Thoughts on the Final 409(p) Regulations
2.5.07

In December, the IRS published in final form the long-awaited regulations ("Final Regs") under Internal Revenue Code ("IRC") Section 409(p). These regulations were first published in proposed form in 2003, and then again as proposed and temporary regulations in 2004. The Final Regs largely follow the 2004 temporary regulations. We thought it would be helpful to discuss the issues the IRS considered in finalizing the regulations and the conclusions reached. In a future ESOP Blog, we will explore some of the difficult and unresolved 409(p) issues that remain in the Final Regs

I. Threat of Plan Disqualification

The Final Regs really bring the hammer down on a 409(p) violation. In addition to the onerous 409(p) related excise tax for the plan sponsor and the ugly income inclusion problem for the employee, the Final Regs make clear that a 409(p) violation will constitute a qualification defect under IRC Section 401(a). The IRS takes the position that operating a plan in violation of its terms is a disqualifying event. As a result, the IRS adds plan disqualification to the list of negative consequences of a 409(p) violation.

As the Final Regs point out, if the ESOP is disqualified, then it becomes a trust that is not an eligible shareholder for S corporation purposes. So, in addition to having to pay penalties associated with the loss of qualified plan status, the Final Regs make clear that the S corporation sponsor will lose its S corporation tax benefits.

Any silver lining? Since the IRS will treat the 409(p) violation as a qualification defect, the defect should be correctable under EPCRS (the IRS voluntary correction program). Under EPCRS, the IRS will not waive an excise tax. However, the IRS would have the authority to negotiate over the income inclusion suffered by the disqualified person ("DQP"), as well as the retroactive restoration of the ESOP's qualified status, which would retroactively restore the S corporation status. I guess that's more of a brass lining than silver.

II. 409(p) Avoidance Methods – Profit Sharing Plan Transfer Clarified

The proposed regulations provided that a 409(p) violation could be avoided if an ESOP transferred sufficient shares to a non-ESOP portion of the plan. However, the shares then held in the non-ESOP would be subject to the Unrelated Business Income Tax (UBIT). The tax from this approach could be an acceptable expense in some cases. It seems the IRS position is that the ESOP cannot merely provide for an automatic transfer of ownership of shares when a problem is detected after the close of the plan year. The Final Regs state that any such transfer of shares must be " . . . effectuated by an affirmative action taken no later than the date of the transfer . . " While the IRS is clearly not satisfied with plan language triggering an automatic transfer of stock, ESOP plan sponsors should consider the possible benefits of such a provision in the event a 409(p) violation is not detected until after the close of the plan year.

III. Reshuffling Slammed Down

The Final Regs appear to have killed the use of "targeted reshuffling" to solve a 409(p) violation. Practitioners had hoped that the IRS might permit an ESOP to convert a portion of a participant's stock account to other investments before a nonallocation year occurs. The IRS has taken the position that such targeted investment conversion would likely result in impermissible discrimination in favor of highly compensated employees. By converting the company stock account of an HCE into other investments, the HCE would be getting an investment opportunity that the non-HCEs could not have.

IV. IRS Suggests Alternatives to Targeted Reshuffling

While the folks from IRS shot down targeted reshuffling, they did suggest some alternatives. First, they suggest that HCEs who are, or are at risk of becoming, DQPs could just be cut out of new allocations for the year. This method won't be popular with senior folks at most companies who are impacted. In addition, this approach may not be sufficient to solve a problem that is being driven by synthetic equity build up. Second, the IRS suggested making disproportionately large contributions for just the non-HCEs who are not DQPs. Again, a nice egalitarian solution but it could be unpopular with senior folks who will perceive a hit to their benefits.

Finally the IRS suggests "mandating diversification" under IRC Section 401(a)(28)(B). The preamble to the Final Regs seems to say that an ESOP could force the diversification of the account of a participant who is eligible to diversify (that is, participants who are age 55 with at least 10 years of ESOP participation). However, a forced election is clearly not intended. It appears that the IRS intended to suggest simply that a "reshuffling" or "rebalancing" of the ESOP through cash contributions to the ESOP would be an acceptable means to reduce the amount of company stock in the accounts of DQPs or potential DQPs. So, while IRS is clearly opposed to targeted reshuffling, a reshuffling approach that treats all participants' accounts equally would be acceptable.

V. Family Attribution and Deferred Compensation Plans

The Final Regs provide some clarification on the application of family attribution rules under 409(p). In a future ESOP Blog, we will consider these rules in detail. For now, let us say that you will need to drill down into these rules if you have in-laws. (pun intended). The IRS also tinkered with the 3-year calculation rule for deferred comp plans but refused to provide guidance on what would be a "reasonable" discount rate for calculations.

VI. Right of First Refusal

The Final Regs except from the definition of synthetic equity a right of first refusal held by a shareholder over shares owned by the ESOP. To qualify for the exception, the right of first refusal must have terms that meet both the ESOP loan regulations and the S corporation second class of stock rules.