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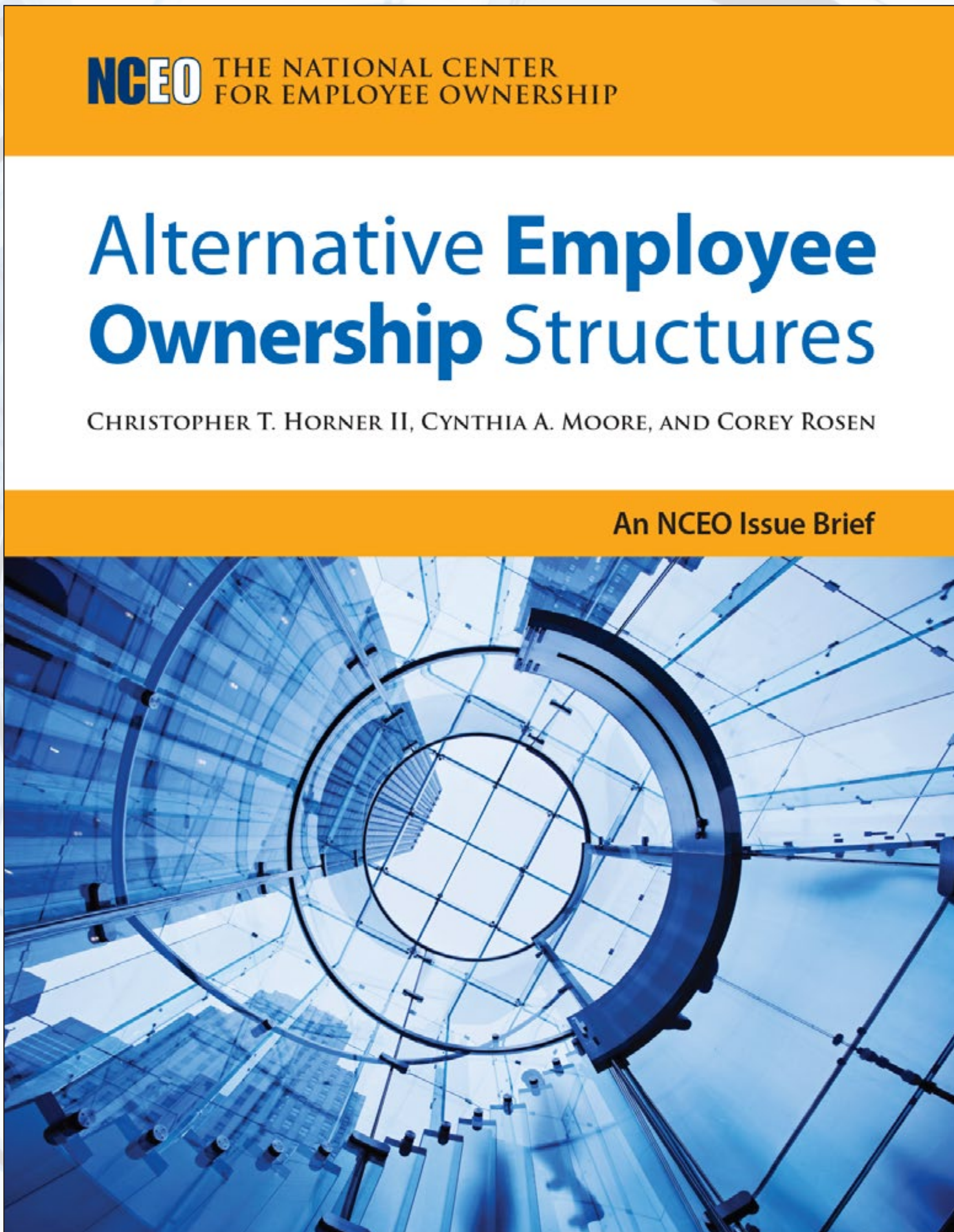

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CYNTHIA A. MOORE AND CHRISTOPHER T. HORNER II

ESOPs and profit sharing plans are employee benefit plans that are governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the "Code") and fall within the concurrent jurisdiction of the US Department of Labor and the Internal Revenue Service (IRS). ESOPs and profit sharing plans are defined contribution retirement plans.[1] Both types of plans must satisfy certain legal requirements to receive preferential federal tax treatment.[2] Unlike profit sharing plans, ESOPs are designed to invest primarily in employer securities. Profit sharing plans can be invested in employer securities in one or more of the following ways: (1) an employer securities fund can be offered as an investment alternative in a plan where a participant directs the investment of his or her account balance; (2) a plan sponsor can make part or all of its contribution to the profit sharing plan in the form of employer securities; and (3) a plan sponsor that makes all investment decisions for a profit sharing plan can choose to hold employer securities as one of the plan's investments.

Employer contributions to a profit sharing plan need not be made from current or accumulated profits.[3] A profit sharing plan must provide a definite, predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds after a fixed number of years, the attainment of a stated age, or upon the occurrence of some event such as layoff, illness, disability, retirement, death or separation from service.[4]

Although profit sharing plans and ESOPs are subject to many of the same rules, ESOPs generally have more favorable tax treatment but are also subject to more restrictive rules than profit sharing plans, as described below.

