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NOTE

EMPLOYEE STOCK OWNERSHIP PLANS: A UNIQUE CONCEPT IN CORPORATE FINANCING AND EMPLOYEE BENEFITS

I. INTRODUCTION

An industrial economy such as ours demands that employees receive benefits from their employers in addition to the compensation which they receive in the form of wages or salaries. One of these benefits, the retirement benefit, has traditionally been provided through pension plans and profit-sharing plans. However, another means of providing the retirement benefit is through an employee stock ownership plan (ESOP). The ESOP, in addition to providing employee benefits, as do the other forms of retirement plans, allows the corporate employer to obtain additional advantages which do not exist with pension and profit-sharing plans.

The ESOP concept is unique from other retirement benefit plans in several respects. In addition to its use for obtaining financing and providing benefits, an ESOP may be utilized for various other purposes. These purposes include providing a market for closely-held stock, acquiring another corporation, and converting a profit-sharing plan into an ESOP.

This Note will explore the basic concept of an ESOP and will discuss the various uses of such a plan. It will also discuss the tax advantages involved through implementation of an ESOP. Finally, it will explore the applicability and use of ESOPs within the state of North Dakota.

II. CONCEPT OF EMPLOYEE STOCK OWNERSHIP PLANS

It is important to discuss briefly the economic and social theories underlying the concept of employee stock ownership plans (ESOPs) in order to fully understand how they function and what advantages exist in adopting such plans. The ESOP concept was originally envisioned by Louis O. Kelso and Patricia Hetter.[1] The ESOP, termed a "second income plan"[2] by Kelso and Hetter, was conceived as a

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1. L. KELSO & P. HETTER, HOW TO TURN EIGHTY MILLION WORKERS INTO CAPITALISTS ON BORROWED MONEY (1967) (paperback version: TWO-FACTOR THEORY: THE ECONOMICS OF REALITY) [hereinafter cited as KELSO & HETTER].
2. *Id.* at 45-58.

basis for achieving a "universal capitalism"[3] that would have a far-reaching and beneficial effect on this nation's economy.

The Kelso-Hetter concept is based on the theory of "universal capitalism."[4] This theory recognizes that both private ownership of the instruments of production and competitive markets are essential to an industrial economy.[5] However, this theory advocates that private ownership should not be limited to a particular class or the moneyed few of a society. Rather, "universal capitalism" refers to an economic system in which all citizens own or have an opportunity to own a portion of productive capital. Indeed, the authors view this opportunity to acquire such capital as an indispensable social goal and personal right.[6]

The Kelso-Hetter theory of "universal capitalism," whereby all citizens have an opportunity to share in the capital, also relies on the proposition that there are two factors of production in an industrial society. These factors are capital and labor.[7] Capital represents the nonhuman factor of production and includes productive land, structures, and machines.[8] Labor, the human factor of production, is composed of intellectual, technical, and manual workers.[9] The authors assert that the bulk of wealth in an industrial society is produced by capital, not by labor. In support of this assertion, they state that technology[10] acts only upon the nonhuman factor of production, capital. The effect of technology on capital, according to the authors, is:

> to increase the productiveness of capital at an accelerating rate; that in turn paves the way for putting more of the nonhuman factor into production. Man himself remains physically outside the process of technological change, his innate capabilities no more altered by the invention of the computer than by the steam engine or the wheel. The notion that technological change increases "human productivity" has no basis in fact; productively, man remains about where history first found him. *Affluence,* in short, *is the product of capital.*[11]

The "universal capitalism" theory rejects the idea that full em-

3. *Id.* at 4.
4. *Id.* at 4-8. The theory of "universal capitalism" is the subject of two other books of which Mr. Kelso is a co-author. They are: L. KELSO & M. ADLER, THE CAPITALIST MANIFESTO (1958); L. KELSO & M. ADLER, THE NEW CAPITALISTS: A PROPOSAL TO FREE ECONOMIC GROWTH FROM THE SLAVERY OF SAVINGS (1961).
5. KELSO & HETTER, note 1 *supra,* at 4.
6. *Id.* at 7.
7. *Id.* at 31.
8. *Id. See also* L. KELSO & M. ADLER, THE CAPITALIST MANIFESTO 45 (1958).
9. KELSO & HETTER, note 1 *supra,* at 31.
10. Technology is defined by the authors as the agent of economic change—the process by which man harnesses nature through his capital instruments and makes it work for him. *Id.* at 31-32.
11. *Id.* at 32 (emphasis in original).

ployment should be the goal of our society.[12] Kelso and Hetter maintain that labor is only one factor of production and that it is not the factor which has been responsible for increasing productivity. They further assert that since capital produces most of the economy's wealth and that since income is distributed on the basis of productive input, an individual cannot obtain an affluent level of income solely by means of his labor, but must rely on capital.[13] Following this reasoning, the authors state:

> Full employment, without simultaneous redistribution of all the wealth or income produced by capital to noncapital-owning employees, will never provide the fully employed with sufficient purchasing power to buy all the goods and services produced.[14]

Therefore, full employment is a deficient economic goal if the function of an economy is to provide universal affluence.

Kelso and Hetter maintain that affluence can be obtained universally by all persons in an industrial economy. This is possible, not through achieving full employment of the labor force, but rather through "universal capitalism."[15] They argue that capitalism, as it presently exists in the United States, creates a narrow and unchanging ownership base.[16] According to the authors, the United States is, therefore, incapable of achieving a goal of universal affluence. The authors further state that in order to broaden this ownership base to provide universal affluence, the cause of the concentration of capital ownership in this country must first be ascertained. This cause, the authors maintain, is the "financing of new capital formation exclusively out of the accumulated financial savings" of wealthy individuals or of corporations owned by these individuals.[17] Therefore, Kelso and Hetter assert, by providing an alternative method of financing capital formation, "universal capitalism" can be obtained.

The method proposed by Kelso and Hetter for such financing is by means of a "second income plan."[18] In setting out the objectives of such a plan, the authors state:

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12. *Id.* at 30-31. Kelso and Hetter state that of the three principal schools of economic theory, the classicists, the Marxians and the Keynesians, all agree that full employment is the economic goal for which a society should strive. *Id.* at 31.

13. *Id.* at 32.

14. *Id.*

15. It must be remembered that the authors maintain that capital, not labor, is the source of affluence. *Id.*

16. KELSO & HETTER, note 1 *supra*, at 40. The authors state that 2.3% of all American households own about 80% of the economy's productive capital. The rest is owned by another 5%-8%. The result of such ownership is that 90% or more of American households lack the purchasing power capable of sustaining affluence. *Id.* at 40.

17. *Id.* at 41. *See also* L. KELSO & M. ADLER, THE NEW CAPITALISTS: A PROPOSAL TO FREE ECONOMIC GROWTH FROM THE SLAVERY OF SAVINGS 28-32 (1961).

18. KELSO & HETTER, note 1 *supra*, at 47.

> The Second Income Plan provides industry with the techniques for financing that gigantic expansion,[19] while protecting and greatly strengthening the private ownership of existing capital against further redistributive erosion. At the same time it is designed to enable the noncapital-owning majority to buy, pay for, and thereafter own, in reasonable-sized holdings, the newly formed capital thus brought into existence. It is these new and expanded enterprises that comprise the second economy. Thus in the macrocosmic sense, the Second Income Plan is a method for building simultaneously (1) the industrial power of the people to produce wealth and therefore, (2) the legitimate power of the masses to consume it.[20]

This "second income plan" as envisioned by Kelso and Hetter involves changing various aspects of our economic system.[21] The primary technique they suggest as a means for accomplishing such changes is the use of alternative sources of financing new capital formation. Kelso and Hetter's "second income plan trust," the model upon which an ESOP is based, provides such an alternate source of financing new capital formation.[22]

Under a "second income plan trust," a trust is established by a corporation. This trust, if it qualifies,[23] is exempt from federal taxation. Contributions of corporate income made to the trust are exempt, within specified limits, from corporate income taxation.[24] Allocations of corporate contributions to the trust are made to the accounts of employees with the allocations being proportionate to the relative compensation paid each employee.[25] Contributions of the corporation made to the trust are not taxable to the employee until his or her interest is withdrawn from the trust.[26] At this time, they may be taxed at capital gain rates if the entire account is delivered to the employee within one year.[27] Furthermore, if distributions to employees are in the form of employer stock, the employee is taxed

19. In order to provide a level of general affluence, the authors assert, the existing economies of countries such as the United States and Canada would have to expand their productive capacities. They state that this increase would have to be several times more than the present rate of production in order to increase their per capita output of goods and services to a level of general affluence. *Id.*

20. *Id.*

21. These changes include: changes in tax policy affecting estate and gift taxation and estate planning, KELSO & HETTER, note 1 *supra*, at 69-71; changes in corporate conduct and strategy, *id.* at 72-81; changes in financing ownership for corporate employees, *id.* at 82-89; and changes in financing capital ownership for noncorporate employees, *id.* at 93-101.

22. The second source of such financing is called a "financed capitalist plan" which enables noncorporate employees to purchase newly issued corporate equities from the pretax earnings of the corporate equities purchased. *Id.* at 79.

23. *Id.* at 85. "Qualification" refers to the Internal Revenue requirements, INT. REV. CODE OF 1954, § 401, and U.S. Treasury regulations which must be met for the trust to obtain tax-exempt status. These requirements are discussed in the text accompanying notes 52-76 *infra*.

24. KELSO & HETTER, note 1 *supra*, at 85.

25. *Id.*

26. *Id.*

27. *Id.*

at capital gain rates only on the basis of the trust's cost of the stock.[28] The employee is not taxed on any unrealized appreciation until he or she sells the stock.[29]

By establishment of this "second income plan trust," the corporation has expanded its capital through the loan obtained by the trust. At the same time, the corporate employees have received ownership in that capital via the stock allocated to their accounts. The employees have thus received a "second income." As a result of this "second income," they are able to share in the wealth produced by the capital formed under the "second income plan."

