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

FROM: Andrew Zuckerman
Director, Employee Plans Rulings and Agreements

SUBJECT: Response to Technical Assistance Request (#5)

This memorandum is in response to your Request for Technical Assistance, dated March 8, 2010, with regard to reshuffling provisions in employee stock ownership plans ("ESOPs") (within the meaning of Internal Revenue Code ("Code") section 4975(e)(7)) designed to prevent the occurrence of a nonallocation year (within the meaning of Code section 409(p)(3)). 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.

Issue:

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 in order to prevent a nonallocation year (within the meaning of Code section 409(p)(3)) will violate the current and effective availability requirements of section 1.401(a)(4)-4 of the Income Tax Regulations ("Regulations")?

General Statement of the Law:

Code section 4975(e)(7) provides that the term "ESOP" 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 ESOP 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).

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.

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 section 1.410(b)-5 of the Regulations).

Code section 410(b) provides that a trust shall not constitute a qualified trust under section 401(a) unless such trust is designated by the employer as part of a plan which meets one of the following requirements: (A) The plan benefits at least 70 percent of employees who are not highly compensated employees, (B) The plan benefits a percentage of employees who are not highly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan, or (C) The plan meets the requirements of the average benefit percentage test.

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).

Code section 409(p)(1) provides that an employee stock ownership plan holding employer securities consisting of stock in an S corporation shall provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person.

Code section 409(p)(3) defines "nonallocation year" as any plan year of an employee stock ownership plan if, at any time during such plan year (i) such plan holds employer securities consisting of stock in an S corporation, and (ii) disqualified persons own at least 50 percent of the number of shares of stock in the S corporation.

Code section 409(p)(4) defines "disqualified person" as any person if (i) the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation, or (ii) in the case of a person not described in clause (i), the number of

deemed-owned shares of such person is at least 10 percent of the number of deemed-owned shares of stock in such corporation.

Analysis and Conclusion:

A reshuffling provision designed to prevent a failure under Code section 409(p) (a "reshuffling/409(p) provision") typically involves the movement of shares of employer stock out of the accounts of disqualified persons (within the meaning of Code section 409(p)(4)), or persons who would otherwise become disqualified, and into the accounts of non-disqualified persons, while replacing those removed shares with cash or other assets taken from the accounts of the non-disqualified persons. The right of each participant to have or not have a particular investment in his or her account (either as a participant-directed investment or as a trustee-directed investment) 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. Because disqualified persons and persons who would, in the absence of steps to avoid a nonallocation year, become disqualified are often HCEs, we would expect a reshuffling provision that mandatorily exchanges assets in the accounts of one or more nonhighly compensated employees ("NHCEs") to cause the plan to fail to satisfy the nondiscriminatory availability requirements. In the Preamble to the final section 409(p) regulations, we stated that "it would be difficult for a plan to prevent a nonallocation year through reshuffling without violating section 401(a)(4)." In contrast, the provisions discussed in Response to Technical Assistance Request #4 ("TA-4") dealing with rebalancing, ESOP asset segregation, and age-related transfers did not raise issues under section 1.401(a)(4)-4.

As we stated in TA-4, any reshuffling provision must meet the definite written program requirements of sections 1.401-1(a)(2) and 1.401-1(b)(1)(ii) and (iii) of the Regulations. A reshuffling/409(p) provision would also need to include a means for satisfying section 1.401(a)(4)-4 in the plan document. ESOPs with provisions that merely provide the plan trustee with the ability to transfer between plan accounts to the extent necessary to avoid a nonallocation year under section 409(p) would fail the written plan requirement and will not be issued a determination letter in the interest of sound tax administration. See section 3.10 of Revenue Procedure 2010-4, 2010-1 IRB 122. All other ESOPs with reshuffling/409(p) provisions will continue to be processed. However, since we expect these reshuffling provisions to violate section 1.401(a)(4)-4, determination letter applications for these ESOPs will also need to include a Demo 3. Applications without a Demo 3 will not be ruled upon in the interest of sound tax administration. All ESOP applications with a Demo 3 are to be sent to Employee Plans Technical for Technical Advice.

For purposes of applying Demo 3, the benefits resulting from reshuffling under the particular reshuffling/409(p) provision will be treated as unpredictable event benefits. See line 1(d) in the Instructions for Schedule Q (Form 5300). Accordingly, the event will need to be described and the availability of the benefits will be determined based on the methodology set forth in the plan language.

Practitioners should be aware that there are several alternative means to prevent a nonallocation year, without the use of reshuffling, described in the Preamble to the Final Regulations under Code section 409(p) and the Final Regulations. Further, the Regulations provide relief from the nondiscrimination requirements of section 1.401(a)(4)-4 for a plan provision that prevents section 409(p) failures by transferring stock from an ESOP to a separate portion of the plan (or to another qualified plan of the employer) that is not an ESOP. The IRS has provided Sample Language for such transfers in a Special Edition of Employee Plan News, published July 1, 2008, and updated on its website, at http://www.irs.gov/ retirement/article/ 0,,id=205523,00.html.

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