

# Tracking ESOP Shares

**Peter J. Prodoehl**  
**John P. Prodoehl**  
**Tina M. Fisher**

**T**HIS CHAPTER FOCUSES ON THE NEED to track employer securities owned by an ESOP. In the ESOP context, “tracking” refers to keeping a record of how and when shares are acquired so that these shares can be accorded proper treatment. Because different rules may apply to shares acquired at different times or under different circumstances, there are many legal and administrative reasons for properly tracking shares within the ESOP. From a legal or regulatory standpoint, Treas. Reg. § 54.4975-11(d)(2) provides that a leveraged ESOP must consistently allocate to the participants’ accounts non-monetary units representing the participants’ interest in assets withdrawn from the suspense account. A suspense account is created when the ESOP acquires shares with the proceeds of an ESOP loan and agrees to repay the loan over a specific term. As the loan is repaid, shares are released from the suspense account and allocated to the accounts of eligible participants. From administrative and compliance standpoints, there are many different reasons why share accounting and tracking is important and necessary. Following is a review of the requirements for properly tracking shares.

## **Prohibited Allocation Rules**

Section 409(n) of the Internal Revenue Code (the “Code”) provides that no portion of the assets of the ESOP attributable to (or allocated in lieu of) employer securities acquired by the plan in a sale to which Section 1042 applies may accrue (or be allocated directly or indirectly under the plan) during the non-allocation period for the benefit of any taxpayer who makes an election under Section 1042(a), or any individual who is related to the taxpayer under the attribution rules of Code Section

267(b). Section 1042 provides for a tax-deferred rollover for owners of privately held firms selling to an ESOP that owns 30% or more of the shares after the sale. For purposes of this rule, the non-allocation period begins on the date of the sale and ends on the later of the date 10 years later, or the date on which the final payment is made on the loan used to acquire such securities.

There is an exception to the family member rule for lineal descendants of the taxpayer if the allocations to such descendants during the non-allocation period do not exceed 5% of the total shares sold to the plan by any person related to such lineal descendants.

The prohibited allocation rules also provide that more-than-25% shareholders are precluded from sharing in the allocation of these shares. There are special rules that apply to determining which individuals are deemed to be more-than-25% shareholders; these special rules are beyond the scope of this chapter. However, one important rule that is sometimes easy to overlook is that an individual is deemed to be a more than 25% shareholder, for purposes of these rules, if he or she owns, directly or indirectly under the rules of attribution in Code Section 318(a), more than 25% of *any* class of the employer's stock.

## **Leveraged vs. Non-leveraged Shares**

It is not uncommon for an ESOP to receive direct contributions of shares in addition to cash contributions used to pay down an ESOP loan. For recordkeeping and allocation purposes, the leveraged shares should be tracked separately from the non-leveraged shares.

## **Forfeitures**

Forfeitures of shares acquired with the proceeds of a securities acquisition loan, as well as employer contributions used to pay interest on the ESOP loan, may be excluded when calculating the annual additions to a participant's account under Code Section 415. However, this exclusion applies only if no more than one-third of the contributions used to repay the loans for a year are allocated to highly compensated employees. Therefore, it is important to track leveraged shares separately from non-leveraged shares in order to perform the special one-third

test and to calculate Section 415 limits and annual additions properly. (See Code Section 415(c)(6).)

## **Shares Released from Each Separate Loan Must Be Tracked Separately**

To comply with the dividend deduction rules under Code Section 404(k), one must track shares attributable to each securities acquisition loan separately. For securities acquired after August 4, 1989, dividends paid on employer securities held by an ESOP are deductible if they are used to make payments on a securities acquisition loan only if the loan proceeds were used to acquire the shares on which the dividend is paid. In other words, dividends on shares acquired with loan number one proceeds would not be deductible if used to pay down loan number two. Therefore, each loan should be tracked separately, each having its own share release method, its own cost basis, and its own dividend deductibility treatment.

## **Section 133 Loan vs. Non-Section 133 Loan**

ESOPs may have several loans, some of which qualify for favorable treatment under Code Section 133, whereby the lender may exclude 50% of the interest income on the loan from its taxable income. ESOP loans made after July 10, 1989, must pass through voting rights to participants for all allocated shares on all issues to qualify for the tax benefits under Code Section 133. This voting right requirement may differ from the voting rights of other shares owned by the ESOP. Therefore, it is important to track the allocation of Section 133 loan shares versus non-Section 133 loan shares.

Note: This provision was repealed by the 1996 Small Business Job Protection Act, generally effective for loans incurred after August 20, 1996.

## **Releasing Shares from the Suspense Account for Leveraged ESOPs**

In a leveraged ESOP, all shares acquired with loan proceeds are held in a suspense account when purchased. They are released from the

suspense account as the loan is repaid. The released shares are then allocated to participant accounts as directed by the plan document or the ESOP loan documents.

Each year, the ESOP administrator must determine how many shares are released from the suspense account. To determine the release properly, one must determine the breakdown of payments between principal and interest.

Securities held in each ESOP suspense account are released under one of two formulas. In any particular plan, each method can be used; in many cases, one method is used for one loan and the other for one or more of the other loans. It is not, however, an annual election with respect to any particular loan. Once the determination is made, it may not be changed unless the loan ceases to qualify for the method chosen. The two formulas are the principal-only method and the principal and interest method (table 1).

To use the principal-only method, the ESOP loan must be for a term not exceeding 10 years. Repayments of principal and interest must be at least as rapid at all times as level payments over 10 years, thereby permitting some balloon payments if the term of the loan is less than 10 years. It is important to track each loan separately for purposes of allocations to participant accounts. (See Treas. Reg. § 54.4975-7(b)(8).)

