Introduction

An employee stock ownership plan (“ESOP”) is a qualified defined contribution retirement plan, in the same category as a profit-sharing or 401(k) plan. An ESOP differs from other defined contribution plans, however, because it is designed to invest primarily in employer securities. The ESOP concept pre-dates the Employee Retirement Income Security Act of 1974, but ERISA now, in combination with the Internal Revenue Code, provides substantial tax incentives and planning opportunities for employers that sponsor ESOPs. Besides providing retirement benefits for eligible employees, ESOPs also can facilitate corporate finance and other objectives. For example, an ESOP might enable a company or its owners to:

- resolve ownership succession issues;
- diversify investments;
- plan their estates and charitable donations;
- borrow funds to finance transactions or refinance debt;
- reduce or eliminate federal income tax; or
- increase employee benefits and productivity incentives

ESOPs are attractive to employers for many reasons, but they have special characteristics and requirements that distinguish them from other defined contribution plans with which most employers and their advisors may be familiar. The purpose of this article is to provide an overview of some of the unique features of ESOPs that employers should consider as they design and operate their ESOPs.

Defined Contribution Plans

The tax code classifies all qualified deferred compensation plans in two categories – defined contribution plans and defined benefit plans. A defined contribution plan provides benefits equal to a participant’s account balance, which may include employer contributions, participant
benefit plans include profit-sharing, stock bonus, money purchase, and 401(k) plans.

An ESOP is another type of defined contribution retirement plan. An ESOP sponsor has several plan design alternatives, but an ESOP must contain a stock bonus plan element to satisfy IRC §4975(e)(7) and qualify as an ESOP. Stock bonus plans are described in the Treasury regulations as plans established and maintained to provide benefits similar to those provided by profit-sharing plans, but stock bonus plan benefits are distributable in employer stock. Stocks bonus plans and ESOPs are subject to the same general qualification requirements as profit-sharing and other defined contribution plans, but there are several characteristics that distinguish them, as described in the following discussion. The primary distinctions highlighted in this report include:

- Qualification requirements
- Contribution and allocation rules and limitations
- Dividends
- Benefit distribution form and timing
- Diversification
- Repurchase liability
- Anti-cutback rules
- Annual valuation
- Voting rights
- Fiduciary duties

Employee Stock Ownership Plans

Qualification Requirements Under IRC §§401(a) and 4975

IRC §401(a) contains the qualification requirements that apply to all tax-qualified deferred compensation plans, including ESOPs. A comprehensive discussion of those requirements is beyond the scope of this article, so this section focuses on the qualification rules under IRC §401(a) and the requirements under IRC §4975 that are unique to ESOPs.

Designed to Invest Primarily in Employer Securities

An ESOP must be formally identified in the plan document as an employee stock ownership plan and must be designed to invest primarily in employer securities. The IRS has not interpreted the phrase “designed to invest primarily in employer securities,” but the phrase implies that an ESOP must be intended to permit the plan trustees to invest or hold most of the plan assets in employer securities without specific duration or percentage requirements. Similarly, Department of Labor guidance does not establish a specific standard for the “primarily invested” requirement, but instead looks to facts and circumstances. In Advisory Opinion 83-6A, DOL stated that neither ERISA nor the regulations impose a maximum or minimum percentage on the amount of plan assets that must be invested in employer securities under ERISA §407(d)(6).
IRC §409(l) defines “employer securities” as common stock issued by an employer that is readily tradable on an established securities market. If an employer’s common stock is not publicly traded, the term “employer securities” generally means common stock issued by the employer that has a combination of voting powers and dividend rights equal to or greater than the powers and rights of the class of common stock of the employer that has the greatest voting powers and the class of common stock that has the greatest dividend rights. “Employer securities” also include non-callable preferred stock if such stock is convertible into the qualified common stock described above at a reasonable conversion price (as of the date of acquisition by the ESOP).8

For purposes of IRC §409(l), the term “employer securities” includes, for a non-publicly traded company, securities issued by any member of the employer’s controlled group of corporations. Under IRC §409(l)(4), the phrase “controlled group of corporations” has the meaning set forth in IRC §1563(a) (disregarding subsections (a)(4) and (e)(3)(C)), except that the parent company must own only 50 percent (rather than 80 percent) of the stock of a subsidiary for that subsidiary and those below it to be members of the controlled group.

**Nondiscrimination Rules**

IRC §410(b) requires ESOPs and other qualified deferred compensation plans to benefit a broad range of employees.9 Although the tax code permits certain plans to be considered together for coverage testing, an ESOP generally may not be aggregated with another plan to demonstrate compliance with this coverage requirement10 unless the “average benefits test” is used.11 Regulations under IRC §§401(k) and 401(m) previously provided that the employee deferral and employer contribution features under defined contribution plans sponsored by a single employer must be tested separately from ESOP features.12 However, §401(k) and §401(m) regulations that became effective for plan years beginning on or after January 1, 2006, eliminated the required disaggregation of the ESOP and non-ESOP portions of a single IRC §414(l) plan for actual deferral percentage (“ADP”) and actual contribution percentage (“ACP”) testing purposes. The IRC §401(k) and §401(m) regulations now also permit a plan sponsor to aggregate two §414(l) plans – which may include an ESOP and a non-ESOP – to conduct the ADP test and/or the ACP test.13

Several safe harbors are available to enable plan sponsors to satisfy the nondiscrimination requirements for contributions to defined contribution plans, such as compensation-based allocation formulas and formulas based on age or service.14 However, ESOPs may not use the age- or service-weighted allocation formulas for purposes of the cross-testing rules.15 ESOPs also may not be cross-tested based on benefits16 and they may not use Social Security integration to comply with §401(a)(4).17 Therefore, in most cases an ESOP must either use a uniform allocation formula under which all participants receive contribution allocations and forfeitures based on the same percentage of compensation18 or satisfy a complex “general test” to demonstrate compliance with the nondiscrimination rules.19

**Other Regulatory Requirements**

The tax code and ERISA contain other general requirements that an ESOP must satisfy to retain its ESOP status, many of which apply (or do not apply) based on an ESOP’s leveraged status and therefore differ markedly from the other general rules that govern defined contribution plans.20 For example, if an ESOP is leveraged the plan document must provide for a suspense account to hold stock acquired with the proceeds of an exempt loan used by the ESOP to purchase employer securities, and for a method of releasing the stock from the suspense account as the loan is repaid.21 The plan also must provide participants certain rights related to plan assets acquired with the proceeds of an exempt ESOP acquisition loan. These rights primarily relate to the “put option” requirement (discussed in more detail in the Distribution section below)
and the requirement that no security acquired with the proceeds of an exempt loan may be subject to a put, call, or buysell or similar arrangement when it is held by or distributed from the plan, regardless of the plan’s status as an ESOP at the time.22

As of the end of each plan year, a leveraged ESOP must allocate to participant accounts units that represent the participants’ interests in assets released from the exempt loan suspense account.23 Income on securities acquired with the proceeds of an exempt loan must be allocated as income of the plan, except to the extent that the ESOP provides for use of the income on such securities to repay the loan.24 However, income paid on qualifying employer securities acquired by an ESOP in taxable years beginning after 1974 may be distributed any time after the plan receives them to participants on whose behalf such securities are allocated.25

If part of a participant’s account is forfeited, employer securities allocated as of the end of the plan year must be forfeited only after other assets held in the account are forfeited. If interests in more than one class of employer securities have been allocated to the participant’s account, the participant must be treated as forfeiting the same proportion of each such class.26 If employer securities acquired under an ESOP with the proceeds of an exempt loan consist of more than one class (e.g., common stock and convertible preferred stock), the participant (or beneficiary) must receive substantially the same proportion of each class.27

A plan is considered to satisfy the ESOP requirements as of the date it is designated as an ESOP if it is amended (retroactively, if necessary) to satisfy the requirements at any of the following times:

- 12 months after the date on which the plan is so designated;
- 90 days after a determination letter is issued regarding the qualification of the plan as an ESOP, but only if the determination is requested within 12 months after the date on which the plan is designated as an ESOP; or
- a later date approved by the IRS district director.28

Contributions and Deductions

After employer ESOP contributions are allocated to participant accounts, vested and available for distribution, an ESOP generally must distribute the benefits in the form of employer securities at the election of the participants as they become entitled to distributions.29 To facilitate such distributions, an employer may contribute the securities directly to the plan or it may contribute cash for the plan to use to purchase the securities. Depending on the contribution method, the ESOP sponsor should keep in mind special rules and deduction limitations.

**Employer Securities**

An employer recognizes no gain or loss by contributing its securities (which may include treasury stock) to an ESOP.30 However, the employer must ensure that any in-kind contribution qualifies for an exemption under ERISA §408 (or IRC §4975(d)) to avoid prohibited transaction penalties. For example, according to DOL Interpretive Bulletin 95-3, an employer that resolves to contribute 10,000 shares of treasury stock to a plan should not run afoul of the prohibited transaction rules because the resulting contribution of employer securities does not result from any monetary obligation to the plan. However, an employer that resolves to contribute $10,000 worth of company stock to the plan would have to qualify for a prohibited transaction exemption (e.g., the exemption under ERISA §408(e) for a sale of employer securities at a price that represents no more than adequate consideration) to avoid penalties.
**Cash/ESOP Loan Exemption**

It may be helpful for an ESOP to hold liquid assets such as cash. The cash may be used to purchase employer securities, satisfy the diversification elections of qualified participants or provide cash distributions to electing participants. If a sale of stock to an ESOP is anticipated, the employer could make cash contributions to the plan to be accumulated over a short period to purchase a selling shareholder’s interest.

