MEMORANDUM FOR DANIEL R. JONES, MANAGER, EP DETERMINATIONS QUALITY ASSURANCE

FROM: Andrew E. Zuckerman, Director, Employee Plans Rulings and Agreements

SUBJECT: Response to Technical Assistance Request (#3)

This Memorandum is in response to your Request for Technical Assistance, dated April 2, 2009, with regard to the timing of an amendment of an employee stock ownership plan (as defined in Internal Revenue Code ("Code") section 4975(e)(7)), ("ESOP"), of an S corporation, and the language required in such amendment, for purposes of the ESOP's compliance with Code section 409(p).

Issues:

I. Whether an amendment to an S corporation ESOP that imposes the general statutory prohibitions of Code section 409(p) on allocations to accounts of "disqualified persons", without defining specific terms set forth in the statute, satisfies the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") good faith amendment requirement and enables the EGTRRA remedial amendment period for the plan to remain intact until the expiration of the plan's initial five- or six-year remedial amendment cycle within the meaning of Rev. Procedures 2005-66 and 2007-44, provided that the plan is amended to comply with subsequent changes in the law which are applicable to the plan.

II. Whether an ESOP must be amended by the close of the EGTRRA remedial amendment cycle to define certain terms set forth in Code section 409(p) and the regulations thereunder. Specifically, whether an ESOP plan document that is intended to comply with Code section 409(p) must set forth (A) the general statutory prohibition of Code section 409(p) on allocations to the account of a disqualified person during a nonallocation year, and (B) the definition of certain terms set forth in Code section 409(p) or the regulations thereunder including, but not limited to, the following:

i. Disqualified Person

ii. Nonallocation Year

iii. Deemed-Owned Shares

iv. Deemed 10% Shareholder

v. Synthetic Equity

vi. Impermissible Allocation

vii. Impermissible Accrual

Additionally, if a plan is required to define the term “nonallocation year”, must the definition also include language that sets forth the attribution rules of Code section 409(p)(3)(B)?

III. Whether a (A) failure to timely amend a plan to comply with Code section 409(p), either on a good-faith basis or by the close of the plan’s initial five- or six-year remedial amendment cycle, or (B) failure to comply with Code section 409(p) in operation by permitting an allocation of assets to the account of a disqualified person during a nonallocation year, will cause the plan to fail the qualification requirements of Code section 401(a).

Background and General Statement of the Law:

Code section 409(p)(1) provides that an ESOP holding securities consisting of stock in an S corporation must provide that no portion of the assets of the ESOP attributable to (or allocable in lieu thereof) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of Code section 401(a)) for the benefit of any disqualified person.

Code section 409(p)(2) provides that if a plan fails to meet the requirements of Code section 409(p)(1), the plan will be treated as having distributed to any disqualified person the amount allocated to the disqualified person’s account, at the time of such allocation.

Code section 409(p)(3)(A) defines “nonallocation year” as any plan year of an ESOP if, at any time during such plan year, the plan holds employer securities consisting of S corporation stock and disqualified persons own at least fifty percent (50%) of the number of shares of stock in the S corporation.

Code section 409(p)(3)(B) provides that, subject to certain exceptions, the attribution rules of Code section 318(a) generally apply in the determination of stock ownership for purposes of Code section 409(p)(3)(A).

Code section 409(p)(4)(A) provides that the term “disqualified person” means any person if (i) the aggregate number of deemed-owned shares of such person and the members of such person’s family is at least twenty percent (20%) of the number of deemed-owned shares of stock in the S corporation, or (ii) in the case of a person not described in clause (i), the number of deemed-owned shares of such person is at least ten percent (10%) of the number of deemed-owned shares of stock in the S corporation.

Code section 409(p)(4)(B) provides that any member of a disqualified person's family with deemed-owned shares shall be treated as a disqualified person if not otherwise so treated under Code section 409(p)(4)(A). The definition of "deemed-owned shares" is set forth in Code section 409(p)(4)(C). The definition of "member of the family", for purposes of Code section 409(p)(4), is set forth in Code section 409(p)(4)(D).

