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LEVERAGED EMPLOYEE STOCK OWNERSHIP PLANS AND THE CLOSELY HELD CORPORATION

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I. INTRODUCTION

Leveraged Employee Stock Ownership Plans (LESOPs)¹ have been given favored treatment by a series of new laws² designed to en-

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1. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978), *reprinted in* [1978] 11B U.S. CODE CONG. & AD. NEWS [hereinafter referred to as the 1978 Act]. Section 141(f)(5) of the 1978 Act modified the definition of an employee stock ownership plan (ESOP) in I.R.C. § 4975(e)(7) to limit its application to leveraged employee stock ownership plans (LESOPs). It is apparent that this definition was included in the Code by the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.) [hereinafter cited as ERISA], primarily for purposes of the ESOP loan exemption in I.R.C. § 4975(d)(3). The definition of ESOP in ERISA § 407(d)(6) has remained unchanged for purposes of ERISA § 408(e) sale exemption from the prohibited transaction rules and the definition of eligible individual account plan in ERISA § 407(d)(3). The change in name made by the 1978 Act was presumably to prevent confusion with ESOPs which qualify for the additional investment tax credit. Pursuant to the new definitions, an ESOP is a tax-qualified defined contribution plan that is designed to invest primarily in employer securities and meets certain requirements enabling the employer to obtain an extra investment tax credit. A LESOP is a qualified stock bonus plan or a stock bonus plan and money purchase plan designed to invest primarily in qualifying employer securities. Since, under the new definition in the 1978 Act a LESOP may qualify as an ESOP, or the statute cited may still use the term "ESOP," ESOP may be proper even when referring to a LESOP.

2. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified at 26 U.S.C.); Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of 26, 42 U.S.C.) [hereinafter cited as the 1975 Act]; Trade Act of 1974, Pub. L. No. 93-618, 88 Stat. 1978 (1975) (codified in scattered sections of 5, 19, 26, 31, 42 U.S.C.); Employee Retirement In-

courage LESOPs as an innovative method of strengthening the free enterprise system. This is accomplished by securing capital for corporate expansion, while at the same time affording employees a means for obtaining stock ownership in their employer corporation. Congress has stated that employee stock ownership plan objectives should not be frustrated by regulations and rulings "which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans and which otherwise block the establishment and success of these plans."³

The concept of employees owning stock in their employer corporation has its basis in the economic theory of the production of wealth.⁴ In a capitalistic economy, the primary elements for the production of wealth are land, labor and capital. As the economy has become more technological, labor and capital have become the variable elements in the equation, with capital the more important of the two. Thus, those who control capital, potentially, at least, control wealth. In addition to this emphasis on capital as the main element for the production of wealth, the concentration of wealth through capital formation has been accelerated through the use of corporations.

come Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.); Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1974) (codified in scattered sections of 31, 45 U.S.C.). The preferential treatment offered to ESOPs by these statutes are briefly stated as follows:

(a) ERISA favored ESOPs mainly by exemption of ESOPs from its prohibitions against qualified plans holding more than 10% of plan assets in employer securities and engaging in certain otherwise prohibited transactions under I.R.C. § 4975 (*e.g.*, sales or leases between the plan and disqualified parties).

(b) Section 301(d) of the 1975 Act established a separate type of ESOP with a special tax advantage which grants qualifying corporate employers and additional investment tax credit. A Tax Reduction Act Stock Ownership Plan (TRASOP) is an employee stock ownership plan that meets specified requirements which entitle a corporate employer to receive an extra investment credit of up to 1 1/2% of qualifying contributions to the plan. The 1978 Act makes a number of important changes in the TRASOP rules (referred to as ESOP in the language of the 1978 Act), and incorporates the modified TRASOP rules into the Code. The term "TRASOP" does not appear in the 1978 Act. *See* the 1978 Act § 141(a), (d), (e), (f), (g), adding I.R.C. § 409A(a)-(f) and amending I.R.C. §§ 46(a)(2)(E), 56(c), 4975(e)(7).

(c) The Trade Act of 1974 aids communities hurt by increased imports. The Secretary of Commerce is authorized to guarantee loans to private borrowers in these communities, with preference given to borrowers who establish or maintain an ESOP. 19 U.S.C. § 2373(f)(5) (1976).

