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Memorandum**

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subject: Employee Stock Ownership Plan (ESOP) Price Protection Agreements

This Generic Legal Advice Memorandum (GLAM) responds to your request for assistance. This GLAM may not be used or cited as precedent.

ISSUE

You have asked whether amounts received under an ESOP Price Protection Agreement (as described below) are eligible rollover distributions under § 402(c)(4).

BACKGROUND

Price Protection Agreements are agreements into which an ESOP trustee and the employer maintaining the ESOP commonly enter. These agreements are designed to provide additional payments to recipients of stock distributions from an ESOP during a fixed time period following a loan taken on by the employer as part of an ESOP's second loan transaction in which the ESOP increases the number of employer shares it holds.

FACTS

To address your question, we will analyze two situations.

Situation 1. The employer is an S corporation as defined in § 1361(a). The employer maintains an ESOP (as defined in § 4975(e)(7)) that previously acquired a portion of the shares of the employer using funds obtained from the employer through an exempt loan described in § 4975(d)(3). As part of a second ESOP transaction, the employer borrows funds from a bank (“bank loan”) with a multi-year repayment schedule and lends the funds to the ESOP through an exempt loan described in § 4975(d)(3). The ESOP uses the proceeds from the loan to buy shares from the remaining non-ESOP shareholders.¹ As part of the ESOP trustee’s agreement to purchase these additional shares, the employer and the trustee execute a Price Protection Agreement (“Agreement”). The Agreement provides that, for a period not longer than the term of the bank loan, any participant who had shares allocated to his or her ESOP account prior to the bank loan (“Subject Shares”) and who receives a distribution of the Subject Shares upon separation from service by reason of attainment of normal retirement age, death, or disability, will receive an additional payment (“Price Protection amount”). Under the Agreement, the Price Protection amount equals the excess, if any, of the fair market value of the distributed Subject Shares at the time of the distribution determined without regard to the bank loan over the actual fair market value of the Subject Shares at the time of distribution. The ESOP provides for the distribution of employer securities subject to the employer’s mandatory and immediate repurchase under the rules in § 409(h)(1)(B) and § 409(h)(2)(B)(i). Under the Agreement, the employer pays the Price Protection amount, if any, directly to the participant in a single payment that, in addition, includes the fair market value of the employer securities that the employer repurchases in accordance with § 409(h).

Situation 2. The facts are the same as Situation 1, except that instead of paying the Price Protection amount directly to the participant, the employer contributes the Price Protection amount to the ESOP. Under the terms of the ESOP, this non-elective employer contribution is allocated to the account of the participant eligible to receive Price Protection amounts based on the Subject Shares in the participant’s account immediately before the distribution. The Price Protection amount is then distributed from the ESOP to the participant along with the Subject Shares. The Price Protection amount is treated as an employer contribution for purposes of all applicable qualification rules, such as the nondiscrimination requirements under § 401(a)(4) and the limit on annual additions under § 415, and the requirements of these subsection as well as all other applicable qualification rules are met.

CONCLUSIONS

Situation 1

¹ In a variation of this transaction, the employer takes out a bank loan with a multi-year repayment schedule and uses the funds to redeem shares from the remaining non-ESOP shareholders. The ESOP then acquires these shares with proceeds from an exempt loan from the employer. This variation does not change the conclusion of Situation 1 or 2.

The Price Protection amount is not an eligible rollover distribution under § 402(c)(4). It is neither a portion of the participant's ESOP account balance nor sales proceeds for the distributed Subject Shares. Rather, the Price Protection amount is paid through a separate payment to the participant by the employer. Accordingly, the Price Protection amount is includable in the income of the participant in year of distribution.

Situation 2

The Price Protection amount may be an eligible rollover distribution within the meaning of § 402(c)(4) because it is a portion of the balance to the credit of the participant in the ESOP. Accordingly, the Price Protection amount may be excludable from income if the amount is rolled over and the requirements of § 402(c)(4) are satisfied.

