Employee Stock Ownership Plans (ESOPs)

ANDREW L. ORINGER, DECHERT LLP AND MICHAEL J. SEGAL, WACHTELL, LIPTON, ROSEN & KATZ, WITH PRACTICAL LAW EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

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This Note provides an overview of employee stock ownership plans (ESOPs) under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (Code). An ESOP is a stock bonus plan, or a stock bonus plan combined with a money purchase pension plan, that is designed to invest primarily in "qualifying employer securities" and satisfies other specific requirements set out in ERISA and the Code.

Since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Congress, through various tax incentives and other relief, has encouraged the use of employee stock ownership plans (ESOPs) both as a means of providing retirement benefits to employees and as a corporate financing vehicle. An ESOP is a stock bonus plan, or a stock bonus plan combined with a money purchase plan, that:

- Is designed to invest primarily in "qualifying employer securities" under ERISA Section 407(d)(5) (29 U.S.C. § 1107(d)(5)) and Internal Revenue Code (Code) Sections 409(l) and 4975(e)(8) (see Qualifying Employer Securities).
- Satisfies other specific requirements set out in ERISA and the Code, including the tax-qualification requirements of Code Section 401(a) (see Practice Note, Requirements for Qualified Retirement Plans (3-506-6895)).

The ESOP is unique among tax-qualified plans in that it is potentially a dual-purpose vehicle that can also be used as a corporate finance vehicle.

This Note provides an overview of ESOPs, including:

- The impact of legislative, regulatory and judicial decisions on the viability of ESOPs as a dual-purpose employee benefits and corporate finance vehicle.
- The qualification rules for ESOPs, including:
  - qualifying employer securities under ERISA and the Code;
  - maximum ESOP contributions and corresponding employer deductions;
  - timing and commencement of ESOP distributions; and
  - diversification requirements.
- The rules for leveraged ESOPs.
- The tax rules that permit gain deferrals on sales to ESOPs.

Since the enactment of the Small Business Job Protection Act of 1996, ESOPs are permitted to be shareholders of S-corporations, and there are potentially significant tax benefits that can be obtained through the use of an S-corporation ESOP. The special rules that apply to S-corporation ESOPs are beyond the scope of this Note.

VIABILITY OF ESOPS: A POTENTIAL DUAL-PURPOSE VEHICLE

Congress has encouraged the use of ESOPs since the enactment of Section 803(h) of the Tax Reform Act of 1976. Senator Russell B. Long was one of Congress's principal ESOP proponents and was instrumental in supporting provisions giving favorable treatment to ESOPs under ERISA and the Code.

However, over the last decade aggressive litigation has been pursued in the private sector and by the Department of Labor (DOL) against ESOP trustees. Some believe that a number of DOL officials may question whether ESOPs, and the concentration of investment in a single stock that is the hallmark of an ESOP, are fundamentally inconsistent with good retirement policy. In 2014, in *Fifth Third Bancorp v. Dudenhoeffer*, weighed in on the so-called Moench presumption of prudence and rejected that presumption, holding that ESOP fiduciaries are generally bound by the same duty of prudence that applies to all ERISA fiduciaries (No. 12-751, 2014 WL 2864481 (June 25, 2014)) (see Legal Update, Supreme Court Rejects Moench Presumption of Prudence (8-572-5125) and Article, Fifth Third v. Dudenhoeffer: Advisory Board Roundtable Discussion (6-575-0700)). However, the Supreme Court's analysis in *Dudenhoeffer*, particularly taken together with the follow-up case of *Amgen Inc. v. Harris* (136 S. Ct. 758 (2016)), contains additional discussion that, in a number of circumstances, could serve to make it more difficult for plaintiffs to prevail in litigation against ESOP fiduciaries.

More recently, there was concern that the DOL's fiduciary investment advice regulation would include provisions that would make appraisers of stock held in ESOPs, or those issuing ESOP fairness opinions, fiduciaries. This change would have subjected these persons to the broad range of fiduciary duties under ERISA. However, the final regulation, which was issued in April of 2016, does not include any provisions specifically addressing ESOPs. The DOL indicated in the preamble to the final regulation that it intends to issue separate guidance on ESOPs. It should also be noted that whether the final regulation will ever ultimately become applicable (and, if it does, what it may provide at that time) remains uncertain at this time in light of the results of the 2016 election (see Practice Note, Definition of Fiduciary Investment Advice (3-610-6145) and Legal Update, DOL Delays Applicability of Fiduciary Investment Advice Rule by 60 Days (W-006-7286)).

Another development potentially adversely affecting ESOPs is the trend in certain cases to effectively view corporate decision-making by company personnel as fiduciary in nature when the company is owned to a significant extent by an ESOP (see *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009) and *Fernandez v. K-M Indus. Holding Co.*, 646 F. Supp. 2d 1150 (N.D. Cal. 2009)).

