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Aftermath of the 1986 Tax Reform Act- Part II

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AFTERMATH OF THE 1986 TAX REFORM ACT-PART II

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USE OF ESOPS IN CLOSELY HELD CORPORATIONS

BACKGROUND AND OVERVIEW OF ESOPs

Background. Since 1973, twenty separate Federal laws have been enacted dealing with employee stock ownership plans (ESOPs). In addition, 18 states (plus New York City) have enacted legislation promoting employee stock ownership. The Federal laws include:

- Employee Retirement Income Security Act of 1974
- Trade Act of 1974
- Tax Reduction Act of 1975
- Tax Reform Act of 1976
- Revenue Act of 1978
- Small Business Employee Ownership Act of 1980
- Chrysler Loan Guarantee Act of 1980
- Trade Adjustment Assistance Act of 1983
- Deficit Reduction Act of 1984
- Foreign Assistance Act of 1985
- Tax Reform Act of 1986
- Omnibus Budget Reconciliation Act of 1987

*Note. Technical corrections to the 1986 and 1987 Acts include a significant number of ESOP-related amendments.

In the past, ESOPs have often been viewed as applying principally to publically held corporations, but in recent years the numerous legislative improvements have made ESOPs also quite attractive to the owners of closely held corporations.

Overview of ESOP Applications. An employee stock ownership plan (ESOP) is a combination technique of corporate finance and employee benefits.

As a technique of corporate finance:

* An ESOP provides a technique for obtaining financing at a lower interest rate than would otherwise be available.

* An ESOP can be used to raise capital and to amortize financing with pre-tax dollars.

* An ESOP can be used to acquire other companies with the acquisition debt being repaid with pre-tax dollars.

* An ESOP can be used to divest a subsidiary or a division.
An ESOP can be used to refinance outstanding debt.

* An ESOP can provide a market for a company's stock without the expense or exposure of a public offering.

* An ESOP can enable shareholders to defer tax on the gain realized on their sale of stock.

* An ESOP can be used to reduce estate taxes, provide liquidity to pay estate taxes, and assume federal estate tax obligations.

* An ESOP can generate an employer deduction for dividends paid.

* An ESOP can be used to both resist and facilitate takeover.

* An ESOP can be used to spin off a subsidiary or a division.

* An ESOP can be used to recapture taxes paid in previous years.

**Overview of ESOP Operations.**

Because employer contributions to an ESOP are tax deductible (as contributions to an employee benefit plan), employer contributions to service ESOP debt -- both principal and interest payments -- are payable with pre-tax dollars. Dividends paid on ESOP-held stock are deductible by the employer if either paid out to employees or utilized to repay an ESOP loan.

Because commercial lenders are able to exclude from their taxable income 50% of the interest paid on ESOP loans, the interest rate offered on such loans is lower than conventional rates.

As an employee benefit plan, an ESOP is a type of deferred compensation plan which invests primarily in employer stock. Each participant has an individual account credited with shares which are generally distributed and often reacquired upon retirement, death, disability or other termination of service. The plan must also comply with reporting, disclosure and fiduciary responsibility rules applicable to qualified employee benefit plans in general.

A partial diversification option must be offered to employees (with 10 years of participation) when they reach age 55.
Distributions to employees may be made as soon as possible after termination of employment or may be deferred for up to 6 years (or longer if an ESOP loan is still outstanding). Where employment terminates due to retirement, disability or death, distribution must commence in the following year. Amounts distributed may be "rolled over" (e.g., into an IRA). In the case where an employer's stock is not readily tradable, an employee must be provided with a put option back to the employer.

In publicly traded companies, employees must be allowed to direct the trustee how to vote shares allocated to their accounts. In closely held companies, this "pass-through voting" requirement is limited to major corporate issues, such as merger, dissolution, or a sale of substantially all of the company's assets.

**ESOP-Facilitated Corporate Finance.** An ESOP: a) is required to invest primarily in employer stock, and b) is the only employee benefit plan able to borrow funds based on employer credit in order to acquire employer stock.

Thus, an ESOP is a highly flexible technique of corporate finance able to accomplish a wide variety of corporate objectives, including:

**In-House Market for Shares.** ESOPs are often used to acquire shares from retiring or departing shareholders. Where, after a sale, at least 30% of the company's shares are held by an ESOP, selling shareholders are allowed to defer tax on the proceeds to the extent that the proceeds are reinvested in other operating companies.

**Estate Tax Relief.** Up to a 50% reduction in estate taxes can be achieved by an estate's sale of stock to an ESOP. Also, an ESOP can assume federal estate tax obligations upon an estate's transfer of stock to an ESOP in return for a corporation's guaranty to pay the estate taxes over a period of years.

**A Market for Shares.** Companies have used ESOPs in "going private" transactions financed on more favorable terms utilizing ESOP tax incentives.

**Asset Financing.** Utilizing the "leveraged" ESOP, a company is able to amortize its loan out of pre-tax income -- thereby enabling indebtedness to be serviced at a lower level of revenue.

**Refinance Outstanding Debt.** ESOP tax benefits are available for restructuring outstanding debt so as to be serviceable with pre-tax revenue.
Acquisitions, divestitures, spin-offs, etc. By enhancing a company's cash flow, financing is easier to obtain to facilitate common corporate transactions.

In Summary. As a financing technique, the various ESOP incentives have a common denominator: enhanced employer cash flow -- due to the deductibility both of loan principal payments and of dividends on ESOP stock, the access to below-market interest rates and, where applicable, access to unreduced net operating loss carryforwards and untaxed excess pension plan assets. In addition, ESOPs provide significant planning opportunities for business continuity, capital liquidity and estate planning.

OVERVIEW OF ESOP INCENTIVES

1. Employer tax deduction. Up to 25% of participants' payroll may be claimed as a deduction by an ESOP sponsor to make principal payments on an ESOP loan used to acquire employer securities. Deductible contributions in excess of 25% are permitted to the extent the excess is used to pay interest expense on an ESOP loan. IRC §404(a)(9).

2. Employee tax deferral. The annual amount that may be allocated to each participant's account in an ESOP cannot exceed the lesser of 25% of pay or $60,000. IRC §415(c)(6). Stock acquired for employees' accounts is not taxed until distributed. Distributions are taxed at original cost utilizing 5-year averaging rates if received in a lump sum after age 59-1/2, on account of separation from service, or due to death or disability. IRC §402(e).

3. Lender interest exclusion. Commercial lenders and mutual funds may exclude from taxable income 50% of the interest earned on ESOP loans, thereby enabling lenders to offer lower interest rates for ESOP financing. The partial exclusion also applies to loans matched by contributions of stock to an ESOP provided the stock is allocated within one year. IRC §133.

4. Rollover of gain. If, after a sale, at least 30% of the stock of a closely-held company is held by an ESOP, tax is deferred on any gain realized by selling shareholders to the extent that sale proceeds are "rolled over" (reinvested) in securities of other operating companies. IRC §1042.

5. Dividend deductions. Companies may claim a deduction for dividends paid on ESOP-held stock provided the dividends are either applied to repay an ESOP loan or paid out to employees on a current basis. IRC §404(k).
6. Pension plan asset reversions. Through December 31, 1988, employer reversions of amounts held in defined benefit pension plans are exempt from both income tax and the 10% reversion excise tax to the extent reversion amounts are transferred to an ESOP. IRC §4980.

7. Exception to net operating loss limitations. The Tax Reform Act of 1986 TRA 86 imposes certain limitations on the use of a corporation's net operating loss carryforward deductions following a more-than-50% change in ownership. These limitations are inapplicable to a transaction which results in an ESOP owning at least 50% of the corporation. IRC §382(1)(3)(c).

