

JUN 17 2008

Uniform Issue List 409.01-07

INTERNAL REVENUE SERVICE
EMPLOYEE PLANS
TECHNICAL ADVICE MEMORANDUM
FOR DIRECTOR, FIELD OPERATIONS, LARGE & MID SIZE BUSINESS (LMSB)

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Date of Conference:

T:EP:RA:T3

Years Involved:

ISSUE

LMSB has requested technical advice concerning whether stock distributions from the Taxpayer's employee stock ownership plan to its participants should be treated as "cash" distributions in the case in which participants exercise their put options at the time of distribution and sell their shares back to the Taxpayer.

FACTS

("Taxpayer") is a calendar year taxpayer and maintains the Employee Stock Ownership Plan ("Plan"), which is intended to be qualified under section 401(a) of the Internal Revenue Code ("Code") and to be an employee stock ownership plan ("ESOP") as described in Code section 4975(e)(7). The Taxpayer's stock is not publicly traded and otherwise meets the requirements of Code section 409(l)(2). The Taxpayer administers the Plan through its Retirement Department. The Taxpayer, through its Stockholder Services Department, serves as its own stock registrar and transfer agent for shares inside and outside of the Plan.

Section 9.3 of the Plan provides that the amount of any benefit to which a participant is entitled "shall be paid to him, to the extent possible, in units of Employer securities." Section 9.6(b) provides for a put option.

When a participant retires or otherwise terminates employment with the Taxpayer or one of its subsidiaries, the Taxpayer's Retirement Department distributes to the terminated participant a Tax Information Notice, as required by Code section 402(f), which explains the rules relating to the taxation of the benefits to which the participant is entitled. The Taxpayer's Retirement Department also distributes two forms to the terminated participant: ESOP Form #1, "Request for Distribution Form", and ESOP Form #2, "Election to Sell (Election to Exercise Put Option)."

ESOP Form #1 informs participants that they are entitled to receive a distribution of the vested balance credited to their ESOP account and that this distribution will be paid in the form of shares of the Taxpayer's common stock in the manner elected on the back of the form (deferred distribution, lump sum distribution, or direct rollover). Form #1 provides that if participants elect to receive their benefits in a lump-sum distribution, they will receive a Taxpayer stock certificate for their shares issued in their individual names, unless they designate joint tenant ownership with right of survivorship. Form #1 also informs participants that they have the right to sell to the Taxpayer any shares they may receive. Form #1 further states that, if the participant wishes to sell some or all of his shares of Taxpayer stock immediately following distribution of such shares from the Plan, then he must sign ESOP Form #2 and return it to the Taxpayer's Retirement Department.

Form #2 includes a statement to be signed by the participant in which he acknowledges the distribution of shares from the ESOP and notifies the Taxpayer that as of the date of the participant's distribution from the ESOP, he is exercising his right to sell (Put Option) shares of Taxpayer common stock to the Taxpayer.

When a participant elects to receive his benefits in a lump-sum distribution and elects to sell to the Taxpayer either a portion or all of his shares immediately following distribution from the Plan, the Retirement Department upon receiving the completed forms from the participant will complete ESOP Form #3, "Recipient's Disposition as Elected on ESOP Form #1" and notify the Taxpayer's Stockholders Services Department of the transaction by providing copies of ESOP Form #1; ESOP Form #2; and ESOP Form #3 (collectively, "Forms"). The Taxpayer's Stockholder Services Department establishes personal stockholder accounts outside of the Plan for electing participants.

In order to process a distribution and put option (as described in the previous paragraph) to a participant's personal stockholder account outside of the Plan, the following steps occur:

1. The Stockholder Services Department manually keys or electronically uploads the data from the Forms into the Taxpayer's stock system ("Stock System").
2. The Stockholder Services Department cancels a stock certificate in the name of the Plan.
3. The Stockholder Services Department issues a new stock certificate to the participant in the participant's name for the shares distributed to the participant which are being put back to the Taxpayer and issues a new stock certificate in the name of the Plan for the shares remaining in the Plan after the distribution to the participant. Shares for which participants elect the put option receive their own stock certificate number. If the participant elects the put option for part of the shares distributed ("partial put"), the Stockholder Services Department issues a separate stock certificate for the shares which are not being put back to the Taxpayer.
4. The stock certificate (or certificates in the event of a partial put) is transferred to a participant's personal stockholder account outside of the Plan by book entry.
5. The stock certificate for the shares subject to the put option is processed for redemption and cancelled by the Stockholder Services Department, which can occur on the day of the distribution.
6. A check drawn on the Taxpayer's bank account is then issued to the participant.
7. The shares which are redeemed become part of the Taxpayer's treasury stock.

LAW

Code section 4975(e)(7) states in part that the term "employee stock ownership plan" means a defined contribution plan which is a stock bonus plan which is qualified or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and which is otherwise defined in regulations prescribed by the Secretary. A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h) and certain other specified Code sections. Section 4975(e)(8) states in part that the term "qualifying employer security" means any employer security within the meaning of section 409(l).

Code section 409(l)(1) states that, for purposes of section 409, the term "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market.

Code section 409(l)(2) states that if there is no common stock which meets the requirements of paragraph (1), the term "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of (A) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, and (B) that class of common stock of the employer (or of any other such corporation) having the greatest dividend rights.