Unlike other defined contribution plans, an ESOP established under IRC §4975(e)(7) may obtain a loan to purchase employer securities. ERISA §408(b)(3) and IRC §4975(d)(3) provide an exemption from the prohibited transaction rules that otherwise would preclude the direct or indirect lending of money or other extension of credit between the ESOP and a party in interest, such as the plan sponsor. This exemption permits an ESOP to borrow money using a direct loan, loan guarantee or installment sale from a party in interest to acquire employer securities. The acquisition loan exemption distinguishes an ESOP from other qualified plans that invest in employer stock because an ESOP is the only type of eligible individual account plan that may borrow to purchase employer securities.

To qualify for the prohibited transaction exemption, an ESOP loan must satisfy the following requirements:

- The loan must be primarily for the benefit of ESOP participants and their beneficiaries.\(^31\)
- The loan (or other extension of credit) must be entered into for the acquisition of employer stock or to repay a prior exempt loan.\(^32\)
- The interest rate on the loan must be reasonable\(^33\) and the purchase price of the stock must not be so high that plan assets might be drained off.\(^34\) The loan terms must be as favorable to the ESOP as the terms that could be achieved from arm’s-length negotiations between independent parties.\(^35\)
- Any collateral pledged by an ESOP (whether or not it is pledged to a party in interest) must be limited to the shares of employer stock acquired with the proceeds of the loan and those that were used as collateral on a prior exempt loan that is repaid or freed from encumbrance with the proceeds of the current exempt loan.\(^36\)
- Any shares of employer stock provided as collateral for an ESOP loan must be released from pledge on a prorata basis as the loan is repaid, based either on principal and interest payments or solely on principal payments.\(^37\) Even if the stock is not pledged, the shares are released for allocation to participant accounts using the same methods.\(^38\)
- An ESOP’s loan repayment liability must be limited to the collateral provided for the loan, contributions (in a form other than employer securities) made to the ESOP for loan repayment purposes, and earnings on the contributions and collateral.\(^39\) The ESOP’s payments on an exempt loan during a plan year must not exceed the amount that equals the sum of the ESOP contributions and the earnings on the contributions and collateral (to the extent that such earnings were not used for loan payments in prior years).\(^40\)
- An ESOP loan must be for a fixed term and must satisfy certain default requirements (including that a party in interest lender may not accelerate payments in the event of default). The loan may not be payable on demand of the lender except in the case of default.\(^41\)
• An employer security purchased by an ESOP with an exempt loan must be subject to a put option if it is not publicly traded or if a trading restriction applies at the time of distribution.42

• The employer stock purchased by an ESOP with an exempt loan generally may not be subject to any additional put, call, or other option or any buy-sell or similar arrangement (except as required under securities laws).43

If an ESOP loan does not satisfy the exempt loan rules, a prohibited transaction penalty tax may apply under §4975. The tax is imposed on a disqualified person that extends credit to the ESOP and initially equals 15 percent of the amount involved.44 If the loan is not modified or the transaction unwound within the taxable period to satisfy the exemption requirements, an additional 100 percent tax on the amount involved may apply.45

Contribution Deductions

The general rule under IRC §404(a)(3) is that an employer’s deduction for contributions to a qualified deferred compensation plan is limited to 25 percent of the compensation of eligible participants. However, IRC §404(a)(9) contains special deduction rules for ESOP contributions that are used to repay principal and interest on an exempt ESOP loan. Under §404(a)(9)(A) (disregarding §§404(a)(3) and (7)), an employer may claim a deduction of up to 25 percent of eligible participant compensation for ESOP contributions used to repay the principal on an ESOP acquisition loan.46 In addition, an employer that is a C corporation is not limited with respect to the amount it may deduct for ESOP contributions that are used to repay interest on an ESOP acquisition loan.47 IRC §404(a)(9) does not apply to an S corporation, however, so contributions made by an S corporation that are used to pay ESOP loan interest will count against the 25 percent of compensation deduction limit.48 If an employer exceeds the deduction limits, IRC §4972 imposes a 10 percent excise tax on the excess.

Example:

ABC Company sponsors an ESOP and has an eligible payroll of $2,000,000. The exempt ESOP acquisition loan requires ABC Company to make ESOP contributions that consist of principal payments of $500,000 and interest payments of $35,000 each year for several years.

If ABC Company is a C corporation, it may deduct the ESOP contributions as follows:

<table>
<thead>
<tr>
<th>IRC §§404(a)(3) and 404(a)(9)(A) Limits</th>
<th>Principal paid on exempt loan</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>25% of eligible payroll</td>
<td>plus</td>
<td></td>
</tr>
<tr>
<td>IRC §404(a)(9)(B) Amount</td>
<td>Interest paid on exempt loan</td>
<td>$35,000</td>
</tr>
<tr>
<td></td>
<td>Total Deduction</td>
<td>$535,000</td>
</tr>
</tbody>
</table>
If ABC Company is an S corporation, it may deduct the ESOP contributions as follows:

<table>
<thead>
<tr>
<th>IRC §404(a)(3) Limit</th>
<th>Principal paid on exempt loan</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>25% of eligible payroll</td>
<td>plus</td>
<td>plus</td>
</tr>
<tr>
<td>IRC §404(a)(9)(B) Amount – N/A</td>
<td>Interest paid on exempt loan – N/A</td>
<td>$0</td>
</tr>
<tr>
<td>Total Deduction</td>
<td>$500,000</td>
<td></td>
</tr>
</tbody>
</table>

The IRS has confirmed in private letter rulings that employers that sponsor both a profit-sharing plan and a separate leveraged ESOP are not required to aggregate annual contributions to the two plans for tax deduction purposes. IRC §404(a)(3) permits the deduction of employer contributions to a profit-sharing plan up to 25 percent of eligible payroll. Based on the IRS rulings, the IRC §404(a)(9)(A) ESOP contribution deduction is separate from the §404(a)(3) deduction. Therefore, an employer could take a 25 percent of eligible compensation deduction under §404(a)(9)(A) for ESOP contributions used to make principal repayments on an exempt loan in the same plan year as the employer takes a 25 percent of eligible compensation deduction under the general rule of §404(a)(3) for contributions to another defined contribution plan – provided that the total annual additions for participants in the plans comply with the IRC §415 limits (described below).

**Allocation Rules and Limitations**

As described above in the Nondiscrimination Rules section, employer securities acquired by an ESOP are allocated based on the rules that generally apply to other types of qualified defined contribution plans. However, the tax code contains special limitations that prohibit allocations to certain individuals under ESOPs. Special rules also apply when an ESOP acquires employer securities with the proceeds of an exempt loan.

**Allocation of Shares Purchased With an Exempt Loan**

Employer securities that are acquired by an ESOP with the proceeds of an exempt loan are placed in a suspense account. As the principal and interest on the exempt loan is repaid, a pro rata amount of securities must be released from the suspense account and allocated to the accounts of eligible participants for such year in accordance with a schedule that is at least as rapid as one of two schedules in the regulations — the principal-and-interest method or the principal-only method. Under the principal-and-interest method, the number of shares released is the total number of shares in the suspense account multiplied by a fraction in which the numerator is the principal and interest paid during the year and the denominator is the sum of the numerator plus the total remaining principal and interest to be paid over the life of the loan (assuming, in the case of a variable interest rate, that the rate in effect at the end of the year remains in effect for the duration of the loan). The principal-only method is similar, except that interest is excluded from both the numerator and the denominator of the fraction and the ESOP loan must satisfy special requirements. As the plan sponsor and its advisors are preparing the loan amortization schedule, they should keep in mind the deduction limits under IRC §409(a)(9) and the annual addition limits under IRC §415.
Illustration:
Principal (P) + Interest (I) Release Method

\[
\text{Year } X \cdot P + I \times \frac{\text{Number of shares in }}{\text{ESOP suspense account}} = \text{Number of shares to be released for Year } X
\]

Illustration:
Principal (P)-Only Release Method

\[
\text{Year } X \cdot P \div \text{Year } X \cdot P + \text{Remaining } P \times \frac{\text{Number of shares in }}{\text{ESOP suspense account}} = \text{Number of shares to be released for Year } X
\]

The shares normally are allocated, based on relative compensation, to the ESOP accounts of participants who satisfy the allocation eligibility rules under the plan and are not prohibited from receiving an allocation in a particular year (as described above). As with other defined contribution plans, the plan sponsor has some flexibility in establishing the allocation criteria. For example, many ESOPs provide that a participant must be employed on the last day of the plan year or satisfy a minimum hours of service requirement to receive an allocation for that year. Regardless of the approach the plan sponsor chooses, the allocation criteria must be set forth in the plan document and applied in accordance with plan terms.

Special IRC §415 Limitations

IRC §415(c)(1) generally provides that the contributions that may be credited as “annual additions” to a participant’s defined contribution plan accounts in a limitation year may not exceed the lesser of (i) $45,000 (for 2007; adjusted in accordance with §415(d)), or (ii) 100 percent of the participant’s compensation. The term “annual addition” means the sum of employer contributions, employee contributions, and forfeitures for the year to all defined contribution plans sponsored by an employer. IRC §415(c)(6) contains a special limitation rule for leveraged ESOPs sponsored by C corporations. Under this special rule, if no more than onethird of the employer ESOP contributions are allocated to highly compensated employees (as defined in IRC §414(q)), the employer contributions to the ESOP that are used to pay interest on the ESOP loan and reallocated forfeitures of employer securities that were acquired with the proceeds of the loan are excluded from the annual addition limitation calculation.

