DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

NOV 0 3 2009

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

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 ~~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, 2003-1 C.B. 599, and 2004-14, C.B. 489, 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*

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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, with regard to plans described in Code section 409(h)(2)(B)(ii) (i.e., 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 Treasury 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 Income Tax Regulations ("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.

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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.

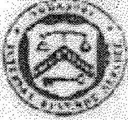
Analysis and Conclusion:

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).



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TAX EXEMPT AND
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NOV 03 2009

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 employer 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

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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).

<u>Analysis and Conclusion</u>:

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, <u>the plan must be amended</u> 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";

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(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) & (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.

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FEB 23 2010

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

This memorandum responds to your Request for Technical Assistance, dated December 14, 2009, with regard to exempt loan provisions in non-leveraged employee stock ownership plans ("ESOPs").

Issue:

Whether, in the case of a non-leveraged ESOP that includes exempt loan provisions, the Determinations Branch should (a) request that the plan sponsor strike the exempt loan language from the plan document, or (b) add a caveat to the determination letter stating that the plan may not rely on such letter with respect to the exempt loan provisions.

Conclusion:

Non-leveraged ESOPs are permitted to include exempt loan language as a contingency in the event the plan becomes leveraged. We see no reason to require that such language be stricken from the plan document, or to include a caveat in the determination letter stating that the plan may not rely on the letter with respect to the exempt loan provisions. Such provisions are similar to other contingency language that we allow plans to include, such as participant loan provisions. The request indicates that obligating non-leveraged ESOPs to strike exempt loan language would be consistent with our position on 401(k) safe harbor language, but the policy rationale behind prohibiting safe harbor language as a contingency does not apply here. In a 401(k) safe harbor plan, an employer who includes safe harbor language as a contingency might disadvantage participants by implementing the safe harbor provisions only when the plan fails to pass ADP testing. The participants would not be able to predict the amount of employer contributions they would receive in a given year. Exempt loan provisions, on the other hand, raise no such concern. Moreover, the draft instructions for Form 5300, dated January 2010, state that a plan containing loan language for a leveraged ESOP must be marked as such, even though the plan has not utilized the provision in operation. Thus, in future determination letter applications, non-leveraged ESOPs containing exempt loan language will need to identify themselves as leveraged in their Forms 5300, even if the language is included only as a contingency.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Washington, D.C. 20224

Date: December 14, 2009

MEMORANDUM FOR Daniel R. Jones, Mgr, EP Determinations Quality Assurance

FROM: Donald J. Kieffer Jr., Area 1 Manager (acting), EP Determinations

SUBJECT: ESOP exempt loan language provisions

As you are aware, several issues are pending in Headquarters for informal technical assistance on matters related to ESOP arrangements. I believe three separate responses have been returned to date, numbered as "TA-1" through "TA-3", or the approximate thereof. A fourth is currently pending. Please add the following issue to this pending assistance request.

EP Determinations cadre staff requests a formal interpretation on the issue of "unused" exempt loan language in a non-leveraged ESOP application. This issue arises where a plan determination letter submission identifies the plan as "non-leveraged", within the meaning of § 4975(e), on the application form. In many of these submissions, notwithstanding this entry, the plan document contains exempt loan provisions.

When this issue has been raised by determination specialists; on query, a typical employer / practitioner response is to the effect that this language is "in case" in nature: the plan contains this language as a contingency in the event that the sponsor ever secures leverage financing.

EP Determinations requires a response as to two alternatives. One is whether this language can be requested to be stricken from the document. For example, if an application indicates that the plan is non-leveraged, but nevertheless it contains exempt loan language, specialists would contact the representative and require all exempt loan provisions to be redacted. This would ensure that reliance on any favorable determination letter is given only to employed, rather than contingent or "default" provisions.[1]

An alternate, Determinations would propose adding a specific caveat that indicates no reliance is to be given with regard to these provisions. Currently, a caveat is added only to the extent that the plan indicates it is leveraged. Adding a negating caveat,

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[1] This would be consistent with our position taken on safe harbor as opposed to traditional 401(k) plan language.

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although contrary to current policy, would indicate clearly that we have not ruled on "unused language."

Please advise accordingly, and thank you in advance for your consideration.

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FEB 23 2010

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

FROM: JoAnna H. Weber, Acting Director, Employee Plans Rulings and Agreements

SUBJECT: Response to Technical Assistance Request (#4)

This memorandum is in response to your Request for Technical Assistance, dated April 3, 2009, with regard to rebalancing and reshuffling provisions in employee stock ownership plans ("ESOPs") (within the meaning of Internal Revenue Code ("Code") section 4975(e)(7)) and stock bonus plans. The guidance in this memorandum is to be used to determine appropriate plan language. Please contact us if additional guidance is needed with respect to specific plan provisions.