Code section 409(h)(1) states that a plan meets the requirements of this subsection if a participant who is entitled to a distribution from the plan (A) has a right to demand that his benefits be distributed in the form of employer securities, and (B) if the employer securities are not readily tradable on an established market, has a right to require that the employer repurchase employer securities under a fair valuation formula.

Code section 409(h)(4) states that an employer shall be deemed to satisfy the requirements of paragraph (1)(B) if it provides a put option for a period of at least 60 days following the date of distribution of stock of the employer and, if the put option is not exercised within such 60-day period, for an additional period of at least 60 days in the following plan year (as provided in regulations promulgated by the Secretary).

Section 54.4975-7(b)(10) of the Excise Tax Regulations states that a qualifying employer security acquired with the proceeds of an exempt loan by an ESOP after September 30, 1976, must be subject to a put option if it is not publicly traded when distributed or if it is subject to a trading limitation when distributed.

Section 54.4975-7(b)(11) of the Excise Tax Regulations states as a general rule that a put option must be exercisable at least during a 15-month period which begins on the date the security subject to the put option is distributed by the ESOP.

Code section 402(e)(4)(A) provides in part that, for purposes of Code sections 402(a) and 72, in the case of a distribution other than a lump sum distribution, the amount actually distributed to any distributee from a trust described in section 401(a) shall not include any net unrealized appreciation in securities of the employer corporation attributable to amounts contributed by the employer (other than deductible employee contributions within the meaning of section 72(o)(5)).

Code section 402(e)(4)(B) provides in part that, for purposes of Code sections 402(a) and 72, in the case of any lump sum distribution which includes securities of the employer corporation, there shall be excluded from gross income the net unrealized appreciation attributable to that part of the distribution which consists of securities of the employer corporation. A taxpayer may elect not to have this subparagraph apply to such distribution.

Code section 402(e)(4)(E) provides generally that the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 424(e) and (f)) of the employer corporation.

Section 1.402(a)-1(b)(1)(i) of the Income Tax Regulations ("regulations") provides that if a trust described in section 401(a) which is exempt under section 501(a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the extent set forth therein. The regulation further states that the amount of net unrealized appreciation which is excludable under the regulations of (a) and (b) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of the distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of the distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction.

Section 1.402(a)-1(b)(2)(i) of the regulations provides that the amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Section 1.402(a)-1(b)(2)(ii) of the regulations sets forth the manner in which the cost or other basis to the trust of a distributed security of the employer corporation is calculated for the purpose of determining the net unrealized appreciation on such security.

Rev. Rul. 81-158, 1981-1 C.B. 205, holds that, for purposes of Code section 402, a distribution from a profit sharing plan occurs upon delivery of stock certificates to a transfer agent with instructions to reissue them in the name of the distributee.

ANALYSIS

In accordance with the terms of the Plan and as required by Code section 409(h)(1), Plan participants have the right to demand distributions in the form of employer securities. In accordance with Rev. Rul. 81-158, a distribution of stock occurs when the Taxpayer's Stockholder Services Department cancels a stock certificate in the name of the Plan and, as transfer agent, reissues a new stock certificate to the participant in the participant's name pursuant to the instructions received from the participant on the Forms.

In a supplemental memorandum dated May 1, 2007, submitted to us from LMSB, LMSB stated that it agreed that in form the Plan made stock distributions to participants. LMSB further stated that if the Plan itself had redeemed the participants' stock, then the Plan would have obviously distributed cash to the participants, and that the exercise of the put option to obtain cash after stock was distributed is no different. LMSB noted that participants intended all along to receive cash. LMSB stated that their position is that stock should not be considered issued to participants where it is immediately redeemed pursuant to a prearranged plan.

In accordance with the terms of the Plan and as required by Code section 409(h)(4), Plan participants can require that the Taxpayer repurchase employer securities under a fair valuation formula as set forth in the Plan because the Taxpayer's stock is not publicly traded. In accordance with section 54.4975-7(b)(10) and section 54.4975-7(b)(11) of the Excise Tax Regulations, this put option begins on the date that the securities (if they are not readily tradable at that time) are distributed and remains available for 15 months. In the operation of the Plan, it is possible for participants to exercise their put options at the time of distribution.

With respect to LMSB's position as described above, there is no provision in the statute or regulations which either prevents participants who have received a distribution of employer stock from immediately exercising their put options or prevents employers from immediately buying the stock put to them. Similarly, there is no statutory or regulatory provision which prohibits participants from providing instructions for the put in advance of receiving a distribution of stock. We note that inherent in the concept of the put option under Code section 409(h) is the participant's intention to obtain cash and that the immediate sale of stock pursuant to a prearranged plan is consistent with the statutory and regulatory provisions concerning put options. Therefore, stock distributed from the Plan is not treated as cash when it is put back to the Taxpayer. Since this stock constitutes employer securities as defined in Code section 402(e)(4)(E), net unrealized appreciation may be excluded in accordance with section 402(e)(4).

CONCLUSION

Stock distributions from the Taxpayer's employee stock ownership plan to its participants should not be treated as "cash" distributions when participants exercise their put options and sell their shares back to the Taxpayer. Participants who receive stock distributions are entitled to exclude the net unrealized appreciation in accordance with Code section 402(e)(4).