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IRS Cautions Plan Sponsors of ESOPs

by R. Sterling Perkinson

As part of SECURE 2.0, Congress directed the Department of Labor to develop an employee ownership initiative to encourage and incentivize employee ownership in the companies they work for. Last month, the Department of Labor launched the Employee Ownership Initiative to support and promote worker ownership arrangements. On Wednesday, however, the IRS published News Release 2023-144 (the "News Release"), warning businesses and tax professionals of certain transactions involving a form of employee ownership: Employee Stock Ownership Plans, or ESOPs. The IRS stated in the News Release that it is concerned that ESOPs can be used by high-income taxpayers as a tax avoidance tool, and so ESOPs will be an area of focus for the agency.

ESOPs are employee benefit plans subject to provisions of the Tax Code and ERISA. These plans primarily invest in qualifying employer securities. Shares purchased by an ESOP are held in trust, but the Company's employees are the beneficial owners of the shares.

In the News Release, the IRS said that it would go after "aggressive schemes involving complex or questionable transactions, including those involving ESOPs." The IRS said it would use a range of compliance tools, including additional examinations, to address perceived compliance issues associated with ESOPs.

The IRS singled out one particular promoted arrangement involving a management company organized as an S corporation whose stock is wholly owned by an ESOP. In the arrangement described in the News Release, the management company provides loans to business owners in the amount of the company's business income. In this case, the IRS indicated that it disagrees with the position taken by taxpayers that loans are not taxable income. Further, the IRS cautioned that the management company could lose its S corporation status.

The IRS has also identified other ESOP issues, including valuation, prohibited allocation of shares to disqualified persons, and prohibited transaction issues involving ESOP loans. In this regard, SECURE 2.0 instructs the Department of Labor to develop acceptable standards and procedures for valuing shares purchased by an ESOP.

In addition to additional examinations, the News Release notes that the IRS will continue to use education and outreach as a tool to address compliance issues with ESOPs.