8. Estate tax advantages. An exclusion from an estate is permitted for up to 50% of the proceeds realized on an estate's sale of stock owned by the decedent to an ESOP sponsored by a closely held corporation (reducing estate tax by up to $750,000). IRC §2057. The liability for payment of estate taxes may be assumed by an ESOP in return for a transfer from the estate of stock of an equal value, provided the ESOP company guarantees payment of the taxes and agrees to pay such taxes over a 14-year period with interest payments only for the first four years (4% interest on the first $1 million, prime for the balance). IRC §2210.

DESCRIPTION OF ESOP TAX INCENTIVES

I. General ESOP Requirements. An ESOP must be a qualified stock bonus plan (or a combination stock bonus plan and money purchase pension plan) designed to invest primarily in qualified employer securities. IRC §4975(e)(7).

A. "Qualified Employer Securities" means common stock issued by an employer, or a corporation which is a member of the same controlled group, which is readily tradable on an established securities market or, if no such stock exists, common stock issued by the employer or by a corporation which is a member of the same controlled group, which has a combination of voting power and dividend rights equal to or in excess of those classes of common stock of the employer (or controlled group member) having the greatest voting power and the greatest dividend rights. IRC §§409(1) and 4975(e)(8).

1. Non-voting preferred stock qualifies under this definition provided it is at all times convertible into common stock meeting these requirements. IRC §§409(1)(3).
2. A special 50% control group rule applies in determining whether securities are to be treated as those of the employer. IRC §409(1)(4).

B. Designed to Invest Primarily. Although an ESOP must be required to specifically state that it is designed to "invest primarily" in qualified employer securities Treas. Reg. §54.4975-11(b), an ESOP will not cease to be considered an ESOP if it temporarily has less than a majority of its assets so invested. Compliance with this requirement will be judged over the life of the plan. As an eligible individual account plan under ERISA, the diversification requirement and the prudence requirement (to the extent it requires diversification) are not violated by the acquisition or holding of qualified employer securities. ERISA §404(a)(2).

C. Qualification Requirements. An ESOP is generally required to satisfy other requirements applicable to qualified stock bonus or money purchase plans. However the "exclusive benefit" test of IRC §401(a)(2) is not violated merely because an ESOP gives plan assets as collateral for an exempt ESOP loan or, in the event of a default, uses plan assets to repay an ESOP loan. Treas. Reg. §54.4995-11(a)(8)(i). In addition, an ESOP will not be considered to violate the "annual addition" limitations under IRC §415 merely because such additions are based on contributions used to repay an ESOP loan rather than on the value of securities allocated from a suspense account. Treas. Reg. §54.4975-11(a)(8)(ii); Treas. Reg. §1.415-6(g). This is particularly important where the ESOP stock has substantially appreciated in value.

D. Deduction and Allocation Limitations.

1. Up to 25% of participant's payroll is deductible by the sponsoring employer for repayment of principal on ESOP loans; there is no limit on deductibility of interest. IRC §404(a)(9).

2. Deductions to other defined contribution plans (other than money purchase pension plans) are limited to 15% of payroll. IRC §404(a).

3. Employer deductions are also limited on an individual basis by the maximum annual addition that can be allocated to participants' accounts. IRC §415.
4. The annual addition that may be allocated to each participant's account cannot exceed the lesser of 25% of pay or $60,000 ($50,000 for plan years beginning in 1989) IRC §415(c)(6) (provided no more than one-third of total allocations are to the accounts of the prohibited group). Interest (on ESOP loans) and forfeitures (during the ESOP loan repayment period) are disregarded in determining annual addition limitations.


1. An exemption is provided from the general prohibition against the direct or indirect lending of money or extension of credit between a qualified plan and a "disqualified person" if, among other things, the following requirements are met: Treas. Reg. §54.4975-7(b).

a. Loan must be "primarily" for the benefit of plan participants and beneficiaries.

b. Interest rate on the loan must not be in excess of a reasonable rate.

c. Collateral which the ESOP gives for the loan must be limited to the qualifying employer securities acquired with the proceeds of the ESOP loan.

d. Loan proceeds must be used within a reasonable time after receipt to acquire qualifying employer securities or to repay the loan (or a prior exempt loan).

e. Loan must be without recourse against the ESOP, except as to (i) collateral given for the loan, (ii) cash contributions made to meet the ESOP's obligation under the loan and (iii) earnings attributable to such collateral and contributions. If the lender is a "disqualified person," the loan may not be accelerated upon default.

f. Collateral must be released in installments over the term of the loan.

g. Loan must be a term loan, not a demand loan.

h. ESOP may not normally make loan payments other than from contributions made to enable
the ESOP to meet its loan obligations, from dividends. Terms of the loan must be at least as favorable to the ESOP as the terms of a comparable loan resulting from arms-length negotiations between independent parties.

2. Because of this exemption, the leveraged ESOP may borrow funds to purchase qualifying employer securities -- i.e., ESOP borrows funds from the employer, or from a third-party lender who obtains the employer's guarantee to contribute annually sufficient funds to the plan to amortize the loan.

F. **Suspense Account.** Assets acquired by an ESOP with the proceeds of an exempt loan may be maintained in a suspense account for later allocation to participants' accounts as the ESOP loan is repaid. This "release and allocation" process may be based on the rate at which principal is repaid or the rate at which principal and interest are repaid. Plan qualification is jeopardized if the release is accomplished in varying annual amounts, particularly if payments are backloaded or if terminal balloon payments are utilized. Treas. Reg. §54.4975-7(b)(8).

G. **Integration, Buy-Sell Agreements, Anti-discrimination.**

1. Benefits provided to participants under an ESOP may not be integrated with those provided under social security. Treas. Reg. §54.4975-11(a)(7)(iii).

2. An ESOP cannot obligate itself to acquire securities from a particular stockholder at an indefinite time based on the happening of an event such as death of the holder. Treas. Reg. §54.4975-11(a)(7)(i). Thus, although an ESOP may be utilized in conjunction with a "buy-sell" agreement with the company, an ESOP cannot be bound by such an agreement (due to the "prudence" requirements applicable to plan investments). Treas. Reg. §4975-11(a)(3).

3. In testing for compliance with the antidiscrimination rules of IRC §§401(a)(4) and (5) and 410(b), an ESOP may not be considered together with another plan. Treas. Reg. §54-4975-11(e).
H. **Pass-Through Voting.** IRC §409(e).

1. If an ESOP holds "registered" stock (i.e., stock requiring registration under §12 of the Securities Exchange Act of 1934), each participant must be allowed to direct the plan trustee as to how to vote securities allocated to his account IRC §409(e)(2).

   **Note:** §12 of the 1934 Act requires registration of securities if the issuing corporation has total assets of at least $1,000,000 and 500 or more stockholders.

2. Where an ESOP holds securities that are not registered, participants must be given the right to vote allocated securities with respect to any corporate matter which involves the voting of such shares 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, or such similar transaction as may be prescribed by regulation. IRC §409(e)(3). The requirement applies after December 31, 1986 to stock acquired after December 31, 1979.

3. Voting on a "one-participant-one vote" basis is permitted. IRC §409(e)(5)

   a. **General Rule.** The trustee of an ESOP is permitted to vote the shares held by the ESOP determined on a "one man, one vote" basis provided:

   (i) the ESOP permits each participant one vote with respect to each issue on which the shares held by the ESOP are entitled to vote, and

   (ii) the trustee votes the shares held by the ESOP in the proportion determined by the votes of the participants.

   b. Note that there is no requirement that stock be allocated to participant's accounts.

   c. This provision is effective October 22, 1986.
I. Right to Demand Employer Securities; Taxation of Distributions.