Issues:

1) Whether an ESOP or stock bonus plan can include a reshuffling provision which allows a trustee, fiduciary, and/or administrator, at its discretion, to involuntarily exchange employer stock held in the account of one or more participants for cash or other assets allocated to the accounts of one or more plan participants in view of several potential violations of law that may arise from the implementation of such provisions. Specifically, does the transfer of assets pursuant to a reshuffling provision cause the plan to operate in violation of sections 1.401-1(b)(1)(i), (ii) or (iii) of the Income Tax Regulations ("Regulations") and Revenue Ruling 80-155, respectively, by contravening prior allocations to participant accounts of 1) employer contributions, in cash or employer stock, and 2) earnings on trust assets?

2) Whether an involuntary transfer of assets made in accordance with a reshuffling provision violates the diversification requirements of Code sections 401(a)(28) and 401(a)(35) and/or plan provisions for voluntary self-direction of participant accounts by altering prior allocations of cash, stock and other assets made by the trustee, fiduciary or administrator at the instruction of the participant.

3) Whether the establishment and implementation of a reshuffling provision is consistent with the fundamental nature of how trusts under a defined contribution plan are structured and operated. With the exception of participant self-directed accounts, which hold assets segregated from assets of the general trust in an

account established in the name of the participant, amounts held in the accounts of other participants merely reflect the value of trust assets which are allocated to such accounts for bookkeeping purposes. Assets allocated to these accounts can be acquired, invested or disposed at the discretion of the trustee, fiduciary and/or administrator, subject to trust provisions and the fiduciary standards of the Employee Retirement Income Security Act ("ERISA"). In light of the foregoing, the trustee or administrator is at liberty to engage in transactions involving employer stock, cash or other assets held in the general trust fund without having to adjust allocations to participant accounts to reflect exchanges of assets between the accounts in accordance with a reshuffling provision.

4) Whether a reshuffling provision which operates to contravene a prior allocation of stock made to a participant's account in the form of an employer contribution to the plan or an allocation to a self-directed account pursuant to written instructions from the participant will cause the plan to:

   a. violate the current and effective availability requirements of section 1.401(a)(4)-4 of the Regulations with respect to the right of a participant to retain the employer stock held in his or her account and participate in the growth of stock value, unless and until the stock is distributed to the participant upon the occurrence of a distributable event, including an election made by an eligible participant in accordance with Code section 401(a)(28)(B); or

   b. violate the current and effective availability requirements of section 1.401(a)(4)-4 of the Regulations with respect to the right of a participant to a particular form of investment when assets transferred to and from a participant's account pursuant to a diversification election made in accordance with Code sections 401(a)(28) and 401(a)(35) and/or plan provisions for voluntary self-direction of assets held in participant accounts are removed from the account by application of a reshuffling provision.

5) Whether the transfer of stock from a self-directed participant's account in accordance with a reshuffling provision causes the plan to violate Code section 411(a)(11) by placing a significant detriment on a participant who elects to defer a distribution until it is no longer immediately distributable by denying the participant the opportunity to choose among investment alternatives with materially different risk and reward characteristics. Refer to section 1.411(a)-11(c)(2) of the Regulations and Rev. Rul. 96-47.

<u>Example Plan Language</u>

1) *The Trustee may debit a Participant's Company Stock Subaccount with one type of Employer Securities provided the Trustee credits such Participant's Company stock Subaccount with another type of Employer Securities equal in fair market value as*

determined by the Independent Appraiser as of such date. The Trustee may debit a Participant's Company Stock Subaccount provided the Trustee credits such Participant's Other Investments Subaccount on the date of such debit with assets equal to the fair market value of the Employer Securities debited as determined by the Independent Appraiser of such date.

2) *Required Divestiture for Participants Who Have Attained the Age of 60: The Trustee shall transfer from a Participant's account the Employer stock in such Participants account in accordance with the following schedule:*

Attained Age	*Fraction of Stock to be Transferred*
60	*1/8*
61	*1/7*
62	*1/6*
63	*1/5*
64	*¼*
65	*1/3*
66	*½*
67	*100%*

The transfer of the stock in the Participant's account shall be made internally within the Plan or sold by the Plan. The consideration to the Participant's account shall be the fair market value of the stock as of the date of such transfer. Once the transfers take place, the Participant shall be entitled to direct the investment of the Participant's non-stock account in accordance with the provisions of 9.15.

