Office of Chief Counsel
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Memorandum

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subject: Request for advice on plan language designed to prevent the occurrence of a nonallocation year under section 409(p) of the Internal Revenue Code

This Chief Counsel Advice responds to your request for assistance relating to § 409(p). This advice may not be used or cited as precedent.

Issues:

I. Whether an employee stock ownership plan (ESOP) may include plan language providing for a trustee, fiduciary and/or administrator to transfer employer securities in an S-corporation and assets attributable to such securities back to the ESOP if: (1) the ESOP previously transferred such securities and related assets to prevent a nonallocation year, pursuant to the "transfer method" described in § 1.409(p)-1(b)(2)(v)(A) of the Income Tax Regulations ("regulations"), from the account of a participant who was a disqualified person (or was reasonably expected to become a disqualified person as described in § 409(p) ("Disqualified Person") to a non-ESOP plan of the employer or a separate portion of the ESOP that is not an ESOP; and (2) the transfer back to the ESOP will not a cause a non-allocation year or a prohibited allocation in a nonallocation year for purposes of § 409(p).

2. Whether an ESOP may include plan language that provides for the use of the alternative methodologies for prevention of a nonallocation year suggested in the preamble to the final regulations under § 409(p), either independently or in advance of transfers of S corporation stock and assets attributable to such stock to a non-ESOP plan of the employer or a separate portion of the ESOP that is not an ESOP; provided, the application of one or more of the methodologies does not (1) discriminate in favor of highly compensated employees with respect to the availability of S corporation stock, (2) improperly reduce an existing allocation to a participant's account in violation of § 411(d)(6) and the definite allocation formula requirement, (3) provide for employer discretion in determining which participants are impacted by reductions or increases in allocations of S corporation stock, in violation of the definite written program and definite allocation formula requirements, and (4) provide for use of a prevention methodology which fails to become operative until after a nonallocation year has occurred and assets held in the accounts of disqualified persons are deemed an impermissible accrual as defined in the regulations under section 409(p).

In particular, you ask whether an S corporation ESOP may include provisions designed to prevent a nonallocation year by: (1) excluding from allocations only the highly compensated employees ("HCEs") who would otherwise become Disqualified Persons; (2) excluding from allocations all HCEs; (3) expanding allocations to NHCEs (who are not Disqualified Persons) with less than 1,000 hours service; (4) expanding allocations to the nonhighly compensated employees ("NHCEs") (who are not Disqualified Persons) with less than 1,000 hours service and who were employed on the last day of the plan year or (5) expanding allocations to NHCEs (who are not Disqualified Persons) and who were employed on any day of the plan year. You further ask whether an ESOP may include more than one of these provisions, in addition to a provision providing for the transfer method.

You also ask whether an ESOP may include the following (or a substantially similar) provision: "Notwithstanding any other provision of the plan to the contrary, no allocation of any company stock whether by reason of any Employer contribution, forfeiture, dividend or otherwise, shall be made to or on behalf of XX or any member of XX's family that would make XX or such family member a "disqualified person" within the meaning of § 409(p)(4)."j

In all these prevention methods (referred to as Prevention Methods (1) through (5)), the §409(p) prevention provisions operate exclusively before the actual allocations are made to participant accounts.

3. Whether an ESOP may include plan language that includes a methodology which provides for multiple adjustments to participant accounts through incremental

reallocations of stock initially allocated to HCEs, with such reallocations continuing until total allocations of stock released from the ESOP loan suspense to HCE participants, as a percentage of compensation, do not exceed the lowest percentage allocated to the account of a NHCE participant?

Law

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 § 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 § 409(h), § 409(o), and, as applicable, § 409(n), § 409(p), and § 664(g) and, if the employer has a registration-type class of securities (as defined in § 409(e)(4)), it meets the requirements of § 409(e).

Section 1.401-1(a)(2) 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) 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 base compensation of each participant.

Section 1.401-1(b)(1)(iii) 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. 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 HCEs.

Section 1.401(a)(4)-4 of the regulations provides rules for determining whether the benefits, rights, and features provided under a plan (that is, 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) 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 § 410(b) (without regard to the average benefit percentage test of § 1.410(b)-5 of the Regulations).

Section 410(b) provides that a trust shall not constitute a qualified trust under § 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 1.410(b)-7(c) provides that the portion of the plan that is an ESOP and the portion of the plan that is not an ESOP are treated as separate plans for purposes of § 410(b).

Section 1.401(a)(4)-4(b)(2) 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) 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(e)(3)(i) 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) 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 409(p)(1) provides that an ESOP 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 § 401(a)) for the benefit of any Disqualified Person.

Section 409(p)(3) defines "nonallocation year" as any plan year of an ESOP 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.

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.