Implicit in Kelso and Hetter's concept of "universal capitalism" obtainable through the "second income plan" is increased production. The overall production of an economy must increase to allow ownership of capital by all individuals in the economy.[30] This increased production is achieved, according to Kelso and Hetter, by the utilization of the "second income plan trust" because the corporation is building new capital through the financing obtained by the trust.[31] Hence, the "second income plan," according to Kelso and Hetter, is the means by which the goal of "universal capitalism" may be obtained.[32]

III. EMPLOYEE STOCK OWNERSHIP PLANS DEFINED

A. STATUTORY DEFINITIONS OF EMPLOYEE STOCK OWNERSHIP PLANS

Employee stock ownership plans were first legally defined in the Regional Rail Reorganization Act of 1973,[33] which was enacted January 2, 1974. It defined an ESOP as:

> a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under section 401(a) of Title 26 [of the Internal Revenue Code] in connection with the financing of corporate improvements, transfers in the ownership of corporate assets, and other capital requirements of a corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees.[34]

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28. *Id.*
29. KELSO & HETTER, note 1 *supra*, at 85-86.
30. *See* note 19 *supra*.
31. KELSO & HETTER, note 1 *supra*, at 83.
32. *Id.* at 59-92.
33. 45 U.S.C. §§ 701-793 (Supp. V 1975) [hereinafter referred to as Rail Act].
34. *Id.* § 741(e) (Supp. V 1975). This provision for the utilization of ESOPs would allow the United States Railway Association (USRA) to establish an ESOP to repurchase

This statutory definition provides an accurate statement of what an ESOP is and sets forth the major purposes for which an ESOP may be used. These purposes include obtaining corporate financing, transferring ownership of corporate assets and making capital improvements.[35]

Although the ESOP provisions of the Regional Rail Reorganization Act of 1973 were included in that Act only to provide a means of capitalization for reorganization of a rail services system, this definition is important in that it was the first legal definition and provision for such plans. Further recognition of the ESOP concept came with the Employee Retirement Income Security Act of 1974[36] (ERISA), commonly known as the 1974 Pension Reform Act and finally, with the Tax Reduction Act of 1975.[37]

The term "employee stock ownership plan" was first introduced into the Internal Revenue Code with the passage of the Employee Retirement Income Security Act of 1974 (ERISA).[38] The ERISA definition of an ESOP which meets Internal Revenue Code tax requirements is:

> The term "employee stock ownership plan" means a defined contribution plan—
>
> (A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and
>
> (B) which is otherwise defined in regulations prescribed by the Secretary or his delegate.[39]

The Tax Reduction Act of 1975[40] in providing for ESOPs defined an ESOP as a defined contribution plan which:

> (A) is a stock bonus plan, a stock bonus and a money purchase pension plan, or a profit-sharing plan,
>
> (B) is designed to invest primarily in employer securities, and
>
> (C) meets such other requirements (similar to requirements applicable to employee stock ownership plans as defined in section 4975(e)(7) of the Internal Revenue Code of 1954) as the Secretary of the Treasury or his delegate may prescribe.[41]

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common stock issued for capitalization. For a discussion of utilization of ESOPs under the Rail Act, *see* text accompanying notes 77-88 *infra.*

35. For a discussion of the uses of an ESOP, *see* text accompanying notes 143-74.

36. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified primarily in scattered sections of the INT. REV. CODE OF 1954 and of 29 U.S.C. (Supp. V 1975)) [hereinafter referred to as ERISA].

37. Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the INT. REV. CODE OF 1954).

38. ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified primarily in scattered sections of the INT. REV. CODE OF 1954 and of 29 U.S.C. (Supp. V. 1975)).

39. *Id.*, tit. II, § 2003(a), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 4975(e)(7).

40. Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the INT. REV. CODE OF 1954).

41. *Id.*, tit. III, § 301(d)(2), 89 Stat. 26, 38 (1975).

B. COMMONLY USED DEFINITIONS

1. *Kinds of Plans*

It may be helpful, in gaining a clearer understanding of the ESOP concept, to discuss terms commonly used in statutory definitions of ESOPs. All three of the definitions set out in the preceding statutes provide that an ESOP may consist of a stock bonus plan or trust.[42]

A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan,[43] except that the contributions made by the employer are not necessarily dependent upon profits, and the benefits are distributable to the employee in employer stock.[44]

The Rail Act provides that an ESOP may use a money purchase pension trust.[45] ERISA[46] and the Tax Reduction Act of 1975[47] provide that an ESOP may consist of a combined stock bonus and money purchase pension plan. Under a money purchase pension plan, annual contributions to the plan are fixed amounts which are based upon either a dollar amount or a percentage of compensation paid to an employee. These contributions are made annually regardless of whether the company has any profits for that year.[48]

The Tax Reduction Act of 1975 also expands the ESOP definition of the two prior acts by providing that an ESOP may consist of a profit-sharing plan[49] as well as a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan.[50] The only effect of this addition, however, is that for purposes of the eleven percent investment credit given corporations for transfer of its qualified investment through an ESOP, a profit-sharing plan may be used.[51]

2. *Qualification*

A stock bonus plan or a combined stock bonus plan and money purchase plan constituting the ESOP must meet several requirements

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42. Throughout this Note the terms "stock bonus plan" and "stock bonus trust" are used synonymously. It should be kept in mind, however, that a trust is created under the plan as a part of that plan. However, statutory definitions often refer to a "trust" or a "plan".

43. J. CHOMMIE, THE LAW OF FEDERAL INCOME TAXATION § 98 (2d ed. 1973) defines a profit-sharing plan as a plan that provides for employee participation in profit sharing. The plan must also provide a formula for the allocation and distribution of employer contributions.

44. Treas. Reg. § 1.401-1(b)(1)(iii) (1956).

45. 45 U.S.C. §§ 702(5), 741(e) (Supp. V 1975).

46. ERISA, Pub. L. No. 93-406, tit. II, § 2003(a), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 4975(e)(7).

47. Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the INT. REV. CODE OF 1954).

48. L. RICE, JR., BASIC PENSION AND PROFIT-SHARING PLANS 91 (1961).

49. For a definition of "profit-sharing plan," *see* note 43 *supra*.

50. Pub. L. No. 94-12, tit. III, § 301(d)(2)(A), 89 Stat. 26, 38 (1975).

51. For a discussion of the Tax Reduction Act 1975, *see* text accompanying notes 111-24 *infra*.

to qualify under section 401(a) of the Internal Revenue Code. First, contributions made to the trust created under the plan must be for the purpose of distributing the income accumulated in the trust to the employees or their beneficiaries.[52] These contributions are made by the employer to the trust and they are then used by the trust to amortize the loan which has been obtained to purchase stock from the employer. As the loan is paid off, shares of stock are allocated to employees' accounts. This stock is later distributed to the employees in amounts based on a vesting schedule determined by age of the employee or years in service.[53]

A second requirement is that the corpus or income of the trust must not be diverted or used for any purpose other than for the "exclusive benefit" of the employees or their beneficiaries.[54] This requirement is, in essence, a restatement of the basic purpose of an ESOP—to provide benefits for the corporation's employees. Whether or not the ESOP meets this "exclusive benefit" requirement would be determined by the Internal Revenue Service.[55]

A third requirement is that contributions or benefits provided under the plan may not discriminate in favor of employees who are officers, shareholders or those who are highly compensated.[56] A plan is not discriminatory, however, merely because it excludes employees whose remuneration consists of "wages,"[57] or because it is limited to salaried or clerical employees.[58] Nor is a plan discriminatory merely because contributions or benefits bear a uniform relationship to compensation paid employees.[59]

A fourth requirement provides that the plan of which the trust is a part must satisfy the minimum participation standards of section 410 of the Internal Revenue Code.[60] These minimum participation standards require that participation of an employee in the plan must begin no later than the date such employee attains the age of twenty-five or the date such employee completes one year of service.[61] The minimum participation standards also provide that the trust shall not qualify under section 401(a) unless the plan benefits either:

> (A) 70 percent or more of all employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 per cent or more of all the employees are eli-

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52. INT. REV. CODE OF 1954, § 401(a)(1).
53. These vesting schedules are set out in note 65 *infra*.
54. INT. REV. CODE OF 1954, § 401(a)(2).
55. Treas. Reg. §§ 1.401 (1968); 1.401-1 (1972); 1.401-2 (1964).
56. INT. REV. CODE OF 1954, § 401(a)(4).
57. The term "wages" refers to the definition in the Internal Revenue Code of 1954, § 3121(a)(1), relating to employment taxes.
58. INT. REV. CODE OF 1954, § 401(a)(5).
59. *Id.*
60. INT. REV. CODE OF 1954, § 401(a)(3).
61. *Id.* §§ 410(a)(1)(A)(i), (ii).

gible to benefit under the plan, excluding in each case employees who have not satisfied the minimum age and service requirements, if any, prescribed by the plan as a condition of participation, or

(B) such employees as qualify under a classification set up by the employer and found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated.[62]

The trust must also satisfy the minimum vesting standards required by section 411 of the Internal Revenue Code.[63] These vesting standards provide that a trust shall not qualify under section 401(a) unless the plan provides that an employee's right to normal retirement benefits is nonforfeitable upon attainment of normal retirement age.[64] Furthermore, the plan must provide that vesting of stock is made in accordance with one of three vesting formulas.[65] Vesting, used in this context, refers to the determination of the amount of stock to which an employee is entitled under the plan at any given time.

To qualify under section 401(a), the plan, of which the trust is a part, must also provide that forfeitures will not be applied to increase the benefits any employee would otherwise receive under the plan.[66] A forfeiture would occur, for example, if a participant employee died or otherwise terminated employment with the corporation before he or she was entitled by the particular vesting formula to receive 100 percent of the amount credited to his or her account.[67] In those situations the unvested portion must not be reallocated to the accounts of other participants in the plan.[68]

Section 401(a) also requires that for qualification purposes, the plan must provide that the entire interest of each employee:

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62. *Id.* §§ 410(b)(1)(A), (B).
63. *Id.* § 401(a)(7).
64. *Id.* § 411(a).
65. These alternative vesting schedules are:

(1) Ten-year vesting rule. An employee who has at least ten years of service has a nonforfeitable right to 100 percent of the accrued benefit derived from employer contribuions. ERISA, Pub. L. No. 93-406, tit. II, § 1012, 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 411(a)(2)(A);

(2) Five- to fifteen-year rule. An employee who has completed at least five years of service has a nonforfeitable right to a percentage of the accrued benefit derived from employer contributions. *Id.*, tit. II, § 1012, 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 411(a)(2)(B);

(3) Rule of forty five. An employee who is not separated from the service, who has completed at least five years of service, and whose age and years of service equals or exceeds forty five has a nonforfeitable right to a percentage of the accrued benefit from employer contributions. *Id.*, tit. II, § 1012, 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 411(a)(2)(C).

66. INT. REV. CODE OF 1954, § 401(a)(8).
67. The amount of stock to which the employee is entitled at the time of death or termination is the vested portion, which is determined according to a vesting schedule. *See* note 65 *supra*.
68. This treatment of forfeitures is contrary to the rule applicable to pension trusts because pension trusts will not qualify for tax benefits if forfeitures increase benefits of other plan participants. INT. REV. CODE OF 1954, § 401(a)(8); Treas. Reg. § 1.401-7 (1963).

> (A) either will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an owner-employee (as defined in subsection (c) (3)),[69] in which he retires, whichever is the later, or
>
> (B) will be distributed, commencing not later than such taxable year, (i) in accordance with regulations prescribed by the Secretary or his delegate, over the life of such employee or over the lives of such employee and his spouse, or (ii) in accordance with such regulations, over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and his spouse.[70]

Distributions refer to the disbursements made to employees of the vested stock which has been credited to their accounts. Distributions may be made either in a lump sum or in installments,[71] and are made in shares of the employer's stock.[72]

Although there are other requirements that a trust must meet for qualification purposes,[73] those set forth above enumerate the major provisions. If the trust meets all of the requirements of section 401(a) of the Internal Revenue Code, it is "qualified."

