

Rev. Proc. 2004-14

SECTION 1. PURPOSE

The Treasury Department and the Internal Revenue Service have determined that it is consistent with the purposes of, and policies underlying, employee stock ownership plans (ESOPs) to enable an ESOP to direct certain rollovers of distributions of S corporation stock to an individual retirement plan (IRA) in accordance with a

distributee's election without terminating the corporation's S election. Accordingly, if the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover.

Rev. Proc. 2003-23, 2003-1 C.B. 599, provides that the Service will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA, the S corporation actually repurchases the stock, and the other requirements of that revenue procedure are satisfied. This revenue procedure modifies Rev. Proc. 2003-23 by providing that the Service also will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA, the ESOP repurchases the stock, and the other terms of this revenue procedure are satisfied.

SECTION 2. BACKGROUND

In 1996, Congress amended § 1361(b)(1)(B) of the Internal Revenue Code to make ESOPs (as defined in § 4975(e)(7)), along with other plans qualified under § 401(a), eligible S corporation shareholders. A fundamental purpose of an ESOP, including an ESOP that holds stock in an S corporation, is to provide participants with equity ownership in the employer corporation through participation in the ESOP, including distributions of employer securities to participants. *See* S. Rep. 94-938 at 180, 1976-3 C.B. 218 (stating that an ESOP "is a technique of corporate finance designed to build beneficial equity ownership of

shares in the employer corporation in its employees").

Section 409(h) generally requires that an ESOP provide for distributions in the form of employer securities. An ESOP meets the requirements of § 409(h)(1)(A) and (B) if a participant who is entitled to a distribution has the right to demand that the participant's benefits be distributed in the form of employer securities and, if the employer securities are not readily tradeable on an established securities market, has a right to require that the employer repurchase the securities under a fair valuation formula. This right is commonly referred to as a "put option." The put option must permit a participant to put the security to the employer in accordance with § 409(h) and § 54.4975-7(b)(10) of the Excise Tax Regulations. However, under no circumstances may the put option bind the ESOP. The put option may grant the ESOP an option to assume the rights and obligations of the employer to repurchase the securities at the time that the put option is exercised.

Section 409(h)(2)(B) provides that an ESOP maintained by an S corporation is permitted to provide for distributions only in cash or for distributions of employer securities subject to a repurchase requirement which meets the requirements of § 409(h)(1)(B).

Under § 401(a)(31) and A-1 of § 1.401(a)(31)-1 of the Income Tax Regulations, a qualified plan, including an ESOP, is required to permit the distributee of any eligible rollover distribution (as defined in § 402(c)(4)) to have the distribution paid in a direct rollover (as defined in A-3 of § 1.401(a)(31)-1) to an eligible retirement plan (as defined in § 402(c)(8)(B)) specified by the distributee. Therefore, an ESOP that holds S corporation stock and permits distributions in the form of employer securities is required to permit participants to elect to have any distribution of S corporation stock that is an eligible rollover distribution be paid in a direct rollover to an eligible retirement plan specified by the distributee, including an IRA. An IRA trustee or custodian, however, is not a permissible S corporation shareholder. *See* §§ 1361(b) and 1361(c)(6).

Under § 409(h)(2)(B), an ESOP that provides for distributions in the form of securities of an employer that is an S corporation is permitted to provide that the S corporation stock included in the distribution is subject to a repurchase requirement. Thus, an ESOP is permitted to provide that any stock in an S corporation that is distributed is subject to immediate repurchase by the S corporation upon a direct rollover of the stock from the ESOP to an IRA.

SECTION 3. SCOPE

This revenue procedure sets forth certain requirements related to an ESOP's distribution of S corporation stock to a participant where the participant elects to have the S corporation stock distributed to an IRA in a direct rollover. If these requirements are satisfied, the Service will accept the position that the distribution does not affect the S corporation's election to be taxed as an S corporation.

SECTION 4. APPLICATION

The Service will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock where the participant directs that such stock be distributed to an IRA in a direct rollover, provided that:

.01 The terms of the ESOP require that the S corporation repurchase the stock immediately upon the ESOP's distribution of the stock to an IRA;

.02 Either, pursuant to the terms of the ESOP, the S corporation actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution, or, pursuant to the terms of the ESOP, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA and the ESOP actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution; and

.03 No income (including tax-exempt income), loss, deduction, or credit attributable to the distributed S corporation stock under § 1366 is allocated to the participant's IRA.

SECTION 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2003-23 is modified and superseded.

SECTION 6. DRAFTING INFORMATION

The principal authors of this revenue procedure are Audrey W. Ellis of the Office of Associate Chief Counsel (Passthroughs and Special Industries), John Ricotta of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Robert Gertner of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding the S corporation aspects of the revenue procedure, contact Ms. Ellis at (202) 622-3060 (not a toll-free call). For further information regarding the employee plans aspects of the revenue procedure, contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free call) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday or contact Mr. Gertner at (202) 283-9888 (not a toll-free call).