Background and General Statement of the Law:

Code section 4975(e)(7) provides that the term "employee stock ownership plan" means a defined contribution plan -- (A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and (B) which is otherwise defined in regulations prescribed by the Secretary. A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h), section 409(o), and, as applicable, section 409(n), section 409(p), and section 664(g) and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).

Code section 401(a)(23) provides that a stock bonus plan shall not be treated as meeting the requirements of section 401(a) unless such plan meets the requirements of subsections (h) and (o) of section 409, except that in applying section 409(h) for purposes of this paragraph, the term "employer securities" shall include any securities of the employer held by the plan.

Section 1.401-1(a)(2) of the Regulations provides that a qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is

communicated to the employees and which is established and maintained by an employer.

Section 1.401-1(b)(1)(ii) of the Regulations provides that a profit-sharing plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant.

Section 1.401-1(b)(1)(iii) of the Regulations provides that a stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan. See also Code section 409(h)(2) for special rules applicable to ESOPs (via Code section 4975(e)(7)) and to stock bonus plans (via Code section 401(a)(23)).

Code section 411(d)(6) provides that a plan amendment may not decrease a participant's accrued benefit.

Section 1.411(d)-4, A-1(d) of the Regulations provides that the right to a particular form of investment (e.g., investment in employer stock or securities or investment in certain types of securities, commercial paper, or other investment media) is not a section 411(d)(6) protected benefit.

Code section 401(a)(4) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees ("HCEs") (within the meaning of Code section 414(q)).

Section 1.401(a)(4)-4 of the Regulations provides rules for determining whether the benefits, rights, and 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 and the effective availability requirement of this section.

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 the plan year satisfies section 410(b) (without regard to the average benefit percentage test of § 1.410(b)-5).

Section 1.401(a)(4)-4(b)(2) of the Regulations provides that whether a benefit, right, or feature that is subject to specified eligibility conditions is currently available to an employee generally is determined based on the current facts and circumstances with respect to the employee.

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 HCEs.

Section 1.401(a)(4)-4(d)(6) of the Regulations, which provides special rules for ESOPs, states that an ESOP does not fail to satisfy the current availability and effective availability requirements merely because it makes an investment diversification right or feature or a distribution option available solely to all qualified participants (within the meaning of section 401(a)(28)(B)(iii)), or merely because the restrictions of section 409(n) apply to certain individuals.

Section 1.401(a)(4)-4(e)(3)(i) of the Regulations defines "other right or feature," in general, to mean any right or feature applicable to employees under the plan. Different rights or features exist if a right or feature is not available on substantially the same terms as another right or feature.

Section 1.401(a)(4)-4(e)(3)(iii) of the Regulations provides that "other rights and features" include, but are not limited to, the right to direct investments and the right to a particular form of investment including, for example, a particular class or type of employer securities (taking into account, in determining whether different forms of investment exist, any differences in conversion, dividend, voting, liquidation preference, or other rights conferred under the security).

Section 1.401(a)(4)-10 of the Regulations provides the rules for applying the nondiscrimination requirements of Code section 401(a)(4) to former employees. A plan satisfies section 401(a)(4) with respect to the availability of benefits, rights and features provided to former employees if any change in the availability of any benefit, right or feature to any former employee is applied in a manner that, under all the facts and circumstances, does not discriminate significantly in favor of former HCEs.

Code section 401(a)(28)(B)(i) provides that a trust which is part of an employee stock ownership plan (within the meaning of section 4975(e)(7)) or a plan which meets the requirements of section 409(a) shall not constitute a qualified trust under this section unless each qualified participant in the plan may elect within 90 days after the close of each plan year in the qualified election period to direct the plan as to the investment of at least 25 percent of the participant's account in the plan (to the extent such portion exceeds the amount to which a prior election under this subparagraph applies). In the

case of the election year in which the participant can make his last election, the preceding sentence shall be applied by substituting "50 percent" for "25 percent."

Code section 401(a)(28)(B)(ii) provides that a plan meets the above requirement if: (I) the portion of the participant's account covered by the election under clause (i) is distributed within 90 days after the period during which the election may be made, or (II) the plan offers at least 3 investment options (not inconsistent with Regulations prescribed by the Secretary) to each participant making an election under clause (i) and within 90 days after the period during which the election may be made, the plan invests the portion of the participant's account covered by the election in accordance with such election.