There are three tax advantages obtained from this qualification. First, income earned by the qualified trust is exempt from taxation.[74] Second, contributions made by the employer to the qualified trust are tax deductible.[75] Third, contributions are not taxable to the employees until benefits are "actually distributed" or made available to them.[76] The consequences of these three tax advantages will be discussed in more detail below.

IV. HISTORY OF EMPLOYEE STOCK OWNERSHIP PLANS

A. REGIONAL RAIL REORGANIZATION ACT

Although the basic concept of employee stock ownership plans has been utilized by companies for several years, such plans were not legally defined and provided for until the Regional Rail Reorgan-

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Also, the allocation of forfeitures must not result in discrimination. Treas. Reg. § 1.401-4(a)(1)(iii) (1956).

69. INT. REV. CODE OF 1954, § 401(c)(3) defines the term "owner-employee" as an employee who:

> (A) owns the entire interest in an unincorporated trade or business, or
>
> (B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

70. *Id.* § 401(a)(9)(B).

71. Lump sum distributions may be advantageous to participant employees because the unrealized appreciation is entitled to capital gains treatment when the participants sell the stock. ERISA, Pub. L. No. 93-406, tit. II, § 2005(b), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 402(a)(2).

72. Treas. Reg. §§ 1.401-1(a), (b) (1972).

73. *See* INT. REV. CODE OF 1954, §§ 401(a)(6), (10), (12), (13), (15), (16).

74. INT. REV. CODE OF 1954, § 501(a).

75. *Id.* § 404(a)(1). For further discussion of tax consequences, *see* text accompanying notes 195-229 *infra*.

76. *Id.* § 402(a)(1).

ization Act in 1973.[77] The purpose of the Act was to salvage rail services operated by eight insolvent railroads in the Midwest and Northeast[78] by replacing them with a new rail service system. The Act created a non-profit government corporation, the United States Railway Association (USRA),[79] to plan and to finance the acquisition, rehabilitation, and modernization of a new rail services system. This revitalization was to be accomplished by establishing a private enterprise, Consolidated Rail Corporation (Conrail), which would operate the rail service system.[80] Certain criteria for the formulation of a final rail service system plan[81] were also established by the Act.[82]

The Rail Act provided that Conrail, in order to carry out the final system plan, could issue stock and other securities as initial capitalization.[83] The Act further provided that common stock must be issued initially to the estates of railroads in reorganization in exchange for rail properties conveyed to Conrail pursuant to the final system plan.[84] In allowing establishment of an ESOP, the Rail Act provided:

> Nothing is this subsection shall preclude the Corporation [Conrail] from repurchasing the common stock initially issued through payments out of profits in order to establish an employee stock ownership plan; and nothing in this subsection shall preclude the recipients of common stock initially issued from establishing an employee stock ownership plan.[85]

The Rail Act conference committee report pointed out that the law merely required that the ESOP feasibility study be made by USRA, but that the law did not mandate that an ESOP be utilized.[86] To date, an ESOP has not been established under the Rail Act. However, the provision is a significant one in that it would provide employee ownership in the rail services system were an ESOP adopted. In light of the lack of a profit margin of the corporation

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77. [Rail Act] 45 U.S.C. §§ 701-793 (Supp. V 1975).
78. The eight railroads were: Penn Central, Reading, Erie Lackawanna, Central of New Jersey, Lehigh Valley, Boston & Maine, Ann Arbor, and Lehigh & Hudson River. Regional Rail Reorganization Act Cases, 419 U.S. 102, 108-09 n.3 (1974).
79. [Rail Act] 45 U.S.C. § 711 (Supp. V 1975).
80. *Id.* §§ 741-744.
81. *Id.* § 702(6) defines "final system plan" as:
> the plan of reorganization for the restructure, rehabilitation, and modernization of railroads in reorganization prepared pursuant to section 716 of this title and approved pursuant to section 718 of this title.

82. The Rail Act provided that the final system plan adopted by the United States Railway Association (USRA) must have been submitted to Congress for approval by July 26, 1975. If neither the Senate nor the House disapproved the plan within 60 working days after submission, it became "effective." *Id.* §§ 702(4), 718. However, even if the final system plan became effective, approval by a three-judge district court was required. *Id.* § 719(b).
83. *Id.* § 741(e).
84. *Id.*
85. *Id.*
86. H.R. REP. No. 93-744, 93d Cong., 1st Sess. 46 (1973).

(Conrail) thus far, the ESOP may not be feasible.[87] However, it is conceivable that a plan might be implemented in the future if the system were operating successfully.[88]

B. EMPLOYEE RETIREMENT INCOME SECURITY ACT

The second major piece of federal legislation which provided for ESOPs was the Employee Retirement Income Security Act of 1974[89] (ERISA), commonly known as the 1974 Pension Reform Act. This Act was a comprehensive law dealing with the myriad of areas involved in private pension and employee benefit plans. The term "employee stock ownership plan" was first introduced into the Internal Revenue Code as a result of ERISA.[90]

The purpose of the Act was to remedy certain defects in the private retirement system.[91] It was hoped that the enactment of comprehensive legislation in the area of retirement and benefit plans would result in protection against past abuses in the administration of such plans.[92] The House[93] and Senate Reports[94] cite the reasons for enactment of the Act as including:

> 1. increasing the number of individuals participating in retirement plans;
> 2. making certain that participants do not lose their benefits as a result of unduly restrictive forfeiture provisions or failure of the plan to accumulate and retain sufficient funds to meet its obligations;
> 3. making tax laws relating to such plans more fair by providing greater equality of treatment under such plans for the different tax-paying groups involved;
> 4. establishing equitable standards of plan administration;
> 5. mandating minimum standards of plan design for vest-

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87. Conrail incurred a net loss of $34.4 million in its first three months of operation. Wall Street Journal, Aug. 13, 1976, at 4, col. 2.

88. In urging support in the Senate of the ESOP provisions of the Rail Act, Senator Russell Long stated:

> [T]he use of the ESOP finanacing technique to the maximum extent—ideally to the extent of 100 percent—in connection with solving the current railroad crisis, is the onlv logical alternative to nationalization of the railroads, for it is not just a way to efficiently finance economic growth, but also to build market power, and to motivate, in the most powerful way, the entire labor force to perform as never before in order to solve this problem.

119 CONG. REC. 40753 (1974).

89. ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified primarily in scattered sections of the INT. REV. CODE OF 1954 and of 29 U.S.C. (Supp. V 1975)).

90. *Id.*, tit. II, § 2003(a), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 4975(e)(7). *See* text accompanying notes 38-39 *supra.*

91. H.R. REP No. 93-533, 93d Cong., 2d Sess. —— (1974).

92. Congress passed the Welfare and Pension Plan Disclosure Act in 1958, 29 U.S.C. §§ 301-309 (1970) after making a comprehensive investigation of the abuses in administering pension plans. This Act, however, has been inadequate in dealing with the problems of protecting the rights and benefits of workers, H.R. REP. No. 93-533, 93d Cong., 2d Sess. —— (1974), and was repealed by ERISA, tit. I, § 111(a)(1), 88 Stat. 829, 851 (1974). The Act, however, remained effective as to any conduct and events which occurred before Jan. 1, 1975.

93. *See* H.R. REP. No. 93-533, 93d Cong., 2d Sess. —— (1974); H.R. REP. No. 93-807, 93d Cong., 2d Sess. 8-14 (1974).

94. *See* S. REP. No. 93-383, 93d Cong., 2d Sess. —— (1974).

ing of plan benefits;

6. requiring minimum standards of fiscal responsibility by requiring amortization of unfunded liabilities.[95]

ERISA provided that ESOPs which are designed to invest primarily in qualifying employer securities are entitled to treatment as qualified plans.[96] The Act defines the term "qualifying employer security" as an employer security which is:

> (A) stock or otherwise an equity security or
> (B) a bond, debenture, note or certificate or other evidence of indebtedness.[97]

The bonds, debentures, notes or certificates referred to in the above definition are marketable obligations.[98] The ESOP's holdings of such debt securities cannot exceed twenty-five percent of the plan's total assets,[99] nor can such holdings exceed twenty-five percent of the aggregate amount of any employer debt issue.[100] Also, the plan can hold these securities only as long as at least fifty percent of any single debt issue remains in the ownership of parties independent of the employer.[101]

The ERISA definition of employee stock ownership plans does not mention use of such plans for purposes of obtaining corporate financing. However, other sections of the Act make it clear that such a method of financing is permissible. For example, section 406 of the Act[102] provides that the lending of money or other extension of credit between a plan and a party in interest[103] is a prohibited transaction. However, the prohibitions of section 406 do not apply to a loan to an employee stock ownership plan if:

> (A) such loan is primarily for the benefit of participants and beneficiaries of the plan, and
> (B) such loan is at an interest rate which is not in excess of a reasonable rate.[104]

As a result of this exemption, an ESOP authorized by ERISA

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95. *See* notes 93-94 *supra*.
96. ERISA, Pub. L. No. 93-406, 595. II, § 2003(a), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 4975(e)(7).
97. *Id.* tit. II, § 2003(a), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 4975(e)(8). *See also* ERISA, Pub. L. No. 93-406, tit. I, §§ 503(e)(1), (2), (3), 88 Stat. 829, —— (1974).
98. ERISA, Pub. L. No. 93-406, tit. I, § 407(e), 88 Stat. 829, —— (1974).
99. *Id.*, tit. I, § 407(e)(2)(A), 88 Stat. 829, —— (1974).
100. *Id.*, tit. I, § 407(e)(3), 88 Stat. 829, —— (1974).
101. *Id.*, tit. I, § 407(e)(2)(B), 88 Stat. 829, —— (1974).
102. *Id.*, tit. I, § 406(a)(1)(B), 88 Stat. 829, —— (1974).
103. "Party in interest" is defined in *id.*, tit. I, § 3(14), 88 Stat. 829, —— (1974).
104. *Id.*, tit. I, § 408(b)(3), 88 Stat. 829, —— (1974). This section also provides that if the plan gives collateral to a party in interest for such loan, the collateral may consist only of qualifying employer securiies, as defined in *id.*, tit. I, § 407(d)(5), 88 Stat. 829, —— (1974).

may borrow money, repayment of which is guaranteed by the corporation. This ability of an ESOP to utilize the corporation's credit, and thereby provide the corporation with a method of financing, is critical to the ESOP concept.

