

ESOPs In A Nutshell

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This memo is not designed to be comprehensive. Further, it has not been re-written to include the very latest changes in the law. Rather, the memo is intended to provide the layperson with a general overview of some of the more important rules and considerations involved in deciding whether the adoption of an Employee Stock Ownership Plan could be a viable option for further consideration.

Relevant IRC ¹ Sections.	§133
	§401(a)(22)
	§401(a)(23)
	§401(a)(28)
	§404(a)(3)
	§404(a)(9)
	§404(k)(2)
	§409(h)
	§1042
	§4975(d)(13)
	§4975(e)
	§4978
	§4979A

General ESOP Requirements. An Employee Stock Ownership Plan (ESOP) is a type of pension benefit plan covered by the Employee Retirement Income Security Act of 1974 (ERISA) which is designed to invest primarily in employer stock. If the ESOP takes the form of a stock bonus plan qualified under Code §401(a) it may be exempt from some of the prohibited transaction and fiduciary rules otherwise imposed by ERISA §406 and Code §4975(e). (An ESOP may *additionally* contain a money purchase formula if desired. In a nonleveraged ESOP, attaching a money purchase formula can increase the deduction for ESOP contributions by as much as 10% of covered payroll. The usual limit in a nonleveraged ESOP is 15% of covered payroll.²)

In addition to the usual requirements applicable to all §401(a) plans, ESOPs must meet certain conditions set forth in Code §§401(a)(22), (23) and (28), 409 and 4975(e).

An ESOP must be designed to invest primarily in employer securities.³ Employer securities means common stock of the employer that is readily tradable on an established securities market, but if such stock does not exist, then the term generally means common stock of the employer having a combination of voting power and dividend rights equal to or in excess

¹All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

²Code §404(a)(3).

³Code §4975(e)(7)(A).

of the class of the employer's common stock having the greatest voting power and the class of stock having the greatest dividend rates.⁴

The participants must be given certain voting rights.⁵ If stock in an ESOP is of a "registration-type" class of securities, each participant must be entitled to direct the vote of the employer securities allocated to his account.⁶ Registration-type class of securities means stock required to be registered under Section 12 of the Securities and Exchange Act of 1934, or stock that is exempt under Section 12(g)(2)(H) of the Act.

If the securities are not registration-type, then the participants need only be given the power to direct the trustee's vote on major corporate matters, such as merger, consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all of the assets of a trade or business of the corporation, and similar issues.⁷ The ESOP can provide that where the securities are not registration-type, each participant may be given only one vote (on major corporate issues), regardless of the number of shares allocated to the participant's account. The trustee then votes the shares proportionately to the individual single votes.⁸ However, unless the ESOP plan document actually incorporates this special rule, votes are to be calculated on the basis of the actual number of shares allocated to the account of the participant doing the directing.

Although distributions can be made in the form of cash, the participants must ordinarily have the right to demand that the distributions be made in the form of employer stock instead.⁹ However, if the employer's articles of incorporation or bylaws restrict ownership of substantially all (at least 80%¹⁰) of the employer's stock either to employees or to a qualified trust, then a terminating employee may be denied the right to receive a distribution in the form of stock.¹¹ Further, the regulations allow the employer to retain a right of first refusal with respect to the future sale or transfer of ESOP stock distributed to a participant.¹²

⁴Code §409(l).

⁵Code §409(e) and 401(a)(22).

⁶Code §409(e)(2) and Code §4975(e).

⁷Code §409(e)(3).

⁸Code §409(e)(5).

⁹Code §409(h)(1)(A).

¹⁰Treas. Reg. §1.368-2(d)(ii).

¹¹Code §409(h)(2).

¹²Treas. Reg. §54.4975-7(b)(9).

If the employer securities are not readily tradable on an established market, the participants must be given a put option to require that the employer (not the plan) repurchase any employer stock distributed under a fair valuation formula.¹³ This is an important obligation which should not be overlooked.

