

MEMORANDUM FOR DANIEL R. JONES, MANAGER, EMPLOYEE PLANS  
DETERMINATIONS QUALITY ASSURANCE

FROM: Andrew E. Zuckerman, Director, Employee Plans Rulings and  
Agreements

SUBJECT: Request for Technical Assistance (#1)

This Memorandum is in response to your Request for Technical Assistance, dated March 6, 2009, concerning immediate resale provisions in employee stock ownership plans (within the meaning of Internal Revenue Code section 4975(e)(7)) and Internal Revenue Code section 409(h).

**Issues**

1. Whether a distribution from an employee stock ownership plan (“ESOP”) of stock that is subject to an immediate resale provision meets the requirements of Internal Revenue Code (“Code”) section 409(h), specifically the put option requirement of Code section 409(h)(1)(B).
2. Whether the immediate resale provisions set forth in Rev. Proc. 2003-23, as modified by Rev. Proc. 2004-14, may be applied to any distributions of stock from an ESOP or are limited solely to situations involving the rollover of S corporation stock from an S corporation ESOP to an IRA.
3. Whether distributions from an ESOP of stock that is subject to immediate resale provisions, in the case of a plan under which the trustee or plan administrator has discretion to determine which participants will receive distributions in cash and which participants will receive distributions in the form of employer securities, violates the nondiscrimination requirements of the Code.

**Issues 1 and 2: Mandatory Repurchase of S Corporation Stock**

**Law:**

With regard to issues 1 and 2, Code section 409(h)(1) provides that a participant who is entitled to a distribution from an ESOP must (A) have the right to demand that his or her benefits be distributed in the form of employer securities, and (B) if the employer securities are not readily tradable on an established market, the

participant must have the right to require the employer to repurchase the employer securities under a fair valuation formula (the “put option”).

Code section 409(h)(2)(A) provides, generally, that benefits under the ESOP may be distributed in cash or in the form of employer securities, provided that the plan otherwise meets the requirements of Code sections 409(h) and 4975(e)(7).

Code section 409(h)(2)(B)(i) states that a plan, as described in section 409(h)(2)(B)(ii), shall not be treated as failing to meet the requirements of this subsection or section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash, except that such plan may distribute employer securities subject to a requirement that such securities may be resold to the employer under terms which meet the requirements of paragraph (1)(B).

Code section 409(h)(2)(B)(ii) provides that section 409(h)(2)(B) applies to a plan which is established and maintained by (I) an employer whose charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a trust described in section 401(a), or (II) an S corporation. Section 409(h)(2)(B), as enacted under the Tax Reform Act of 1986 (“TRA’86”), was amended under the Taxpayer Relief Act of 1997 to include S corporations.

Code section 409(h)(4) provides that an employer is deemed to satisfy the put option requirement under Code section 409(h)(1)(B) if it provides a put option period of at least 60 days following the distribution date of the employer securities and, if the put option is not exercised within such 60-day period, for an additional period of at least 60 days in the following plan year as provided in regulations promulgated by the Secretary of the Treasury.

Revenue Procedures 2003-23 and 2004-14 provide that the Service will accept the position that an S corporation’s election will not be affected as a result of an ESOP’s distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation (or the ESOP) repurchase this stock immediately upon the ESOP’s distribution of this stock to an IRA.

The Conference Report to TRA ‘86 states:

The Conference agreement adopts the provision in the Senate amendment which permits a plan sponsored by a corporation whose bylaws or charter restrict ownership of substantially all outstanding employer securities to employees or certain trusts to distribute employer securities in certain cases. The conferees intend that, if such plan does distribute employer securities, the distribution requirements and put option requirements generally applicable to ESOPs (*except for the requirement that the employee has a right to demand that distribution be paid in employer securities*) will apply to the distribution. (emphasis added).

### Analysis and Conclusion:

We have determined that plans described in Code section 409(h)(2)(B)(ii) (i.e., plans maintained by an S corporation or a company whose charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a trust described in Code section 401(a)) which provide for the distribution of employer securities subject to immediate resale to the employer or in appropriate cases to the ESOP (i.e., “mandatory repurchase”) are consistent with the statutory framework of section 409(h). This is without regard to whether the distribution is made to a participant or as a direct rollover to an IRA. Because the participant in such plan does not have the right to demand employer securities to begin with, there is no abuse when such right is not extended to the participant upon the distribution of employer securities. Rather, these provisions give the distributee the added benefit of capital gains treatment on the proceeds of the mandatory repurchase which exceeds the cost basis of the distributed stock (i.e., the net unrealized appreciation). See section 1.402(a)-1(b)(1) of the Income Tax Regulations (“Regulations”).