(d) The Regional Rail Reorganization Act of 1973, 45 U.S.C. §§ 701-794 (Supp. 1975), established a non-profit corporation (United States Railway Association) to generate plans for a consolidated rail corporation. This association is to report on the manner in which an ESOP may be used to meet the capitalization needs of the corporation. *Id.* § 711. *See also id.* § 702(5).

3. STAFF OF JOINT COMM. ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 533.

4. P. SAMUELSON, ECONOMICS: AN INTRODUCTORY ANALYSIS 48 (7th ed. 1967).

In bygone days corporate charters were rarely awarded by governments, and their use was limited.⁵ Now the limitations are no longer formidable, and one major stimulus behind the use of the corporate structure is its very ability to consolidate capital in one entity. This, coupled with its perpetual existence feature,⁶ makes the corporation an excellent vehicle through which to raise, consolidate, and control capital. Due to the nature of the ownership of the corporate entity, however, it can also result in the concentration of wealth in the hands of a few.

This concentration of wealth can be redistributed to the labor element by allowing employees to have an ownership interest in their employer corporations. One way in which this goal can be achieved is through the employee stock ownership concept. Philosophically this shifting of wealth back to the employees through employee stock ownership plans can be viewed as a capitalist adaptation of the thesis-antithesis-synthesis theory,⁷ with employee stock ownership plans being the synthesis aspect in the transition from the sole proprietorship form of business to the corporate form. Whereas previously one individual could control the production of wealth elements directly, now he can control it, or some part of it, indirectly through stock ownership.

II. A PLAN DESCRIPTION

From a tax standpoint the concept of employee stock ownership plans has been around for some time.⁸ It was not, however, until the enactment of the Employee Retirement Income Security Act of 1974 (ERISA)⁹ that the concept was specifically defined and Employee Stock

5. At one time it took an act of the legislative body to grant permission to form a corporation. Now, in most instances, one needs only to file the necessary papers with the Secretary of State of the incorporating jurisdiction. See generally H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 12 (2d ed. 1970).

6. See, e.g., N.Y. BUS. CORP. LAW § 202 (McKinney 1963), which empowers each corporation "to have perpetual duration" unless otherwise provided by statute or its certificate of incorporation. Cf. OKLA. STAT. tit. 18, § 1.14 (1971), which limits the duration of an Oklahoma corporation to a period of 50 years, renewable for 50 year periods.

7. The triad dialectic of thesis-antithesis-synthesis is widely attributed to Hegel, although he did not use those terms. The dialectic is an historical process which explains the past, present, and future of historical man; it is part of a philosophical system which integrates social, political, economic and intellectual events. See, e.g., W. DAUFMANN, *HEGEL* (1965); A. KOJEVE, *INTRODUCTION TO THE READINGS OF HEGEL* (1969); J. LOEWENBERG, *HEGEL SELECTIONS* (1957).

8. Section 219(f) of the Internal Revenue Code of 1921 authorized stock bonus plans.

9. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.). In 1974 Congress gave its blessing to the concept in I.R.C. § 4975(e)(7) under the name "Employee Stock Ownership Plan" (ESOP). Since ERISA requires the assets of employee benefit plans to be held in trust, ERISA § 403(a), the term "Employee Stock Ownership Trust"

Ownership Plans came into vogue. Pre-ERISA restrictions on plans investing in their employers' stock had tended to limit application of the concept to large corporations with an active market for their stock and a history of regular dividend payments, thus effectively excluding the participation of most closely held corporations. No substantial restrictions are imposed, however, upon such plans implemented since ERISA.

Tax deferral is the essence of LESOPs. Qualified employee benefit plans, however, are not the only income tax deferral device utilized by employers. Often, in addition to or in lieu of qualified plans, an employer will establish a nonqualified retirement plan or deferred compensation arrangement for employees. Most nonqualified plans involve the transfer of some type of property or right to the employee in a manner which defers taxation. At some later point the property becomes vested in the employee (and therefore subject to some tax liability). The employee's objective in participating in such an arrangement is usually tax deferment. The underlying assumption is that the effective tax rate at the later time of payment will be lower than the current rate. The application of this lower rate will allow him to retain a larger portion of the total amount paid to him. The employer, for his part, wants a tax deduction at the time he makes a contribution to the plan. The disadvantage of nonqualified plans is that they defer the employer's tax deduction until such time as the employee incurs a tax liability on the deferred amount.¹⁰

For the best of two worlds, the ideal plan provides for a tax deduction to the employer when he makes a contribution to the plan, while the tax liability of the employee is deferred until he receives the benefit. This is, in essence, what qualified retirement plans accomplish. They allow a current deduction to the employer when he makes his contribution and defer the employee's tax liability until a distribution under the plan is made to him.

