A Brief Primer on S Corporation ESOPs

Unraveling the Statutory Maze

By **Michael E. Williams**

Most practitioners are aware of the existence of employee stock ownership programs (ESOPs). You may have dealt with them as tax or labor attorneys, as part of a qualified domestic relations order, exempted them on a bankruptcy petition, and so forth.

ESOPs are retirement plans which invest primarily in employer securities and are largely governed by the Employee Retirement Income Security Act of 1974 (ERISA).[1] As such, they are qualified plans and non-taxable entities. The stock is owned by a trust with the employees as beneficiaries (or participants). When a participant retires, the sponsoring corporation buys the employee's stock, so ESOPs provide a culture of employee ownership and, as such, the employees feel like they are also owners of the corporation and have a vested interest in its success.[2] Some examples of ESOP-owned corporations are home-improvement giant Lowe's, Publix Super Markets, wholesale distributor Graybar Electric, and Southfield-based contractor and builder Barton Malow.[3] ESOPs may exist in conjunction with subchapter C or subchapter S corporations; this article primarily addresses S corporation ESOPs.

Technically, these corporations are owned by an employee stock ownership trust (ESOT), a non-taxable entity.[4] ESOP is the name of the program as referred to as a whole, and the ESOT is the owner of all of the shares. The ESOT owns the corporation stock; the employees are the beneficiaries or plan participants. Under most plans, when employees become vested and retire or are disabled, the ESOT buys their stock. The employees can roll this money into an IRA and the stock sale will be non-taxable under IRC 402(c)(1).

The trustee's fiduciary duties

As a trust, the ESOT is controlled by a trustee responsible for the usual fiduciary duties of the trust and additional duties under ERISA.[5] In this writer's opinion, the general common-law duties owed by the trustee and the corporate officer—good faith, the prudent investor rule, no self-dealing—coupled with an attorney's common sense and reason, are in many cases sufficient to protect the trustee from the tremendous liability for violation of his or her duties. 29 USC 1104 codifies the prudent standard of care. Unlike other ERISA fiduciaries, however, diversification of investments is not required; an ESOP's purpose is investing in employer securities, which remains true even if the value of employer stock falls.[6] There is no presumption of prudence for an ESOP fiduciary and such fiduciaries cannot break the law,[7] as if that needs to be said. The fiduciary also has a duty to establish the annual stock value and there are anti-abuse rules specific to ESOPs, both of which will be discussed further.

The beginning of S corporation ESOP legislation

When ERISA was enacted in 1974, only C corporations were permitted to be ESOT-owned but now they are so authorized.[8] And although C corporation ESOPs are slightly off topic, they are, in many cases, an excellent retirement vehicle for a retiring key person or owner whose shares are sold to employees, a purchase usually financed through a bank loan. The proceeds are non-taxable to the selling owner as long as the owner rolls the money into qualified replacement property.[9] This provides an opportunity for an owner who may not have saved enough for retirement or wants more retirement income to cash in on their asset. C corporation ESOPs are an excellent option for attorneys practicing in estate or business succession planning.

One more note about C corporation ESOPs: calling them non-taxable entities is misleading. Although the ESOT itself is not taxed, the C corporation is taxed at the usual corporate rate.[10] In 1996, the Small Business Job Protection Act amended the code to permit S corporation ESOPs to make both the ESOT and the corporation tax-free as distributions from the non-taxable S corporation flow to the ESOT.[11]

How an S corporation ESOP begins

The intricacies of setting up an S corporation ESOP begin with hiring an attorney. Generally, the attorney sets up a corporation by making the standard S election or converting to an S corporation on IRS Form 2553, using the reason for late-election sale of the stock to a new owner (the ESOT). Before making the S conversion or election, the cautious practitioner will consider (1) if the election will trigger a tax on built-in gains; (2) a last-in, first-out recapture tax; (3) a tax on excessive passive income; (4) the capital gains tax on the sale of the shares; and (5) the primary shareholder's retirement goals.[12] The final step is ensuring the corporation has 100 or fewer eligible shareholders—living human beings who are citizens and lawful residents—and one class of stock.

The rest of the article focuses on the situation in which the corporation is begun from scratch and filed immediately for S election. However, in most situations, such clarity is not the case. Visualizing the operation from the beginning and applying it to an existing situation down the road is an effective course of action.

