

New IRS Ruling Regarding Taxation of ESOP Distributions

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Introduction

The national office of the Internal Revenue Service (IRS) has issued a new Technical Advice Memorandum (TAM) regarding distributions from an Employee Stock Ownership Plan (ESOP) to terminated plan participants. TAM 200841042. This TAM is important for all ESOP companies that allow or require terminated participants who receive distributions of company stock to sell that stock back to the company. The issue presented in the TAM related to a recent case involving the proper tax treatment of distributions of employer stock to a group of terminated employees who elected to sell the shares allocated to their accounts back to the company immediately upon distribution of their benefits. The local office of the IRS took the position that the terminated participants were in effect receiving their benefits in the form of cash, and that therefore the plan sponsor was liable for penalties for failing to withhold taxes in connection with the distributions. The local IRS office also took the position that the participants were not entitled to claim capital gain treatment with respect to the net unrealized appreciation on the shares that were credited to their accounts.

Background

Upon termination of employment, a participant in the plan sponsor's ESOP is entitled to receive his or her benefits in the form of company stock. The participant may elect either to roll the company stock that he or she is entitled to receive into an IRA or to take a distribution of the stock. If a terminated participant elects to receive the shares of company stock allocated to his or her ESOP account, then he or she has the right to sell some or all of those shares back to the company, either immediately or at any time within 15 months from the date of the distribution of the stock.

When an employee of the company retires or otherwise terminates employment, the company distributes to the terminated participant a Tax Information Notice, which explains the rules relating to the taxation of the benefits to which the participant is entitled. The company 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 a terminated participant that he or she may be entitled to receive a distribution of the vested balance credited to his or her ESOP account and that this distribution "will be paid in the form of shares of [company] common stock in the manner you elect on the back of this form." The participant may elect to be paid either in a lump sum or in installments.

Form #1 also informs the terminated participant that he or she has the right to sell to the company any shares that he or she may receive. If the terminated participant wishes to sell some or all of his or her shares of company stock immediately, then he or she must sign and return to the company ESOP Form #2. Form #1 also provides that if a terminated participant elects to receive his or her benefits in a lump-sum distribution, then he or she will receive a company stock certificate for his or her shares. If the terminated participant elects a direct rollover of his or her benefits, his or her shares then will be issued to the IRA rollover custodian.

When a terminated participant elects to receive his or her benefits in a lump-sum distribution, the company shares credited to his or her ESOP account are transferred to an account in the name of the terminated participant on the company's stock ledger. At that time, one of the company stock certificates issued in the name of the ESOP is canceled, and a new certificate is issued to the ESOP in the amount of the shares evidenced by the cancelled certificate, minus the number of shares that were credited to the terminated participant's account.

If a terminated participant does not exercise his or her right to sell some or all of the company stock allocated to his or her ESOP account, then the stock is transferred by book entry on the company's stock records, and a share certificate covering the shares is printed and mailed to the former participant. If a terminated participant elects to sell all of the company shares that were allocated to his or her account, then those shares are transferred to him or her by a book entry on the company's records, but no share certificate is printed.

If the terminated participant elects to sell some, but not all, of the company shares that were credited to his or her ESOP account, the company then issues two stock certificates to the terminated participant—one for the shares with respect to which the participant has elected to exercise his or her put option, and one for the remaining shares. The company mails to the terminated participant the certificate for the shares that he or she has elected to retain, and the certificate representing the shares that the terminated participant has elected to sell is canceled. The terminated participant receives payment for the shares of company stock that he or she has elected to sell by means of a check from the company drawn on a company checking account.

The Position of the Local IRS Office

The local office of the IRS with which the company files its federal income tax returns took the position that the cash paid to terminated participants who elected to exercise their put options constituted cash disbursements from the ESOP. Therefore, according to the local IRS office, the company should have been withholding taxes from the distributions to participants who exercised their put options and was liable for penalties for failure to withhold. In addition, the local IRS office denied a number of the terminated participants their claims for capital gain treatment with respect to the net unrealized appreciation on the shares credited to their accounts.

After the company objected to the proposed recharacterization of the cash payments made to terminated ESOP participants as distributions of benefits from the ESOP, the local IRS office requested technical advice from the national office of the IRS. In its original submission to the national office, the local office based its position, in large part, on the fact that no stock certificates were issued to the terminated participants with respect to the shares that they elected to sell immediately.

In response, the company noted that under applicable corporate law, it was authorized to issue shares without certificates. The company contended that the determinative issue was whether ownership was

reflected on its books and records, and that legal ownership of the shares by the former participants was established by being clearly reflected in the company's books and records.

In a supplemental submission to the national office, the local office conceded that the stock had been distributed by the ESOP to the terminated participants, but that stock should not be considered issued to plan participants where it is immediately redeemed pursuant to a prearranged plan. In that case, the local office argued, the result is no different than if the plan had sold the stock to the company and then distributed the sale proceeds to the participants. Therefore, the local office argued, the payments to the terminated participants should be treated as cash distributions from the ESOP.

The National Office Ruling

The national office rejected the local office's position, and ruled that the stock distributions from the company's ESOP to the participants should not be treated as cash distributions when the participants exercised their put options and sold their shares immediately back to the company. The national office noted that there is nothing in the law that either prevents participants who have received a distribution of employer stock from immediately exercising their put options or prevents plan sponsors from immediately buying the stock with respect to which the options have been exercised.

Similarly, the national office noted that there was nothing in the law that prohibited participants from providing instructions for the exercise of their put options in advance of receiving a distribution of their stock. In this regard, the national office noted 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, the national office ruled that stock distributed from the ESOP should not be treated as cash when it is sold back to the plan sponsor. The national office went on to state that the participants could exclude net unrealized appreciation from their taxable income under the rules applicable to distributions of employer securities.

Conclusion

This Technical Advice Memorandum is important because many companies that sponsor ESOPs allow or require terminated participants who receive their distributions in the form of company stock to sell that stock back to the company immediately. If the national office had upheld the position taken by the local office, ESOP companies that allowed for ESOP benefits to be paid in the form of company stock would be required to issue share certificates to the participants even in situations where the participants elect or are required to immediately sell the stock back to the company. This would create a significant administrative burden for companies with large numbers of employees.

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