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PURPOSE

This transmits complete reprint for IRM 4.72.2, Employee Plans Technical Guidance, Employee Stock Ownership Plans (ESOPs).

BACKGROUND

This IRM provides guidance for examiners on how to examine an IRC 4975(e) leveraged ESOP.

NATURE OF CHANGES

This transmittal reissues existing procedures in the new IRM format. IRM 4.72.4 replaces IRM 7.71 Chapter 4 using the same catalog number. These procedures have also been updated to include legislative and regulatory changes up to and including the Taxpayer Relief Act of 1997.

INTENDED AUDIENCE

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4.72.4.1 (08-13-2001)

Overview

- (1) Guidance is provided for examiners on how to examine an IRC 4975(e) leveraged ESOP.
- (2) This guideline considers changes enacted under the Small Business Job Protection Act of 1996 (SBJPA) P. L. 104–188 (see 4.4.2) and the Taxpayer Relief Act of 1997 (TRA '97) P. L. 105–34 (see 4.2.7).

4.72.4.1.1 (08-13-2001)

General ESOP Requirements

- (1) ESOPs are qualified retirement plans designed to invest primarily in employer securities.
- (2) ESOPs are also used as a technique of corporate finance. ESOPs can be used to meet the general financing requirements of a corporation, as well as transfer ownership of corporate stock to employees.
- (3) Generally, qualified plans are not permitted to acquire or hold employer securities or employer real property with a fair market value in excess of 10% of plan assets. See ERISA 406(a)(1)(E), 406(a)(2) and 407(a)(2).
 - a. Eligible individual account plans are specifically exempted from the 10% limitation and the investment diversification rules. See ERISA 407(b)(1), 404(a)(1)(C), and 404(a)(2). Because ESOPs are eligible individual account plans under ERISA 407(d)(3), ESOPs can invest in employer securities without regard to the 10% limitation if the plan document so provides.
- (4) An ESOP can debt-finance its acquisition of employer securities.

4.72.4.1.1.1 (08-13-2001)

How an ESOP Operates

- (1) Following is a scenario of how an ESOP operates within the provisions of the law.
 - a. An ESOP gets a loan from an outside lender, such as a bank. The ESOP signs a promissory note for the money. (In a back-to-back loan, the employer receives the loan and loans the proceeds to the ESOP to acquire employer securities for the ESOP.)
 - b. The employer gives a written guarantee to the bank promising that the ESOP will repay the loan, and each year the employer will pay the ESOP enough money to permit the ESOP to make its annual loan repayment.
 - c. The ESOP uses the money from the loan to buy stock from the employer (or a shareholder). Thus, the employer has received new capital. The loan can be secured by the pledge of the stock acquired by the ESOP.
 - d. The stock is held in an ESOP suspense account, and is released for allocation to participant accounts as the loan is repaid with funds contributed to the ESOP by the employer, and/or by the use of dividends on employer securities in the ESOP.
 - e. Each year, the employer makes a tax-deductible payment to the ESOP sufficient to enable the ESOP to make its annual debt repayment to the bank. As the debt is repaid, employer securities in the ESOP suspense account are released to the participants'

accounts. The employer can repay the acquisition indebtedness of the ESOP out of the earnings from its new capital.

- f. Since the employer's contributions to the ESOP are deductible within the IRC 404(a)(9) limits, a leveraged ESOP allows the company to repay the entire loan on a tax-favored basis.

4.72.4.1.2 (08-13-2001)

**Prohibited
Transaction
Exemption**

- (1) There is a prohibited transaction exemption for loans to a leveraged ESOP. See IRC 4975(d)(3) and IRC 4975(e)(7). The loan to the ESOP is not a prohibited transaction if the loan is:
- a. Primarily for the benefit of plan participants, and
 - b. At a reasonable interest rate and any collateral given to a disqualified person by the plan consists only of qualifying employer securities.
- (2) The leveraging transaction described above would be a prohibited transaction if the plan was not an ESOP. The lending of money or other extension of credit between a plan and a disqualified person, such as the employer, is a prohibited transaction under IRC 4975(c)(1)(B). The employer's guarantee to the lender that the ESOP will repay the loan is an extension of credit to the plan. See Reg. 54.4975-7(b)(1)(ii).

4.72.4.1.3 (08-13-2001)

**Tax Credit
ESOPs**

- (1) Prior to 1987, there were two other forms of ESOPs: Tax Reduction Act stock ownership plan (TRASOP) and Payroll stock ownership plan (PAYSOP).
- a. The Tax Reduction Act of 1975 allowed employers an additional 1% tax credit for a contribution of employer securities to a TRASOP equal to 1% of the employer's qualified investment in property for the year. See IRC 48(n) (repealed).
 - b. An additional 1/2% tax credit was allowed by later legislation for a contribution of employer securities to a TRASOP equal to employee contributions of up to 1/2% of the employer's qualified investment in property for the year (the matching employee plan percentage).
 - c. The Economic Recovery Tax Act of 1981 (ERTA) replaced the TRASOP with the PAYSOP, which provided a tax credit of 1/2% based on the compensation of participants in the PAYSOP paid after 12/31/82. See IRC 41 (repealed). The PAYSOP was repealed by the Tax Reform Act of 1986 (TRA '86) for compensation paid or accrued after 12/31/86.

4.72.4.1.3.1 (08-13-2001)

**Unused Credits
Carryforward**

- (1) The TRASOP and PAYSOP rules are repealed. However, IRC 39 provides for the carryforward of unused business credits. The TRASOP credit may be carried forward for a 15 year period. But the PAYSOP credit had to be elected and funded in the year the compensation was paid.
- (2) Prior to its repeal by TRA '86, IRC 404(i) provided for the deductibility of the unused portion of the employee stock ownership credit. Under IRC 404(i), any part of the credit under IRC 41 that was not allowed for a

taxable year due to IRC 38, was allowed as a deduction for the last taxable year to which it could have been allowed as a credit. This provision is still effective for the portion of the IRC 41 credit attributable to compensation paid or accrued before 1987.

- a. Thus, an otherwise allowable TRASOP credit attributable to a qualifying investment made prior to 1983 may be carried forward for 15 years.
- b. If it has not been exhausted due to the tax liability limitations, that portion may be deducted in the last year (at the latest, the 15th year) without regard to the usual limits on deductions for contributions to qualified plans. See IRC 404(i) (repealed).

4.72.4.1.3.2 (08-13-2001)

**Failure to
Comply Penalty**

- (1) Prior to its repeal by TRA '86, IRC 6699 imposed a penalty on a taxpayer who had claimed the TRASOP or PAYSOP credit for any taxable year and then failed to satisfy all of the IRC 409 requirements or failed to make any required contributions within the specified time.
 - a. The penalty is equal to the amount involved in the failure.
 - b. The "amount involved" is an amount determined by the Secretary of the Treasury, but not greater than the amount of the credit claimed for the taxable year in which the failure occurred and not less than the product of 1/2 of 1% of the maximum amount, multiplied by the number of months, or parts thereof, during which such failure continued.
- (2) No penalty is imposed if the failure is corrected within 90 days after the employer is notified by the Secretary of such failure.
 - a. A separate failure to comply occurs each year in which a failure remains uncorrected.
 - b. IRC 6699 continues to apply to TRASOPs and PAYSOPs that remain in existence.

4.72.4.1.4 (08-13-2001)

**Examination
Steps**

- (1) As part of the pre-examination planning, determine whether Form 5309, Application for Determination of Employee Stock Ownership Plan, has been filed.
 - a. If Form 5309 was not filed, indications are the plan never intended to be an IRC 4975(e)(7) ESOP and/or it has never been updated for changes in the regulations.
 - b. If Form 5309 was filed but does not consider whether the plan complied with the ESOP requirements under IRC 4975(e)(7), then no determination letter was issued to that effect. Indications are only the IRC 401(a) issues were considered on determination.
 - c. If Form 5309 was filed, verify that a determination letter was requested and received specifically with respect to whether the plan is an ESOP under IRC 4975(e)(7).

- (2) A question on the Form 5500 series asks for information about the plan features. Note whether code "A" (ESOP) or code "B"(leveraged ESOP) is filled in.

4.72.4.2 (08-13-2001)

Qualification Requirements

- (1) When the ESOP forms a part of a plan, the ESOP portion of the plan must meet the IRC 4975(e)(7) requirements, certain portions of IRC 409, and the plan as a whole must meet IRC 401.

4.72.4.2.1 (08-13-2001)

ESOP Defined

- (1) An ESOP is a defined contribution plan which is a stock bonus plan, or a stock bonus plan and money purchase plan. See IRC 4975(e)(7).
 - a. When the trust books are kept separately for each type of plan, the applicable rules are applied to the ESOP accounts. When the accounts are kept as a whole, break down the accounts by plan to ensure the necessary requirements are being followed.
 - b. If a plan fails to be an ESOP under IRC 4975(e)(7) and IRC 409, it can still be a qualified plan (such as a stock bonus plan) under IRC 401(a).

4.72.4.2.1.1 (08-13-2001)

Examination Steps

- (1) Check whether the ESOP is a portion of the plan.
- (2) If yes, make sure the ESOP requirements apply to the portion of the trust assets that make up the ESOP.