Unless the participant elects otherwise, the distribution to a participant must *begin* not later than one year after the end of the plan year during which the participant terminates employment after attaining normal retirement age, or because of disability or death, or if earlier, six years after termination of employment for other reasons.¹⁴ Unless the participant elects otherwise, distributions must be made in substantially equal annual installments over a period not longer than five years.¹⁵ There is an exception where the participant's account balance exceeds \$500,000.¹⁶ Further, these distribution timing rules do not apply to the part of a participant's account which consists of securities acquired with the proceeds of an ESOP acquisition loan until the *entire* loan is repaid.¹⁷

Assets in an ESOP trust are allocated similarly to an allocation under other defined contribution plans, with two important exceptions. ESOPs may not be integrated with social security (i.e., the permitted disparity rules do not apply),¹⁸ and stock acquired with the proceeds of an exempt loan is not allocated to the accounts of the ESOP participants until and to the extent that the loan is paid off.¹⁹

¹³Code §409(h)(1)(B).

¹⁴Code §409(o).

¹⁵Code §401(o)(C)(1)(i).

¹⁶Code §401(o)(C)(1)(ii).

¹⁷Code §401(o)(1)(B).

¹⁸Treas. Reg. §54.4975-11(a)(7)(ii).

¹⁹Treas. Reg. §54.4975-11(c) and (d).

Leveraged ESOPs. It is the ability to leverage ESOPs that makes them so attractive. Leveraged ESOPs are ESOPs that acquire the assets of the employer, at least in part, with borrowed funds. The borrowed funds are used to purchase stock that is held in suspense and is only released (and then allocated to the participants) as the note is paid off.²⁰ Stock released from the suspense account no longer serves as security for the loan. (This means that the lender cannot rely on having recourse against the entire original collateral as protection against devaluation of the securities in later years.) The regulations specify the permissible terms of an exempt loan.²¹ The loan cannot be a demand loan and must provide for a repayment schedule;²² however, the repayment schedule need not provide for level payments. There is no stated payment term, but the IRS has informally indicated that it would be concerned with a loan having a repayment term over 20 years. If level payments are not used, the regulations caution that special scrutiny will be given to the terms, since they could have the effect of substantially varying the rate at which securities are released:

“Release from encumbrance in annual varying numbers may reflect a failure on the part of the employer to make substantial and recurring contributions to the ESOP which will lead to loss of qualification under section 401(a). The Internal Revenue Service will observe closely the operation of ESOPs that release encumbered securities in varying annual amounts, particularly those that provide for the deferral of loan payments or for balloon payments.”²³

If the lender is not a disqualified person, the debt against the stock may be accelerated for failure to make payments when due; otherwise, the debt may not be accelerated.²⁴

In the case of a leveraged ESOP, the allocation of employer contributions to the accounts of plan participants differs from the treatment of allocations under other defined contribution plans to the extent that the contributions are used to discharge plan debt used to acquire securities held in a suspense account. Because the stock is allocated only as the loan is repaid, special rules apply. **There is a deemed allocation to the participants’ accounts in each year in which the debt is retired.** The size of the allocation is apparently computed by reference to the value of the stock at the time of the contribution made, rather than by reference to the value of the stock actually released and allocated.

The release and allocation takes place under one of two methods specified in the regulations.²⁵ Under the general rule, the number of shares of stock to be released from suspense in a plan year is calculated by multiplying the number of encumbered shares by a fraction, the

²⁰Treas. Reg. §54.4975-7(b)(8).

²¹Treas. Reg. §54.4975-7.

²²Treas. Reg. §54.4975-7(b)(13).

²³Treas. Reg. §54.4975-7(b)(8)(iii). (Emphasis added.)

²⁴Treas. Reg. §54.4975-7(b)(6) and (13).