Further, some ESOP incentives have been repealed over time, such as:

- The partial exclusion from income of interest paid on certain ESOP loans under former Code Section 133.
- The partial exclusion from a taxable estate of employer securities sold to an ESOP under former Code Section 2057.

Despite these developments, ESOPs remain a viable employee benefits and financing vehicle and, in appropriate cases, can provide a package of plan design and financial advantages that may not otherwise be available.

QUALIFICATION RULES

An ESOP must meet the requirements generally applicable to all tax-qualified defined contribution plans (see Practice Note, Requirements for Qualified Retirement Plans (3-506-6895)).

The additional requirements for a plan to qualify as an ESOP under ERISA and the Code are similar, but not identical. For example, while the definition of "qualifying employer securities" under ERISA Section 407(d)(5) (29 U.S.C. § 1107(d)(5)) includes any type of stock as well as certain marketable obligations which are not stock (see Practice Note, Employer Securities and Employer Real Property in Qualified Retirement Plans: Qualifying Employer Securities (0-533-0646)), the corresponding definition under Code Sections 409(l) and 4975(e)(8) includes only specific types of stock. Therefore, it is possible for a plan to qualify as an ESOP for purposes of either ERISA or the Code, while failing to qualify under the other statute.

However, the advantages of being characterized as an ESOP are fully available only if the plan meets the requirements of both ERISA and the Code. Therefore, references in this Note to an ESOP mean a plan that complies with the ESOP requirements of both statutes.

The remainder of this section describes the qualification rules under ERISA and the Code that apply to ESOPs.

QUALIFYING EMPLOYER SECURITIES

An ESOP must be designed to invest primarily in qualifying employer securities (26 U.S.C. 4975(e)(7)-(8) and 26 C.F.R. § 54.4975-11(b)). This term generally includes common stock that is:

- Issued by the employer or by a corporation that is a member of the same controlled group (see Practice Note, Controlled Group and Affiliated Service Group Rules (3-522-4866)).
- Tradable on an "established securities market." For this purpose, an established securities market includes:
  - a national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. § 78f); or
  - a foreign national securities exchange that is officially recognized, sanctioned or supervised by a governmental authority and where the security is deemed by the Securities and Exchange Commission (SEC) as having a ready market under Rule 15c3-1 under the Exchange Act.

(26 U.S.C. § 409(l).)

The Internal Revenue Service (IRS) cleared up some lingering uncertainty around the meaning of "established securities market" by issuing Treasury Regulation Section 1.401(a)(35) (26 C.F.R. § 1.401(a)(35)-1) in May 2010 (applicable to investment diversification requirements for certain defined contribution plans) and IRS Notice 2011-19, which extended the application of that regulation to, among other things, Code Section 409(l) and, therefore, ESOPs (see Article, Required 2012 Qualified Plan Amendments and Cycle B Determination Letter Filing Deadline (9-520-8665)).

If the employer's common stock is not tradable on an established securities market, common stock issued by the employer may be used if it has a combination of voting power and dividend rights equal to or in excess of the class of common stock with the combination of the greatest voting power and dividend rights (26 U.S.C. § 409(l)(1)-(2)).

If a company has only two classes of non-publicly traded common stock outstanding, the ESOP generally must own shares of the class with greater voting power and dividend rights. For example, if one class is Class A common stock with five votes and the other is Class B common stock with one vote, and the stock terms are otherwise similar, the ESOP must own Class A stock. However, if the company also has a class of publicly traded, nonvoting common stock, the ESOP would generally be required to hold the class of publicly traded stock, even though the non-publicly traded stock has better voting rights.

Noncallable preferred stock also constitutes qualifying employer securities if:

- It is immediately convertible at any time into otherwise qualifying stock.
- The conversion price is reasonable.

(26 U.S.C. § 409(l)(3).)

The term "noncallable" preferred stock is actually a misnomer, as callable preferred stock also qualifies if there is a reasonable opportunity to convert after the call.

Valuations of employer securities held in an ESOP that are not readily tradable on an established securities market must be made by an independent appraiser (26 U.S.C. § 401(a)(28)(C)) (for a recent case dealing with the valuation employer stock purchased by an ESOP, see *Perez v. Bruister*, 823 F.3d 250 (5th Cir. May 3, 2016)). This requirement is consistent with the requirement that, under the ERISA rules governing prohibited transactions, an ESOP may not:

- Purchase employer securities from the sponsoring employer (or another party in interest) for more than adequate consideration (see Status as a Party in Interest Checklist (3-506-3340)).
- Sell employer securities to the sponsoring employer (or another party in interest) for less than adequate consideration.

