

# ***Employee Stock Ownership Plans (ESOP)***

---

# *Employee Stock Ownership Plans (ESOP)*

---

## Table of Contents

I.	INTRODUCTION.....	1
A.	ESOP Is a Stock Bonus Plan Where the Employer Uses Stock as a Financing Vehicle.....	1
B.	Pension Protection Act of 2006 Requirement of Diversification of Investments in Employer Stock. (effective Plan Years commencing after December 31, 2006).....	1
C.	In Addition to Benefiting Employees, ESOPs Can Be Used to Benefit Employers and Shareholders.....	2
D.	Loans Used to Acquire Employer Securities. (Loans Prior to June 10, 1996). I.R.C. § 133.....	3
II.	REQUIREMENTS OF AN ESOP .....	4
A.	I.R.C. Definition Is More Restrictive Than Under ERISA. ....	4
B.	“Primarily” Invested in Employer’s Securities Means More Than Fifty Percent. ....	5
C.	Special Controlled Group Rules Apply in Testing QES Definition.....	5
D.	<i>ESOP cannot consist of preferred stock</i> unless the preferred stock is at all times convertible into common stock which constitutes QES. I.R.C. § 409(l)(3). ....	5
E.	Leveraged ESOP Assets Must Be Held in a Suspense Account. ....	5
F.	Participants Generally Must Have the Right to Receive Their Distributions in the Form of Stock. ....	5
G.	Participants of ESOPs of banks or companies whose stock ownership is substantially restricted by law or by charter. ....	5
H.	Participants in S Corporation ESOPs Do Not Have the Right to Receive Distributions in Stock. ....	6
I.	Prohibited Transaction Exemption.....	6
J.	Certain Voting Rights Must Be Passed Through the ESOP to the Participants. ....	6
K.	Put Option to Receive Cash in Lieu of Stock for Leveraged ESOP If Stock Is Not Publicly Traded.....	6
L.	Payment upon exercise of put option.....	6
M.	Trust Investment in Employer Securities Exception.....	7
N.	An ESOP Cannot Be Integrated with Social Security or be Cross-Tested.....	7
O.	An ESOP Must Meet All of the Other Requirements of a Qualified Plan as Applicable.....	7
P.	Conversion of Existing Plan into an ESOP.....	7
III.	DEFERRING TAXES FROM THE SALE OF STOCK TO AN ESOP BY PURCHASING QUALIFIED REPLACEMENT SECURITIES. I.R.C. § 1042, § 4978 .....	7
A.	I.R.C. § 1042 Requires an Election to Be Made. ....	7
B.	Rollover Must Be from the Sale of Qualified Securities and the Purchase of Qualified Replacement Property.....	8
C.	ESOP Must Meet Certain Requirements for § 1042 Treatment to Apply:.....	8
D.	Miscellaneous Requirements. ....	9
IV.	OTHER ISSUES RELATING TO ESOPs.....	10
A.	Upon Disposition of QES by a Participant, an Employer or the ESOP May, But Need Not, Have a Right of First Refusal If:.....	10
B.	Deductibility of Dividends Paid on ESOP Stock. § 404(k). ....	10
C.	No Deduction Limitation on Contribution to Plan to Pay Interest on a Loan Used to Purchase QES. ....	11

D.	Allocating the Stock of a Closely Held Corporation or Stock Which Is Not Traded on the Open Market. ....	11
E.	S Corporation ESOPs (SESOPs).....	13
F.	Professional Corporations. ....	15
G.	A Possible Issue with the Sale of Stock to the ESOP. ....	15
H.	Distribution Requirements (Applies to Stock Acquired by the ESOP After December 31, 1986). I.R.C. § 409(o)(1). ....	15
I.	Investment Diversification Rules (Effective for Stock Acquired After December 31, 1986). I.R.C. § 401(a)(28)(B); § 409(h)(7).....	16
V.	SUMMARY .....	18
A.	Which Companies Are Best Suited for ESOPs? Corporations <i>Well Suited for an ESOP Include Companies Which:</i> .....	18
B.	A Company with the Following Characteristics Should Be More Cautious About Implementing an ESOP:.....	18
C.	The Benefits Available to a Company Contemplating an ESOP Include: .....	19
VI.	ESOP ISSUES TO CONSIDER.....	19
A.	Advantages.....	19
B.	Disadvantages. ....	19
C.	Additional Issues for Non-Publicly Traded Corporations.....	20
VII.	EXAMPLE AND CHARTS OF ESOP LOAN TRANSACTION .....	20
A.	The ESOP Borrows Money from a Bank. Charts I and II.....	20
B.	Alternatively, the loan can be made to the sponsoring employer which can, in turn, make a similar loan to the ESOP. ....	21
C.	The ESOP uses the loan proceeds to purchase securities from the sponsoring employer and/or from another selling shareholder.....	21
D.	In order to repay the loan, the corporation makes contributions to the ESOP which are used by the ESOP to make loan payments to the Bank. ....	21
E.	Summary. ....	21
	CHART I. ....	22
	CHART II.....	23
	CHART III.....	24
	CHART IV. ....	25
	CHART V.....	26

# ***Employee Stock Ownership Plans (ESOP)***

---

## **I. INTRODUCTION**

### **A. ESOP Is a Stock Bonus Plan Where the Employer Uses Stock as a Financing Vehicle.**

1. An ESOP can either be a stock bonus plan or a stock bonus *and* a money purchase plan. It must be qualified under I.R.C. § 401(a), and be designed to invest primarily in Qualifying Employer Securities (QES). *See* I.R.C. § 4975(e)(7); ERISA § 407(d)(6).
2. Although the term ESOP has been used to describe a variety of qualified plans which hold employer securities, one of the primary features of an ESOP is that the employer's stock is used to secure a loan. The loan is usually from a commercial lender, and the loan proceeds are paid to the party selling stock to the ESOP. This party could either be the company or an individual shareholder. The loan is then repaid through deductible employer contributions to the ESOP which, in turn, repays the loan. Profits or accumulated earnings are not a pre-requisite for the employer contributions to the ESOP to be deductible.

### **B. Pension Protection Act of 2006 Requirement of Diversification of Investments in Employer Stock. (effective Plan Years commencing after December 31, 2006)**

1. The Pension Protection Act of 2006 requires any defined contribution plan holding publicly traded employer securities to permit participants to diversify account balances invested in such employer securities. At least three materially different investment alternatives must be available.
2. The diversification requirements apply to employee elective deferrals and after-tax contributions.

3. Participants with three or more years of service must be permitted to diversify the investment of employer contributions (e.g., employer matching or non-elective contributions). This rule is phased in ratably over three years for securities acquired prior to 2007 (except for participants age 55 or older with 3 years of service by the first plan year beginning in 2006; such participants may diversify 100% in 2007).

