RETIREMENT TAXATION UPDATE

UNDERSTANDING EMPLOYEE STOCK OWNERSHIP PLANS

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I. WHAT'S AN ESOP?

A. The Legal Framework

1. A tax qualified defined contribution plan much like a profit sharing plan or a stock bonus plan.

    a. With special features to permit it to borrow funds (including from a party-in-interest).

    b. Contribution discretionary from 0 up to 25% of covered compensation.

    c. Contribution not limited by profits of employer corporation.

    d. ESOPs <u>cannot</u> be integrated with social security benefits for contribution allocation purposes.

    e. Differ in being able to buy employer stock and not worry about diversification or prohibited transaction aspects of stock acquisition (initial stock purchase must still be "prudent").

    f. No "fair return" from investment required from investment in employer stock.

    g. Stock bonus plans--ESOPs differ in being able to do borrowing and leveraged funding without becoming subject to excise tax on prohibited transaction if loan involves the loan from or guarantee of a party-in-interest.

    h. Benefits must be distributable in whole shares of employer stock.

        (1) Some exceptions exist.

    i. Voting rights on non-publicly traded shares need to be extended to participants only for unusual circumstances.

        (1) For example, mergers, consolidations, sales of substantially all assets (but not election of Board of Directors).

    j. ESOPs now have other benefits created over recent years not available to stock bonus plans (e.g., leveraging, § 1042, etc.).

2. Benefits to Employees Provided by Legal Framework

    a. Employees are not taxed on amounts contributed to the ESOP nor on earnings of the ESOP until they actually receive distributions (except for dividends distributed).

b. A distribution of employer securities is not subject to the 20% mandatory withholding rules.

c. An ESOP can provide employees with a significant retirement income primarily through appreciation on employer stock.

d. An employee can share to some extent in the success of his employer by virtue of his stock ownership through ESOP participation.

e. If the participant receives a "lump sum payment" which includes employer stock, the stock value increase from date of allocation to participant's account can be deferred upon distribution (gain above this amount will be taxed as a capital gain).

3. Benefits to Shareholders

a. An ESOP can create a ready current market for the stock of a major shareholder and thus provide liquidity not otherwise available.

ESOP stock acquisitions are made with pre-tax $, obtained generally from (i) annual deductible employer contributions; or (ii) loans received by the ESOP and usually guaranteed by the corporation.

b. An ESOP can provide a future market for stock held by the estate of a deceased shareholder.

c. Life insurance on key-man shareholders can be made tax deductible by having the ESOP buy and hold the policy which will provide liquidity for the future purchase of stock.

d. Capital gain treatment is made available even though the purchase price comes from corporate contributions or corporate guaranteed loans.

4. Benefits to Employers

a. Employer contributions to an ESOP, whether in stock or cash, are tax deductible by the employer.

(1) Merely issuing a stock certificate can provide needed tax deductions!

b. If the company decides to pay dividends, the dividends paid to the ESOP are tax-deductible to the corporation:

(1) If the dividend is actually distributed to ESOP participants within 90 days following the end of the plan year; or

(2) If the dividend is used to help repay a loan made to the ESOP; or

(3) Beginning this year an employer will be allowed to deduct dividends paid to an ESOP if participants are permitted to receive the dividends in cash or leave them in the plan to be invested in company stock.

c. An ESOP can provide an incentive for key employees to remain with the company by providing them with indirect stock ownership.

