

Treasury Proposes New ESOP Regulations And Invites Public Comment 2.15.08

In January 2008, the IRS published proposed regulations ("Proposed Regulations") under the new ESOP diversification rules of Section 401(a)(35) of the Internal Revenue Code ("Code"). The Proposed Regulations could impact several ESOP provisions of the Code, including: the independent appraiser requirement of Section 401(a)(28)(C), the put option rules of Section 409(h)(1)(B), the definition of employer securities under Section 409(l)(1), and the eligibility for a tax deferred sale to an ESOP under Section 1042, all of which apply to employer stock that is not publicly-traded.

Since the applicability of these four Code provisions turns on whether the ESOP plan sponsor has publicly-traded stock, the Proposed Regulations suggest a test for determining when stock is publicly-traded for ESOP purposes. The IRS has invited public comments on this matter.

Existing IRS Position on the Meaning of "Publicly-Traded"

Since 1977, the Treasury Regulation Section 54.4975-7(b)(1)(iv) (the "Prohibited Transaction Regulations") has provided that an employer security is treated as publicly traded for ESOP purposes if it is listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (the '34 Act") or is quoted on a system sponsored by a national securities association registered under Section 15A(b) of the Securities Exchange Act. For many years, this definition effectively meant that a stock needed to be either quoted on one of the U.S. stock exchanges or quoted on the NASDAQ National Market System to be publicly traded.

When the Code was amended after 1977 to add new ESOP benefits (and requirements), Congress used the term "readily traded on an established securities market" rather than "publicly-traded." However, the IRS in several private letter rulings ("PLRs") confirmed that the term "readily traded on an established securities market" would be defined by reference to the term "publicly traded" in the Prohibited Transaction Regulations until further guidance was published.

Clearly, all stocks traded on the New York and regional stock exchanges (that are registered) and stocks traded on NASDAQ would be publicly-traded for this purpose.

In 1990, NASD created the Over The Counter Bulletin Board ("OTCBB"). The OTCBB was essentially an automated version of the 'pink sheet' quotation system. A question arose as to whether the OTCBB, having been created by NASD, could be said to be a system "sponsored by a national securities association." In PLR 200052014, a taxpayer seeking to complete a Section 1042 transaction using stock quoted on the OTCBB requested a ruling on the matter. In the PLR, the IRS found that the Section Prohibited Transaction Regulations were written based on an assumption that the qualifying quotation systems would have "comprehensive standards" and broad powers which would be protective of the interests of participants and provide for enhanced marketability of quoted securities. In the PLR, the IRS ruled that the OTCBB did not offer these benefits and protections and held accordingly that a stock quoted only on the OTCBB is not publicly-traded for ESOP purposes.

Stocks quoted only on foreign stock exchanges would not qualify as publicly-traded, since those exchanges are not registered under Section 6 of the '34 Act.

Proposed Regulations Definition

Under the Proposed Regulations, the IRS has continued its position that stock quoted on a Section 6 stock exchange is publicly-traded. The Proposed Regulations note that NASDAQ is now itself an exchange and falls under that definition. In addition, the IRS appears to have confirmed its position in PLR 200052014 that a stock quoted on the OTCBB is not public-traded. However, the IRS has taken the position, at least for the diversification rule of Section 401(a)(35), that a stock quoted on a foreign stock exchange that is regulated by its local government will be treated as publicly-traded, even though the foreign exchange is clearly not registered under the '34 Act.

The IRS has invited public comments on the question of whether the final definition under Section 401(a)(35) should be applied to the four other ESOP requirements that use the term "publicly-traded." Some thoughts on the extension of the regulation follow:

Practical Considerations

Desire for Certainty in Legal Compliance. First and foremost, ESOP sponsors need to know whether they are subject to the requirements to arrange for an independent appraisal of the stock in the ESOP each year and whether ESOP participants must be given a "put option" in connection with ESOP benefit distributions of stock. For these reasons, it seems best to draw a bright line between what stock is and what stock is not publicly-traded. Moreover, a shareholder who intends to make a Section 1042 election in connection with a sale of stock to an ESOP needs to know with certainty that he or she is eligible to make the election.

The Two Value Problem. The "bright-line" approach could create some difficulty for an OTCBB company with a relatively liquid market by requiring it to obtain an annual stock valuation. The Company and the ESOP may believe that the quoted price for the stock properly reflects the stock's fair market value. Nevertheless, the Company's ESOP would need to obtain an annual valuation. Further, the exercise of a "put option" by a participant at a time when the

market price is substantially lower than the prior year-end ESOP valuation could create difficulties for the ESOP and plan sponsor.

Coordination with the Adequate Consideration Definition. Section 3(18) of ERISA provides a definition of the term "adequate consideration" for purposes of determining whether a purchase or sale of stock by an ESOP is exempt from the prohibited transaction rules by reason of Section 408 of ERISA. Under Section 3(18) of ERISA, stock for which there is a "generally recognized market" can be bought and sold by an ESOP based on either: (1) the price prevailing on the Section 6 registered exchange on which it trades, or (2) if the stock is not quoted on a registered exchange, then at the bid/ask price established by "persons independent of the issuer." If there is no "generally recognized market" for the stock, then the Department of Labor proposed regulations require an independent appraisal to establish value. It is possible that an OTCBB quoted stock could have a "generally recognized market" if it is traded frequently, but would not meet the publicly-traded definition in the regulations proposed under Section 401(a)(35) of the Code. It would be helpful if the Department of Labor could coordinate its position under Section 3(18) of ERISA with any final regulations published by IRS.

We expect to work with the Legislative & Regulatory Committee of The ESOP Association to develop appropriate comments for the IRS on the Proposed Regulations.