<u>Plan Year</u>	<u>Applicable Percentage</u>
2007	33%
2008	66%
2009	100%

4. Participants must receive 30 day advance notice of the diversification requirement. A \$100 per day penalty per participant applies for failure to provide the notice. The DOL will provide a model notice.
5. These provisions do not apply to ESOPs that have no elective deferrals, after-tax contributions, or matching contributions and do not form part of another qualified plan. Collectively bargained plans and affected ESOPs have later effective dates.

C. In Addition to Benefiting Employees, ESOPs Can Be Used to Benefit Employers and Shareholders.

1. Facilitating a company's cash flow and raising capital.

If the company provides the stock, it can provide an immediate benefit to employees with an amortized cost. A company can also use an ESOP to raise capital without selling its stock in the general market. A leveraged ESOP can be used to obtain loans at below market rates and to effectively deduct both principal and interest on the loan repayment.

2. Providing a market for non-marketable stock and estate planning techniques.

Often shareholders of private or closely held corporations have difficulty finding a market for their stock. An ESOP can create a friendly buyer while at the same time providing an incentive for employees who now have an ownership interest. Estate planning is facilitated because currently a shareholder who sells stock to an ESOP can defer taxes on the gain by purchasing Qualified Replacement Securities (QRS). *See* I.R.C. § 1042 and Part III of this outline.

3. Personal tax planning.

An ESOP can be a key component of a major shareholder's personal tax plan. Although an ESOP cannot be contractually bound to purchase employer securities in advance of the purchase date (Treas. Reg. § 54.4975-11(a)(7)(i); DOL Reg. § 2550.407d-6(a)(6)), a shareholder's personal tax plan could take into account an ESOP which could provide liquidity before or after the shareholder's death.

4. Employee incentive.

One of the principal benefits of an ESOP can be employee motivation. In order to be successful, however, the program must be properly communicated to employees in a positive fashion and followed-up with efforts to continue employee involvement.

5. Other uses of ESOPs.

Exchanging stock in a family-owned business for stock which is more readily tradable; fighting take-overs (note: fiduciary duty requirements could preclude this option if the financial transaction is less favorable to the ESOP than it is to other parties); and as part of a plan to help a company go private.

D. Loans Used to Acquire Employer Securities. (Loans Prior to June 10, 1996). I.R.C. § 133.

1. For loans for which a binding contract was in effect prior to June 10, 1996, a *commercial lender* (a bank, insurance company, corporation actively engaged in the business of lending money or regulated investment company) *making an ESOP loan can exclude from gross income fifty percent of the interest income it earns on such a loan.* I.R.C. § 133. This interest exclusion does not apply to a loan made by a sponsoring employer or by a company which is part of a controlled group of the sponsoring employer. Interest exclusion also applies to loans made to an employer if employer securities in an amount equal to the proceeds of the loan are transferred to the ESOP within thirty days after the date of the loan. *Loans to a corporation must have an original commitment of seven or fewer years unless the corporation makes a "mirror image" loan to the ESOP.* I.R.C. § 133(b)(3). Under 1988 TAMRA, *ESOP refinancing loans are limited to the later of the last day of the term of the original loan or seven years from the date of the original loan for the interest exclusion to apply.* I.R.C. § 133(e). Under 1989 OBRA, the length of a securities acquisition loan is limited to fifteen years. I.R.C. § 133(b)(1).
2. 1989 OBRA amended I.R.C. § 133 to limit its application to loans in which, immediately following the transaction, the ESOP owns more than fifty percent of (i) each class of outstanding stock of the corporation issuing the employer securities; or (ii) the total value of all outstanding stock of such corporation. I.R.C. § 133(b)(6).

Additionally, *the stock acquired with proceeds from a § 133 loan must have a full pass-through of voting rights regardless of whether such stock is a registration-type class of securities.* Any preferred stock acquired with such a loan must have voting rights equivalent to the stock to which it may be converted. § 133(b)(7).

- a. *For the interest exclusion to apply, the ESOP must initially meet the fifty percent ownership test and must continue to do so for the term of the loan.* If the ESOP's ownership falls below the fifty percent level, the interest exclusion is eliminated, although the IRS may permit a correction of a temporary failure within 90 to 180 days following such an occurrence. I.R.C. § 133(b)(6)(B).
- b. I.R.C. § 4978B imposes a ten percent excise tax on the sponsoring employer on the amount realized (or the fair market value if the securities are not sold or exchanged) on certain dispositions of § 133 securities (*i.e.*, securities acquired with the proceeds of a § 133 loan). I.R.C. § 4978(b)(2) establishes an order under which securities held by the ESOP are deemed disposed of for purposes of the § 4978B excise tax. The initial distributions are deemed to be the § 133 securities acquired during the three-year period immediately prior to the disposition. § 4978B applies to any disposition of employer securities by the ESOP within three years after the ESOP acquired § 133 securities if, after such disposition, (i) the total number of employer securities held by the plan after such disposition is less than the total number of such securities held by the plan immediately following the acquisition of § 133 securities; or (ii) the value of employer securities held by the plan is fifty percent or less of the total value of all employer securities at the time of such disposition.
- c. Repeal of Interest Exclusion.

Section 1602(a) of the Small Business Job Protection Act of 1996 repeals I.R.C. § 133. The fifty percent interest exclusion will not apply to loans unless a binding contract was in effect prior to June 10, 1996.

## **II. REQUIREMENTS OF AN ESOP**

An ESOP Must Be Established to Invest Primarily in Qualifying Employer Securities (QES).

### **A. I.R.C. Definition Is More Restrictive Than Under ERISA.**

QES are common stock issued by the employer, which are readily tradable on an established securities market. Alternatively, with respect to non-tradable securities, QES constitute an employer's common stock which have a combination of voting and dividend rights which equal or exceed the common

stock of the employer which has the greatest of those rights. *See* I.R.C. §§ 4975(e)(8) and 409(i).

- B. “Primarily” Invested in Employer’s Securities Means More Than Fifty Percent.

This is a Department of Labor requirement. An ESOP, however, will not lose its qualification status because investments in QES temporarily go below fifty percent.

- C. Special Controlled Group Rules Apply in Testing QES Definition.

These rules are set forth at I.R.C. § 409(1)(4), and are based upon the controlled group rules of I.R.C. § 1563(a). However, with respect to a parent-subsidiary, a fifty percent test, as opposed to an eighty percent test, is used.

- D. *ESOP cannot consist of preferred stock* unless the preferred stock is at all times convertible into common stock which constitutes QES. I.R.C. § 409(1)(3).

- E. Leveraged ESOP Assets Must Be Held in a Suspense Account.

As the ESOP loan is repaid, assets from the suspense account are proportionally allocated to the participant’s account pursuant to one of two described formulas. Treas. Reg § 54-4975-7(b)(8)-11(c).

- F. Participants Generally Must Have the Right to Receive Their Distributions in the Form of Stock.