LAW

Section 402(c)(1) provides that if (A) any portion of the balance to the credit of an employee in a qualified trust is paid to the employee in an eligible rollover distribution, (B) the distributee transfers any portion of the property received in the distribution to an eligible retirement plan, and (C) in the case of a distribution of property other than money, the transferred amount consists of the property distributed, then the distribution (to extent transferred to an eligible retirement plan) is excludable from gross income for the taxable year in which it is paid.

Section 402(c)(4) defines an eligible rollover distribution as any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust, but excludes (A) any distribution that is one of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary or for a specified period of 10 years or more, (B) any distribution to the extent it is required under § 401(a)(9), or (C) any distribution made upon hardship of the employee.

Section 402(c)(6)(A) provides that, for purposes of this subsection, the transfer of an amount equal to any portion of the proceeds from the sale of property received in the distribution is treated as the transfer of property received in the distribution.

Section 402(c)(6)(B) provides that the excess, if any, of the fair market value of the property on sale over its fair market value on distribution is treated as the transfer of property received in the distribution. The legislative history of the Revenue Act of 1978 (Public Law 95-600) includes an example of an individual receiving a lump sum distribution consisting of \$50,000 in cash and \$50,000 worth of employer stock valued as of the distribution date. Thirty days later the individual sells the stock for its then fair market value of \$60,000. The maximum rollover contribution, to be completed within 60 days from distribution, is \$110,000 (\$50,000 in cash plus the \$60,000 of proceeds received on the sale of the stock). See Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 at 111-112 (March 12, 1979) (JCS 7-79).

Section 409(h)(1)(A) provides that a participant who is entitled to a distribution from an ESOP has the right to demand that his benefits be distributed in the form of employer securities. Section 409(h)(1)(B) provides that if the employer securities are not readily tradable on an established securities market, then the participant has a right to require that the employer repurchase the employer securities under a fair valuation formula. The legislative history of the Revenue Act of 1978 describes this provision as requiring the employer to repurchase the securities at fair market value. See S. Rep. No. 95-1263 at 86 (1978) and the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 at 90-91 (March 12, 1979) (JCS 7-79).

Section 409(h)(2)(B) provides, in pertinent part, that an ESOP maintained by an S corporation does not fail to meet the requirements of § 409(h)(1)(A) merely because it fails to provide participants the right to demand employer securities if instead the participant either has a right to receive the distribution in cash or has a right to resell any distributed employer securities to the employer under terms which meet the requirements of § 409(h)(1)(B).

Section 54.4975-7(b)(12)(iii) of the Excise Tax Regulations provides that the price at which a put option must be exercised is the value of the security, determined under § 54.4975-11(d)(5). Section 54.4975-11(d)(5) provides, in relevant part, that valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities.

ANALYSIS

Situation 1

If certain requirements are met, § 402(c)(1) excludes from gross income “any portion of the balance to the credit of an employee in a qualified trust [that] is paid to the employee.” The Price Protection amount described in Situation 1 is not a “portion of the balance to the credit of an employee in a qualified trust.” The Price Protection amount is never contributed to, nor distributed from, the ESOP trust. The Price Protection amount is not subject to any § 401(a) requirements because it is not a benefit provided under the ESOP. The Price Protection amount arises from a separate agreement between the ESOP trustee and the employer under which the employer is obligated to make a direct payment to the participant.² The fact that the employer’s obligation to pay the Price Protection amount to the employee is triggered by the participant’s distribution from the ESOP does not convert the Price Protection amount into a distribution from the ESOP. See *LTV Steel Co. v. United States* 215 F.3d 1275 (2000). Similarly, the fact that the employer agreed to pay the Price Protection amount to induce the ESOP trustee to approve the second ESOP transaction does not convert the Price Protection amount into a benefit under the ESOP.