Deductible Contributions

ESOPs and profit sharing plans are defined contribution plans that entitle the employer sponsoring the plan to a deduction in the amount of the contribution in the taxable year in which the contribution is made.[5] The law imposes the same limitation on the amount that may be properly deducted by the employer; employer contributions to either an ESOP or a profit sharing plan are deductible up to 25% of covered payroll.[6] One significant difference arises in the case of a C corporation sponsoring a leveraged ESOP, in which case the 25% limitation does not include employer contributions made to enable the ESOP to amortize interest under an exempt loan.[7] Moreover, the law permits a C corporation to make a deductible contribution up to an additional 25% of covered compensation to the ESOP, provided this amount is not used to amortize principal or interest under the exempt loan.[8] The deduction limitations for an S corporation are the same as the limitations for a C corporation, except that the 25% limitation includes

1. A defined contribution plan is a plan in which an employer commits to making contributions to participant accounts. In the case of a defined contribution plan there is no guaranteed retirement benefit; the retirement benefit is based exclusively upon the contributions to the plan and the earnings attributable to such contributions. In contrast, in a defined benefit plan participants (and spouses) are guaranteed a certain level of retirement benefit typically determined by reference to an individual participant's wages and duration of service with the employer.
2. For example, ESOPs and profit sharing plans are subject to the same rules governing eligibility and vesting.
3. Code § 401(a)(27)(A).
4. Treas. Reg. § 1.401-1(b)(1)(ii).
5. See, e.g., Code § 404(a)(3)(A) (S corporation ESOPs and profit sharing plans); Code § 404(a)(9) (C corporation ESOPs).
6. Id.
7. Code § 404(a)(9)(B).
8. See, e.g., PLR 9548036 (Sept. 7, 1995) (the IRS ruled that the limitations under Code Section 404(a)(3) and Code Section 404(a)(9)(A) are applied separately).

employer contributions made to enable the ESOP to amortize interest under an exempt loan.[9]

Deductible Dividends

Congress also bestowed ESOPs with a number of significant tax advantages relating to the payment of dividends that profit sharing plans do not enjoy. For example, a C corporation is entitled to a deduction for dividends declared and paid on employer securities owned by an ESOP, provided a number of legal requirements are satisfied.[10] To be deductible, the dividend must be paid directly to participants and beneficiaries, paid to the ESOP and passed through to participants and beneficiaries, reinvested in employer securities at the direction of participants and beneficiaries, or used to satisfy the ESOP's obligations under an exempt loan.[11]

The deduction on account of dividends is not subject to the 25% limitation discussed above. Furthermore, a dividend must be "reasonable" in order to be properly deductible.[12] In contrast, distributions declared and paid by an S corporation on shares owned by the ESOP are not deductible.[13] The deductibility of dividends is a significant tax benefit afforded to a C corporation that maintains an ESOP. ESOP companies frequently declare and pay dividends on employer securities owned by the ESOP to fund the company's repurchase obligation or repay an exempt loan made to the ESOP.[14]

Unlike a C corporation sponsoring an ESOP, an employer declaring and paying a dividend on employer securities held by a profit sharing plan is not entitled to a deduction.[15]

Section 1042: Deferral of Recognition of Long-Term Capital Gain

One of the most significant differences between an ESOP and a profit sharing plan is the ability of an ESOP to afford a taxpayer the opportunity to defer recognition of the long-term capital gain realized by such taxpayer in connection with the sale of his or her stock to the ESOP.[16] The ability to do this is subject to various requirements, the analysis of which is beyond the scope of this article. These requirements include: (1) the plan sponsor must be a C corporation at the time of the sale, (2) the ESOP must own at least 30% of the outstanding stock of the plan sponsor immediately following the sale, and (3) the taxpayer must reinvest his or her sale proceeds in qualified replacement property within the qualified replacement period.[17] A profit sharing plan does not provide a taxpayer with an analogous tax deferral.[18]

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9. See Code §§ 404(a)(3) and (a)(9). Section 404(a)(9) of the Code permits an employer to make contributions in excess of 25% of covered payroll provided that such contributions are used to amortize interest under an exempt loan. However, Section 404(a)(9) of the Code applies only to C corporations sponsoring ESOPs. See Code § 404(a)(9)(C) ("This paragraph shall not apply to S corporations"). As a result, S corporations are subject to the deduction limitation imposed under Section 404(a)(3) of the Code, which does not permit an employer to make contribution in excess of 25% of covered payroll, even if such contributions are used to amortize interest under an exempt loan.
10. Code § 404(k). An S corporation sponsoring an ESOP is not entitled to a deduction for distributions declared and paid on employer securities owned by the ESOP. Id.
11. Code § 404(k). Note that for a dividend to be deductible on account of being used to amortize an exempt loan, it must be declared and paid on shares purchased with the proceeds of the exempt loan being amortized. Id.
12. See Code § 404(k)(5)(A) (disallowing the dividend deduction if the dividend constitutes, in substance, an evasion of taxation). The legislative history of Code Section 404(k) suggests that the reasonableness of a particular dividend is evaluated in terms of a reasonable compensation test. See H.R. Rep. Conf. No. 841, 99th Cong., 2d Sess. (1986). The IRS has ruled that the standard is what the corporation can be expected to pay on a recurring basis, and a reasonable dividend does not include an unusually large dividend used to amortize an exempt loan. See TAM 9304003 (Sept. 30, 1990).
13. Code § 404(k) (explicitly limiting the dividend deduction to C corporations).
14. Id.
15. To be deductible, the dividend must be declared and paid on "applicable employer securities" which are held by an employee stock ownership plan (as opposed to any other qualified plan). See Code § 404(k)(3).
16. See generally Code § 61 (defining gross income); see also Code § 1042 (nonrecognition provision applying to qualified employer securities sold to an ESOP).
17. See, e.g., Code § 1042.
18. The nonrecognition provision of Section 1042 of the Code applies only to sales of qualified employer securities to

Unrelated Business Income Tax

Profit sharing plans are subject to federal taxation on unrelated business taxable income (UBTI), whereas ESOPs are not. The effect is to reduce the benefits distributable to participants and beneficiaries of a profit sharing plan in an amount equal to the unrelated business income tax (UBIT) liability of the tax-exempt trust forming a part of the profit sharing plan. This distinction is relevant in the context of an S corporation sponsoring an ESOP. As discussed below, the portion of taxable income of the S corporation allocated to the ESOP is exempt from UBIT, whereas the same portion of taxable income of the S corporation allocated to the profit sharing plan is considered UBTI subject to UBIT.