An ESOP, however, is not precluded from making distributions in cash. I.R.C. § 409(h). Also, an employer can have a right of first refusal to buy back the stock from a participant if the stock is not publicly traded and was purchased with an exempt loan. Reg. § 54.4975-(b)(9).

- G. Participants of ESOPs of banks or companies whose stock ownership is substantially restricted by law or by charter.

*Participants of ESOPs of banks or companies whose stock ownership is substantially restricted by law or by charter do not have to be given the right to receive distribution in stock.* I.R.C. § 409(h)(2) and (3). Additionally, if the sponsoring corporation’s charter or bylaws restrict stock ownership to the ESOP or current employees, stock will not be distributed to former participants.

H. Participants in S Corporation ESOPs Do Not Have the Right to Receive Distributions in Stock.

I. Prohibited Transaction Exemption.

ESOPs qualify for exemption from many of the prohibited transaction provisions of I.R.C. § 4975 including the entitlement to enter into an ESOP loan transaction.

J. Certain Voting Rights Must Be Passed Through the ESOP to the Participants.

If the QES are subject to § 12 of the Securities Exchange Act of 1934 and, thus, are publicly traded, a participant must be allowed to direct the plan on how to vote his allocated shares. If the QES are not publicly traded, the participants need only be given the right to direct their votes on corporate matters with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution or sale of substantially all assets of a trade or business. I.R.C. § 4975(e)(7); § 409(e). The voting rights requirements will be satisfied if the plan permits one vote to each participant with respect to each issue and the trustee votes the shares held by the plan in the same proportion as the total participant votes. I.R.C. § 409(e)(5). As noted above, employer stock acquired with the proceeds of a § 133 exempt loan must have a complete pass-through of voting rights, even if such stock does not constitute registration-type securities.

The ESOP trustee votes the ESOP stock either directly or pursuant to the direction of the Plan Committee or Plan Administrator. The Sixth Circuit Court of Appeals held that an ESOP Administrative Committee did not have to pass through voting rights even though the ESOP owned eighty-five percent of the employer stock and a failure to pass through the voting rights resulted in a “corporate entrenchment.” *Grindstaff v. Green*, 133 F.3d 416, (6<sup>th</sup> Cir. 1998).

K. Put Option to Receive Cash in Lieu of Stock for Leveraged ESOP If Stock Is Not Publicly Traded.

Upon a distribution, the participant has a non-terminable option against the employer to receive cash instead of stock. Although the plan may not be required to satisfy a put option, it may assume the rights and obligations of the employer at the time the put option is exercised. The option must be given twice: for a period of at least sixty days following the distribution; and for at least a sixty day period in the following plan year. I.R.C. § 4975(e)(7); § 409(h)(4), and Reg. § 54.4975.

L. Payment upon exercise of put option.

*Payment upon exercise of put option* (for stock acquired after 1986 TRA enactment date). I.R.C. §§ 409(h)(5) and (6). Requires that in the case of a lump sum distribution of employer securities, if employee “puts” securities to

employer, put option price be paid in substantially equal installments over a period not exceeding five years, and

1. The five-year period during which the employer must purchase a lump-sum distribution of securities with respect to which a participant has exercised a put option begins thirty days after the date of exercise of the put option;
2. The employer must provide security with respect to the put option installment payments; and
3. In the case of a put option exercised with respect to a distribution other than a lump sum, the employer must pay the full option price to the participant within thirty days after the close of the sixty-day option period.

M. Trust Investment in Employer Securities Exception.

As an Eligible Individual Account Plan (EIAP), an ESOP is not subject to the normal (I.R.C. § 401(a)(22)) limitation that no more than ten percent of plan assets can be invested in employer securities. ERISA § 407(b)(1).

N. An ESOP Cannot Be Integrated with Social Security or be Cross-Tested.

The prohibition on integration does not apply to ESOPs established before 11-1-77. Reg. § 54.4975-11(a)(7)(ii).

Reg. § 1.401(a)(4)-8(b)(1)(i) provides that an ESOP cannot be cross-tested. An ESOP may not be tested for nondiscrimination on the basis of benefits.

O. An ESOP Must Meet All of the Other Requirements of a Qualified Plan as Applicable.

P. Conversion of Existing Plan into an ESOP.

The conversion of an existing pension, profit-sharing or stock bonus plan into an ESOP may constitute a termination of the existing plan. This would require the full vesting of all participants in the plan at the time of the conversion into an ESOP. DOL Reg. § 2550.407d-6(a)(5). Use of existing plan assets to purchase employer securities can result in potential fiduciary liability. *Eaves v. Penn*, 587 F.2d 453 (10<sup>th</sup> Circ. 1978). If employee-source funds are involved, securities considerations must be reviewed.

### III. DEFERRING TAXES FROM THE SALE OF STOCK TO AN ESOP BY PURCHASING QUALIFIED REPLACEMENT SECURITIES. I.R.C. § 1042, § 4978

A. I.R.C. § 1042 Requires an Election to Be Made.

Seller must file election by the due date (including extensions) of the income tax return corresponding to the year of the sale. The seller must be an

individual, trust, estate, partnership or S corporation. The seller *cannot* be a C corporation. A “statement of purchase” must be signed and notarized within thirty days after the purchase of each item of Qualified Replacement Property. Temp. Reg. § 1.1042-IT (Q&A 3).

B. Rollover Must Be from the Sale of Qualified Securities and the Purchase of Qualified Replacement Property.

1. “Qualified securities” are defined at I.R.C. § 1042(c)(1). They are:
  - a. Issued by a domestic corporation that has no outstanding readily tradable securities (*i.e.*, *not* publicly traded);
  - b. Neither attributable to a distribution from a qualified plan nor pursuant to the exercise of a compensatory stock option;
  - c. Securities that have been held by the seller for at least three years prior to the sale to the ESOP (I.R.C. § 1042(b)(4)) *and* would qualify for long-term capital gain for the seller (I.R.C. § 1042(a)); and
  - d. Securities that are “best common” as defined by I.R.C. § 409(l). Common stock with voting and dividend rights at least equal to the class of common stock with the greatest dividend and voting rights, or certain noncallable preferred stock which is convertible into such common stock.

2. Qualified replacement property is at I.R.C. § 1042(c)(4).

Stock which the seller purchased within the replacement period. This time period commences three months before the date of the sale to the ESOP and ends twelve months after the date of the sale. I.R.C. § 1042(c)(3).

Stock issued by a domestic corporation which does not, for the taxable year in which such stock is issued, have passive investment income exceeding twenty-five percent of its gross receipts. PLR 8724009 provides that shares of stock in a mutual fund do not constitute qualified replacement property.

- a. Qualified Replacement Property can include common stock, preferred stock, corporate bonds and notes and convertible bonds.
- b. Qualified Replacement Property does *not include* U.S. government securities, municipal bonds, foreign securities, mutual funds or limited partnerships.