1. An ESOP is permitted to make distributions in either stock or cash although a participant generally must be permitted the right to demand his distribution in employer securities. IRC §409(h). If the securities distributed are not publicly traded, they may be subject to a right of first refusal in favor of the employer or the ESOP. Treas. Reg. §54.4975-7(b)(9).

2. Where an employer's charter or bylaws restrict ownership of substantially all employer securities to employees and to qualified plans, participants need not be given the right to receive distributions in stock provided that the plan provides a right to receive a cash distribution, except that the plan may distribute employer securities subject to a "call" -- requiring that such securities be resold to the employer under terms applicable to put options (discussed below). IRS §409(h)(2).

3. The Tax Reform Act of 1986 (TRA 86) imposes a 10% excise tax on taxable distributions (after 1986) from a qualified plan to a participant prior to age 59-1/2 unless the distribution occurs as the result of death, disability or retirement under the plan after age 55, unless the distribution is part of a series of substantially similar equal periodic payments, made at least annually, over the life (or life expectancy) of the participant or the joint lives (or joint life expectancies) of such participant and his beneficiary, or unless the distribution is used to pay certain medical expenses, or is part of a distribution pursuant to a qualified domestic relations order. IRC §72(t). Two types of ESOP distributions are exempt from this excise tax:

   a. Cash dividends on ESOP-held stock that are distributed to participants under IRC §404(k). IRC §72(t)(2)(A)(vi).

   b. Certain "qualifying ESOP distributions" made prior to January 1, 1990. IRC §72(t)(2)(C).

      (i) Such distributions are exempt to the extent that, on average, a majority of plan assets have been invested in employer securities (as defined in IRC
§409(l)) for the 5 plan year period preceding the plan year in which the distribution is made, and provided that the benefits distributed have been invested in such securities at all times during such period (or a shorter period if the ESOP has been in existence for less than 5 years). TRA 86 Conf. Rept. II-457 confirmed in IRS Notice 87-13, IRB 1987-4 (January 5, 1987).

(ii) The exemption applies to a plan converted to an ESOP if the predecessor plan's assets were invested in employer securities for 5 plan years prior to distribution, and "tacking" of investment periods is permitted (e.g., assets transferred to an ESOP would qualify for the exemption 2 years after transfer provided such assets meet the investment criteria for 3 years prior to such transfer). TRA 86 Conf. Rept. II-458 confirmed in IRS Notice 87-13.

(iii) The exemption applies to distributions attributable to plan assets actually invested in employer securities for the requisite period; a "first-in, first-out rule" is used in determining how long an ESOP has held distributed securities, with an assumption that the first benefits distributed will be those invested in employer securities for the requisite period.

(iv) Note that the pending Technical Corrections Act would change this provision to exclude certain employer securities transferred to the ESOP from other qualified plans.

4. Distributions are taxed at original cost utilizing 5-year averaging rates if received in a lump sum after age 59-1/2 on account of separation from service or due to death or disability. IRC §402(e). Dividends distributed to participants may not be treated as a nontaxable distribution of employee contributions. IRC §72(e)(5)(D).
5. Net Unrealized Appreciation

a. TRA 86 eliminates the preferential tax treatment for capital gains after 1986. However, the Act permits a person receiving a distribution from an ESOP to elect to include any appreciated value of employer stock while in the ESOP ("net unrealized appreciation") as part of the taxable amount eligible for special income tax averaging available for certain lump-sum distributions. IRC §402(e)(2)(J).

b. In the case of certain corporate transactions which result in a substitution of stock (which might otherwise result in a stepped-up basis for employees' ESOP stock), TRA 86 allows the computation of net unrealized appreciation without regard to the transaction (thereby granting ESOP participants a carryover basis and a lower tax upon distribution). Covered transactions include:

   (1) an exchange of employer securities in an ESOP for other employer securities, and

   (ii) a disposition of employer securities in an ESOP and use of the proceeds within 90 days (or longer if authorized by the IRS) to acquire other employer securities (exception is inapplicable to any employee to whom a distribution of money is made after the sale and before the purchase).

   The general effective date applies to any transaction occurring after December 31, 1984.

J. Distributions, Put Option and Payment

1. Distribution of ESOP Benefits. IRC §409(o). Unless an employee otherwise elects in writing, the distribution of benefits under an ESOP must begin no later than

   a. one year after the close of the plan year in which the participant terminates employment by reason of the attainment of normal retirement age under the plan, disability or death, or
b. the fifth plan year following the participant's termination of service (provided he does not return to service prior to that time).

c. An exception is provided in the case of "certain financed securities" which defers the commencement of distributions until the first anniversary of the date on which the loan incurred to purchase those employer securities is repaid, thereby ensuring that employers need not incur liabilities to purchase stock under the put option until the liability incurred to acquire that stock is repaid.

d. The above requirements are intended to accelerate the otherwise applicable benefit commencement date. Thus, the general rules of IRC §§401(a)(9) and 401(a)(14) may require commencement at an earlier date. TRA 86 Conf. Rept. II-555.

e. Unless a participant elects a longer distribution period, an ESOP must provide for distributions at least as rapidly as installments over a period not in excess of 5 years. If the participant's account balance exceeds $500,000, this distribution period may be extended by 1 year (up to 5 additional years for each $100,000 or fraction thereof) by which the account balance exceeds $500,000. IRC §409(o)(1)(C). The dollar amounts will be adjusted for inflation. IRC §409(o)(2)

f. Note that it may be inappropriate for an ESOP's administrative committee to use its discretion to determine the type of distribution (lump-sum or installment) or perhaps even the length of the installment period. See Prop. Treas. Reg. §1.411(d)-3T, Q&A-2 and -5 (decision to be made by reference to objective criteria).

g. The above rules apply to distributions attributable to stock acquired after December 31, 1986.
2. **Put Option.**

   a. Where plan participants receive stock that is not readily tradable on an established market, they must receive a "put option" exercisable against the employer under a fair valuation formula. IRC §409(h)(1)(B).

   b. The put option period must extend for at least 60 days following the date the stock is distributed and, if not exercised within that initial 60-day period, for at least an additional 60 days in the following plan year. IRC §409(h)(4).

   c. In the case of banks prohibited from buying their own stock, this put option requirement is not applicable so long as participants are provided an opportunity to receive their distributions in cash. IRC §409(h)(3).

   d. No employer securities in ESOPs may be subject to any other put, call, option, buy-sell, or similar arrangement (other than a right of first refusal). Treas. Reg. §4975-11(a)(3). Cf. IRC §409(h)(2).

3. **Payment.** IRC §409(h).

   a. In the case of a total distribution (i.e., the balance to the credit of a participant's account is distributed within one taxable year), the option price must be paid in substantially equal installments (not less frequently than annually) over a period at least as rapidly as installments over five years and beginning not more than 30 days after exercise of the put option. IRC §409(h)(5)(A).

   b. The employer must provide adequate security with respect to installment payments and credit a reasonable rate of interest on the outstanding balance. IRC §409(h)(5)(B).

   c. Where a put option is exercised as part of an installment distribution, an employer is required to pay the option price no later than 30 days after the exercise of the option on each installment. IRC §409(h)(6).
d. These payment and security requirements apply
to distributions attributable to stock
acquired after December 31, 1986, except that
a plan may elect to have the provisions apply
to all distributions after October 22, 1986.

e. TRA 86 extends to stock bonus plans the
above-described benefit commencement and put
option rules, but for this purpose the term
"employer securities" includes any securities
of the employer held by the plan. IRC
§401(a)(23).

f. Retirement Equity Act. The Retirement Equity
Act of 1984 amended IRC §411(d)(6) to provide
that a plan amendment is treated as reducing
accrued benefits if, with respect to benefits
accrued before the amendment is adopted, the
amendment has the effect of either eliminating
or reducing an early retirement benefit or a
retirement-type subsidy, or eliminating an
optional form of benefit.