²⁵Treas. Reg. §54.4975-7(b)(8).

numerator of which is the total principal **and interest** paid for the plan year, and the denominator of which is the total principal and interest paid for the plan year and all future years.²⁶ **The application of this formula will result in the stock being released ratably, in equal amounts each year over the course of the loan,** if level payments are used to retire the debt. An example is given in the regulations.²⁷

Under an alternative method, the stock is released as and only to the extent that principal is repaid.²⁸ If the alternative method is used, **(1)** the repayment schedule must be as rapid as would be the case if it were amortized using level principal and income payments over ten years, **(2)** the amount of interest paid on the loan must not exceed the amount of each payment that would be treated as interest under a standard loan amortization schedule, and **(3)** the term of the loan must not exceed ten years. Under the alternative method, less stock is allocated to the participant's accounts, since only principal payments are allocated.

Income from stock acquired with an exempt loan may either (1) be allocated to the individual accounts of the participants or, if the plan so provides, **may be (2) used instead to retire the debt** secured by the stock.²⁹

In order for a leveraged ESOP to be viable, the employer must be able to make and deduct contributions to the ESOP in future years in an amount sufficient to amortize the acquisition loan over a reasonable period of time in accordance with the schedule called for in the note. The size of the deduction will be limited by the size of the covered payroll of the ESOP participants. The size of this payroll will affect the size of the deduction allowed directly under the §404 deduction rules, and indirectly under the §415 annual addition limitations. ESOPs are privileged in that there are a couple of exceptions to the normal deduction and annual addition rules in the case of interest and dividends used to pay off an exempt loan.

²⁶Treas. Reg. §54.4975-7(b)(8)(i).

²⁷Treas. Reg. §54.4975-7(b)(8)(iv).

²⁸Treas. Reg. §54.4975-7(b)(8)(ii).

²⁹Treas. Reg. 54.4975-11(d)(3).

Ordinarily, an employer would only be able to deduct 15% of covered payroll as a contribution to an ESOP, unless the ESOP also had a money purchase formula.³⁰ **However, the deductible limit is increased to 25% of covered payroll to the extent used to reduce principal of an exempt loan, and there is an unlimited deduction for contributions used to make interest payments.**³¹ This is true even if the employer is contributing to another plan. (Under the usual rule, contributions to other plans are taken into account in applying the percentage limits.) **Moreover, dividends on the stock held by the ESOP that are used to make payments on an ESOP loan used to acquire the stock are also deductible.**³² The importance of these rules cannot be overemphasized.

There are annual addition limitations under §415(c) of the Code which restrict the amount that may be allocated to an employee's account in any given year. The §415 limit is important because allocations cannot be made in excess of this limit without disqualifying the plan, and employer contributions are ordinarily not deductible if in excess of the amount that can be allocated under §415.³³ **This is a major stumbling block where an ESOP is to be used in a leveraged buy out of a retiring owner of a closely held business, where covered payroll is small and the value of the securities sought to be transferred is high.**

The 415(c) limit is usually the lesser or 25% of compensation or \$30,000. However, ESOPs get several breaks here too, as was the case with the contribution deduction. For example, according to the committee reports, **dividends paid on employer stock are not counted as annual additions if used to repay ESOP loans.**³⁴ Although this seems logical, there is nothing in the Code or regulations to support this statement. The ability to use dividends to retire the ESOP debt is an extremely important planning tool, first, because the dividend is deductible without limitation, and second, because if it is not considered an annual addition under §415, the corporation can make payments on the debt in amounts in excess of 25% of the annual covered payroll.

Further, if less than one-third of the contributions used to repay an exempt loan are allocated to highly compensated employees³⁵ (HCEs), then contributions used to pay loan interest and forfeitures of leveraged employer stock are excluded from the annual addition rules of Code §415(c).³⁶

³⁰Code §§404(a)(1) and (3).

³¹Code §404(a)(9).

³²Code §404(k).

³³Code §404(j)(1)(B).

³⁴S. Rep. No. 313, Cong., 2d Sess p. 682 (1986). Statement of the Managers, Joint Committee of Taxation, DEFRA Blue Book p. 879 and TRA '86 Blue Book p. 847.

³⁵As defined in Code §414(q).

³⁶Code §415(c)(6)(C).