LESOPs, for tax purposes, are defined contribution plans¹¹

(ESOT) is used interchangeably for ESOP. However, due to changes made in terminology by the 1978 Act, the type of ESOP referred to in the 1974 Act is currently referred to as a "Leveraged Employee Stock Ownership Plan." (LESOP).

10. I.R.C. §§ 83(h), 404(a).

11. An ESOP may also be a combination stock bonus and money purchase pension plan, which is a qualified plan. ERISA § 407(d)(6); I.R.C. § 4975(e)(7). Under the Code, all qualified retirement plans are grouped in one of two categories: defined benefit plans or defined contribution plans. Employee benefits are basically fixed under defined benefit plans. Section 414(i) of ERISA defines the term "defined contribution plans" as individual account plans where the em-

designed to invest primarily in the qualifying employer's securities.¹² As a general rule LESOPs utilize the stock bonus format.¹³ Consequently, the LESOP concept is associated with the stock bonus type plan, and henceforth, unless otherwise noted, this is the type of plan referred to in this article.

The essential requirements that a LESOP must satisfy to be considered a qualified plan can be summarized as follows:

1. Generally, the assets of the trust must be maintained in the United States.¹⁴
2. The plan must be for the exclusive benefit of the employees or their beneficiaries.¹⁵
3. Each participant must have the right to receive distribution of benefits in the form of employer securities. Subject to this right, the plan has the right to distribute cash or securities or both.¹⁶
4. Voting rights in employer securities are required to be given to participants.¹⁷
5. Each participant must be given a put option which enables him to require the employer to repurchase employer

employee benefits are based solely on the amount contributed to the participant's account, and on any income, expenses or losses derived from the amount contributed. Under a money purchase plan, contributions are allocated to the individual accounts of participants, and the benefits to each participant are the amounts contributed to his account adjusted by any earnings and losses. Rev. Rul. 74-340; 1974-2 C.B. 128. A money purchase plan is thus a defined contribution plan and must provide a definite formula for allocating contributions to the accounts of participants. Rev. Rul. 70-125, 1970-1 C.B. 87. As a general rule, the annual contribution is determined by a specific formula.

12. I.R.C. § 4975(e)(7)(A). The intent is to give the employee greater interest in his employer's success and the benefits therefrom than that of an outright wage-earning employee.

13. I.R.C. § 4975(e)(7) defines a LESOP as a stock bonus plan or a stock bonus plan coupled with a money purchase plan. ERISA § 407(d)(6), in its definition of ESOP, refers to an ESOP as an individual account plan.

14. I.R.C. § 401(a) and Treas. Reg. § 1.401-1(a)(3)(i) generally require that the trust be created or organized in the United States to constitute a qualified plan. Nevertheless, Part 2(d) of I.R.S. Pub. 778 points out that if a foreign situs trust meets the requirements of § 401(a) in all other respects, employers making contributions thereto are allowed deductions within the limits of § 404(a)(4), and beneficiaries of such trusts are granted the same treatment in accordance with § 402(c) as is applicable to beneficiaries of domestic trusts.

15. I.R.C. § 401(a).

16. I.R.C. § 4975(d)(3), (e)(7) as amended by the 1978 Act, § 141(f)(5). Prior to the 1978 Act, Treas. Reg. § 54.4975-11(f)(1) (1977) required that benefits distributable from a stock bonus ESOP were distributable only in stock of the employer company.

17. I.R.C. § 4975(d)(3), (e)(7) as amended by the 1978 Act, § 141(f)(5). For companies which have publicly traded stock (generally those registered under § 12 of the 1934 Securities Exchange Act), there is a full pass-through of voting rights on employer securities to participants. For other employers a limited voting pass-through requirement applies with respect to corporate matters which by law or corporate charter must be decided by more than a majority vote of outstanding common shares voted.