Code section 401(a)(35) provides that a trust which is part of an applicable defined contribution plan shall not be treated as a qualified trust unless the plan meets the following diversification requirements: (1) participants may divest employer securities in their accounts attributable to employee contributions and elective deferrals, and reinvest an equivalent amount in investment options described below; (2) participants who have completed at least 3 years of service and their beneficiaries (or beneficiaries of deceased participants) may divest employer securities attributable to elective deferrals and reinvest an equivalent amount in the investment options described below, and (3) the plan must provide at least 3 investment options other than employer securities that are diversified and have materially different risk and return characteristics.

Code section 411(a)(11) provides the consent requirements that must be satisfied with respect to certain distributions in order for the plan to qualify under section 401(a).

Code section 411(a)(11)(A) provides that if the present value of any nonforfeitable accrued benefit exceeds $5,000, a plan meets the requirements of this paragraph only if such plan provides that such benefit may not be immediately distributed without the consent of the participant.

Section 1.411(a)-11(c)(2)(i) of the Regulations provides that a consent to a distribution is not valid if a significant detriment is imposed under the plan on any participant who does not consent to a distribution. This section further provides that whether or not a significant detriment is imposed shall be determined by examining the particular facts and circumstances.

Revenue Ruling 96-47, 1996-2 C.B. 35, involved a profit-sharing plan that allowed participants to choose among a broad range of investment alternatives in directing the investment of their accounts, but restricted terminated participants who did not elect an immediate distribution to investing their accounts in a money market fund. The revenue ruling concluded that the loss of the right to choose among a broad range of investments is a significant detriment under section 1.411(a)-11(c)(2)(i) of the Regulations imposed on a participant who does not consent to a distribution.

Analysis and Conclusion:

For purposes of our analysis, we define "rebalancing" as the mandatory transfer of employer securities into and out of participant plan accounts, usually on an annual basis, designed to result in all participant accounts having the same proportion of employer securities. A plan provision that allows participants to opt out of such mandatory transfers is not a rebalancing provision, but is rather a provision providing for participant-directed investment elections. "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.

As stated in section 1.411(d)-4 of the Regulations, the right to a particular form of investment (e.g., investment in employer stock or securities) is not a section 411(d)(6) protected benefit. Accordingly, plan provisions may provide for rebalancing or reshuffling, subject to the limitations set forth below.

Any plan provision providing for the mandatory transfer of stock must meet the requirements of section 1.401-1(a)(2) of the Regulations (for a "definite written program") as well as sections 1.401-1(b)(1)(ii) and (iii) (requiring a definite predetermined allocation formula). Thus, in general, the provision must have language that directs the plan administrator as to the number of shares or amount of cash to transfer in or out of plan accounts. In addition, the plan must state the manner in which the transfers will be effectuated, such as the date of valuation.

In addition, the right of each participant to have or not have a particular form of investment in his or her account is a plan right or feature that is subject to the current and effective availability requirements of section 1.401(a)(4)-4 of the Regulations. Any plan provision that raises issues of current or effective availability in form may be considered inappropriate. Plans must also meet these requirements in operation. Rebalancing, which treats all participants the same, will not raise issues of current and effective availability. Because terminated employees comprise a coverage group under section 1.401(a)(4)-10, a plan provision providing for the transfer of all employer securities from plan accounts of terminated employees also does not raise issues of current or effective availability in form. However, see our response to issue #5 below, where we discuss the application of section 1.411(a)-11(c)(2) of the Regulations to this provision. Further, a reshuffling provision will not fail to satisfy section 1.401(a)(4)-4 in form merely because it imposes age or service conditions on the availability of an investment option.

The right to retain employer securities is not a protected benefit under section 411(d)(6), but the diversification rights in sections 401(a)(28)(B) and 401(a)(35) include a participant's right not to have shares diversified pursuant to such sections mandatorily transferred back into his or her account. As a result, any rebalancing or reshuffling provision must preclude shares diversified under sections 401(a)(28)(B) or 401(a)(35) from being mandatorily returned to participants' accounts.