   (i) A plan may not deny a participant an
alternative form of benefit for which
he is otherwise eligible through the
employer's withdrawal of consent or
otherwise exercising discretion.

   (ii) The availability of alternative forms
of benefits is subject to the IRC
§401(a)(4) nondiscrimination
1.401(a)-4 (Q&A-1).

   (iii) TRA 86 clarifies that an ESOP (or a
tax credit ESOP) shall not be treated
as failing to meet the requirements of
IRC 411(d)(6) merely because it
modifies distribution options in a
nondiscriminatory manner IRC
§411(d)(6)(C) and ERISA §204(g).

   (iv) The Senate Report accompanying TRA 86
(at p. 1110) provides that:

   - an ESOP sponsor is allowed the
flexibility to amend the plan to
change distribution and payment
options (provided such amendments
comply with distribution and payment
requirements);
- An employer will not be considered to violate the "anti-cutback" rules if the employer eliminates, or retains the discretion to eliminate, a lump-sum option or an installment payout option with respect to a nondiscriminatory class of employees;

- An employer is permitted to retain discretion to limit employees' stock distribution option in cases where the employer becomes substantially employee-owned or the plan ceases to be an ESOP or a stock bonus plan;

- An employer may retain discretion to eliminate a required cash distribution option in cases where the employer securities become readily tradeable; and

- an employer is permitted to retain discretion to require a cash distribution in cases where the stock held in an ESOP is sold in connection with a sale of substantially all of the company;

- IRC §411(d)(6)(C) is effective as if included in the Retirement Equity Act of 1984 which applies to plan amendments made after July 30, 1984.


1. General Rule. An ESOP participant who has attained age 55 and completed 10 years of participation may elect annually over a 6-year period to diversify a portion of his ESOP balance. Elections over the first five years may cover up to 25% of his account balance; the election in the sixth year may cover up to 50% of his account balance (less any portion previously diversified).

2. Election period. A participant is allowed to make this election during a period beginning with the plan year following the plan year in which the later of the two following events occur:

   a. the participant attains age 55, or
b. the participant completes ten years of participation in the ESOP.

3. **Effect of election.** A qualified participant is entitled to direct diversification of up to 25% of his account balance. A qualified participant who has attained age 60 may direct diversification of 50% of his account balance (as reduced by amounts previously diversified).

4. **Fulfillment of Requirement.** The diversification requirement may be fulfilled by:

   a. allowing participants to elect among three investment options (other than employer stock) IRC §401(a)(28)(B)(ii)(II) and TRA 86 Conf. Rept. II-557,

   b. Allowing participants the option to transfer that portion of the electing employees' account balance to a plan that provides for employee-directed investment and in which the required diversification options are available (TRA 86 Conf. Rept. II-558), or

   c. providing participants with a distribution of that portion of their account balance. IRC §401(a)(28)(B)(ii)(I).

(i) Distributions must be made within 90 days following the end of the diversification period (which is 180 days after the end of the plan year). IRS §401(a)(28)(B)(ii)(I).

(ii) A participant receiving such a distribution would not be subject to the tax on premature distributions, as described above. IRS §72(t)(2)(C).

(iii) A participant may elect to rollover such distributions to an IRA or to another qualified plan. IRC §401(a)(5)(D).

(iv) Technical Corrections may clarify whether such distributions are excluded from the definition of lump-sum distribution.
d. **Example.** In a ESOP with a calendar year, employee completes 10 years of plan participation during 1988 and attains age 55 in 1991. Thus, his diversification election becomes effective in 1992 and will remain in effect with respect to the 1993, 1994, 1995, and 1996 plan years (to direct diversification of up to 25% of his ESOP account) and with respect to the 1997 plan year (to direct diversification of up to 50% of his account).

5. **Election Period and Implementation**

a. An ESOP is required to provide participants with a diversification election within 90 days following the end of the plan year in which they become qualified for the election.

b. Participants' elections must be implemented within 90 days after expiration of the diversification election period. See TRA 86 House Rept. at 791.

c. Example. For an ESOP whose plan year corresponds to the calendar year, the election period would begin January 1, and end March 31. By June 30, the ESOP would have to implement any diversification elections made prior to March 31.

6. **Comments**

a. These investment options need not, but may, include participant self-direction of the amounts. TRA 86 House Rept. at 791.

b. If a qualified participant directs diversification of 25% of his account balance at age 55, the only amount subject to diversification at ages 56, 57, 58, and 59 is increases in his account balance (whether due to additional contributions or appreciation). Regulations are to be issued exempting de minimus amounts from the diversification election requirement. TRA 86 House Rept. at 790-91. Amounts previously diversified cannot be required to be
reinvested in employer securities due to a decrease in the value of employer securities in a participant's account (e.g., if due to a decrease in the value of employer securities in his account, more than 25 or 50 percent of his account balance is invested in assets other than employer securities). House Rept. at 791.

c. It is unclear:

(i) whether the diversification election applies to amounts contributed after the end of the plan year (or perhaps even after the end of the election period) but which are allocated as of the last day of the plan year.

(ii) whether "snapshot accounting" is permitted (i.e., requiring that an individual be employed on a certain date).

d. The diversification requirement applies only to account balances attributable to employer stock acquired after December 31, 1986.

e. Technical Corrections may clarify whether employers will be permitted to allow plan participants to diversify account balances attributable to pre-1987 acquisitions.

L. Independent Appraisal Required.

1. Where employer securities are not readily tradable on an established market, their valuation must be determined by an independent appraiser who that meets requirements similar to those imposed under IRC §170(a)(1) (relating to charitable contributions) and the appraiser's name must be reported to the IRS. IRC §401(a)(28)(C). The provision applies to stock acquired after December 31, 1986. Query: Must the appraiser be independent of other professionals who provide services to the plan?

2. The valuation of non readily tradable employer securities is based on a good faith valuation which takes into account factors such as the following:
a. The nature and history of the business,

b. The economic outlook of the particular industry,

c. The book value and financial condition of the business,

d. The dividend paying capacity and the earning capacity,

e. Whether the business has goodwill or other intangible value,

f. Other sales of stock and the size of the block to be valued, and

g. the market price of stock of corporations engaged in similar businesses.


3. ERISA §3(18)(B) defines "adequate consideration" in the case of non readily tradable securities as the "fair market value" determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations to be promulgated by the Secretary (of Labor). The DOL has now promulgated proposed regulations in support of this requirement. Fed. Reg. Vol. 53, No. 95, May 17, 1988. In general, these proposed regulations require an independent appraisal by a qualified appraiser, and allow for the payment by the ESOP of a "control premium" under certain circumstances.

4. Treas. Reg. §54-4975-11(d)(5) requires valuation to be made in good faith and based on all relevant factors.

5. Rev. Rul. 59-60 establishes standards for valuing closely held stock for estate and gift tax purposes.

M. Fiduciary Responsibilities. ERISA §404.

1. Plan trustee becomes a fiduciary whose duties include:

   a. Acting solely in the interest of participants and beneficiaries.
b. Acting for the exclusive purpose of providing benefits to participants and beneficiaries;

c. Acting with the care, skill, prudence and diligence of a prudent man;

d. Acting in accordance with the plan documents.

2. A fiduciary may be personally liable to the plan for losses resulting from his breach of duty.

N. Accounting Treatment

1. AICPA (76-3) requires that the obligation of a leveraged ESOP be recorded as a liability when the obligation is covered by either an employer guarantee or by an employer commitment to make future contributions to service the ESOP debt. Assets held by an ESOP should not be included in the employer's financial statements.

