



IRS Issues Private Ruling allowing International ESOP Participants

ESOP Law Group, LLP recently obtained a private letter ruling (“PLR”) on behalf of its client, a federal government contractor (the “Company”), allowing the inclusion of certain internationally-based employees in its employee stock ownership plan (the “ESOP” or “Plan”).

Why it Matters – ESOP sponsors have typically excluded from ESOP participation nonresident alien employees working outside the United States. Frequently, these ESOP sponsors have two technical concerns: First, that the U.S. parent’s stock will not meet the “qualified securities” requirement of the Internal Revenue Code with respect to unincorporated foreign entities and second, that contributions made to the ESOP by the U.S. parent for international employees will not be tax deductible by the U.S. parent. In the PLR, the ESOP plan sponsor was able to designate all international ESOP participants as employees of either: (i) the U.S. parent corporation; or (ii) an entity that qualifies as a disregarded entity for U.S. tax purposes.

Background

The Plan in the PLR permits certain international employees referred to as “Local National Staff Employees”, or LNSEs, to participate in the Plan. Under the Plan, LNSEs who work in certain countries and territories listed in the Plan would be eligible to participate in the Plan.

The Company sought ruling requests on five aspects related to the LNSEs. The IRS responded favorably to three of the five ruling requests and deferred the other two (relating to discrimination testing and waiver of participation election) to the determination letter process.

Who is a LNSE

The Plan defines a LNSE as an employee who:

(a) is not a United States citizen or in possession of an Alien Registration Card issued by U.S. Citizenship and Immigration Services,

(b) performs services almost entirely outside the United States, and

(c) is (1) employed directly by the Company or (2) is hired locally in the foreign country and is employed by the Company either through:

- (i) a domestic or foreign entity owned by the Company that is treated as a “disregarded entity” for U.S. income tax purposes,
- (ii) a branch office, or
- (iii) a local hiring office.

All eligible LNSEs do not receive United States sourced income subject to tax in the United States under section 861(a)(3) of the Internal Revenue Code (the “Code”) and are either:

- (a) employed by the Company and paid wages either directly by the Company or through a payroll agency in the local jurisdiction,
- (b) employed by a domestic limited liability company (“LLC”) that is treated as a disregarded entity under section 7701 of the Code, or
- (c) paid by a local entity that is eligible to and elects to be a disregarded entity under section 7701 of the Code.

Does the Company’s common stock constitute “employer securities” under Section 409(l)?

The Company first requested the IRS to find that the common stock of the Company qualified as “employer securities” under section 409(l) of the Code with respect to eligible LNSEs. This is critical because an ESOP can only allocate employer stock to a participant’s account if that participant is employed by a corporation in the controlled group (as defined in IRC Section 409(l)(4)) of the corporation issuing the stock. Since some of the LNSE’s are employed by domestic LLCs owned by the Company or international entities formed in accordance with local rules and customs, none of which are corporations, the Company sought confirmation that LNSEs employed by these types of affiliated entities could participate in the ESOP, which holds Company stock.

In light of the fact that not all of the LNSEs in question are employed by the Company directly, the IRS considered the facts concerning the other type of entities employing such LNSEs. The Company represented that if not directly employed by the Company, the LNSEs in question were either employed by a domestic LLC or a foreign entity, each of which is wholly owned by the Company and treated as a disregarded entity for income tax purposes. Under these facts, the IRS concluded that each of these types of disregarded entities would be treated as a division of the Company for controlled group purposes, and, therefore, the common stock of the Company would qualify as “employer securities” within the meaning of the Code.

Will the compensation paid to international employees by the Company, or by its international affiliates, constitute “compensation” for Section 415(c) purposes?

The second requested ruling pertained to compensation paid to the LNSEs and whether such compensation will be treated as “compensation” under Section 415(c) of the Code, which limits the amount of contributions to a defined contribution plan, such as an ESOP, with respect to a participant. Section 415(c) of the Code provides that contributions with respect to a participant may not exceed the greater of (a) a specified dollar amount (as adjusted annually for cost of living increases) or (b) 100% of the participant’s compensation.

Section 1.415(c)-2(c)(1) of the Regulations provides that for purposes of the limitation in section 415 of the Code, “compensation” includes an employee’s wages, salaries, fees for professional services, and any other amount received for services rendered in the course of employment with the employer maintaining the plan, to the extent the amounts are includible in gross income. In the case of a non-resident alien, gross income includes only (1) gross income derived from sources within the United States and (2) gross income which is effectively connected with the conduct of trade or business in the United States according to Section 872(a) of the Code.

While Section 872(a) on its own suggests that the compensation paid to the LNSEs may not constitute “compensation” within the meaning of section 415 of the Code because an LNSE performs services almost entirely outside the United States and does not receive United States sourced income subject to tax in the United States, the Company proposed, and the IRS concurred, that section 1.415(c)- 2(g)(5)(i) of the Regulations provides that amounts paid to an individual for personal services do not fail to be treated as compensation merely because those amounts are not includible in the individual’s gross income on account of the location of services.

Ultimately, the IRS ruled that the amounts paid to LNSEs from the Company or from the disregarded entities as compensation for personal services is treated as “compensation” for purposes of section 415 of the Code, regardless of whether such compensation is excluded from the LNSE’s gross income based on location of services.

Can the Company deduct the contributions it makes to the ESOP on behalf of all eligible LNSEs and will compensation to such LNSEs constitute “compensation” for purposes of the tax deduction limits?

Section 404(a)(3) of the Code provides that contributions paid into a trust are deductible up to 25% of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the stock bonus or profit-sharing plan. Generally the IRS has held that one company cannot make retirement plan contributions for another company. Because the Company, and not the domestic LLCs or international entities that employ some of the LNSEs as the case may be, will make all contributions to the ESOP for the benefit of the LNSEs, the

Company sought confirmation from the IRS that the LNSEs are considered to be employees of the Company for this purpose. The IRS stated that because the entities other than the Company that employ the LNSEs are disregarded entities and because the compensation paid to participating LNSEs constitutes “compensation” for purposes of section 415 of the Code (see above for further discussion on this point), it concluded that the Company may deduct the contributions it makes to the Plan on behalf of participants who are LNSEs, subject to generally applicable limitations on such deductions. Moreover, the IRS concluded that the compensation paid to such participating LNSEs will constitute “compensation” for purposes of the deduction limits of Code section 404(a).

[For additional information on this private letter ruling, or to discuss any related questions, please contact Larry Goldberg at ESOP Law Group LLP.]