(29 U.S.C. § 1108(e)(1)) and 29 C.F.R. § 2510.3-18 (proposed May 17, 1988).) For more information on prohibited transactions, see Practice Note, Prohibited Transactions and Exemptions under ERISA and the Code (9-526-8386)).

If the employer securities are traded on an established securities market, adequate consideration is defined as the prevailing trading price on the market (29 U.S.C. §§ 1002(18)(A) and 1107(e)(1)). If the securities are not traded on an established securities market, adequate consideration is the fair market value, as determined in good faith by the trustee or named fiduciary (29 U.S.C. § 1002(18)(B)).

Pass-through of Certain Voting Rights

Certain voting rights must be passed through to ESOP participants in respect of employer securities held in participant accounts. If the employer has a registration-type class of securities, which under Code Section 409(e)(4) is a class of securities required to be registered under Section 12 of the Exchange Act (15 U.S.C. § 78l), each participant must be entitled to direct the voting of securities allocated to the participant's account on all matters (26 U.S.C. §§ 409(e)(2) and 4975(e)(7)).

In some leveraged buyouts, the stock held by the ESOP is not required to be registered, but debt securities issued by the sponsoring employer are sold on a national securities exchange and are required to be registered under Section 12 of the Exchange Act. In this case, voting rights should likely be passed through to ESOP participants.

If the employer does not have a registration-type class of securities, the ESOP generally must permit participants to direct the voting of the securities allocated to their accounts regarding any matter that involves the approval or disapproval of any corporate:

- Merger or consolidation.
- Recapitalization.
- Reclassification.
- Liquidation.
- Dissolution.
- Sale of substantially all assets of a trade or business. (26 U.S.C. §§ 409(e)(3) and 401(a)(22).)

The ESOP generally must also permit participants to direct the voting of the securities allocated to their accounts regarding any matter that involves the approval or disapproval of any transaction similar to those listed above as may be prescribed in Treasury regulations (26 U.S.C. § 409(e)(3)).

The ESOP fiduciary is allowed to vote the shares on all other issues, including voting for the election of directors. Additionally, the ESOP fiduciary is allowed to vote:

- Allocated shares for which voting rights would otherwise be passed through to participants for which voting instructions are not received from participants.
- Shares that are not allocated to participants' accounts. Typically, unallocated shares are held in the suspense account of a leveraged ESOP pending allocation on repayment of the ESOP's loan (see Leveraged ESOPs).

Under a leveraged ESOP, the ESOP (or associated trust) document may provide that the applicable fiduciary will vote undirected and unallocated shares in the same proportion as shares for which participant voting directions are received. Though ERISA Section 404(a)(1)(D) (29 U.S.C. § 1104(a)(1)(D)) generally requires a fiduciary to act in accordance with plan documents, that requirement applies only if the plan documents are otherwise consistent with ERISA. Consequently, a fiduciary generally may not follow a proportional voting pass-through provision applicable to undirected or unallocated ESOP shares without first determining if doing so is consistent with ERISA (see, for example, DOL Opinion Letter on Tender Offers (Feb. 23, 1989) and DOL Information Letter re: Pass-through Voting Provisions in Collectively Bargained Employee Stock Ownership Plans, to Ian D. Lanoff (Sept. 29, 1995)). Note that the DOL's general guidance on proxy voting has been updated (see In FAB 2018-01, DOL Clarifies Its Views on Proxy Voting, Shareholder Engagement, and Plan Investments in ETIs and Legal Update, DOL Issues Interpretive Bulletin 2016-1 on Voting of Proxies on Securities Held in Employee Benefit Plan Investment Portfolios (W-005-2142)).

ESOP CONTRIBUTIONS AND EMPLOYER DEDUCTIONS

There is a limit on the amounts that can be contributed to an ESOP as well as a corresponding deduction limit for employers sponsoring ESOPs.

Contribution Limit: Annual Additions

The maximum amount of "annual additions" that can be contributed to a plan participant's account under a defined contribution plan, including an ESOP, is generally the lesser of:

- $56,000 for 2019 ($55,000 for 2018) (adjusted annually for increases in the cost of living).
- 100% of the participant's compensation (see Practice Note, Compensation Definition for Qualified Retirement Plans (3-524-1601)).

(26 U.S.C. § 415(c)(1)-(2).)

In the case of a leveraged ESOP in which stock purchased by the ESOP with the proceeds of a loan is allocated to participants over the period of loan repayment (see Leveraged ESOPs), annual additions for a particular year may be determined by reference to employer contributions made to the ESOP to enable it to make loan payments, rather than by reference to the value of the stock allocated to participants' accounts for the year on account of those loan payments (26 C.F.R. § 54.4975-11(a)(8)(ii)). For a leveraged ESOP that holds stock that appreciated after being acquired by the ESOP, this rule can result in a value annually allocated to participants' accounts that exceeds the otherwise applicable annual limit.