4.72.4.2.2 (08-13-2001)

Floor Offset Arrangements

- (1) Generally, under the prohibited transaction rules of ERISA, a plan may not invest more than 10% of its assets in qualifying employer securities. This limitation does not apply to an eligible individual account plan. See ERISA 407(a) and (b).
 - a. An ESOP is an eligible individual account plan, unless its benefits are taken into account in determining the benefits payable to a participant under any defined benefit plan. See ERISA 407(d)(3)(C).
 - b. This means an ESOP cannot be used to offset the benefits under a defined benefit plan in a floor-offset arrangement, effective with respect to arrangements established after 12/17/87. After that effective date, a floor-offset arrangement is treated as a single plan for purposes of the 10% limit.
 - c. Where the 10% limit is exceeded, a prohibited transaction has taken place under IRC 4975(c)(1)(A) due to the sale or exchange of employer securities between a plan and a disqualified person which is not exempt under IRC 4975(d)(13), if there is a transaction with a disqualified person.

4.72.4.2.2.1 (08-13-2001)

Examination Steps

- (1) Determine whether the employer maintains any defined benefit plans. If yes,
 - a. Determine whether the benefits provided by the defined benefit plan are reduced by benefits under the ESOP in an arrangement established after 12/17/87.
 - b. Determine whether the value of the employer securities exceeds 10% of the combined assets of the ESOP and the defined benefit plan.
 - c. Impose the prohibited transaction tax on the fair market value of the employer securities that exceeds 10% of the assets of the combined plans, if there is a transaction with a disqualified person.

4.72.4.2.3 (08-13-2001)

Joint and Survivor Annuity Rules

- (1) IRC 401(a)(11)(C) provides an exception to the qualified joint and survivor annuity (QJSA) and qualified preretirement survivor annuity (QPSA) requirements for the portion of a participant's accrued benefit in an ESOP to which the IRC 409(h) rules apply.
- (2) The exception is applicable where the plan provides that the ESOP participant's vested benefits are payable to the spouse on death, where the participant does not elect a life annuity, and where the ESOP is not a transferee plan of assets from a defined benefit plan or a defined contribution plan subject to IRC 412 minimum funding standards. See also Reg. 1.401(a)-20, Q&A 3(c).

4.72.4.2.3.1 (08-13-2001)

Examination Steps

- (1) Verify that the ESOP contains QJSA and QPSA language.
- (2) If not, insure the ESOP contains language that satisfies the exception to the QJSA and QPSA requirements.

4.72.4.2.4 (08-13-2001)

Participation, Coverage and Nondiscrimination Requirements

- (1) The participation (IRC 401(a)(26) for years beginning before January 1, 1997), coverage (IRC 410(b)), and nondiscrimination (IRC 401(a)(4)) requirements are applicable to an ESOP. These requirements must be satisfied separately by an ESOP. An ESOP may not be considered together with another plan in order to meet the participation, coverage or nondiscrimination requirements. See Regs. 54.4975-11(e)(1), 1.401(a)(26)-2(d)(1)(i), 1.410(b)-7(c)(2) and 1.401(a)(4)-(c)(4). IRC 401(a)(26) is inapplicable to defined contribution plans for years beginning after December 31, 1996.
- (2) An ESOP cannot be aggregated with another plan.
 - For example, the use of matching employer contributions to an ESOP to satisfy nondiscrimination requirements relating to qualified cash or deferred arrangements (CODAs) (including a cash or deferred arrangement which forms a portion of the ESOP) is not permitted. See Reg. 1.401(k)-1(b)(3)(ii)(B), IRC 401(k)(3) and the Technical Guidance on CODAs in IRM 4.72.2.

- (3) An ESOP cannot satisfy the IRC 401(a)(4) nondiscrimination requirements through the use of the nondesign-based safe harbor at Reg. 1.401(a)(4)–(b)(3), or by cross-testing under Reg. 1.401(a)(4)–8(b).

4.72.4.2.4.1 (08-13-2001)

Examination Steps

- (1) Check that the ESOP satisfies the participation, coverage and nondiscrimination requirements without being aggregated with any other plan, or with the non-ESOP portion of the plan of which it is a part.
- (2) In the case of an ESOP which is part of a CODA, check the terms of the ESOP to ensure that if the employer matches the employees' elective deferrals under the CODA by making contributions to the ESOP, the matching contributions to the ESOP are not taken into account for purposes of meeting the nondiscrimination rules of IRC 401(k). Also, check the CODA's terms. Insure also that the ESOP matching contributions satisfy IRC 401(m). See the Technical Guidance on Matching Contributions in IRM 4.72.3.

4.72.4.2.5 (08-13-2001)

Vesting

- (1) For ESOPs, the vesting requirements of IRC 411 and, in the case of top-heavy plans, IRC 416, apply.

4.72.4.2.5.1 (08-13-2001)

Examination Step

- (1) Check that ESOP participants vest in their accounts in accordance with the vesting rules in IRC 411 or 416.

4.72.4.2.6 (08-13-2001)

Deduction Limits

- (1) There are special deduction rules for contributions to an ESOP used to repay principal and interest on a loan to an ESOP. See IRC 404(a)(9).
- a. An employer's deduction for contributions to a stock bonus or profit-sharing plan is limited to 15% of the participants' compensation. See IRC 404(a)(3).
 - b. Where an employer maintains one or more defined contribution plans and one or more defined benefit plans, an employer's deduction for contributions for all plans is the greater of 25% of compensation or the amount necessary to meet the minimum funding standards of IRC 412. See IRC 404(a)(7).
- (2) IRC 404(a)(9)(A) states that notwithstanding the provisions of IRC 404(a)(3) and (a)(7), an employer's deduction for contributions paid to an ESOP to repay the principal on a loan used to acquire qualifying employer securities can be as high as 25% of the ESOP participants' compensation.
- a. There is no limit on the employer's deduction for contributions to an ESOP used to repay interest on a loan. See IRC 404(a)(9)(B). The ESOP must actually use the employer contributions to repay the loan by the due date of the employer's return (including extensions) to take advantage of the increased limits.

Example: Company M maintains a leveraged ESOP. For the 1997 plan year, Company M makes a contribution of 30% of the participants' compensation to repay principal and interest on the ESOP loan: 25% of compensation was used to repay the principal on the loan and 5% of compensation was used to repay the interest on the loan. The entire 1997 contribution is deductible under IRC 404(a)(9).

4.72.4.2.6.1 (08-13-2001)

**IRC 404(k)
Deduction**

- (1) In addition to the deduction permitted under IRC 404(a)(3) or 404(a)(9), under IRC 404(k) an employer may deduct dividends (called applicable dividends) paid on employer securities held by an ESOP if such dividends are—
 - a. Paid in cash to the participants,
 - b. Paid to the plan and distributed in cash to the participants within 90 days after the end of the plan year in which the dividends are paid to the plan, or
 - c. Used to repay an ESOP loan.
- (2) If the employer securities paying the dividends were acquired after 8/4/89, such dividends are deductible under IRC 404(k) only if they are used to repay a loan the proceeds of which were used to acquire the employer securities which are paying the dividends.

Example: Company M maintains an ESOP that acquired employer securities in an exempt loan in 1994. Also in 1994, Employer M terminated a profit-sharing plan and permitted participants to have a direct transfer of their profit-sharing plan accounts to the ESOP. The cash transferred from the profit-sharing plan to the ESOP is reinvested in employer securities. The exempt loan obtained by the ESOP is repaid with contributions made by Company M and with cash dividends paid on the employer securities held by the ESOP which were purchased with the exempt loan proceeds. Company M can claim a dividend deduction under IRC 404(k) for the dividends paid on the securities acquired in the exempt loan which are used to repay the loan. Company M can not claim a dividend deduction under IRC 404(k) to the extent the exempt loan was repaid with cash dividends paid on employer securities purchased with the funds transferred from the terminated profit-sharing plan. This is because these employer securities were acquired by the ESOP after 8/4/89, but not with the proceeds of the exempt loan.

- (3) Dividends on employer securities that were not acquired in an exempt loan, but were acquired by an ESOP before 8/5/89, can be used to repay a loan the proceeds of which were used to acquire employer securities and deducted under IRC 404(k).
- (4) If dividends on allocated stock are used to repay a loan, the fair market value of employer securities released from suspense and allocated to participants' accounts must equal or exceed the amount of such dividends. This allocation due to the use of dividends is in addition to the allocation due to the loan repayment.

- (5) Disallow an IRC 404(k) dividend deduction if the dividend constitutes, in substance, an evasion of taxation or is not a dividend as defined in IRC 316. See IRC 404(k)(5)(A).

Example 1: Amounts paid that exceed accumulated and current earnings and profits may not constitute a dividend. Amounts that constitute the payment of unreasonable compensation, or are not reasonable dividends, are an evasion of taxation and cannot be deducted as dividends under IRC 404(k). An example of a reasonable dividend is one that is at a rate normally paid by the employer in the ordinary course of business.

Example 2: Company M repays an exempt loan with dividends on employer securities acquired with exempt loan proceeds. Company M claims a dividend deduction under IRC 404(k). You ascertain the dividend rate is 70%, and that this is an extraordinary dividend that is greatly in excess of the dividend Company M can reasonably be expected to pay on a recurring basis. These dividends are not reasonable and are not deductible under IRC 404(k).

- (6) Corporate payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants do not constitute “applicable dividends” under IRC 404(k) and are not deductible. See Rev. Rul. 2001–6, 2001–6 I.R.B. 491.