Before 1950, a tax-exempt entity, such as an employee benefit trust, could operate a business unrelated to its tax-exempt purposes without incurring a federal tax liability, based on the premise that all income used to support charitable purposes was tax-exempt.[19] Congress imposed a tax on UBTI of tax-exempt trusts to address concerns regarding unfair competition.[20] Generally, UBTI of the tax-exempt trust forming a part of a profit sharing plan is subject to UBIT.[21] UBTI includes gross income derived from a trade or business the conduct of which is not substantially related to the purpose of the tax-exempt trust.[22]

The enactment of the Small Business Jobs Protection Act of 1996 enabled ESOPs to be permitted S corporation shareholders.[23] In addition, the legislation imposed UBIT on the S corporation income allocated to the tax-exempt trust forming a part of an ESOP. The practical effect was to impose two levels of taxation for S corporation income allocated to the tax-exempt trust (one level on the UBTI of the tax-exempt trust itself and one level on distributions to participants and beneficiaries), compared to one level of taxation for income allocated to individual S corporation shareholders. Congress responded by passing the Taxpayer Relief Act of 1997, which exempted ESOPs from UBIT.[24] Congress did not exempt profit sharing plans holding employer securities in an S corporation from UBIT. For this reason, it is generally impractical for a profit sharing plan to hold employer securities of its S corporation sponsor.

Federal Taxation of Benefit Distributions and Net Unrealized Appreciation

The federal tax consequences of benefits distributed to participants of a profit sharing plan and an ESOP are the same. As a general rule, benefit distributions to a participant or beneficiary of a qualified plan are taxable to the participant or beneficiary in the taxable year in which benefits are distributed.[25] One exception to this rule is if the participant rolls the distribution over to an individual retirement account (IRA) or another qualified plan that accepts rollover distributions. In this case, the participant is not currently taxable. The rollover benefits are taxed at ordinary income rates when the benefits are distributed from the IRA or qualified plan.

Participants in both profit sharing plans and ESOPs are subject to an early withdrawal penalty tax.[26] If the participant is under age 59½ (or age 55 if the participant has terminated employment), the participant is subject to an excise tax equal to 10% of the benefit distributed.[27]

The law affords favorable tax treatment of lump-sum distributions of employer securities from a qualified plan, including both profit sharing plans and ESOPs. Section 402(e) of the Code excludes from gross income the net unrealized appreciation of the employer securities during the time it was held by the qualified plan.[28] In other words, the Code allows a participant to take a lump-sum distribution of employer securities from a qualified plan, pay ordinary income tax on the cost basis (in the hands of the qualified plan),

ESOPs and certain eligible worker-owned cooperatives. See Code § 1042(b)(1).

19. H.R. Rep. 2319, 81st Cong. 2d Sess. 36 (1950), 950-2 C.B. 412.
20. Code § 511; Treas. Reg. §1.513-1(b).
21. Code § 511.
22. Code § 513(a).
23. Pub. L. 104–188, H.R. 3448, 110 Stat. 175.
24. Code § 512(e)(3); Pub. L. 105–34, H.R. 2014, 111 Stat. 787.
25. Code § 402(e).
26. Code § 72(t).
27. See Code § 72(t)(2) for exception to the general rule.
28. Code § 402(e)(4)(B).

and pay long-term capital gain taxes on the amount constituting the net unrealized appreciation.[29]

Prohibited Transactions and Exemptions

ERISA prohibits certain transactions between a plan and parties in interest regardless of whether the transaction is fair or beneficial to the plan. Congress perceived such transactions as inherently risky and subject to abuse.[30] Both ESOPs and profit sharing plans are subject to the prohibited transaction rules under ERISA and the Code. However, ESOPs are unique in that they can borrow money from, or on the credit of, the employer to buy employer securities. And along with profit sharing plans, ESOPs can invest up to 100% of plan assets in qualifying employer securities and can acquire qualified employer securities from a party in interest.

Extension of Credit or Guaranty of Extension of Credit

Generally, ERISA and the Code prohibit a fiduciary of an employee benefit plan from causing the plan to engage in a transaction that constitutes the lending of money or extension of credit between the plan and a party in interest (including the employer).[31] ERISA imposes personal liability on the *fiduciary* who breaches its duty, and requires that such fiduciary make good to the plan, any loss incurred by reason of its breach.[32] In contrast, the Code imposes an excise tax on any *disqualified person* who engages in a prohibited transaction.[33] An initial excise tax of 15% of the amount involved in a prohibited transaction for each year in the taxable period is imposed on the disqualified person.[34] In the case of an impermissible lending of money or extension of credit between a plan and a disqualified person, the amount involved equals the greater of the interest paid or the fair market value of the interest under the credit facility.[35]

Congress exempted ESOPs from this general rule to the extent that the lending of money or loan qualifies as an "exempt loan."[36] As a result, an ESOP can finance the acquisition of employer securities with the proceeds of an exempt loan made to it; this is known as a "leveraged ESOP."[37] Congress did not exempt profit sharing plans from the application of this rule.

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29. To be clear, the participant would not be taxed on the net unrealized appreciation until the participant disposes of the employer securities.

