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LOREN D. STARK COMPANY

## Eligible Individual Account Plans

One of the objectives of a principal owner may be the use of plan assets of a qualified plan sponsored by the corporation as working capital for the corporation. However, the corporation is generally prohibited from such use by several rules, which would create substantial financial penalties (excise taxes), and personal liability for plan losses attributable to such transactions. A brief summary of these rules is a follows:

1. ERISA Section 407(a)(3) provides that a qualified plan may not maintain more than 10% of its market value in qualifying employer securities and qualifying employer real property.

2. ERISA Section 406 provides that the acquisition of any qualifying employer real property by a plan in excess of the "10% rule" is a prohibited transaction. Prohibited transactions require the payment of excise taxes by the disqualified person.

3. ERISA Section 404(a) provides substantially that a fiduciary shall discharge his duties for the sole benefit of the plan participants in the same manner as a prudent man and with appropriate diversification. A variation on this same principle is set forth in Revenue Rule 69-494 referred to as the "exclusive benefit" rule.

The conventional means of avoiding the above-referenced rule is the use of an Employee Stock Ownership Plan (ESOP). However, ESOP's are subject to many requirements which may not be appropriate in many situations. Some of these requirements are the following:

1. All distribution to all plan beneficiaries must be made in qualifying employer securities.

2. ESOP's are designed to invest all employee participant accounts in qualifying employer securities

3. Qualifying employer securities acquired by the plan after 31 December 1986 must be valued by an independent appraiser [Internal Revenue Code (IRS) Section 401(a)(28)(C)].

4. The securities distributed to a participant must be subject to a put option to the plan or the corporation.

5. Certain pass through voting must be given to the participants of the plan of such qualifying employer securities.

A potential solution to the above dilemma is the combination of the Eligible Individual Account plan with the "participant control" of ERISA Section 404(c). ERISA Section 407(d)(3) defines an Eligible Individual Account Plan as an individual account plan which "explicitly provides for the acquisition and holding of qualifying employer securities." The prohibited transaction rules of ERISA Section 406 and 407 do not apply to an Eligible Account Plan if the acquisition of the qualifying employer security is for adequate consideration and no commission is paid [ERISA Section 408(e)]. Therefore, a plan may purchase qualifying employer securities from a disqualified person that is an employee, officer, or stockholder of the sponsor or beneficiary of the plan. Further, ERISA Section 408(e)(3)(B) exempts an Eligible Individual Account Plan from the "10% rule" of ERISA Section 407(a).

If the plan participants have control or discretion as to the type of investments to be made in their individual accounts in accordance with the regulations issued by the Labor Department pursuant to ERISA Section 404(c), including the right to purchase qualifying securities, the plan fiduciaries would have further insulation from fiduciary associated with participant investment sections. Also, ERISA Section 404(a)(2) specifically exempts Eligible Individual Account Plans from the diversification requirements of ERISA. However especially if the plan is a 401(k) plan, great care must be taken to avoid the violation of any federal or state security rules. It would seem that a very explicit statement as to the substantial risk of such an investment which would tend to discourage the selection of qualifying employer securities by all participants other than principal owners would avoid any potential security rule issues. Even so, most situations would be exempt because of the limited size in dollars of the offering, the limited number of participants eligible to purchase the offering, and the intrastate situs of the plan and issue. The repeal of the 40% participation requirement of ERISA Section 401(a)(26) as to a defined contribution plan benefit or feature results in some reduction in the need to offer stock to all participants

The most difficult question relates to the type of qualifying employer securities which might be available. ERISA Section 407(d)(5) defines qualifying employer securities as an employer security which is <u>STOCK</u> or a marketable obligation. A marketable obligation is defined by ERISA Section 407(e) as evidence of indebtedness (bond, venture, note, etc.) which is acquired at a price currently paid for such issue by person's independent of the issuer, not more than 25% of such issues outstanding as owned by the plan and at least 50% of the outstanding issue is held by persons independent of the issuer. This requirement that the price of such issue of such marketable security must be established by independent persons would generally eliminate their use for our stated purpose. Although ERISA Section 407(f) requires <u>STOCK</u> to meet similar publicly traded percentages, ERISA Section 407(d)(5) specifically exempts the qualifying securities of an eligible individual account plan from some such ownership diversity.

If <u>STOCK</u> is available under the scenario set forth, what precisely is meant by <u>STOCK</u>? Although a plan qualified under IRC Section 401(a) can own S Corporation stock [IRC Section 1361(c)(b)], such ownership shall be treated as an interest in an unrelated trade or business causing all "pass-through" income as well as gains upon the sale of the stock to be taxable to the plan [IRC Section 512(e)] That is, S Corporation stock income is Unrelated Business Taxable Income (UBTI). An exception to this rule is S Corporation stock owned by an ESOP [IRC Section 512(e)(3)]. Therefore, since an eligible individual account is not an ESOP so as to avoid all of the ESOP rules set forth above, the only type of stock which could be owned by a plan to best benefit the account beneficiary is the stock of a C Corporation.

Then as to a "C Corporation," what constitutes STOCK for purposes of an eligible individual account plan? Although the STOCK issue may be some form of non-voting preferred, the issue must nevertheless be some form of corporate ownership. Say, for example, that the issue was a non-voting cumulative preferred stock. Unless such shares were convertible to common at the option of the holder under some window of opportunity an argument could be made that the issue was actually a debenture and not a stock and, therefore, subject to the independent personal ownership rule set forth above for marketable obligations. Further, the STOCK must trade for "adequate consideration" in order to escape the prohibited transaction rules. Therefore, although an annual appraisal would not be required as necessary for an ESOP, the STOCK would need to be valued by an independent appraiser whenever there was a trade of such security. An exception to the appraisal requirement might be available upon the initial funding of a new corporation.