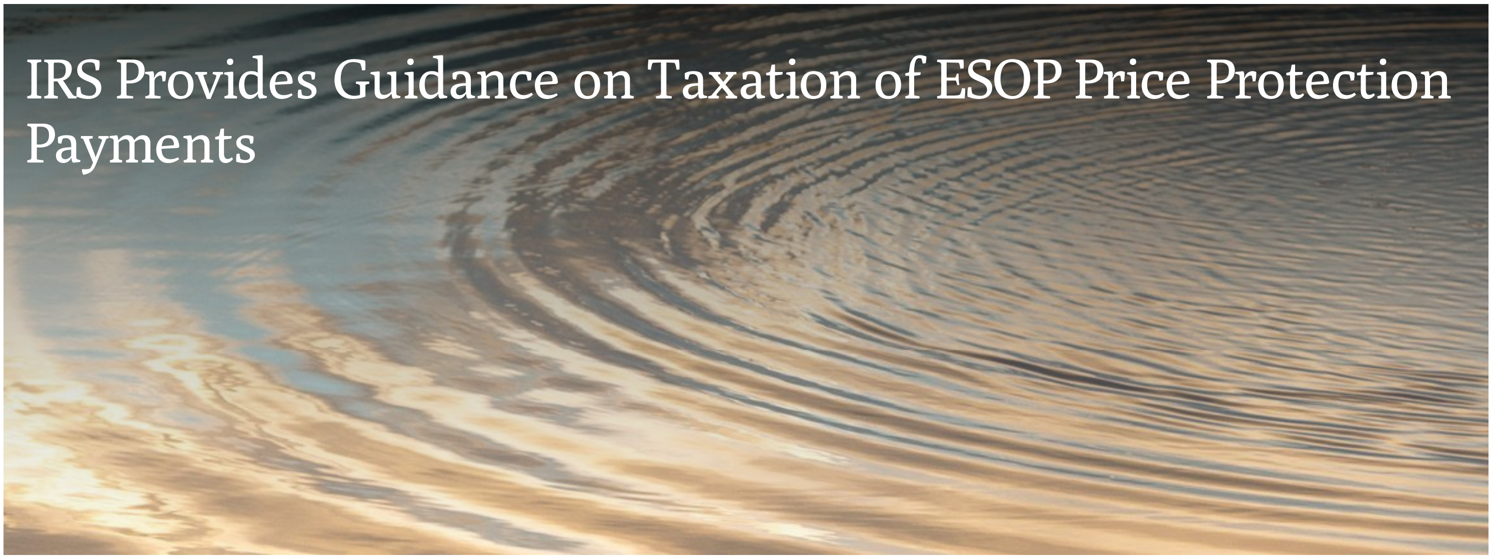
WINSTON & STRAWN LLP

BLOG



IRS Provides Guidance on Taxation of ESOP Price Protection Payments

JANUARY 17, 2020

Summary

In a Generic Legal Advice Memorandum (GLAM) dated December 13, 2019, the IRS provides guidance on whether the amount paid to an employee stock ownership plan (ESOP) participant pursuant to a price protection agreement between the ESOP trustee and the plan sponsor may be treated as an eligible rollover distribution. This guidance is long-awaited, as plan sponsors with price protection agreements and the affected participants have struggled with inconclusive statutory provisions. The IRS concludes that the price protection payment in one of the scenarios considered is an eligible rollover distribution, but the difficulty will be in the application.

What are Price Protection Agreements?

ESOPs frequently make multiple purchases of company stock. If the plan sponsor borrows money to help its ESOP finance a subsequent ESOP purchase, the value of the company stock already held by the ESOP may decline solely due to the company's new debt, rather than due to the company's business performance. An ESOP participant who incurs normal retirement, disability, or death shortly after the subsequent transaction may suffer because his or her ESOP account value will drop just as he or she is scheduled to receive a distribution. These participants may not benefit from the subsequent ESOP transaction, but their account will feel the impact of the debt the plan sponsor incurred for the subsequent purchase.

To protect affected participants, during the subsequent transaction the ESOP trustee commonly negotiates a "Price Protection Agreement" with the plan sponsor. Under a Price Protection Agreement, for a period of time following a subsequent transaction, a participant receiving a distribution from his or her ESOP account due to separation from service by reason of normal retirement, death, or disability will receive payment for the shares allocated prior to the subsequent purchase based upon the value of the shares determined without regard to the impact of the debt incurred for the subsequent purchase. The difference between the current fair market value of the shares determined by the ESOP Trustee and the value determined under the Price Protection Agreement is the "Price Protection Amount." Although the Department of Labor has not issued official guidance regarding the treatment of participants in a subsequent ESOP purchase, officials have suggested that ESOP trustees must consider the impact of the transaction on participants and that price protection may be appropriate.