4.72.4.2.6.2 (08-13-2001)

Examination Steps

- (1) Cancelled checks, payroll records, trust receipts and disbursement records, and participant's accounts should be examined to determine that the IRC 404 limits have not been violated. Problems could also arise if the number of participants decreased so as to lower the deductible limits.
- (2) Look at the applicable question on Schedule E, ESOP Annual Information, of Form 5500, to find out whether the employer repaid the exempt loan using dividends on employer securities.
- (3) Look at the question on Schedule E with regard to whether any dividends used to repay an exempt loan were not generated by employer securities acquired in that exempt loan. If the answer is yes, find out if the employer securities paying those dividends were acquired after 8/4/89. If yes, disallow the deduction.
- (4) Determine whether the amount of dividends paid exceed the employer's current or accumulated earnings or profits under IRC 316. Review the question on Schedule E of Form 5500 for this information. If yes, disallow the deduction.
- (5) Check whether the dividends paid on employer securities held by the ESOP are reasonable. A reasonable dividend does not include an unusually large dividend used to repay ESOP debt which is greatly in excess of the dividend the ESOP sponsor can reasonably be expected to pay on a recurring basis.
- (6) Determine whether any corporate redemptions of ESOP stock were deducted under IRC 404(k). If yes, disallow the deduction.

4.72.4.2.7 (08-13-2001)

Distributions

- (1) Distributions from an ESOP may be made in cash subject to the participant's right to demand distribution in the form of employer securities. An employee also has the right to require the employer to repurchase certain employer securities which the employee receives in a distribution. See 4.72.4.2.8, Put Options. If the employer's corporate charter (or by-laws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan, the participant may be precluded from demanding a distribution in the form of employer securities. Also, TRA '97 provides that an ESOP which is maintained by an S corporation can preclude the distribution of employer securities to a participant. See IRC 409(h).
- (2) IRC 409(o) provides that an ESOP participant who is entitled to receive a distribution can elect to commence distributions sooner than the period described under IRC 401(a)(14) and IRC 401(a)(9). A participant can elect, with the consent of his/her spouse (as required by IRC 401(a)(11) and IRC 417), to commence the distribution of his/her account balance not later than one year after the close of the plan year—(i) in which the participant separates from service by reason of normal retirement age, disability, or death, or (ii) the 5th plan year following the plan year in which the participant otherwise separates from service, as long as the participant is not reemployed by the employer before this distribution is required to begin. IRC 409(o) applies to stock acquired after 12/31/86.
 - a. The election for accelerated distribution does not apply to any employer securities acquired with the proceeds of an ESOP loan until the close of the plan year in which the loan is repaid in full.
 - b. Unless the participant elects otherwise, the account balance must be distributed in substantially equal periodic payments (at least annually) over a period not to exceed 5 years. Equal periodic payments may be measured in dollars or shares.
 - c. If the participant's account balance exceeds \$500,000 (adjusted for cost-of-living increases), the distribution period is increased, unless the participant elects otherwise, to 5 years plus one additional year (up to 5 additional years) for each \$100,000 (adjusted for cost-of-living increases), or fraction thereof, by which the balance exceeds \$500,000 (as adjusted). See Notice 95-55, 1995-45 I.R.B. 11.
- (3) If an ESOP acquires more than one class of employer securities available for distribution with the proceeds of the loan, the distributee must receive substantially the same proportion of each class. Thus, a distributee may not receive only nonvoting or preferred stock if the loan proceeds were also used to acquire voting common stock. See Reg. 54.4975-11(f)(2).
 - a. The above distribution is based on shares allocated to a participant's account and such allocation is proportionate (as to separate classes of stock) with respect to shares acquired with each loan.
 - b. This rule does not apply when separate loans at separate times are used to buy different classes of stock.

- (4) Assets released from a suspense account (described in IRM 4.3.6) and allocated to a participant's account can be forfeited only after other assets have been forfeited. See Reg. 54.4975-11(d)(4).

4.72.4.2.7.1 (08-13-2001)

Examination Steps

- (1) Make sure the plan gives employees the right to get a distribution in the form of employer securities, unless the corporate charter or by-laws restricts stock ownership to employees or to a qualified plan, or unless the ESOP is maintained by an S corporation that precludes the distribution of employer securities to participants.
- (2) Check the plan to make sure a participant can elect an accelerated distribution under IRC 409(o).
- (3) Look at the assets allocated to a participant from the suspense account. If securities available for distribution consist of more than one class, check that the participant received substantially the same proportion of each class as reflected in the suspense account assets available for distribution.
- (4) Check that the released suspense account assets allocated to a participant's account were forfeited after other assets were forfeited. If more than one class of qualifying employer securities has been allocated to a participant's account, make sure the participant forfeits the same proportion of each class.

4.72.4.2.8 (08-13-2001)

Put Option

- (1) IRC 409(h) and Reg. 54.4975-7(b)(10) require an employer security to be subject to a put option if it is not readily tradeable on an established market when distributed or if it is subject to a trading limitation when distributed.
- (2) Employer securities are "readily tradeable on an established securities market" if they are "publicly traded" as defined at Reg. 54.4975-7(b)(1)(iv). "Publicly traded" includes securities that are:
 - a. listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934, or
 - b. quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act.
- (3) The National Association of Securities Dealers (NASD) is a national securities association registered under section 15A(b). It runs the National Association of Securities Dealers Automatic Quotation System (NASDAQ). Therefore, over-the-counter stocks traded on NASDAQ are publicly traded.

Note: Stocks listed on the "pink sheets" are not publicly traded because the "pink sheets" are not a system sponsored by the NASD.

- (4) The put option must permit a participant to "put" the security to the employer. However, if the employer will violate Federal or state law by honoring such put option, the put option must permit the security to be put, in

a manner consistent with such law, to a third party (other than the ESOP) that has substantial net worth at the time the loan is made and whose net worth is reasonably expected to remain substantial. An ESOP cannot be required to honor a put option, but it can have the right to assume the obligations of the put option.

- (5) The put option must be exercisable for at least 60 days following the date of the distribution and for at least an additional 60 day period in the following plan year. See IRC 409(h)(4).
 - a. If the participant receives a total distribution which is required to be repurchased by the employer, the employer must make payments in substantially equal periodic payments (at least annually) over a period beginning not later than 30 days after exercise of the put option and not exceeding 5 years. The employer must provide adequate security and pay reasonable interest on the unpaid amounts of the total distribution. See IRC 409(h)(5).
- (6) If the participant receives installment distributions which are required to be repurchased by the employer, the employer must pay for the securities no later than 30 days after the put option is exercised. See IRC 409(h)(6).
- (7) In the case of an ESOP established and maintained by a bank or similar financial institution which is prohibited by law from redeeming or purchasing its own securities, an exception to the general rule provides that put options be given on securities that are not readily tradeable. No put option is required if participants have the right to receive distributions in cash.

4.72.4.2.8.1 (08-13-2001)

Examination Steps

- (1) Check that employer securities not readily tradeable on an established market can be put to the employer.
- (2) Make sure the put is exercisable for two 60 day periods: 60 days following the date the employer securities were distributed and 60 days in the following plan year.
- (3) If the employee puts shares to the employer received in a total distribution, make sure the employer provides adequate security and pays reasonable interest on the unpaid portion. A put option is not adequately secured if it is not secured by any tangible assets.
 - For example, adequate security may be an irrevocable letter of credit, a surety bond issued by a third party insurance company rated "A" or better by a recognized insurance rating agency, or by a first priority perfected security interest against company assets capable of being sold, foreclosed upon or otherwise disposed of in case of default. Promissory notes secured by a company's full faith and credit are not adequate security. Nor are employer securities adequate security.

4.72.4.2.9 (08-13-2001)

Allocations

- (1) Assets released from the suspense account under an IRC 4975 ESOP due to repayment of an exempt loan must be allocated to the participants' accounts at the end of the plan year. This allocation must be based on shares of stock or other nonmonetary units, rather than by dollar amounts. See Regs. 54.4975-11(d)(1) and (2).

4.72.4.2.9.1 (08-13-2001)

Examination Step

- (1) Check the participants' accounts to verify the trustee is following the allocation formula in the plan.