Employer Deduction Limit

Employer contributions to an ESOP are generally deductible by the employer if they do not exceed 25% of the participants' aggregate includable compensation (26 U.S.C. § 404(a)(3)). For more information on calculating participants' compensation for this purpose, see Practice Note, Compensation Definition for Qualified Retirement Plans (3-524-1601).

Dividends paid regarding the ESOP's employer securities:

- Are considered earnings on account balances, and therefore do not count towards the annual addition limitation (IRS Priv. Ltr. Rul. 200716027, 2007 WL 1170407 (Apr. 20, 2007) and IRS Priv. Ltr. Rul. 200243055, 2002 WL 31402511 (Oct. 25, 2002)).
- Can be deductible if the applicable requirements of Code Section 404(k) are satisfied and they are either:
  - paid out to the plan participants; or
  - used to repay an ESOP loan.

There is some controversy regarding whether amounts paid to purchase stock from participants, sometimes called "redemptive dividends," are deductible under Code Section 404(k). The IRS has continued to litigate the position stated in Treasury Regulation Section 1.56(g)-1(d)(3)(iii)(E) and Revenue Ruling 2001-6, and several US Circuit Courts of Appeal have agreed, that redemptive dividends are not deductible under Code Section 404(k) (*Nestlé Purina Petcare Co. v. Comm'r*, 594 F.3d 968 (8th Cir. 2010), *General Mills, Inc. v. United States*, 554 F.3d 727 (8th Cir. 2009), *Conopco, Inc. v. United States*, 572 F.3d 162 (3d Cir. 2009), and *Snap-Drape, Inc. v. Comm'r*, 98 F.3d 194 (5th Cir. 1996)).

However, the US Court of Appeals for the Ninth Circuit has held that the deduction was proper because the ESOP trust (and not the participants) was the beneficial owner of the stock and because the redemption payment and subsequent distribution of funds were "two segregable" and "entirely separate" transactions (*Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003)). In response to the Ninth Circuit's holding in *Boise Cascade*, the IRS promulgated another regulation reaffirming its position that redemptive dividends are not deductible (26 C.F.R. § 1.404(k)-3).

If no more than one-third of deductible employer contributions for the year are allocated to certain highly compensated employees (HCEs) in an ESOP, then annual additions will not include:

- Forfeitures of employer securities held in the ESOP that are reallocated to participants' accounts.
- Employer contributions to the ESOP that are used to make interest payments on an ESOP loan.

(26 U.S.C. § 415(c)(6)(A)-(B) and see Standard Clause, Plan Language, Definition of Highly Compensated Employee (5-524-0144)).

In addition, an ESOP must not be integrated directly or indirectly with Social Security contributions or benefits (26 C.F.R. § 54.4975-11(a)(7)(ii)).

ESOP DISTRIBUTION RULES

As with any qualified retirement plan, an ESOP is subject to the generally applicable distribution rules of the Code (see Practice Notes, Required Minimum Distributions from Retirement Plans (9-522-6805) and Requirements for Qualified Retirement Plans (3-506-6895)).

However, there are additional distribution rules specific to ESOPs under the Code relating primarily to the timing and form of distributions.

Timing of Distributions

An ESOP must provide each participant with an election to begin distribution of the participant's account balance no later than one year after the close of the plan year:

- In which the participant separates from service due to:
  - reaching normal retirement age under the plan;
  - disability; or
  - death.
- That is the fifth plan year after the participant separates from service for any other reason, if the participant is not reemployed during that five-year period.

(26 U.S.C. § 409(o)(1)(A).)

However, in the case of a leveraged ESOP (see Leveraged ESOPs), any securities acquired with the proceeds of an ESOP loan are not subject to this special ESOP distribution rule. These securities are not required to be distributed until the ESOP loan is repaid in full (26 U.S.C. §§ 4975(e)(7) and 409(o)(1)(B)). Consequently, leveraged ESOPs may be able to defer distributions beyond the time that would be permitted in a non-leveraged ESOP.

Even if neither the special ESOP rules nor the generally applicable qualified plan rules require distribution, ESOPs may provide for earlier distributions if the employer considers this approach to be good plan design. For example, an ESOP may provide for an in-service distribution before a participant attains normal retirement age, disability or death.

When a participant begins receiving ESOP distributions, unless he elects otherwise, his account balance generally must be distributed in substantially equal periodic payments over a period no longer than five years (26 U.S.C. § 409(o)(1)(C)(i)). For account balances in excess of $1,130,000 for 2019 ($1,105,000 for 2018) (as adjusted for cost-of-living increases), the five-year distribution period may be extended by one year for each $225,000 ($220,000 for 2018) (adjusted for cost-of-living increases) that the balance exceeds $1,130,000 ($1,105,000 for 2018), to a maximum distribution period of ten years (26 U.S.C. §§ 409(o)(1)(C)(ii) and (o)(2)).