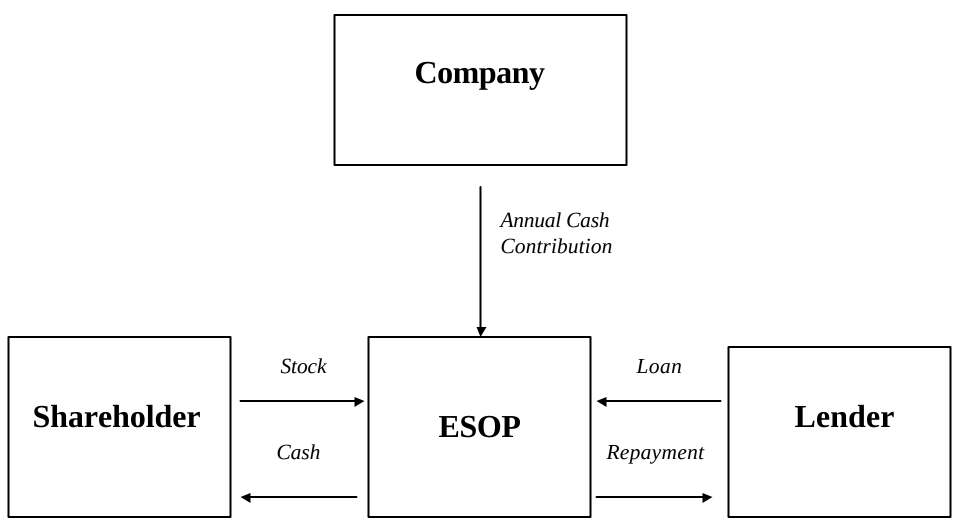
d. Well-designed and communicated plans can have a great effect on employee morale and produce increased effort to provide a greater profit for all.

e. Acquisitions of other businesses can be made on a pre-tax basis.

f. One of the biggest benefits an ESOP can offer a corporation is the ability to provide a method for financing and increasing working capital with pre-tax dollars used to repay the loans supplied to the ESOP by outside lenders.

g. ESOP ownership of an S Corporation can permit the business to operate as a tax free entity.

Leveraged ESOP
Purchase of Existing Shares from Shareholder



II. OVERVIEW OF SIGNIFICANT CHANGES IN THE ESOP LEGAL FRAMEWORK IN THE LAST FEW YEARS

A. Pre-TRA'86 Changes

1. Tax deferral on sale of stock to an ESOP, A BIG DEAL!

   a. Seller must have held shares for at least 3 years prior to sale to ESOP (a 1989 Tax Act requirement).

   b. Must reinvest proceeds in US securities.

   c. At least 30% of outstanding stock must be owned by ESOP after sale to qualify.

   d. Thereafter, selling participant/shareholder (or his family) or any other 25% shareholder cannot share in allocations for 10 years following sale.

   e. Election required by selling shareholder. 10% Excise Tax imposed if stock disposed of within 3 years of acquisition (tax imposed on corporation) except for participant distributions because of death, disability, certain corporate reorganizations or post-59½ retirement.

   f. State Income Tax deferral also available.

   See Section VI for more details!

2. Deductions allowed for dividends paid to ESOP:

   a. Dividends must be distributed to participants within 90 days of end of plan year.

B. TRA '86 Changes

1. Dividend deduction broadened

   a. Dividends paid to an ESOP and used to repay a loan are deductible to corporation (making it possible to repay larger loans or repay loans faster).

      (1) Payments are not annual additions under IRC § 415. Helps where corporation has high value but low payroll.

2. Stricter appraisal rules

   a. Independent appraisal required for ESOP stock--must now have "fair market value" determined by independent, outside appraiser.

b. Diversification of assets

c. For stock acquired after 12/31/86, at age 55, employees with 10 years of participation in the ESOP can require the company to distribute 25% of their account balances to them or to offer them three diversified investment options within the plan for this amount.

d. At age 60, the percentage increases to 50%.

3. Distributions to participants

a. Unless the participant elects otherwise, distribution of stock acquired after 12/31/86 must begin not later than one year after the close of the plan year in which the participant separates from service by reason of attaining normal retirement age, disability or death or the fifth plan year following the plan year in which the participant otherwise separates from service.

4. Slight relaxation of rules after a tax-deferred sale to an ESOP

a. TRA '86 permits lineal descendants of individuals taking advantage of rollover of gain on ESOP stock sales to receive an ESOP allocation to extent of 5% of stock sold.

