is generally exempt from the ERISA prohibition against an ERISA plan's holding more than 10% of its assets in qualifying employer securities. ERISA § 407(a) (29 U.S.C. § 1107(a)). This is because the 10% limit does not apply to investments in qualifying employer securities or qualifying employer real property held by an "eligible individual account plan " particularly one that is an ESOP, as defined in I.R.C. § 4975(e)(7). ERISA § 407(b)(2)(B)(iii) (29 U.S.C. § 1107(b)(2)(B)(iii)).

Pursuant to these regulations, an ESOP may invest 100% of its assets in qualifying employer securities or qualifying employer real property. To the extent that an ESOP invests in assets other than qualifying employer securities or real property, the ERISA diversification requirements apply. ERISA § 404(a)(1)(C) (29 U.S.C. § 1104(a)(1)(C)).

Prudence Applied to ESOP Creation and Maintenance

Unique to the creation of an ESOP, and what makes the ESOP a financing device as well as an employee benefit vehicle is the ESOP trust's purchase of employer securities from the sponsoring employer. Thus, the potential for self-dealing by fiduciaries exists because the interests of plan fiduciaries may conflict with the interests of participants. To guard against those potential abuses, the IRS will subject these transactions to special scrutiny. Treas. Reg. § 54.4975-7(b)(2)(ii). The fiduciary should thus use special care in all aspects of acquiring the employer securities and arranging and servicing the exempt loan, particularly:

- In determining that the interest rate on the loan does not exceed a reasonable rate of interest
- That a reasonable process is followed in the valuation of the employer securities, where they are not publicly-traded –and–
- That actual allocations to participant accounts are based on assets withdrawn from the ESOP suspense account

Failure to follow this latter requirement particularly can lead to plan disqualification and may require the sponsor's use of the IRS Employee Plans Compliance Resolution System (EPCRS). See Rev. Proc. 2019-19, 2019 IRB LEXIS 144 and EPCRS Correction Rules and Procedures.

Directed Trustee

An ESOP, like other defined contribution plans, must have a trustee or custodian to manage or control plan assets. In many instances, the trustee is a "directed trustee" that conducts transactions with instructions from a named fiduciary of the plan. The named fiduciary is often the plan sponsor or a committee that the plan sponsor appoints. Pursuant to definition, a plan trustee will always have some ERISA fiduciary responsibility derived from its control over plan assets. However, under most circumstances, the fiduciary responsibilities of a directed trustee are deemed to be narrower than the fiduciary responsibilities held by a discretionary trustee. DOL, Field Assistance Bulletin No. 2004-03 (Dec. 17, 2004).

Despite a directed trustee's narrower fiduciary responsibilities, the directed trustee is required to perform its duties according to ERISA standards. These standards mandate that they be performed prudently and solely in the interest of plan participants and beneficiaries. ERISA § 404(a)(1) (29 U.S.C. § 1104(a)(1)). Since ESOPs are designed to invest primarily in employer securities, the directed trustee must examine company operations. The directed trustee must also monitor transactions and developments as they occur and implement directions only when they do not violate the terms of the ESOP document or conflict with the provisions of ERISA.

When an ESOP has a directed trustee and a tender offer is made to purchase the employer securities held by the ESOP a careful process must be followed. If the ESOP allows participants to direct the trustee to determine whether to tender employer stock allocated to their accounts, ERISA § 403(a)(1) (29 U.S.C. § 1103(a)(1)) states that a trustee may implement the directions of named fiduciaries, including participants. The directions must be proper, made in accordance with plan provisions and not contrary

to the provisions of ERISA. Note, there is little guidance on this issue. Where a direction would result in a breach of a fiduciary duty, the trustee may be liable for any loss resulting from this direction except if the trustee seeks court instructions. Thus, the directed trustee needs to carefully evaluate that transaction and its consequences to the plan.

The IRS advised that an ESOP provision which enabled the trustee to consider non-financial employment-related factors when considering tender offer situations, including the continuing job security of participants, violates the exclusive benefit rule of I.R.C. § 401(a)(2). I.R.S. General Counsel Memorandum 39870, 1992 GCM LEXIS 16 (Apr. 7, 1992). The Memorandum observed that the DOL had reasoned that this provision also violated the exclusive benefit rule of ERISA § 404(a) (29 U.S.C. § 1104(a)). The IRS noted its independent authority to interpret the disputed provision and enforce the separate sanction of plan disqualification. The guidance concluded that a plan provision that allows the use of non-financial factors violates the prudent person standard as stated in Rev. Rul. 69-494 because that would enable trustees to reject tender offers that would be acceptable if financial factors alone were considered.

According to the Treasury Department and the DOL, decisions relating to tender offers must be in the economic best interest of an employee benefit plan that holds employer securities. The agencies recognized that the plan is a separate legal entity designed to provide retirement income. DOL, Field Assistance Bulletin No. 2004-03.