² Note that, depending on plan terms, the Price Protection amount may be includible in the definition of “compensation” under the ESOP for purposes of applying § 415.

Unlike the Price Protection amount, the Subject Shares are a “portion of the balance to the credit of an employee in a qualified trust.” When property other than money is distributed from a qualified trust, § 402(c)(6)(A) generally allows the participant to roll over any portion of the proceeds from the sale of that property. Under § 402(c)(6)(B), the proceeds that may be rolled over include not only the fair market value of the property on the date it is distributed from the qualified trust but also any increase in the fair market value of the property between the time it is distributed and the time it is sold. Thus, for example, in the case of an ESOP distribution without an immediate mandatory repurchase of employer securities, § 402(c)(6)(B) may apply to distributed shares subject to a put option that are sold to the employer within 60 days at fair market value. In that case, the proceeds that could be rolled over would include any excess of the fair market value at sale over the fair market value at distribution.

The situation described in the preceding paragraph is distinguishable from Situation 1. The Price Protection amount in Situation 1 is not proceeds from the sale of property distributed from a qualified trust under § 402(c)(6)(A) and (B) because it is an amount in excess of the fair market value of the stock on the date of sale. The fact that the employer pays the Price Protection amount to the participant at the same time that the employer pays the participant the fair market value of the Subject Shares does not convert the Price Protection amount into proceeds from the sale of the Subject Shares; because by its very nature the Price Protection amount supplements the fair market value of the Subject Shares. It is not a component of the purchase price for the Subject Shares but rather a separate payment.³

In addition, § 409(h) does not support the assertion that the Price Protection amount should be treated as sales proceeds for the Subject Shares. Under § 409(h)(2)(B)(i), an S corporation’s ESOP is not required to distribute employer securities, but if it does the shares may be made subject to a mandatory repurchase by the employer that meets the requirements of § 409(h)(1)(B). Under § 409(h)(1)(B), the participant must have the right to require that the employer repurchase the employer securities under a “fair valuation formula,” which the legislative history equates to fair market value. As explained above, the Price Protection amount in Situation 1 is an additional payment of income. It is not a component of the fair market value of the Subject Shares or of the sales proceeds of those shares. For all of these reasons, the Price Protection amount in Situation 1 is not an eligible rollover distribution under § 402(c)(4).

Situation 2

³ In general, all payments of remuneration by an employer for services performed by an employee are subject to employment taxes, unless the payments are specifically excepted from the term “wages” or the services are specifically excepted from the term “employment.” Consequently, a Price Protection amount would be treated as remuneration for services in most cases and would be subject to employment taxes under Subtitle C of the Code, which include Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) tax, and federal income tax withholding, and must be reported on an employee’s Form W-2, Wage and Tax Statement.

Unlike the Price Protection amount in Situation 1, the Price Protection amount in Situation 2 is a “portion of the balance to the credit of an employee in a qualified trust”, that meets all the qualification requirements of § 401(a), and results in a benefit under the ESOP. The Price Protection amount is contributed to the qualified trust by the employer and then distributed from the qualified trust to the participant eligible for the Price Protection amount. Like other ESOP benefits, the Price Protection amount is subject to all the applicable qualification requirements of § 401(a), including the nondiscrimination rules under § 401(a)(4) and the limit on annual additions under § 415. Thus, for example, the Price Protection amount is subject to the rules for nondiscriminatory availability of benefits, rights, and features under § 1.401(a)(4)-4.

Because the Price Protection amount in Situation 2 is a portion of the balance to the credit of an employee in a qualified trust, that meets all the qualification requirements of § 401(a), and results in a benefit under the ESOP, if the distribution of the Price Protection amount in Situation 2 is rolled over in accordance with the requirements of § 402(c), it is excludable from the participant’s gross income in the year of distribution. Thus, the distribution of the Price Protection amount in Situation 2 is an eligible rollover distribution if it otherwise meets the requirements of § 402(c)(4).

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