Any securities acquired by a leveraged ESOP with the proceeds of an ESOP loan are not subject to these special rules while the loan is outstanding (see Leveraged ESOPs).

Form of Distributions: Employer Securities

An ESOP must generally provide participants with a right to demand distributions in the form of employer securities (26 U.S.C. §§ 409(h)(1)(A) and 4975(e)(7)).

The requirement to provide for distributions in the form of employer securities does not apply to an ESOP if the issuer of the securities:

- Is an S-corporation.
- Has a charter or by-laws that restrict the ownership of substantially all outstanding employer securities to employees or a tax-qualified trust.

(26 U.S.C. § 409(h)(2)(B)(ii).)

Net unrealized appreciation (NUA) generally refers to the appreciation in the value of the stock after it is contributed to or purchased by the ESOP. As with lump sum distributions of certain employer securities under qualified plans in general, under Code Section 402(e)(4), NUA may be excludable from the income of the distributee in the case of certain stock distributions by an ESOP.

If an ESOP distributes employer securities that are not readily tradable on an established market, a participant must be given a put option. Under Code Section 409(h)(1)(B), a put option is the right to require the employer to repurchase the employer securities under a fair valuation formula. If a participant exercises the put option on employer securities distributed as part of a total distribution, the employer may make this payment over five years in substantially equal periodic payments (made at least annually), beginning no later than 30 days after the exercise of the put option, if:

- Reasonable interest is paid on the unpaid amounts.
- Adequate security is provided.

(26 U.S.C. § 409(h)(5).)

Employer securities acquired by a leveraged ESOP with the proceeds of an ESOP loan also may be subject to a right of first refusal (26 C.F.R. § 54.4975-7(b)(9)).

As a result of the combination of the distribution and put option rules, for an ESOP (or leveraged ESOP whose loan has been repaid), an employer whose stock is not publicly traded will have no more than five years from the time that a participant's distributions start to monetize the distributions. If put option obligations will apply, the need for cash to meet those obligations should be carefully analyzed when first considering an ESOP. Also, an employer may wish to undertake a so-called "repurchase liability" study to be in a better position to determine if future cash obligations will be manageable.

DIVERSIFICATION

The Code requires ESOPs to give certain participants the ability to diversify the investment of a portion of their account balances into investments other than employer securities.

Required Election to Diversify

An election to diversify must be offered to "qualified participants." Qualified participants are those who have:

- Attained age 55.
- Completed ten years of participation in the ESOP.

(26 U.S.C. § 401(a)(28)(B)(iii).)

IRS Notice 88-56 offers detailed rules explaining how ESOPs may satisfy the requirement to offer the election to diversify.

The ten-year participation requirement allows new ESOPs to significantly defer the time at which an older participant can elect to diversify his account balance. However, the IRS has concluded in a private letter ruling that participation in "predecessor" plans must be taken into account for this purpose (IRS Priv. Ltr. Rul. 200317023, 2003 WL 1950944 (Sept. 24, 2002), citing H.R. Rep. No. 100-795, 100 Cong., 2d Sess. 1,196 (1988)).

The ESOP must provide that a qualified participant can elect annually during a specified qualified election period to direct the diversification of an amount that is at least 25% of the participant's ESOP account balance, and at least 50% of the participant's account balance for the last qualified election period (26 U.S.C. § 401(a)(28)(B)(i)). The qualified election period is the 90-day period following the close of:

- The ESOP plan year in which the participant first attains qualified participant status.
- Each of the next five plan years.

(26 U.S.C. § 401(a)(28)(B)(i) and (iv).)

Required Diversification Options

The rules require that an ESOP offer no fewer than three investment options other than employer securities to each qualified participant.

Alternatively, distributing the portion of the account balance subject to diversification eliminates the need for providing the investment options.

(26 U.S.C. § 401(a)(28)(B)(ii).)

Other Diversification Requirements

Code Section 401(a)(35) contains other diversification requirements that are generally applicable to tax-qualified defined contribution plans holding publicly traded employer securities, but those requirements do not apply to an ESOP if the ESOP:

- Does not hold any employee salary deferral or employer matching contributions.
- Is treated as a separate plan from every other plan of the sponsoring employer for tax-qualification purposes.

(26 U.S.C. § 401(a)(35)(E)(ii).)

If the ESOP provides that employee contributions or elective deferrals are invested in employer securities, then the ESOP must allow the participants to:

- Divest their accounts of those securities.
- Direct the proceeds into a permissible range of investment options.

A permissible range of investment options is one in which each investment option:

- Itself is diversified.
- Has materially different risk and return characteristics.