C. TRADE ACT OF 1974

The next federal legislation which included ESOP provisions was the Trade Act of 1974.[105] This Act authorized the President to enter into trade agreements with foreign countries during a five-year period. The purpose of the Act was to establish fairness and equity in international trading agreements.[106]

The Act provided relief to communities injured by increased imports.[107] To assist such communities, the Act authorized the Secretary of Commerce to guarantee up to 500 million dollars in loans to private borrowers who proposed to create jobs in trade-impacted areas.[108] The Act also provided that companies agreeing to pay twenty-five percent of the loan proceeds to a qualified trust established under an ESOP would be given preference in consideration for a guaranteed loan.[109]

Again, through this Act, ESOPs are recognized as a technique of corporate financing. The Senate Finance Committee, in endorsing the ESOP concept, stated that it considered an ESOP to be "an innovative technique of finance which could have important benefits for labor, management and the economy of the United States."[110]

D. TAX REDUCTION ACT OF 1975

The most recent congressional legislation involving ESOPs was the Tax Reduction Act of 1975.[111] This Act accomplished several objectives. It provided a refund of 1974 individual income taxes[112] and increased the low income allowance and the percentage standard deduction for individuals.[113] Investment credit and surtax exemptions for corporations were also increased under the Act.[114]

The Tax Reduction Act increased the normal investment credit available to corporations from seven percent to ten percent.[115] Also,

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105. 19 U.S.C. §§ 2101-2487 (Supp. IV 1974).
106. S. REP. No. 93-1298, 93d Cong., 2d Sess. 3 (1974).
107. 19 U.S.C. §§ 2371-2374 (Supp. IV 1974).
108. *Id.* § 2373(g) (Supp. IV 1974).
109. *Id.* § 2373(f)(1)(A) (Supp. IV 1974). This section also provided that the ESOP must meet the requirements of 19 U.S.C. §§ 2373(f)(2), (3), (4), (5) (Supp. IV 1974).
110. S. REP. No. 93-1298, 93d Cong., 2d Sess. 160 (1974).
111. Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the INT. REV. CODE OF 1954).
112. *Id.*, tit. I, §§ 101-102, 89 Stat. 26, 27-28 (1975).
113. *Id.*, tit. II, §§ 201-202, 89 Stat. 26, 28-29 (1975).
114. *Id.*, tit. III, §§ 301-304, 89 Stat. 26, 36-45 (1975).
115. *Id.*, tit. III, § 301(a)(1), 89 Stat. 26, 36 (1975).

under section 301 (d) of the Act, corporations are entitled to claim an additional tax credit in an amount equal to one percent of the corporation's qualified investment if such an amount is transferred to an ESOP.[116] However, to claim the eleven percent investment credit, the corporation must adopt an ESOP which meets the requirements of section 301 (d) of the Act.[117] Under the Act, a corporation having an ESOP may elect to apply the eleven percent investment credit only with respect to properties acquired and placed in service after January 21, 1975, and before January 1, 1977.[118]

The Act of 1975 provides that in order for a corporation to obtain the eleven percent credit, its ESOP must be funded by employer securities[119] and must be a defined contribution plan established in writing.[120] The plan must also provide for allocations proportionate to participants' compensation.[121] Furthermore, the participants of the plan must be allowed to vote the shares.[122]

The Tax Reduction Act of 1975 defined ESOPs to include profit-sharing plans.[123] The Committee Report accompanying this Act indicates that the additional one percent tax credit could be obtained by corporations which adopt plans that combine an ESOP with an existing plan.[124]

An ESOP might therefore be attractive to a corporation due to the one percent credit allowed on its qualifying capital investments. Although this one percent credit might involve a significant dollar amount in a large corporation, the amount would not necessarily be a significant percentage of compensation paid to employees.

V. IMPLEMENTATION OF AN EMPLOYEE STOCK OWNERSHIP PLAN

There are various forms of employee stock ownership plans which may be utilized for different purposes. However, implementa-

116. *Id.*, tit. III, § 301(a)(1)(B), 89 Stat. 26, 36 (1975).
117. *Id.*
118. Pub. L. No. 94-12, tit. III, § 301(a)(1)(D)(i), 89 Stat. 26, 36 (1975).
119. *Id.*, tit. III, § 301(d)(1), 89 Stat. 26, 38 (1975). This section provides that the ESOP must be funded by employer securities in accordance with *id.*, tit. III, § 301(d)(6), 89 Stat. 26, 39 (1975) which provides:

> On making a claim for credit, adjustment, or refund under section 38 of the Internal Revenue Code of 1954, the employer states in such claim that it agrees, as a condition of receiving any such credit, adjustment, or refund, to transfer employer securities forthwith to the plan having an aggregate value at the time of the claim of 1 percent of the amount of the qualified investment (as determined under section 46(c) and (d) of such Code) of the taxpayer for the taxable year. For purposes of meeting the requirements of this paragraph, a transfer of cash shall be treated as a transfer of employer securities if the cash is, under the plan, used to purchase employer securities.

120. *Id.*, tit. III, §§ 301(d)(2)(A), (B), (C), 89 Stat. 26, 38 (1975). For the statutory definition of a defined contribution plan, *see* text accompanying notes 40-41 *supra*.
121. *Id.*, tit. III, § 301(d)(3), 89 Stat. 26, 38-39 (1975).
122. *Id.*, tit. III, § 301(d)(5), 89 Stat. 26, 39 (1975).
123. *See* text accompanying notes 40-41 *supra*.
124. S.R. No. 94-36, 94th Cong., 1st Sess. 59 (1975).

tion of a simple ESOP generally follows a procedure similar to the following example. The company adopts a qualified stock bonus plan and establishes a qualified trust.[125] The trust borrows money from a lending institution and invests the loan proceeds in company stock at its current market value.[126] The trust then gives the lender its note, which may or may not be secured by a pledge of stock.[127] The company guarantees the lender that it will make annual contributions to the trust in amounts sufficient to enable the trust to amortize its debt to the lender.[128] If the loan is secured by stock held by the trust, as installment payments are made on the trust's note proportionate amounts of the debt-security stock are released each year.[129] This released stock is allocated among participant employees' accounts in amounts equivalent to each employee's commensurate share of such installment payment.[130] As the financing is completed and the loan is paid off, beneficial ownership of the stock accrues to the participant employees.[131] Although amounts of stock are allocated to each employee's account as each payment is made, the employees only obtain beneficial ownership when the stock vests in their accounts.[132]

An example of how this technique might work is as follows: Assume that Corporation X desires to raise $500,000 to use for company expansion. The corporation considers conventional financing, but decides this method is too expensive or otherwise inappropriate. It decides to set up an ESOP and the ESOP trust borrows $500,000 from a lending institution. The trust gives the lender its note, which is secured by the corporation's pledge of stock. The loan, which is guaranteed by Corporation X, is payable in level installments over a five-year period at a ten percent interest rate. The trust uses the $500,000 loan proceeds to purchase newly issued company stock valued at $500,000. Corporation X's covered payroll[133] totals $1 million, so pursuant to section 401 (a) of the Internal Revenue Code, it may

125. For a discussion of qualified stock bonus plans and qualified trusts, *see* text accompanying notes 42-76 *supra*.

126. This purchase must comply with ERISA's standard of "adequate considerations." ERISA, Pub. L. No. 93-406, tit. I, §§ 3(18), 408(e)(1), 88 Stat. 829, —— (1974).

127. If the lender is a party in interest under *id.*, tit. I, § 3(14), 88 Stat. 829, —— (1974), the loan may be secured *only* by employer stock. *Id.*, tit. I, § 408(b)(3), 88 Stat. 829, —— (1974).

128. INT. REV. CODE OF 1954, § 404(a)(3)(A) provides that contributions equal to 15% of the annual compensation paid to employees covered by the plan are tax deductible. Section 404(a)(3)(A) is set out at note 196 *infra*.

129. For a discussion of this method, *see* text accompanying notes 133-36 *infra*.

130. Allocation to participants' accounts must be based on a formula. A ratio to be used is set out in the Trade Act of 1974, 19 U.S.C. § 2373(f)(4) (Supp. IV 1974).

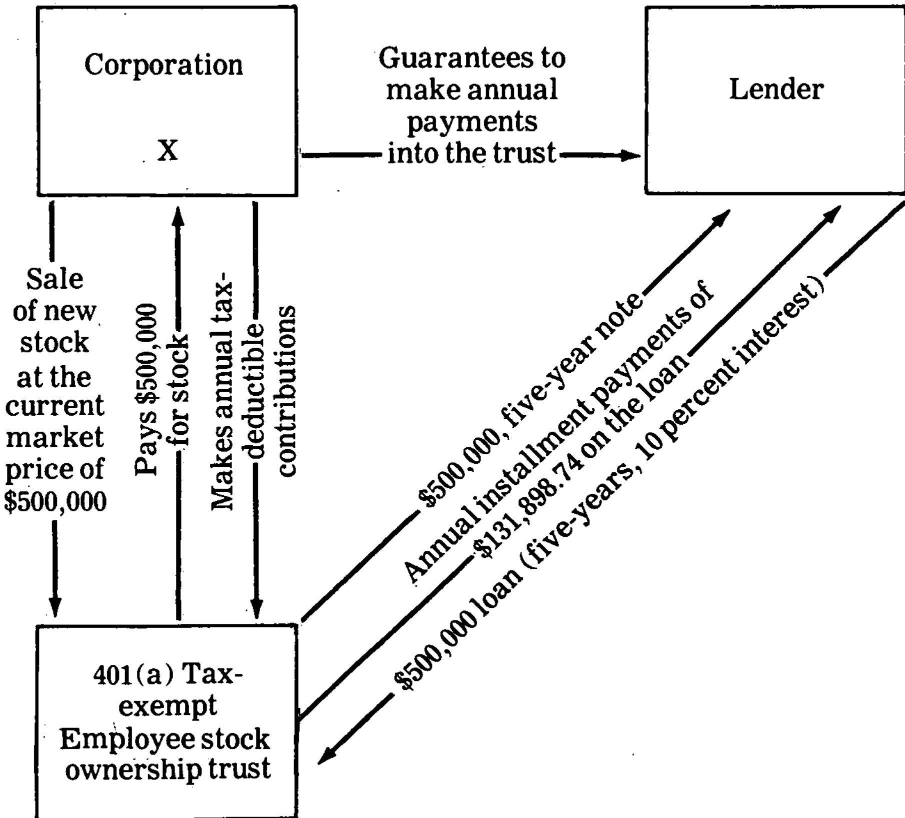
131. For a discussion of this method, *see* text accompanying notes 137-41 *infra*.

132. Vesting should be distinguished from allocation. Generally, when an employer makes a contribution to an ESOP trust, this contribution is allocated to participant employees' accounts. This amount vested in a participant's account represents the amount of stock to which he or she is entitled at a given time.

133. The term "covered payroll" refers to the total amount of compensation paid to the employees covered by the ESOP.

make annual tax deductible contributions to the trust totalling up to $150,000, fifteen percent of its covered payroll.[134] This annual contribution is more than enough to cover the annual repayment installments on the loan.[135] Therefore, each year as the employer contribution is made to the trust, a proportionate amount of stock is allocated to participant employees' accounts.[136]

As the loan is amortized, both principal and interest payments will, in effect, be deductible to the corporation through its contributions to the trust. As a result, the Corporation's tax liability will be significantly reduced over the five year period of the loan.[137] Also, Corporation *X's* employees will have obtained a block of company stock at its appraised value at the time of the sale to the trust.[138] The following diagram demonstrates this technique.