Applying these principles to the two examples, the plan language in Example 1 would fail to satisfy section 1.401-1(b)(1) of the Regulations because it allows the Trustee discretion over which participants' accounts receive ESOP shares and which accounts are divested of their shares.[1]

The language in Example 2, on the other hand, provides a definite formula by which employer stock will be transferred from participants' accounts: starting at age 60, a fraction of a participant's employer stock is transferred out of his or her account; this fraction increases each year until the participant reaches age 67, at which time the percentage is 100%. However, regarding the accounts indirectly affected by this provision (i.e. accounts of participants who have not attained age 60), the provision needs language providing the Trustee with a method for determining which of these participants' accounts, if any, will receive employer securities. For example, the plan could specify that transfers will occur pro rata, based on the amount of employer securities in the account of each participant under the age of 60. The provision in Example 2 does not raise any issues of current or effective availability in form. However, this provision raises concerns of potential violation of Code section 411(b)(2)(A) (relating to age discrimination in allocations), but we would at this time recommend against requiring this provision to be removed (or made elective) in light of the absence of authority to support the conclusion that, for purposes of Code section 411(b)(2)(A), the allocation rate includes investment options. Note that if this provision provided for mandatory transfers of employer stock into participant accounts, it must also preclude the mandatory transfer of shares diversified pursuant to sections 401(a)(28)(B) or 401(a)(35) back into a participant's account.

We conclude as follows to the specific questions raised:

1) As explained above, we agree that a reshuffling provision such as that in Example 1 that affords an administrator discretion to choose which participants will receive or transfer shares violates section 1.401-1(b)(1) of the Regulations.

2) As to whether rebalancing or reshuffling violates Code sections 401(a)(28)(B) and 401(a)(35), our view is that it does not, so long as the rebalancing or reshuffling is carried out within the parameters discussed above. Both Code provisions require ESOPs (and in the case of section 401(a)(35), stock bonus plans) to allow participants to diversify the shares in their accounts that are invested in employer securities, but neither section prohibits mandatory transfers. As mentioned above, however, the plan may not mandatorily reinvest a participant's shares in employer securities after the participant has diversified those shares pursuant to sections 401(a)(28)(B) and 401(a)(35).

3) In order to comply with various requirements for ESOPs and other stock bonus plans, an administrator needs to keep track of the number of shares in each participant's account. For example, to comply with sections 401(a)(28)(B) (in the case of ESOPs) and

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[1] It may be argued that this provision might be appropriate if it were limited by its language to actions taken by the plan administrator that relate to specific fiduciary obligations under section 404(a)(1) of ERISA. Should this become an issue, please discuss with us.

section 401(a)(35) (in the case of certain ESOPs and stock bonus plans), the administrator must determine the total shares in a participant's account so as to provide the participant with the ability to diversify employer securities in his or her account. Similarly, section 409(p) requires that an ESOP administrator have the ability to calculate a participant's number of deemed-owned shares. Accordingly, any stock transactions must necessarily result in adjustment of the stock allocations in individual accounts.

4) As previously stated, plans may provide for the rebalancing and reshuffling of employer securities held in participants' accounts. There is no right to a particular form of investment, whether that investment is the result of a participant election or an employer allocation, although shares of employer securities diversified pursuant to sections 401(a)(28)(B) or 401(a)(35) elections cannot be mandatorily transferred back. Otherwise, any rebalancing or reshuffling provision must meet the benefits, rights, and features test of section 1.401(a)(4)-4 of the Regulations.

5) As previously stated, mandatory transfers of stock within a plan are permitted under the Code (see section 1.411(d)-4 of the Regulations), although the transfer must satisfy the nondiscrimination requirements of section 1.401(a)(4)-4 of the Regulations. As we stated above, reshuffling provisions that apply only to terminated employees and treat all of the terminated employees the same do not raise current or effective availability concerns, since under section 1.401(a)(4)-10 of the Regulations, terminated employees are tested separately from active employees. However, such reshuffling provisions must also comply with section 1.411(a)-11(c)(2)(i) of the Regulations, which provides that consent to a distribution is not valid if the plan imposes a significant detriment on a participant who does not consent to a distribution. In Revenue Ruling 96-47, terminated participants who did not elect a distribution lost the ability to choose from a range of investment options and were required to invest in a money market fund. The ruling concluded that the participants experienced a significant detriment under 1.411(a)-11(c)(2)(i). Accordingly, a plan providing participants with the option of an immediate distribution would need to have language that preserves sufficient investment options in order to ensure that the loss of the employer stock investment is not a "substantial detriment." For example, the plan might offer three alternative investment options such as described in Code section 401(a)(28)(B) or might offer other choices that include a life-cycle fund or targeted-retirement-date fund. Since ESOPs and stock bonus plans may provide for the option of an immediate distribution upon termination of employment, we believe that it is appropriate to request language providing for sufficient investment options. Please discuss with us should this become an issue.

Should you have any questions concerning this memorandum or any questions on related issues, please contact Robert Gertner at 202-283-9622 or Clare Diefenbach at 202-283-9614.