Section 409(p)(7)(A) provides that the Secretary shall prescribe such regulations that be necessary to carry out the purposes of this subsection.

Section 1.409(p)-1(b)(2)(v)(A) provides that an ESOP may prevent a nonallocation year by having assets, including S corporation securities, allocated to the account of a Disqualified Person (or a person reasonably expected to become a Disqualified Person without the transfer described here) be transferred to the non-ESOP portion of the plan or to another plan of the employer that is qualified under § 401(a), but is not an ESOP. Under § 1.409(p)-1(b)(2)(v)(B), these transfers will not cause either the ESOP or the non-ESOP portion of the plan to fail the requirements of § 1.401(a)(4)-4. Further, subsequent to the transfer, both the transferee plan and the non-ESOP portion of the plan will not fail to satisfy the requirements of § 1.401(a)(4)-4 merely because of the benefits, rights and features with respect to the transferred benefits if those benefits, rights, and features would satisfy the requirements of § 1.401(a)(4)-4 if the mandatory disaggregation rule for ESOPs at § 1.410(b)-7(c)(2) did not apply. This is what was previously referred to as the "transfer method", described in the preamble to the final § 409(p) regulations.

Section 411(d)(6)(A) provides that a plan does not satisfy § 401(a) if an amendment to the plan decreases a participant's accrued benefit (that is, the anti-cutback rules). Section 411(d)(6)(B) provides that a plan amendment that has the effect of eliminating an optional form of benefit with respect to benefits attributable to service before the amendment is treated as reducing accrued benefits.

Section 411(d)(6)(C) provides that an ESOP is not treated as failing to meet the requirements of § 411(d)(6) merely because it modifies distribution options in a nondiscriminatory manner.

Section 411(a)(7)(A)(ii) provides that for defined contribution plans, the balance of the employee's account constitutes his accrued benefit.

Issue I: Analysis and Conclusion

As explained in its legislative history, Section 409(p) was enacted to address Congress's belief that ESOPs should not be used by S corporation owners to obtain inappropriate tax deferral (H.R. Rep. No. 107-51, part 1, at 100 (2001)). As an anti-abuse statute, its violation through the occurrence of a nonallocation year results in serious consequences for the ESOP, the participant, and the employer. These consequences may include deemed distributions, subjecting the exempt loan to excise taxes under § 4975(a) & (b), loss of § 401(a) qualified plan status, jeopardizing the employer's status as an S corporation, and the imposition of excise taxes under § 4979A. With § 409(p) compliance required on a current operational basis, a plan may violate § 409(p) and trigger these consequences in real time. Within this context, several options have been formulated that a plan may use to maintain its ongoing compliance. These options, described in the preamble to the § 409(p) regulations ("preamble"), include the transfer method under § 1.409(p)-1(b)(2)(v)(A) and (B). The preamble states that these options must also satisfy applicable legal and qualification requirements, including the nondiscrimination requirements of § 401(a)(4).

The transfer method allows an ESOP to transfer S corporation securities allocated to the account of a Disqualified Person (or a person reasonably expected to become a Disqualified Person) to the non-ESOP portion of the plan, or to another plan of the employer that is qualified under § 401(a), prior to the occurrence of a nonallocation year. Under § 1.409(p)-1(b)(2)(iv)(B), these transfers will not cause either the ESOP or the non-ESOP portion of the plan to fail the requirements of § 1.401(a)(4)-4. Since the right to a particular investment in a participant's account is a plan right, benefit or feature under § 1.401(a)(4)-4, a transfer would likely involve a mandatory exchange of assets with a NHCE. This would likely violate the § 1.401(a)(4)-4 rules without the special exception. Further, since the non-ESOP portion would likely be covering only

HCEs, it would likely fail the coverage standard under the current availability requirement without the exception from the disaggregation rule.

There is no basis to expand the applicability of the special exception beyond the scope described in § 1.409(p)-1(b)(2)(v)(A). The transfer, as described in the regulations, is designed as a measure that may be used by an ESOP to prevent the occurrence of a nonallocation year. It serves to prevent a § 409(p) violation through the transfer of S corporation shares from the S corporation ESOP trust to a non-ESOP trust. Any transfer of S corporation stock back into the ESOP trust would only serve to increase the likelihood of a § 409(p) violation.

Accordingly, the exception to the current availability rule applies only to the transfer described in § 1.409(p)-1(b)(2)(v)(A) and not to the transfers as described in Issue l. Without the exception to the current availability rules, the transactions described in Issue 1 would likely cause both the ESOP and the non-ESOP portion to violate §1.401(a)(4)-4. Thus, any plan language providing for this is not appropriate.