134. INT. REV. CODE OF 1954, § 404(a)(3)(A). This section provides that contributions of up to 15% of total compensation paid employees covered by the plan may be deducted by the employer.

135. An annual payment of $131,898.74 will amortize a loan of $500,000 at a rate of 10% interest over five years.

136. *See* notes 130-31 *supra*.

137. Assuming a corporate tax rate of 48%, the annual tax savings would be $72,000 (48% x $150,000)—hence, a savings of $360,000 over 5 years.

138. This example illustrates the Kelso-Hetter concept of providing employees with bene-

Using the foregoing example, Corporation *X* makes annual contributions to the trust. Section 401(a) of the Internal Revenue Code provides that an amount of fifteen percent of annual compensation paid to participant employees may be contributed to the trust.[139] The trust then uses these contributions to make annual installment payments to the lender of the $500,000 loan. As installment payments are made, shares of stock are released to be allocated among participant employees' accounts. The allocation made to each participant's account must also be made in proportion to the total amount of all such stock allocated to all accounts.[140]

To illustrate how allocations are made, assume there are the following employees covered by Corporation *X's* plan: a vice president whose salary is $40,000 (4 percent of the $1 million covered payroll); a department head whose salary is $15,000 (1.5 percent of covered payroll); a clerk whose salary is $8,000 (.8 percent of covered payroll); and other employees whose aggregate compensation is $937,000 (93.7 percent of covered payroll). The amounts of stock allocated to the participants' accounts would be stock valued at $6,000 to the vice president (4 percent x $150,000 contribution); $2,250 to the department head (1.5 percent x $150,000); $1,200 to the clerk (.8 percent x $150,000) and $140,550 to the other employees (93.7 percent x $150,000).

After five years the loan will be paid off. During this five-year period annual contributions have been made and stock has been released to be allocated proportionately among participating employees' accounts. As the allocated stock gradually vests, the employees become beneficial owners of the corporation. The number of shares of stock which have vested determines the amount of stock to which an employee is entitled at a given time. This amount is determined by the corporation's vesting schedule which is usually graduated: the longer an employee works for the corporation, the greater the vested percentage of his or her account.[141] ERISA sets minimum vesting standards which provide that employee benefits due at retirement must be nonforfeitable upon attainment of normal retirement age and that employer contributions must satisfy one of three vesting schedules.[142]

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fits in the form of partial ownership of the corporation. For a discussion of this concept, *see* text accompanying notes 1-32 *supra*.

139. *See* note 134 *supra*.

140. *See* note 130 *supra*.

141. If an employee terminates employment with the corporation before he or she is entitled to receive 100% of the amount credited to his or her account, the unvested portion is forfeited and reallocated to the accounts of the remaining participants. INT. REV. CODE OF 1954, § 401(a)(8); Treas. Reg. § 1.401-7 (1963).

142. The three alternative vesting schedules are set out at note 65 *supra*.

VI. USES OF AN EMPLOYEE STOCK OWNERSHIP PLAN

As discussed in the previous section, an employee stock ownership plan might be utilized for the purpose of company expansion. However, ESOPs are not limited only to this purpose. Other uses of an ESOP include providing a market for stock, acquiring control of an independent corporation, selling a division or subsidiary of the corporation, and increasing equity by converting a profit-sharing plan into an ESOP.

A. MARKET FOR STOCK

An ESOP is often used for the purpose of creating a market for stock of a closely-held corporation. Suppose that Shareholder *A* owns 100 percent of the stock of Corporation *X* and that this stock is worth $1 million. Shareholder *A* wishes to sell forty-nine percent of her stock for $490,000. If Corporation *X* redeems this stock, the redemption proceeds will be taxed to Shareholder *A* as an ordinary income dividend, and the redemption price paid by Corporation *X* would be paid from its after-tax dollars.[143] To avoid these tax consequences, Corporation *X* can establish an ESOP which borrows $490,000 from a lending institution, with Corporation *X* guaranteeing the loan. The ESOP purchases the stock from Shareholder *A* for $490,000, which results in a capital gain to her.[144] Corporation *X* receives a tax deduction for its contributions to the trust.[145] The trust, from these contributions, then repays the loan from the lender.

As a result of utilizing this method for selling closely-held stock, many benefits are obtained: the shareholder is taxed on capital gains, not ordinary income; the shareholder may sell as much or as little as she wishes; the shareholder still retains control of the company; the shareholder avoids sale of the stock to an outside buyer which might have a disruptive effect on employees; and the corporation obtains a tax deduction for its contributions to the trust.

This same technique may also be utilized for purchasing closely-held stock of a decedent's estate. By utilization of an ESOP, the same liquidity is obtained as under a section 303 redemption.[146] A redemption under section 303 of the Internal Revenue Code may be used when a large portion of the decedent's estate consists of closely-held stock.[147] This section provides that a distribution in redemption

143. If the stock were purchased by Corporation *X*, the transaction might be treated as a redemption resulting in taxation of the proceeds as ordinary income. INT. REV. CODE OF 1954, §§ 301, 302(d).

144. Shareholder *A* receives capital gain treatment on profit realized because the stock is not redeemed by the corporation (and thereby subject to taxation as ordinary income). Rather, the stock is purchased by a separate legal entity, the ESOP trust.

145. *See* note 134 *supra*.

146. INT. REV. CODE OF 1954, § 303.

147. When this situation exists, often the stock will be the only source from which

of stock, which is part of the taxable estate, will be treated as a payment in exchange for stock.[148] Certain requirements, however, must be met before such a redemption may be used.[149] If these requirements are met, the Corporation can redeem the shares of stock up to the amount of federal and state death taxes, interest thereon, and funeral and administrative expenses of the estate.[150] Consequently, the stock redemption is treated as a sale. Therefore, if the stock is a capital asset, which it almost always is, the sale of such stock results in a capital gain.

The corporation could establish an ESOP whereby the trust under the plan would purchase the decedent's closely-held stock. The effect would be the same as if a stock redemption under section 303 had been made. However, the corporation obtains an additional benefit by the use of an ESOP in that the purchase of such stock was made with tax deductible dollars.

B. CONTROL OF A CORPORATION

An ESOP might also be established to acquire control of an independent corporation. Assume that Corporation A wishes to acquire Corporation *X* because Corporation *A* relies heavily on raw materials which it purchases from Corporation *X*. Since Corporation *A* is closely-held, the lack of marketability of its own stock makes acquisition by use of its own stock infeasible. Corporation *A* also lacks the necessary amount of cash to make such an acquisition. Also, if it purchased Corporation *X* with cash, this money would represent after-tax dollars. However, the use of an ESOP allows Corporation *A* to make the acquisition with pre-tax dollars. In establishing its ESOP, Corporation *A* makes a cash and/or stock contribution to the trust in an amount of $150,000.[151] The trust then pays the cash and/or Corporation *A* stock to the stockholders of Corporation *X* in exchange for the stock of Corporation *X*. The trust then exchanges the stock

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death taxes and administration expenses can be paid. The time within which such taxes and expenses must be paid may not be sufficient to accumulate the requisite amount through dividends paid by the stock, if dividends are paid at all.

148. INT. REV. CODE OF 1954, § 303(a).

149. The provisions of INT. REV. CODE OF 1954, § 303 apply if the following conditions are met:

> (1) value of redeemed stock was included in decedent's gross estate for federal tax purposes;
>
> (2) value included in gross estate was either more than 35% of the gross estate or more than 50% of the taxable estate; the stock of two or more corporations may be aggregated if more than 75% of the value of such stock was included in the gross estate;
>
> (3) redemption is made within 90 days after expiration of period for assessment of the estate tax or within 60 days after a final court decision.

Id. §§ 303(b)(1), (2).

150. *Id.* § 303(a).

151. The use of this amount assumes that Corporation *A's* covered payroll for that particular year equals $1,000,000. It may make deductible contributions to the trust in an amount up to 15% of its covered payroll. INT. REV. CODE OF 1954, § 404(a)(3)(A).

of Corporation *X* for an appropriate amount of Corporation *A* stock. Corporation *A* now owns the stock of Corporation *X*. As a result of this method, Corporation *A's* net worth has been increased by the value of Corporation *X's* stock; the acquisition has been made with pre-tax dollars;[152] and the employees' accounts have been credited with the stock acquired from Corporation *A*.

C. INCREASING EQUITY AFTER CONVERSION OF PROFIT-SHARING PLAN

Corporations which have profit-sharing plans might desire to convert these plans into employee stock ownership plans. In most instances, this conversion may be achieved with minimal difficulty.[153]

The proposed conversion must provide each employee with benefits equal to or greater than the benefit to which he or she was entitled under the old plan.[154] When such a conversion is contemplated, the first issue which should be considered is whether the merger[155] or replacement of the original plan will constitute a termination of the profit-sharing plan for purposes of section 411(d)(3) of the Internal Revenue Code. This provision requires full vesting upon termination of a qualified trust.[156] The majority of such conversions probably involve maintaining the original profit-sharing plan by continuing to invest assets in a diversified portfolio. However, if assets are to be reinvested in employer stock under the ESOP, there are two other factors which might be considered. These are whether the ESOP or the original profit-sharing plan are for the exclusive benefit of the parti-

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152. Had this acquisition been made with cash, the amount would have represented after-tax dollars; hence, the corporation would not receive the same tax advantages as under an ESOP.

153. It may be advisable, however, for a corporation that is considering a conversion to obtain confirmation of its proposal from the Internal Revenue Service. ERISA provides that benefits under the merged or consolidated plan must be equal to or greater than benefits provided under the previous plan. ERISA, Pub. L. No. 93-406, tit. II, § 1021(b), 88 Stat. 829, —— (1974).

154. *Id.* tit. II, § 1021(b), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 401(a)(12) provides:

> A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan after the date of the enactment of the Employee Retirement Income Security Act of 1974, each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated). . . .

155. If the plans are merged, the payroll percentage limitation for deductible contributions applies to the total of the combination of the plans. INT. REV. CODE OF 1954, § 404(a)(3).