The IRS final regulations issued in April 2007 state that annual additions under an ESOP for purposes of the IRC §415 limits may be calculated based on employer contributions used to repay an exempt loan or based on the fair market value of the employer securities allocated to participant accounts. If the annual additions are calculated based on employer contributions, appreciation in the value of the employer securities from the time they were purchased and placed in the suspense account is not counted for §415 purposes.

Dividends paid on employer securities held by an ESOP generally are treated as plan earnings and do not count against the §415 annual addition limits. However, the IRS is authorized under Treasury Regulation Section 1.415-6 to recharacterize amounts that an employer designates as dividends if the IRS determines that such dividends should be treated as annual additions.

Prohibition on Allocations of Stock Acquired in an IRC §1042 Transaction

IRC §409(n) provides that no portion of the assets attributable to (or allocable in lieu of) employer securities acquired in a transaction to which the tax deferral provisions of IRC §1042 apply may be allocated (i) during a “non-allocation period” to a selling shareholder who makes a §1042 election or any person related to such an electing shareholder (as defined in IRC §267(b)), or (ii)
at any time to a 25 percent shareholder (determined using the attribution rules of IRC §318(a)). A de minimis exception to the prohibited allocation rule is provided for the lineal descendants of a selling shareholder (but not for a 25 percent shareholder).\textsuperscript{59} Under the de minimis exception, allocations that otherwise would be prohibited may be made to such lineal descendants if the aggregate amount of allocated stock does not exceed 5 percent of the amount sold by the selling shareholder in the §1042 transaction.

The prohibited allocation rule precludes an employer from making special contributions or allocations of other assets under an ESOP or any aggregated qualified plan for the benefit of participants who are prohibited from receiving allocations under the rule unless additional contributions are made to other participants in an amount sufficient to satisfy applicable coverage and non-discrimination requirements.\textsuperscript{60} The prohibited allocation rule does not, however, apply to allocations of employer securities or contributions of cash made to a non-qualified deferred compensation plan.\textsuperscript{61}

The “non-allocation period” that applies to IRC §1042 sellers and persons related to them (but not to 25 percent shareholders) is the period beginning on the date of the §1042 transaction and ending on the later of the date that is 10 years after the date of the transaction or the date of the plan allocation resulting from the final payment on the loan used to purchase the §1042 shares.\textsuperscript{62} For 25 percent shareholders, the non-allocation period is perpetual. Failure to comply with the prohibited allocation rule is an ESOP qualification issue under IRC §4975(e)(7). An employer that violates the non-allocation rule will be liable for a tax under IRC §4979A equal to 50 percent of the amount of the prohibited allocation. In addition, IRC §409(n)(2) provides that the ESOP is to be treated as having distributed the prohibited allocation to the participant, who generally must include the corresponding amount in his or her taxable income for the year.

**Prohibition on Allocations to Disqualified Persons in an S Corporation ESOP**

An ESOP established by an S corporation must provide that no portion of the ESOP’s assets attributable to (or allocable in lieu of) employer securities can accrue or be allocated directly or indirectly under any qualified plan maintained by the S corporation for the benefit of a disqualified person during a non-allocation year.\textsuperscript{63} A plan that does not satisfy this requirement is not treated as an ESOP.\textsuperscript{64}

IRS has issued rules that address prohibited allocations of stock in S corporations under IRC §409(p),\textsuperscript{65} which involve four important terms that are defined below.

**Disqualified person** means a deemed 10 percent shareholder or a member of a deemed 20 percent shareholder group.\textsuperscript{66} An individual is a deemed 10 percent shareholder if he or she is not a member of a deemed 20 percent shareholder group and the number of his or her deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock of the corporation. An individual is a member of a deemed 20 percent shareholder group if the aggregate number of deemed-owned shares of the individual and his or her family members is at least 20 percent of the number of deemed-owned shares of stock in the S corporation. For this purpose, the term “family member” is broadly defined in §409(p)(4)(D) to include:

- the spouse of the individual;
- an ancestor or lineal descendant of the individual or his or her spouse;
- a sibling of the individual (or the individual’s spouse) and any lineal descendant of the sibling; and
- the spouse of any person described in the second and third items in this list.\textsuperscript{67}
The regulations provide that the determination of a person’s disqualified status is made first without regard to any synthetic equity, and then again by including all synthetic equity in both the numerator and denominator of the 10 percent and 20 percent computations. The regulations further provide that the IRC §318 attribution rules generally apply to determine ownership of synthetic equity and shares in the S corporation. The IRS also may designate any individual as a disqualified person in any year in which the IRS determines that a non-allocation year occurs because the principal purpose of the S corporation ownership structure is an avoidance or evasion of IRC §409(p).

Deemed-owned shares means: (i) stock allocated to the account of an individual under an ESOP, and (ii) an individual’s share of the unallocated stock held by the ESOP. An individual’s share of the unallocated stock is the amount of unallocated stock that would be allocated to such person if the unallocated stock were allocated to all participants in the same proportion as the most recent stock allocations under the plan. In the first year of an ESOP, it seems likely that none of the unallocated shares would be attributed to participants for this purpose because there have been no preceding allocations to apply. The term “deemed-owned shares” does not include shares of stock owned outright by an individual in his or her own name.

Synthetic equity, which also is taken into account as “deemed-owned shares,” is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or arrangement that gives the holder the right to acquire or receive stock of the S corporation in the future. Options or other rights to acquire stock that are not vested or exercisable, and/or which are “out of the money” (i.e., have an exercise price greater than the fair market value of the stock), appear to be included in the synthetic equity definition. Deferred compensation is treated as synthetic equity, with the corresponding number of “shares” of synthetic equity based on the present value of the deferred compensation divided by the fair market value of the stock for the year being tested.

Non-allocation year means any plan year of an ESOP that holds S corporation employer securities if, at any time during the plan year, “disqualified persons” own at least 50 percent of the number of outstanding shares of the S corporation. Unlike the disqualified person computation, the non-allocation year computation includes all shares held by the person – both deemed-owned shares and shares owned outright. As is the case with the disqualified person definition, the test is run twice, once based only on outstanding shares and once using both outstanding shares and all synthetic equity. To determine whether a plan has a non-allocation year, stock ownership generally is attributed as required under IRC §318, except that:

- the family attribution rule is modified to include additional family members;
- option attribution does not apply (but special rules relating to synthetic equity apply instead); and
- deemed-owned shares held by the ESOP are treated as held by the individual with respect to whom they are allocated.
Example: XYZ Company is an S corporation in which the ESOP owns 50 percent of the stock. Outside the ESOP, Executive A owns 25 percent, Executive B owns 15 percent, Executive C owns 5 percent and a non-employee owns the remaining 5 percent of the XYZ Company stock. Executive A has 7 percent of the XYZ stock allocated to his ESOP account, Executive B has 4 percent allocated to her ESOP account, and Executive C has 1 percent allocated to her ESOP account.

Disqualified Persons: Executive A has 25 percent + 7 percent, so he is a deemed 10 percent shareholder. Executive B has 15 percent + 4 percent, so she is a deemed 10 percent shareholder.

Non-allocation Year: Yes — because the Disqualified Persons together are deemed to hold 51 percent of the XYZ Company stock, which exceeds the 50 percent non-allocation year threshold.

An ESOP that has a prohibited allocation under IRC §409(p) in a non-allocation year is treated as having made a distribution of the prohibited allocation to the individual on whose behalf the allocation was made. The S corporation is liable under IRC §4979A(a) for an excise tax equal to 50 percent of the amount of the prohibited allocation. In the first non-allocation year the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person that are held by the ESOP, even though those shares were not first allocated to the disqualified person in that year. Finally, the S corporation also is liable for a 50 percent excise tax with respect to any synthetic equity interest owned by any disqualified person in a non-allocation year. Unlike the tax on prohibited allocations, which is imposed only once for each prohibited allocation, the tax on ownership of synthetic equity by a disqualified person during a non-allocation year is assessed every non-allocation year.

Dividends

Defined contribution plans normally do not distribute current plan earnings to participants and beneficiaries, primarily because of legal constraints and adverse tax consequences for participants. However, ESOPs operate differently with respect to dividends paid on employer securities, in part because of special dividend deduction rules.

A C corporation may deduct dividends paid on employer securities held by a leveraged ESOP maintained by the corporation or a controlled group member, provided that the dividends are:

• paid in cash directly or through the ESOP to ESOP participants or their beneficiaries;
• reinvested in employer securities, if participants have been given the election to receive the dividends in cash or to reinvest them in employer securities; or
• used to repay an ESOP loan.

The IRS has privately ruled that dividends paid by a foreign corporation that is subject to U.S. taxes are eligible for this deduction as well. However, since the issuance of the private letter ruling (which is not binding precedent), the IRS has published proposed regulations that would deny a deduction to a U.S. subsidiary of a foreign parent for dividend payments made by the parent. In addition, the IRS has the authority to disallow a dividend deduction that constitutes an avoidance or evasion of taxation.
**Dividends Paid to Participants**

Dividends paid to ESOP participants or their beneficiaries are deductible if they are paid in cash directly or paid to the ESOP with a subsequent distribution to participants or beneficiaries within 90 days after the end of the plan year in which the dividends are paid.\(^86\) The corporation paying the dividends is entitled to take a deduction in the year in which the ESOP participants or beneficiaries have a corresponding income inclusion.\(^87\) Accordingly, if dividends are paid in cash directly to ESOP participants, the deduction is permitted in the year the dividends are paid. If dividends are paid in cash to the ESOP and then distributed to participants not later than 90 days after the close of the plan year, the deduction is permitted in the employer’s taxable year in which the dividends are distributed from the ESOP to its participants.

