Price Protection Proceeds
Eligible for Rollover

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Price Protection (General): It is not uncommon for companies that have operated as a partially owned by an employee stock ownership plan (ESOP) to become wholly owned by the ESOP. The event pursuant to which this occurs is often referred to as a “second-stage transaction.”

The second-stage transaction may involve one of two scenarios (or a blended transaction): (1) the ESOP purchases non-ESOP shares from existing owners, or (2) the plan sponsor redeems all shares of stock held by such non-ESOP owners. In either situation, it is likely that the company (and maybe the ESOP) will be required to incur additional debt to facilitate the transaction. Such debt will have the effect of – at least temporarily – reducing the value of the shares held by existing participants in the ESOP.

Younger participants who remain employed with the company will likely see a recovery of value relating to pre-second-stage transaction held shares and additional value added to their accounts as the newly purchased shares are allocated amongst ESOP participants. In other words – the younger worker has an appropriate time horizon to retirement to allow his/her account balance to reclaim value that may have been lost from the incursion of additional debt. However, participants who are facing retirement, die while employed, have a disability event, or have a diversification window in the short term following the second-stage transaction may see a dramatic impact on their account balance without the luxury of time during which value would be recaptured.

Price protection has become a popular methodology for protecting certain ESOP participants from this short term decline in value. Some common terms seen in such policies include:

1. **Length of the Price Protection Period**: Such period can be pegged to the repayment date for the second-stage transaction debt, can be truncated if the valuation recovers to exceed the value prior to the incursion of debt, regardless of debt outstanding, and/or can be tied to a specified number of years (e.g., fifth anniversary of the closing date of the transaction).

2. **Identification of Participants Covered**: Generally Price Protection Policies limit favorable treatment to those who would not have a choice but to take lower valued shares following a second-stage transaction: retirees, those who die or become disabled during the provided period, and participants eligible for diversification.

3. **Limitation on Protected Shares**: Price protection may be limited to only those shares that were *allocated* as of the second-stage transaction. So if additional shares from an original purchase are allocated post-transaction, such shares would not be included in the protected value.

4. **Amount of Price Protection**: There are several alternatives that may be used for purposes of calculating the value paid on protected shares: (i) a simple floor value – the value is at least equal to the value of the shares immediately prior to the second stage transaction, (ii) the current fair market value, as determined by the ESOP, but adjusted to back out the debt facilitating the second-stage transaction, or (iii) a set formula that balances current
value with certain other metrics (e.g., adds back cash used from the company to pay amounts in the second-stage transaction).

5. **Payment of Price Protection**: The price protected amount will be paid by company (not the ESOP) directly to the affected participant. This is functionally facilitated by a distribution of the stock to the participant and (an often immediate) redemption of the distributed stock by the company (see below).

**Issue**: Is the amount paid under a price protect policy able to be rolled over in connection a retirement plan distribution.

**Applicable Law**:

As noted above, price protected shares must be distributed out of the ESOP and sold back to the plan sponsor – i.e., price protection is facilitated by the “put” option requirements applicable to an ESOP. The price at which the employer must purchase the shares is equal to a “fair valuation formula.”

(h) **Right to demand employer securities; put option**

(1) In general. 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.

(2) **Plan may distribute cash in certain cases**

(A) In general. A plan which otherwise meets the requirements of this subsection or of section 4975(e)(7) shall not be considered to have failed to meet the requirements of section 401(a) merely because under the plan the benefits may be distributed in cash or in the form of employer securities.

(B) **Exception for certain plans restricted from distributing securities**

(i) In general. A plan to which this subparagraph applies shall not be treated as failing to meet the requirements of this subsection or section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash, except that such plan may distribute employer securities subject to a requirement that such securities may be resold to the employer under terms which meet the requirements of paragraph (1)(B).
Applicable plans. This subparagraph shall apply to a plan which otherwise meets the requirements of this subsection or section 4975(e)(7) and which is established and maintained by—

(I) an employer whose charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a trust described in section 401(a), or

(II) an S corporation.

Treasury Regulation 54.4975-7(b)(12) provides indication on what value must be paid in connection with a put option transaction, including cross reference to 54.4975-11(d)(5)

54.4975-7(b)(12)(iii) Price. The price at which a put option must be exercisable is the value of the security, determined under §54.4975-11(d)(5).

54.4975-11(d)(5) Valuation. For purposes of §54.4975-7(b)(9) and (12) and this section, valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities. In the case of a transaction between a plan and a disqualified person, value must be determined as of the date of the transaction. For all other purposes under this subparagraph (5), value must be determined as of the most recent valuation date under the plan. An independent appraisal will not in itself be a good faith determination of value in the case of a transaction between a plan and a disqualified person. However, in other cases, a determination of fair market value based on at least an annual appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any party to a transaction under §54.4975-7(b) (9) and (12) will be deemed to be a good faith determination of value.