156. INT. REV. CODE OF 1954, § 411(d)(3) provides:

> [A] trust shall not constitute a qualified trust under section 401(a) unless the plan of which such trust is a part provides that:
>
> (A) upon its termination or partial termination, or
>
> (B) in the case of a plan to which section 412 does not apply, upon complete discontinuance of contributions under the plan,
>
> the rights of all affected employees to benefits accrued to the date of such termination, partial termination, or discontinuance, to the extent funded as of such date, or the amounts credited to the employees' accounts, are nonforfeitable. . . .

cipating employees and beneficiaries,[157] and whether the fiduciaries, consistent with obligations to participants as required by ERISA, agree to the reinvestment. If the assets are to be reinvested in employer stock, the "exclusive benefit" requirement must be met.[158] The fiduciary obligations set forth under ERISA would also have to be met.[159]

An example of how such a conversion might be made follows. Assume Corporation *A* has an existing profit-sharing plan with $500,000 in liquid assets held by the profit-sharing trust and that the plan has been in existence for four years. The corporation is growing rapidly and is in need of cash to fund that growth. Assume further that the corporation is dissatisfied with the performance of the investments of the profit-sharing plan and wishes to convert it to an ESOP. The annual payroll of the corporation has averaged $2 million, but contributions made by Corporation *A* to the profit-sharing plan during the past four years have totaled only $400,000. This amount is well below the $1,200,000 maximum amount of contributions the corporation could have deducted during those four years.[160] Corporation *A* establishes an ESOP, liquidates the profit-sharing assets and transfers the cash to the ESOP trust. The trust has an initial $500,000 fund of preconversion trust assets plus a credit carryover of $800,000.[161] The ESOP may then invest both the $500,000 of trust assets and the employer's current contribution of $500,000, a total of $1 million in increased working capital and net worth.[162]

As a result of this conversion, not only has the corporation realized the tax savings normally associated with ESOP financing, but the current contribution, made possible because of the credit carryover, may result in a net operating loss carryback that can be used to recover previously paid taxes.[163] Also, the participant employees retain the same vesting standard that they had prior to the conversion.[164]

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157. INT. REV. CODE OF 1954, § 401(a)(2).

158. *See* text accompanying note 54 *supra*.

159. *See* INT. REV. CODE OF 1954, §§ 404(c), 410(b).

160. The employer is entitled to make contributions in an amount equal to 15% of its covered payroll. INT. REV. CODE OF 1954, § 404(a)(3)(A). Corporation *A*, in this example, would be entitled to make annual contributions in amount of $300,000 (15% x $2,000,000). Over the four-year period, therefore, contributions could total $1,200,000 ($300,000 x 4).

161. The credit carryover amount is obtained by subtracting the employer's annual contributions for four years, $400,000, from the maximum deductible contributions allowed, $1,200,000. The credit carryover provisions are discussed in text accompanying notes 197-203 *infra*.

162. Current contributions for the year total $300,000 (15% of covered payroll) plus an additional $200,000 (10% of covered payroll). A credit carryover may total 25% of the covered payroll. *See* INT. REV. CODE OF 1954, § 404(a)(3)(A) and text accompanying notes 197-203 *infra*.

163. INT. REV. CODE OF 1954, § 172. Corporation *A* may take advantage of the unused credit carryover in the old plan if the new plan is considered a comparable one. Treas. Reg. §§ 1.401-6(b)(1) (1963); 1.381(c)(11)-1(d)(4) (1972).

164. For discussion of vesting, *see* note 132 *supra*.

D. GENERAL USES OF AN EMPLOYEE STOCK OWNERSHIP PLAN

A telephone survey made of eleven national companies is illustrative of the current uses of ESOPs.[165] Of the ten major companies who responded, it was found that the majority had a stock bonus plan[166] and that two had combination stock bonus and money purchase plans.[167] The results of the survey indicated common characteristics among the plans. Employee contributions were usually not allowed.[168] The majority of the plans provided for allocation of contributions in proportion to participants' compensation,[169] and distributions were generally made in employer stock.[170]

Five of the ten companies responded that they had utilized ESOPs as a corporate financing technique.[171] When asked their reasons for implementing ESOPs, nine of the ten companies cited increasing employee incentive as a reason.[172] Other reasons given most frequently were that the plans offered an alternate means of corporate financing, provided retirement benefits, and supplemented an existing pension plan.[173] Seven of the ten companies, when asked to evaluate their plans, rated them as either very good or excellent in accomplishing the goals set for their ESOP.[174]

From this survey, it appears that those companies currently utilizing ESOPs have been generally satisfied with them. Because of the general satisfaction of those companies presently utilizing them, it seems inevitable that more corporations will adopt ESOP plans.

VII. COMPARISON OF STOCK BONUS PLANS, PROFIT-SHARING PLANS AND EMPLOYEE STOCK OWNERSHIP PLANS

A. STOCK BONUS PLANS AND PROFIT-SHARING PLANS

Generally, the rules which govern stock bonus plans[175] and their associated trusts likewise apply to profit-sharing plans and their associated trusts. Like profit-sharing trusts, stock bonus trusts must

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165. HEWITT ASSOCIATES, ESOPS: AN ANALYTICAL REPORT (1975) (the survey was taken in July-Aug. 1975 and prepared for the Profit Sharing Council of America) [hereinafter cited as ESOPS]. The criteria used to determine which companies would be included in the survey was whether or not the company considered its plan to be an ESOP. *Id.* at 45.

166. *Id.* at 47.

167. *Id.* One half of the companies also provided their employees with a defined benefit pension plan. *Id.*

168. ESOPS, note 165 *supra*, at 49.

169. *Id.*

170. ESOPS, note 165 *supra*, at 50. In those plans where employee contributions were permitted, contributions were not invested in employer stock. *Id.*

171. ESOPS, note 165 *supra*, at 52.

172. *Id.*

173. *Id.*

174. *Id.* Of the other responses, one company responded that the ESOP was "good" in accomplishing the goals set while the other two companies responded that it was too early for them to make an evaluation. *Id.*

175. The term "stock bonus plan" is defined in text accompanying notes 43-44 *supra.*

satisfy the Internal Revenue Code qualification requirements.[176] Basically, there are two major distinctions between the two types of benefit plans. First, employer contributions made to a stock bonus plan are not dependent upon profits of the company.[177] Therefore, payments to the plan may be used to create a net operating loss. Second, vested benefits in a stock bonus plan must be paid out to participants in the form of employer stock.[178]

The strict requirements regarding allocations and distributions to employees' accounts must be met by both profit-sharing and stock bonus plans.[179] Both types of plans must also provide a definite predetermined formula for allocating contributions made to the trust among the participants and allocation formulas may be based on compensation or on compensation and service.[180]

The Internal Revenue Service has ruled that, generally, mandatory employee contributions of six percent or less of eligible annual compensation are not discriminatory.[181] A maximum limitation has also been placed on an annual voluntary contribution by a participant of ten per cent of his or her eligible compensation.[182] These rules are applicable to both profit-sharing and stock bonus plans.

B. STOCK BONUS PLANS AND EMPLOYEE STOCK OWNERSHIP PLANS

An ESOP as defined by ERISA may consist of a qualified stock bonus plan or a stock bonus plan and money purchase plan, both of which are qualified.[183] Therefore, an ESOP using a stock bonus plan differs from a conventional stock bonus plan[184] in that ESOP

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176. INT. REV. CODE OF 1954, § 401(a). *See also* text accompanying notes 52-76 *supra.* Also, as qualified plans, profit-sharing and stock bonus plans must meet non-discriminatory requirements, INT. REV. CODE OF 1954, § 410. These requirements provide that participation in a plan may not discriminate in favor of officers, shareholders or highly compensated employees. Generally, a plan may not set more stringent minimum age and service conditions than the later of either the date on which the employee attains age 25 or the date on which the employee completes one year of service. A plan which provides for immediate vesting, however, may substitute three years of service for one year of service.

177. Contributions made to a profit-sharing plan must be made from current or accumulated profits. Treas. Reg. § 1.401-1(b)(1)(ii) (1972).

178. *Id.* § 1.401-1(b)(1)(iii) (1972). Distributions may be made in either a lump sum or in installments. However, a lump sum distribution may be advantageous to participant employees because the unrealized appreciation is entitled to capital gain treatment when the participants sell the stock. ERISA, Pub. L. No. 93-406, tit. II, § 2005(b), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954, § 402(a)(2).

179. Treas. Reg. §§ 1.401-1(b)(1)(ii), (iii) (1972).

180. *Id.*

181. Rev. Rul. 59-185, 1959 CUM. BULL. 86; Rev. Rul. 72-58, 1972-1 CUM. BULL. 111.

182. *Id.* The test as to whether or not the contributions are discriminatory is whether the provisions operate to deprive lower paid employees of benefits at least as high in proportion to compensation as are provided for higher paid employees. Employee contributions, however, may raise some SEC considerations as mandatory employee contributions may constitute a "sale" for Securities Act purposes. Generally, the SEC has treated voluntary employee contributions to a stock bonus plan under a "no sale" philosophy, but the statutory basis for not requiring registration is unclear. *See* 15 U.S.C. §§ 77b, e (1970).

183. ERISA, Pub. L. No. 93-406, tit. II, § 2003(a), 88 Stat. 829, —— (1974), INT. REV. CODE OF 1954. § 4975(e)(7). *See* text accompanying notes 38-39 *supra.*

184. A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that contributions by the employer are not necessarily dependent upon profits. Treas. Reg. § 1.401-1(b)(1)(iii) (1956).

stock bonus plan must meet the qualification requirements of section 401 of the Internal Revenue Code,[185] whereas the conventional stock bonus plan need not. ERISA distinguishes an ESOP from a stock bonus plan further in that it provides that only ESOPs may purchase employer stock with employer-guaranteed loans,[186] whereas the conventional stock bonus plan may not be used in such manner. An ESOP also differs from a conventional stock bonus plan in that an ESOP may be used to buy stock on an installment basis from a shareholder.[187]

An ESOP also enables employees covered by the plan to acquire larger blocks of employer stock more quickly than they could under a conventional stock bonus plan. Generally, a conventional stock bonus plan accumulates employer stock over several years. This may be accomplished by either employer contributions of stock to the plan or by cash contributions used to purchase stock.[188] Under an ESOP, however, because of the ESOP's ability to borrow, a larger block of stock may be purchased in the first year. Therefore, appreciation of that stock will accrue to the benefit of the employees over a longer period of time.[189]

C. PROFIT-SHARING PLANS AND EMPLOYEE STOCK OWNERSHIP PLANS

Employee stock ownership plans differ from profit-sharing plans in the same ways that they differ from stock bonus plans.[190] The two types of plans also differ in that ESOP employer contributions need not be based on company profits,[191] and distributions under an

185. *See* text accompanying notes 52-76 *supra*.

186. ERISA, Pub. L. No. 93-406, tit. I, § 408(b)(3), 88 Stat. 829, —— (1974) provides that the prohibitions of *id.*, tit. I, § 406, 88 Stat. 829, —— (1974) shall not apply to:

> A loan to an employee stock ownership plan (as defined in sections 407(d)(6)), if—
>
> (A) such loan is primarily for the benefit of participants and beneficiaries of the plan, and
>
> (B) such loan is at an interest rate which is not in excess of a reasonable rate.
>
> If the plan gives collateral to a party in interest for such loan, such collateral may consist only of qualifying employer securities (as defined in section 407(d)(5)).

187. *Id.*, tit. I, § 408(b)(3), 88 Stat. 829, —— (1974). *See* also text accompanying notes 143-50 *supra*.

188. Treas. Reg. §§ 1.401-1(b)(1)(ii), (iii) (1956).

189. Of course, the employees will gain less if the stock depreciates over a period of time. This possible risk of incurring loss as a result of depreciation, however, is offset by the employer's guarantee to make contributions sufficient to amortize the loan.