4.72.4.2.10 (08-13-2001)

Qualifying Employer Securities

- (1) An ESOP must invest primarily in qualifying employer securities. See IRC 4975(e)(7). There is no specific percentage that defines the term "primarily". It is a flexible term that takes into account facts and circumstances such as the investment performance of the qualifying employer securities.
- (2) An ESOP can sell qualifying employer securities or refrain from purchasing additional securities based on the investment performance of the securities. This would be consistent with the fiduciary duties under Title I of ERISA. The Department of Labor (DOL) stated in Advisory Opinion 83-6A (1/24/83) there may be instances where the investment of more than 50% of plan assets in qualifying employer securities would not satisfy the fiduciary responsibility requirements of Title I. The DOL Advisory Opinion concluded the "primarily" requirement must be satisfied over the life of the ESOP.
- (3) IRC 4975(e)(8) defines a "qualifying employer security" as an employer security within the meaning of IRC 409(l). IRC 409(l) provides that employer securities consist of the following:
 - a. Common stock issued by the employer, or by a corporation within the same controlled group, which is readily tradeable on an established securities market. This requires that sales of the stock take place regularly and consistently based on the facts and circumstances.
 - b. If there is no readily tradeable common stock, closely held common stock of the employer which has a combination of voting power and dividend rights equal to or in excess of the class of common stock of the employer having the greatest dividend rights.
 - c. Noncallable preferred stock if the stock is convertible into stock which meets the requirements of **a. or b. above**, and if the conversion price is reasonable as of the date the ESOP acquired the preferred stock.
- (4) For purposes of IRC 409(l), a "controlled group of corporations" is defined at IRC 1563(a), but without regard to the insurance company rule at IRC 1563(a)(4) and without regard to the exception to the attribution from trusts rule at IRC 1563(e)(3)(C).
 - a. IRC 409(l)(4) provides special circumstances in which a first tier subsidiary may be considered to be includable in a controlled group of corporations for purposes of IRC 409, even where the parent

- owns less than 80% of the first tier subsidiary. The effect of this provision is to permit the acquisition of the controlling corporation's stock by an ESOP maintained by the first tier subsidiary. If a corporation owns directly stock possessing 50% of the voting power in all classes of stock and at least 50% of each class of non-voting stock in the first tier subsidiary, then the first tier subsidiary (and all other corporations below it in the chain which would meet the 80% test of IRC 1563(a) if the first tier subsidiary were the parent) is considered to be an "includable corporation" for IRC 409 purposes.
- b. IRC 409(l)(4) provides special circumstances in which a second-tier subsidiary may be considered to be includable in a controlled group of corporations for purposes of IRC 409. The effect of this provision is to permit the acquisition of the controlling corporation's stock by an ESOP maintained by the second-tier subsidiary. If a corporation owns directly stock possessing all of the voting power in all classes of stock and all of the non-voting stock of a first-tier subsidiary, and if the first-tier subsidiary owns stock possessing at least 50% of the voting power of all classes of stock and at least 50% of each class of non-voting stock of the second-tier subsidiary (and all other corporations below it in the chain which would meet the 80% test of IRC 1563(a) if the second-tier subsidiary were the common parent) is considered to be an "includable corporation" for purposes of IRC 409.

4.72.4.2.10.1 (08-13-2001)

**Examination
Steps**

- (1) Examine the ESOP's investment accounts to verify it is investing primarily in employer securities.
- (2) If the ESOP holds closely held common stock of the employer, check that the employer has no readily tradeable common stock. This information may have to be requested from the employer. If there is readily tradeable common stock, then the ESOP cannot hold the closely held stock.
- (3) If the ESOP holds preferred stock, determine whether the conversion price is reasonable. Look at the conversion formula in the corporate charter documents. Also look at the answer to the question concerning the conversion formula on Schedule E, ESOP Annual Information. If the conversion formula does not allow participants to share in any appreciation in the value of the common stock, the conversion price is not reasonable.

Note: A conversion price that is based on the common stock's fair market value as of the date the ESOP acquired the preferred stock is reasonable because it permits participants to share in all of the appreciation in the value of the common stock. A formula that includes a conversion premium is permitted if the conversion premium is reasonable. The reasonableness of a conversion premium is determined on its facts and circumstances. Generally, a reasonable conversion premium will be in the 20% to 30% range.

- 4.72.4.2.11 (08-13-2001)
Permitted Disparity
- (1) An ESOP established after 11/1/77, cannot be integrated with Social Security benefits.
 - (2) ESOPs established and integrated on or before 11/1/77, can remain integrated. Such plans can continue in operation to increase the integration level if the increase is determined by reference to criteria existing outside of the plan.
 - a. Plans can not be amended to increase the integration percentage or level. See Reg. 54.4975-11(a)(7)(ii).
 - b. The permitted disparity rules of IRC 401(l) do not apply to ESOPs, except for ESOPs which were in existence on 11/1/77, which were integrated. See Reg. 1.401(l)-1(a)(4).
- 4.72.4.2.11.1 (08-13-2001)
Examination Steps
- (1) During an examination you may encounter integrated ESOPs. Examine corporate minutes, the plan itself, amendments subsequent to adoption, and relevant dates to verify the plan was established on or prior to 11/1/77, and the integration level or percentage has not been increased by plan amendment(s).
 - (2) Verify that no ESOP established after 11/1/77, is integrated.
- 4.72.4.2.12 (08-13-2001)
Valuation
- (1) Since ESOPs are designed to invest primarily in employer securities, the examination of this type of plan necessitates that you be able to determine the fair market value of qualified employer securities. See IRM 4.72.8, Employee Plans Technical Guidance on Valuation of Assets.
- 4.72.4.2.12.1 (08-13-2001)
Examination Steps
- (1) The balance sheet on Form 5500 provides information such as whether investments are in employer securities, acquisition indebtedness and/or other liabilities (indicates leverage), and party-in-interest transactions. In smaller plans determine whether a valuation was made by adding the assets at the beginning of the year to the contributions and receipts less the disbursements during the year and comparing the total to the assets at the end of the year. If the total equals the assets at the end of the year, a valuation probably has not been made because the total only reflects the receipts and disbursements.
 - (2) When reviewing the income statement, note any noncash contributions as these may also indicate the acquisition of employer securities.
 - (3) Where stock is publicly traded, examine stock confirmation slips, trust receipt and disbursement accounts, and market records to verify the fair market value of security transactions.
 - (4) Where stock is not publicly traded, and the transaction does not involve a disqualified person, the fair market value must be determined as of the plan's most recent valuation date. Examine the records used to value the stock at the last valuation date in order to determine whether the

assigned value is comparable to the value of comparable non-publicly traded companies. See Reg. 54.4975-11(d)(5).

- (5) Where stock is not publicly traded and the transaction involves a disqualified person, the fair market value must be determined as of the transaction date. Secure the appraisal report, if any, and use it as a basis for verifying the adequate consideration rules. If possible request both the prior and subsequent appraisals for comparison purposes. If the appraisal method is not consistently applied, inquire as to the reason for the change. In addition, determine whether any projections used were reasonable estimates of what has actually occurred.

Note: Particular attention should be given to subsequent events that could have been foreseen and have an impact on value. See Rev. Rul. 59-60, 1959-1 C.B. 237. The independent appraisal will not in itself be a good faith determination. Also, examine the capital stock accounts of the employer to substantiate transactions of similar stock. If there is a problem with the stock valuation, use Form 5202, "Request for Engineering Service" to request assistance from the Examination engineer.

4.72.4.2.12.2 (08-13-2001)

**Independent
Appraiser**

- (1) TRA '86 enacted IRC 401(a)(28)(C) which provides that employer securities acquired by an ESOP (whether by contribution or purchase) after 12/31/86 that are not readily tradeable on an established securities market must be valued by an independent appraiser (within the meaning of IRC 170(a)(1)). Valuation by an independent appraiser is not required in the case of employer securities which are readily tradeable on an established securities market. See IRM 4.72.8, Technical Guidance on Valuation Assets for a detailed discussion of the independent appraiser rules for nonpublicly traded shares held by an ESOP.

4.72.4.2.12.2.1 (08-13-2001)

**Examination
Step**

- (1) Review the applicable question on the Form 5500 series return concerning independent appraisers to determine whether employer securities held in an ESOP that are not readily tradeable on an established securities market were valued by an independent appraiser.

4.72.4.2.12.3 (08-13-2001)

**Employer
Securities and
Prohibited
Transactions**

- (1) The fiduciary is responsible for determining that employer securities are properly valued. It is not enough for a fiduciary to rely in good faith on a third party valuation to establish that adequate consideration was paid. A fiduciary must make his/her own prudent investigation of value and determine that the underlying assumptions on which the valuation was made have not changed at the time the ESOP purchases the shares. See Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983) and Rev. Rul. 59-60.
 - a. There is a prohibited transaction if an ESOP pays a disqualified person too much for employer securities. This may occur due to an improper valuation of employer stock that is closely-held.

- b. There is a prohibited transaction if there is a sale of any property between a plan and a disqualified person (e.g., an employer) unless the prohibited transaction exception below applies. See IRC 4975(e)(2)(C) and IRC 4975(c)(1)(A).
- c. There is a prohibited transaction exception where the sale is for “adequate consideration”. See IRC 4975(d)(13) and ERISA 408(e). Adequate consideration is defined as the fair market value of the security as determined in good faith by the plan trustee or named fiduciary. See ERISA 3(18).

4.72.4.2.12.3.1 (08-13-2001)

Examination Steps

- (1) Determine whether fair market value was paid for the stock. Look at the valuation report on the company’s shares. See if the company that makes products has share prices that rise and fall with its earnings. If the company’s earnings have fallen but the report says the price per share has risen, it may indicate an incorrect valuation. Also check the correlation between earnings and stock price if there is no valuation report.
- (2) Check the employer’s audit report to see if the company’s earnings have fallen after the valuation report was written. If they have, it is likely the shares’ value should also have fallen. The plan fiduciary can no longer rely on the price per share from the valuation report because the facts on which it was based have changed.
- (3) Ask to see documentation of the fiduciary’s prudent investigation to ensure the underlying assumptions have not changed since the last valuation.

4.72.4.2.12.4 (08-13-2001)

Exclusive Benefit Rule

- (1) An exclusive benefit violation may occur if an ESOP acquires stock for more than its fair market value, (e.g., the stock is acquired from a shareholder).
 - a. Rev. Rul. 69–494, 1969–2 C.B. 88, provides guidelines for determining whether a plan investment is consistent with the exclusive benefit rule. These guidelines, as applied to ESOPs, require a determination of whether the amount paid for the stock exceeds its fair market value at the time of acquisition. (All requirements of Rev. Rul. 69–494 do not apply to stock bonus plans and ESOPs.)
 - b. An exclusive benefit violation should be considered only where there is a significant depletion of plan assets.