2. The offsetting debit should be recorded as a reduction of shareholders' equity. Thus, if new shares are issued to an ESOP (or when outstanding shares are acquired by an ESOP), an increase in shareholders' equity should be reported only as the ESOP debt is repaid (also reducing the employer's recorded liability).

3. ESOP contributions should be charged to compensation expense, with a separate reporting of the interest element. The interest rate and debt terms should be disclosed in footnotes to the financial statements. Dividends paid on ESOP-held shares should be charged to retained earnings.

4. All shares held by an ESOP should be treated as outstanding in determining earnings per share.

5. The ESOP tax credit (which expired at the end of 1986) should be accounted for (to the extent that it is available and used as a reduction of income tax expense) in the same year in which the ESOP contribution is charged to expense.

II. Lender Partial Interest Exclusion IRC §133.

A. General Rule. A commercial lender (i.e., a bank, an insurance company, or a corporation actively engaged in the business of lending money) may exclude from its gross income 50% of the interest received with
respect to a securities acquisition loan. Under TRA 86, this exclusion also applies to interest earned on such loans held by regulated investment companies (mutual funds). IRC §133(a)(4).

1. Shareholders in the mutual fund are entitled to exclude from their income 50% of the interest they receive. IRC §852(b)(5)(C).

2. Including mutual funds as lenders should expand the funds available from ESOP lending.

B. Securities Acquisition Loan. Includes any loan to a corporation or to a leveraged ESOP to the extent that the proceeds are used to acquire employer securities for the plan or are used to refinance such a loan. IRC §133(b)(1)(A).

1. Securities acquisition loans do not include loans made between corporations which are members of the same controlled group of corporations, or any loan made between a leveraged ESOP and a person that is the employer of employees who are covered by the ESOP or a controlled group member of such employer. IRC §133(b)(2).
   a. For example, a bank could not exclude interest on a loan made to an ESOP sponsored by one of its controlled group members.
   b. Securities acquisition loans may be syndicated to other eligible lending institutions.
   c. Technical Corrections may clarify whether an otherwise ineligible securities acquisition loan is eligible for the §133 interest exclusion if refinanced in a manner qualifying for §133 treatment.

2. If a corporation borrows funds which it in turn lends to its ESOP, the loan to the corporation will be eligible for the lender interest exclusion only if the terms of the two loans are "substantially similar" or if the payment terms are substantial similar except for the fact that the loan to the ESOP provides for more rapid payment of principal and interest, allocations under the plan attributable to such payment do not discriminate in favor of highly-compensated employees (within the meaning of IRC §414(q)), and the commitment period of the loan to the
corporation does not exceed 7 years. IRC §133(b)(3). Temp. Reg. §1.133-1T.

3. The Tax Reform Act of 1986 extends the interest exclusion to apply to a loan (with an original commitment period of 7 years or less) to an employer to the extent that (within 30 days after the date interest begins to accrue on the loan), employer securities are transferred to the ESOP in an amount equal to the proceeds of the loan and such securities are allocated to participants' accounts within one year after the date interest begins to accrue on the loan. IRC §133(b)(1)(B).

   a. This "immediate allocation loan" may prove particularly useful for companies wishing to finance stock buybacks, and for those companies uncomfortable with acquiring a large block of stock in a leveraged ESOP with allocation only as the securities acquisition loan is repaid (and with company stock held in the suspense account being subject to fluctuations in value in the interim).

   b. The 30-day and the one-year periods described above begin on the date interest begins to accrue on the loan. TRA 86 Conf. Rept. II-559.

   c. This new provision is effective for loans made after October 22, 1986.

4. If a securities acquisition loan is refinanced after October 22, 1986, the loan will continue to be eligible for the partial interest exclusion if the total commitment period of the loan does not exceed the greater of 7 years or the original commitment period of the loan. If such loan is refinanced prior to October 22, 1986 and the repayment period is extended, only the interest accruing during the first 7 years of the total commitment will qualify for the partial interest exclusion. The prepayment of interest that has not yet accrued (i.e., it relates to periods beyond the 7 years) will not qualify for the income exclusion. The interest exclusion is extended to refinancings of loans used to acquire employer securities after May 23, 1984. TRA 86 Conf. Rept. II-558, 559.

C. For purposes of IRC §265 (regarding expenses and interest relating to tax-exempt income), and IRC §291(e) (relating to certain preference items):
1. Interest on obligations eligible for the partial exclusion of interest earned on ESOP loans will not be treated as exempt from tax (i.e., otherwise §265 generally disallows deductions for expenses relating to the production of tax-exempt income).

2. An exception to the rules on corporate tax preference items is provided for the §133 interest exclusion to insure that such interest income will not be treated as tax exempt for purposes of determining a "financial institution preference item" and to insure that, for purposes of determining the interest allocable to indebtedness on tax-exempt obligations, loans eligible for the interest exclusion will not be taken into account and calculated for taxpayers average adjusted basis for all assets as well as for tax-exempt obligations. IRC §291(e)(1)(B)(iv).

3. An exception provides that an appropriate adjustment is made to the "applicable federal rate" to take into account the lender interest exclusion and apply to the time value of money rules to insure that such loans are not considered "below-market". Thus, no interest will be imputed on ESOP loans to the extent that the interest discount does not exceed that which is justified by the partial interest exclusion. IRC §133(d).

III. Deduction of ESOP Dividends. IRC §404(k).

A. General Rule. An employer deduction is allowed to the extent that cash dividends paid are either currently distributed to participants (to whose accounts such stock is allocated) or utilized to repay an ESOP loan. Dividends are deductible if paid on any employer "stock"; they are not limited to dividends paid on "qualified employer securities" within the meaning of IRC §409(1).

B. The dividend deduction is allowed in the taxable year of the corporation in which employees have a corresponding income inclusion or the taxable year of the corporation in which the dividend is used to repay the loan.

1. Due to the requirement that to be deductible dividends must be paid in cash, a deduction for stock dividends is ruled out. Although participants may be provided a choice of
receiving their dividends currently or leaving them in the plan, the deduction is limited to dividends actually distributed.

2. The deduction is allowed if the dividend is either paid in cash directly to plan participants or if the dividend is paid in cash to an ESOP and distributed to participants not later than 90 days after the close of the plan year in which the dividends are paid.

C. ESOP dividends received by participants are treated as plan distributions. Note:

1. they are not subject to the pension withholding rules. IRC §3405(d)(1).

2. they are not subject to the backup withholding provisions that apply to dividends generally. IRC §3406.

3. they are not taken into account as annual additions under IRC §415(c). TRA 86 Conf. Rept. at II-556.

4. dividend distributions in excess of $3,500 are not subject to the general rule requiring participant consent of amounts in excess of $3,500 and will not be treated as a violation of the involuntary cash-out rules. IRC §411(a)(11)(C).

5. they will not affect the ESOP's qualification under IRS §401, 409 or 4975(e)(7).

D. Because a deduction is allowed with respect to dividends on any stock of a corporation held by an ESOP, dividends paid on the nontraded stock (of a company with traded stock) would be deductible as would dividends on employer stock (in a company without traded stock) that did not have the best voting or dividend rights.

E. Dividends paid on employer stock held in a 401(k) plan would be deductible if the 401(k) plan is amended to comply with the ESOP requirements of IRC §4975, whether or not an ESOP loan is taken out in connection with that plan.

F. The IRS is authorized to disallow the dividends-paid deduction if their payment constitutes an "avoidance of taxation." IRS §404(k) (flush language). The
pending Technical Corrections Act of 1987 clarifies that "evasion" is the standard intended.