Code section 409(p)(5) provides that, for purposes of paragraphs (3) and (4) of Code section 409(p), in the case of a person who owns synthetic equity in the S corporation, except to the extent provided in the regulations, the shares of stock in the S corporation on which the synthetic equity is based shall be treated as outstanding stock in such corporation and deemed-owned shares of such person if such treatment of synthetic equity of one or more persons results in (A) the treatment of any person as a disqualified person, or (B) the treatment of any year as a nonallocation year.

Code section 409(p)(6) provides the definitions of "employee stock ownership plan", "employer security", and "synthetic equity", for purposes of Code section 409(p).

Notice 2001-42 provides that a plan provision is designated as a disqualifying provision under section 1.401(b)-1(b) of the Income Tax Regulations if:

(A) the plan provision either (1) causes the plan to fail to satisfy the qualification requirements of the Code because of a change in those requirements made by EGTRRA, or (2) is integral to a qualification requirement that has been changed by EGTRRA; and

(B) if a "good faith" EGTRRA plan amendment is required to be in effect with respect to the plan provision, the provision was added or changed by a "good faith" EGTRRA plan amendment adopted no later than the later of (1) the end of the plan year in which the EGTRRA change in the qualification requirements is required to be, or is optionally, put into effect under the plan or (2) the end of the GUST remedial amendment period for the plan.

Notice 2001-42 provides that the EGTRRA remedial amendment period under Code section 401(b) for a disqualifying provision described above shall not end prior to the last day of the first plan year beginning on or after January 1, 2005.

Revenue Procedure 2007-44 further extends the EGTRRA remedial amendment period to the end of the initial five-year or six-year remedial amendment cycle, as applicable.

Notice 2001-42 further provides that a plan is required to have a "good faith" EGTRRA amendment in effect for a year if:

(A) the plan is required to implement a provision of EGTRRA for the year, or the plan sponsor chooses to implement an optional provision of EGTRRA for the year, and

(B) the plan language, prior to the amendment, is not consistent either with the provision of EGTRRA or with the operation of the plan in a manner consistent with EGTRRA, as applicable.

For purposes of Notice 2001-42, a plan amendment is a "good faith" EGTRRA plan amendment if the amendment represents a "reasonable effort" to take into account all of the requirements of the applicable EGTRRA provision and does not reflect an unreasonable or inconsistent interpretation of the provision. The Notice further provides that a plan amendment that merely incorporates by reference an EGTTRA change in a qualification requirement that would not otherwise be permitted to be incorporated by reference is not a "good faith" EGTTRA plan amendment.

Analysis and Conclusion:

EGTRRA was enacted on June 7, 2001, and includes numerous changes to the plan qualification rules. Section 409(p) was added to the Code by Section 656 of EGTRRA – generally, effective for plan years beginning after December 31, 2004, but effective for plan years ending after March 14, 2001, for an ESOP established after that date, or if the employer securities held by the plan consist of stock of an S corporation that did not have an S election in effect on that date.

A qualified plan is required to be operated in accordance with its terms. In general, a determination letter provides reliance that a plan is qualified in form and that operation of the plan in accordance with its terms will not cause the plan to be disqualified.

A plan that is not amended for Code section 409(p) may violate section 409(p) if the plan is operated in accordance with its terms. This is because the terms of the plan may require an allocation to be made that would cause the plan to violate section 409(p). If, on the other hand, the plan is operated in a manner consistent with section 409(p), the plan may fail to be operated in accordance with its terms. This is because an allocation that is required to be made under the terms of the plan is either not made or is made in a different amount or proportion than what is required by the terms of the plan in order to avoid a violation of section 409(p).

A favorable determination letter should not be issued where operation of a plan in accordance with its terms, which is required in order to be able to rely on the letter, could result in a violation of section 409(p). Conversely, as a condition of issuing a favorable determination letter, it is appropriate to require the terms of a plan that is subject to section 409(p) to provide that allocations that would cause

the plan to violate section 409(p) will be prohibited. This requirement is consistent with the language of section 409(p) which states that an ESOP "shall provide" that such allocations will be prohibited. Furthermore, requiring a plan to include the section 409(p) prohibition ensures that the operation of a plan in a manner that is consistent with the requirements of section 409(p) will not cause the plan to fail to be operated in accordance with its terms or lose reliance on the determination letter.