- securities not readily tradable on an established market.¹⁸
6. The plan must invest primarily in qualifying employer securities.¹⁹
 7. The cost of employer securities purchased by the plan must not exceed their fair market value.²⁰
 8. The plan must be established pursuant to a written instrument.²¹
 9. The Code requirements of section 401(a) for vesting, coverage, nondiscrimination in contribution or benefits, and nonforfeitability of rights upon termination of the plan must be met.²²

Employer contributions to a LESOP are not necessarily dependent on profits and can be made either in cash or in qualifying employer securities. The plan may also hold qualifying employer real property, provided the plan specifically provides that its funds can be so invested and to what extent.²³

Prior to the issuance of I.R.C. Regulations section 54.4975-12, the phrase "must invest primarily in qualifying employer securities"²⁴ caused some concern about what type of securities could be contributed to a LESOP. The term "security" could mean any number of instruments, including bonds, notes, preferred stock, and common stock, as encompassed within the definition of security in the Securities Act of 1933.²⁵ This concern has been removed by Regulations section 54.4975-12, which defines the term "qualifying employer security" to mean an employer security which is:

1. Stock or otherwise an equity security; or
2. A bond, debenture, note or certificate or other evidence of indebtedness which is described in paragraphs (1), (2) and (3) of section 503(e)²⁶ of the I.R.C.

18. I.R.C. § 4975(d)(3), (3)(7) as amended by the 1978 Act, § 141(f)(5).

19. I.R.C. § 4975(e)(7)(A); Treas. Reg. § 54.4975-11(b) (1977). A qualifying employer security is an employer security that is either (a) stock or otherwise an equity security, or (b) a bond, debenture, note or certificate, or other evidence of indebtedness that meets the special acquisition, price, and ownership percentage rules of I.R.C. § 503(e).

20. ERISA § 408(e).

21. ERISA § 402(a)(1).

22. I.R.C. § 401(a).

23. The LESOP is basically a stock holding concept. Until the rules pertaining to investment procedures are clarified, one should be cautious about making large employer real property contributions to the plan. It is possible that such contributions could run afoul of the rule that the plan must be maintained for the best interests of the employees or their beneficiaries.

24. I.R.C. § 4975(e)(7)(A).

25. 15 U.S.C. § 776 (1976).

26. Debt securities are subject to the limitations of I.R.C. § 503(e).

When cash is contributed to the plan, the question of when it must be invested in employer securities arises. The Regulations on this point simply state that "a stock bonus plan or a money purchase pension plan constituting an ESOP may invest part of its assets in other than qualifying employer securities."²⁷ Thus, it seems that over the term of the plan more than 50% of the contributions should be invested in employer securities.²⁸ In any one year, however, it does not seem that the plan would have to be primarily invested in employer securities. Cash contributions could be invested in other investments and accumulated, as long as they were ultimately invested in employer securities.

At the time a LESOP invests in employer securities, the cost of such securities must be for adequate consideration.²⁹ The purchase can be made either from the corporation or from a shareholder, including a controlling shareholder. If the LESOP lacks sufficient funds to purchase the securities, it can borrow the purchase price,³⁰ provided the interest rate is not unreasonable.

In addition to loans from independent third parties, a LESOP may obtain an "exempt loan"³¹ from the employer corporation or other disqualified persons.³² However, the proceeds of an exempt loan must be used within a reasonable time after their receipt by the borrowing LESOP for one of the following purposes:³³

1. To acquire qualifying employer securities.
2. To repay such a loan.
3. To repay a prior exempt loan.

If a LESOP consists solely of a stock bonus plan, the employer may deduct 15% of the aggregate compensation paid or accrued to plan participants for the year.³⁴ Contributions in excess of this limit may be

27. Treas. Reg. § 54.4975-11(b) (1977).

28. Although there appears to be no statutory definition of the term "invest primarily" as it is used in § 4975(e)(7), the investment of a minimum of 50% of contributions to the plan in employer securities would seem to meet that requirement.

