Employee Stock Ownership Trusts: Tax Advantages for Estate Planning in Close Corporations

Follow this and additional works at: https://digitalcommons.law.yale.edu/ylj

Recommended Citation

Available at: https://digitalcommons.law.yale.edu/ylj/vol84/iss7/6

This Article is brought to you for free and open access by Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in Yale Law Journal by an authorized editor of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.
Employee Stock Ownership Trusts: Tax Advantages for Estate Planning in Close Corporations

Stock bonus and employee stock ownership plans are among the several types of employee deferred compensation programs that can qualify for special tax status under the Internal Revenue Code. These plans benefit the national economy by affording corporate employees an equity interest in the employer's business, thus creating new incentives for employee efficiency and productivity. The plans expand the ownership of income-producing capital, helping to avoid increased concentration of wealth, and they benefit employees by furnishing them with a valuable second income source in addition to wages.

Largely for these reasons, Congress has consistently granted such plans favorable tax treatment, particularly in the recent pension reform act, known officially as the Employee Retirement Income Security Act of 1974 (ERISA).

Qualified stock bonus and employee stock ownership plans have a multitude of uses, in both publicly held and closely held corpora-

1. A trust forming part of a stock bonus, pension, or profit-sharing plan that qualifies under INT. REV. CODE OF 1954, § 401(a), is exempt from income taxation by virtue of INT. REV. CODE OF 1954, § 501(a). Special treatment applies both in the taxation of the trust beneficiaries and in the employer's deduction of contributions to these trusts. See INT. REV. CODE OF 1954, §§ 402, 404(a).

At the present time pension and profit-sharing plans far outnumber stock bonus (or employee stock ownership) plans. Williams, Stock Bonus Plans—An Undiscovered Possibility in the Internal Revenue Code for Closely Held Corporations, 1 J. CORP. TAX. 409 (1975).

2. For an example of the potential incentives and employee benefits that employee stock ownership may bring, see Profit Sharing: Lowe's Largesse, NEWSWEEK, Mar. 31, 1975, at 61.


4. 88 Stat. 829. Prior to the enactment of ERISA, INT. REV. CODE OF 1954, § 401(a), and the relevant Treasury regulations provided qualified status for "stock bonus" plans. ERISA and the amendments to the Internal Revenue Code therein continue to use the term "stock bonus" plan while introducing the hybrid "employee stock ownership" plan, which is a stock bonus plan "designed to invest primarily in qualifying employee [sic] securities." See ERISA § 407(d)(6), 29 U.S.C.A. § 1107(d)(6) (Supp. 1975); ERISA § 2003(a), amending INT. REV. CODE OF 1954, § 4975(e)(7). This Note uses the term "ESOT" (employee stock ownership trust) to refer to the trust through which both types of plans are operated.
tions. In close corporations, however, establishing an employee stock ownership trust (ESOT) to hold the assets of and administer the plan for the employees carries the extra virtue of serving the estate planning needs of the close corporation's shareholders. The shareholders can sell their stock to the ESOT and avoid most of the principal problems surrounding traditional means for the disposition of close corporation stock. In addition to employee benefits, the ESOT thus provides an in-house stock market through which the closely held corporation can fund the purchase of its outstanding shares on attractive terms.

This Note examines the use of ESOT's as a vehicle for estate planning in closely held corporations, pointing out the potential advantages of the ESOT purchase over traditional arrangements for the disposition of close corporation stock. It then considers some problem areas in the use of the ESOT as an estate planning device, and attempts to resolve the issues in a manner consistent with the underlying purposes of qualified stock bonus and employee stock ownership plans.

I. The ESOT Purchase Arrangement for the Disposition of Close Corporation Stock

A. Mechanics of the ESOT Purchase Transaction

A stock bonus or employee stock ownership plan is an employee compensation program, established and maintained by an employer corporation, which distributes benefits in stock of the employer company. A trustee designated by the employer holds the assets of and administers the plan under a stock bonus or employee stock ownership trust. If it qualifies under Internal Revenue Code § 401(a), the trust is exempt from income taxation.