If an S corporation or a company whose charter or bylaws restrict the ownership of substantially all outstanding employer securities, as described above and in Code section 409(h)(2)(B)(ii), desires to provide for the distribution from an ESOP of employer securities subject to immediate resale to the employer, the plan must contain applicable language to so provide.

### **Issue 3: Plan Administrator Discretion re: Form of Distribution**

#### Law:

Code section 401(a)(4) generally provides that contributions or benefits under a qualified plan may not discriminate in favor of highly-compensated employees (as defined in Code section 414(q)).

Section 1.401(a)(4)-4(a) of the Regulations provides the rules for determining whether benefits, rights or features provided under a plan (i.e., *all optional forms of benefit*, ancillary benefits, and other rights and features available to any employee under the plan) are made available in a nondiscriminatory manner.

Benefits, rights, and features provided under a plan are made available to employees in a nondiscriminatory manner only if each benefit, right, or feature satisfies the current availability requirement under section 1.401(a)(4)-4(b) of the Regulations and the effective availability requirement under section 1.401(a)(4)-4(c) of the Regulations.

Section 1.401(a)(4)-4(b) of the Regulations provides that the “current availability” requirement is satisfied if the group of employees to whom a benefit, right, or feature is currently available during a plan year satisfies the minimum coverage requirements of Code section 410(b) (without regard to Code section 410(b)(2) and the regulations thereunder).

Section 1.401(a)(4)-4(c) of the Regulations provides that the “effective availability” requirement is satisfied if, based on all of the relevant facts and circumstances, the group of employees to whom a benefit, right, or feature is effectively available does not substantially favor highly-compensated employees.

Section 1.401(a)(4)-4(e) of the Regulations defines “optional form of benefit” as a distribution alternative (including the normal form of benefit) that is available under the plan with respect to benefits described in Code section 411(d)(6). Section 1.411(d)-3(g)(6) defines the types of benefits protected under Code section 411(d)(6).

Section 1.411(d)-3(g)(6)(ii) describes the meaning of the term “optional form of benefit” for purposes of Code section 411(d)(6).

Sections 1.411(d)-3(g)(6)(ii) and 1.401(a)(4)-4(e) each provide that different optional forms of benefit exist if a distribution alternative is not payable on substantially the same terms as another distribution alternative. For this purpose “term” includes all terms affecting the value of the optional form including, but not limited to, terms relating to benefit payment schedule, timing, commencement of benefit, *medium of distribution* (e.g., in cash or in kind), and participant election rights with regard to benefit distributions.

Section 1.401(a)(4)-4(d)(6) of the Regulations provides, inter alia, that an ESOP does not fail to satisfy sections 1.401(a)(4)-4(b) or (c) merely because it makes a distribution option available solely to all qualified participants (within the meaning of Code section 401(a)(28)(B)(iii)), or merely because the restrictions of Code section 409(n) apply to certain individuals.

#### Analysis and Conclusion:

The distribution of a benefit in the form of employer securities, instead of in cash (or vice versa), is a distribution alternative and, therefore, an optional form of benefit as defined in section 1.401(a)(4)-4(e) of the Regulations. Under section 1.401(a)(4)-4(a) of the Regulations, such form of benefit is a benefit, right, or feature of a plan which must be made available to participants under a qualified plan in a nondiscriminatory manner.

Therefore, a plan which allows the plan administrator or plan trustee to use its discretion in determining which participants receive a particular type of distribution under the plan will inherently violate Code section 401(a)(4), because the discretion afforded such plan administrator or plan trustee in making such determination will result in certain optional forms of benefit not being made “currently or effectively available” to all plan participants under the plan, as required under the Regulations.

However, as provided under section 1.401(a)(4)-4(d)(6) of the Regulations, an ESOP may provide that certain forms of benefit are available solely to “qualified participants” within the meaning of Code section 401(a)(28)(B)(iii).