29. Rev. Rul. 69-494, 1969-2 C.B. 88.

30. Rev. Rul. 71-311, 1971-2 C.B. 184.

31. Treas. Reg. § 54.4975-7 (1977). The term "exempt loan" refers to a loan that satisfies the provisions of Treas. Reg. § 54.4975-7 (1977).

32. The term "disqualified person" is defined in I.R.C. § 4975(e)(2). The main parties deemed to be disqualified are the plan's fiduciary, the employer, and 10% or more shareholders of the employer corporation.

33. Treas. Reg. § 54.4975-7(b)(4) (1977) and Treas. Reg. § 54.4975-11(c) (1977). All assets acquired with the proceeds of an exempt loan must be added to and maintained in a suspense account. As the exempt loan is repaid, the assets are released from the suspense account pursuant to the rules set forth in Treas. Reg. § 54.4975-11(c) (1977).

34. I.R.C. § 404(a)(3). The percentage limits on benefits and contributions are based on an employee's compensation, which, for this purpose, means the participant employee's wages, salary

carried over and deducted in later years, to the extent that less than the 15% maximum is contributed in those later year.³⁵ If less than the 15% maximum is contributed in any year, the under-contribution may be carried over and added to the 15% maximum limitation in the later years, but the carryover amount in any later year cannot exceed 15% of the participants' compensation for that year; and the carryover plus the regular deduction limitation for the later year cannot exceed 25% of compensation for the later year.³⁶

III. TAX PLANNING WITH LESOPS

A LESOP can be a useful tax planning tool for a closely held corporation and its shareholders. It can be used to provide retirement benefits for participants, corporate financing, lifetime liquidity for shareholders, post-death liquidity for estates of shareholders, and as a means to accomplish corporate acquisitions, mergers, and divestitures.

The LESOP is principally designed to provide retirement benefits. The benefit payout from a LESOP differs from that of the typical qualified retirement plan in that it can be totally in employer securities, in cash, or in some combination thereof.³⁷ This feature of a LESOP gives the plan participant some tax planning flexibility at the time of distribution. For example, where the plan participant does not need cash and his entire interest in the plan is distributed as employer stock in a lump-sum under the termination of employment or age 59-1/2 rules, the recipient incurs no tax on the stock's appreciation—only the value of the stock at the time it was contributed to the LESOP is included in

for professional services, and other amounts actually paid or made available with respect to any limitation year for personal services actually rendered. Foreign source earnings otherwise excluded from gross income under I.R.C. § 911 are nevertheless considered compensation for benefit and contribution limitation purposes. Compensation does not include deferred compensation, stock options, or other distributions that receive special tax benefits.

35. I.R.C. § 404(a)(3).

36. I.R.C. § 415(c), (d) provide that employer's contributions and forfeitures allocable to any employee's account for any year may not exceed the lesser of (a) \$25,000 as adjusted for cost of living increases or (b) 25% of compensation. Under I.R.C. § 415(c)(6), added by § 803(f) of the Tax Reform Act of 1976, the \$25,000 (as adjusted) limit in (a) above may be increased up to double that amount for ESOPs under which no more than one-third of the employer contributions for the year are allocated to officers, to more than 10% stockholders, or to employees earning more than double such limit (as adjusted). However, this increase in limitation may not be reflected in the denominator of the defined contribution plan fraction. I.R.C. § 415(e)(3) as amended by § 803(f) of the Tax Reform Act of 1976.

37. This gives the participant flexibility to plan the type of benefit he wishes to receive from the plan. For example, if the participant did not need cash and felt the company was a growth company, he might prefer to take the distribution in stock, thereby ensuring his participation in the future growth of the company.

the employee's taxable income upon distribution.³⁸ When the stock is subsequently sold, any taxable gain recognized on the sale is usually taxed at capital gain rates. This can result in a substantial tax saving, particularly where the corporation has prospered in the interim and its stock has increased in value.