C. ESOP Must Meet Certain Requirements for § 1042 Treatment to Apply:

1. Immediately after the sale, the ESOP must own at least thirty percent of the total value of the employer securities outstanding as of such

time. I.R.C. § 1042(b)(2). Thus, the seller need not sell all of his stock to qualify for § 1042 treatment. For example, if the selling shareholder owns eighty-one percent of the company stock, he could sell thirty percent to the ESOP and still maintain control of the company.

2. The seller must specifically elect non-recognition treatment not later than the due date (plus extensions) for filing the seller's income tax return for the taxable year in which the sale occurs. I.R.C. §§ 1042(a)(1), (c)(6).
3. The seller must receive from the employer, and file with the IRS, a statement consenting to an excise tax (equal to ten percent of the amount realized on the sale of the stock) if there is a disposition of stock (for reasons other than participants retiring or separating from service) within the three-year period after the sale to which § 1042 applied which causes the employer stock held by an ESOP to fall below thirty percent of the total value of all employer securities. I.R.C. § 4978(a).
4. The seller, a member of his family (determined under I.R.C. §§ 267(b) and (c)) or any person who owns more than twenty-five percent (attribution rules of I.R.C. § 318 apply) of any of the employer's outstanding securities may not participate in the ESOP to the extent of the securities purchased by the ESOP or any assets attributable thereto. I.R.C. § 409(n). The *nonallocation period* begins on the date of the sale of the qualified securities and ends on the later of (i) ten years after the date of the sale; or (ii) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale. I.R.C. § 409(n)(3)(C). Stock allocated to the employee's account under the ESOP is included in the determination of whether the employee is a twenty-five percent shareholder. I.R.C. § 409(n)(1)(B). Allocations are permitted, however, if the individual is a lineal descendent of the taxpayer selling the securities and the total allocation to all such lineal descendants during the non-allocation period does not exceed five percent of the total securities held by the plan which are attributable to the sale. I.R.C. § 409(n)(3).

If the ESOP allocates assets to a person in violation of the I.R.C. § 409(n) restrictions, the amount allocated is deemed distributed to that person under I.R.C. § 409(n)(2)(a). Additionally, an excise tax equal to fifty percent of the prohibited allocation and any other improperly accrued benefit is imposed on the employer sponsoring the plan. I.R.C. § 4979A.

#### D. Miscellaneous Requirements.

1. Seller's basis in qualified replacement property reduced.

The reduction may not exceed the amount which was not recognized under § 1042. Also, § 1042(d) has an allocation formula if the seller has more than one item of qualified replacement property.

2. No rollover treatment is permitted to sellers of securities to an ESOP to the extent that they were acquired by an underwriter in the ordinary course of his trade or business. I.R.C. § 1042(c)(5).

3. Nonrecapture events.

I.R.C. § 1042(e)(3) provides that the transfer of replacement property on account of the following events is not a disposition that would trigger recapture of gain deferred on the sale of stock to an ESOP:

- a. The death of the electing shareholder;
- b. A gift;
- c. Another § 1042 transaction; and
- d. A reorganization under § 368 (*e.g.*, a merger), except in certain situations where the electing shareholder controls the acquired or acquiring corporation.

Under I.R.C. §§ 1014 and 2031 *et seq.*, replacement property passing at death receives a stepped-up basis to fair market value at the date of death or the alternate valuation date, as applicable.

4. Partial recognition of gain.

Gain is recognized only to the extent that sale proceeds exceed the cost of the QRP (*i.e.*, the difference between the sale proceeds and the cost of the QRP is taxable).

#### IV. OTHER ISSUES RELATING TO ESOPs

A. Upon Disposition of QES by a Participant, an Employer or the ESOP May, But Need Not, Have a Right of First Refusal If:

1. The stock, which was purchased with an exempt loan, is not publicly traded (as of the time of the right of refusal).
2. The right is in favor of the employer or the ESOP.
3. The terms under the right to the participant-seller are as favorable as the *greater* of the stock's value based upon a good faith valuation *or* a good faith offer by another buyer to purchase the stock.
4. The right lapses fourteen days after the stockholder gives written notice to the holder of the right. *See Reg. 54.4975-7(b)(9)*.

B. Deductibility of Dividends Paid on ESOP Stock. § 404(k).

EGTRRA Expansion of § 404(k) Dividend Deductions. The deduction for dividends paid in cash on employer stock held by an ESOP has been expanded to include dividends payable at the election of participants (1) in cash directly

to plan participants or beneficiaries, (2) to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of that plan year, or (3) to the plan and reinvested in qualifying employer securities. The standard for disallowing abusive dividends has been broadened. This provision is effective for taxable years beginning after December 31, 2001. (Act § 662 amending IRC § 404(k).)

Under § 404(k) such dividends must be paid to the plan or paid directly in cash to the participants. If paid to the plan, dividends must be distributed to the participants within ninety days after the close of the plan year. In order for the employer to get the deduction, the dividend must be actually paid, and not just accrued.

Dividends may also be deducted if used to make payments on exempt loans. 1989 OBRA limits the deduction for dividends paid to an ESOP which are used to repay an exempt loan under § 404(a)(9) to dividends paid on stock acquired by the loan. § 404(k).

An employer with a leveraged ESOP can deduct dividends on ESOP stock that is not being held as collateral for an acquisition loan only if the dividends are used to make scheduled payments on the acquisition loan. The IRS has imposed two criteria for dividends to be deductible: (1) employer securities with a fair market value not less than the amount of such dividends must be allocated to participants; and (2) the dividends cannot constitute in substance, an avoidance of taxation. PLR 8921101.

C. No Deduction Limitation on Contribution to Plan to Pay Interest on a Loan Used to Purchase QES.

The contribution must be made by the due date for filing the employer's tax return (including extensions). Where no more than one-third of the ESOP account balances inure to Highly Compensated Employees (HCEs) and the ESOP is not sponsored by an S corporation, deductible contributions in excess of twenty-five percent of compensation are permitted to the extent that the excess is used to pay interest on an ESOP loan. I.R.C. § 404(a)(9)(B). Although the employer's deduction for principal repayment is twenty-five percent of covered compensation, amounts in excess can be deducted in future years. § 404(a)(9)(A).

D. Allocating the Stock of a Closely Held Corporation or Stock Which Is Not Traded on the Open Market.

1. *In order to determine the fair market value of the stock of a corporation that is not publicly traded, an independent appraisal is necessary.* The appraisal of the stock directly coincides with the company's contributions and deductions.
2. Although such appraisals can be costly and the contributing shareholders are going to want the appraisal to be as favorable as possible, it is important to remember that the appraisal must be able to

withstand IRS scrutiny. Valuations of non-readily tradable employer securities must be made by an independent appraiser.