(26 U.S.C. § 401(a)(35)(D)(i).)

Additionally, a qualified plan (including an ESOP) that provides for employer contributions other than elective deferrals (most commonly matching contributions) must provide diversification rights for any:

- Participant who has completed at least three years of service.
- Beneficiary of a deceased participant.
- Beneficiary of a participant who has a plan account and has completed three years of service.

(26 U.S.C. § 401(a)(35)(C).)

For more information on the diversification requirements under Code Section 401(a)(35), see Practice Note, Employer Stock Diversification Requirements under Code Section 401(a)(35) (7-532-4468).

Under rules added by the Pension Protection Act of 2006 (PPA), ESOPs that are subject to Code Section 401(a)(35) are not subject to the diversification requirements of Code Section 401(a)(28)(B)(ii) and must instead satisfy the diversification requirements of Code Section 401(a)(35).

IRS Notice 2013-17 clarifies that an ESOP that satisfies Code Section 401(a)(28)(B)(i) by making an in-service distribution under Code Section 401(a)(28)(B)(ii) and subsequently becomes subject to the requirements of Code Section 401(a)(35) under the PPA may amend the ESOP to eliminate that distribution option (which may not otherwise be permissible under Code Section 401(a)(35) or the anti-cutback rules of Code Section 411(d)(6)), provided the amendment is adopted and put into effect by the later of:

- The last day of the first plan year beginning on or after January 1, 2013.
- The time the plan must be amended to satisfy Code Section 401(a)(35).

(IRS Notice 2013-17, 2013-20 IRB 1082, 2013 WL 1688852.)

For more information on the Code's anti-cutback rules, see Practice Note, Protected Benefits under Code Section 411(d)(6) (8-521-5906).

LEVERAGED ESOPS

One common use of an ESOP involves the purchase of a block of the employer's stock using borrowed money and the allocation of that stock to ESOP participants' accounts over the term of the loan as it is repaid.

The type of ESOP used for this transaction is commonly known as a "leveraged ESOP."

The necessary funds for the ESOP's purchase typically are obtained by the ESOP directly or indirectly from financial institutions or other outside lenders, with the sponsoring employer guaranteeing the loan, although on occasion the sponsoring employer provides the financing directly. The employer securities purchased by the ESOP are generally pledged as collateral for the loan. The ESOP obtains cash to make loan payments through periodic contributions from the sponsoring employer. Where stock purchased by a leveraged ESOP is used to satisfy the employer's matching contribution obligations under a Section 401(k) plan, the ESOP is sometimes referred to as a "KSOP."

Essentially, the lifespan of a leveraged ESOP involves:

- Acquisition of the employer securities with a loan (see Loan Requirements).
- Allocation of the employer securities to individual participant accounts as the loan is repaid by the ESOP (see Allocation of Employer Securities to ESOP Participants) with contributions from the sponsoring employer (see Rules Relating to Deductions and Annual Additions).
- Vesting over time in those participant accounts.
- Distribution of the employer securities to participants (see ESOP Distribution Rules).
- Regarding any employer securities to which the put option applies, ultimate monetization through repurchase of those securities by the employer (see Form of Distribution: Employer Securities).

LOAN REQUIREMENTS

A loan can be made to an ESOP by:

- The employer or another party.
- An outside lender and guaranteed by the employer or another party.

Because outside lenders may wish to stay in close contractual privity with the repayment source (the employer), sometimes the employer borrows funds from an outside lender and turns around and on-lends those funds to its ESOP. This is commonly referred to as a "back-to-back" loan arrangement.

Leveraged ESOPs and Prohibited Transactions

ERISA generally prohibits loans and other extensions of credit, including guarantees, between a plan and a party in interest to the plan (including the sponsoring employer), and the Code imposes excise taxes on these extensions of credit (see Practice Note, Prohibited Transactions and Exemptions under ERISA and the Code (9-526-8386)).

However, a loan to an ESOP that is from or guaranteed by a party in interest is exempt from the prohibited transaction rules of ERISA and the Code if it meets certain requirements (29 U.S.C. § 1108(b)(3) and 26 U.S.C. § 4975(d)(3)). To be exempt, an ESOP loan must be:

- Primarily for the benefit of plan participants and beneficiaries.
- At a reasonable rate of interest (see Practice Note, Qualified Retirement Plan Loans: Reasonable Rate of Interest (0-519-8029)).
- On terms at least as favorable as those of a comparable loan resulting from arm's-length negotiations between independent parties.
- Used only to:
  - purchase qualifying employer securities (see Qualifying Employer Securities); or
  - repay a prior ESOP loan.
- For a specific term.

(26 C.F.R. § 54.4975-7(b) and 29 C.F.R. § 2550.408b-3(b).)