C. Small Business Job Protection Act of 1996

1. Permits S Corporations to maintain ESOPs effective in 1998 but ESOP trust would be taxed on S corporation income.

D. Taxpayer Relief Act of 1997

1. Eliminates tax to ESOP trust on S corporation income.

2. Permits ESOP to assume estate tax liability on closely held company stock by transfer to ESOP from charitable remainder trust of shares in corporation.

E. EGTRRA

1. See S Corporation discussion in Section IV.

2. Expanded § 404(k) dividend deduction for dividends invested into company stock by participant under 401(k) feature of ESOP.

III. USE OF CONVERTIBLE PREFERRED STOCK WITHIN THE C CORPORATION ESOP LEGAL FRAMEWORK

A. In General

A design technique being used with increasing frequency involves the ESOP's purchase of convertible preferred stock. Using convertible preferred stock with a floor value can help "lock in" minimum values when trying to provide a certain level of benefits under an ESOP. In addition, the use of convertible preferred may permit a higher rate of dividends for IRC § 404(k) deductibility purposes as well as avoids the requirement of paying dividends to all shareholders (especially where dividend payments will not be fully deductible to the company such as where non-ESOP shareholders exist).

IRC § 409(l)(3) permits the use of convertible preferred if the following conditions are met:

1. It is convertible at any time into common stock which otherwise meets the IRC § 409 requirements.

2. The conversion price must be "reasonable" as of the date of acquisition; and

3. If callable, there must be a reasonable opportunity to convert after the call.

B. Structuring the Convertible Preferred

Structuring the convertible preferred is commonly left to the domain of the attorney and valuation consultants. Factors to consider in designing the security include voting rights, dividend rights, liquidation preferences, redemption provisions, call provisions, conversion terms and premiums, and valuation.

IV. THE ESOP OWNED S CORPORATION

A. What Made the S Corp ESOP Popular?

According to the ESOP Association statistics, nearly 60% of the approximately 400 100% ESOP-owned companies in America and many partially ESOP-owned companies have converted to S Corp status in or after 1998. Why?

Prior to 1998, it was not possible for S Corporations (which are not subject to a corporate level tax, but taxed at the individual shareholder level) to sponsor employee ownership through an ESOP.

- The Small Business and Job Protection Act of 1996 (effective for the taxable years beginning after December 31, 1997) allowed qualified retirement plan trusts to own stock in an S Corporation.

- Downfall: The retirement trust, even though it was tax exempt, had to report "unrelated business taxable income" (UBTI) on its S Corp holdings. For example, if the S Corp ESOP owned 1% of the S Corp and if the S Corp reports a net income of $100,000, the trust would have $1,000 worth of taxable UBTI.

- This income tax was in keeping with the underlying premise of subchapter S that all income is subject to tax. However, the UBTI imposed on S Corp ESOPs resembled the corporate double tax since not only would the trust be subject to tax, so would the participants when distributions were made from the trust.

- The 1997 Taxpayer Relief Act amended the UBTI rules and eliminated the ESOP's tax on its portion of the income earned by the S Corp. An ESOP's share of the income earned by its S Corp sponsor is not taxed until distributed to the employee participants of the ESOP.

- Most states (including California, except to 1.5%) have adopted legislation conforming to the Federal ESOP UBTI exemption.

B. Result of the Elimination of UBTI

Some S Corporations may be wholly owned by an ESOP, so that none of the S corporation's income is subject to current tax. Taxable income can be deferred for many years. Only when the money is paid out to ESOP participants will it be subject to personal income tax.

C. S Corp Requirements

- S Corps can only have one class of stock. S Corps are permitted to have one class of voting and one class of nonvoting common stock. However, if the ESOP acquired its shares with an acquisition loan, the ESOP must hold the shares of the voting class.