Issue 2: Analysis and Conclusion

The preamble provides for a number of actions that may be taken to prevent the concentration of deemed-owned ESOP shares that are prohibited under § 409(p) in addition to the transfer method. Under the preamble, an S Corporation may reduce contributions for HCEs who are or may become Disqualified Persons, provide additional benefits to NHCEs who are not Disqualified Persons or expand coverage to include all employees. These provisions may be used independently or in conjunction with each other and the transfer method. The preamble further states that these provisions must also satisfy any other legal requirements that may apply and be completely implemented before a nonallocation year occurs. These other legal requirements include the non-discrimination rules under § 401(a)(4). Nondiscrimination is an operational requirement, however, a plan provision that would likely result in a § 401(a)(4) violation would be inappropriate. In addition, these other legal requirements include the written plan requirement under § 1.401-1(a)(2), the requirement of a definite pre-determined formula for allocating the contributions made to the plan among the participants under § 1.401-1(b)(1)(ii) and the anti-cutback rules as they apply to ESOPs.

The Prevention Methods (1), (2), (3), (4) and (5) described in your inquiry are all variations on the two examples in the preamble that provide for the reduction of allocations to HCEs or the increase of allocations to NHCEs. In Prevention Method (1) and (2), allocations are not made to HCEs who would otherwise be Disqualified Persons or to all HCEs, respectively. In Prevention Methods (3) through (5) allocations are expanded to include NHCEs, who are not Disqualified Persons, with less than 1,000

hours of service (Prevention Method 3), who had less than 1000 hours of service and were employed on the last day of the plan year (Prevention Method 4) and who were employed on any day of the plan year (Prevention Method 5). Since these examples either expand allocations to NHCEs or exclude allocations to HCEs, they would not likely discriminate in favor of HCE's as prohibited under § 401(a)(4).

With respect to the requirements for a written plan and for a definite pre-determined formula in allocating contributions, these provisions also need to articulate a methodology to guide the ESOP administrator in making the allocations. Prevention Methods (1) and (2) simply provide that either all or an identifiable group of HCEs are excluded from allocations in a plan year. Similarly, Prevention Methods (3), (4) and (5) provide for the expansion of allocations, in a plan year, to include all or an identifiable portion of the NHCEs. In addition, all these provisions are effective in plan years prior to the allocations for such years. As a result, these Prevention Methods, analyzed independently of any other provision designed to prevent a nonallocation year, meet all the legal requirements as stated in the preamble.

ESOPs with two or more of these provisions, including the transfer method, illustrate multiple § 409(p) prevention methods working together. For example, in ESOPs with provisions described in Prevention Methods (1) through (5), the exclusion of allocations in (1) and (2) might be insufficient to prevent a nonallocation year. Subsequent to the exclusions described in Prevention Methods (1) and (2), the expansion of allocations to the three groups of NHCEs described in Prevention Methods (3), (4) and (5) might be applied. Another example would be an ESOP having the same provisions, but after applying the allocation exclusion in Prevention Methods (1) and (2) and subsequently applying allocation expansion in Prevention Method (3), a nonallocation year is prevented.

Lastly, in an ESOP with the above Prevention Methods in addition to the transfer method, upon the failure of the methods in Prevention Methods (1) through (5), the transfer method would be applied. As stated above, all these provisions meet the standards stated in the preamble analyzed independently. However, ESOPs with more than one of these provisions raise issues related to the predetermined allocation requirement. One way to meet this requirement is for the ESOP to have plan language stating the order in which these provisions are to be applied. For example, a plan can provide that each provision (that is, Prevention Methods (1) through (5)) will be applied individually in a specified order until the allocations are sufficient to prevent the occurrence of a nonallocation year.

You also ask whether an ESOP may include the following or a substantially similar provision: "Notwithstanding any other provision of the plan to the contrary, no allocation

of any company stock whether by reason of any employer contribution, forfeiture, dividend or otherwise, shall be made to or on behalf of XX or any member of XX's family that would make XX or such family member a "disqualified person" within the meaning of § 409(p)(4)."

This provision provides that no member of a particular family would receive any allocations that would make one of these persons a Disqualified Person under § 409(p). Similar to Prevention Methods (1) through (5), this example meets the requirements as stated in the preamble. This provision meets the requirements of a written plan and a definite predetermined formula. With regard to the nondiscrimination rules, it would be unlikely that the members of this family who would otherwise become Disqualified Persons under § 409(p) would be NHCEs.

Issue 3: Analysis and Conclusion

As discussed above, one of the standards used to determine whether a plan amendment is appropriate is whether it would cause the anti-cutback rules, as applied to ESOPs, to be violated. The subject plan provision provides for the re-allocation of stock that has been already allocated to participants' accounts. This would result in the forfeiture of accrued benefits, as described in § 411(a)(7)(A)(ii). Accordingly, the plan language described in Issue 3 would be not acceptable.

Please call Robert Gertner at (202) 317-4102 if you have any further questions.