In order to qualify under Internal Revenue Code § 401(a), a stock


bonus plan must meet certain requirements relating to coverage,\(^8\) discrimination,\(^9\) and vesting.\(^{10}\) It must be communicated to the employees,\(^{11}\) and be established and operated for the exclusive benefit of the employees.\(^{12}\) There can be no reversion of trust assets or diversion for purposes other than the exclusive benefit of employees.\(^{13}\)

The plan provisions\(^{14}\) state the criteria for employer contributions, which may be made according to the employer's discretion if the plan so provides.\(^{15}\) The employer corporation can annually deduct contributions not in excess of 15 percent of the total compensation otherwise paid or accrued during the taxable year to the employees covered by the stock bonus plan.\(^{16}\)

Contributions to the stock bonus plan are allocated to individual employee accounts and benefits are distributed to the covered employees or their beneficiaries according to a definite predetermined formula, as in a profit-sharing plan.\(^{17}\) Stock bonus plans are generally comparable to profit-sharing plans, except that contributions to stock bonus plans do not depend necessarily upon the existence of profits\(^{18}\) and benefits are distributable only in stock of the employer.\(^{19}\) The
covered employees or their beneficiaries are not taxed with respect to these benefits until the trust actually distributes stock to them.\textsuperscript{20}

The employer corporation's contributions to the trust usually consist of cash or employer stock, although the employer may contribute certain other property.\textsuperscript{21} There are no explicit limitations upon the assets the trust may hold,\textsuperscript{22} except that any employer securities or real property held must be "qualifying" assets.\textsuperscript{23} Since the trust can distribute benefits only in the form of employer stock, however, the trust must acquire employer stock prior to the time of distribution to the participating employees or their beneficiaries. When trust funds are invested in employer stock, the trustee must make full disclosure concerning the investment so that the Internal Revenue Service can determine whether the trust violates the exclusive-benefit-of-employees rule.\textsuperscript{24}

The trust's acquisition of any property from a "party in interest" (which includes the employer corporation, its employees, officers and directors, and shareholders owning, directly or indirectly, 10 percent or more of the employer or the trust)\textsuperscript{25} generally is a prohibited trans-


The trust must distribute benefits to an employee within 60 days after the close of the plan year in which the latest of the following events occurs: (i) the employee reaches 65, or an earlier retirement age specified in the plan; (ii) his completion of 10 years of plan participation; or (iii) his termination of employment. ERISA § 1021(a)(2)(d), INT. REV. CODE OF 1954, § 401(a)(14). The ESOT may (if the terms of the stock bonus plan so provide) distribute stock after a fixed number of years, which has been interpreted to mean at least two years, Rev. Rul. 295, 1971-2 Cum. BULL. 184, or upon the prior occurrence of some event (e.g., retirement, death, layoff, disability). See Treas. Reg. § 1.401-1(b)(1)(ii) (1956). "Some event" also can mean the completion of a period of participation in the plan or the attainment of a stated age. Rev. Rul. 24, 1968-1 Cum. BULL. 150.


The acquisition and holding of employer stock do not violate the "prudent man" rule, which must be applied "bearing in mind the special nature and purpose of employee benefit plans." H.R. REP. NO. 1280, 93d Cong., 2d Sess. 302 (1974). But cf. Note, supra note 5, at 215-16. This is consistent with the position taken by the Internal Revenue Service under the prior law. See Rev. Rul. 65, 1969-1 Cum. BULL. 114, 115 ("fair return" test held inapplicable to stock bonus plan); Rev. Rul. 421, 1969-2 Cum. BULL. 59, 65. Rev. Rul. 65 acknowledged the special purpose of the stock bonus plan "to give the employee-participants an interest in the ownership and growth of the employer's business."

In addition, the 10 percent limitation with respect to acquisition and holding of qualifying employer securities and real property does not apply to "eligible individual account" plans (e.g., stock bonus and employee stock ownership plans). ERISA §§ 407(b)(1), (d)(5)(A), 29 U.S.C.A. §§ 1107(b)(1), (d)(5)(A) (Supp. 1975).