- An S Corp may only have 75 shareholders. Certain types of entities are not eligible shareholders of an S Corp, such as C Corps, partnerships, IRAs, certain types of trusts. The ESOP is treated as one shareholder regardless of the number of participants.

- S Corp ESOP participant distributions can be made in cash, not in company stock. S Corps therefore do not have to worry about dispersal of ownership.

D. S Corp ESOPs Lack Some C Corp ESOP Benefits

- An S Corp is not eligible to deduct dividends paid on ESOP shares under IRC § 404(k).

- Beginning in 2002, the S Corp ESOP contribution deduction limit has increased to 25% of payroll, but is inclusive of the interest portion on a leveraged transaction (unlike a C Corporation ESOP where a 25% of payroll contribution is allowed, plus the interest expense).

- Shareholders of an S Corp are not able to defer tax on their gains if they sell S Corp shares to an ESOP (Code § 1042 election). However, there is nothing currently in the tax code which would result in tax being owed if shareholders of a C Corp sold their stock to the ESOP, elected the § 1042 tax deferral and then the company converted to an S Corp.

E. EGTRRA S Corp Anti-Abuse Rules

Any S Corporation sponsoring an ESOP must now meet a two-part test measuring the ownership of:

- The Company
- The Deemed Owned Shares

1. If the Test Is Failed – A Non-Allocation Year Results

   - Non-Allocation Year occurs when "Disqualified Persons" as a group own 50% or more of the outstanding shares of the S Corporation (at any time during the year).
   - "Deemed Owned Shares" are included as outstanding shares in the ownership percentages.
   - Synthetic Equity is included in the tests only if, by doing so, it creates a Non-Allocation Year.

2. Disqualified Persons

   - *Deemed 10% Shareholder* - The individual holds or has a right to at least 10% of the Deemed Owned shares in the S Corporation.
   - *Deemed 20% Shareholder Group* - The individual and his family members hold or have a right to at least 20% of the Deemed Owned Shares in the S Corporation.
   - Note: Synthetic Equity interests are included in the calculation if by doing so it would create disqualified persons.

3. Deemed Owned Shares

   - Stock allocated to the ESOP account of the individual; plus

- The individual's share of the unallocated stock in the ESOP as if it was allocated in the same way as the most recent allocation in the plan (most likely based on eligible compensation); plus

- Synthetic Equity held by the individual.

4. Synthetic Equity Interests

- Stock options

- Warrants

- Restricted stock

- Deferred issuance stock rights

- Similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future

- Also includes stock appreciation rights, phantom stock units, or similar right to a future cash payment based on the value of such stock or appreciation in such value

5. Family Members

- Spouse

- Ancestors and lineal descendents of the individual or his or her spouse

- Sibling of the individual or the individual's spouse

- Lineal descendants of the brother or sister

- Any spouse of anyone already mentioned

6. Ramifications of Failing the Test

- Excise tax of 50% of the amount of any allocation to Disqualified Persons

- Excise tax of 50% of the Synthetic equity held by Disqualified Persons

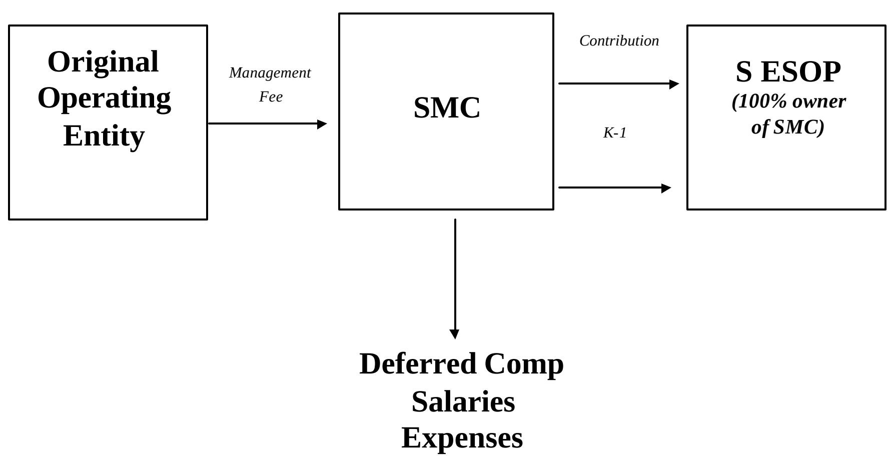
- The amount allocated to an individual who is a disqualified person is treated as distributed and included in the taxable income of such individual