IRC §404(k) dividends paid in cash to ESOP participants and beneficiaries are treated as taxable income to those persons rather than a nontaxable return of basis (even if an employee has employee contributions or basis in the plan).\(^88\) Although such cash dividends constitute ordinary income to the participants and beneficiaries, they are exempt from the 10 percent penalty tax on early distributions from qualified plans.\(^89\) Tax withholding is not required with respect to such dividend payments\(^90\) and the payments are exempt from the $5,000 mandatory distribution restrictions.\(^91\) However, they are not eligible for tax-free rollover to an IRA or another qualified plan.\(^92\) Also, dividends that are paid to an ESOP and passed through to the participants (or that are paid directly to ESOP participants with respect to their allocated ESOP shares) are not eligible for the 15 percent tax rate on qualified dividends.\(^93\)

The special rules for distributions of dividends paid on employer securities held in an ESOP specifically refer to dividends as described in IRC §404(k), which does not cover S corporations. Therefore, the special dividend distribution rules are not available to S corporations. Any S corporation distributions that are passed through an ESOP in a manner similar to C corporation dividends will be treated as distributions from the plan. The 10 percent penalty tax on early distributions will apply, withholding will be required, participants whose account balances exceed $5,000 must consent in writing to receive the distribution, and the distribution will be eligible for rollover to an IRA or a qualified plan.\(^94\)

**Dividends Reinvested in Employer Securities**

Under IRC §404(k)(2)(A), an ESOP sponsor may give participants and their beneficiaries an opportunity elect to reinvest applicable ESOP dividends in qualified employer securities through their accounts in the ESOP without causing the employer to lose the dividend deduction. According to IRS Notice 2002-2,\(^95\) an ESOP sponsor that offers such an election must allow participants to elect, at a minimum:

- either (i) payment of dividends in cash, or (ii) payment to the ESOP and distribution in cash (not later than 90 days after the close of the plan year in which the dividends are paid by the corporation); or
- payment of dividends to the ESOP for reinvestment in employer securities.\(^96\)

An ESOP may offer participants a choice among the two cash payment options and the reinvestment option. Also, the ESOP may provide that one of the options will be the default election for participants who fail to submit their dividend elections.

Dividends that are paid or reinvested as provided in IRC §404(k)(2)(A)(iii) are not treated as annual additions under IRC §415(c), elective deferrals under IRC §402(g), elective contributions

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under §401(k), or employee contributions under §401(m). Dividends that are reinvested in qualifying employer securities at a participant’s election must be nonforfeitable.

For dividends covered by a participant election to be considered “applicable dividends” that may be deducted under IRC §404(k)(2)(A), the participant dividend election must satisfy the following requirements:

- participants must be provided a reasonable opportunity to make the election before the dividend is paid or distributed;
- participants must have a reasonable opportunity to change their dividend elections at least annually; and
- if there is a change in plan terms governing the manner in which the dividends are paid or distributed to participants, participants must be given a reasonable opportunity to make elections under the new plan terms before the date on which the first dividend subject to the new plan terms is paid or distributed.

Notice 2002-2 provides that dividends reinvested in employer securities are deductible by the employer corporation in the later of the taxable year of the corporation in which the dividends are reinvested in employer securities at the participant’s election or the taxable year in which the participant’s election becomes irrevocable. Under the Notice, an election is not considered made until the date the election becomes irrevocable, so dividends are not considered to be reinvested before the participant’s election becomes irrevocable.

Dividends that are reinvested in qualifying employer securities at the participant’s election lose their identity as dividends and are treated as earnings in the same manner as dividends with respect to which a participant is not provided an election. Therefore, for example, dividends that are reinvested at a participant’s election are not eligible for the exception to the 10 percent penalty tax on early distributions for dividends paid on employer securities under IRC §404(k), nor are such amounts treated as dividends for purposes of IRC §§72, 402, 411(a)(11), or 401(k).

To satisfy the §404(k) vesting requirement, an ESOP must provide that a participant is fully vested in any dividend with respect to which the participant is offered an election under IRC §404(k)(2)(A)(iii). An ESOP may comply with this requirement by providing that participants are fully vested in dividends with respect to which an election is offered, without regard to whether the participant is vested in the stock for which the dividend is paid. An ESOP also may comply with the vesting requirement by offering an election only to vested participants.

**Dividends Used to Make Loan Payments**

A corporation that sponsors a leveraged ESOP may use dividends or distributions paid on employer securities held by the ESOP to make loan repayments. For dividends or distributions paid on allocated shares to be deductible and, in the case of S corporations, to avoid violating the plan qualification and prohibited transaction rules, employer securities with a fair market value of not less than the amount of the dividends or distributions must be allocated to participant accounts for the year in which the dividends or distributions would have been paid to the participants. This deduction applies only to dividends or distributions paid on employer securities (whether or not they are allocated to participant accounts) actually acquired with the proceeds of the loan that is being repaid. Dividends or distributions paid on shares in an ESOP that were not acquired with the loan proceeds (e.g., shares contributed by the employer or acquired with the proceeds of another loan) are not eligible for the deduction or, with respect to S corporations, the qualification and prohibited transaction relief. If an ESOP loan is refinanced,
dividends or distributions on shares acquired with the original loan may be deducted or eligible for the qualification and prohibited transaction relief if they are used to pay the refinanced debt.107

**Benefit Distribution Timing and Form**

A closely-held company that maintains an ESOP must consider the liquidity needs that will arise in the future and the “repurchase liability” the ESOP will create. Careful planning at the time an ESOP is established (and periodic review of the repurchase obligations) is necessary to ensure that the ESOP and the employer can accommodate participant and plan demands for cash as benefits become distributable from the ESOP. An ESOP sponsor can control repurchase liability to some extent by spreading out distributions, contributing a combination of employer securities and cash, carefully timing stock purchases and planning its use of dividends or distributions on employer securities and income on other plan assets.

**Distribution Requirements**

An ESOP, like other qualified deferred compensation plans, must provide that, unless a participant elects otherwise, the distribution of his or her vested account balance will begin not later than one year after the end of plan year during which he or she terminates employment because of retirement on or after the plan’s normal retirement age, disability or death or, if he or she resigns or is dismissed, not later than one year after the end of the fifth plan year following the plan year during which he or she terminates employment (unless the employer reemploys him or her before such year).108 An ESOP must further provide that, unless the participant elects otherwise, his or her ESOP account balance will be distributed in substantially equal periodic payments (not less frequently than annually) over a period that does not exceed five years.109 ESOP distributions generally are eligible for rollover to an IRA or another qualified retirement plan.110

If an ESOP participant has an account balance that exceeds $915,000 (in 2007, as adjusted for inflation), the distribution may take place over a period of up to five years, plus one year (or fraction thereof, not exceeding five additional years) for each $180,000 (in 2007, as adjusted for inflation) by which a participant’s account balance exceeds $850,000.111 The $915,000 and $180,000 limits are adjusted at the same time and manner as the defined benefit and defined contribution plan dollar limits under IRC §415.112 Subject to these requirements, an ESOP may modify its distribution options in a nondiscriminatory manner without violating the anticutback rule of IRC §411(d)(6).113

**Example:** David's vested ESOP account balance when he terminates employment in 2007 is $1,200,000. At that time, the ESOP has no outstanding acquisition loans, so David is eligible for immediate commencement of distributions. The ESOP administrator may distribute David's benefits in substantially equal annual payments of approximately $180,000 each for six years and the remainder of approximately $90,000 in the seventh year.

With respect to a leveraged ESOP, the general distribution timing requirements summarized above do not apply to the portion of a participant’s ESOP account balance that consists of employer securities acquired with the proceeds of an exempt ESOP acquisition loan until the end of the plan year in which the entire loan is repaid.114 The requirements also do not apply to employer securities acquired before January 1, 1987, although some employers may elect to extend such requirements to all plan distributions.115 However, distributions may be required earlier in certain circumstances covered by IRC §401(a)(9) and (14). In particular, commencement of distributions of employer securities acquired with the proceeds of an ESOP
loan may not be deferred by the plan sponsor past a participant’s normal retirement date, regardless of the repayment status of the loan.

Special considerations may arise with respect to rehired ESOP participants. Most ESOPs do not have a repayment provision under the cash-out and buy-back rules of ERISA. Instead, ESOPs often provide for automatic restoration of forfeited amounts for partially vested reemployed participants. The primary reason for this distinction between ESOPs and other defined contribution plans is that a repayment to an ESOP that resembles a profit-sharing plan participant’s repayment of a cash distribution received upon employment termination could present an issue under the Securities Act of 1933 and relevant state securities laws. In the repayment situation, a benefit distribution is repaid to a plan voluntarily by an employee. None of the securities law exemptions would be available because employee “contributions” are being used to acquire employer securities. If state securities laws permit, an ESOP sponsor might consider establishing a separate account vesting schedule or drafting the plan to provide that any repayments will not be used to purchase employer stock.116

**Right to Demand Employer Securities / Put Option**

ESOP benefits generally must be distributable in whole shares of employer stock, although the value of any fractional share may be paid in cash.117 Therefore, an ESOP must provide that a participant who is entitled to receive a distribution may demand that his or her benefits be distributed in the form of employer securities.118 If a terminated participant or beneficiary does not request a stock distribution, benefits may be distributed in cash if the plan document provides for cash distributions.