190. INT. REV. CODE OF 1954, § 404(a)(6). This section provides that an employer's contribution for any year can be deemed as having been made on the last day of the preceding year, provided it is made not later than the required date (including extensions) for filing of the employer's tax return for the preceding year.

191. Treas. Reg. §§ 1.401-1(b)(1)(ii), (iii), (1972). Under the Tax Reduction Act of 1975, companies may claim an additional tax credit in an amount equal to 1% of the corporation's qualified investment if such amount is transferred to an ESOP. Pub. L. No. 94-12, tit. III, § 301(d), 89 Stat. 26, 36 (1975). Such contribution must be transferred to the ESOP at one time. Contributions to a qualified plan in excess of the 1% credit would be tax deductible, subject to the limitation of INT. REV. CODE OF 1954, § 404(a). Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the INT. REV. CODE OF 1954).

ESOP must be made in employer stock.[192]

Profit-sharing plans need not distribute benefits in the form of employer stock as is required for ESOPs.[193] However, a profit-sharing plan which invests largely in employer stock may include a provision that distributions should be made in employer stock when, and to the extent possible.[194]

VIII. FEDERAL INCOME TAX ADVANTAGES

There are several tax and tax-related advantages to both employees and the employer corporation which make an ESOP an attractive option.

A. BENEFITS TO EMPLOYER

Contributions made by the employer are deductible up to certain limits.[195] If an ESOP consists only of a qualified stock bonus plan, the employer may deduct an amount not greater than fifteen percent of the compensation paid all employees covered by the plan in a given year.[196] If contributions equal more than fifteen percent in any year, the employer is entitled to deduct the excess amount, or contribution carryover, in subsequent years.[197] The total deduction in a later year for current contributions plus the contribution carryover from a previous year, however, may not exceed the fifteen per-

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192. Again, as is required for stock bonus plans, funds accumulated under the plan must be distributed according to a definite predetermined formula. Treas. Reg. § 1.401-1(b)(1)(iii) (1972).

193. *Id.*

194. *Id.*

195. INT. REV. CODE OF 1954, § 404(a).

196. INT. REV. CODE OF 1954, § 404(a)(3)(A) provides:

> In the taxable year when paid, if the contributions are paid into a stock bonus or profit-sharing trust, and if such taxable year ends within or with a taxable year of the trust with respect to which the trust is exempt under section 501(a), in an amount not in excess of 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan. If in any taxable year, there is paid into the trust, or a similar trust then in effect, amounts less than the amounts deductible under the preceding sentence, the excess, or if no amount is paid, the amounts deductible, shall be carried forward and be deductible when paid in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any succeeding taxable year shall not exceed 15 percent of the compensation otherwise paid or accrued during such succeeding taxable year to the beneficiaries under the plan. but the amount so deductible under this sentence in any one succeeding taxable year together with the amount so deductible under the first sentence of this subparagraph shall not exceed 25 percent of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under the plan. In addition, any amount paid into the trust in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this subparagraph shall be deductible in the succeeding taxable years in order of time. but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this subparagraph shall not exceed 15 percent of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under the plan. . . .

197. *Id.* Hence, if, in one given year, the employer made a contribution in an amount equaling 17% of its covered compensation, the 2% excess could be carried over until the next year.

cent limitation of covered compensation for that year.[198] Likewise, if contributions in a given year are less than fifteen percent of covered compensation, the difference, or credit carryover, may be deducted in subsequent years.[199] However, the deduction allowed for a credit carryover differs from that allowed for a contribution carryover. The deductible sum of current contribution and any credit carryover may total twenty-five percent of covered compensation,[200] whereas a deduction for contribution carryover is limited to fifteen percent of covered compensation.[201]

An employer may also increase its overall allowable deductions by establishing an ESOP consisting of both a stock bonus and money purchase plan. If this method is used, the annual deduction limit is twenty-five percent of current contributions alone.[202] The credit carryover provision is of no benefit to the employer, however, because the limit on allowable deductions for contributions to all plans maintained by an employer is just twenty-five percent.[203]

Also of significance with respect to tax advantages is the Tax Reduction Act of 1975.[204] This Act increases the ten percent investment credit to which a corporation may be entitled[205] by one percent if the corporation establishes an ESOP under section 301(d) of the Act.[206] A corporation may claim this additional tax credit in an amount equal to one percent of its qualified investment if such an amount is transferred to an ESOP.[207] The eleven percent credit is available with respect to property acquired and placed in service after January 21, 1975, and before January 1, 1977.[208] The Act further provides that certain other requirements must be met for an ESOP to qualify for the tax credit.[209]

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198. *Id.*
199. *Id.*
200. *Id.* The 25% limitation became effective Dec. 31, 1975. ERISA, Pub. L. No. 93-406, tit. II, § 2004(d), 88 Stat. 829, —— (1974).
201. INT. REV. CODE OF 1954, § 404(a)(3)(A).
202. *Id.* § 404(a)(7).
203. *Id.* This limit applies to plan years beginning after Sept. 2, 1974. ERISA, Pub. L. No. 93-406, tit. II, § 1017(a), 88 Stat. 829, —— (1974).
204. Pub. L. No. 94-12, 89 Stat. 26 (1975) (codified in scattered sections of the INT. REV. CODE OF 1954).
205. INT. REV. CODE OF 1954, § 46(a).
206. Pub. L. No. 94-12, tit. III, § 301(d), 89 Stat. 26, 38-40 (1975). This section provides that a corporation must establish an ESOP as provided for in the Act. It also provides that allocations must be made at the close of each year in an amount bearing substantially the same proportion to the amount of all securities allocated to all participants as the amount of compensation paid to such participant bears to the compensation paid to all participants during that year. *Id.*, tit. III, § 301(d)(3), 89 Stat. 26, 38-39 (1975).
207. *Id.*, tit. III, § 301(d), 89 Stat. 26, 38-40 (1975).
208. INT. REV. CODE OF 1954, § 46(a)(D).
209. These requirements are:

(1) The ESOP may not require employee contributions or reductions of other employee benefits, Pub. L. No. 94-12, tit. III, § 301(d), 89 Stat. 26, 38-40 (1975);

(2) Qualifying employer securities must be common or convertible preferred stock, *id.*, tit. III, § 301(a)(9), 89 Stat. 26, 39 (1975);

(3) Employer contributions are to be allocated to participants in proportion to compensation on a non-integrated basis. Annual pay in excess of $100,000 is to be disregarded, *id.*, tit. III, § 301(d)(3), 89 Stat. 26, 38-39 (1975);

Contributions to an ESOP trust may be made in real property, employer or non-employer securities, or cash.[210] Contribution of real property to a trust does not permit the employer corporation to recognize a loss.[211] However, a corporation may recognize a gain to the extent that the fair market value of the property at the time of the contribution exceeds its basis to the employer.[212] The employer, however, may not recognize a gain on the contribution of its own stock.[213]

B. BENEFITS TO EMPLOYEES

The ESOP trust is a stock bonus trust and can, therefore, qualify as a tax-exempt trust under section 401 (a) of the Internal Revenue Code.[214] Furthermore, employer contributions made to the trust,[215] earnings of the trust,[216] and dividends paid into the trust[217] are not taxable to the participating employees. Hence, employees are not subject to taxation on benefits received under the plan until such benefits are actually distributed to them.[218] If distributions to the emloyees are made in a lump sum, they enjoy additional tax advantages.[219] If such a lump sum distribution is made, the net "unrealized appreciation" portion of the distribution is excluded from the employee's gross income.[220] The remaining portion of the distribution, the

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(4) Employees must have a right to vote the stock allocated to them, *id.*, tit. III, § 301(d)(5), 89 Stat. 26, 39 (1975);

(5) Amounts allocated to participants must be fully vested, *id.*, tit. III, § 301(d)(4), 89 Stat. 26, 39 (1975);

(6) Distributions to a participant (except in case of death, disability or separation from service) may not occur until the end of the 84th month beginning with the month in which the stock is allocated to the participants' accounts, *id.*

210. The types of real property and employer securities that plans may acquire and hold are limited. ERISA, Pub L. No. 93-406, tit. I, §§ 406(a)(1)(e), 406(2), 407(a)(1), 414(a), 88 Stat. 829, —— (1974). However, ERISA does not restrict the classes of employer stock that plans may acquire and hold. *Id.*, tit. I, §§ 407(d)(5), (e), 88 Stat. 829, —— (1974).

211. Dillard Paper Co. v. Commissioner, 341 F.2d 897, 898 (4th Cir. 1965), *aff'g per curiam* 42 T.C. 588 (1964); INT. REV. CODE OF 1954, §§ 267(a)(1), (b)(4); 1032(a).

212. INT. REV. CODE OF 1954, §§ 1011, 1016.

213. United States v. General Shoe Corp., 282 F.2d 9, 11-14 (6th Cir. 1960). *See also* Tasty Baking Co. v. United States, 383 F.2d 992 (Ct. Cl. 1968); Rev. Rul. 73-345, 1973-2 CUM. BULL. 11.

214. *See* text accompanving notes 52-76 *supra.*

215. INT. REV. CODE OF 1954, § 402(a)(1). Likewise, to the extent that stock was acquired with the employee's own contributions, the receipt of the stock is tax free. *Id.* § 402(e)(4)(D)(i).

216. *Id.* § 402(a)(1).

217. Dividends are taxable to the employee only when they are distrbuted to the employee.

218. INT. REV. CODE OF 1954, § 402(a)(1).

219. *Id.* §§ 402(e)(4)(A), (D), (E), (J). Under the lump sum distribution rules, the employee will benefit from a lump sum distribution if he or she has participated in the plan for at least five years, *id.*, § 402(e)(4)(H); and so long as the employee's entire interest is distributed to him or her (or to the beneficiaries of the employee) in one taxable year, *id.*, § 402(e)(4)(A); and arises from death, attainment of age 59½ or older, termination of service or disability, *id.* It should also be noted that employees may be eligible for more than one lump sum distribution because lump sum distribution treatment is allowed for any distribution which represents the full balance of a credit to a participant in any given year. After reaching age 59½, an employee could qualify for such a distribution each year. *Id.*

220. *Id.* § 402(e)(4)(D)(ii). *See also* note 221 *infra.* The amount of net unrealized appreciation is the excess of the market value of the stock at the time of distribution over the cost or other basis of the stock to the trust. Treas. Reg. § 1.402(a)-1(b)(2)(i) (1972).