Furthermore, prudence also mandates that fiduciaries make investment decisions, including tender offer decisions, based upon facts and circumstances related to a particular plan. Therefore, an ESOP trustee, including one that is directed, should:

- Evaluate a tender offer on its merits –and–
- Weigh the underlying intrinsic value of the target company and the likelihood of that value being realized by current management or by a subsequent tender offer.

Also for consideration is the ability to invest the tender offer proceeds elsewhere.

Reducing Risk Associated with Holding Employer Securities

While ESOPs are required under statutory and regulatory requirements to be invested "primarily in employer securities," case developments show that ESOPs are being successfully challenged in an environment where the value of participant accounts decline as a result of a sharp decline in the value of the underlying ESOP stock.

In the U.S. Supreme Court decision in Dudenhoeffer v. Fifth Third Bank, 134 S.Ct. 2459 (2014), the Supreme Court challenged the long-held presumption that an ESOP fiduciary acted prudently by acquiring and holding employer securities. That presumption had been established in a 1995 Third Circuit case which also established that the presumption can only be overcome by a showing that ESOP fiduciaries abused their discretion when they chose to continue to invest in or hold employer stock. Moench v. Robertson, 62 F. 3d 553 (3rd Cir. 1995). However, the Supreme Court held in *Dudenhoeffer* that ESOP fiduciaries are subject to the same duty of prudence under ERISA § 404(a) (29 U.S.C. § 1104(a)) as all other ERISA fiduciaries. Thus, ESOP fiduciaries are not fully-protected from challenges in "stock-drop" cases by relying on the exemption of ESOP fiduciaries from the ERISA duty to diversify plan investments.

Dudenhoeffer requires ESOP fiduciaries to set a course of action for future dealings with respect to acquiring and holding employer securities. However, the decision provides some assurance to ESOP fiduciaries. In the context of publicly-traded stock, allegations alone that the market was over- or undervaluing the employer stock, in reliance on publicly available information, do not sufficiently plead the plaintiff's case.

Plus, with respect to non-public information, *Dudenhoeffer* articulates three helpful principles:

- ERISA cannot require an ESOP fiduciary to perform an action in violation of securities laws (e.g., divesting ESOP holdings of employer stock on the basis of inside information)
- In determining a fiduciary breach, courts should consider the conflict between:
  - An ERISA-based obligation to:
    - Refrain from making a planned trade on the basis of inside information –or–
    - Disclose inside information to the public –and–
  - Insider trading and corporate disclosure requirements imposed by federal securities laws or their objectives
- A complaint must plausibly allege that a prudent fiduciary could not have concluded that it would do more harm than good to the fund and cause a drop in share value to:
  - Terminate the continued purchase of employer securities which the market might interpret as an indicator that corporate insiders viewed the employer's stock as a bad investment –or–
  - Publicly disclosing negative information

Post *Dudenhoeffer*, the Supreme Court was confronted by an allegation that plan fiduciaries breached their fiduciary duties, particularly the duty of prudence, when the employer stock allocated to an employer stock fund experienced a sharp decline in value. The Court determined that the plan participants had not alleged sufficiently plausible facts showing that a prudent fiduciary should have removed the employer stock fund from the list of investment options and that such removal would not cause more harm than good. Such facts, the court concluded, must be alleged to state a proper claim. Amgen v. Harris, 127 S. Ct. 2499 (2016).

For an additional discussion on the *Dudenhoeffer* decision, see Note: For Whom the Plan Tolls: Tatum v. RJR Pension Investment Committee and the Emergence of Exacting Scrutiny Awaiting Fiduciaries in Breach in the ERISA Litigation Landscape Post-Dudenhoeffer, 49 Creighton L. Rev. 437.

Different Worlds for 401(k) Plans and ESOPs

Dudenhoeffer and Amgen were rendered with respect to a 401(k) plan that was sponsored by a publicly-traded company in a stock-drop scenario. An employer stock fund was one of multiple investment choices in the plan. 401(k) plans typically provide participants an opportunity to transfer amounts between funds on a daily basis, allowing them almost immediate liquidity. The employer's financial statements are publicly available and are updated quarterly. Plus, financial analysts offer reports frequently on whether investors should buy, hold or sell shares.

Private Company ESOPs

By comparison, most ESOPs are sponsored by private, not public, companies. As a result, purchases and sales of employer securities are far less frequent, and normally occur in an ESOP only when:

- The founder(s) or the employer offers shares for sale to the ESOP –or–
- A third-party buyer purchases shares from the ESOP.

Outside of this context, the fiduciary in the private ESOP generally hasn't liquidity or access to markets.

Impact on ESOP Fiduciaries Public Company ESOPs

The path for ESOP fiduciaries of publicly traded employers is clearer. In large part this is because the *Dudenhoeffer* decision specifically relates to the plans of a publicly-traded employers.