If an ESOP sponsor’s corporate charter or by-laws restrict ownership of “substantially all” outstanding employer securities to employees or to a trust qualified under IRC §401(a), or if the ESOP sponsor is an S corporation, the ESOP may distribute all benefits in cash without granting participants the right to demand stock.119 Alternatively, the plan may distribute employer securities subject to a requirement that the securities be immediately resold to the employer under terms that satisfy the put option payment requirements.120

If employer securities held by an ESOP are not readily tradable on an established market, the ESOP participants must be given the right (a “put option”) to require the employer (not the ESOP) to repurchase distributed employer securities under a fair valuation formula.121 The fair market value for the stock subject to this put option is to be determined by an independent appraiser in accordance with IRC §401(a)(28)(C). To satisfy the put option requirement, the ESOP generally may use the fair market value of the employer securities determined as of the immediately preceding valuation date under the ESOP.122

The put option period must cover at least 60 days following the date of distribution. If the put option is not exercised during that period, an additional put option period of at least 60 days must be made available during the next plan year, generally after the new valuation of employer stock has been completed and communicated to the former participant.123 The put option may not bind the ESOP to repurchase the stock, but may permit the ESOP to purchase stock tendered to the employer.124

When a participant or beneficiary takes a total distribution of the employer securities held in his or her ESOP account in one taxable year and exercises his or her put option, the employer must pay the option price in either a single sum or in substantially equal annual installments over a period that begins no later than 30 days after the distributee exercises the option and extends no longer than five years.125 If the employer chooses the installment payment method, the employer also must provide “adequate security” for the unpaid amounts and must pay a “reasonable” rate...
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of interest on those amounts. According to the IRS, “adequate security” means security that is backed by something tangible that may be sold, foreclosed upon or otherwise disposed of in case of default. If a participant or beneficiary is receiving installment distributions of his or her ESOP benefits and exercises a put option with respect to an installment, the employer must pay the fair market value of the shares covered by the put option election within 30 days after the exercise.

Diversification

IRC §401(a)(28) Diversification

ESOP assets, unlike the assets of most other qualified plans, usually are not invested in a broad range of investment alternatives. Therefore, an ESOP must provide “qualified participants” – those who are at least age 55 and have at least 10 years of participation in the plan – an opportunity to “diversify” their plan holdings that consist of employer securities acquired by the ESOP after 1986. To satisfy this diversification requirement, the ESOP must permit the qualified participants to direct the investment of a certain percentage of the employer securities held in their ESOP accounts into other investment options during the “qualified election period.” The “qualified election period” is the six-plan-year period beginning with or after the plan year in which the participant attains age 55 (or, if later, beginning with the plan year in which the participant completes 10 years of plan participation). Qualified participants are entitled to make their diversification elections during the first 90 days of each plan year during the election period.

An ESOP may satisfy this diversification requirement in two ways. Under one alternative, the plan may distribute to a participant, in stock or cash, the portion of the participant’s account subject to the diversification requirement within 90 days after the period in which the diversification election may be made. If the ESOP distributes stock, the put option requirements apply and the stock may be rolled over into an IRA. An IRA that receives a rollover of ESOP stock retains the put option if the stock is not readily tradable on an established market at the time of distribution. If the ESOP distributes cash, the participant may roll the cash over into an IRA or another qualified plan that accepts rollovers. Any portion of a diversification distribution that is not rolled over is subject to taxation, including the 10 percent early distribution penalty under IRC §72(v).

The other alternative is for the ESOP to make available to qualified participants at least three diversified investment options (other than employer stock). An option to transfer assets to a plan that permits employee selfdirection of investments (such as the employer’s 401(k) or profit-sharing plan) satisfies the diversification requirement, but an option to invest in employer securities does not.

The ESOP is only required to offer the distribution or investment options to qualified participants. A participant does not have to accept the diversification opportunity and may choose to keep his or her ESOP account fully invested in employer securities.

De Minimis Exception

If the fair market value (determined as of the valuation date immediately preceding the first day in which a qualified participant is eligible to make a diversification election) of the employer securities acquired by or contributed to an ESOP after 1986 and allocated to a qualified participant’s account is $500 or less, these securities will be considered a de minimis account that is not subject to the diversification requirement. For this purpose, employer securities held in a qualified participant’s accounts in all of the ESOPs maintained by an employer and the
members of the controlled group of corporations that include the employer are considered to be held by the same plan. If the fair market value of employer securities acquired by or contributed to an ESOP after 1986 and allocated to the account of a qualified participant exceeds the de minimis amount for any year of the participant’s qualified election period, then all shares allocated to the account of that qualified participant after 1986 are subject to the diversification requirements in each remaining year of the participant’s qualified election period.

**Calculation of Diversification Portion**

The portion of a qualified participant’s account that is subject to the diversification election during the qualified election period is equal to:

- 25 percent (for the first five years of the qualified election period) of the total number of shares of employer securities acquired by or contributed to the plan after 1986 that have ever been allocated to the qualified participant’s account on or before the most recent plan allocation date, less
- the number of shares of employer securities previously distributed, transferred or otherwise diversified pursuant to a diversification election made after 1986.

The resulting number of shares may be rounded to the nearest whole number. With respect to a qualified participant’s final diversification election in the sixth year of the qualified election period, “50 percent” is substituted for “25 percent” in determining the amount subject to the diversification election.

The diversification computation is based solely on the number of shares allocated to the qualified participant’s account. Other assets allocated to the account are not included in the computation.

*Example:* Amy begins participating in an ESOP in 2007 at age 46. Assuming that she remains employed by the employer sponsoring the ESOP, in the year 2017 she will have participated in the plan for 10 years and will be age 56. Therefore, for 2017 and each of the next five plan years, Amy will be eligible to elect a pre-retirement diversification distribution or transfer. If Amy has 100 shares of employer stock credited to her ESOP account at the end of the 2017 plan year, during the first 90 days of 2018 she may elect a diversification distribution or transfer of up to 25 shares (25 percent of 100 shares). Amy elects a distribution of 10 shares. At the end of 2018, Amy has 8 new shares of employer stock credited to her ESOP account. During the first 90 days of 2019, she may elect a distribution or transfer of up to 17 shares (25 percent of 108 total shares allocated to her ESOP account, minus the 10 shares previously diversified). Each year from 2017 through 2021, Amy’s diversification election may result in the distribution or transfer of up to 25 percent of the number of shares allocated to her ESOP account, reduced by the number of shares previously diversified. For 2022, the final year of her qualified election period, Amy may elect to diversify up to 50 percent of the number of shares allocated to her ESOP account, reduced by the number of shares covered by her earlier diversification elections.

**Treatment of Diversification Distributions**

Amounts that are required to be available for diversification and are diversified by distribution generally are treated as amounts that are not held by an ESOP. Therefore, a distribution in satisfaction of a diversification election is not subject to the right to demand employer securities under IRC §409(h). However, to the extent that a distribution in satisfaction of a diversification election consists of employer securities, the distribution is subject to the IRC §409(h) put option provisions. A distribution in satisfaction of a diversification election does not fail to satisfy the anticutback rules of IRC §411(d)(6) merely because it is not available in the form of employer securities or is available only as a single sum distribution.
A distribution or transfer in satisfaction of a diversification election is eligible for the special exception for ESOP benefits under the qualified joint and survivor annuity rules of IRC §§401(a)(11)(C) and 417. However, in the case of an ESOP that is a money purchase pension plan, amounts that have been diversified and remain invested in the ESOP’s other investment funds or have been transferred to another tax-qualified plan may not be distributed before the participant’s separation from service and do not qualify for the special ESOP exception from the qualified joint and survivor annuity rules.141

A distribution in satisfaction of a diversification election must satisfy IRC §411(a)(11), which requires the consent of the participant to a distribution. However, the distribution is not subject to the IRC §401(a) rules that restrict the distribution of plan benefits before employment termination (in the case of a money purchase pension plan) or the occurrence of certain other events (in the case of a profit-sharing plan).142

**IRC §401(a)(35) and ERISA §204(j) Diversification**

The Pension Protection Act of 2006143 requires defined contribution plans that hold publicly traded employer stock to provide new diversification rights for amounts invested in employer stock. These plans are required to permit participants and certain beneficiaries to direct that the portion of their accounts invested in employer stock be reinvested in other investment options.144 The time when the diversification requirements apply depends on the type of contributions (i.e., elective deferrals, employee after-tax contributions, and employer matching contributions) invested in employer stock.