3. Department of Labor proposed regulations at 29 C.F.R. § 2510.3-18 define “adequate consideration” for purposes of valuing plan assets for which there exists no generally recognized market. The regulations list several factors to be reviewed by the independent appraiser performing the valuation including:
  - a. The nature of the business and the history of the enterprise from its inception;
  - b. The economic outlook in general and outlook of the specific industry in particular;
  - c. The book value of the securities and the financial condition of the business;
  - d. The earning capacity of the company;
  - e. The dividend-paying capacity of the company;
  - f. Whether or not the enterprise has goodwill or other intangible value;
  - g. The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;
  - h. The marketability, or lack thereof, of the securities; and
  - i. Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued.
4. In *Las Vegas Dodge, Inc. v. United States* (U.S. Tax Court No. 85-2), the Court sustained the employer’s valuation of \$61.35, as opposed to the IRS’ valuation of \$8, per share. Finding that it was proper to include in its valuation the company’s projections of future earnings, the Court noted that the valuation was made in good faith and was reasonable.
5. Notwithstanding the *Las Vegas Dodge* case, the law provides very little guidance on how to value the stock of a closely held corporation. In the event that the appraisal is found to be excessive, there could be a partial denial of the deductions as well as prohibited transaction consequences.
6. Since the IRS has not issued regulations on valuing the stock of a closely held corporation, the guidelines set forth in Rev. Rul. 59-60 (which pertains to valuing such stock for estate and gift tax purposes)

are often looked to for guidance on these issues. That Rev. Rul. looks to the following factors:

- a. The type of business and its entire history;
  - b. The general economic outlook as well as the outlook for the specific industry;
  - c. The stock's book value and the business' financial condition;
  - d. The company's earnings ability;
  - e. The company's ability to pay dividends;
  - f. Whether the company has good will or other important non-capital assets;
  - g. Previous stock sales; and
  - h. The market value of the stock of similar companies whose stocks are traded in a stock market.
7. For companies whose stocks are traded in a stock market, their stock value is easily determined. I.R.C. § 41(c)(7) refers to the average closing prices over the twenty-day consecutive trading period which immediately precedes the date the stock was contributed to the plan.
  8. The put option requirement strengthens the valuation of stock which is not publicly traded, because the put option creates a market for this stock.

E. S Corporation ESOPs (SESOPs).

1. ESOPs and S corporations.

Effective for tax years commencing after 1997, I.R.C. § 1361(c)(7) permits an ESOP (as well as other tax-qualified retirement plans) to be a shareholder in an S corporation. To avoid the seventy-five-shareholder limit applicable to S corporations, the legislative history provides that “[f]or purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder.” H. Rep’t No. 104-137, 104<sup>th</sup> Cong., 2d Sess. 60 (1996).

2. Section 1042 treatment not available.

The nonrecognition of gain provisions of § 1042 are *not* available with respect to the sale of S corporation stock to an ESOP.

3. Deduction limit is 25% of compensation.

Unlike a C corporation ESOP, interest payments on an SESOP stock acquisition loan are included in the 25% deduction limitation.

For plan years commencing on or after January 1, 2002, the deduction limit for all defined contribution plans is 25% of the compensation for plan participants.

4. Non-access to I.R.C. § 404(k) corporate dividend deductions.

S corporations cannot deduct dividends paid to SESOPs.

5. SESOPs not subject to UBTI.

SBJPA '96 provided that a SESOP would be subject to tax on the net income and gains attributable to its investment in the S corporation. TRA '97 repealed this provision. Thus, a SESOP's share of its sponsor's earnings is subject to tax only when distributed by the SESOP to its participants. I.R.C. § 512(e)(3).

6. SESOP entitlement to distribute cash rather than stock.

Due to the danger that distributed employer stock could end up by being held by an ineligible shareholder (*e.g.*, an Individual Retirement Account), TRA '97 deleted the normal ESOP entitlement of participants to demand the distribution of employer stock.

7. EGTRRA Limitations on S Corporation ESOPs.

For plan years beginning after December 31, 2004, certain S corporations which sponsor an ESOP must prohibit the allocation of S corporation employer securities to certain disqualified persons. A "disqualified person" is a person who (1) has "deemed owned shares" constituting more than 10% of all of the deemed owned shares of the corporation's stock, or (2) is a member of a family that has more than 20% of the deemed owned shares. "Family" includes spouses, ancestors, descendants, siblings, and siblings' descendants. "Deemed owned shares" include (1) shares allocated to a participant's ESOP account, (2) the participant's portion of the shares in any unallocated account, such as a loan suspense account, assuming that all such shares become allocated in the same proportion as the most recent stock allocation under the plan, and (3) any synthetic equity. "Deemed owned shares" do not include shares held outright by an individual outside of the ESOP. If disqualified persons own, or are deemed to own, 50% or more of the stock of the S corporation at any time during a plan year, such year will be deemed to be a "nonallocation year." During a nonallocation year, the plan will be treated as having made a distribution of any amount allocated to such disqualified person during such year. The S corporation will be liable for a 50% excise tax based on the amount allocated. EGTRRA also prohibits the use of "synthetic equity" where an S corporation sponsors an ESOP. "Synthetic equity"

is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future or similar right to a future cash payment based on the value of such stock or appreciation in such value. The S corporation will be subject to the 50% excise tax for any year in which a disqualified person has an interest in synthetic equity. These provisions will also apply to S corporation ESOPs established after March 14, 2001 or ESOPs established before that date which hold employer securities that elect S corporation status. (Act § 656 adding new IRC § 409(p) and amending IRC § 4979A.)

F. Professional Corporations.

Although ERISA and the I.R.C. do not preclude a professional corporation from establishing an ESOP, there could be an issue under state law as to whether legal title to the stock is held by someone other than a member of the applicable profession. If the trustee is deemed by the applicable state to hold legal title to the stock held in the ESOP, there should not be a problem with the applicable state's corporate law if the trustee is a member of the class of professionals covered under the professional corporation. The ESOP would be required to contain a provision prohibiting the distribution of stock to former employees/participants of the professional corporation. Ohio Attorney General (OAG) Opinion 85-065 permits shares of stock in a professional corporation to be held in trust for the benefit of non-professionals if legal title is held by a trustee who is duly licensed or otherwise legally authorized to render the professional service.

G. A Possible Issue with the Sale of Stock to the ESOP.

There could be an issue as to whether the sale of stock to the ESOP by a shareholder of a closely held corporation is essentially equivalent to a dividend pursuant to I.R.C. § 302. This would be the case if the IRS determines that the company and the ESOP should be aggregated into a single entity for purposes of I.R.C. §§ 301 and 302. Generally, the two will not be aggregated if the selling shareholder's and his family's combined interests in the plan does not exceed twenty percent of the total plan assets or if the selling shareholder's and his family's salaries do not exceed twenty percent of covered compensation of all plan participants. Rev. Proc. 77-30, 1977-2 CB 539. *See also* Rev. Proc. 78-23.

H. Distribution Requirements (Applies to Stock Acquired by the ESOP After December 31, 1986). I.R.C. § 409(o)(1).

1. Unless an employee elects otherwise, payment of ESOP benefits must begin no later than one year after the close of the plan year:
  - a. In which the participant terminates employment due to retirement, disability or death; or

- b. Which is the fifth plan year following separation from service for any other reason (provided the participant does not return to service prior to that time).