One might reasonably conclude that to the extent that the loan is paid off, stock will be released from suspense, and if released from suspense it will be allocated based on either the original value of the stock or on the value at the time of allocation, and that to the extent allocated it would be an annual addition, unless the contribution is made in the form of a dividend. However, this is not the way the regulations apply the §415 limit. The regulations appear to require that for §415 purposes, the stock will be valued on the basis of the employer contributions used to retire the debt, including interest (unless the one-third rule applies). Three statements in the regulations address this issue, without altogether resolving it:

“The amount of employer contributions which is considered an annual addition [under §415] for the limitation year is calculated with respect to employer contributions of both principal and interest used to repay the exempt loan for that limitation year.”³⁷

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“Under §54.4975-11(d)(2) *actual allocations* to participants’ accounts are based upon assets withdrawn from the suspense account. **Nevertheless, for purposes of applying the limitations under section 415 to these [actual] allocations, under §54.4975-11(a)(8)(ii) contributions used by the ESOP to pay the loan are treated as annual additions to participants’ accounts.** Therefore particular caution must be exercised to avoid exceeding the maximum annual additions under section 415.”³⁸

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“An ESOP will not fail to meet the requirements of section 401(a)(16) merely because annual additions under section 415(c) are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to securities allocated to participants.”³⁹

The regulations clearly indicate that for purposes of applying §415, the securities are not revalued at the time of allocation, and seem to suggest that whichever allocation method is used (the general method or the principal only method) the annual additions for §415 purposes will be the same and will be determined by assigning to the stock actually allocated a value equal to the ratio of the number of shares released over the principal and income payments made to retire the debt, unless the one-third rule applies, in which case the interest factor may apparently be ignored.

³⁷Treas. Reg. §1.415-6(g)(5).

³⁸Treas. Reg. §54.4975-7(b)(8)(iii). (Emphasis added.)

³⁹Treas. Reg. §54.4975-11(a)(8)(ii).

Tax Deferral Under §1042. Code §1042 provides that if “qualified securities” are sold to an ESOP and if (1) **after the sale the ESOP owns at least 30%** of each class of outstanding stock of the corporation (with some exclusions) or 30% of the total value of the stock, and (2) the corporation agrees to pay a penalty if there is a premature disposition or prohibited allocation of the stock, then the taxpayer selling the stock may elect to defer recognition of gain on the sale to the extent that the proceeds are invested in certain securities issued by a domestic corporation (not more than 25% of whose income for the tax year before the reinvestment purchase is passive investment income) that is readily tradable on an established securities market. The selling shareholder must have held the stock for at least 3 years prior to the sale, and must invest the proceeds in domestic operating corporation securities within a 15 month period that begins 3 months before the sale date. In order to qualify for the special tax deferral treatment, the stock sold must be that of a closely held C corporation and the sale must be one that would have qualified for long term capital gain treatment but for the deferral. There are a number of other special rules that apply here. The principal advantage (obviously) is that the selling shareholder does not recognize gain at the time of the sale; rather, gain (or loss) is recognized when the domestic operating corporation securities are sold.

There is one potentially major impediment to the free use of §1042: Under §409(n) of the Code, **non recognition treatment will not be available unless** the plan provides that for at least ten years the stock acquired in a §1042 transaction may not be allocated to (1) the taxpayer, (2) a member of the taxpayer’s family (within the meaning of section 267(b))⁴⁰, or (3) for the benefit of any other person who owns (after application of section 318(a)) more than 25 percent of either the total value of the corporation or of any class of outstanding stock of the corporation. In addition, if the ESOP disposes of the stock within three years of the acquisition, a 10% excise tax is imposed on the corporation.⁴¹

⁴⁰§267(b) states that “[t]he persons referred to in subsection (a) [include] (1) Members of a family, as defined in subsection (c)(4).” IRC §267(c)(4), in turn, states that “[t]he family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.”