## **Forfeitures for Terminated Employees**

Typically, an ESOP participant's account includes a cash balance, leveraged shares, and non-leveraged shares. If a participant terminates employment before becoming 100% vested, the law requires that other assets must be forfeited before the leveraged shares. If there are two or more classes of stock, the participant must forfeit the same proportion of each class of stock. To comply with these requirements, each class of stock, and all shares allocated from each leveraged loan transaction, should be tracked separately. (See Treas. Reg. § 54.4975-11(d)(4).)

## **Diversification**

An ESOP must allow any participant who attains age 55 and has 10 years of plan participation to diversify the share account balance by

### Table 1. Formulas for Releasing Shares from ESOP Suspense Accounts

*Principal and Interest Method:*

1. Determine the principal and interest payment for the plan year.
2. Determine the total principal and interest for the remaining term of the loan as of the end of the plan year.
3. Determine shares in the suspense account at the beginning of the plan year.
4. Calculate the shares to be released as follows:

$$\begin{array}{l} \text{Number of shares} \\ \text{to be released} \\ \text{and allocated} \end{array} = \frac{\text{P \& I paid for plan year}}{\text{P \& I paid for plan year} \\ \text{plus projected P \& I to} \\ \text{be paid over remaining} \\ \text{term of loan}} \times \begin{array}{l} \text{Number of shares} \\ \text{in suspense} \\ \text{account at} \\ \text{beginning of plan} \\ \text{year} \end{array}$$

For variable-rate loans, a new amortization schedule should be calculated each year to determine the interest component in the denominator. Always use the interest rate in effect on the last day of the plan year for future year interest calculations.

*Principal-Only Method:*

1. Determine principal payments for the plan year.
2. Determine loan balance at the beginning of the plan year.
3. Determine the loan balance at the end of the plan year.
4. Determine the number of shares held in the suspense account at the beginning of the plan year.
5. Calculate the number of shares to be released as follows:

$$\begin{array}{l} \text{Number of shares} \\ \text{to be released} \\ \text{and allocated} \end{array} = \frac{\text{Principal paid for plan year}}{\text{Principal outstanding at} \\ \text{beginning of plan year}} \times \begin{array}{l} \text{Number of shares} \\ \text{in suspense} \\ \text{account at} \\ \text{beginning of plan} \\ \text{year} \end{array}$$


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having up to 25% of such share balance directed to other investments or distributed to the participant. The diversification period continues for five years, with the sixth-year election going from 25% to 50%.

The diversification rules as described above are required for stock acquired after December 31, 1986. Therefore, it is important to track stock acquired on or before December 31, 1986, separately from stock acquired after December 31, 1986. (See Code Section 401(a)(28).)

## **Processing Distributions**

If an ESOP is leveraged, distributions attributable to leveraged shares may be deferred until the plan year following the plan year in which the loan incurred to purchase those shares has been fully repaid. To take advantage of this delayed distribution, the ESOP administrator must track leveraged shares by loan to know which shares are from loans that have been repaid and which shares are from loans that have not been fully repaid.

The special ESOP distribution rules were added to the Code by the Tax Reform Act of 1986 and apply, at a minimum, to distributions attributable to stock acquired by an ESOP after December 31, 1986. An ESOP that acquired employer stock before January 1, 1987, might be designed so that the newer rules do not apply to these shares. Therefore, the ESOP administrator must track pre-1987 stock separately from post-1986 stock. (See Code Section 409(o).)

## **Put Option**

The requirement to provide a put option applies to all non-leveraged stock acquired by a closely held ESOP company after December 31, 1979, and to all leveraged stock acquired by such a company after November 1976 regardless of when acquired. The put option payment requirements of Code Section 409(h)(5)–(6) were added by the Tax Reform Act of 1986 and apply, at a minimum, to distributions attributable to stock acquired by an ESOP after December 31, 1986. Therefore, it is important to track stock separately if it has different treatment for put option purposes for pre-1987 and post-1986, and possibly pre-1980 and post-1979.

## **Tax Consequences of Distributions**

The taxable amount of a lump-sum distribution following termination of employment is the lesser of (1) the ESOP participant's cost basis in the shares received, or (2) the fair market value of the shares on the date of distribution. The taxable amount does not include any "net unrealized appreciation" attributable to shares received, unless the participant elects on his or her tax return, for the year the distribution is received, to have the "net unrealized appreciation" included. The "net unrealized appreciation" is the difference between the cost basis in the shares received and the fair market value of the shares on the date of distribution. To properly complete Form 1099-R for terminated participants, the ESOP administrator must track the cost basis for all shares allocated to the participant's account.

## **Money Purchase Plan Shares**

If an ESOP is drafted to include a money purchase plan element (a mandatory contribution), there are two reasons why the money purchase plan shares should be tracked separately. First, money purchase plans are required to comply with the joint and survivor annuity requirements within Code Section 401(a)(11). There is an exception to this requirement if the money purchase plan element is a part of an ESOP. However, should the plan lose its ESOP status, the joint and survivor annuity option would have to be offered. The second reason for tracking these shares is that the money purchase plan shares, or account balances, cannot be distributed while a participant remains employed unless the participant has reached the plan's retirement age. To date the IRS has not issued any exception for ESOPs. Thus, these shares should be tracked separately.

## **Conclusion**

Engaging in administrative and recordkeeping services for an ESOP is not a simple task, but it can be accomplished with a good understanding of all the issues and a flexible data processing system. Tracking shares properly in the course of ESOP administrative and recordkeep-

ing services is extremely important to ensure compliance with all legal and administrative requirements. Therefore, the manner in which a recordkeeping system for a new ESOP is set up is extremely important for administering the plan properly several years later, when the potential for additional complexity may be realized.