2. Exception.

Securities acquired with the proceeds of an acquisition loan in accordance with I.R.C. § 404(a)(9) do not have to begin to be paid until the close of the plan year in which the loan is repaid. However, if the participant attains normal retirement age in an earlier year, benefits must commence no later than sixty days after the year in which the participant attains normal retirement age, absent a contrary election by the participant.

3. Distribution must be in substantially equal periodic payments (not less frequently than annually) and must be over a period not greater than:

- a. five years; or

- b. In the case of a participant with an account balance in excess of \$500,000 (\$985,000 for 2009), 5 years plus one for each \$100,000 (\$195,000 for 2009) or fraction thereof in excess of \$500,000 (\$985,000 for 2009). I.R.C. § 409(o)(1)(C).

4. If general qualified plan distribution rules require earlier distribution, they must begin at that time.

5. These rules also apply to stock bonus plans.

6. The maximum time periods for distributions under this section are subject to participant and spousal consent, if applicable, under I.R.C. §§ 401(a)(11), 411(a)(11) and 417.

7. Forfeitures.

All non-vested amounts in a participant's account are forfeited and allocated among the accounts of other participants. A forfeiture can occur within one year after the participant leaves service, or, alternatively, the employer can hold on to such forfeited amounts in a suspense account for five years. The decision on whether to use the one year or five year forfeiture rule will have some impact on the amount of stock reallocated to participants and on the employer's repurchase liability.

I. Investment Diversification Rules (Effective for Stock Acquired After December 31, 1986). I.R.C. § 401(a)(28)(B); § 409(h)(7).

1. Participants eligible to diversify.

Any employee who has completed at least ten years of participation under the plan and has attained age fifty-five is considered a "qualified participant" and is eligible to diversify a certain percentage of his or

her account balance over a six-year period. I.R.C. §§ 409(h)(7) and 401(a)(28)(B).

2. Election period.

Each “qualified participant” has the option to elect within ninety days after the close of each plan year to direct the plan as to the investment of at least twenty-five percent of the participant’s account in the plan for the first five plan years after becoming a qualified participant. Election in the sixth and final year may be made up to fifty percent of his or her account balance less any amounts which were previously diversified. I.R.C. § 401(a)(28)(B)(i).

3. Method of diversification.

The plan can satisfy the diversification requirements in one of three ways:

a. Distribution to IRA.

That portion of the participant’s account eligible to be diversified may be distributed within ninety days after the period during which the election may be made. Such amounts are eligible to be rolled over tax-free into an Individual Retirement Account or to another qualified plan. I.R.C. § 401(a)(28)(B)(ii)(I).

b. Investment options.

The plan may offer at least three investment options to each participant and transfer amounts to such investments within ninety days after the expiration of the election period. I.R.C. § 401(a)(28)(B)(ii)(II).

c. Direct transfer to another qualified plan.

The plan could transfer the portion of the participant’s account that is eligible to be diversified, to another qualified plan that allows for participant-directed investment and contains at least three investment options. IRS Notice 88-56, Q&A-13.

4. Shares applicable.

Diversification requirements apply only to shares acquired after December 31, 1986.

5. *De minimis* amounts.

Participants with an account balance of \$500 or less need not be given the diversification election. IRS Notice 88-56, Q&A-7.

## V. SUMMARY

### A. Which Companies Are Best Suited for ESOPs? Corporations *Well Suited for an ESOP Include Companies Which:*

1. Are closely held by ten or fewer shareholders;
2. Are well seasoned and have a long history of increasing sales and profits;
3. Have consistently been in a high tax bracket;
4. Have a large payroll represented by generally a non-union work force;
5. Already have a retirement plan of some sort;
6. Have a substantial net worth and little debt;
7. Are well managed with dedicated employees; and
8. Are projecting high growth potential.

This is the ideal ESOP candidate scope. Many companies have developed successful ESOPs without possessing all of the ideal characteristics. The decision of implementing an ESOP will often center on whether to use the ESOP as a corporate financing vehicle or as a vehicle to provide an in-house market for existing shareholders.

### B. A Company with the Following Characteristics Should Be More Cautious About Implementing an ESOP:

1. Companies in which profits and payrolls fluctuate widely from year to year;
2. Start-up companies without any earnings history;
3. Companies going downhill as a result of economic changes or changes in the market beyond their control;
4. Companies whose future depend solely upon the efforts of one or two essential individuals;
5. Capital intensive companies typically do not generate substantial payroll to take full advantage of the ESOP contributions twenty-five percent rule; and
6. Uncontrolled high growth companies typically have difficulties with cash flow and debt service.

C. The Benefits Available to a Company Contemplating an ESOP Include:

1. A retirement plan for employees;
2. A vehicle to boost employee moral and motivation by offering employees an equity position whereby they participate and share in the rewards of their own hard work;
3. The company can improve cash flow with pre-tax loan principal and interest repayments in conjunction with a lower loan interest rate;
4. In a closely held corporation, the current owner has the option to rollover the proceeds from the sale of his stock to the ESOP into the stock market and defer paying tax on any gains, or he can receive installment payments from the ESOP to spread out the proceeds, or he can implement certain advantageous estate planning provisions available to owners selling stock to an ESOP;
5. The current owner may still maintain effective corporate control even if he sells a large block of stock to the ESOP;
6. An ESOP transforms a retirement program from a cash drain to a cash generator; and
7. An ESOP can provide a market and facilitate the financing for sale of the stock in a closely held corporation.

**VI. ESOP ISSUES TO CONSIDER**

A. Advantages.

1. An ESOP can reduce the cost of financing debt for the company. Both the principal and interest payments on an ESOP acquisition loan are deductible to the employer. This is because the employer makes a fully tax-deductible contribution to the ESOP and the ESOP uses the contribution to make the loan payments on the ESOP acquisition loan.
2. The ESOP trust can be a mechanism to buy and sell shares of employer stock. The ESOP should, however, not be used to manipulate the price of a thinly traded stock.
3. The ESOP can provide employees with a stake in the company. This should, hopefully, motivate employees to work harder and more efficiently.

B. Disadvantages.

1. Fiduciary liability of the ESOP committee members who administer the ESOP. These can include fiduciary issues of whether employer stock is a prudent investment for the plan at any given time.

2. There can be investment diversification issues. If the employer stock does not perform as well as other investments employees could be upset and the ESOP could have a negative, rather than a positive, impact on employees. In the worst case scenario, the employer stock could become worthless and employees could lose a substantial portion of their retirement funds (e.g., ENRON).
  3. Transaction and administrative costs of the ESOP, both initial and ongoing.
- C. Additional Issues for Non-Publicly Traded Corporations.