A LESOP may be used to increase working capital by contributing unissued stock to the plan. This would give the corporation a tax deduction based on the value of the unissued stock contributed to the plan. An equal amount of income will be sheltered from taxation, resulting in an increase of working capital from dollars that otherwise would have left the corporation's cash account in the form of taxes.³⁹ For example, if a corporation's marginal tax bracket is 46%, and it contributes unissued stock worth \$100 to a LESOP, it would retain \$46 in its cash account that otherwise would have been payable to the government in taxes. Thus, the corporation's available working capital has been increased by \$46.⁴⁰

The LESOP's ability to borrow money to purchase qualifying employer securities can make it a useful financing tool. If the LESOP lacks sufficient assets to secure the loan, the employer corporation may guarantee the loan.⁴¹ The guarantee will usually take the form of the employer corporation's promise to make annual cash contributions to the plan that are sufficient to amortize the loan. When the corporation makes its contribution to the plan, it is in essence getting a tax deduction for both the principal and interest payments of the LESOP. If the corporation had borrowed the money directly, it would get an interest deduction but no deduction for the principal payment. Since the loan is being repaid through contribution to the LESOP, the corporation is, in effect, getting a tax deduction for repayment of funds borrowed for

38. I.R.C. § 402(a)(1), (e)(4)(J); Treas. Reg. § 1.402(a)-1(b), T.D. 6887, 1966-2 C.B. 130; Reg. § 1.402(a)-1(b)(i). Where the stock is received other than as a lump sum distribution, only the appreciation on employer stock attributable to the participant's own contribution is subject to tax deferral.

39. If the corporation had no taxable income or had an operating loss, the contribution to a LESOP, as a deduction against taxable income, could create or increase an operating loss, which may be carried backward or forward by the corporation. If carried back, it could result in a tax refund.

40. Although ERISA exempts ESOPs from its diversification requirements, ERISA § 404(a)(2), an ESOP is not exempt from the prudent investor rules. The language of ERISA § 404(a)(1) is clear that an ESOP is for the exclusive benefit of the employees or their beneficiaries and that the fiduciary in discharging his duty should do so solely for the benefit of the participants.

41. I.R.C. § 4975(d)(3).

its benefit.⁴²

A LESOP can be used to provide both lifetime liquidity for shareholders and post-death liquidity for estates of shareholders. Typically, the best markets for the stock of a closely held corporation are other shareholders, the corporation, or a LESOP. Selling the stock to other shareholders is often the easiest method of disposing of one's stock, if available. Funding such a sale is often difficult, however. Having the corporation redeem the stock is a viable alternative if the shareholder wants to terminate completely his interest in the corporation.⁴³ Where the shareholder wants only a partial redemption of his interest, however, he runs the risk of the redemption proceeds being treated as a dividend distribution.⁴⁴ For example, if common stock with a basis of \$30 was redeemed for \$50, the taxpayer would have \$50 of dividend income if the redemption was treated as a dividend distribution. On the other hand, he would have only \$20 of income taxable as capital gain if the redemption was treated as a sale of his interest. From a tax liability standpoint, assuming the taxpayer was in the 50% income tax bracket, he would have incurred a tax liability of \$25 if the redemption was treated as a dividend distribution, but a \$4 tax liability if it was treated as a sale.⁴⁵

If, in the above example, the shareholder had sold the same inter-

42. Treas. Reg. § 54.4975-7 (1977) imposes limitations on the use of borrowed funds. At all times the loan must be for the primary benefit of the LESOP participants and their beneficiaries. Also, the proceeds of an exempt loan may not be used to acquire life insurance policies. See FED. TAX COORDINATOR 2d (RIA) ¶ H-7205, at 27,209.

43. I.R.C. § 302. If the rules of § 302 are not complied with, cash or property paid by a corporation to a shareholder to redeem part of his stock may be treated as a corporate dividend and taxed to the shareholder as ordinary income. The tax rate on this type of income can be as high as 70%. In addition, the whole amount distributed is taxable, as a general rule. A redemption pursuant to § 302 will be treated as an "exchange" if it falls into any one of the following four categories: (1) a redemption that is "not essentially equivalent to a dividend;" (2) the redemption is substantially disproportionate; (3) the redemption terminates the shareholder's interest in the corporation; or (4) the redemption of the stock issued by railroad corporations in certain reorganizations. If the exchange does not fall within one of these four categories, then § 302(d) provides that the redemption is to be treated as a distribution equivalent to a dividend under § 301.

