

Introduction of the ESOP Promotion and Improvement Act of 2009

September 3, 2009

ESOP-owned businesses received encouraging news this month when the ESOP Promotion and Improvement Act of 2009 (S. 1612) (the Act) was introduced on August 6 by Senator Blanche L. Lincoln (D-Ark.). Senator Mary L. Landrieu (D-La.) co-sponsored the proposed Act. The ESOP Association, a national trade association representing approximately 2,500 members throughout the United States, hailed the proposed Act as “an important step to broaden ownership in the U.S.”

The proposed Act would amend the Internal Revenue Code (the Code) to improve the operations of ESOPs as follows:

- The 10% penalty on early distributions from qualified retirement plans would no longer apply to distributions made by an S corporation, to the extent the distributions are paid in cash to the participants in the ESOP or are paid to the ESOP and distributed in cash to the participants in the ESOP.
- Dividends paid by C corporations on stock held by an ESOP would no longer be a preference item in calculating the corporate alternative minimum tax. This amendment would apply to taxable years beginning after December 31, 1989.
- Section 1042 treatment would be extended to owners of S corporations. Currently, Section 1042 treatment allows only owners of C corporations to defer capital gains tax on stock, providing that the stock is sold by the owner to an ESOP and (i) the ESOP owns, immediately after the sale, 30% or more of the total value of all outstanding stock, and (ii) the owner purchases qualified replacement property (securities of certain U.S. corporations) with the proceeds of the sale during a fixed period.
- In connection with a Section 1042 transaction, qualified replacement property would include securities of any regulated investment company (e.g., mutual funds) if substantially all of the securities held by the regulated investment company are securities issued by an operating U.S. corporation.
- A plan to which Section 1042 applies must provide that no portion of the assets of the plan attributable to employer securities acquired in a Section 1042 transaction may accrue, during the nonallocation period, for the benefit of any person who owns more than 25% of (i) the total combined voting power of *all classes of stock* of the corporation that issued the employer

securities or of any corporation that is a member of the same controlled group, or (ii) the total value of *all classes of stock* of such corporation. Currently, the 25% shareholder rule applies to 25% of *any class of outstanding stock* of the corporation that issued the employer securities or of any corporation that is a member of the same controlled group, or 25% of the total value of *any class of stock* of such corporation.

The amendments would take effect on the date of the enactment of the proposed Act, unless otherwise noted above.

The proposed Act also notes that since 1974 many small businesses in the United States have become ESOP-owned businesses. These small businesses are often eligible for benefits under the Small Business Act due to the number of employees, amount of revenue, or racial, gender, or other criteria, yet under the Small Business Act these businesses lose their eligibility for benefits once they are owned 50% or more by an ESOP.

The proposed Act would amend the Small Business Act to allow a small business that was eligible for certain benefits under the Small Business Act prior to the ESOP owning 50% or more of the business, to continue its eligibility even after the business becomes 50% or more ESOP-owned, if the following stipulations are followed:

- On a continuing basis a majority of the shares of and control of the ESOP that owns the business are held by individuals who would otherwise meet criteria necessary to be eligible for the benefits
- Control of the business is vested in the shareholders of the ESOP
- The ESOP complies with all requirements of a tax-qualified deferred compensation arrangement under the Code

These amendments would take effect on January 1 of the first calendar year beginning after the date of enactment of the proposed Act.

The proposed Act is in the initial stages of the legislative process, and the ESOP community will need to educate members of Congress on the benefits of ESOPs if the proposed Act is to become law.

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