The loan must be without recourse against the ESOP, and the only collateral the ESOP may give is qualifying employer securities:

- Purchased with the proceeds of the loan.
- Used as collateral for a prior loan to the ESOP and then repaid with the proceeds of the later loan.

(26 C.F.R. § 54.4975-7(b) and 29 C.F.R. § 2550.408b-3(e).)

For a loan that is made (as opposed to guaranteed) by a party in interest, the maximum amount of collateral that can be taken in the case of a default is limited to the aggregate amount of:

- The collateral given for the loan.
- Contributions made to the ESOP to meet the loan obligation.
- Earnings attributable to the collateral and the investment of those contributions.

(26 C.F.R. § 54.4975-7(b)(5) and 29 C.F.R. § 2550.408b-3(e).)

ALLOCATION OF EMPLOYER SECURITIES TO ESOP PARTICIPANTS

When an ESOP purchases shares (or other employer securities) with borrowed funds, it becomes the record owner of the shares (or other securities). The shares, which are generally pledged as security for the ESOP loan, are initially held unallocated in a suspense account within the ESOP's related trust. As the loan is repaid with contributions made to the ESOP by the sponsoring employer, the shares are released from the suspense account and allocated to participants' individual accounts.

The number of shares released from the suspense account and allocated to participant accounts each year is computed based on a formula that either:

- Computes the percentage of the current year's principal and interest payment to the total principal and interest remaining to be paid on the loan (including the current year's principal and interest payment; essentially, mortgage-type amortization of the suspense account shares).
- Uses that same computation but based only on principal payments.

(26 C.F.R. § 54.4975-7(b)(8) and 29 C.F.R. § 2550.408b-3(h).)

The "principal-and-interest" method is the default method of releasing shares. If the "principal-only" method of collateral release is selected, additional requirements apply. For example, the loan generally cannot have a term of more than ten years. The IRS has stated that the release rules are both documentary and operational requirements (Technical Adv. Memorandum 201425019 (June 20, 2014)).

No beneficial interest in the shares is transferred to specific participants until the shares are released from the suspense account and allocated to their accounts.

RULES RELATING TO DEDUCTIONS AND ANNUAL ADDITIONS

The annual deduction for employer contributions to a defined contribution plan generally is limited to 25% of the participants' aggregate includible compensation (see Employer Deduction Limit). For a leveraged ESOP, however, contributions used by the ESOP to make repayments on a loan used to acquire qualifying employer securities count toward this limitation only to the extent used by the ESOP to make repayments of principal (26 U.S.C. § 404(a)(9)(A)).

Contributions that are used by the ESOP to pay interest on the loan are generally fully deductible (26 U.S.C. § 404(a)(9)(B)). Since the employer's contributions to the ESOP used to repay the loan are deductible within the Code Section 404(a)(9) limits, a leveraged ESOP allows the employer to repay the entire loan using deductible contributions.

The ability of an employer to effectively deduct principal repayments on a loan through contributions to a leveraged ESOP is somewhat unique. The sponsoring employer generally receives the proceeds of an ESOP loan through its sale of stock to the ESOP in exchange for the loan proceeds. So, from a corporate finance standpoint, the borrowing by an ESOP (particularly from an outside lender) is effectively borrowing by the sponsoring employer itself. However, the employer could generate the same tax deduction indirectly by borrowing from an outside lender and making periodic contributions to an ESOP or other tax-qualified plan in amounts equal to the periodic repayments of principal on the loan.

Moreover, the annual additions to a participant's account under Code Section 415(c)(6) is generally the allocated employer contribution, not the value of the allocated shares. This can have a material effect on the ability of the ESOP participants to receive substantial allocations if the value of the shares increases significantly over the period during which the loan is repaid.

Deductibility of Dividends Paid for ESOP-owned Employer Stock

Dividends paid on employer stock owned by an ESOP may be tax-deductible if the dividends are used by the ESOP to repay an ESOP loan (26 U.S.C. § 404(k)). Several requirements apply, including that dividends used by the ESOP to repay a loan must result in an allocation of employer securities to each participant's account with a fair market value of not less than the amount of the dividend paid on employer securities in that account (26 U.S.C. § 404(k)(2)).

Where the dividend deduction is intended to be used under a leveraged ESOP, the employer often will sell the ESOP convertible preferred stock which carries a stated dividend rate. This generates tax-deductible funds that the ESOP may use to repay a loan without being subject to the general deduction limitations applicable to employer contributions. However, these planning techniques must be undertaken carefully, particularly in light of Code Section 404(k)(5(A), which provides that the deduction for dividends may be disallowed if they constitute, in substance, an avoidance or evasion of taxation.