30. See, e.g., *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (purpose of prohibited transaction rules "was to make illegal per se the types of transactions that experience had shown to entail a high potential for abuse"); *M & R Investment Co. v. Fitzsimmons*, 685 F.2d 283 (9th Cir. 1982) (prohibited transaction rules are "a broad per se prohibition against transactions ERISA implicitly defines as not arm's-length"); *Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979) ("Congress intended to create an easily applied per se prohibition of the type of transaction in question").

31. ERISA § 406(a)(1)(B); DOL Reg. § 2550.408b-3(a)(2) (prohibited transaction includes loan to ESOP that is guaranteed by a party in interest); see also Code § 4975(c)(1)(B); Treas. Reg. § 54.4975–7(b)(1)(ii) (prohibited transaction includes loan to ESOP that is guaranteed by a disqualified person).

32. ERISA § 409(a). Additionally, the fiduciary must restore to such plan any profits made by it through the improper use of plan assets. Id. Finally, a fiduciary is subject to other equitable and remedial relief, including injunctions and removal, attorney's fees, and interest. Id.

33. The Code does not impose liability on a fiduciary that is acting only in a fiduciary capacity. In addition, unlike the prohibited transaction rules under ERISA, the Code does not require the disqualified person to have had knowledge of the prohibited transaction.

34. Code § 4975(a). In the event the prohibited transaction is not corrected within the taxable period, the Code imposes a tax equal to 100% of the amount involved on the disqualified person who participated in the prohibited transaction. See Code § 4975(b). The "taxable period" begins on the date of the prohibited transaction and ends on the earliest of (1) the date a notice of deficiency under Code § 6212 is mailed; (2) the date on which the 15% tax under Code § 4975(a) is assessed; or (3) the date on which the prohibited transaction is corrected. Code § 4975(f)(2).

35. Treas. Reg. § 53.4941(e)-1(b)(2)(ii).

36. ERISA § 408(b)(3); DOL Reg. § 2550.408b-3; Code § 4975(d)(3); Treas. Reg. § 54.4975–7(b); Treas. Reg. § 54.4975-11. Among other requirements, an exempt loan must be made primarily for the benefit of the participants and beneficiaries of the ESOP; must be at a reasonable rate of interest; and any collateral securing the ESOP's obligations under an exempt loan consists only of certain qualifying employer securities. Code § 4975(d)(3); Treas. Reg. § 54.4975-7(b).

37. Code § 4975(d)(3).

Diversification of Plan Assets

With limited exceptions, ERISA requires a fiduciary of an employee benefit plan to diversify plan assets.[38] Generally, an employee benefit plan is prohibited from acquiring or holding employer securities with a fair market value in excess of 10% of plan assets.[39] An exception from this general rule exists for an eligible individual account plan (EIAP).[40] Both ESOPs and profit sharing plans are included within the definition of an EIAP, provided that the plan explicitly provides for the acquisition and holding of qualifying employer securities.[41] In fact, Congress designed ESOPs "to invest primarily in employer securities."[42] The term "primarily" is undefined. The US Department of Labor has stated that there may be instances where a fiduciary would breach its fiduciary duties if it invested more than 50% of plan assets in qualifying employer securities.[43] The Department of Labor concluded that the "primarily" requirement must be satisfied over the life of the ESOP.[44]As a result, both an ESOP and a profit sharing plan can be designed to invest 100% of their assets in qualifying employer securities.

Sale or Exchange of Property

In addition to prohibitions on the lending of money or extension of credit, ERISA and the Code prohibit a fiduciary from engaging in a transaction that constitutes the sale or exchange of property with a party in interest.[45] As with the lending of money or extension of credit, ERISA imposes personal liability on the *fiduciary* who breaches its duty, and requires that such fiduciary make good to the plan, any loss incurred by reason of its breach.[46] In contrast, the Code imposes an excise tax on any *disqualified person* who engages in a prohibited transaction.[47] An initial excise tax of 15% of the amount involved in a prohibited transaction for each year in the taxable period is imposed on the disqualified person.[48] In the case of an impermissible sale or exchange of property between a plan and a disqualified person, the amount involved equals (1) the greater of the amount of money and the fair market value of the other property given by the plan and (2) the amount of money and the fair market value of the other property received by the plan.[49]

Congress exempted plans (both ESOPs and profit sharing plans) from this general prohibition to the extent that the sale or exchange satisfies certain legal requirements.[50] First, the plan must be acquiring or selling qualifying employer securities.[51] Second, the acquisition or sale must be for adequate consideration.[52] Third, no commission can be charged in connection with the acquisition or sale.[53] Finally, the plan must constitute an eligible individual account plan.[54]

Administration

Eligibility

The same eligibility requirements apply to all qualified retirement plans, including ESOPs and profit sharing plans.[55] Generally, the Code and ERISA permit a

38. ERISA § 404(a)(1)(C).
39. ERISA § 407(a).
40. ERISA § 407(d)(3)(B).
41. Id.
42. Code § 4975(e)(7).
43. DOL Advisory Opinion 83–6A (January 24, 1983).
44. Id.
45. ERISA § 406(a)(1)(A).
46. ERISA § 409(a). Additionally, the fiduciary must restore to such plan any profits made by it through the improper use of plan assets. Id. Finally, a fiduciary is subject to other equitable and remedial relief, including injunctions and removal, attorney's fees, and interest. Id.
47. The Code does not impose liability on a fiduciary that is acting only in a fiduciary capacity. In addition, unlike the prohibited transaction rules under ERISA, the Code does not require the disqualified person to have had knowledge of the prohibited transaction.
48. Code § 4975(a). In the event the prohibited transaction is not corrected within the taxable period, the Code imposes a tax equal to 100% of the amount involved on the disqualified person who participated in the prohibited transaction. See Code § 4975(b).
49. Code § 4975(f)(4).
50. ERISA § 408(e); DOL Reg. 2550.408e; Code § 4975(d)(13).
51. ERISA § 408(e). The term "qualifying employer securities" is defined in ERISA § 407(d)(5).
52. ERISA § 408(e)(1). The term "adequate consideration" is defined in ERISA § 3(18) and DOL Prop. Reg. § 2510.3-18(b).
53. ERISA § 408(e)(2).
54. ERISA § 408(e)(3). The definition of an eligible individual account plan includes an ESOP and a profit sharing plan. See note 41 and accompanying text.
55. See Code § 410(a).