7. Effective Dates of the Provision

- Provisions apply for existing plans as of March 14, 2001, for plan years beginning after December 31, 2004.
- For ESOPs established or "S" elections made after March 14, 2001, the effective date is plan years ending after March 14, 2001.

F. S Corp Planning Opportunities—Post EGTRRA!

The S Management Corporation (SMC) ESOP



CAVEAT – This concept has recently been under attack by national ESOP trade organizations who fear the concept will result in a backlash of negative ESOP related legislation since the belief is that these programs primarily benefit key management. We believe these arrangements, if properly structured and operated, can comply with current law. The major areas of concern are (1) deductibility of management fee; (2) whether ESOP participants are getting a substantial and recurring contribution under the ESOP; and (3) constructive receipt on the deferred compensation.

V. CONVERSIONS TO ESOPs

The conversion of an existing retirement plan to an ESOP holds its own set of design and legal issues. Apart from the § 411(d)(6) issues relating to the prohibition on the cutback of certain accrued benefits by plan amendment, the primary issue facing practitioners in the design of an ESOP as a conversion from an existing plan is the disposition of pre-ESOP assets.

Since the decision in *Eaves v. Penn*, 587 F.2d 453 (CA-10 1978), plan sponsors have been apprehensive about the propriety under ERISA of using the assets of an existing plan, which has been invested in a diversified portfolio, for the purchase of qualifying employer securities. The *Eaves* case established a need for extreme caution when facing the decision as to the investment of pre-ESOP assets.

The obvious solution under *Eaves* would be to give the participants a choice as to whether each participant desired his account balance invested in qualifying employer securities under the new ESOP. Historically, this choice was viewed as requiring an investment decision on the part of the participant, invoking the securities laws and registration requirements.

In an attempt to clarify the matter, the SEC had issued no-action letters which make it clear that no securities offering is involved where participants in a non-contributory plan are given a choice limited to whether or not they wish to invest their pre-ESOP account balances in stock purchased by the ESOP where such accounts represent exclusively employer contributions. It is important to note that these no-action letters characterize the transaction as not involving an offering of securities, rather than as an offering subject to a registration exemption (see SEC Release Nos. 33-6188 and 33-6281). State securities laws must be complied with. As a result, at a minimum, employees making this decision will need to be provided adequate disclosure documents such as a prospectus.

Another method designers may use to limit fiduciary exposure for using pre-ESOP assets to purchase employer securities would be to recommend that only a portion of the pre-ESOP accumulations (e.g., 25-50%) be used for this purpose.

VI. TAX DEFERRAL ON STOCK SALES TO ESOPs

A. Section 1042 Requirements

General rule no gain recognized by a taxpayer (other than a C Corporation) on sale of "employer securities" to an ESOP:

1. Immediately after the sale, the ESOP owns at least 30% of either each class of outstanding employer stock (other than certain nonvoting, non-convertible preferred stock), or the total value of all employer securities (other than certain nonvoting, non-convertible preferred stock) of the corporation that issued the qualified securities; and

2. Within a 15-month period beginning 3 months prior to the date of sale, "qualified replacement securities" are purchased by the seller.

3. Temporary Treasury Regulations § 1.1042-1T (Q & A: 2(b)) provides that, for purposes of the 30% requirement, sales of qualified securities by two or more taxpayers may be treated as a single sale if such sales are made as a part of a single, integrated transaction under a prearranged agreement between the taxpayers.