GAIN DEFERRALS ON SALES TO ESOPS

A common problem for the owner of a closely held corporation is that most of the owner's wealth may be invested in the corporation's illiquid stock. That stock often has a high value but a very low tax basis so that a simple sale to the company or to another party would result in substantial taxable capital gains (26 U.S.C. §§ 302 and 1001). To encourage the use of ESOPs, Congress allows certain shareholders of non-public corporations to sell stock to an ESOP (possibly while retaining control) and defer taxation of the gain on the sale, if "qualified replacement securities" are timely purchased with the proceeds of the sale (26 U.S.C. § 1042).

Therefore, an entrepreneur can benefit in a practical fashion from ownership of a corporation and, at a later time, diversify his wealth by selling stock to an ESOP, without paying taxes until the replacement securities are sold. If the substituted investments are retained until death, there apparently would never be capital gains tax imposed on the deferred gain due to the step-up in basis on the securities owned at death (26 U.S.C. §§ 1042(e)(3)(B) and 1014). A similar positive result could occur, subject to applicable limitations and possible alternative minimum tax considerations, if certain deductible gifts of the replacement securities are made (where a deduction for the full value of the securities would otherwise be allowed) (26 U.S.C. §§ 170 and 1042(e)(3)(C)).

Before a shareholder can obtain this favorable tax deferral on a sale of his stock to an ESOP, several requirements must be met. These include:

- Meeting the qualification rules for the sale (see Qualification Rules).
- Making the required taxpayer election to the IRS (see Shareholder Election).

- Purchasing qualified replacement securities (see Purchase of Qualified Replacement Securities).
- Meeting the 30% post-sale stock ownership requirement for the ESOP (see Stock Ownership Requirement).
- Obtaining a statement by the employer agreeing to excise taxes for certain ESOP transactions (see Statement of Excise Tax).

QUALIFICATION RULES

For a sale to qualify for this special tax treatment:

- The corporation that issued the stock and maintains the ESOP must be a corporation whose stock is not publicly traded
- The shareholder must not have received the stock:
  - as a distribution from an employee benefit plan;
  - from the exercise of a restricted, qualified or incentive stock option (see Practice Note, Overview of the Taxation of Equity Compensation Awards (7-505-9204)); or
  - from the vesting of a restricted stock award (see Standard Document, Restricted Stock Award Agreement (0-510-7388)).

(26 U.S.C. § 1042(c)(1)).

Some controlling shareholders of public companies may consider privatization principally to take advantage of the tax deferral. However, under a temporary Treasury regulation, a one-year waiting period following privatization is required (26 C.F.R. § 1.1042-IT, Q&A 1(b)(temporary)).

SHAREHOLDER ELECTION

The shareholder must elect on the shareholder's income tax return the desired tax treatment. The IRS has established procedural guidelines for this purpose, including how the election should be reflected on the shareholder's federal income tax return. (26 C.F.R. § 1.1042-IT, Q&A 3 (temporary).)

PURCHASE OF QUALIFIED REPLACEMENT SECURITIES

During the 15-month period beginning three months before the sale to the ESOP, the shareholder must use an amount equal to the proceeds from the sale to purchase qualified replacement securities.

Qualified replacement securities are securities issued by a domestic operating corporation (other than the employer sponsoring the ESOP or a corporation that is in the same controlled group as that employer) that did not have passive investment income (for example, rents, royalties, dividends, interest and the like) of more than 25% of its gross receipts in the previous year (26 U.S.C. § 1042(c)(4)).

An operating corporation must use more than 50% of its assets in conducting its trade or business. Financial institutions and insurance companies, even if they do not meet this test, may in some cases qualify as domestic operating corporations (26 U.S.C. § 1042(c)(4)).

STOCK OWNERSHIP REQUIREMENT

Immediately after the purchase of the shareholder's securities, the ESOP generally must own on a fully diluted basis at least 30% of either:

- Each class of outstanding stock of the corporation.
- The value of all outstanding stock of the corporation.

(26 U.S.C. § 1042(b)(2).)

Certain classes of preferred stock are not taken into account. In this regard in particular, valuation can be extremely important. Code Section 401(a)(28)(C) requires independent appraisals in some circumstances.

STATEMENT OF EXCISE TAX

The employer who maintains the ESOP must sign a statement under Code Section 1042(b)(3) agreeing to:

- The application of a 10% excise tax for certain dispositions by the ESOP of stock (other than normal distributions to participants) within three years from the date of purchase (26 U.S.C. § 4978).
- A 50% excise tax if the shares are improperly allocated to, among others, the selling shareholder or certain members of the shareholder's family (26 U.S.C. §§ 409(n)(2) and 4975(e)(7)).

Prohibited allocations may also result in adverse tax consequences to the participants who benefit from the allocations. The prohibitions on full participation in the ESOP by the selling stockholder and his family members can present significant problems. An excess benefit plan or other executive compensation arrangement is sometimes used to address this problem for the seller and his family.

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