In the non-publicly traded context, additional issues could be:

1. Advantages:
  - (a) Selling shareholder may be able to utilize IRC section 1042 treatment and indefinitely defer tax on the gain on the sale of the employer stock to the ESOP. However, if section 1042 treatment is elected, the ESOP must own at least 30% of all outstanding employer stock. Additionally, the selling shareholder, members of the family of the selling shareholder, and other 25% owners cannot participate in the ESOP.
  - (b) The ESOP can be created as a purchaser of the company where one might not otherwise exist.
2. Disadvantages:
  - a. Dilution of the ownership of the current owners.
  - b. Transaction costs including the requirement of an annual independent valuation of the company.
  - c. Participant pass through of voting rights. There must be at least a limited pass through of stock voting rights to the ESOP participants.
  - d. Decrease in stock value due to the obligation to repay the ESOP stock acquisition loan.
  - e. The ESOP's obligation to repurchase stock from participant accounts upon retirement, death, separation from service and attainment of age 55 with 10 years of participation in the ESOP. These repurchase obligations can be huge and must be budgeted for by the company.

## **VII. EXAMPLE AND CHARTS OF ESOP LOAN TRANSACTION**

- A. The ESOP Borrows Money from a Bank. Charts I and II.

- B. Alternatively, the loan can be made to the sponsoring employer which can, in turn, make a similar loan to the ESOP.
- C. The ESOP uses the loan proceeds to purchase securities from the sponsoring employer and/or from another selling shareholder.

If the securities are purchased from a selling shareholder and other criteria are satisfied, the shareholder may elect non-recognition of gain treatment under I.R.C. § 1042. The securities purchased by the ESOP are pledged to the Bank as security for the loan. Charts III and IV.

- D. In order to repay the loan, the corporation makes contributions to the ESOP which are used by the ESOP to make loan payments to the Bank.

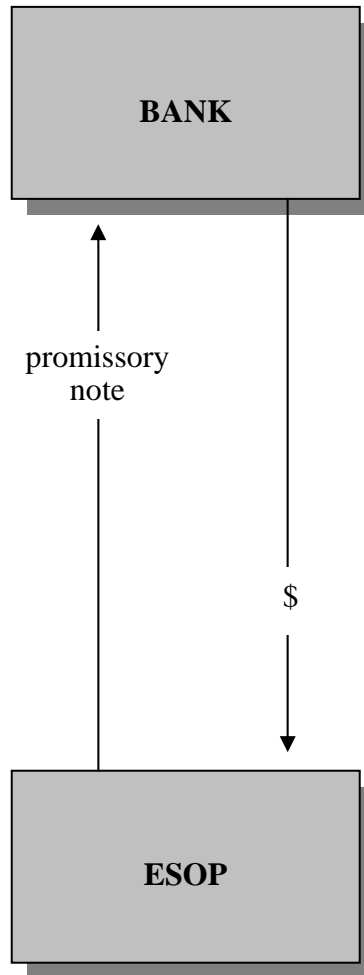
Since the contributions to the ESOP are fully deductible as contributions to the tax-qualified retirement plan, the corporation effectively receives a deduction for both principal and interest on the loan repayment. Chart V.

- E. Summary.

In summary, the ESOP reduces the cost of corporation borrowing by permitting the corporation to borrow at seventy-five percent to eighty-five percent of the going rate of interest and deduct both principal and interest on the loan repayments. Additionally, a selling shareholder may receive non-recognition of gain treatment for the sale of stock to the ESOP under I.R.C. § 1042.

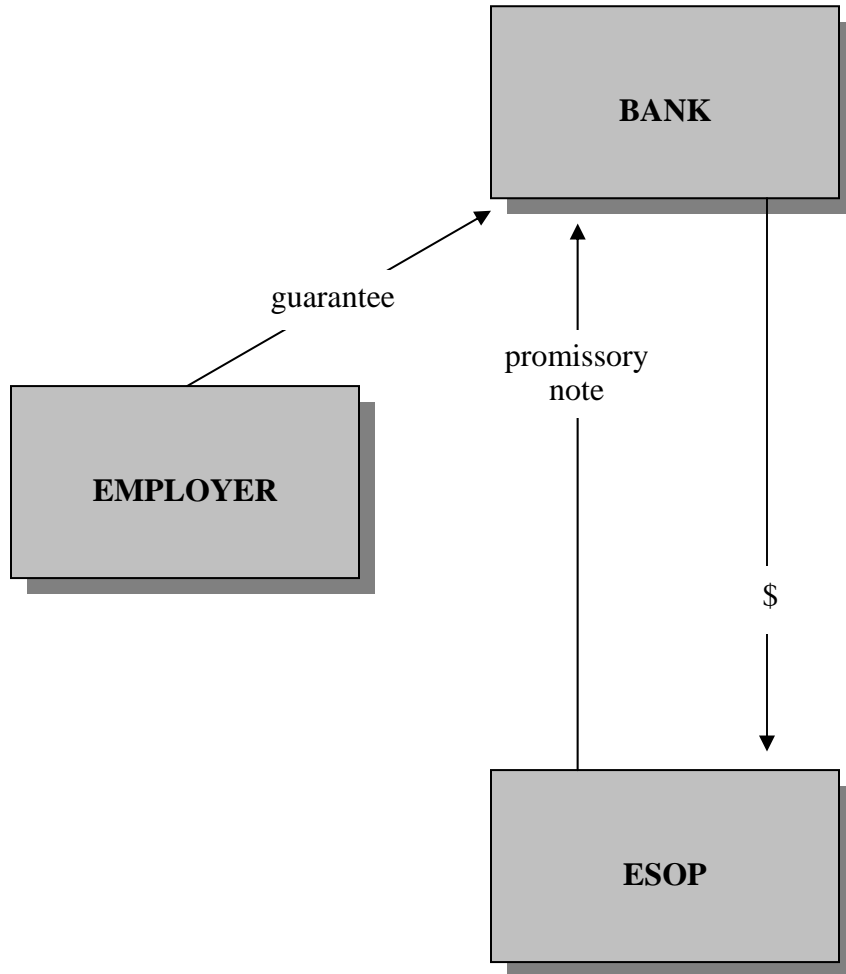
**I.**

In this situation, the ESOP borrows the money from the bank, and signs a promissory note for the money.