G. Effective Dates.

1. Distributed dividends are deductible for taxable years commencing after July 18, 1984.

2. Loan repayment dividends are deductible for taxable years beginning after October 22, 1986.

H. No Cost Recovery. Where employees are allowed to make voluntary after-tax contributions to an ESOP, distributions are generally treated as first a nontaxable recovery of the employee's basis. In the case of deductible ESOP dividends, however, all such dividends constitute taxable income to the participant.

I. Technical Corrections.

(1) The Technical Corrections Act of 1987 clarifies that dividends paid on allocated stock may be used to repay ESOP indebtedness provided that employer securities "in an amount" equal to such dividends are allocated to the participant to which such dividends would have been allocated, correcting the "Blue Book" interpretation (at II-847).

(2) The Technical Corrections Act of 1988 may address the confusion now created by the "in an amount" language (i.e., if the value of employer securities increases or declines in relationship to the value of dividends used to pay debt).

IV. Tax-Free Rollover of Gain. IRC §§1042 and 4978

A. General Rule. No gain is recognized by a taxpayer from the sale of employer securities to an ESOP if immediately after the sale,

1. the ESOP holds either:

   a. 30% of the total number of shares of each class of stock (other than preferred stock), or

   b. 30% of the total value of all stock of the corporation (other than preferred stock) that issued the qualified securities. IRC §1042(b)(2).
2. Within a 15-month period beginning 3 months prior to the date of sale, "qualified replacement property" is purchased by the seller.

3. For purposes of the 30% requirement, sales by two or more taxpayers may be treated as a single sale if made as part of a single, integrated transaction under a prearranged agreement. Temp. Treasury Reg. §1.1042-1T (Q&A:2(b))

4. Due to application of the attribution rules of IRC §318(a)(4), the 30% test also includes options to buy stock (with respect to sales completed after May 6, 1986). IRC §1042(b)(2).

5. This tax-free "rollover" treatment must be elected by the taxpayer (or his executor) in writing on a timely-filed return (including extensions) for the taxable year of sale, including a written statement of the employer consenting to application of the provisions of IRC Section 4978A imposing a 10% employer excise tax if, within 3 years after the acquisition, the ESOP disposes of stock and:

   a. the ESOP owns less stock than it did immediately after the ESOP's purchase, or

   b. The value of qualified securities held by the ESOP falls below 30% of the total value of all employer securities as of the date of disposition.

   c. This excise tax is inapplicable if the disposition is due to plan distributions made by reason of:

      (i) death or disability of an employee,

      (ii) retirement after age 59-1/2, or

      (iii) separation from service (resulting in a one year break in service).

6. The electing taxpayer is required to file with the IRS the employer's written statement consenting to the imposition of an excise tax on the employer equal to 50% of the amount involved if there is a prohibited allocation to the ESOP accounts of certain relatives of the decedent or any 25% shareholders. IRS §409(n).
a. The prohibited allocation applies to any benefits under the ESOP (or under any other qualified plan of the employer attributable to the employer securities acquired in the transaction).

b. The persons comprising this "prohibited group" are

(i) The decedent who transferred stock to the ESOP,

(ii) Persons who are related to the decedent (within the meaning of IRC §267(b), and

(iii) Any other person who owns (within the meaning of IRC §318(a) more than 25 percent of--

(1) Any class of outstanding stock of the employer or

(2) The total value of any class of outstanding stock of the employer.

In determining ownership, the person's interest in the shares held by the ESOP is taken into account. IRC 409(n)(1).

c. For this purpose, a person is a member of the prohibited group if he is a more than 25% shareholder either

(i) during the one-year period ending on the date of sale by the decedent, or

(ii) on the date on which the employer securities are allocated to ESOP participants. IRC §409(n)(3)(8).

d. A de minimus rule permits allocations to lineal descendants of the decedent provided that not more than 5% of the employer securities acquired from the decedent are allocated to lineal descendants. IRC §409(n)(3)(A).

e. Members of the prohibited group who are more than 25% shareholders must be permanently excluded from participating in allocations attributable to the transaction. IRC §409(n)(1)(3).
f. Other members of the prohibited group may not receive allocations under the ESOP until the end of a "nonallocation period" beginning on the date of sale of the qualified securities and ending 10 years after the final allocation attributable to any debt incurred to acquire the stock. IRC §409(n)(3)(C).

g. Should an ESOP fail to meet the requirement banning allocations to a prohibited group –

(i) The person whose account receives the allocation will be taxed as though he had actually received such amount.

(ii) The sponsor employer will be subject to a 50% excise tax on the prohibited allocation. IRC §4979A(a).

(iii) A 3-year statute of limitation applies to the assessment of such excise tax beginning on the later of the first allocation of employer securities in connection with an IRC 1042 sale to the plan or the date Secretary is notified of the failure to comply.

h. The prohibited allocation rules do not apply to amounts provided to prohibited group members outside of a qualified plan (e.g., through a non-qualified deferred compensation arrangement) TRA 86 Conf. Rept. II-852.

7. A "statement of purchase" must be filed with the IRS within a prescribed period after the purchase of replacement property.

8. The seller's basis in the replacement property is adjusted by the amount of unrecognized gain, with a cost allocation between properties if more than one item of replacement property is acquired. A step-up in basis is permitted if replacement property is held at death. The holding period of the employer securities sold is "tacked on" to the holding period of the replacement property.

9. Gain is recognized only "to the extent" that the sale proceeds exceed the cost of replacement property; thus, the difference is currently taxable.
10. C corporations are not permitted to elect nonrecognition treatment. IRC §1042(c)(7) as amended by §1854(a)(60(A) of TRA 86. This limitation applies to sales after March 28, 1985.

11. The corporation issuing the stock sold to the ESOP may have publicly traded debt securities but not publicly traded stock. IRC §1042(C)(1) as amended by §1854(a)(4)(A) of TRA 86.

B. The definition of "qualified securities" means employer securities:

1. as defined in IRC §409(1) -- i.e., common stock (or certain convertible noncallable preferred stock) with voting and dividend rights at least equal to the class of common stock with the greatest dividend rights and the greatest voting rights,

2. issued by a domestic corporation with no securities outstanding that are readily tradable on an established securities market. Temp. Tres. Reg. §1.1042-IT (Q & A:1(b)) requires that for at least one year before and after the sale, the domestic corporation which issued the securities (and each controlled group member) must have no stock outstanding which is readily tradable on an established securities market (Requirement is not reflected in the statute or the legislative history).

3. have been held by the seller for the long-term capital gain holding period (IRC §1042(a)), and

4. which were not received in a distribution from a qualified retirement plan or a transfer under an option or other right to acquire stock to which IRC §§83, 422, 422A, 423, or 424 applies (See discussion at V.A.2.)

C. "Qualified replacement property" (which may consist of more than one piece of property) means:

1. "Securities" i.e.,

   a. Stock

   b. Rights to subscribe for, or to receive, stock, or

   c. Bonds, debentures, notes, certificates or other evidence of indebtedness, issued with interest coupons or in registered form, but
d. excluding securities issued by a government or political subdivision thereof.

e. issued by a domestic operating corporation (i.e., more than 50% of the assets of which must be used in the active conduct of a trade or business at the time the securities were purchased or before the close of the replacement period) other than the corporation that issued the stock involved in the nonrecognition sale and its controlled group members. Financial institutions described in IRC §581 (i.e., banks) or §593 (e.g., building and loan associations) and insurance companies are treated as operating corporations. IRC §1042(c)(4).

