

MEMORANDUM FOR DANIEL R. JONES, MANAGER, EP DETERMINATIONS
QUALITY ASSURANCE

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

SUBJECT: Response to Technical Assistance Request (#2)

This Memorandum is in response to your Request for Technical Assistance, dated March 6, 2009, with regard to the language that is required under Internal Revenue Code section 401(a)(28) to be included in an employee stock ownership plan (within the meaning of Internal Revenue Code section 4975(e)(7)).

Issues:

1. For purposes of meeting the requirements of Internal Revenue Code (“Code”) section 401(a)(28), may an employee stock ownership plan (“ESOP”):

(a) Define “qualified participant”, in part, as “a participant or former participant”, instead of as “an employee”?

(b) Define “qualified participant” as an employee who has completed at least 10 “years of service” instead of 10 “years of participation”?

(c) Permit a participant who has attained age 55 but who has completed less than 10 years of participation in the plan to be treated as a “qualified participant”?

(d) Permit a participant with 10 or more years of participation who has a severance from employment before attaining age 55 to be treated as a “qualified participant” upon his or her attaining age 55 after severance from employment?

If the above definitions are permitted, does the special ESOP rule under section 1.401(a)(4)-4(d)(6) of the Income Tax Regulations (the “Regulations”) still apply in each case to the plan?

2. May an ESOP require a participant to complete at least 1,000 hours of service in order to be credited with a “year of participation”? May an ESOP define “year of participation” as a plan year in which a participant has an account balance under the ESOP (regardless of whether he or she is actively employed in such year and eligible for a contribution/allocation under the plan, and/or

regardless of whether he or she has competed at least 1,000 hours of service (or other minimum) during such period?

3. In the event that an alternative definition of “qualified participant” as described above violates Code section 401(a)(28) – what relief, if any, would be available to a plan sponsor whose ESOP utilizes such definition, particularly if the plan sponsor has reliance on a determination letter which approves such definition?

Background and General Statement of the Law:

Code section 401(a)(28) was added to the Code by section 1175(a) of the Tax Reform Act of 1986 (“TRA ‘86”), and sets forth certain requirements that must be satisfied by an ESOP in order for the ESOP to be qualified under Code section 401(a).

Code section 401(a)(28)(B) provides that an ESOP must allow each “qualified participant” to elect, within 90 days after the close of each plan year in the “qualified election period”, to direct the plan to diversify a certain percentage of the qualified participant’s account.

Code section 401(a)(28)(B)(iii) defines “qualified participant” as any employee who has completed at least 10 years of participation under the plan and has attained age 55.

Code section 401(a)(28)(B)(iv) defines “qualified election period” generally as the 6-plan-year period beginning with the later of —

- (a) the 1st plan year in which the individual first became a qualified participant, or
- (b) the first plan year beginning after December 31, 1986.

Code section 401(a)(28) does not define “year of participation”.

For purposes of the diversification requirement of Code section 401(a)(28)(B), the General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation (the “Blue Book”) states, on page 835, that “[t]he diversification requirement applies with respect to participants *who have separated from service* with the employer.” (emphasis added).

In addition, the Blue Book provides the following example:

“ . . . Assume a participant in a calendar year ESOP *terminated employment* in 1987, when the participant has 10 years of participation and is age 54. The participant’s account balance remains in the plan. The participant will become a qualified participant beginning in 1988 (the year in which the participant

attains age 55), and will be eligible to direct diversification during the annual election periods in 1989, 1990, 1991, 1992, 1993 and 1994.” (emphasis added).

Analysis and Conclusion:

In order to facilitate the issuance of ESOP determination letters, with regard to the definition of “qualified participant” under Code section 401(a)(28)(B)(iii) we have adopted an interim position that a plan may define “year of participation” for such purpose as any year in which an individual has assets in an account under the ESOP, regardless of whether such individual is employed by the employer at such time and regardless of whether such individual has completed 1,000 hours of service (or such lesser number required under the definition of “year of service” under the plan) in the plan year.

Plans which currently have more restrictive language may keep that language or may adopt less restrictive language reflecting our interim position. However, existing plan language cannot be made more restrictive.

For example, a plan which defines “year of participation” as a year in which an employee completes at least 1,000 hours of service may retain that language or amend the plan to provide for less restrictive language (e.g., fewer hours of service required, or no hours of service required, etc.). However, a plan that defines “year of participation” as any year in which the participant has an account balance under the plan cannot be amended to add any additional requirements, such as the requirement to be an employee or to complete a certain number of hours of service.

Notwithstanding the foregoing, if a plan provides that, in order to qualify as a “qualified participant” under the plan, an individual must complete a number of hours of service that is *in excess* of the number of hours of service that the individual must complete in order to be credited with a “year of service” for other purposes under the plan, the plan must be amended to provide that the number of hours of service required to be completed by the individual in order to qualify as a “qualified participant” does not exceed the number of hours of service required for a “year of service” for other purposes under the plan.

Accordingly, with regard to the definition of “qualified participant” for purposes of Code section 401(a)(28), we conclude as follows to the questions presented:

1. (a): The term “participant and former participant” may be utilized by a plan, for purposes of such definition, instead of the term “employee”;

(b): The term “year of service” may be utilized by the plan, for purposes of such definition, instead of the term “year of participation”, provided that not more than 1,000 hours of service are required under the plan in order to be credited with a “year of service” or, in the alternative, a “year of participation”;

(c): The plan must provide that in order to be a “qualified participant” an individual must have attained age 55 and completed *not less than* 10 years of participation in the plan, or 10 years of service, as provided under the plan; and

(d): A plan may provide that a participant with 10 or more years of participation who has a severance from employment before attaining age 55 is treated as a “qualified participant” upon his or her attaining age 55 *after* severance from employment.

As provided in the special ESOP rule under section 1.401(a)(4)-4(d)(6) of the Regulations, an ESOP generally will not fail to satisfy sections 1.401(a)(4)-4(b) and (c) merely because it makes an investment diversification right or feature or a distribution option available solely to *all* “qualified participants” within the meaning of Code section 401(a)(28)(B)(iii), as described herein.

2. A definition of “year of participation” utilized by a plan for purposes of Code section 401(a)(28) may *not* require the completion of more than 1,000 hours of service, and, as stated above, an hour of service requirement is not mandatory. Therefore, a “year of participation” may be defined under the plan as a year in which an individual has an account balance under the plan, regardless of whether he or she is actively employed in such year and/or eligible to receive a contribution/allocation under the plan for such year.

3. Since the alternative definitions described above may be utilized by ESOP sponsors, we don’t believe that any relief will be necessary.

4. Until further notice, an employer may use any of the approved definitions set forth above for the purpose of Code section 401(a)(28), provided that the definitions used are clearly set forth in the ESOP plan document.