ESOPs, S Corporations and Excise Taxes

By Robert W. Wood • Wood LLP

Employee Stock Ownership Plan (ESOP) transactions are notoriously complex and expensive. At their most basic, they can seem too good to be true. Suppose that you have closely held company and you cannot find a buyer. A solution may be to form an ESOP for the benefit of your employees. Then you sell the company (or at least part of it) to the ESOP.

There are a number of tax advantages to such deals. The advantages can make it worth navigating the various requirements that include fiduciary concerns and valuation difficulties. The economic and tax benefits can be outstanding, including deductible contributions, favorable interest provisions and even estate planning advantages.

But the hallmark tax and diversification advantage that hooks many small business owners is embodied in Code Sec. 1042. It provides the seller the opportunity to roll over his or her gain on the shares on a tax deferred basis into a portfolio of public company securities. A potential basis step-up on death can be tempting too.

An ESOP can be especially alluring for a seller who has not located an appropriate buyer and who may want a more gradual exit from the company. The ESOP can seem made to order, allowing the seller to remain at the helm for some period of years. That makes the ESOP buyout even more attractive. But there are numerous hurdles to get over and risks of fiduciary and other liabilities to contend with. And there are expenses.

Only one of the potential downsides is excise taxes. But a recent case in the Tax

Court and Eighth Circuit Court of Appeals has underscored it, adding to the list of many potential disadvantages. As we'll see, though, the excise tax wasn't the only thing to go wrong in this case.

Code Sec. 409(p)?

Code Sec. 409(p) was enacted to limit the tax deferral opportunities provided by an S corporation ESOP with broad-based employee coverage benefitting rank-and-file as well as highly compensated employees. An ESOP that holds employer securities consisting of S stock must provide that no portion of the plan assets attributable to employer securities can benefit disqualified persons in a "nonallocation year." If it does, the plan is hit with a 50-percent excise tax.

A nonallocation year is any plan year of an ESOP during which at any time the plan holds employer securities consisting of S stock, and disqualified persons own at least 50 percent of the number of shares of stock in the S corporation. Constructive ownership rules generally apply.

Ries Enterprises

In *Ries Enterprises Inc.* [(CA-8 Dec. 31, 2014) 114 AFTR 2d ¶2014-5570], the company ran a rental and leasing business. An S corporation, it had (impermissibly, it turned out) two classes of stock, and it promptly adopted an ESOP. The ESOP owned 80 percent of the common stock, and Mr. Ries and his wife owned the balance.

Mr. Ries was the company's sole employee and the plan's sole participant. The IRS spotted the violation and levied the excise tax of $161,200 under Code Sec. 4979A. The company argued that the plan was not an ESOP. Predictably, the IRS said it was an ESOP *until* it violated Code Sec. 409(p).

The Tax Court easily ruled for the IRS, holding that the plan was an ESOP and that an impermissible allocation was made, triggering the excise tax. As to the company's S status, despite the two classes of stock, the duty of consistency demanded that the company be classified as an S corporation at least for 2002. With attribution, Mr. Ries owned everything, was a disqualified person and violated the rules. The Eighth Circuit Court of Appeals affirmed.

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