ESOPs that hold employer stock that is not publicly traded generally are not subject to the new diversification requirements.145 If an ESOP sponsor or a member of the ESOP sponsor’s controlled group has issued a class of stock that is publicly traded, that ESOP would be subject to the new requirements even if it does not hold publicly traded stock, unless it satisfies the exemption under the Pension Protection Act for ESOPs that hold publicly traded stock or are under common control with an issuer of publicly traded stock.146 To be exempt from the new diversification requirements, such an ESOP must be a standalone plan (meaning that it is not combined with any other defined contribution or defined benefit plan) and cannot hold contributions, and earnings thereon, that are subject to the nondiscrimination tests applicable to employee elective deferrals, employee after-tax contributions and employer matching contributions.147

Under the new requirements, plans must permit amounts that are attributable to elective deferrals and employee after-tax contributions that are held in employer stock to be invested in alternative investments by participants or beneficiaries who are permitted to exercise participant rights.148 With respect to non-elective employer contributions and employer matching contributions that are held in employer stock, each participant who has completed at least three years of vesting service, a beneficiary of such a participant, and a beneficiary of a deceased participant must be permitted to direct the investment of such amounts in other investment options.149

A transition rule applies to amounts attributable to employer contributions that are invested in employer stock acquired before the plan year beginning in 2007. For the first three years the new requirements apply to plans holding such contributions, the portions of such amounts subject to diversification are as follows:150

- **Plan Year 2007** - 33 percent
- **Plan Year 2008** - 66 percent
- **Plan Year 2009** - 100 percent
Example: If Participant A, who has three years of vesting service, has 150 shares of employer stock contributed as employer matching contributions allocated to his account as of December 31, 2006, 50 shares of employer stock are subject to diversification during the first year, 99 shares may be diversified in the second year, and 150 shares may be diversified in the third year.

The transition rule does not apply to the employer contribution accounts of participants who are age 55 and have completed at least three years of service before the first plan year beginning after December 31, 2005. Such participants must be given the opportunity to diversify all or a portion of their employer contribution accounts held in employer stock during the first plan year beginning after December 31, 2006.151

The new diversification requirements require a plan to provide a participant or beneficiary a choice of at least three investment alternatives other than employer stock. The investment alternatives must be diversified and must have materially different risk and return features.152 Diversification opportunities must be provided at least quarterly and at least as frequently as other investment changes are permitted under the plan.153 A plan may not provide less favorable treatment, such as a lower rate of employer contributions, to a participant who diversifies his or her employer stock account.154

The diversification provisions are effective for plan years beginning after December 31, 2006.155 Special effective dates apply for plans maintained pursuant to collective bargaining agreements and plans with employer matching and non-elective contributions invested in employer preferred stock as of September 17, 2003.156

Anti-Cutback Rules

General

IRC §411(d)(6) and ERISA §204(g) generally provide that a qualified retirement plan may not be amended to decrease the accrued benefit of any participant and that any amendment that eliminates an optional form of benefit under a plan that applies to benefits attributable to service before the amendment is adopted is treated as reducing an accrued benefit. The Treasury regulations list several protected benefits that, to the extent they have accrued, cannot be reduced, eliminated or made subject to employer discretion except under limited circumstances.157 These include early retirement benefits, retirement-type subsidies and optional forms of benefit. An “optional form of benefit” is a distribution form that is available under the plan and is identical as to all features relating to the distribution form, including the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in kind), the portion of the benefit to which the distribution features apply, and the election rights with respect to such optional forms.158

The regulations generally prohibit employer discretion regarding which optional form of benefit will be provided to a participant,159 based on the theory that allowing an employer to select an optional form of benefit for a participant is equivalent to amending the plan to eliminate all of the optional forms not selected for that participant. Therefore, a plan generally may not authorize an employer, or a committee selected by an employer, to choose how distributions to a terminated participant are to be made (e.g., in the form of a lump sum or in the form of installments if both forms of distribution are available under the plan). Similarly, the employer or committee may not choose whether distributions are made in cash or shares of employer securities or the commencement date of a distribution (although the plan may authorize participants to make such choices).
Special ESOP Rules

IRC §411(d)(6)(C) and ERISA §204(g)(3) include a special exception for ESOPs that modify distribution options in a nondiscriminatory manner. Treasury Regulation Section 1.411(d)-4, Q&A-2 lists four types of plan amendment that would violate the anti-cutback rules but for the fact that a plan is eligible for the ESOP exception:

- The employer may eliminate, or retain the discretion to eliminate, a single sum or installment optional form of distribution, provided that the form retained is consistent with the ESOP distribution requirements of IRC §409(o).
- An employer that is substantially employee-owned or is an S corporation may eliminate or retain the discretion to eliminate distributions in the form of employer securities and replace such distributions with distributions in the form of cash, as permitted under IRC §409(h)(2).
- An employer whose stock becomes readily tradable on an established market may eliminate or retain the discretion to eliminate distributions in the form of cash and replace them with distributions in the form of employer securities, with respect to benefits that are subject to IRC §409(h).
- An employer whose stock ceases to be readily tradable on an established market or is sold may eliminate or retain the discretion to eliminate distributions in the form of employer securities.

In each case, the amendments and exercise of discretion must satisfy the nondiscrimination requirements of IRC §401(a)(4). Also, the benefits with respect to which the optional form of benefit is eliminated must have been held in an ESOP (as opposed to another plan that is converted into an ESOP or transfers assets to an ESOP) for at least five years (or for the entire life of the ESOP, if it is fewer than five years old). The Treasury regulations also provide – for all qualified plans, including ESOPs – that, after plan termination, a plan may be amended to substitute distribution in cash for distribution in some other specified form of property, including employer securities, as long as the employer maintains no other plan that provides for distribution in the other specified form of property.

If a plan holds or has distributed securities acquired with the proceeds of an exempt loan and the loan is repaid or the plan ceases to be an ESOP, the put option and anti-cutback protections and rights must continue to exist under the plan terms. However, the protections and rights will not fail to be non-terminable merely because they are not exercisable under regulatory and statutory requirements. For example, if, after a plan ceases to be an ESOP, employer securities acquired with the proceeds of an exempt loan cease to be publicly traded, the normal put option periods include the time during which the securities are publicly traded.

If an ESOP sponsor sells its stock, including the shares held by the ESOP, the employer must consider the right of participants to receive distributions in the form of employer securities. When the ESOP sponsor’s stock is sold, the ESOP will receive property other than employer securities, making it impossible in most cases to comply with the employer stock distribution requirement, even though the anti-cutback regulations provide that such a right generally may not be eliminated. The regulations do state that certain terminating plans that offer a stock distribution right may be amended to eliminate that right prospectively if, upon termination, a current right to receive employer securities is provided. However, in most sale situations it is inappropriate to offer such a current right. Therefore, an ESOP sponsor that is selling or considering an offer for its stock must determine what course to take with the ESOP and whether or not it may cease to provide an employer security distribution option. The ESOP sponsor might argue that following the sale the ESOP ceases to exist and becomes a profit-sharing plan that
Additional alternatives may be available to an ESOP sponsor that is a substantially employee-owned company and is exempt under IRC §409(h)(2) from distributing stock if the acquirer continues to maintain the ESOP.

**Annual Valuation**

All defined contribution retirement plans are required to provide participant account statements at least once each calendar year. Plans that permit participants to direct the investment of their account assets must provide account statements at least once each calendar quarter. The account statement requirement often is more burdensome for ESOPs than for other defined contribution plans, particularly if the employer securities held by an ESOP are not publicly traded. The proper valuation of employer securities contributed or sold to an ESOP is an important and difficult aspect of plan administration. Improper valuation may result in the loss of some deductions if the valuation is overstated. If an ESOP purchases securities for more than their fair market value, an excise tax could be imposed and, in egregious circumstances, the ESOP could be disqualified.

IRC §401(a)(28)(C) provides that an ESOP that holds employer securities acquired after 1986 that are not readily tradable on an established securities market must have all valuations of those securities made by an independent appraiser. An “independent appraiser” means any appraiser that satisfies requirements similar to the requirements described in the regulations under IRC §170(a)(1). Generally, the ESOP independent appraiser should be a person who does not perform any services for a party whose interests may be adverse to the ESOP and who would satisfy an objective standard of impartiality.

Treasury Regulation Section 54.4975-11(d)(5) states that “valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities.” For transactions that do not involve a disqualified person, value may be determined as of the most recent annual valuation date and an independent appraisal will be determinative. For transactions between a plan and a disqualified person, value must be determined as of the date of the transaction, and an independent appraisal will be required for acquisitions after 1986.

The Department of Labor proposed regulations defining “adequate consideration” under ERISA §3(18) in 1988. Although these proposed regulations have not been finalized, many practitioners rely on the proposed regulations as the most definitive guidance available regarding the valuation of stock of closely-held companies for ESOP purposes.

**Voting Rights**

IRC §409(e) contains voting right pass-through requirements that apply to ESOPs and stock bonus plans of employers whose stock is not publicly traded. Profit-sharing plans are not subject to such requirements. In general, if an employer has a class of securities required to be registered under Section 12 of the Securities and Exchange Act of 1934 (the “Exchange Act”) or a class of securities that would be required to be registered except for the registration exemption provided by Section 12(g)(2)(H) of the Exchange Act, then the ESOP must permit each participant to direct the voting of the employer securities allocated to his or her account.

For an ESOP maintained by an employer that does not have registration-type class of securities, the voting rights passthrough is required only with respect to any corporate matter that involves the voting of shares for or against a corporate merger, consolidation, sale of all or substantially all of the corporation’s assets, recapitalization, reclassification, liquidation, dissolution, or such similar transaction as the Treasury Department may prescribe in regulations. No regulations have been issued to provide more guidance regarding the requirements for complying with this
The voting rights requirements of IRC §409(e) apply only to shares of employer stock allocated to participant accounts. To the extent that shares in an ESOP are not allocated (such as shares acquired since the last allocation date, or shares held in a suspense account), the ESOP trustee may exercise its discretion in voting such shares, unless the plan provides otherwise.