B. Important Rules Governing Operation of Section 1042

1. The 30% ownership test is to be applied after application of some of the attribution rules of IRC § 318.

   a. IRC § 318(a)(4) -- Options to buy stock.

   b. IRC § 318(a)(2) -- Attribution from partnerships, estates, trusts and corporations.

2. Tax-free treatment must be elected by a taxpayer or his executor in writing on a timely-filed return (including any extensions) for the taxable year of sale, including a written statement of the employer whose employees are covered by the ESOP consenting to application of the provisions of IRC § 4978(a) to that employer.

3. Temporary Treasury Regulations § 1.1042-1T (Q & A: 3) sets forth in detail the procedure for making the "statement of election" with Form 1040 filed on or before the due date (including extension of time) for the taxable year of the sale and a notarized "statement of purchase" within 30 days after the purchase of each item of qualified replacement property.

4. IRC § 1042(d) provides that the seller's basis in qualified replacement securities is adjusted by the amount of gain not recognized by reason of the election. If the replacement securities are held at death, a stepped-up basis will be permitted under IRC § 1014. An immediate sale of the replacement securities following death may permit total avoidance of income recognition.

5. If the cost of the replacement securities is less than the amount of the sales proceeds, the difference is currently taxable.

6. If the taxpayer elects non-recognition treatment, the holding period of the employer securities sold will be "tacked on" to the holding period of the replacement securities (for capital gains purposes).

7. In the case of an individual who sold "qualified securities" to an ESOP, the executor of the decedent's estate is eligible to elect to defer the recognition of gain, if any, realized on the sale, to the extent that the proceeds are invested by the executor in qualified replacement property and the other conditions of IRC § 1042 are satisfied.

8. A special three-year statute of limitations applies if rollover treatment is elected, under which a deficiency in tax may be assessed <u>within three years after the date of receipt</u>, by the District Director of Internal Revenue or the Director of Regional Service Center with whom the statement of election was originally filed, of:

a. A notarized statement of purchase of replacement securities;

b. A written statement of the taxpayer's intention not to purchase qualifying replacement property within the replacement period; or

c. A written statement of the taxpayer's failure to make such purchase within the replacement period.

9. Definition of "employer securities" (IRC § 1042(c)(1)) qualified for tax-free rollover includes:

   a. Common stock (or certain convertible "non-callable" preferred stock) with voting and dividend rights at least equal to the classes of common stock having the greatest dividend and voting rights.

   b. Issued by a domestic corporation with no securities outstanding that are readily tradeable on an established securities market, whether or not the corporation or any member of the controlled group has outstanding any readily tradeable debt securities.

      Temporary Treasury Regulations § 1.1042-1T (Q & A: l(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 that is readily tradeable on an established securities market.

   c. Have been held by the seller for at least three years, and are otherwise eligible for long-term capital gain treatment.

   d. Not received by the seller in a distribution from a qualified retirement plan or a transfer under an option or other right to acquire stock granted by the employer corporation.

10. Definition of "qualified replacement property" under IRC § 1042(c)(4) (which may consist of more than one piece of property):

    a. "Securities," i.e.:

       - Stock;
       - Rights to subscribe for, or to receive, stock; or
       - Bonds, debentures, notes, certificates, or other evidence of indebtedness, issued with interest coupons or in registered form;
       - But, excludes securities issued by a government or political subdivision thereof (<u>no municipal bonds</u>).

b. Issued by a domestic operating corporation (i.e., one whose assets are used in the active conduct of a trade or business) other than the corporation that issued the stock involved in the non-recognition sale and its controlled group members.