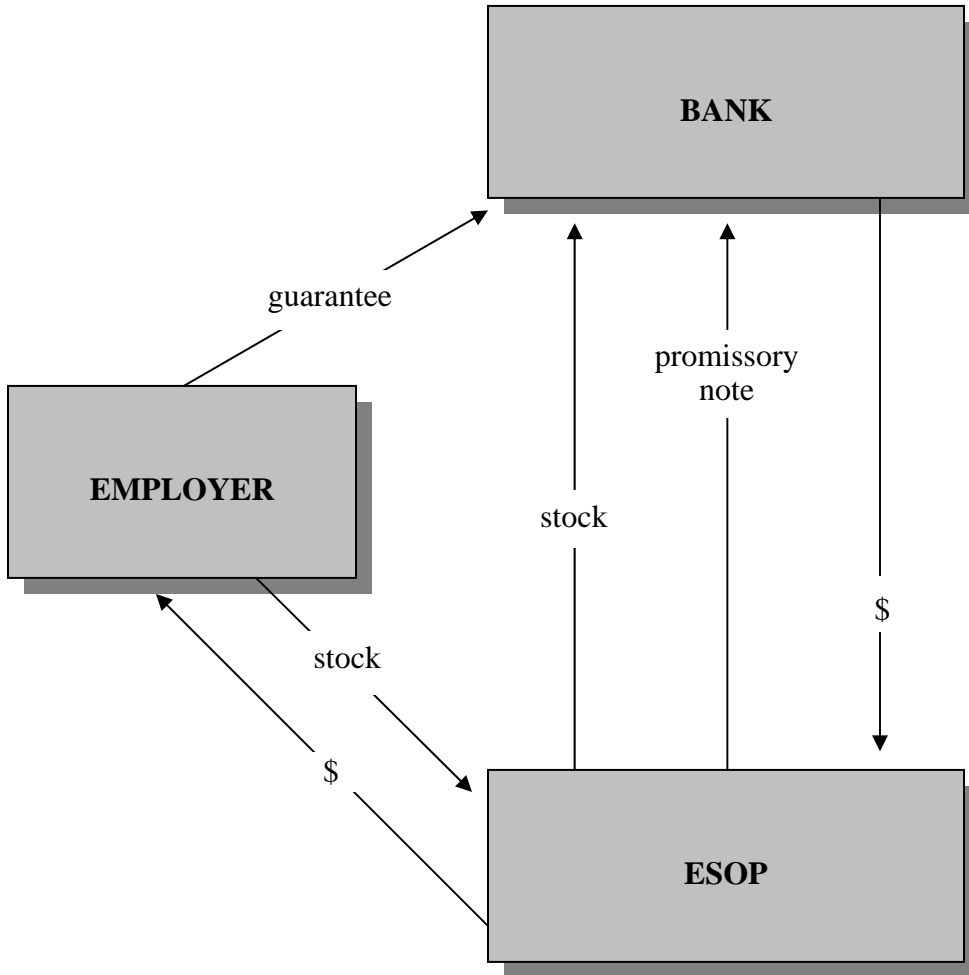
## II.

As part of the ESOP loan, the employer gives a written guarantee to the bank, promising that the ESOP will repay the loan and that each year the employer will pay to the ESOP enough money to permit the ESOP to make its annual repayment of the loan.



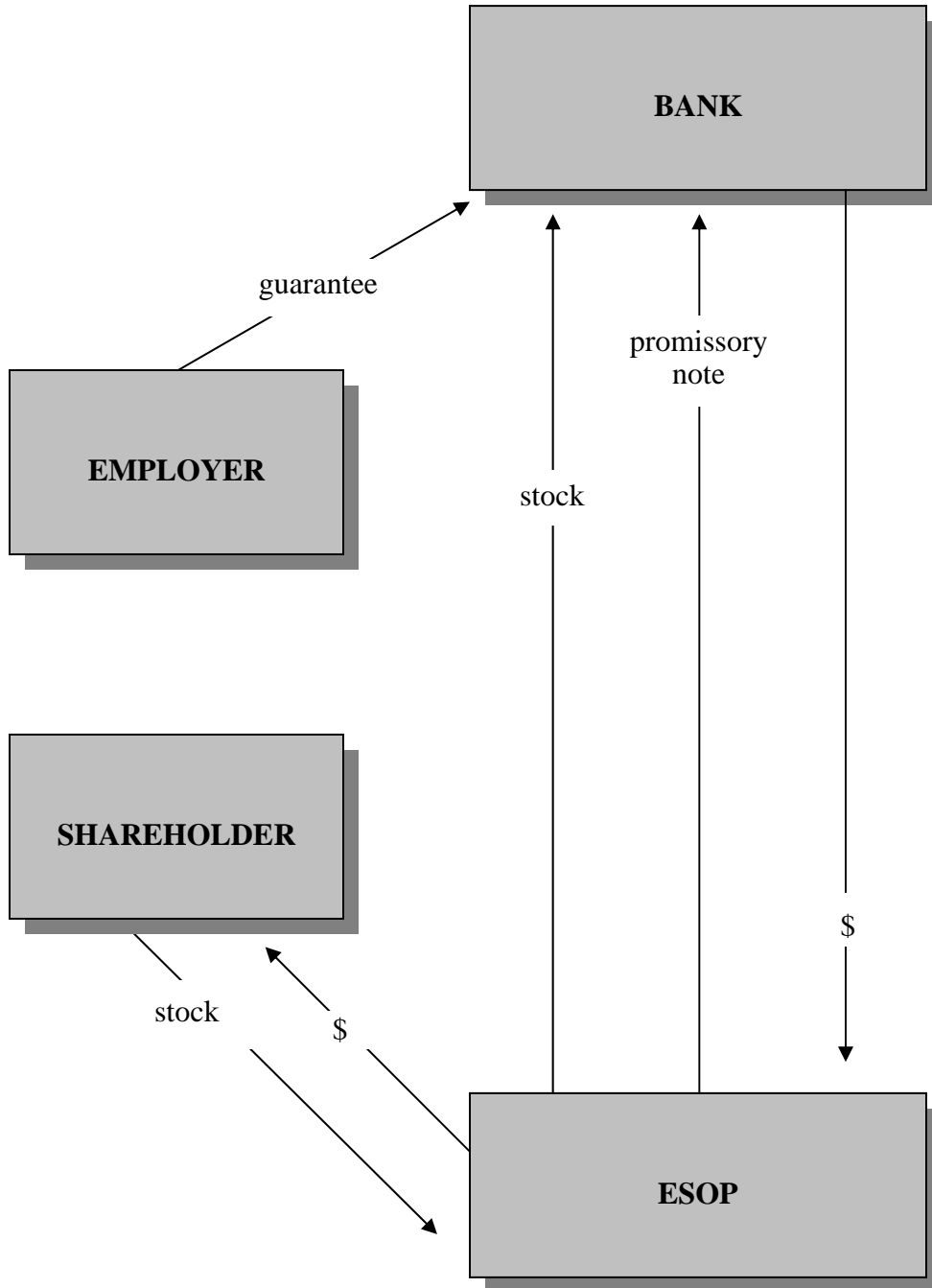
### III.

The ESOP then uses the money from the loan to buy stock from the employer and pledges the stock as security for the loan.



#### IV.

Alternatively the ESOP may use the money from the loan to buy stock from an individual shareholder.



V.

Each year, the employer makes a tax-deductible payment to the ESOP, sufficient to let the ESOP make its annual debt repayment to the bank; as the loan payments are made, a portion of the stock held as security for the loan is returned to the ESOP.