Employee Stock Ownership Trusts

action.\(^{26}\) ERISA § 408(e),\(^{27}\) however, provides an exception for "eligible individual account plans" (a term which includes stock bonus and employee stock ownership plans).\(^{28}\) These plans may acquire "qualifying employer securities" (for example, employer stock)\(^{29}\) from parties in interest if the acquisition is for adequate consideration\(^{30}\) and no commission is charged.\(^{31}\) Because of the ESOT's ability to purchase stock of the employer corporation at fair market value from the pre-existing shareholders,\(^{32}\) the close corporation's establishment of a stock bonus or employee stock ownership plan creates an in-house market for its stock.

The basic ESOT purchase arrangement proceeds as follows: the corporation establishes a stock bonus or employee stock ownership plan for its employees, and makes tax-deductible cash contributions to the ESOT which administers the plan. The ESOT purchases stock from the existing shareholder or shareholders at an arm's length price (as determined by outside appraisal), and allocates the purchased shares among the accounts of the covered employees. The interests of the individual employees vest in accordance with a specific schedule, and upon an employee's retirement, death, or other events specified in the plan, the ESOT distributes the vested shares to the employee or his beneficiary, at which time the recipient is taxed with respect to the stock received.

29. ERISA §§ 407(d)(5), 29 U.S.C.A. §§ 1107(d)(5) (Supp. 1975). "Individual account plans" are generally those in which the employees may choose their own investments. See H.R. REP. No. 1280, 93d Cong., 2d Sess. 305-06 (1974). However, in a stock bonus or employee stock ownership plan, which is designed to invest in employer stock, by definition there can be no employee control over investments. Such plans are, nonetheless, included within the definition of "eligible individual account plans."
30. See ERISA § 3(18), 29 U.S.C.A. § 1002(18) (Supp. 1975) (defining "adequate consideration" with respect to unlisted securities as fair market value as determined in good faith by the trustee).
31. The Internal Revenue Service took the position before the enactment of ERISA that the exclusive-benefit-of-employees rule did not prevent the seller from deriving some benefit from a transaction with the trust—for instance, the trust's purchase of securities at fair market value was permissible even though the seller sold at a profit. Rev. Rul. 421, 1969-2 Cust. Bull. 59, 65. ERISA § 408(e), which expressly approves trust acquisitions from parties in interest, codifies this approach.

Although Treas. Reg. § 1.401-1(b)(3) (1956) provides that a plan “so designed as to amount to a subterfuge for the distribution of profits to shareholders” will not qualify under the exclusive-benefit-of-employees rule, the regulation cannot be read to disqualify plans on the basis of transactions protected by ERISA provisions. The regulations promulgated under the former law must be read in light of ERISA and the congressional policies embodied therein.

1523
The basic ESOT purchase arrangement is subject to many possible variations. The ESOT can gradually acquire stock from the pre-existing shareholders as it receives cash contributions from the corporation, or it can purchase stock when it is available, as on a shareholder's death or retirement. In the interim, the trust could make temporary income-producing investments with the cash contributions received, possibly purchasing insurance on the life of the selling shareholder to provide sufficient cash for a purchase from his estate. The ESOT might enter a mandatory agreement (on terms favorable to the employees) requiring it to purchase and the shareholder to sell stock at his death, disability, or retirement, although such an agreement should generally be unnecessary.

An important variation from the basic ESOT purchase arrangement uses the corporation's credit in a leveraged purchase on behalf of a stock bonus or employee stock ownership plan. The ESOT obtains funds for the stock purchase from an outside lender in exchange for a promissory note secured by both the ESOT's pledge of the purchased stock and the corporation's guarantee of the ESOT's note. The ESOT uses the loan funds to purchase a block of outstanding stock from the present shareholders, and the corporation makes annual tax-