(1) To be considered an operating corporation, more than 50% of the corporation's assets must be used in the active conduct of a trade or business during the replacement period and that financial institutions and insurance companies are treated as an operating corporation.

c. Issued by a corporation with no passive investment income over 25% of the gross receipts for the preceding taxable year. "Passive income" has the same meaning as under the S Corporation rules (mutual funds will not qualify).

d. Does not include securities issued by a corporation which is a member of the same controlled group of corporations as the corporation that issued the qualified securities sold to the ESOP.

e. Not acquired by gift, inheritance, or property transfer pursuant to a stock dividend (Temporary Regs § 1.1042-1T (Q & A: 1(e)).

11. IRC § 1042(c)(3) defines "replacement period" as the period which begins 3 months before the date on which the sale of qualified securities occurs and which ends 12 months after the date of such sale.

12. Disposition of qualified replacement property.

a. Results in pro-rata recognition of deferred gain (IRC § 1042).

b. Exceptions to gain recognition upon disposition exists for transfers which occur (IRC § 1042(e)(3)):

- In any controlled, non-taxable reorganization;
- By reason of the death of the taxpayer who made the IRC § 1042 election;
- By gift; or
- In any transaction to which a new election under IRC § 1042 is made (i.e., sale of replacement securities to ESOP followed by new purchase of "qualified replacement property").

c. The amount of gain required to be recognized is limited to the amount not recognized pursuant to the election provided by the tax-free rollover provisions; any gain in excess of that amount continues to be eligible for any otherwise applicable tax-free rollover treatment.

d. If a taxpayer owns stock representing control of the corporation issuing the qualified replacement property, the taxpayer shall be treated as having disposed of such property when that corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business (IRC § 1042(e)(2)).

13. If the ESOP disposes of employer securities acquired in a transaction in which the seller elects § 1042 treatment within three years after acquiring them, a 10% (of the amount realized on sale, exchange, distribution or other disposition) excise tax is imposed under IRC § 4978 on the employer. There is no tracing, the excise tax applies if, within the three-year period, there is a disposition of any employer securities; and

a. The total number of shares held by the ESOP after the disposition is less than before the disposition; or

b. Except as provided in future regulations, the value of the employer securities held by the plan falls below 30% of the value of all employer securities as of the date of the disposition.

Exceptions

- Distributions to employees are not counted if they are made by reason of:
  - Death (IRC § 4978(d)(1)(A))
  - Retirement after age 59½ (IRC § 4978(d)(1)(B))
  - Disability or other separation from service (but only if it results in a one-year break in service) (IRC § 4978(d)(1)(c))
  - Any exchange of qualified securities in any tax-free corporate reorganization described in IRC § 368(a)(1) for stock of another corporation (IRC § 4978(d)(2))

14. Prohibited allocation rule (IRC § 409(n)).

a. No portion of the assets attributable to qualified securities with respect to which a tax-free rollover election is made may be allocated to:

(1) The taxpayer seeking tax-free rollover treatment.

(2) Any person who is related to that taxpayer; or

(3) Any other person that owns more than 25% of the value of any class of qualified securities of the corporation that issued such qualified securities or the total value of stock of certain related corporations or their family members.

b. IRC § 4979A provides for an excise tax of 50% of the amount of any allocation in violation of the prohibited allocation rule (on the Employer) as well as immediate taxation of the Participant who received the prohibited allocation.

c. This restriction applies to prohibit any direct or indirect accrual of benefits (under the ESOP or any other plan of the employer) or an allocation of assets attributable to qualified securities involved in the tax-free rollover transaction.

(1) A participant's right to previously accrued benefits, including the right to increase vesting in such benefits is not affected by this rule, nor is the allocation of earnings to account balances to be treated as an allocation prohibited under this rule.

(2) Prohibited allocation period limited to the period beginning on date of sale and ending on the later to occur of ten years after the sale or the date on which the purchased shares are last allocated from a leveraged transaction (IRC § 409(n)(3)(c)).