After the initial corporate filing is completed and the S election is made, the trust is drafted and the corporate board of directors adopts the ESOP.[13] The plan itself will define the years of service to vest.[14] The simplest way is graded vesting; every six years, the employee is 20 percent vested with full

There is a way to make this process much simpler: don't include owners and their family members as ESOP participants. Find other ways to compensate them, such as contracts for compensation or qualified plans.

vesting the final year.[15] The plan also defines employee eligibility, the eligibility date, what happens when an employer is disabled, and more.[16] Once complete, the practitioner may request a determination letter from the IRS. An ESOP checklist for the determination letter is available through the IRS.[17]

Abuse and non-allocation years

As previously mentioned, trustees have specific duties and obligations, and must avoid certain pitfalls. If one shareholder or a handful of shareholders pass profit through an ESOT to themselves, the IRS considers that action abuse.[18] For example, in the 1990s, a solo practitioner that made $400,000 annually could receive that money tax-free from an ESOT.

IRC 409(p) discusses prohibited allocations, which are allocations during a non-allocation year attributable to a disqualified person. A disqualified persons is someone who owns more than 10 percent of deemed shares (shares plus synthetic equity, stock options, and more) of the corporation *or* owns 20 percent of the deemed shares along with family members (which includes grandchildren and in-laws, who should not be shareholders in the first place).[19] In other words, this causes a non-allocation year: if 50 percent or more of the shares are owned by the disqualified persons, an excise tax equal to 50 percent of the amount of those prohibited allocations is assessed, and the entire ESOP can be disqualified.

There is a way to make this process much simpler: don't include owners and their family members as ESOP participants. Find other ways to compensate them, such as contracts for compensation or qualified plans.

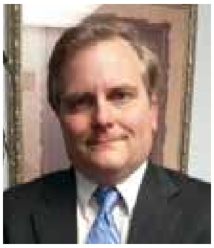
The fiduciary's annual valuation of shares

As previously mentioned, the fiduciary must annually value the shares owned by the ESOT. The U.S. Department of Labor requires application of the IRS's fair market value standard, which is the value of the shares on the open market.[20] Since ESOP shares are not traded on the public market, this is problematic.

Among the methods used to value shares, the income approach to valuation is most common. There are a few customary methods used to calculate value via the income approach. One is the capitalization method, which determines values by dividing the income by the number of years of look-back. The discounted cash flow method forecasts the future but is discounted at the present value. There's also the asset approach, which is simply a comparison of assets versus liabilities. Other methods value shares as if they are on the open market. Remember that the fiduciary owes a duty to the employees when conducting a valuation.[21]

Conclusion

This article provides a foundation to statutory creation of S corporation ESOPs. When implemented properly, they serve an excellent function. ■



Originally a general practitioner based out of Livonia, Michael E. Williams has focused his practice on employee stock ownership plans through Benefit Plan Consulting PLLC since 2018. He has a passion for ESOPs and the tax benefits for employers and employees. His office is currently in Farmington Hills.

ENDNOTES

1. 26 USC 401(a) and 26 USC 4975(e)(7).
2. 29 USC 18.
3. *The Employee Ownership 100; America's Largest Majority Employee-Owned Companies*, NCEO (July 27, 2020) <https://www.nceo.org/articles/employee-ownership-100> [https://perma.cc/4A6V-BSZH] (website accessed October 7, 2020).
4. 26 USC 401(a) and 26 USC 4975(e)(7).
5. 26 USC 4975.
6. *Amgen Inc v Harris*, 136 S Ct 758, 759; 193 L Ed 2d 696 (2016).
7. *Fifth Third Bancorp v Dudenhoeffer*, 573 US 409, 428; 134 S Ct 2459; 189 L Ed 2d 457 (2014) and *Retirement Plans Comm of IBM v Jander*, 140 S Ct 592, 594; 205 L Ed 2d 432 (2020).
8. 26 USC 409(h)(2)(B)(II)(ii)
9. 26 USC 1042
10. 26 USC 11(b).
11. 23 USC 11361.
12. It may be advisable to complete the stock sale as a C corporation before converting to an S corporation.
13. 26 CFR 54.4975-11.
14. 29 USC 1102.
15. 26 CFR 54.4975-11.
16. *Id.*
17. *ESOP Checksheet*, IRS (2014), available at <https://www.irs.gov/pub/irs-tege/esop_checksheet.pdf> [https://perma.cc/QA2Z-8ZD7] (website accessed October 3, 2020).
18. *Law Office of John H. Eggertsen PC v Commissioner of Internal Revenue*, 143 TC 13 (2014).
19. 26 USC 409(p)(3)–(4).
20. A good faith determination of the fair market value of the stock is the requirement for the fiduciary. *Kloots v American Express Tax and Business Services, Inc*, unpublished opinion of the United States Court of Appeals for the Sixth Circuit, issued May 15, 2007 (Docket No. 06-3916), p 2.
21. *Perez v Bruister*, 823 F3d 250, 262 (CA 5, 2016).