

ESOP Law Blog

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The Government is Here to Help; No Really!

Today, Robert Gertner and Claire Diefenbach of the Employee Plans branch of the Internal Revenue Service (the "IRS") conducted a Phone Forum focused on the issues arising out of the ESOP determination letter process. The IRS focused on two of the [Technical Assistance \("TA"\) requests](#) released earlier this year and last year. We thought we would summarize some of the items discussed.

1. Introduction - First, Mr. Gertner mentioned that the IRS is thinking about new ESOP guidance, in the form of either comprehensive regulations or revenue rulings and procedures on specific ESOP topics. He stated that no decision has yet been made. Obviously, the existing regulations are over 30 years old and becoming obsolete. Second, he mentioned the four TA responses that his office has provided to the determination letter folks in Cincinnati.

2. Non-ESOP Diversification – Section 401(a)(35). The Forum addressed the final regulations just published on this subject. (This was the one topic covered that was not addressed in the TAs). These regulations are covered in our ESOP Law Blog posting of June 4, 2010. However, in the Forum, Mr. Gertner provided some additional thoughts. First, he made clear that the regulations are intended to create a bright-line test on the definition of publicly traded securities. Therefore, stocks that are quoted only in the Pink Sheets or in the OTCBB will not be treated as publicly traded, even if there is a relatively liquid market for the stock. Second, Mr. Gertner emphasized that a stand alone ESOP intended to meet the ESOP exception to Section 401(a)(35) must be kept separate from any other defined contribution plan of the employer that may have an employer securities investment feature.

3. ESOP Diversification – Section 401(a)(28)(B). Mr. Gertner discussed the terms "qualified participants" and "years of participation" for purposes of Section 401(a)(28)(B). He noted that the TA provides flexibility, as it permits the determination letter folks to approve both expansive and restrictive interpretations of the terms. However, Mr. Gertner noted that IRS would be moving towards a more refined approach in the future.

4. Mandatory Repurchase of Employer Securities under Section 409(h)(2)(B)(i) - While the presentation of this topic presented no new issues, an audience member asked the IRS to consider whether it should be more flexible in permitting ESOPs to shift from cash distributions to distributions in the form of stock with a mandatory cash out. It was suggested that this is a

common practice, is useful in corporate planning and not harmful to participants. Mr. Gertner asked for a written question so he could consider it further.

5. Rebalancing and Reshuffling of Employer Securities – Claire Diefenbach began the discussion of this topic by confirming the IRS position in the TA that rebalancing and reshuffling language is permissible in an ESOP plan document, provided four areas of concern (described below) are satisfied. She then reiterated the IRS definition of these terms as follows: Rebalancing is the mandatory transfer of employer securities into and out of participant plan accounts designed to result in all participant accounts having the same proportion of employer securities. Reshuffling is the mandatory transfer of employer securities into or out of plan accounts, not designed to result equal proportions of employer securities. Based on an interpretation of IRC § 411(d)(6), the IRS found that subject to certain limitations, ESOPs may provide for rebalancing or reshuffling, because the right to a particular form of benefit is not a protected benefit.

The four specific areas of concern related to rebalancing and reshuffling are: (1) The definite allocation formula requirements of §1.401-1(b)(1)(i), (ii), and (iii); (2) Preservation of prior participant diversification elections under §401(a)(28)(B); (3) Discrimination testing for benefits, rights, and features under §1.401(a)(4)-4; and (4) segregation of investments for former employees relating to Code Sections 401(a)(4) or 411(a)(11).

6. Some Additional Q &A –

- a. Mr. Gertner stated that the issuance of ESOP determination letters has not been formally frozen. He noted that some ESOP determination letters are being issued. However, he confirmed that some are being held up pending resolution of outstanding issues, including the scope of permissible 409(p) prevention language.
- b. He also confirmed that an ESOP that rebalances or reshuffles could do so using the annual stock valuation used for other plan administrative purposes.
- c. He plans to look further into the possible administrative challenges for record keepers who must prevent a participant from having previously diversified shares of stock end up back in his account.

For further information please contact a member of the [Sheppard Mullin ESOP team](#).