After October 21, 1986, an ESOP sponsored by a corporation that does not have a registration-type class of securities may provide each participant one vote on each issue on which he or she is entitled to direct the trustee to vote (without regard to the actual number of shares allocated to his or her account) and the trustee may vote the shares held in the plan in the proportions so directed by participants. Under this voting method, the trustee does not vote unallocated shares in its discretion. The IRS has ruled that an ESOP trustee may vote shares allocated to participants’ and beneficiaries’ accounts for which no directions are timely received without causing the ESOP to fail to comply in operation with the pass-through voting requirements of §409(e)(2).

The DOL has issued guidance regarding the duties of employee benefit plan fiduciaries in proxy voting situations which generally applies to all defined contribution retirement plans. However, DOL Interpretive Bulletin 94-2 also provides guidance that is particularly pertinent for ESOP fiduciaries regarding the requirements for more active monitoring of corporate management. The DOL’s opinion is that, in situations in which proxy voting decisions may affect the value of a plan’s investment in company stock, plan fiduciaries should make voting decisions with a view to enhancing value, taking into account the period over which the plan expects to hold the stock. In certain situations, it may be appropriate for a plan fiduciary to act to monitor or influence corporate management if the fiduciary expects that such activities are likely to enhance the value of the plan’s investment.

The DOL Bulletin lists several issues that might prompt active monitoring and communication by fiduciaries, including the following:

- investigating the independence and expertise of candidates for the board of directors
- ensuring that the board of directors has sufficient information to carry out its responsibility to monitor management
- determining the appropriateness of executive compensation
- examining corporate policy regarding mergers and acquisitions
- analyzing the extent of debt financing and capitalization
- investigating long-term business plans and workforce development; and
- reviewing financial and non-financial measures of corporate performance.

Fiduciaries may carry out their monitoring and communication role through various methods, such as conducting meetings and corresponding with corporate management and exercising the legal rights of a shareholder.

**Fiduciary Duties**

An ESOP and its fiduciaries are subject to the general fiduciary rules of ERISA §404(a), although the application of such rules to an ESOP often differs from the application to other qualified plans. For example, ERISA provides special exemptions for ESOPs with respect to the investment diversification requirements and related rules.
Exclusive Purpose and Prudence Rules

Although an ESOP is subject to the “exclusive purpose” and “prudence” requirements of ERISA that apply to all qualified defined contribution plans subject to ERISA, the application of these rules to ESOP fiduciaries must take into account the special attributes of an ESOP as a plan “designed to invest primarily in qualifying employer securities.”181 Under ERISA §404(a)(1), ESOP fiduciaries are responsible for acquiring employer stock for the benefit of participants in a manner that demonstrates compliance with the “exclusive purpose” and “prudence” rules under ERISA. The fiduciaries’ responsibility is not to maximize retirement benefits through investments in assets other than employer stock, but to maximize the benefits that may be achieved by investing ESOP assets primarily in employer stock.182

Qualified plans are prohibited from investing in employer securities that are not “qualifying employer securities” and ERISA generally limits plan investments in qualifying employer securities to 10 percent of plan assets.183 However, the 10 percent limit does not apply to investments in qualifying employer securities (or qualifying employer real property) by an “eligible individual account plan.”184 Eligible individual account plans include:

- profit sharing, stock bonus, thrift and savings plans;
- ESOPs, as defined in ERISA §407(d)(6); and
- certain money purchase plans that were invested primarily in qualifying employer securities on September 2, 1974 (the date ERISA was enacted).

Under these rules, an ESOP may invest 100 percent of its assets in qualifying employer securities (or qualifying employer real property).185 To the extent that an ESOP invests in assets other than qualifying employer securities or real property, the diversification requirements of ERISA §404(a)(1)(C) apply.

Directed Trustee

Like other defined contribution plans, an ESOP is required to have a trustee or custodian that manages or controls plan assets.186 In many cases, the trustee is a “directed trustee” that conducts transactions according to instructions from a named fiduciary of the plan, which often is the plan sponsor or a committee appointed by the plan sponsor. A plan trustee by definition always will have some fiduciary responsibility under ERISA because of its control over plan assets. However, in most cases the fiduciary responsibilities of a directed trustee are narrower than the fiduciary responsibilities generally held by a discretionary trustee.

DOL guidance about the fiduciary responsibilities of directed trustees, particularly with respect to directions that relate to employer securities, highlights special issues that ESOP sponsors (as well as sponsors of other types of plans that invest in employer stock) need to consider as they appoint or monitor their fiduciaries.187 Despite a directed trustee’s limited fiduciary responsibilities, the trustee is required to perform its duties prudently and solely in the interest of plan participants and beneficiaries. Given that an ESOP is designed to invest primarily in employer securities, the directed trustee must monitor company operations and investigate transactions and developments as they occur and carry out directions only if they are in accordance with the ESOP terms and do not conflict with ERISA.

Special considerations arise when an ESOP has a directed trustee and a tender offer is made to purchase the employer securities held by the ESOP. The ESOP may allow participants to direct the trustee whether to tender employer stock allocated to their accounts. ERISA §403(a)(1) provides that a trustee may carry out the directions of named fiduciaries, including participants, if the directions are proper, made in accordance with plan provisions and not contrary to ERISA (for
which there is little guidance). However, if a direction would result in a breach of a fiduciary duty, the trustee may be liable for any loss as a result of following the direction unless it seeks court instructions.\footnote{188}

In GCM 39870, the IRS Chief Counsel advised that an ESOP provision that allowed the trustee to consider non-financial employment-related factors in tender offer situations, such as the continuing job security of participants, violates the exclusive benefit rule of IRC §401(a)(2). The GCM noted that the DOL had concluded that this provision also violated the exclusive benefit rule of ERISA §404(a), but indicated that the IRS has independent authority to construe the disputed provision and impose the separate sanction of plan disqualification. The GCM concluded that a plan provision that permits consideration of non-financial factors violates the prudent person standard in Revenue Ruling 69-494 because it permits trustees to reject tender offers that would be acceptable if financial factors alone were considered.\footnote{189}

According to the Treasury Department and the DOL, decisions relating to tender offers must be based on the economic best interest of an employee benefit plan that holds employer securities, recognizing that the plan is a separate legal entity designed to provide retirement income.\footnote{190} Prudence also requires fiduciaries to make investment decisions, including tender offer decisions, based on the facts and circumstances applicable to a particular plan. Therefore, an ESOP trustee – particularly one that is directed

Conclusion

An ESOP is a unique form of qualified defined contribution retirement plan because it allows the sponsoring employer to provide valuable retirement benefits and an equity interest in the company to a broad base of employees while simultaneously increasing the employer’s corporate finance alternatives and/or fulfilling other objectives. In part because of their uniqueness and the specific tax rules that apply to them, many of which are addressed in this report, ESOPs present many complexities with respect to plan design and operational compliance. Despite the similarities between ESOPs and other defined contribution plans, employers that are considering establishing ESOPs, as well as those who have implemented them, must take special care to ensure that they consider all of the planning opportunities and nuances of ESOPs and comply with the special ESOP requirements under the tax code and ERISA.

APPENDIX

- DOL Advisory Opinion 836A (January 24, 1983).
- PLR 9442015.
- PLR 200436015 and PLR 9548036.
- IRS Announcement 95-33.
- PLR 200243055.
- PLR 200237026.
- PLR 8921011.
• TAM 9435001.
• TAM 9516003TAM.
• PLR 9847005.
• PLR 200122034.
• TAM 9438002.
• IRS Announcement 92-182.
• DOL Interpretive Bulletin 94-2.
• DOL Field Assistance Bulletin 2004-03 (December 17, 2004).

Footnotes

1 IRC §414(i); ERISA §3(34).
2 IRC §414(j); Treas. Reg. § 1.4011(b).
3 For ESOP sample plan language and an IRS checklist of ESOP provisions, see Practice Aids.
4 Treas. Reg. § 1.4011(a)(2)(iii) and (b)(1)(iii).
6 Treas. Reg. §54.4975-11(b).
7 DOL Advisory Opinion 836A (January 24, 1983).
9 IRC §401(a)(3).
10 Treas. Reg. §54.4975-11(e).
11 Treas. Reg. §1.410(b)-7(e).
12 Treas. Reg. §§1.401(k)-1(b)(5)(ii) and 1.401(m)-1(b)(3).
13 Treas. Reg. §§1.401(k)-1(b)(4)(i)-(vi) and 1.401(m)-1(b)(4) (effective for plan years beginning on and after January 1, 2006).
14 Treas. Reg. §1.401(a)(4)-2(b).
15 Treas. Reg. §1.401(a)(4)-1(b)(3).
19 Treas. Reg. §1.401(a)(4)-2(c).
20 Treas. Reg. §54.4975-11; DOL Reg. §2550.408b-3.
21 Treas. Reg. §54.4975-11(c).
29 Treas. Reg. §1.401-1(b)(1)(iii); but see IRC §409(h)(2).
30 IRC §§409(m) and 1032.
31 DOL Reg. § 2550.408b-3(c); Treas. Reg. §54.4975-7(b)(3)(i).
32 DOL Reg. § 2550.408b-3(d); Treas. Reg. §54.4975-7(b)(4).
33 DOL Reg. §2550.408b-3(g); Treas. Reg. §54.4975-7(b)(7).
34 DOL Reg. §2550.408b-3(c)(2); Treas. Reg. §54.4975-7(b)(3)(ii).
35 DOL Reg. § 2550.408b-3(c)(3); Treas. Reg. §54.4975-7(b)(3)(iii).
36 IRC §4975(d)(3); ERISA §408(b)(3); DOL Reg. § 2550.408b-3(e); Treas. Reg. §54.4975-7(b)(5).
37 Treas. Reg. §54.4975-7(b)(8)(ii). The principal-only method is subject to special requirements described in Treas. Reg. §54.4975-7(b)(8)(ii).
38 DOL Reg. § 2550.408b-3(h); Treas. Reg. §54.4975-7(b)(8).
39 DOL Reg. § 2550.408b-3(e); Treas. Reg. §54.4975-7(b)(5).
40 DOL Reg. § 2550.408b-3(e); Treas. Reg. §54.4975-7(b)(5).
41 DOL Reg. § 2550.408b-3(f) and (m); Treas. Reg. §54.4975-7(b)(7), (13).
42 DOL Reg. § 2550.408b-3(j); Treas. Reg. §54.4975-7(b)(10).

