

EMPLOYEE TAX BASIS CONSIDERATIONS RELATED TO EMPLOYER CORPORATION STOCK DISTRIBUTIONS

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When an ESOP employee/participant receives a stock distribution of employer corporation stock, the employee has to keep track of (1) the stock's fair market value per share, (2) the stock's tax basis per share, and (3) the total amount of net unrealized appreciation related to the stock.

The ESOP sponsor company, with or without the assistance of a third-party administrator, should provide the employee/participant with the necessary information to make these calculations. This discussion summarizes some of the practical procedures related to tracking the employee tax basis tax information with respect to employer corporation stock distributions. These procedures affect both the ESOP sponsor company and the ESOP employee/participant.

INTRODUCTION

According to The ESOP Association, there were over 11,000 employee stock ownership plans (ESOPs) in the United States as of the end of 2008. These 11,000 or so ESOPs included approximately 10 million employee participants. And, the number of ESOP-owned employer corporations is expected to increase in 2009.

The reason for the expected increase in the number of ESOPs is due, in part, to the failing national economy. That is, more ESOPs are expected to be formed as employees decide to purchase their failing employer corporations, at least in part in an effort to save their jobs.

The number of ESOPs is expected to increase in the near term. Accordingly, the need for tax accounting, financial accounting, and administrative recordkeeping services for ESOPs is also expected to increase. There is an established body of professional literature regarding (1) the structuring of ESOP employer stock purchase transactions, (2) the valuation of sponsor company stock, (3) the income tax benefits to the employer corporation related to an ESOP formation, (4) the capital gains tax deferral benefits to certain selling shareholders in certain ESOP employer stock purchase transactions, and (5) the potential for increased employee productivity through ESOP employee ownership.

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This discussion, however, focuses on a more mundane, but no less important, ESOP administration issue: how to track the ESOP employee participant's tax basis in his or her sponsor company stock distributions.

EMPLOYER TAXATION ON THE DISTRIBUTION OF THE EMPLOYER CORPORATION STOCK

An employee participant in an ESOP receives the sponsor company stock as an employee benefit. The employee participant accumulates this employer corporation stock over time. And, those allocations of employer corporation stock serve as a form of employee retirement savings.

The employee participant is not currently taxed on his or her accumulation of wealth in the sponsor company stock. Rather, the employee is taxed only when the employer corporation stock (or other funds) are withdrawn from the ESOP, similar to the taxation of distributions from a 401(k) plan.

Distributions from the ESOP may be paid to the employee in either (1) a lump sum or (2) substantially periodic payments. The ESOP plan documents should specify if the distribution of the ESOP benefits may be paid in cash or in the sponsor company stock.

When an employee participant leaves the employer corporation, the ESOP plan typically obligates the sponsor company to buy back the distributed employer corporation stock at its fair market value. Unless the ESOP owns the stock of a publicly traded corporation, an annual independent valuation is required to determine the repurchase price of the employer corporation shares.

EMPLOYEE TAXATION ON LUMP SUM DISTRIBUTION OF THE EMPLOYER CORPORATION STOCK

The employee participant will defer the payment of the tax related to any net unrealized appreciation (NUA) on the lump-sum distribution of the employer corporation stock.¹ This tax is deferred until the underlying employer corporation stock is disposed of by the employee.

Alternatively, the employee may elect to be taxed currently on any NUA on the employer corporation stock in the year in which the lump-sum employer stock distribution is reported. Therefore, employees who receive lump-sum distributions and who are not required to immediately sell back the employer stock should consider making this tax election. This tax election should be considered due to the expected change in capital gains tax rates.

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NET UNREALIZED APPRECIATION

NUA is defined as:²

1. the excess of the employer corporation stock fair market value at the distribution date over
2. the employee’s cost or other basis to the qualified plan’s trustee.

The employee is taxed on the NUA at long-term capital gains tax rates.

This long-term capital gains treatment occurs regardless of:

1. the ESOP’s holding period for the employer shares distributed or
2. the employee’s holding period once the employer corporation shares are distributed.

If the employer corporation shares are not rolled over tax free to a qualified plan, then the employee must recog-

nize as ordinary income his or her basis in the employer corporation shares received.