(3) Stock owned by lineal descendants of a selling shareholder will not disqualify the descendants if such descendants are allocated not more than 5% (in the aggregate) of the employer securities held by the ESOP which are attributable to a sale to the ESOP by any person related to such descendants in a transaction to which IRC § 1042 applied (IRC § 409(n)(3)(A)).

(4) However, if the seller still directly owns more than 25% of the outstanding stock of the employer, the lineal descendant, through attribution, under IRC § 318 will be considered a 25% shareholder and thus subject to the penalties under IRC § 409(n)(2).

(5) Clarification is provided that an individual is a 25% shareholder for purposes of the rule if the individual owns (after attribution) more than 25% of either any class of outstanding stock of the corporation that issued the employer securities or the total value of any outstanding stock of the corporation. The attribution rules are applied

without regard to an employee trust exception and the time as of which the individual's status as a 25% shareholder is to be determined is the one year period ending on the date of sale to the ESOP or the date the securities are allocated to ESOP participants (IRC § 409(n)(3)(B)).

d. Under IRC § 409(n), qualified securities which are allocated in violation of the prohibited allocation rule will be treated as having been distributed to the person to whom such allocation is made (requiring immediate income recognition).

VII. SPECIAL ADVANTAGES OF 401(k)/ESOP (KSOPs)

A. Matching Contributions

Matching contributions can be made in the form of employer stock. This permits the company to retain the cash it would otherwise use for matching contributions for other corporate purposes. In other words, the employer's matching contribution requirement is satisfied without cash. The corporation receives a tax deduction for the fair market value of the stock contributed generating additional cash flow at the corporate level.

A match in the form of employer stock also permits participants to electively increase their stock ownership by obtaining a stock match on their 401(k) salary deferral.

B. Deductibility of Dividends

If the plan also meets the ESOP requirements of IRC § 4975(e)(7), dividends paid to participants and their beneficiaries on shares of company stock allocated to their accounts are deductible if paid to them by the end of the company's taxable year or if paid to the trust by the end of such year and paid within 90 days thereafter to the participants and beneficiaries. The dividend is now also deductible if directed by the participant to be used to acquire employer securities. This dividend deduction is not available to a non-ESOP 401(k) plan which may be holding employer securities.

C. Participants' Tax Deferral on Dividend Payments

Dividends paid on employer stock held by an ESOP and normally distributable to the participants may be deferred, at the participant's election, into the 401(k) portion of the KSOP on a currently tax deferred basis. The IRS approved of this use of the KSOP in private letter ruling 8637097.

D. IRC Section 1042 Tax-Free Rollover for Privately Held Companies

Under certain conditions, the gain on sales of employer securities in a privately held company to a plan meeting the requirements of IRC section 4975(e)(7) may be deferred. Employees' 401(k) deferrals may be used to acquire a portion of the shares (if SEC registration made or exemption exists).

E. Source of Corporate Capital

Funds contributed by employees may be used to buy company stock from the company and thereby create working capital. Again, securities law compliance issues arise.

F. Use of Employee and Matching Contributions - Non-Leveraged ESOP

Funds accumulated under KSOPs, including employee deferrals, may be used to acquire stock either from the company or from a selling shareholder. The use of the employees' deferrals for the stock acquisition permits the employees to acquire company stock on a pre-tax basis, as opposed to using after tax dollars in the traditional stock purchase situation.

Federal securities laws provide, primarily under SEC Rule 701, an exception from the general registration requirements for stock sales to employee benefit plans, including KSOPs. However, state securities laws must still be complied with.

G. Ease of Administration

Combining the 401(k) plan with an ESOP will permit consolidated annual filings (5500 series) for the plan and eliminate the need for a separate audit (required of trusts with over 100 participants) as would be the case if a 401(k) plan and an ESOP were maintained separately.

VIII. CONCLUSION

A. Very few concepts are as useful in as many different planning circumstances as an ESOP!

B. ESOPs create new opportunities for employee ownership, shareholder liquidity, corporate financing, and tax planning opportunities.