4.72.4.2.12.4.1 (08-13-2001)

Examination Steps

- (1) Determine whether fair market value was paid for the stock.
- (2) Evaluate stock purchases for exclusive benefit violations by applying the fair market value rules of Rev. Rul. 69–494 at the time of the initial purchase and again at the time of any subsequent purchase. Even if the

initial purchase did not violate the exclusive benefit rule, a subsequent purchase may have resulted in a violation.

- (3) Although technically an exclusive benefit violation, a violation of the exclusive benefit rule generally should not be pursued where it appears employer securities were acquired at an inflated price but the stock subsequently increased in value with the result that a benefit to plan participants has occurred.
- (4) If such stock was acquired from a disqualified person, imposing the excise tax under IRC 4975 would still be appropriate.
- (5) A violation of the exclusive benefit rule does not occur merely because employer securities acquired at fair market value later decline in value.

4.72.4.2.13 (08-13-2001)
Voting Rights

- (1) Employer securities held by an ESOP must meet the IRC 409(e) requirements pertaining to voting rights.
 - a. If the employer has a “registration-type class of securities,” each participant must be entitled to direct the plan as to the manner in which employer securities, allocated to the account of such participant, are to be voted. A registration-type class of securities means a class of securities required to be registered under section 12 of the Securities Exchange Act of 1934.
 - b. If the employer does not have a registration-type class of securities, each participant must be entitled to direct the plan as to the manner in which voting rights under employer securities, allocated to the account of such participant, are to be exercised with respect to any corporate matter which involves the voting of such shares with respect to the approval or disapproval of a corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all assets of a trade or business. The right to direct the plan as to the voting of allocated securities in the above instances exists only if the applicable state law also provides for shareholder voting in those instances.
 - c. If a plan trustee does not receive voting instructions on employer securities allocated to a participant’s account, the plan can provide that the trustee will vote those shares. See Rev. Rul. 95–57, 1995–35 I.R.B. 5.

4.72.4.2.13.1 (08-13-2001)
Examination Steps

- (1) Check the plan terms to make sure participants are entitled to vote employer securities allocated to their accounts
- (2) Check the summary plan description to make sure participants are aware of their right to vote allocated employer securities in accordance with IRC 409(e).
- (3) Check the corporate minutes to determine whether any events occurred that entitle participants to pass-through voting.

4.72.4.2.14 (08-13-2001)

**Diversification
Election**

- (1) For employer securities acquired after 12/31/86, IRC 401(a)(28)(B) provides that each qualified participant in a plan may elect, within 90 days after the close of each plan year in the qualified election period, to direct the plan with regard to the investment of at least 25% of the participant's plan account. The account balance subject to the diversification election increases to 50% in the final year of the election period.
- (2) Q&A-9 of Notice 88-56, 1988-1 C.B. 540, provides that the portion of a qualified participant's account subject to the diversification election in all years of the qualified election period (other than the final year) is equal to—
 - a. 25% of the number of shares of employer securities acquired by the plan after 12/31/86, that have ever been allocated to a qualified participant's account, less
 - b. The number of shares of employer securities previously diversified pursuant to a diversification election made after 12/31/86.
- (3) A "qualified participant" is any employee who has completed at least 10 years of participation in the plan and has attained age 55. In determining years of participation in the plan, include years the employee participated in a predecessor plan. The "qualified election period" is the 6 plan year period beginning with the later of the first plan year—
 - a. in which the individual first becomes a qualified participant, or
 - b. beginning after 12/31/86.

4.72.4.2.14.1 (08-13-2001)

**Diversification
Requirement**

- (1) There are three methods by which a plan can satisfy the diversification requirement. The first two are statutory and appear in IRC 401(a)(28)(B)(ii). The plan can—
 - a. provide that the portion of the participant's account subject to the diversification election is distributed within 90 days after the period in which the election can be made;
 - b. offer at least three investment options to each participant making the diversification election, and within 90 days after the election period ends, the plan invests the portion of the amount in accordance with the diversification election; or
 - c. offer a participant the option to direct the plan to transfer the portion of the account subject to the diversification election to another qualified defined contribution plan of the employer that offers at least three investment options. This transfer must be made no later than 90 days after the end of the election period. See Notice 88-56, Q&A-13.

4.72.4.2.14.2 (08-13-2001)

**Examination
Step**

- (1) Check that the plan provides a diversification election for employer securities acquired after 12/31/86.

4.72.4.2.15 (08-13-2001)

**Nonterminable
ESOP
Provisions and
IRC 411(d)(6)**

- (1) After an ESOP ceases to be an ESOP (such as where the plan is amended and converted into a non-ESOP plan), and employee's right to put nonreadily tradeable employer securities to the employer continues to exist. It is a nonterminable right described at Reg. 54.4975-11(a)(3)(ii). However, a plan that is no longer an ESOP is not required to be primarily invested in employer securities because the right to a particular form of investment is not an IRC 411(d)(6) protected benefit.
 - a. IRC 411(d)(6) and the regulations thereunder provide that a plan will not satisfy the requirements of IRC 411 if the accrued benefit, early retirement benefit, retirement-type subsidy or optional forms of benefits of participants are eliminated or reduced by a plan amendment. IRC 411(d)(6)(C) provides an exception to the IRC 411(d)(6) prohibitions for ESOPs.
- (2) Reg. 1.411(d)-4, A-2(d) provides guidance on the elimination, with respect to all participants, of IRC 411(d)(6) protected optional forms of benefits applicable to ESOPs.
 - a. A single sum or installment optional form of distribution can be eliminated.
 - b. If the employer becomes substantially employee-owned, or the employer is an S corporation (for taxable years of the employer beginning after December 31, 1997), the right to demand a distribution in employer stock can be eliminated and cash can be substituted instead.
 - c. Where employer securities become readily tradeable, a distribution in the form of employer securities can be substituted for cash, thereby eliminating the put option.
 - d. Where employer securities cease to be readily tradeable, a distribution in the form of employer securities can be eliminated and cash can be substituted instead.
 - e. If the employer securities continue to be readily tradeable, but substantially all of the employer stock or assets of the employer's business are sold, a distribution in the form of employer securities can be eliminated and cash can be substituted instead.
- (3) Although the Commissioner can provide additional rules and exceptions in revenue rulings, notices and other documents of general applicability, this has not been done at this time.

4.72.4.2.15.1 (08-13-2001)

**Examination
Steps**

- (1) In an ESOP amended to become a non-ESOP, make sure the right to put nonreadily tradeable employer securities to the employer is not eliminated.
- (2) Determine whether optional forms of benefits that have been eliminated comply with the exceptions for ESOPs at Reg. 1.411(d)-4, A-2(d).

4.72.4.3 (08-13-2001)

Loan Requirements

- (1) The failure of a plan to follow the exempt loan rules results in the loan being non-exempt and subject to the prohibited transaction tax. Failure to follow the rules does not cause the plan to be disqualified or lose its status as an ESOP.
 - a. An exempt loan is a loan that meets the requirements of Reg. 54.4975-7(b).
 - b. A non-exempt loan is a loan that fails to satisfy the requirements of Reg. 54-4975-7(b).
- (2) An exempt loan is a loan made to an ESOP by a disqualified person or a loan to an ESOP from a third party which is guaranteed by a disqualified person. See Reg. 54.4975-7(b)(1)(ii). Generally, these kinds of loans are prohibited transactions under IRC 4975(c)(1)(B) because they constitute the lending of money or other extension of credit between a plan and a disqualified person. IRC 4975(d)(3) provides that if the requirements for that section are met, such loans to an ESOP are exempt from the prohibited transaction rules.

4.72.4.3.1 (08-13-2001)

Examination Step

- (1) During the examination of an ESOP with loan provisions, if you determine the loan is non-exempt, refer to IRM 4.72.11, Prohibited Transactions.

4.72.4.3.2 (08-13-2001)

Primary Benefit Requirement

- (1) An exempt loan must be primarily for the benefit of the ESOP participants. When a loan is made to an ESOP, the interest rate of the loan and the price of the employer securities acquired with the loan proceeds must not cause plan assets to be drained off. The interest rate on the loan must also be reasonable. See IRC 4975(d)(3) and Reg. 54.4975-7(b)(3).

4.72.4.3.2.1 (08-13-2001)

Examination Steps

- (1) Determine whether the interest rate for the loan and the price for the securities are devices for draining off plan assets. The prime interest rate, rates for a similar transaction, rates charged by banks, and rates charged by other financial institutions should be used as a measuring device to determine an acceptable interest rate.
- (2) Scrutinize the loan against prior loans of the same nature and loans to other entities to determine whether arms-length dealing existed. Items to be compared are interest, cost of assets purchased, collateral, pre-payment penalties, and any other provisions or restriction in the terms of the loan. See 4.72.4.2.12 for methods used to determine fair market value.
- (3) Any other facts and circumstances relating to the loan can be used to substantiate compliance with or violation of the primary benefit requirement.

4.72.4.3.3 (08-13-2001)
Loan Proceeds

- (1) Exempt loan proceeds must be used by an ESOP within a reasonable amount of time after their acquisition by the ESOP:
 - a. to acquire qualifying employer securities;
 - b. to repay the loan; or
 - c. to repay a prior exempt loan.
- (2) Securities acquired with exempt loan proceeds may not be subject to a put, call, or other option, or buy-sell or similar arrangement while held by the ESOP or when distributed from the ESOP, other than the right of first refusal (see 4.72.4.3.8) and put option (see 4.72.4.2.8). See Reg. 54.4975-7(b)(4).

