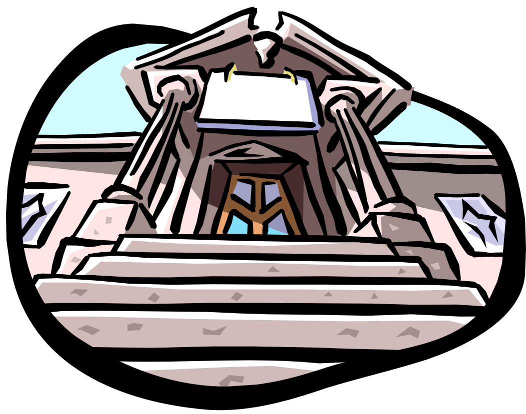

THE ESOP ADVISOR

Be Careful to Preserve Beneficial Taxation of ESOP Stock Distributions

The Employee Benefits Group

The IRS recently issued a ruling[1] that shows how to preserve beneficial tax treatment of a lump-sum ESOP stock distribution that is not rolled over to an IRA. The guidance is very important to anyone involved in administration of an ESOP.

The ruling considered an ESOP maintained by a private company. Under the terms of the ESOP, when a former employee received a distribution from the plan, the payment would be made in the form of company stock. The employee then had a right to immediately sell the stock ("put option") to the employer. If the employee elected an immediate sale of stock, a stock certificate would be prepared in the name of the employee for the shares in the employee's account, but the stock certificate would not be distributed to the employee. Instead, the certificate would be cancelled, and the employer would pay the purchase price in cash to the employee.

A local IRS office took the position that the payment to the employee was actually a distribution of cash, rather than a distribution of stock. If the distribution is rolled over to an IRA, the issue is irrelevant because there is no current tax to the employee. However, if the employee does not roll over the benefit to an IRA, the current tax treatment is very different, depending on whether the distribution is made in cash or stock.

If the distribution is made in cash, the employee simply reports the total value of the payment as ordinary income and pays income taxes accordingly. However, if a lump-sum distribution is made in the form of employer stock, and the employee sells the stock, the "net unrealized appreciation" while the stock was held by the ESOP is taxed as a long-term capital gain. The "net unrealized appreciation" is the excess of the market value of the stock at the time of the distribution to the employee over the cost or other basis of the stock to the ESOP. Here's an example:

> Assume that shares were acquired by an ESOP for $10 per share. When an employee terminates employment, assume he has 5,000 shares of employer stock in his ESOP account, which are currently valued at $50 per share. If he receives a cash distribution of $250,000, and he does not rollover to an IRA, he will report the total amount as ordinary income.
>
> However, if he receives a distribution of the 5,000 shares, elects to sell the stock and does not rollover to an IRA, only $50,000 will be reported as ordinary income ($10 cost basis to the ESOP x 5,000 shares). He can report the "net unrealized appreciation" of $200,000 as a long-term capital gain ($40 x 5,000 shares).
>
> If the employee is under age 59½ there may also be a 10% additional tax on the value of the distribution. However, if the employee is at least age 59½, this method of taxation will be very beneficial if the current stock value includes a substantial "net unrealized appreciation."

[1] Technical Advice Memorandum 200841042

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So, what can we learn from this IRS ruling?

1. It is important to make ESOP stock distributions very carefully, so that the special taxation method is preserved for a former employee who wants to report the "net unrealized appreciation" as a capital gain and pay a lower rate of tax, in lieu of an IRA rollover.

2. It is not necessary to physically distribute a stock certificate to the former employee, if he immediately sells the stock back to the employer. However, it is crucial that the ESOP, the distribution documents and the operating procedures clearly provide that the employee is receiving stock from the ESOP and is immediately selling the stock to the employer.

3. The ruling DOES NOT consider the situation where the ESOP itself purchases the stock from the terminated employee, instead of a purchase by the employer. There is some language in the ruling that implies a sale back to the ESOP would not be eligible for the special method of taxation without first issuing the stock certificate to the employee. Therefore, if the ESOP is purchasing the stock from a terminated employee, and the employee will not be rolling over to an IRA, best practice would be to actually issue a stock certificate to the terminated employee which will then be immediately sold back to the ESOP.

4. What your ESOP and the distribution documents say (and don't say) can be crucial in preserving beneficial tax advantages for the ESOP participants. Those administering the ESOP may have a fiduciary duty to assure the special taxation method is preserved. Your ESOP and distribution documents should be reviewed in light of this IRS ruling.

If you would like to learn more about ESOP distributions, please contact Vern Saper at Warner Norcross & Judd at 616.752.2116 or at vsaper@wnj.com, or Justin Stemple at 616.752.2375 or at jstemple@wnj.com.

EDITOR'S NOTE: This mailing from the Warner Norcross & Judd LLP Employee Benefits Group is being e-mailed to current WN&J ESOP clients, clients who have expressed interest in ESOPs, and other ESOP professionals and interested parties. If there are others within or outside your organization who might benefit from this newsletter, please send their names, organizations and e-mail addresses to vsaper@wnj.com and we will add them to our mailing list.

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