There is an interesting exception to this rule in the case of certain lineal descendants:

(A) Lineal descendants. Paragraph (1)(A)(ii) shall not apply to any individual if --

(i) such individual is a lineal descendant of the taxpayer, and

(ii) the aggregate amount allocated to the benefit of all such lineal descendants during the nonallocation period **does not exceed more than 5 percent** of the employer securities (or amounts allocated in lieu thereof) held by the plan which are attributable to a sale to the plan by any person related to such descendants (within the meaning of section 267(c)(4)) in a transaction to which section 1042 applied.

⁴¹Code §4978(d)(1).

50% Interest Exclusion For ESOP Loans Made By Qualified Lenders. If certain conditions are met, a commercial lender was, prior to August 21, 1996, entitled to a 50% deduction for the interest used to finance an ESOP loan used to acquire qualifying securities. This exclusion was repealed by the §1602(b)(1) of the Small Business Job Protection Act (SBJPA) effective for loans (other than certain then existing or refinancing loans) entered into after 8/20/96.⁴²

ESOPs for S-Corporations (SESOPs). A recent change in the law now permits S-Corporations to adopt ESOPs without being subject to the tax on unrelated business taxable income (UBTI) on the S-corporation stock earnings.⁴³ A major advantage of this change is that neither the ESOP nor the corporation will pay tax on the S-Corporation earnings. Ordinarily, a qualified plan of any type would have to pay a tax on S-corporation and partnership earnings under the rules that require otherwise tax exempt entities to pay a tax on UBTI. The purpose of the UBTI rules is to ensure that no business can operate without paying tax at some level. For example, although a qualified plan (including an ESOP) ordinarily does not have to pay tax on dividends on C-corporation securities held by it, a tax is paid on earnings by the corporation issuing the securities. This is not true in the case of a partnership or S-corporation. Therefore a UBTI tax would ordinarily be paid by an otherwise tax exempt entity on partnership or S-corporation earnings. Again, the new law makes an exception from the UBTI tax for certain S-corporation ESOPs.

No Dividend Deduction For SESOPs. Unlike a C-corporation, an S corporation gets no deduction under 404(k) for dividends paid to the ESOP.⁴⁴

§1042 Not Available for S-Corporation ESOPs. Although the tax benefits under IRC §1042 (discussed above) are not available for an S-Corporation ESOP, it may be possible for a C-corporation to purchase stock from a shareholder and then covert to an S-corporation, provided the step-transaction doctrine does not apply.

Deduction Limits for S-Corporation ESOPs. An S-corporation may not deduct more than 15% of covered compensation

No Plan Loans to Shareholder-Employees. An SESOP —or, for that matter, any qualified plan sponsored by an S-corporation— may not make loans to a shareholder-employee⁴⁵.

Conclusions. Unless covered payroll, **not including 25% owners**, is sufficiently large, it will be very difficult to amortize any significant ESOP debt used to acquire the stock of the

⁴²PL104-188, 104 Cong., 8/20/96.

⁴³IRC §512(e)(3).

⁴⁴ SBJPA §1316(d)(2).

⁴⁵ IRC §4975(d), flush language. For this purpose, the term “shareholder-employee” is as “defined in section 1379, as in effect on the day before the date of the enactment of the Subchapter S Revision Act of 1982.”

owners. It may be possible for a company to contribute to the ESOP (and deduct) each year 25% of covered payroll. In addition, a company can deduct dividends on the stock used to retire the debt. Further a company can deduct contributions used to pay interest on the debt, subject only to the §415 limitations. There is a question, however, as to the extent to which the interest payments can be excluded in applying the §415 limit, discussed above. 25% of covered payroll must be adequate to retire the debt or a leveraged ESOP simply will not work, **unless dividends are used to supplement regular corporate contributions to the plan.** It would take approximately \$150,000 a year to amortize a \$1 million 10% note over ten years. Vary the size, the interest rate, the term of the note, and the size of the payroll, and one can judge on the basis of the facts assumed whether or not an ESOP is feasible.

The tax deferral available under §1042 is very attractive, if the ESOP would qualify. A significant problem may be the rule that no participant under the ESOP can own more than 25% of the company.

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