4.72.4.3.3.1 (08-13-2001)
Examination Steps

- (1) Examine the buy and sell slips, receipt records, and loan contracts to determine the exempt loan proceeds were used to:
 - a. purchase qualifying employer securities;
 - b. repay such loans; or
 - c. repay a prior exempt loan.
- (2) Examine the securities to ensure there is no call, put, other option, buy-sell arrangement or any other restriction on the securities while in the trust or upon distribution, other than those provided in Regs. 54.4975-7(b)(9) and (10).

4.72.4.3.4 (08-13-2001)
Liability of ESOP for Loan

- (1) A lender can seek repayment of an ESOP loan only out of the following plan assets:
 - a. Assets acquired with exempt loan proceeds that are collateral for the loan;
 - b. Collateral used in a prior exempt loan repaid with exempt loan proceeds;
 - c. Contributions made to the ESOP to meet plan exempt loan obligations;
 - d. Earnings on collateral or the contributions noted in c. above.
- (2) Also, the contributions and earnings must be accounted for separately on the books of the ESOP. See Reg. 54.4975-7(b)(5).

4.72.4.3.4.1 (08-13-2001)
Examination Step

- (1) Examine the ESOP, the assets and the exempt loan contract to ensure that any recourse by the lender does not exceed the assets of the ESOP as stated above.

4.72.4.3.5 (08-13-2001)
Default

- (1) If the loan is secured by the employer securities held in the suspense account and there is a default on the loan, a lender who is a third party and not a disqualified person can have suspense account assets transferred to the extent of the remaining loan amount.

- (2) If the lender is a disqualified person (e.g., the employer), then the amount that can be transferred on default is the amount of the missed payment. This prevents an employer from manipulating the default mechanism in order to use plan assets to repay an exempt loan. A default can cause a loan to be a non-exempt loan. See Reg. 54.4975-7(b)(6).

4.72.4.3.5.1 (08-13-2001)

**Examination
Steps**

- (1) Determine whether there has been a default in repaying the loan.
- (2) If there has been a default, check whether the shares in the suspense account are collateral for the loan.
- (3) If the suspense account is collateral for the loan and the employer is the lender, make sure the employer does not use suspense account assets greater in value than the missed payment to repay the loan.
- (4) Determine whether the default has caused the loan to become non-exempt.

4.72.4.3.6 (08-13-2001)

**Release from
Suspense
Account**

- (1) Employer securities acquired with exempt loan proceeds are placed in a suspense account to be allocated to participants accounts as the loan is paid off by employer contributions.
- (2) The loan is repaid and securities are released from a suspense account based on principal and interest payments.
- a. Securities can also be released from a suspense account based solely on principal payments if certain conditions are met. See Reg. 54.4975-7(b)(8). This results in low allocations of securities in the early years of the loan, when mainly interest is being paid off.
- b. Sometimes employers will renew loans in which securities are released based only on principal payments in order to keep allocations low.

4.72.4.3.6.1 (08-13-2001)

**Examination
Steps**

- (1) Refer to the question on Schedule E, ESOP Annual Information, which determines the method the employer uses to repay the loan.
- (2) Analyze the loan contract and its repayment provisions to verify that as the loan is repaid, stock is released from the suspense account and allocated to participant accounts.
- (3) Analyze the loan contract, the encumbrance account, the allocation schedule, and the receipts and disbursements accounts to substantiate compliance with the regulations. Also, if you encounter a situation where contributions have been missed for a period of years, or where there are large repayments to the lender, additional analysis should be undertaken to determine if the effect of such non-payment or large payments proves to be a violation of the exclusive benefit requirement or the anti-discrimination provisions of the Code.

- (4) Determine whether the loan is structured so that securities are being released from the suspense account based on principal payments only. Ensure the plan document permits the release of shares from the suspense account based on the principal only method. If so, determine whether the loan period, and any renewal, extension, or refinancing period exceeds 10 years. The release of employer securities from a suspense account must revert to the principal and interest method when the loan period (including extensions) exceeds 10 years.

4.72.4.3.7 (08-13-2001)

Repaying Exempt Loan

- (1) Employer securities acquired with exempt loan proceeds are placed in a suspense account to be allocated to participants' accounts as the loan is paid off by employer contributions. If unallocated employer securities are used to repay the loan, they will not be available for allocation to participants' accounts.
- (2) IRC 4975(d)(3) and Reg. 54.4975-7(b)(3) provide that an exempt loan must be primarily for the benefit of the ESOP participants. Thus, a plan should not provide that the loan may be repaid using proceeds derived from the sale of unallocated employer securities held in the suspense account.
- (3) Whether an ESOP in operation violates the primary benefit requirement by repaying an exempt loan with the proceeds from the sale of unallocated securities will be determined based on all the surrounding facts and circumstances.
 - a. Among the facts relevant to the primary benefit requirement are whether the transaction promotes employee ownership of employer stock, whether contributions to an ESOP that is part of a stock bonus plan are recurring and substantial, and the extent to which the method of repayment of the exempt loan benefits the employees.
 - b. All aspects of the loan transaction, including the method of repayment, will be scrutinized to see whether the primary benefit requirement is satisfied.

4.72.4.3.7.1 (08-13-2001)

Examination Steps

- (1) Make sure the plan provision covering repayment of the third party loan to the ESOP does not state that the loan can be repaid using proceeds derived from the sale of unallocated employer securities held in the suspense account.
- (2) If a plan in operation does use the proceeds from the sale of suspense account assets to repay a loan, determine whether the facts and circumstances support a finding that the primary benefit requirement has not been violated.

4.72.4.3.8 (08-13-2001)

Right of First Refusal

- (1) Qualifying employer securities acquired with exempt loan proceeds may be, but need not be, subject to a right of first refusal. This is a right in favor of the employer or ESOP, or both, that enables an employer to

keep shares of closely-held stock which have been distributed to a participant in friendly hands and out of the hands of third parties.

- a. When a participant receives an offer by a third party to buy non-publicly traded securities, the participant must notify the employer or ESOP (whichever holds the right of first refusal) of the written offer by the third party to purchase the securities.
- b. The employer, or ESOP, has 14 days to match the offer by the third party or to pay, if greater, the fair market value of the securities. See 4.72.4.2.8 and Reg. 54-4975-7(b)(9).

4.72.4.3.8.1 (08-13-2001)

Examination Steps

- (1) Examine the receipt and disbursement records of the ESOP securities and the employer securities accounts to determine if either the trust or the employer has purchased securities which had previously been distributed to a participant and then reacquired from the participant under a right of first refusal provided in the plan. If the securities in question were purchased originally with the proceeds of an exempt loan, then scrutinize the transaction to ensure:
 - a. The stock is not publicly traded at the time the right is exercised;
 - b. The right only applies to the employer or the trust (ESOP) or both;
 - c. The right was only enforceable within 14 days from the date written notice was given to the holder of the right of an offer by a third party; and
 - d. The selling price and other terms are the greater of—(i) the fair market value per Reg. 54.4975-11(d)(5), or (ii) the price and terms offered by a buyer, excluding the employer and the trust (ESOP), making a good faith offer to purchase the security.
- (2) Secure copies of the good faith offer and, if necessary, contact third parties and the former participants to verify the above requirements. Care should be taken to comply with disclosure requirements.

4.72.4.3.9 (08-13-2001)

IRC 415 Limits

- (1) An ESOP may be funded through an exempt loan (a leveraged ESOP) or may be funded directly by employer contributions (non-leveraged ESOP). Employer securities held by a leveraged ESOP are released from the suspense account and allocated to participants' accounts by reason of employer contributions to the ESOP to repay the loan and by reason of the use of dividends on employer securities in the ESOP to repay the loan.
- (2) If stock has been acquired in an exempt loan, annual additions under IRC 415(c) can be calculated under either of two methods:
 - a. The amount of the employer contributions to the ESOP used to repay a loan, or
 - b. The value of the employer securities allocated to participants. If the annual additions are calculated with respect to employer contributions, appreciation in the stock's value from the time it

entered the suspense account will not be counted for IRC 415 purposes. See Regs. 54.4975–11(a)(8)(ii) and 54.4975–7(b)(8)(iii).

- (3) If an ESOP is not funded by an exempt loan, the fair market value of the employer securities on the date they were purchased by, or contributed to, the ESOP is treated as an annual addition. See Reg. 1.415–6(b)(4).
- (4) IRC 415(c)(6) provides that if not more than one-third of the employer contributions to an ESOP for a plan year are allocated to the accounts of participants who are highly compensated employees, within the meaning of IRC 414(q), then all forfeitures of leveraged stock and all employer contributions to pay interest on a leveraged loan which are charged against the participant's account are eliminated from the computation of the annual addition. This is called a broad-based ESOP.