Dudenhoeffer makes clear for the ESOP fiduciary of a publicly traded employer that the fiduciary need not reference non-public insider information in reaching a decision to buy, hold or sell employer securities. Moreover, unsupported allegations that an ESOP fiduciary should have recognized from publicly available information alone that the market was over or undervaluing the stock, will not withstand a motion to dismiss, without the existence of special circumstances.

Also, public company ESOPs, if held in a combined 401(k)/ESOP plan, are subject to the diversification requirements of I.R.C. § 401(a)(35). That requirement, which does not apply to a stand-alone ESOP, provides most participants that invest in employer securities the opportunity to withdraw from employer securities on a daily basis. This ability alone will take most of the buy, hold and sell burden from the ESOP fiduciary, even where the plan does not meet the requirements of ERISA § 404(c) (29 U.S.C. § 1104(c)). However, this doesn't mitigate the fact that the ESOP fiduciary may have liability exposure for making employer securities available as an investment option.

To reduce the exposure, public companies may appoint an independent fiduciary to monitor and review the performance and viability of an employer securities fund and vest in the independent fiduciary the power to close down and even liquidate the fund. This provides a further layer of fiduciary protection.

Impact on ESOP Fiduciaries of Privately Held Companies

The *Dudenhoeffer* decision is not particularly helpful for ESOP fiduciaries of privately held companies. These fiduciaries lack public information or a market mechanism for liquidity and federal securities laws are inapplicable. These fiduciaries will no longer have the benefit of the presumption of prudence and must proceed in poorly-defined territory. In Dalton v. Greatbanc Trust Co., 2015 U.S. Dist. LEXIS 133711 (N.D. Ill 2015), reversed and remanded by Allen v. GreatBanc Trust Co., 835 F.3d 670 (7th Cir. 2016), the district court initially dismissed a breach of fiduciary complaint against the ESOP trustee of a private company ESOP, finding that the plaintiffs had not plead the special circumstances required by *Dudenhoeffer*, but the Seventh Circuit reversed that decision based on plaintiff's prohibited transaction allegation.

Measures can still be taken to protect the fiduciary's decisions to buy and sell employer securities. Fiduciaries are advised to apply due diligence and use of a qualified independent financial advisor in a disciplined and documented approach. This process should provide a significant measure of protection against conclusory allegations in a participant complaint or suit by the DOL.

As far as holding employer securities the ESOP fiduciary at a privately held employer has fewer reasonable choices in light of any drop in the appraised value of employer securities

given evidence of diminished corporate performance from audited and interim financial statements. Options are typically exhausted after the ESOP fiduciary seeks to redeem shares by the sponsoring employer or its non-ESOP shareholder(s). The fiduciary will explore with the employer's board of directors feasible alternatives such as a third-party sale, modification of business strategy or reorganization of senior management. However, it will be difficult for a particular group of participants to argue plausibly that a reasonable fiduciary would have acted differently.

The difficulty here is that it will likely be more difficult for an ESOP fiduciary in the private company rule to shield itself from a prudence claim on a motion to dismiss and more likely that it will have to wait to develop its case in a motion for summary judgment.

ESOP Document Precedents

You can find publicly filed precedents of ESOP documents using Transactions Search powered by Intelligize®. Transactions Search enables Lexis Practice Advisor® users to leverage Intelligize data and technology to find precedent documents and market intelligence. Transactions Search is included in your Lexis Practice Advisor subscription.

Click here to run a search for ESOPs filed with the SEC over the last three years. While filing ESOP documents with the SEC is not mandatory, some corporations do so as part of their disclosures to shareholders. This search yields filings over the past three years of documents with "employee stock ownership plan" OR ESOP in the title. You can customize this search by modifying or adding filters. For more information on Transactions Search, click here. See also our short training-on-the-go video Transactions Search for Employee Benefits & Executive Compensation Attorneys.

Following are a few ESOP documents located using Transactions Search:

- BankPlus Corporation Employee Stock Ownership Plan (with 401(k) Provisions)
- Alcon Swiss Employee Share Ownership Plan
- Form of Newton Federal Bank Employee Stock Ownership Plan
- Trinity Capital Corporation Employee Stock Ownership Plan and Trust
- The Toro Company Investment, Savings and Employee Stock Plan

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Greg Brown represents clients in a broad range of corporate and transactional matters. His practice focuses on employee stock ownership plans (ESOP), the Employee Retirement Income Security Act (ERISA) fiduciary matters, tax-qualified retirement plans, executive compensation and ERISA litigation. He is also experienced in handling audits and investigations of plans by the U.S. Department of Labor and Internal Revenue Service and advises clients on ways to minimize litigation risk through benefit plan design, governance and administration.

Greg represents both closely held companies and national Fortune 500 publicly traded companies on employee benefits matters, in addition to organizations throughout the food and beverage, government contracting, technology, retail and direct marketing, healthcare, banking and financial services industries.

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