Consequently, a favorable determination letter should not be issued for a plan that is subject to section 409(p) unless the plan has been amended to satisfy section 409(p), and for purposes of the administration of the Determination Letter Program and the Voluntary Correction Program, a failure to timely amend an S corporation ESOP to comply with Code section 409(p) should be considered a plan qualification failure.

Because section 409(p) was added to the Code by EGTRRA, if an amendment is required to a plan in order to bring the plan into compliance with Code section 409(p), such amendment is subject to the EGTRRA "good faith" amendment requirements of Notice 2001-42, and not the interim amendment rules that apply to certain non-EGTRRA changes in the law.

Therefore, an EGTRRA "good faith" amendment to an S corporation ESOP for compliance with Code section 409(p) generally must be adopted no later than the later of (A) the end of the plan year in which the provision applied to the plan, or (B) the end of the GUST remedial amendment period for the plan.

The terms that need to be included in an EGTRRA good faith plan amendment for compliance with Code section 409(p) must represent a "reasonable effort" to set forth the requirements of that Code section. We have already determined that, in order to facilitate the administration of the Determination Letter Program and the Voluntary Correction Program, we will consider a failure to timely amend an ESOP to comply with Code section 409(p) a plan qualification failure. To further facilitate the administration of these programs, we have determined that a "reasonable effort" would include the incorporation by reference of the provisions of Code section 409(p).

Notwithstanding the foregoing, however, for purposes of obtaining a favorable determination letter an S corporation ESOP is required to include certain language for compliance with Code section 409(p). Therefore, as part of the determination letter process, certain S corporation ESOPs (i.e., those that do not include all of the required language) will have to be amended to include the required language. Such required language includes language that imposes the general statutory prohibitions of Code section 409(p) with respect to accruals or allocations under the plan for the benefit of "disqualified persons", as well as definitions of the following terms:

(i) Disqualified Person;

(ii) Nonallocation Year;

(iii) Deemed-Owned Shares;

(iv) Deemed 10% Shareholder;

(v) Synthetic Equity;

(vi) Impermissible Allocation; and

(vii) Impermissible Accrual.

In addition, the plan must include language that sets forth the attribution rules of Code section 409(p)(3)(B).

Accordingly, the responses to Issues I, II, and III, above, are as follows:

Issue I: An amendment to an S corporation ESOP that imposes the general statutory prohibitions of Code section 409(p) on allocations to accounts of "disqualified persons", without defining specific terms set forth in the statute, satisfies the EGTRRA good faith amendment requirement and enables the EGTRRA remedial amendment period for the plan to remain intact until the expiration of the plan's initial five- or six-year remedial amendment cycle within the meaning of Revenue Procedures 2005-66 and 2007-44, provided that the plan is amended to comply with subsequent changes in the law which are applicable to the plan.

Issue II: An S corporation ESOP must be amended by the close of the EGTRRA remedial amendment cycle to define certain terms set forth in Code section 409(p) and the regulations thereunder. Specifically, an ESOP plan document that is intended to comply with Code section 409(p) must set forth (A) the general statutory prohibition of Code section 409(p) on allocations to the account of a disqualified person during a nonallocation year, and (B) the definition of certain terms set forth in Code section 409(p) or the regulations thereunder including, but not limited to, the terms set forth in subsections (i) through (vii) of Issue II, above, and include language that sets forth the attribution rules of Code section 409(p)(3)(B).

Issue III: A failure to timely adopt a good faith amendment to comply with Code section 409(p) should be considered a Code section 401(a) qualification failure for purposes of the administration of the Determination Letter Program and the Voluntary Correction Program. In addition, a plan that does not operate in accordance with its terms to reflect Code section 409(p) fails to satisfy the plan qualification requirements of Code section 401(a).