44. I.R.C. §§ 301, 302, 318. Section 318 sets forth constructive ownership rules that can cause a shareholder to be regarded as the owner of stock not actually owned by him, but owned by other persons or entities related to him, including certain members of his family, other corporations in which he owns at least 50% interest, trusts and estates of which he is a beneficiary, and partnerships of which he is a member.

45. The full amount of a dividend distribution is taxable; therefore, a taxpayer in the 50% bracket would incur a tax liability of \$25 on that dividend. Where the distribution is treated as a sale or exchange, the realized gain is the difference between the taxpayer's basis in the stock and the amount received, in this case \$20. Under the current rules for determining capital gains tax, only 40% of the \$20 gain realized on the transaction is recognized as taxable income. Thus, a taxpayer in the 50% bracket would incur a tax liability of \$4.

est to a LESOP, the transaction would have been treated as a sale of his interest. The main advantage of selling stock to a LESOP rather than to the issuing corporation is that the LESOP is treated as an unrelated party so that the redemption rules of section 302 do not apply, and the danger of having the redemption proceeds treated as a dividend distribution is avoided.⁴⁶

In addition to providing capital gain treatment, the sale of stock can have other results that are advantageous to a majority shareholder. Often a majority shareholder is the participant in the LESOP with the highest salary. As the LESOP acquires stock, it allocates that stock to the plan participants' accounts in the proportion that their salaries bear to the corporation's total payroll. If the majority shareholder has the largest salary, he gets the largest allocation. In essence, he is getting back part of the same stock he sold to the plan, which can then be "recycled" to fund his retirement. If he was to die before receiving his benefits, the value of his benefits under the plan can pass to his heirs estate-tax free.⁴⁷ Thus, the shareholder may obtain both income and estate tax savings through the proper use of a LESOP.

LESOPs can be useful in providing post-death liquidity in the estate of a decedent shareholder. Where the value of the shareholder's stock represents more than 50% of his estate (less debts, funeral and administrative expenses, and casualty losses), the corporation can redeem enough stock to pay taxes, funeral, and administrative expenses.⁴⁸ This type of redemption is treated as an exchange, and any

46. I.R.C. §§ 302, 318. On the issue of the applicability of the attribution rules of § 318, the IRS has resisted their nonapplication where a related party sells stock to an ESOP. In Rev. Proc. 77-30, 1977-2 C.B. 539, the IRS set forth conditions for obtaining a ruling on whether a sale of stock to an ESOP is entitled to capital gains treatment. Under the provisions of Rev. Proc. 77-30, an advance ruling will generally not be issued unless the following conditions have been satisfied:

- (1) The beneficial interest in the ESOP of the selling shareholder (and all related parties) does not exceed 20%;
- (2) Any restrictions on disposition of employer securities held by the plan are no more onerous than the restrictions on at least the majority of stock held by other shareholders; and
- (3) A representation is made that there is no plan for the employer to redeem any of the stock from the ESOP.

The IRS stressed in Rev. Proc. 77-30 that its position was only for ruling purposes and was not a matter of law. Therefore, while Rev. Proc. 77-30 is a consideration, the attribution rules of § 318 should, as a matter of law, override Rev. Proc. 77-30, thereby assuring the seller of capital gains treatment, provided, of course, that the transaction is in the best interests of the plan participants. Recently, the IRS in Rev. Proc. 78-23, 1978-34 I.R.B. 30, and Rev. Proc. 78-18, 1978-30 I.R.B. 13, has attempted to clarify Rev. Proc. 77-30.

47. I.R.C. § 2039(c), (3).

48. I.R.C. § 303.

taxable gain therefrom is generally taxable as capital gain.⁴⁹ If the estate cannot qualify for section 303 treatment, it may be able to structure the redemption pursuant to section 302, thereby obtaining exchange treatment.⁵⁰ The estate may find that selling the stock to a LESOP is a desirable alternative for several reasons: taxes, money, and control. The tax reasons are basically the same as in the lifetime situation previously discussed.⁵¹ Such a sale usually avoids having the redemption proceeds being treated as a dividend distribution. As to money, the LESOP may be the best vehicle to hold life insurance on the participants, particularly key man insurance.⁵² Where a corporation owns a life insurance policy on a key employee, it normally cannot take a tax deduction when it pays the premium.⁵³ If a LESOP holds the policy, however, and part of the corporation contribution to the LESOP is used to pay the premium, the premium payment becomes fully deductible by the corporation.⁵⁴