4.72.4.3.9.1 (08-13-2001)

Examination Steps

- (1) Determine whether the ESOP is funded by an exempt loan or by direct employer contributions.
- (2) If the ESOP is not funded by an exempt loan, make sure the fair market value of stock on the date it was purchased by, or contributed to, the ESOP is treated as an annual addition.
- (3) If the ESOP is funded by an exempt loan, determine whether annual additions are calculated based on employer contributions to repay the loan, or based on the value of the employer securities allocated to participant accounts.
- (4) If annual additions are calculated based on employer contributions to repay an exempt loan, a separate computation will be necessary to arrive at each participant's share of the contribution used by the ESOP to repay the loan.
 - a. Analyze the encumbered stock account and the liability accounts of the trust to determine the number of shares released from encumbrance and the employer contribution, so that a contribution per released share can be determined.
 - b. Multiply the number of released encumbered shares allocated to a participant's account by the cost per released share in order to arrive at an amount to be used to verify compliance with IRC 415.
 - c. Do not include shares released due to the payment of dividends. Also, if you are examining a broad-based ESOP, do not include shares released due to the payment of loan interest.
- (5)
$$\text{TOTAL CONTRIBUTION TO PAY LOAN} \div \text{TOTAL NUMBER OF RELEASED SHARES} = \text{COST PER RELEASED SHARE}$$
- (6) Determine whether more than 1/3 of employer contributions to a leveraged ESOP were allocated to the accounts of highly compensated employees. If so, check that annual additions include forfeitures of employer securities and employer contributions used by the ESOP to pay interest on loans to acquire employer securities.

- (7) Check the plan document to see if it permits the plan to use the special ESOP rules at IRC 415(c)(6).

4.72.4.4 (08-13-2001)

**Special ESOP
Transactions**

- (1) Other issues involving ESOPs include—
 - a. The exception to the reversion tax for a transfer to an ESOP,
 - b. The partial interest exclusion on loans to an ESOP, and
 - c. Nonrecognition sales of securities to an ESOP.

4.72.4.4.1 (08-13-2001)

**IRC 4980
Exception**

- (1) There was an exception to the tax on the amount of any employer reversion from a qualified plan to the extent any of the reversion is transferred to an ESOP. IRC 4980(c)(3). This exception applied to any amount transferred—
 - a. after 3/31/85, and before 1/1/89, or
 - b. after 12/31/88, pursuant to a termination which occurs after 3/31/85, and before 1/1/89.
- (2) Within 90 days after the transfer (or longer period as the Secretary may prescribe), the amount transferred, and the income therein, must be invested in employer securities or used to repay an ESOP loan that was used to purchase employer securities.
 - a. The amount allocated to participant accounts in the year of the transfer cannot be less than the lesser of the maximum allowable under IRC 415 or 1/8 of the amount attributable to the securities acquired.
 - b. Any portion of the transferred amount which is not allocated to participant accounts in the year of the transfer must be credited to a suspense account (IRC 4980 suspense account) and allocated from that account to the accounts of participants ratably over a period not greater than seven years. Additional employer contributions to an ESOP cannot be made until the allocation of such amount. When amounts are allocated to participant accounts from the IRC 4980 suspense account, they are treated as employer contributions for IRC 415 purposes, except the annual addition will not exceed the value of the securities when they were placed in the IRC 4980 suspense account.
 - c. At least half of the participants in the qualified plan from which the reversion is being transferred must be ESOP participants as of the close of the first plan year in which the allocation is required.

4.72.4.4.1.1 (08-13-2001)

**Examination
Steps**

- (1) Check whether the ESOP contains an IRC 4980 suspense account. If yes, go on to the other examination steps in this section.
- (2) Make sure the transfer of assets to the IRC 4980 suspense account took place:
 - a. After 3/31/85, and before 1/1/89; or

- b. After 12/31/88, due to a plan termination after 3/31/85 and before 1/1/89. There is no exception to the reversion tax for amounts transferred to an ESOP after these dates.
- (3) Check that the transferred assets were used within 90 days (or longer, if an extension was granted) to purchase employer securities or to repay a loan.
- (4) Make sure amounts in the IRC 4980 suspense account are allocated over a period not greater than seven years.
- (5) If (2), (3) or (4) are not met, impose the 20% excise tax under IRC 4980(a) on the amount transferred to the ESOP.

4.72.4.4.2 (08-13-2001)
**Partial Interest
Exclusion**

- (1) A bank, insurance company, corporation actively engaged in the business of lending money, or a regulated investment company may exclude 50% of the interest received from a securities acquisition loan. See IRC 133(a). A securities acquisition loan may result in a lower interest rate on a loan to an ESOP.

Note: IRC 133 has been repealed by the SBJPA effective with respect to loans made after 10/13/95, (other than loans made pursuant to a written binding contract in effect on such date).

- (2) A "securities acquisition loan" is:
 - a. A loan to a corporation (back to back loan) or ESOP (direct loan) to the extent the proceeds are used to acquire employer securities for the ESOP (see IRC 133(b)(1)(A)), or
 - b. A loan to a corporation to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the loan proceeds, provided the securities are allocable to participant accounts within one year of the loan (an immediate allocation loan). See IRC 133(b)(1)(B).
- (3) A loan to a corporation which is lent to an ESOP is treated as a securities acquisition loan if:
 - a. The repayment terms are substantially similar to the loans terms to the corporation from the lender (a mirror loan), or
 - b. The loan from the corporation to the ESOP requires a more rapid repayment of interest or principal (a rapid payment loan), and allocations under the ESOP attributable to this repayment do not discriminate in favor of highly compensated employees (within the meaning of IRC 414(q)). See IRC 133(b)(3).
- (4) The term of a securities acquisition loan made after 7/10/89, cannot be greater than 15 years.
 - a. If a securities acquisition loan is made after 7/10/89, a plan must hold more than 50% of each class of outstanding stock of the em-

ployer corporation, or more than 50% of the value of all outstanding stock of the corporation. See IRC 133(b)(6).

- b. If a loan is made after 7/10/89, ESOP participants must be able to direct the voting of all allocated securities in the ESOP acquired through a securities acquisition loan in accordance with IRC 409 (e)(2). The full pass-through of voting rights applies even if the securities are not a registration-type class of securities (i.e., are closely-held). See IRC 133(b)(7).
- (5) The excludable period during which the partial interest exclusion is available is, in general, the 7 year period beginning on the date of the loan for any original securities acquisition loan (i.e., the direct loan or back to back loan described at IRC 133(b)(1)(A) or immediate allocation loan described at IRC 133(b)(1)(B)).
- a. If the term of an original acquisition loan described at IRC 133(b)(1)(A) is greater than 7 years, the excludable period is the term of the loan (which cannot be greater than 15 years).
 - b. The excludable period for a rapid payment loan described at IRC 133(b)(3)(B) or an immediate allocation loan described at IRC 133(b)(1)(B) cannot be greater than 7 years.

4.72.4.4.3 (08-13-2001)

IRC 133 Excise Tax

- (1) An excise tax is imposed if a taxable event occurs with respect to securities acquired by an ESOP in an IRC 133 transaction. See IRC 4978B. A taxable event subject to the excise tax occurs where there is any disposition of employer securities acquired in a IRC 133 transaction within 3 years of their acquisition if:
 - a. the total number of employer securities held by the plan after the disposition is less than the total number of employer securities held after the acquisition, or
 - b. except to the extent provided in regulations, the value of the employer securities held by the plan after the disposition is 50% or less of the total value of all employer securities at the time of the disposition.
- (2) A taxable event subject to the excise tax also occurs if there is a disposition of employer securities acquired in an IRC 133 transaction to which a. and b. above do not apply if the disposition occurs before the securities are allocated to participant accounts, and the proceeds of the disposition are not allocated.
- (3) The excise tax is equal to 10% of the amount realized on the disposition to the extent allocable to IRC 133 securities, determined as if such securities were disposed of from:
 - 1. IRC 133 securities acquired during the 3-year period ending with disposition, beginning with the securities first so acquired;
 - 2. IRC 133 securities acquired prior to the 3-year period, unless such securities (or proceeds from their disposition) have been allocated to participant accounts;

3. IRC 1042 securities acquired during the 3 year period ending on the date of the disposition, beginning with the securities first so acquired;
 4. Any other employer securities.
- (4) The excise tax does not apply to a distribution of IRC 133 securities which is made due to a participant's:
- a. death or disability,
 - b. separation from service for a period which results in a one-year break in service, or
 - c. retirement after attaining 59½ years of age.
- (5) The excise tax does not apply to an exchange of IRC 133 securities—
- a. In a corporate liquidation that has acquired those securities into an eligible worker-owned cooperative.
 - b. Pursuant to a diversification election under IRC 401(a)(28).
 - c. For employer securities of another corporation pursuant to an IRC 368(a)(1) reorganization.
 - d. A forced disposition of IRC 133 securities due to operation of a State law will not be treated as a disposition if the securities were regularly traded on an established securities market at the time they were acquired by the plan.

4.72.4.4.4 (08-13-2001)

**Examination
Steps**

- (1) Look at the applicable questions on Schedule E of Form 5500, ESOP Annual Information, to determine whether the plan has engaged in a securities acquisition loan under IRC 133. If yes, complete the remaining examination steps in this section.
- (2) Determine whether the loan is from a qualified lender.
- (3) Check that the loan qualifies as a securities acquisition loan.
- (4) For post 7/10/89 loans, determine whether the ESOP held 50% of the stock, or 50% of the value of the stock, after the securities acquisition loan.
- (5) For post 7/10/89 loans, make sure full pass-through voting rights apply to IRC 133 securities that have been allocated.
- (6) Determine whether the partial interest rate exclusion of the lender is available for a period not in excess of the excludable period. This is an item for referral to a corporate tax examiner.
- (7) Determine whether any IRC 133 securities were disposed of in a taxable event. If yes, find out whether any of the exceptions to the excise tax apply.