qualified plan to require that an employee complete one year of service and attain age 21 before becoming eligible to participate.[56] A qualified plan may permit earlier participation if the employer so desires.

Vesting

The same vesting requirements apply to all qualified retirement plans, including ESOPs and profit sharing plans.[57]

Allocations

Contributions (whether in the form of employer securities or cash) to an ESOP are allocated to eligible plan participants as the ESOP receives the contributions. In contrast, employer securities acquired by an ESOP with exempt loan proceeds are placed in a suspense account to be allocated to participant accounts as the loan is amortized.[58] As the exempt loan is repaid, employer securities are released from a suspense account based on the "applicable release fraction," which is a fraction based on either (1) principal and interest payments or (2) principal payments only.[59] The *release* of employer securities from the suspense account must be distinguished from the *allocation* of employer securities to participants' employer securities accounts.

Generally, allocations of contributions (whether in the form of employer securities or cash) must be based on a participant's compensation relative to the compensation of all participants in the ESOP. In addition, allocations of employer securities might be based on a more level formula. Integration with Social Security taxable wages and cross-testing, discussed below, are not permissible allocation methodologies for ESOPs.[60]

In a profit sharing plan, a participant must first satisfy any conditions to receive an allocation for a plan year, typically completing 1,000 hours of service and employment on the last day of the plan year. The employer's profit sharing contribution can be discretionary or fixed and is allocated to participants in the manner set out in the plan document. Allocation methods include:

1. pro rata on the basis of each participant's compensation relative to the total compensation of all participants entitled to receive an allocation for the plan year (up to the annual limit on compensation under Section 401(a)(17) of the Code);
2. the contribution can be "integrated" under Section 401(l)(2) of the Code, such that a participant with wages above the Social Security taxable wage base receives a larger contribution;
3. each participant can be given "points" for age, service, and/or compensation, with allocations being made in proportion to each participant's total points relative to all participants' total points; and
4. the allocation can be based on a "cross-tested" formula, in which different classes of participants are established and the contribution is made on a percentage basis to each class.[61]

Code Section 415 Limits

The Code limits the amount of "annual additions" that can be allocated to all of the defined contribution plan accounts of each participant in a limitation year.[62] Annual additions include employer contributions, employee elective deferrals, and certain forfeitures.[63] A participant cannot receive annual additions in excess of the lesser of a dollar limit ($52,000 as of 2014) and 100% of eligible compensation, up to $260,000 (as of 2014; these limits are adjusted for cost-of-living increases).[64]

A special rule applies to leveraged ESOPs sponsored by C corporations. Under this special rule, if no

56. Code § 410(a)(1)(A); ERISA § 202(a)(1)(A).
57. Code § 401(a)(7); Code § 411(a); ERISA § 203(a)(2)(B).
58. Treas. Reg. § 54-4975-7(b).
59. Treas. Reg. § 54.4975–7(b)(8)(i)-(ii). An applicable release fraction based on principal payments only results in low allocations of employer securities in the early years of the loan, when primarily interest is being paid off.
60. Code § 401(a)(4); Treas. Reg. § 1.401(a)(4)-2(b).
61. A cross-tested profit sharing plan satisfies the nondiscrimination test of Code § 401(a)(4) by demonstrating that the benefits (rather than the contributions) do not discriminate in favor of highly compensated employees. Treas. Reg. § 1.401(a)(4)-8(b). An ESOP is not permitted to demonstrate nondiscrimination with respect to benefits. Treas. Reg. § 1.401(a)(4)-8(b)(1)(i).
62. Code § 415(a)(1)(B).
63. Code § 415(c)(2).
64. Code § 415(c)(1)(A); Code § 401(a)(17).

more than one-third of the employer contributions are allocated to highly compensated employees, the employer contributions that are used to amortize interest under the exempt loan and allocated forfeitures of employer securities that were acquired with the proceeds of the exempt loan are excluded from the calculation of annual additions.[65]

In addition, in the case of a leveraged ESOP, annual additions can be calculated based on employer contributions used by the ESOP to amortize an exempt loan or based on the fair market value of the employer securities allocated to participants' employer securities accounts.[66]

Annual additions calculated with respect to employer contributions do not consider appreciation in the employer securities' value from the time such securities are placed into the suspense account.[67] In addition, dividends or distributions declared and paid on employer securities held by an ESOP constitute earnings and generally do not constitute annual additions.[68] Nonetheless, the Internal Revenue Service is empowered to recharacterize amounts that an employer designates as dividends or distributions if it determines that such dividends or distributions are appropriately treated as annual additions.[69]

Profit sharing plans are ineligible for this special rule and thus are subject to the normal annual addition limits.