2. The issuing corporation cannot have "passive income" (utilizing the same meaning as under the S corporation rules of IRC §1362(d)(3)(D)) exceeding 25% of gross receipts for the taxable year preceding the year in which the taxpayer purchased the security. IRC §1042(c)(4)(A)(i).

3. Securities sold by an underwriter do not qualify.

4. Note PLR 8724009 -- shares of voting stock in mutual fund do not constitute qualified replacement property.

D. No portion of the employer securities (or amounts allocated in lieu thereof) may accrue during a prescribed nonallocation period for the benefit of

1. The seller, or any member of his family (a de minimus exception allows lineal descendants of a selling shareholder to participate in up to 5% of the allocations attributable to that sale).

2. Any person owning more than 25% of either:

   a. The total value of any class of stock, or
   b. Any class of outstanding stock of the employer.

E. Upon disposition of qualified replacement property, tax must be paid on the gain not yet recognized (due to the sale and rollover), including any gain realized on the replacement property.

1. Recognition is required if a corporation issuing replacement property disposes of a substantial
portion of its assets (other than in the ordinary course of business) and the taxpayer owning stock representing control holds qualified replacement property.

2. Recognition is not required in certain cases where a transfer of replacement property occurs:

(i) due to an IRC §368 reorganization (unless the §1042 electing shareholder owns stock representing control),

(ii) by reason of the death of the person making the election,

(iii) by gift, or

(iv) due to a subsequent IRC §1042 transaction.

Note: To ensure that the recapture rule is not avoided through the use of controlled corporations, TRA 86 provides that if a §1042 elector owns stock representing control (with in the meaning of IRC §304(a)) of the corporation issuing the replacement property and that corporation disposes of a substantial portion of its assets other than in the ordinary course of business, the electing shareholder is treated as having disposed of the replacement property.

V. Estate Tax Advantages IRC §§2057 and 2210

A. Estate tax deduction for sales to ESOP. IRC §2057.

1. General Rule. A deduction from the taxable estate of a decedent is permitted for an amount up to 50% of the proceeds from an executor's sale of employer securities to an ESOP. IRC §2057(a).

2. A deduction is not allowed for securities acquired by a decedent

(a) in a distribution from a qualified plan or

(b) as a transfer pursuant to an option or other right to acquire stock which is subject to the provisions of Code Section--

(i) 83 (relating to property transferred in connection with the performance of service),
(ii) 422 (relating to qualified stock options),

(iii) 422A (relating to incentive stock options),

(iv) 423 (relating to employee stock purchase plans), or

(v) 424 (relating to restricted stock options). IRC §2057(c)(2).

3. The sale proceeds qualifying for the deduction include only amounts received by an estate before the federal estate tax return is due (including extensions). IRC §2057(c)(1).

4. The provision is inapplicable unless the company sponsoring the ESOP files with the IRS a written statement consenting to the imposition of an excise tax if there is an allocation to the ESOP accounts of certain relatives of the decedent or any 25% shareholder. IRC §§2057(d)(2), 4979A and 409(n). These are the same prohibited allocation rules and penalties that operate under IRC §1042 ("ESOP rollover") sales, except that the lineal descendant exception does not apply to IRS §2057 transactions. See IV. A.6. for a detailed discussion.

5. IRS Notice 87-13 (Q&A-23) provides that

a. the IRS will treat an executor sale to an ESOP as not satisfying the requirements for the estate tax exclusion unless the decedent directly owned the securities immediately before death and

b. the securities thereafter are allocated to participants or held for future allocation in connection with an exempt loan under the rules of IRC §4975 or in connection with a transfer of assets under the rules of IRC §4980(c)(3).

c. The employer securities sold to the ESOP may not be substituted for other employer securities that had previously been allocated or held for future allocation, except in the case of a bona fide business transaction (i.e., a merger of employers).

6. Legislation enacted in 1987 (H.R. 5491 and S. 1311) amended this provision as follows:
a. Codifying the provisions of IRS Notice 87-13, including the limitation that securities must be held at death (applicable to sales after October 22, 1986) but permitting indirect (i.e., trust) ownership by the decedent prior to death -- by clarifying that the provision applies also to sales of employer securities includible in the gross estate, regardless of whether included in the probate estate and sold to the ESOP by the executor (versus the IRS Notice 87-13 requirement of "direct" ownership by the decedent at death). Effective as if included in TRA 86.

b. Extending the provision to include sales to tax credit ESOPs.

c. Limiting the provision to the sale of non-publicly traded securities (effective after February 26, 1987).

d. Imposing a holding period requirement equal to the lesser of 5 years or the period between October 22, 1986 (date of enactment of the provision) and the date of death (including periods during which the securities were held by the decedent's spouse). Effective for sales after February 26, 1987.

e. Limiting the tax benefit (for sales after February 26, 1987) as follows:

   (i) Limiting the deduction to 50% of the taxable estate, (without regard to IRC §2057),

   (ii) Limiting the amount of the estate tax reduction to $750,000.

   (iii) Effective for sales after February 26, 1987 although sales prior to that date would be taken into account in determining whether the new limitations are met.

f. Making the provision inapplicable to the extent employer securities are acquired by an ESOP with assets transferred from another qualified plan (other than another ESOP) maintained by the employer, or assets attributable to a period when the plan was
not an ESOP (other than assets held on February 26, 1987).

g. Imposing a 30% excise tax on the employer to the extent

(i) a securities acquisition loan is repaid with assets described in f. above;

(ii) a disposition of qualified securities is made within 3 years of a sale qualifying for the IRC §2057 deduction; or

(iii) a disposition of qualified securities is made after 3 years but before such securities are allocated to participants' accounts and the proceeds are not allocated to such accounts effective for loan repayments or dispositions after February 26, 1987.

h. Tightening the prohibition in IRS Notice 87-13 on substitutions by reducing the IRC §2057 deduction by the excess (if any) of proceeds from the ESOP's disposition of employer securities during the 1-year period preceding the IRC §2057 sale over the cost of employer securities purchased by the ESOP during such 1-year period, disregarding dispositions made on account of death, disability, or certain separations from service, certain exchanges in corporate reorganizations, and dispositions required to comply with the new diversification requirements added by TRA 86.

8. IRC §2057 applies to sales after Oct. 22, 1986 with respect to which an election is made by the executor of an estate which is required to file an estate tax return on a date (including extensions) after Oct. 22, 1986. Enacted with a 5-year "sunset" provision (i.e., sales prior to January 1, 1992).

B. Assumption of Estate Tax Liability. IRC §2210.

1. General Rule. Executors of estates eligible to make deferred payments of estate taxes under IRC §6166 (i.e., generally where the value of the interest in a closely held business exceeds 35%
of the adjusted gross estate) may arrange for an ESOP to assume the estate tax liability of a decedent's estate provided the estate transfers to the ESOP employer securities equal in value to the liability assumed and the employer-sponsor of the ESOP guarantees the payment of tax.

2. The executor must elect application of this deferred payment arrangement and file agreements signed by the plan administrator of the ESOP and by the employer consenting to the payment of tax by the plan and guaranty by the employer.

3. ESOP distributions on account of death, retirement after age 59-1/2 disability, or any separation from service (resulting in a one year break in service) will not be regarded as a disposition for purposes of accelerating the payment of unpaid tax (i.e., as under IRC §6166) and will not be taken into account in determining whether subsequent distributions trigger accelerated payment.

4. Absent an administrative exemption, note the potential for the Department of Labor to characterize an IRC §2210 transaction as a prohibited transaction based on the analysis that

a. Although IRC §2210(f) provides that the ESOP's assumption of estate tax liability shall be treated as an exempt loan described in IRC 4975(d)(3), there is no comparable provision under Title I of ERISA, and

b. There is no independent exemption provided for the employer's required guarantee that the ESOP will pay the estate tax (arguably an extension of credit between the employer and the ESOP without an exemption under IRC §4975 (c)(1)(B) and ERISA §406 (a)(1)(B)).