FOUR METHODS FOR DETERMINING THE EMPLOYEE TAX BASIS IN THE EMPLOYER CORPORATION STOCK

Four methods are provided for determining the cost or other basis in the employer corporation stock.³

First, if the employer stock was earmarked for an employee’s account at the time it was released to the account of the employee, then such cost or other basis will be used.

Second, if the employer stock was purchased during the tax year, or other period not exceeding 12 months, and allocated to more than one employee, then the average cost can be used as the employer stock cost.

The final two remaining methods relate to employer stock that was not tracked or allocated to the individual employee accounts.

The stock of an S corporation held by an ESOP is subject to the same tax basis adjustments as stock held by any other S shareholder.⁴ The employer stock’s NUA is determined using the ESOP adjusted basis in the stock.

However, the tax basis of a share of employer corporation stock to the ESOP for purposes of determining NUA does not control its tax basis in the hands of the employee distributee. The employee distributee’s tax basis will be the same for each share of employer corporation stock received.

TRACKING THE EMPLOYEE’S TAX BASIS IN THE EMPLOYER CORPORATION SHARES

The third-party administrators (TPAs) who provide benefit plan services for an ESOP will typically track:

1. the allocation of employer shares to each employee participant’s account in the respective plan and
2. the original cost basis of the employer shares.

However, the TPA typically does not track the tax basis for an ESOP-owned S corporation.

Therefore, the responsibility for tracking the cost basis for the employer corporation shares often falls to the S corporation’s tax advisers.

The S corporation shareholder should take into account all items of income, loss, deduction, or credit.⁵ And, the S corporation allocates these items on a pro rata basis to each share of the employer corporation. It is the employer corporation's responsibility to request the TPA to track these items for all employee participants in its ESOP plan.

This tracking would include providing the TPA with a Schedule K-1, Shareholder's Share of Current Year Income, Deductions, Credits, etc., each year to allocate the appropriate share of income or loss. The TPA should determine if it has the adequate knowledge to properly track the employer stock tax basis.

If an employee with a significant ownership in the ESOP retires or receives distributed employer stock, then the S corporation tax ramifications are much easier to compute. However, this is only the case when the information has been tracked since the ESOP's inception.

If the ESOP plan allows for only cash distributions, then there should be no need to track the employer corporation stock tax basis.

The following simplified Alpha Sponsor Company example illustrates how the employer corporation stock tax basis would be computed for an individual employee participant. This illustrative Alpha Sponsor Company example also explains the tax impact when the employer corporation shares are distributed to the ESOP employee participant.

"The S corporation shareholder should take into account all items of income, loss, deduction, or credit."

ILLUSTRATIVE EXAMPLE—COMPUTING THE EMPLOYER CORPORATION STOCK BASIS

Let's assume that Alpha Sponsor Company ("Alpha"), a calendar-year S corporation, maintains Plan A, an ESOP. Let's assume that Plan A holds 1,000 shares of Alpha stock that were purchased on January 1, 2007, for \$200,000 with employer corporation contributions.

The Plan A pro rata share of the Alpha taxable income for tax year 2007 is \$50,000, or \$50 per share. For tax year 2008, the Plan A pro rata share of the Alpha taxable income is \$10,000, or \$10 per share.

Let's assume that there are no Section 1366(a)(1) adjustments other than for taxable income.

Betty Beta is an employee of Alpha and an eligible employee participant in Plan A. Let's assume that 50 Alpha shares are maintained in Plan A for Betty's benefit from January 1, 2007, to December 31, 2008. On the latter date, Plan A distributes to Betty the fifty shares of Alpha stock.

Let's assume that the Alpha stock is required to be repurchased by the employer corporation under a fair

market valuation formula.⁶ On December 31, 2008, let's assume that the fair market value of the fifty Alpha shares is \$15,000.

As presented in Exhibit 1, in the year of the stock distribution, let's assume that the fair market value of Betty's fifty employer corporation shares is \$15,000. This fair market value estimate would be based on an independent valuation of the Alpha employer stock.

Based on the analysis presented in Exhibit 1, the tax basis of Betty's Alpha shares is \$13,000. And, the amount of the net unrealized appreciation in Betty's Alpha shares is \$2,000.