Valuation

The Code requires that all defined contribution plans, including ESOPs and profit sharing plans, must provide for a valuation of investments held by the trust, at least once a year, on a specified date, in accordance with a method consistently followed and uniformly applied.[70] Moreover, the Code provides that an ESOP is not a qualified plan unless all valuations of employer securities that are not readily tradeable on an established securities market, with respect to activities carried on by the ESOP, are performed by an independent appraiser.[71] A valuation by an independent appraiser is not required in the case of employer securities that are readily tradeable on an established securities market.[72]

Although profit sharing plans are not required to obtain an annual valuation by an independent appraiser, a profit sharing plan must value non-publicly traded employer securities on an annual basis to comply with its obligations under both ERISA and the Code. Form 5500 must reflect the "current value" of all plan assets, including employer securities, as of the first and last day of the plan year and must also reflect unrealized appreciation and depreciation of plan assets.[73] "Current value" means the fair market value where available. Otherwise, it means the fair value as determined in good faith by a trustee or a named fiduciary, assuming an orderly liquidation at the time of the determination.[74] Furthermore, an accurate assessment of fair market value is essential for a plan's ability to comply with certain requirements in the Code, such as the exclusive benefit rule of Section 401(a)(2), the annual limit on contributions under Code Section 415, and the deduction rules under Code Section 404.[75] Finally, the valuation of a profit sharing plan's assets will determine the value of a participant's account and, ultimately, the amount of his or her distribution.

Distributions

Timing of Payment

Both profit sharing plans and ESOPs are subject to the general rules governing distributions from qualified benefit plans. However, ESOPs are subject to a second set of rules for stock the plan acquired after 1986 (which nowadays often means all the stock that an ESOP holds). In any given situation, the set of rules

65. Code § 415(c)(6).
66. Treas. Reg. § 1.415-6(g)(4) and Notice 87-21, Q&A 11.
67. Treas. Regs. §§ 1.415-6(g)(4), 54.4975–11(a)(8)(ii) and 54.4975–7(b)(8)(iii).
68. PLR 200243055 (Feb. 20, 2003); see also Treas. Reg. § 1.415-2(b)(1)(iv).
69. See, e.g., *Steel Balls, Inc. v. Commissioner*, 69 TCM 2912, *aff'd* 89 F.3d 841 (8th Cir. 1996) (unpublished per curiam).
70. Rev. Rul. 80-155, 1980-1 C.B. 84; Treas. Reg. § 1.415-6(g)(4); Notice 87-21, Q&A 11.
71. Code § 401(a)(28)(C).
72. See Treas. Reg. § 54.4975–7(b)(1)(iv) (defining the term "readily tradeable on an established securities market").
73. ERISA § 103(b)(3)(A); Instructions to Schedule H of Form 5500.
74. ERISA § 3(26).
75. Internal Revenue Manual Section 4.72.8.1.

that would mandate an earlier distribution apply; usually it is the special ESOP rules that do so.

Under the general rules applying to both profit sharing plans and ESOPs, unless otherwise elected by the participant, distributions must begin no later than 60 days after the end of the plan year in which the latest of the following events occurs: (1) the date on which the participant attains the earlier of age 65 or the normal retirement age specified under the plan; (2) the 10th anniversary of the year in which the participant commenced participation in the plan; or (3) the date the participant terminates from service with the employer.[76] If the participant's account balance is greater than $5,000, the participant's consent is generally required before a distribution can be made.[77] If a participant elects a distribution, it is generally payable within the time period specified in the plan document, which may be as soon as administratively feasible after the distribution is elected. However, if the plan holds non-publicly traded employer securities, distributions may be restricted until after the annual valuation of employer securities has been performed, so that the account value is properly determined.

Under the special ESOP rules, distributions usually begin sooner than they would under the general rules above. A participant can elect, with the consent of his or her spouse, to commence distribution of benefits from an ESOP not later than one year after the close of the plan year in which the participant separates from service by reason of the attainment of normal retirement age under the plan, disability, or death, or the close of the plan year that is the fifth plan year following the plan year in which the participant separates from service for any other reason.[78] The rules governing the commencement of distributions represent the legal limit on how long the employer can postpone distributing benefits from an ESOP to a participant. Applicable law permits an employer to adopt more liberal rules governing the timing of distributions. In addition, the "financed securities exception" provides that the distribution of employer securities acquired with the proceeds of an exempt loan may be delayed until the close of the plan year in which such exempt loan is repaid in full.[79]

Both ESOPs and profit sharing plans may provide for in-service distributions after a fixed number of years (after contributions have been held in the plan for at least two years)[80] or upon a bona fide hardship.[81] However, ESOPs generally do not permit in-service distributions.

Both ESOPs and profit sharing plans must permit a direct rollover to an IRA or other qualified plan in accordance with Section 401(a)(31) of the Code. Further, both ESOPs and profit sharing plans are subject to the required minimum distribution rules of Section 401(a)(9) of the Code which provides that distributions must begin by the April 1 after the later of the year in which the participant attains age 70½ or retires.[82]

Method of Payment

Unless an ESOP participant elects otherwise, distributions must be distributed in substantially equal periodic payments (at least annually) over a period not to exceed five years.[83] However, if the participant's account balance exceeds $1,050,000 (as of 2014), the distribution period is increased, unless the participant elects otherwise, to five years plus one additional year (up to five additional years) for each $210,000 (as of 2014), or fraction thereof, by which the balance exceeds $210,000 (as of 2014; this and the other dollar figures are adjusted for cost-of-living increases).[84]

Profit sharing plans are exempt from the qualified joint and survivor annuity (QJSA) rules if (1) the plan provides that the participant's vested benefit is payable in full, upon the participant's death, to the participant's surviving spouse, unless the participant elects, with the spouse's consent, that such benefit be paid instead to a designated beneficiary; (2) the