IRS Analysis
In GLAM 2019-003, dated December 13, 2019, the IRS Office of Chief Counsel issued its first guidance on Price Protection Agreements. The guidance is provided in the form of a memorandum from the IRS Chief Counsel to the Division Counsel of the Tax Exempt & Government Entities (TEGE) Division. A GLAM is not specifically enforceable by taxpayers, but provides guidance as to how the IRS will treat these issues if presented in an audit. The TEGE Division Counsel asked the IRS Chief Counsel whether the Price Protection Amount received under an ESOP Price Protection Agreement is an eligible rollover distribution. If so, the participant could defer taxation on the Price Protection Amount by rolling over the payment to an IRA or another employer's qualified plan.

The GLAM describes a Price Protection Agreement and two different methodologies for providing the Price Protection Amount to the ESOP participant: payment of the Price Protection Amount when the plan sponsor redeems the shares distributed to the participant, or payment through a contribution to the ESOP, which is then distributed to the participant with the underlying shares.

1. Situation 1 – The Price Protection Amount is paid by the Plan Sponsor when the applicable shares are put to the Plan Sponsor upon distribution.

The IRS first evaluates the consequences of the plan sponsor's payment of the Price Protection Amount directly to the participant, the most common payment methodology. In this approach, the ESOP distributes the shares to the participant, which shares are then subject to mandatory and immediate repurchase by the plan sponsor. When the plan sponsor purchases the shares distributed, it pays the participant the shares' full fair market value and the Price Protection Amount.

The Internal Revenue Code (the "Code") specially addresses the rollover of property distributed from a qualified plan, and then sold. Code Section 402(c)(6)(A) provides that the transfer of an amount equal to any portion of the proceeds from the sale of property received in the distribution shall be treated as the transfer of property received in the distribution. This provision suggests that if shares are distributed to the ESOP, and sold to the plan sponsor, then the entire amount received in payment of the shares may be rolled over to defer taxation on the entire amount. Separately, Code Section 401(c)(6)(B) provides that the excess of the fair market value of property on the date of sale over its fair market value on the date of distribution shall be treated as property received in the distribution. Prior to the issuance of this GLAM, when assessing the taxation of Price Protection Amounts, plan sponsors and participants have read these provisions to permit the rollover of the Price Protection Amount as part of the proceeds from the sale of the shares distributed from the ESOP.

In the GLAM, the IRS assesses Situation 1 in two steps. First, the IRS concludes that the Price Protection Amount is not part of the balance to the credit of the participant paid in a distribution from the ESOP, because it had not been an asset of the ESOP. The fact that the plan sponsor's obligation to pay the Price Protection Amount is due to the participant's distribution from the ESOP does not make the payment a distribution from the ESOP. This conclusion does not complete the analysis, however.

The IRS then concludes that neither Code Section 401(c)(6)(A) nor Section 401(c)(6)(B) allows the Price Protection Amount paid directly by the plan sponsor in Situation 1 to be treated as an eligible rollover distribution. The IRS interprets Section 401(c)(6)(A) to require that the proceeds of the sale represent the fair market value of the shares distributed from the ESOP. The IRS does not assess whether the Price Protection Agreement creates value in the shares for which it applies, and simply concludes that the Price Protection Amount is a separate payment which supplements the fair market value of the shares. Based on this interpretation, the IRS concludes that no portion of the Price Protection Amount paid in Situation 1 is an eligible rollover distribution.

2. Situation 2 – The Price Protection Amount is contributed to the ESOP and distributed to the affected participant.

The GLAM also assesses paying the Price Protection Amount through a contribution to the ESOP. Under this Situation 2, a non-elective contribution equal to the Price Protection Amount is made to the ESOP and allocated to the affected participant's account immediately before the distribution. Upon distribution, the participant will receive the special contribution in addition to the shares. The IRS states that as long as the contribution complies with all rules applicable to contributions to qualified plans (including nondiscrimination requirements and annual additions limits), the payment of the Price Protection Amount from the ESOP is an eligible rollover distribution. The rationale is that the amount is a payment of a portion of the balance to the credit of the participant's ESOP account.

Conclusions

While plan sponsors and participants benefit from the definitive guidance from the GLAM, the overall result is that price protection will not be as valuable to affected participants. While participants still benefit from Price Protection Agreements, the oft-stated goal of putting the participants in the position they would be in if the ESOP's subsequent purchase did not occur will not be achieved. Contributing the Price Protection Amount will not be feasible in most cases for two reasons. First, satisfying the nondiscrimination requirements will be very fact-specific and require detailed testing. Second, in order for a contribution to satisfy the annual additions limitations, the contribution may not exceed a percentage of the participant's compensation. Often, however, distributions are not made until a year following termination of employment, when the participant does not have any compensation.

5 Min Read

Related Locations

Chicago

Related Topics

ESOPs

Related Capabilities

Employee Benefits & Executive Compensation

Labor & Employment

Tax

Related Regions

North America

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.