Control is another important consideration in selling stock to a LESOP. The LESOP can be used to buy out a shareholder's interest or to transfer control of the corporation. For example, assume that A is the sole shareholder of a corporation. He has two children—one who wants to continue the business and the other who does not want to be involved. A could bequeath one half of his interest to the active child and one half of his interest to the inactive child. Then the inactive child's interest could be redeemed by the LESOP. The result is that the active child has control of the corporation and the inactive child has cash. The same approach could be used to transfer control of the business to minority shareholders. The variables of the above example are

49. I.R.C. § 303.

50. I.R.C. § 302.

51. See notes 48-49 *supra* and accompanying text.

52. A LESOP may invest in life insurance policies on the lives of the plan participants, but under Treas. Reg. § 1.72-16(b)(1), the participant is taxed currently on the cost of the life insurance protection if the proceeds are either (1) payable to the participant's estate or beneficiary; or (2) payable to the trustee of the plan but the trustee is required by a provision in the plan to pay them to the employee's estate or beneficiary. However, under Treas. Reg. § 1.72-16(b)(6), the insured is not taxed on the insurance cost if the plan has the right to retain any part of the death proceeds. Thus the insured will not be taxed where the plan purchases key man insurance as a plan investment.

53. I.R.C. § 264(a)(1) expressly provides that no deduction shall be allowed for premiums paid on any life insurance policy covering the life of any officer or employee, or the taxpayer corporation, or any person financially interested in the taxpayer's business who is either directly or indirectly a beneficiary under the policy.

54. The premium is deductible as a contribution to the LESOP, not as a premium payment.

limited only by the estate planner's imagination and his factual situation.

The advantage to acquiring control in this manner is that the transaction is funded with pre-tax dollars. If the child or the employee was to buy the stock directly, he would have to pay the purchase price with post-tax dollars. If he was in a 50% tax bracket, he would have to earn two dollars of income for every one dollar of purchase price paid. Where the corporation redeems the stock, it too funds the transaction with post-tax dollars. By using a LESOP, the purchase price is funded with pre-tax dollars, resulting in a smaller cash outlay for the corporation to buy the stock. In addition, the use of a LESOP avoids the problem of the transaction being treated as a dividend distribution.

The LESOP offers, through a variety of tax-advantageous maneuvers, the means to accomplish corporate acquisitions, mergers, and divestitures. For example, the employer corporation can use funds derived from sale of its stock to a LESOP to acquire another corporation. If the corporation desires to acquire another corporation or merge with it, it could buy a small amount of stock in said corporation, followed by a LESOP being established by the acquired corporation to purchase the remaining stock. This would leave the acquiring corporation in control of the acquired corporation. Where a corporation desires to dispose of part of its business, the selling corporation could organize a new subsidiary. The subsidiary could then establish a LESOP which, with borrowed funds, could buy stock from the subsidiary. The subsidiary, in turn, would purchase the part of the business to be disposed of. At this point the subsidiary could either operate the acquired business or be acquired by another corporation for cash or in a tax-free reorganization.⁵⁵ The development of the details of these transactions is beyond the scope of this article; however, the possibilities do exist and should be considered in appropriate circumstances.

IV. CONCLUSION

The ideal candidate for a LESOP is a profitable, closely held corporation with a small number of shareholders, little debt, substantial assets, and non-union employees. The LESOP allows the corporation

55. Section 368 provides a complex set of rules for acquiring the stock or assets of another corporation which is treated as a tax-free reorganization. For example, if pursuant to § 368(a)(1)(B), voting stock of one corporation is exchanged solely for voting stock of another corporation, no taxable income will result. Normally, in this type of transaction, one corporation will become the subsidiary of the other.

to use its own securities to defer taxes, thereby increasing the amount of capital available for expansion of the business. By shifting some of the fruits of the production of wealth derived from capital back to labor, it can be used as an incentive for employees to take a greater interest in the employer's success and the benefits therefrom. It can also be used as a device to transfer control of a business and is, perhaps, the most practical means of keeping a family business in the family. In sum, the LESOP can perform desirable socio-economic functions by giving the independent business person and his employees the means to maintain their positions in the business community.