76. Code § 401(a)(14).
77. Code § 411(a)(11).
78. Code § 409(o)(1)(A). These rules assume the participant is not reemployed by the employer before commencement of distributions.
79. Code § 409(o)(1)(B). Discussion regarding the applicability of the financed securities exception is beyond the scope of this article.
80. Rev. Rul. 71-295, 1971-2 C.B. 184.
81. Rev. Rul. 71-224, 1971-1 C.B. 124.
82. Notwithstanding the general rule, required minimum distributions to a 5% owner must begin no later than the April 1 after the calendar year in which the individual attains age 70½. Code § 401(a)(9)(C)(ii).
83. Code § 409(o)(1)(C)(i).
84. Code § 409(o)(1)(C)(ii).

participant does not elect the payment of benefits in the form of a life annuity; and (3) the plan is not a transferee or an offset plan.[85]

Unless a profit sharing plan is subject to the QJSA rules, the Code does not specify any particular form of distribution from the plan, and distributions are made in the form specified in the plan document. Distributions are typically permitted in the form of a lump sum, periodic installments (not to exceed the life expectancy of the participant or the joint life expectancies of the participant and his/her beneficiary), or in an annuity form, as elected by the participant.

Form of Payment

Distributions from an ESOP may be made in the form of cash, subject to the participants' right to demand distribution in the form of employer securities.[86] Two exceptions to this general rule exist. First, if the employer's corporate charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan, the participant may be precluded from demanding a distribution in the form of employer securities.[87] Second, participants in an ESOP sponsored by an S corporation may be also be precluded from demanding a distribution in the form of employer securities.[88] Distributions in the form of employer securities that are not readily tradeable on an established securities market are subject to the put option rules discussed below.

Distributions from a profit sharing plan may be made in cash or in kind, as specified in the plan document. If the plan holds employer securities that are publicly traded, it is typically distributed in the form of stock.

Put Option

Employer securities distributed from an ESOP that are not readily tradeable on an established securities market or subject to a trading limitation must be subject to a put option.[89] The put option must permit a participant to "put" the employer security to the employer.[90] An ESOP cannot be obligated to honor a participant's put option, but the ESOP can have a right of first refusal to assume the employer's obligations of the put option.[91] With respect to timing, the put option must be exercisable for at least 60 calendar days following the date of the distribution and for at least an additional 60 calendar day period in the following plan year.[92]

If the participant receives a "total distribution" that is required to be repurchased by the employer, the employer must make payments in substantially equal periodic payments (at least annually) over a period beginning not later than 30 calendar days after exercise of the put option and not exceeding five years.[93] The employer must provide adequate security and pay reasonable interest on the unpaid amounts.[94] If the participant receives installment distributions that are required to be repurchased by the employer, the employer must remit payment for the employer securities no later than 30 calendar days after the put option is exercised by the participant.[95]

Employer securities distributed from a profit sharing plan are not required to be subject to a put option.

Diversification

ESOPs that acquired employer securities of private companies on or after January 1, 1987, are subject to certain diversification requirements.[96] Under these

85. Treas. Reg. § 1.401(a)-20, Q&A 3.
86. Code § 409(h)(1)(A).
87. Code § 409(h)(2)(B)(ii)(I).
88. Code § 409(h)(2)(B)(ii)(II).
89. See Code § 409(h); Treas. Reg. § 54.4975–7(b)(10).
90. Code § 409(h)(1).
91. Treas. Reg. § 54.4975-7(b)(9).
92. Code § 409(h)(4).
93. Code § 409(h)(5). A "total distribution" is a distribution within one taxable year to the recipient of the balance to the credit of the recipient's account. Id.
94. Id.
95. Code § 409(h)(6). An exception to the general put option rule exists for ESOPs established and maintained by a bank or other financial institution that is prohibited by applicable law from redeeming its own securities. In this case, the employer securities are not required to be subject to a put option, provided that the participants have a right to receive distributions in the form of cash. See Code § 409(h)(3).
96. Code § 401(a)(28)(C). Certain ESOPs that hold publicly traded employer securities are subject to a different set of diversification rules. See Code § 401(a)(35) and the discussion below.

rules, a qualified participant is entitled to elect to diversify a portion of his or her ESOP account during the qualified election period. A qualified participant is an employee who has completed at least 10 years of participation under the ESOP and has attained age 55. The initial opportunity to elect must be offered within 90 calendar days after the close of the plan year in which the participant becomes a qualified participant. The amount must be distributed within 180 calendar days after the close of the plan year in which the election is made. The qualified election period is the 6-plan-year period commencing after a participant becomes a qualified participant. A qualified participant is eligible to diversify 25% of his or her employer securities account balance for the first 5 years of his or her qualified election period and 50% of his or her employer securities account during their sixth and final plan year. The diversification calculation is a cumulative calculation. In other words, the employer securities account balance consists of the number of eligible shares that have ever been allocated to a qualified participant's account less any shares previously distributed, transferred, or diversified. An employer can satisfy its diversification obligation by a distribution, a transfer to another qualified plan, or offering three or more investment options within the ESOP.[97]

Effective for plan years beginning on and after January 1, 2007, a profit sharing plan that holds publicly traded employer securities is subject to a different set of diversification rules.[98] Any "applicable individual" may elect to reinvest the portion of the account attributable to nonelective employer contributions and invested in employer securities in other investment funds. An individual is an "applicable individual" if he or she is a participant who has completed three years of service; is an alternate payee of a participant who has completed three years of service; or is the beneficiary of a deceased participant.[99] The plan must make available at least three investment options, other than employer securities, to which an applicable individual may direct the proceeds from the divestment of employer securities, each of which is diversified and has materially different risk and return characteristics.[100] Divestment and reinvestment may be limited to periodic, reasonable periods occurring at least on a quarterly basis.[101] Thus, unlike an ESOP, an applicable individual in a profit sharing plan holding publicly traded employer securities may choose to divest up to 100% of the portion of his or her account attributable to employer contributions out of employer securities on an ongoing basis. Employer securities held in a profit sharing plan sponsored by a private corporation are not subject to diversification rules.