43 DOL Reg. §2550.408b-3(d); Treas. Reg. §54.4975-7(b)(4).

44 IRC §4975(a).

45 IRC §4975(b).

46 Eligible compensation for purposes of the 25 percent limitation in IRC §404(a)(9)(A) does not include the compensation of employees who are ineligible to share in the allocation of stock acquired by an ESOP in an IRC §1042 sale. See PLR 9442015.

47 IRC §404(a)(9)(B).

48 IRC §404(a)(9)(C).

49 See, e.g., PLR 200436015 and PLR 9548036.

50 IRC §415(f)(1)(B).

51 Treas. Reg. §54.4975-11(d).

52 Treas. Reg. §54.4975-11(c) and (d).

53 Treas. Reg. §54.4975-7(b)(8).

54 Treas. Reg. §54.4975-7(b)(8)(ii).


57 PLR 200243055. See also Treas. Reg. §1.415-2(b)(1)(iv).

58 See, e.g., Steel Balls, Inc. v. Commissioner, 69 TCM 2912, affirmed in an unpublished opinion, 8th Cir. No. 95-3431 (1996).

59 IRC §409(n)(3)(A))

60 Treas. Reg. §1.1042-1T, Q&A-2(c).


62 IRC §409(n)(3)(C).

63 IRC §409(p).

64 IRC §4975(e)(7).

65 Treas. Reg. §1.409(p)-1.

66 IRC §409(p)(4).

67 IRC §409(p)(4)(D).

69 Treas. Reg. §1.409(p)-1T(c)(1).
70 Treas. Reg. §1.409(p)-1T(c)(2).
71 IRC §409(p)(4)(C).
72 IRC §409(p)(5).
73 IRC §409(p)(6)(C).
75 IRC §409(p)(3). See Treas. Reg. §1.409(p)-1(c)(1).
76 Treas. Reg. §1.409(p)-1(c)(1).
77 Treas. Reg. §1.409(p)-1(c)(2).
78 IRC §409(p)(2).
79 IRC §4979A(e)(2)(C).
80 IRC §4979A(a)(4).
81 IRC §4979A(a)(4).
82 IRC §404(k).
83 See, e.g., PLR 200237026.
84 Prop. Treas. Reg. §1.404(k)-2.
85 IRC §404(k)(5)(A).
86 IRC §404(k)(2)(A)(i),(ii).
87 IRC §404(k)(4)(A).
88 Treas. Reg. §1.404(k)-1T, Q&A-3.
89 IRC §72(t)(2)(A)(vi).
90 IRC §3405(e)(1)(B)(iv).
91 IRC §411(a)(11)(C).
92 Treas. Reg. §1.402(c)-2, Q&A-4(e).
94 Corporate law “dividends” in an S corporation may not be treated as “dividends” for tax purposes because a “dividend” for tax purposes must be paid from current or accumulated earnings and profits, which an S corporation does not have (unless it carries over accumulated earnings and profits from a prior status as a C corporation). IRC §§316 and 1371(c).
Notice 2002-2, Q&A-2.

Notice 2002-2, Q&A-6.

IRC §404(k)(4)(B) and (7).

Notice 2002-2, Q&A-3.

Notice 2002-2, Q&A-4.

Notice 2002-2, Q&A-7.

Notice 2002-2, Q&A-7.

Notice 2002-2, Q&A-9.


IRC §404(k)(2)(B).

IRC §404(k)(2)(A)(iv). This restriction applies only to shares acquired after the effective date of the Omnibus Reconciliation Act of 1989 – August 5, 1989. Dividends on employer securities acquired before this date may be used to make payments on a subsequent ESOP loan. PLR 8921011; TAM 9435001; TAM 9516003.

PLR 9847005.

IRC §409(o)(1)(A).

IRC §409(o)(1)(C)(i).

A rollover of S corporation stock to an IRA is available only under limited circumstances. See, e.g., PLR 200122034.

IRC §409(o)(1)(C)(ii).

IRC §409(o)(2).

IRC §411(d)(6)(C). Treas. Reg. §1.411(d)-4, Q&A-2(d) lists several types of ESOP plan amendments that may eliminate optional forms of benefit under §411(d)(6)(C).

IRC §409(o)(1)(B). It is unclear whether an S corporation ESOP may take advantage of this exception, because IRC §404(a)(9)(C) states that §404(a)(9) shall not apply to an S corporation.


Treas. Reg. §1.411(a)-7(d)(5)(iii).

IRC §401(a)(23).

IRC §409(h)(1).

IRC §409(h)(2)(B)(ii).
120 IRC §409(h)(1)(B) and (2).

121 IRC §409(h)(1). This put option requirement applies to all shares of employer stock acquired after 1979 if the shares are not "readily tradable on an established market" at the time of distribution. The requirement applies to leveraged shares acquired by an ESOP and any shares acquired by a tax-credit ESOP after September 30, 1976.


123 IRC §409(h)(4).

124 Treas. Reg. §54.4975-7(b)(10).

125 IRC §409(h)(5)(A).

126 IRC §409(h)(5)(B).

127 TAM 9438002.

128 IRC §409(h)(6).

129 IRC §401(a)(28)(B).

130 IRC §401(a)(28)(B)(iii).


132 IRC §402(c).

133 IRC §401(a)(28)(B)(ii)(II). If the trustee prefers to minimize its fiduciary liability for the investment decisions made by participants in the selection of one of these funds, the plan should be designed to comply with ERISA §404(c) and DOL Reg. § 2550.404c-1.


136 Notice 88-56, Q&A-7.

137 Notice 88-56, Q&A-8.


139 Notice 88-56, Q&A-14.

140 Notice 88-56, Q&A-14.

141 Notice 88-56, Q&A-16.

142 Notice 88-56, Q&A-14.


144 IRC §401(a)(35)(B); ERISA §204(j)(2).

145 IRC §401(a)(35)(E)(i); ERISA §204(j)(5)(A).
146 IRC §401(a)(35)(F)(i); ERISA §204(j)(D)(i).

147 IRC §401(a)(35)(E)(ii); ERISA §204(j)(5)(B).

148 IRC §401(a)(35)(B); ERISA §204(j)(2).

149 IRC §401(a)(35)(C); ERISA §204(j)(3).

150 IRC §401(a)(35)(H); ERISA §204(j)(7).

151 IRC §401(a)(35)(H); ERISA §204(j)(7).

152 IRC §401(a)(35)(D)(i); ERISA §204(j)(4).

153 IRC §401(a)(35)(D)(ii)(II); ERISA §204(j)(4)(B)(ii).

154 IRC §401(a)(35)(D)(ii)(II); ERISA §204(j)(4)(B)(ii).


158 Treas. Reg. §1.411(d)-4, Q&A1(b)(1).

159 Treas. Reg. §1.411(d)-4, Q&A-4.

160 Treas. Reg. §1.411(d)-4, Q&A-2(d)(2).


163 IRC §409(h).

164 Treas. Reg. §1.411(d)-4, Q&A-2(d).


167 Treas. Reg. §1.411(d)-4, Q&A-2(d).

168 ERISA §105(a)(1)(A)(ii).

169 ERISA §105(a)(1)(A)(i).


171 IRS Announcement 92-182.


173 Prop. DOL Reg. §2510.3-18.
174 IRC §401(a)(22).

175 Section 12(g) of the Exchange Act requires registration of securities if the corporation issuing the securities has total assets of at least $1,000,000 and 750 (or 500) or more stockholders. (An ESOP trust is considered a single shareholder of record on behalf of all of its participants.)

176 Section 12(g)(2)(H) of the Exchange Act exempts from registration “[a]ny interest or participation in any collective trust funds maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (i) a stockbonus, pension, or profit-sharing plan which meets the requirements for qualification under §401 of the Internal Revenue Code....”

177 IRC §§409(e)(3) and 401(a)(22).

178 IRC §409(e)(5). See also DOL Interpretive Bulletin 94-2; DOL Reg. §2509.94-2.


180 DOL Interpretive Bulletin 94-2.

181 IRC §4975(e)(7)(A) and ERISA §407(d)(6).


183 ERISA §407(a)(1) and (2).

184 ERISA §407(b).

185 ERISA §404(a)(2).

186 ERISA §403(a).


188 See, e.g., DOL Reg. §2509.75-5, Q&A-FR-10.