BETTY BETA TAX OPTIONS RELATED TO THE NET UNREALIZED APPRECIATION

Betty Beta could elect to forgo the deferral of the tax on the net unrealized appreciation.⁷ And, Betty could elect to pay the tax on the net unrealized appreciation of the Alpha employer corporation shares distributed.

If the employer corporation shares are not repurchased,⁸ the Service holds that any gain on the subsequent sale of the employer stock not rolled over is taxed as long-term capital gain. This tax treatment holds to the extent of the original net unrealized appreciation, regardless of the sale date.

FACTORS TO CONSIDER IN MAKING THE NONDEFERRAL ELECTION

In determining whether or not to make the nondeferral election,⁹ some of the factors for the employee to consider include the following:

1. the current long-term capital gain tax rates versus ordinary income tax rates
2. speculation on what the future tax rates will be
3. the availability of cash flow to pay the amount of the tax due
4. speculation on the future employer stock performance over time

In addition, unless the distributed employer stock is rolled over to an eligible retirement plan,¹⁰ \$13,000 of ordinary income will be recognized by Betty Beta in the year of the employer corporation stock distribution.

The above Alpha Sponsor Company illustrative example is simplified, of course. For example, the Alpha example does not take into account any employee or employer

Exhibit 1
Alpha Sponsor Company
ESOP Plan A
Tax Basis Considerations for the
Betty Beta Distributed Shares
as of December 31, 2008

Calculation of Tax Basis Per Share	Per Share
Original basis per share tax of the Alpha stock purchased by the ESOP with employer corporation contributions	\$200
Plan A pro rata share of the Alpha 2007 income	50
Plan A pro rata share of the Alpha 2008 income	<u>10</u>
Betty Beta tax basis per share in the Alpha stock as of December 31, 2008	<u>\$260</u>
Calculation of Fair Market Value and Net Unrealized Appreciation	In Total For 50 Shares
Fair market value at December 31, 2008, of the 50 shares of the distributed Alpha stock [a]	\$15,000
Betty Beta tax basis in the distributed 50 shares of Alpha stock [b]	<u>13,000</u>
Net unrealized appreciation (in total for the distributed 50 shares of Alpha stock) [c]	<u>\$2,000</u>
<u>Notes:</u>	
[a] based on an independent valuation of the Alpha Sponsor Company stock.	
[b] based on \$260 tax basis per share × 50 shares of the Alpha stock distributed to Betty Beta.	
[c] equals the difference between the total Alpha stock fair market value and the total tax basis in the Alpha stock.	

contributions. If the employee contributes cash or property, then:

1. the calculation will differ and
2. the net unrealized appreciation will need to be allocated among the employee and the employer contributions in the ESOP.

SUMMARY AND CONCLUSION

Many ESOP employee participants are unaware of the income tax implications and other consequences when they receive distributions of employer corporation stock. With proper record keeping and tax basis tracking, the ESOP, the sponsor company, and the TPA should be able to readily provide the employee participant with adequate information. This information should allow the employee participant to assess the tax consequences of ESOP employer corporation stock distributions.

Such information should allow the employee participant to make informed decisions about (1) taking a lump-sum distribution, (2) rolling over the distribution proceeds to another qualified retirement plan, and (3) other tax or estate planning considerations.

With employee participants continuously entering and exiting the ESOP, it is important for the sponsor company

to keep its ESOP administrative records up to date. These administrative recordkeeping procedures should ensure that the proper tax basis information and other records are maintained on behalf of each ESOP employee participant.

Notes:

1. Internal Revenue Code Section 402(e)(4)(B).
2. Regulations Section 1.402(a)-1(b)(2)(i).
3. Regulations Section 1.402(a)-1(b)(2)(ii).
4. Revenue Ruling 2003-27, Section 1367(a).
5. Section 1366(a)(1).
6. Section 409(h).
7. Section 402(e)(4)(B).
8. Notice 98-24.
9. Section 402(e)(4)(B).
10. In accordance with Section 402(c).

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Robert and Bob are co-authors of the Guide to ESOP Valuation and Financial Advisory Services, 2nd edition. Copies of that book may be purchased through the Institute of Business Appraisers.