VI. Pension Plan Asset Reversions IRC §4980(c)(3).

A. General Rule. The Tax Reform Act of 1986 imposes a 10% excise tax on the reversion of excise assets from an overfunded defined benefit pension plan. Until January 1, 1989, excess pension assets transferred to an ESOP will not be subject to the excise tax (or be included in an employer's gross income under the general "tax benefit recovery" rule) to the extent that such assets are transferred to an ESOP and used within 90 days either to acquire employer stock or to repay an ESOP loan.
B. In order to prevent "undue market disruption," the Secretary of the Treasury is authorized to extend the 90-day period. TRA 86 Conf. Rept. II-483.

C. Employer securities must remain in the plan until distributed to participants in accordance with the terms of the plan.

D. Stock must be allocated to ESOP participants accounts no less rapidly than ratably over a 7-year period.

1. Amounts allocated are treated as employer contributions for purposes of IRC §415(c) but it is the value of the stock when first credited to the suspense account that is utilized in calculating the amount of the annual addition under §415.

2. "The amount allocated in the year of transfer shall not be less than the lesser of the maximum amount allowable under section 415 or 1/8 of the total amount transferred." H. Con. Res. 395, 99th Cong., 2d Sess. (1986), p.76 (as reflected in the pending Technical Corrections to TRA 86). Technical Corrections may also address the confusion created by the word "amount" (e.g., if the value of employer securities increases or declines).

E. At least half of the active participants in the qualified plan from which the assets are transferred must be participants in the ESOP.

1. For this purpose, "only active employees, as opposed to retirees" need be considered. TRA 86 Conf. Rept. II-483.

2. Left uncertain is the treatment of terminated vested participants, employees who elect not to participate (e.g., in order to make IRA contributions), participants in "frozen" defined benefit pension plans, and employees who are "frozen" (e.g., transferred employees whose service still counts for vesting but not for benefit accrual).

F. The ESOP exemption is effective for amounts:

1. transferred after March 31, 1985 and before January 1, 1989, or
2. transferred after December 31, 1988 pursuant to a termination which occurs after March 31, 1985 and before January 1, 1989. IRC §4980(c)(3)(E)

3. while legislation has been introduced (H.R. 41) to make the exemption permanent, its passage is unlikely and this provision is now largely history due to the inadequacy of time to get necessary PBGC approval of the pension plan termination and January 1, 1989.

VII. Exception to Net Operating Loss Limitations. IRC §382(1)(3)(C)

General Rule. The Tax Reform Act of 1986 imposes certain limitations on the use of a corporation's net operating loss carryforward deductions following a more-than-50% change in ownership. These limitations do not apply to transactions which result in an ESOP owning at least 50% of the corporation.

VIII. Eligible Worker-Owned Cooperatives

A. Eligible worker-owned cooperatives (EWOCs) are allowed to qualify for the same tax incentives as those provided to ESOPs under IRS §§1042 (ESOP rollover), 2210 (estate tax assumption) and 2057 (estate tax deduction).

B. An EWOC is any organization a majority of the membership of which is composed of employees of the organization, a majority of the voting stock of which is owned by the members, a majority of the board of directors of which is elected by the members on the basis of 1 person 1 vote, a majority of the allocated earnings and losses of which is allocated to members on the basis of patronage, capital contribution or a combination of the two, and which meets the requirements for taxation as a cooperative under Code §§1381 through 1383. Code §1042(c)(2).

IX. Typical ESOP Transaction Structure

A. Employer establishes ESOP and Trust (ESOP).

B. Employer arranges loan from a third party lender to the ESOP. Alternatively, the employer or other person may make the loan.

C. ESOP gives a note to the lender and employer guarantees ESOP's repayment.
D. ESOP uses the loan proceeds to purchase a block of employer's stock (either from the employer or from an existing stockholder, or, in a leveraged buy-out, from the public) which is pledged as security on the loan.

E. Employer makes annual tax deductible contributions to the ESOP in amount sufficient to amortize the loan.

F. ESOP repays the lender as it receives contributions.

G. Stock initially purchased by ESOP is held in a "suspense account" and released for allocation to participating employees' accounts as subsequent employer contributions are made to amortize the loan.

H. Analysis--Where the employer stock is increasing in value.

1. Leveraged loan -- best for employees since they ultimately will get more stock.

2. Non-leveraged alternative -- may be best for closely-held employer since the plan qualifies for the same aggregate tax deductions, but uses less stock (assuming rising stock value).

3. Note: the exclusion from income of one-half of the interest by lender bank increases the attractiveness of a leveraged ESOP loan.

X. Alternatives to ESOPs

A. Eligible Individual Account Plan (EIAP)

1. Specially designed defined contribution plan that permits up to 100% of trust assets to be invested in employer securities.

2. ERISA normally permits only 10% of plan assets to be invested in employer Securities.

3. EIAP must be a profit-sharing or a stock bonus plan.

4. Stock bonus plan EIAPs are subject to the ESOP's voting pass-through requirements.

5. An EIAP is otherwise similar to an ESOP with certain disparities, including those described below.
B. EIAP v. ESOP

1. EIAP using profit-sharing plan format limits employer deduction to 15% of participants' annual compensation. To the extent a participant is allocated an amount greater than the non-ESOP §415 limits (25% of compensation or $30,000, whichever is less), the excess is not deductible.

2. Employer with an EIAP may contribute any amount up to stated limits, while a leveraged ESOP may be required to contribute a specified percentage of participants' compensation each year (up to a maximum of 25% of participants' annual covered compensation) to meet its ESOP loan commitments.

3. EIAP cannot be leveraged to permit "up-front" purchase of securities.
   a. If employer stock losses value following initial year, participants of EIAP will not sustain as large a loss since each subsequent year's contribution is made at that later year's lower value. Stock purchased by a leveraged ESOP "up-front" is usually valued only at the time of purchase though not yet allocated to participant accounts.
   b. Employer may contribute stock rather than sell it to plan and thereby avoid ERISA §408(e) "adequate consideration" test.

4. An EIAP is exempt from the following ERISA requirements.
   (a) Trust diversification (ERISA §404(a)(2)).
   (b) 10% limitation on holding of employer stock (ERISA §407(b)(1)).
   (c) Prohibition against sale or exchange of property between a plan and a party-in-interest (provided subject matter of sale is employer stock, fair market value is paid, and no commission is charged) (ERISA §2003(d)(13)).
   (d) Requirement for a fair return commensurate with prevailing rate (ERISA §404(a)(1)).
(e) Requirement that sufficient liquidity must be maintained to permit distribution in accordance with terms of plan. Id.

5. An EIAP is not subject to numerous technical requirements of ESOPs.
   a. Profit-sharing EIAP may distribute benefits in stock or cash.
   b. An EIAP can be integrated with benefits under Social Security.
   c. Only an ESOP is subject to the diversification requirements of IRC §401(a)(28)(B).
   d. Profit-sharing EIAP not required to pass through voting rights to participants.

6. EIAP can be more flexible as it may invest in assets other than employer securities if desired, and employer securities are not required to be "qualified employer securities." If other investments are made, however, trustees' investment decisions are subject to all ERISA fiduciary investment rules, including the "prudent man" rule.

7. Employer contribution of stock to plan rather than plan's purchase of stock eliminates risk that sale of overvalued stock will result in excise tax or disqualify the entire plan. Maximum exposure would be a partial loss of a tax deduction.