

IRS Validates Price Protection Agreements for S Corporation ESOPs

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The IRS marked the Fourth of July this year by issuing a private letter ruling that is favorable to S corporation Employee Stock Ownership Plans (ESOPs). The IRS confirmed that an ESOP company can enter into a price protection agreement that favors certain shares without jeopardizing its S corporation status.

In Private Letter Ruling 200827008, the IRS validated a form of price protection commonly used in multistage ESOP transactions. In the letter, the IRS concluded that a floor price protection agreement—which guaranteed a minimum repurchase price for some, but not all, of the shares held by the ESOP—did not create a second class of stock, and thus did not adversely affect the company's S corporation status.

Many ESOP transactions occur in stages, either by original design or by evolution over time. Under a staged approach, an ESOP will initially purchase a minority interest in the sponsoring company's stock. This may occur either because the selling shareholders do not want to relinquish control or because the company does not have the debt capacity to finance a larger purchase. Then, at a later time or times (usually after the bank financing from the original transaction is paid off), the ESOP will purchase more stock from the shareholders. More often than not, the ultimate goal is to have the ESOP own 100% of the company's stock, with the company electing to be treated as an S corporation, with the result that none of the company's postelection income will be subject to federal income tax. The tax savings enjoyed by a 100% ESOP-owned S corporation can be used to pay off the acquisition debt, expand the business, fund stock repurchases, or provide other benefits for employees.

As beneficial as it may be to reach 100% ESOP ownership, there is one potential downside to achieving this in stages. When a company takes on debt to finance a purchase of additional shares for the ESOP, it causes an immediate decline in the company's stock value. This decline is temporary, and the value should recover over time as the loan is paid off. However, the drop in stock value can adversely affect employees who have stock allocated to their ESOP accounts at the time of the transaction (the Pre-Transaction Shares). To protect these employees, many ESOP trustees will negotiate a price protection agreement in which the company agrees to purchase any Pre-Transaction Shares that are distributed to plan participants at a price per share that is computed without regard to the transaction debt. This shields the existing shares from the decline in value caused by the transaction debt.

In Private Letter Ruling 200827008, the IRS dealt with the question of whether a typical ESOP price protection agreement, adopted for the purposes noted above, would pass muster under the IRS regulations relating to S corporations. Specifically, Section 1.1361-1(l) of the IRS regulations provides that an S corporation must have only one class of stock, which means (with some exceptions not relevant here) that all outstanding shares must have identical rights to distribution and liquidation proceeds.

In determining whether stock rights are identical, certain arrangements are disregarded, including (a) redemption agreements that are not entered into for the principal purpose of circumventing the one class of stock rule, and that do not provide for a purchase price significantly different from fair market value; and (b) agreements to redeem stock at the time of death, divorce, disability, or termination of employment. IRS Tax Regulations § 1.1351-1(l)(2)(iii)(A) and (B). In the private letter ruling, the IRS indicated that the ESOP price protection agreement fell into the second category of agreements since it covers repurchases of stock upon death, disability, or termination of employment. As a result, the price protection agreement would not cause there to be a second class of stock under the regulations.

While private letter rulings are only directed to the specific taxpayer requesting the ruling, and are not to be used or cited as precedent, this ruling should provide comfort to ESOPs that are considering second-stage transactions and the typical price protection arrangements that accompany those transactions.

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