IRC 402 reviews requirements relating to what proceeds from a sale of property distributed from a retirement arrangement may be rolled over to an eligible retirement account.

402(c)(6) Sales of distributed property. For purposes of this subsection—

(A) Transfer of proceeds from sale of distributed property treated as transfer of distributed property. 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.

(B) Proceeds attributable to increase in value. The excess of fair market value of property on sale over its fair market value on distribution shall be treated as property received in the distribution.

(C) Designation where amount of distribution exceeds rollover contribution. In any case where part or all of the distribution consists of property other than money—

(i) the portion of the money or other property which is to be treated as attributable to amounts not included in gross income, and
(ii) the portion of the money or other property which is to be treated as included in the rollover contribution,

shall be determined on a ratable basis unless the taxpayer designates otherwise. Any designation under this subparagraph for a taxable year shall be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). Any such designation, once made, shall be irrevocable.

(D) Nonrecognition of gain or loss. No gain or loss shall be recognized on any sale described in subparagraph (A) to the extent that an amount equal to the proceeds is transferred pursuant to paragraph (1).

Internal Revenue Service Argues Against Rollover Treatment for Price Protected Amounts in Excess of ESOP Valuation Calculation

The IRS has determined that the fair market value of common stock distributed from an ESOP—per third party valuation—is the determinative value for purposes of what can be rolled over. The IRS quotes IRC 409(h)(1)(B) and related IRC and Treasury Regulations to shore up their belief that the only appropriate valuation for purposes of put proceeds in the ESOP valuation—as calculated by a third party independent appraiser. Amounts paid in excess of such amount under a price protect policy are considered to be compensation. The IRS argues that this amount is not an increase in the value of the shares but rather, simply, an additional payment from the plan sponsor which should be taxable on receipt.

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Discussion:

Under the IRC, an employee who receives noncash property and sells it at a gain, can roll over the increase in value over the value on the date of distribution without paying tax on the gain. The proceeds are treated as part of the distribution for rollover purposes. Where the sale results in an increase over the value on the date of distribution, the increase is also treated as part of the distribution. Shares distributed from an ESOP fall within these requirements as noncash property sold at a gain and the additional proceeds should be able to be rolled over and continue to receive favorable tax deferral as retirement proceeds.

IRC 402(c)(6)(B) clearly provides that “The excess of fair market value of property on sale over its fair market value on distribution shall be treated as property received in the distribution.” Therefore, the IRS’ conclusions appear premised on the idea that the amounts paid under a price protection policy are not “fair market value” for the shares purchased under the put option. The IRS appears to make such conclusion, in part, based on an idea that the only fair market value for shares of stock distributed from an ESOP is the value calculated by the independent appraiser.

For consideration:

- The IRC requires that shares of privately held company stock distributed by the ESOP must be able to be “put” to the company for purchase. A participant has to be able to convert their investment in illiquid assets to cash for retirement purposes.
The put price must be determined “in good faith and based on all relevant factors for determining the fair market value of securities.” A determination of fair market value based on the annual appraisal process is “deemed to be a good faith determination of value.” However, the Treasury Regulation does not provide that it is the sole determination of value. The annual appraisal process will not – for ESOP purposes – consider an independently negotiated contract right whereby a participant might sell shares of stock for a higher value and, therefore, may not include all relevant factors.

Price protection policies are generally negotiated by a third party in an arm’s length transaction, i.e., the trustee requires such policies as part of the second-stage transaction and may refuse to enter into such transaction without the company’s accommodation. Furthermore, any exempt loan entered into as part of the second stage transaction must be undertaken for the “primary benefit of participants and beneficiaries” and a trustee may feel that such benefit is only met with additional protections for certain classes of participants. As a result such policies do not pose tax avoidance concerns that may arise if employees were simply able to negotiate higher proceeds with employers on a “one off” basis to provide additional tax-favored amounts (e.g., price protection policies can be differentiated from individual contracts which may be speciously entered into to allow an executive to identify certain end of employment payments as retirement proceeds).

Fiduciary considerations – a trustee in agreeing to a second-stage transaction must consider the interests of participants and beneficiaries. Established case law and regulatory guidance makes it clear that such consideration cannot be solely undertaken for future participation but must include consideration of all plan participants. Consideration of the impact of participants nearing retirement (or others with events outside their control, e.g., death) must be included in such analysis. Without the price protection policy, some transactions may be viewed as imprudent vis a vis these individuals.

Reporting requirements under the 1099-R. How should price protection be included on such tax documentation?