Under Section 101(m) of ERISA, a plan administrator of a profit sharing plan holding publicly traded employer securities must provide a notice to applicable individuals not later than 30 days before the first date on which the individuals are eligible to exercise their rights. The notice must set forth the diversification rights and describe the importance of diversifying the investment of retirement plan accounts.[102]

An ESOP that holds publicly traded employer securities is not subject to the diversification rules of Section 401(a)(35) of the Code if it is a separate plan from any other defined benefit or defined contribution plan maintained by the same employer and holds no contributions that are (or were ever) subject to Section 401(k) or 401(m) of the Code.[103] In other words, an ESOP is subject to these rules only if the ESOP is a portion of a larger plan (whether or not that plan holds contributions subject to Section 401(k) or 401(m)).[104]

Voting of Employer Securities

If the employer has a registration-type class of securities, the ESOP must pass through voting rights with respect to all qualifying employer securities that are entitled to vote and are allocated to participants' employer securities accounts.[105] Generally, the term "registration-type class of securities" means securities that are required to be registered under Section 12 of the Securities Exchange Act of 1934.[106]

97. Code § 401(a)(28)(B)(ii).
98. Code § 401(a)(35).
99. Code § 401(a)(35)(C); Treas. Reg. § 1.401(a)(35)-1(c)(2).
100. Code § 401(a)(35)(D).
101. Code § 401(a)(35)(D)(ii)(I).
102. The Internal Revenue Service has provided a model notice that may be used for this purpose in Notice 2006-107.
103. Code § 401(a)(35)(E)(ii).
104. Treas. Reg. § 1.401(a)(35)-1(f)(2)(ii).
105. Code § 4975(e)(7); Code § 409(e)(2).
106. Code § 409(e)(4).

If the employer has no registration-type class of securities, then the pass-through of voting rights is required only if the employer's stock is not publicly traded and more than 10% of the ESOP's assets consist of securities of the employer.[107] Pass-through of voting rights is required only if applicable state law requires one of the corporate matters enumerated in Section 409(e) of the Code to be submitted to a shareholder vote.[108] A participant or beneficiary is entitled to vote all employer securities allocated to his or her employer securities account regardless of whether the participant is vested in such employer securities.

Participants are not entitled to vote unallocated employer securities; unallocated employer securities may be voted by participants and beneficiaries or a fiduciary.[109] The employer must furnish participants and beneficiaries and the ESOP fiduciaries with the same notices and information statements that the employer's charter, bylaws, or applicable federal or state law would require the employer to distribute to other shareholders.[110] Participants and beneficiaries are entitled to vote fractional rights to securities.[111] The fiduciary may vote the employer securities allocated to a participant's employer securities account for which no voting directive is received.[112]

An employer that does not have a registration-type class of securities may satisfy the requirements under Section 409(e)(3) of the Code if the plan provides for "mirror voting," whereby each participant is entitled to one vote with respect to each issue on which the participant has the right to vote, regardless of the number of employer securities allocated to such participant's employer securities account, and the fiduciary votes the employer securities held by the plan in proportion to the directive received from participants and beneficiaries.[113]

A profit sharing plan is not required to pass through voting rights on employer securities held in the plan to participants and beneficiaries.[114] However, a participant-directed individual account plan that is intended to comply with Section 404(c) of ERISA will often pass through voting rights to ensure that the participant is exercising "control" over his or her account.[115] If voting rights are not passed through to participants, the trustee of the plan will vote the shares, either in its discretion or, in the case of a directed trustee, by following the direction of the employer or plan administrator.

Conclusion

Profit sharing plans are a viable alternative to ESOPs as vehicles of facilitating employee ownership. Much like an ESOP, a well-drafted profit sharing plan may invest any portion of its assets in employer securities and may distribute benefits to participants and their beneficiaries in the form of employer securities. As a result, a simpler, more flexible profit sharing plan might accomplish the same goals that a complex ESOP can accomplish. An ESOP should be used where specific objectives exist that only an ESOP can achieve, such as providing an owner with a liquidity event and allowing him or her to defer gain on the sale of stock under Section 1042 of the Code.

107. Code § 401(a)(22).

108. PLR 9705004 (Dec. 15, 1996); *Central Trust Co., N.A. v. American Avents Corp.*, 771 F. Supp. 871, 876 (S.D. Ohio 1989); *Schoenholtz v. Doniger*, 657 F. Supp. 899, 905 (S.D.N.Y. 1987). Such events may include a merger, recapitalization, liquidation, dissolution, or sale of substantially all assets.

109. Treas. Reg. § 1.46-8(d)(8)(i).

110. Treas. Reg. § 1.46-8(d)(8)(ii).

111. Treas. Reg. § 1.46-8(d)(8)(iii).

112. See DOL Op. Ltr. Re: Carter Hawley Hale Stores, Inc. (Apr. 30, 1984); see also Rev. Rul. 95-57, 1995-2 C.B. 62 (concluding that voting by fiduciary of allocated employer securities for which no direction was received is not inconsistent with Section 409(e)(2) and (3) of the Code).

113. Code § 409(e)(5).

114. Code § 401(a)(22) (explicitly carving profit sharing plans out of the defined contribution plans required to satisfy the voting provisions of Section 409(e) of the Code).

115. DOL Reg. §2550.404c-1(c)(1)(ii).

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