4.72.4.5 (08-13-2001)

Stock Sales

- (1) Under IRC 1042, if a taxpayer or executor elects to sell qualified securities to an ESOP, and the taxpayer purchases qualified replacement property within the replacement period, then any long-term capital gain

will be recognized only to the extent the amount realized on the sale exceeds the cost to the taxpayer of the qualified replacement property.

- (2) After the sale, the ESOP must own at least 30% of:
 - a. each class of outstanding stock of the corporation which issued the qualified securities, or
 - b. the total value of all outstanding stock of the corporation.
- (3) The taxpayer must have held the qualified securities for at least 3 years as of the time of the sale. The replacement period is the period which begins 3 months before and ends 12 months after the date of the sale of the qualified securities.
- (4) "Qualified replacement property" is any security issued by a domestic operating corporation which:
 - a. did not, for the taxable year preceding the taxable year in which such security was purchased, have passive investment income in excess of 25% of the gross receipts of the corporation, and
 - b. is not the corporation which issued the qualified securities.
- (5) "Qualified securities" are employer securities, defined in IRC 409(l), issued by a domestic corporation that has no stock readily tradeable on an established securities market, and not received by the taxpayer from a qualified plan or pursuant to the exercise of a stock option.
- (6) The taxpayer's basis in the qualified replacement property is reduced by the amount of the gain not recognized by reason of the purchase. When the taxpayer disposes of any qualified replacement property, any gain is to be recognized to the extent of the gain which was not recognized due to the purchase of the qualified replacement property. But see the exception at IRC 1042(e)(3).

4.72.4.5.1 (08-13-2001)

Prohibited Allocations

- (1) IRC 409(n) states a plan must provide that the assets of an ESOP attributable to employer securities acquired by the ESOP in a sale to which IRC 1042 applies (IRC 1042 securities) cannot accrue for the benefit of the persons specified in IRC 409(n). Also, the IRC 1042 securities acquired by the ESOP cannot be allocated to the accounts of the persons specified in IRC 409(n) directly or indirectly under any qualified plan of the employer. Any stock acquired in a sale to an ESOP will be subject to the restrictions of IRC 409(n) if any of the sellers elect IRC 1042 treatment with respect to their sale of employer securities.
- (2) Allocations of IRC 1042 securities cannot be made during the nonallocation period to any taxpayer who makes an IRC 1042 election, or to anyone who is related to the taxpayer within the meaning of IRC 267(b), unless the lineal descendant exception of IRC 409(n)(3)(A) applies.
 - a. This exception provides that an allocation of IRC 1042 shares to a relative of the taxpayer who made the IRC 1042 election is not

prohibited if he/she is a lineal descendant of the taxpayer, and the amount allocated to all such lineal descendants during the nonallocation period does not exceed 5% of the employer securities held by the plan attributable to a sale under IRC 1042 by a person related to such descendants (within the meaning of IRC 267(c)(4)).

- b. The lineal descendant exception does not apply to persons prohibited from allocations because they are treated as 25% shareholders, described below.
- (3) The nonallocation period is the period beginning when the securities are sold to the plan pursuant to IRC 1042, and ends on the later of—
 - a. 10 years after the date of the sale, or
 - b. the date this indebtedness is repaid, if the plan borrowed money to purchase the IRC 1042 securities.
 - (4) Allocations of IRC 1042 securities also cannot be made, at any time, to a person who owns, after the application of IRC 318(a), more than 25% of
 - (i) any class of outstanding stock of the corporation which issued the employer securities or of any corporation which is a member of the same controlled group, or
 - (ii) the total value of any class of outstanding stock of such a corporation.
 - a. IRC 318(a) is applied to the “25% ownership of any class of stock” test without regard to the employee trust exception in IRC 318(a)(2)(B)(i). Therefore, stock owned by a qualified plan is attributed to a participant or beneficiary for purposes of (i) above.
 - b. A person is treated as a 25% shareholder if he/she has the requisite ownership interest at any time in the one-year period ending on the date of the sale to the plan, or the date the securities are allocated to participants in the plan.

4.72.4.5.2 (08-13-2001)

**IRC 4979A
Excise Tax**

- (1) If there is a prohibited allocation in violation of IRC 409(n) of qualified securities acquired in an IRC 1042 sale, the securities are treated as though they have been distributed to the participant. See IRC 409(n)(2).
- (2) An excise tax under IRC 4979A is imposed if there is a prohibited allocation of qualified securities acquired in an IRC 1042 sale. The tax is equal to 50% of the amount involved and is to be paid by the employer sponsoring the plan.

4.72.4.5.3 (08-13-2001)

**IRC 4978 Excise
Tax**

- (1) An excise tax under IRC 4978 can be imposed if, during the 3-year period after the date on which an ESOP acquired any qualified securities in a nonrecognition sale under IRC 1042, the plan disposes any of the securities and:
 - a. the total number of shares held by the plan after the disposition is less than the total number of employer securities held immediately after the sale, or

- b. except to the extent provided in regulations, the value of qualified securities held by the plan after the disposition is less than 30% of the total value of all employer securities as of the disposition.
- (2) The excise tax will be 10% of the amount realized on the disposition if either **a. or b. above** apply. However, the amount realized for this purpose will not exceed that portion allocable to qualified securities acquired in the sale to which the nonrecognition of gain provisions applied, determined as if such securities were disposed of from:
 1. IRC 133 securities acquired during the 3-year period ending on the date of such disposition;
 2. IRC 133 securities acquired before such 3-year period unless such securities have been allocated to accounts of participants;
 3. IRC 1042 securities acquired during the 3-year period ending on the date of disposition;
 4. Any other employer securities.
 - (3) The 3-year holding period and excise tax do not apply to any distribution of qualified securities (or sale of such securities) which is made by reason of a participant's:
 - a. death or disability,
 - b. separation from service for any period which results in a one-year break in service, or
 - c. retirement after attaining 59½ years of age.
 - (4) The following are exchanges or dispositions on which the excise tax is not imposed.
 - a. An exchange of qualified securities in an IRC 368(a)(1) reorganization for stock of another corporation.
 - b. An exchange of qualified securities in an IRC 332 liquidation into an eligible worker-owned cooperative.
 - c. The disposition of shares pursuant to a diversification election under IRC 401(a)(28).

4.72.4.5.4 (08-13-2001)

Examination Steps

- (1) Check the applicable question on Form 5309 to determine whether the plan is designed to permit the purchase of employer securities under IRC 1042.
- (2) Determine whether after the acquisition of the employer securities, the ESOP owned at least 30% of—
 - a. each class of outstanding stock of the employer corporation, or
 - b. the total value of all outstanding stock of the corporation.
- (3) Check that the employer securities sold to the ESOP were held for at least 3 years by the taxpayer prior to the sale. Refer to the taxpayer's individual or corporate return, if necessary.

- (4) Determine whether “qualified replacement property” was purchased within the replacement period by the taxpayer. Refer to the taxpayer’s individual tax return, if necessary.
- (5) Determine whether any IRC 1042 securities are allocated to the persons specified in IRC 409(n) and whether the allocations occurred during the nonallocation period.
- (6) Check whether any IRC 1042 securities were disposed of within 3 years after the plan acquired them.

4.72.4.6 8-13-2001
**Subchapter S
Corporation
ESOPs**

- (1) SBJPA added IRC 1361(c)(6) to permit ESOPs (as well as other qualified plans) to be shareholders in S corporations, effective for tax years beginning after December 31, 1997. A number of IRC sections that provide advantages to C corporation ESOPs are not available to S corporation ESOPs.
 - a. An S corporation ESOP has lower deduction limits than an C corporation ESOP. The 25% deduction limit under IRC 404(a)(9)(A) for contributions paid to an ESOP to repay the principal on a loan used to acquire qualifying employer securities is unavailable to an S corporation. Also, the unlimited deduction under IRC 404(a)(9)(B) for contributions to an ESOP used to repay interest on a loan is unavailable to an S corporation ESOP. See IRC 404(a)(9)(C). An employer’s deduction for contributions to an S corporation ESOP is subject to the same limits as any profit-sharing or stock bonus plan, i.e. 15% of the participants’ compensation. See IRC 404(a)(3).
 - b. The deduction for dividends paid on employer securities under IRC 404(k) does not apply to S corporation ESOPs. However, an S corporation can use the earnings received on unallocated employer securities held in the ESOP suspense account that are collateral for an exempt loan to repay an exempt loan without violating IRC 4975(d)(3). See Reg. 54.4975-7(b)(5)(i) and (iii). An S corporation that uses the earnings received on employer securities allocated to participant accounts to repay an exempt loan will cause the exempt loan to fail to satisfy IRC 4975(d)(3).
 - c. The exclusion under IRC 415(c)(6) from annual additions for allocations attributable to employer contributions to repay interest on an exempt loan and forfeitures of employer securities does not apply to S corporation ESOPs.
 - d. TRA '97 added IRC 512(e)(3), which exempts an ESOP from the unrelated business income tax (UBIT) on items of S corporation income that are passed through to the ESOP as a shareholder in an S corporation. This tax break for ESOP UBIT is the one incentive that S corporation ESOPs have over C corporation ESOPs.
 - e. The tax deferral on gains received by a shareholder on the sale of qualified securities to an ESOP is not available to S corporation shareholders. See IRC 1042(c)(1)(A).