"total taxable amount," may be divided into capital gains and ordinary income.[221] The capital gains portion of the "total taxable amount" is determined according to a formula based on the total number of years and the number of years before 1974 during which the employee participated in the plan.[222] Distribution to employees who did not participate in the plan until after December 31, 1973, will have no capital gains portion.[223] The remaining portion not subject to capital gains treatment, or the entire distribution if there is no capital gains portion, is taxed as ordinary income.[224]

Although special tax treatment is given the "total taxable amount" portion when a lump sum distribution is made, the net unrealized appreciation portion is not affected by this treatment. The amount of net unrealized appreciation at the date of distribution will be taxed at long-term capital gain rates when the employee disposes of the stock.[225] Any appreciation of the stock that occurs after the date of distribution is taxable at capital gains rates depending upon the length of time the stock was held by the employee.[226]

If the distribution does not qualify for lump sum distribution treatment, the employee is taxed on the distribution as provided under section 72 of the Internal Revenue Code.[227] Under this section, the value of the stock distributed by the trust in excess of the amount contributed by the employee would be taxed as ordinary income,[228] except that net unrealized appreciation of the stock attributable to the

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221. INT. REV. CODE OF 1954, § 402(e)(4)(D) provides:

For purposes of this section and section 403, the term "total taxable amount" means, with respect to a lump sum distribution, the amount of such distribution which exceeds the sum of—

(i) the amounts considered contributed by the employee (determined by applying section 72(f)), which employee contributions shall be reduced by any amounts theretofore distributed to him which were not includable in gross income, and

(ii) the net unrealized appreciation attributable to that part of the distribution which consists of the securities of the employer corporation so distributed.

222. *Id.* § 402(a)(2). The capital gains portion of the distribution is computed by multiplying the total taxable amount, as provided under *id.*, § 402(e)(4)(D), by a fraction, the numerator of which is the number of calendar years of active participation by the employee in such plan prior to Jan. 1, 1974, and the denominator of which is the number of calendar years of active participation by the employee in such a plan.

223. *Id.* § 402(e)(4)(D).

224. *Id.* §§ 402(e)(1)(A), (4)(E). The ordinary income portion of the distribution is computed by multiplying the total taxable amount, as provided under *id.* § 402(e)(4)(D), by a fraction, the numerator of which is the number of calendar years of active participation by the employee in such plan after Dec. 31, 1973, and the denominator of which is the number of calendar years of active participation by the employee in such plan. *Id.* § 402(e)(4)(E). The ordinary income portion of the distribution, however, may be calculated and taxed separately from the tax on all other income for the year of distribution if the taxpayer so elects. *Id.* § 402(e)(4)(B).

225. This amount is taxed at long-term capital gain rates even though disposal may occur within 6 months of the distribution.

226. Treas. Reg. § 1.402(a)-1(b)(1)(i) (1972). If gain on the sale of stock, which is held by the employee for more than six months after the date of distribution, exceeds the amount of unrealized appreciation at the time of distribution, the excess is treated as a long-term capital gain. If it is held less than six months, the gain is treated as a short-term capital gain.

227. *See also* INT. REV. CODE OF 1954, § 402(a)(1).

228. Treas. Reg. §§ 1.72-1(a) (1960); 1.72-11(b)(1) (1966). Amounts subject to provi-

amount contributed by the employee would still escape taxation at the time of distribution.[229]

IX. UTILIZATION OF EMPLOYEE STOCK OWNERSHIP PLANS IN NORTH DAKOTA

There are currently only a few employee stock ownership plans in existence in the state of North Dakota.[230] There are perhaps several reasons for this scarcity of ESOPs in the state. First, many corporations may lack the operating capital necessary to make an ESOP feasible. Although there is no magic dollar amount which would determine such feasibility, the corporation should be operating profitably and should expect to continue doing so. Second, many corporations may not desire to have their employees become owners in a portion of the company. Third, the structures and operations of some corporations may not be conducive to the feasible implementation and operation of an ESOP.

A. STEIGER TRACTOR, INCORPORATED

The first ESOP adopted by a corporation in North Dakota was established in 1972 by Steiger Tractor, Inc.[231] Under this ESOP, all full time employees, those who customarily work more than twenty hours each week and more than five months each year, automatically become participants in the plan after one year of service with the company.[232] The amount of employer contributions, up to fifteen percent of total covered compensation, is determined by the Board of Directors.[233] Allocations to the participant employees' accounts are made at least once each year. These allocations are based on a ratio in which the compensation of each participant bears to the aggregate covered compensation of all participants.[234] Distributions to employees may be made in one of several ways elected by the employee and approved by the committee which administers the plan.[235]

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sions of INT. REV. CODE OF 1954, § 72 are includible in gross income except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid.

229. INT. REV. CODE OF 1954, § 402(a)(1). Treas. Reg. § 1.402(a)-1(b)(1)(i)(b) provides that unrealized appreciation of stock of the employer attributable to amounts contributed by the employee are excluded from basis for purposes of determining gain or loss on subsequent disposition of the stock by the employer.

230. At the writing of this note, the author was aware of only three ESOPs in existence in North Dakota. These were plans adopted by Steiger, Inc.; Crane Johnson Co.; and Dakota Electric Supply Co.; all of Fargo, North Dakota.

231. Steiger Tractor, Inc., 3101 First Avenue North, Fargo, North Dakota. Information concerning the Steiger plan was obtained from *Partners in Progress*, Steiger Tractor, Inc. and interviews with Russell F. Freeman, Attorney at Law, Fargo, North Dakota, who was involved in the formulation of the Steiger plan.

232. *Partners in Progress*, Steiger Tractor, Inc. (Employee Booklet and Employee Stock Ownership Plan).

233. *Id.*

234. *Id.*

235. *Id.*

The Steiger plan provides that initially, assets of the trust will be comprised primarily of funds borrowed by the trust for the purpose of purchasing newly issued stock from the company. It also provides that all employer contributions of cash and other cash received by the trust, other than cash borrowed specifically for the purchase of assets by the trust, will first be used to pay outstanding obligations of the trust. The plan further provides that any excess may be used to buy company stock from either holders of outstanding stock or newly issued company stock.

The Steiger plan was originally adopted for two primary reasons. First, the Steiger management desired to allow its employees to become owners of the corporation. Second, because the Steiger company was a relatively new corporation at the time of the adoption of its ESOP, it desired to borrow money to finance the company's operation. The ESOP was an ideal tool for achieving these objectives.

The Steiger corporation employs approximately 1000 employees who are covered by its ESOP plan. It is, thus far, extremely pleased with the results it has obtained under the plan.

B. Crane Johnson Company

The Crane Johnson Company adopted an ESOP plan which went into effect in 1975.[236] Their ESOP plan includes a provision whereby the trust could obtain a loan if this action should be desired by the management in the future. But obtaining financing was not a major purpose in the adoption of the ESOP by Crane Johnson; instead, it primarily sought the use of an ESOP to provide its employees with benefits.

Prior to the adoption of its ESOP, Crane Johnson had a profit-sharing plan in existence. It elected to consolidate the existing profit-sharing plan in with the ESOP. Under this new plan, contributions may be made to the trust in stock, cash, or a combination of both. Approximately sixty to seventy employees are covered by the plan.

Crane Johnson's major purpose for adopting this particular ESOP was to provide its employees with higher benefits when the company experienced higher profits. One of the features that Crane Johnson sees as beneficial is the flexibility that an ESOP provides the corporation. Although there are requirements which the plan must meet, contributions can be larger when the profits of the company are greater. Therefore, Crane Johnson adopted its ESOP because it desired to pass a share of these additional profits to its employees whenever possible.

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236. Crane Johnson Co., 211 North Tenth Street, Fargo, North Dakota. Information concerning the Crane Johnson plan was obtained from a telephone conversation with Richard Borkenhagen, Crane Johnson Co.

C. DAKOTA ELECTRIC SUPPLY COMPANY

A third ESOP in the state of North Dakota is that adopted by Dakota Electric Supply Company in 1975.[237] The plan covers approximately fifty-five employees and participation in the plan begins after completion of one year of service with the company. Dakota Electric's primary purpose for adopting an ESOP was to provide its employees with benefits and to allow them to become owners of the company.

Prior to the adoption of its ESOP, Dakota Electric provided its employees with benefits under a profit-sharing plan. Upon adoption of the ESOP, however, the corporation chose not to incorporate its profit-sharing plan with the ESOP. Therefore, the corporation still maintains its profit-sharing plan which covers those employees who were participants under it prior to the adoption of the ESOP. The corporation makes contributions to the profit-sharing plan each year in order to keep it active. However, Dakota Electric adds no new personnel to the plan, and all new employees are covered under the ESOP plan. Those employees who were participants under the original profit-sharing plan are also covered by the ESOP.

To date, Dakota Electric is well-satisfied with its ESOP and the corporation believes that it is an excellent way to provide employee benefits.

X. CONCLUSION

A basic ESOP plan consists of a trust which is established by a corporation for the purpose of borrowing money from a lending institution. The corporation guarantees the loan, and the trust gives its note to the lender, which may or may not be secured by a pledge of stock. The corporation makes annual contributions to the trust, which are in turn used by the trust to amortize its loan from the lender. The loan proceeds are used to purchase employer stock. As contributions are made to the trust, proportionate shares of stock are allocated to the accounts of the participating employees. Then as this allocated stock gradually vests, the employees obtain beneficial ownership in part of the corporation.

Although this method might be considered the "classic" or basic ESOP arrangement, it is far from the only way in which an ESOP may be utilized. The ESOP is a flexible, versatile tool which can be applied and designed in various ways to accomplish a variety of purposes. An ESOP may be used merely as a benefit plan for em-

237. Dakota Electric Supply Co., 2601 Third Avenue North, Fargo, North Dakota. Information concerning the Dakota Electric plan was obtained from *Employee Stock Ownership Plan*, Dakota Electric Supply Co. (booklet) and telephone conversation with Wayne M. Garr, Vice President & Director of Purchasing, Dakota Electric Supply Co.

ployees, by allowing the employees to become owners of the company while also providing the corporation with deductible contributions of up to fifteen percent of its covered payroll. Similarly, the ESOP may also be used as a means by which one corporation can acquire another corporation with pre-tax dollars while at the same time providing its employees with benefits. Also, the ESOP technique might be used to provide a market for stock of a closely-held corporation, without relinquishing control of the corporation or without selling the stock to an outside purchaser. Finally, an ESOP may be used as a means of increasing the equity of a corporation through conversion of its profit-sharing plan into an ESOP.

Because of this versatility, an ESOP can be devised in such a way as to be beneficial for various types of corporations with different needs. And while the ESOP is contributing to the success and profitable operation of a corporation, it also provides the corporate employees with valuable benefits in the form of employer stock. Through their acquisition of this stock, the employees gain actual ownership of the corporation. Moreover, because the ESOP provides the employees with shares of stock in the corporation, it simultaneously facilitates the broadening of the ownership base of the capital of the corporation. As a result of this broadened ownership in the corporation, the employees share in the capital factor of the economy. This participation of employees in the capital factor of the economy fulfills one of the major objectives advocated by the proponents of "universal capitalism." Hence, as ESOPs are used more extensively, "universal capitalism" is more likely to become a reality.

VICKI A. KJOS

***Since the writing of this note, the Tax Reform Act of 1976 has been passed. Although the basic concept of the ESOP and its advantages and tax benefits have not been substantially changed by the Act, the new Internal Revenue Code provisions should be consulted when a new ESOP is being formulated.