33. For descriptions of possible uses of the ESOT concept see sources cited in note 5 supra.
34. Blackman, supra note 5, at 280. But see Miller, supra note 5, at 12-13 (commenting on past IRS objections to such insurance purchases by ESOT's).
35. The ESOT should always be a willing buyer, since it can distribute benefits only in stock of the employer corporation. If a willing buyer must be guaranteed, a mandatory future purchase agreement negotiated at arm's length and in good faith by a party in interest and the ESOT trustee might be within the ERISA § 408(e) exception. But the trustee risks a subsequent finding that his entering into such an agreement violated ERISA § 408(b)(2), 29 U.S.C.A. § 1108(b)(2) (Supp. 1975) (fiduciary prohibited from entering any transaction adverse to the interests of the plan) if, for instance, the agreement price exceeds the stock's fair market value at the time of the required purchase.
37. Of course, a lender will always demand the corporation's guarantee since it relies on the credit of the corporation, not the ESOT. If the lender is a party in interest, the ESOT can give only qualifying employer securities as collateral. ERISA § 408(b)(3), 29 U.S.C.A. § 1108(b)(3) (Supp. 1975). If the transaction is structured so that the corporation promises to make certain future employee compensation payments to the ESOT, and the ESOT then assigns its rights under the contract to an outside lender (who is not a party in interest), the obligation to make future employee compensation payments need not appear as a liability on the corporation's balance sheet. Cf. T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 505-07 (1971) (discussion of off-balance sheet financing by means of forward-purchase contracts).

The corporation's guarantee of the ESOT's note might be recast by the Internal Revenue Service as a direct loan to the corporation followed by the corporation's contribution of the entire loan funds to the ESOT. See Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 723-24 (5th Cir.), cert. denied, 409 U.S. 1076 (1972). But such a characterization would present no problems: the amount of the corporation's tax deductions would be unchanged since it could deduct under INT. REV. CODE OF 1954, § 163(a), the interest payments attributed to it and could deduct gradually the ESOT contribution under the carryover provision of id. § 404(a)(3). Repayment of the note by the ESOT would not be a prohibited transaction. See ERISA § 408(b)(3), 29 U.S.C.A. § 1108(b)(3) (Supp. 1975).
Employee Stock Ownership Trusts

deductible contributions to the trust sufficient to permit the trust to amortize the loan obligation. The lender then releases shares from the pledge as the ESOT pays off the note. A related variation is also possible. If the selling shareholder does not require immediate cash, he might take purchase-money notes from ESOT in exchange for his stock in a leveraged transaction that does not involve an outside lender.  

Since 1953 the IRS has explicitly authorized borrowing by employee benefit trusts for the purchase of investments. In 1971 this authorization was extended to a trust’s borrowing funds for investment in employer securities. The new pension reform law specifically approves leveraged purchases of outstanding shares from existing shareholders. ERISA § 408(b)(3) permits borrowing at a reasonable interest rate by employee stock ownership plans for the purchase of qualifying employer securities if the loan is primarily for the participants’ benefit even when the lender is a party in interest. The Conference Report makes it clear that Congress specifically approves the “common practice” of leveraged purchases of stock by these plans from major shareholders. Such leveraged purchases, however, are subject to spe-

39. But see note 43 infra.  
41. Rev. Rul. 311, 1971-2 Cum. Bull. 184, 185, states: The borrowing of funds by a trust and investing them in the securities of, or entering into transactions with, the employer or an entity closely related to the employer do not disqualify a trust as one for the exclusive benefit of employees unless the borrowing is undertaken for the purpose of benefiting the employer as, for example, borrowing in order to furnish capital or property for use in the employer’s business at a time when the employer’s financial condition is such that it is unable to borrow money from usual financial sources.  
43. H.R. Rep. No. 1280, 93d Cong., 2d Sess. 312-13 (1974). The ERISA § 408(b)(3) loan exception from the ERISA § 406 prohibited transaction rules is available only for employee stock ownership plans and not for other plans (including, presumably, “conventional” stock bonus plans). ERISA § 406(a)(1)(B), 29 U.S.C.A. § 1106(a)(1)(B) (Supp. 1975), prohibits transactions constituting a direct or indirect extension of credit between a plan and a party in interest. The approval of these leveraged purchases ties in with the exemptions from the diversification requirement, the inapplicability of the 10 percent limit on investments in employer securities, and the approval of the trust’s acquisition of qualifying employer securities from parties in interest. See ERISA §§ 404(a)(2), 407(b)(1), 407(d)(3)(A), 408(e), 29 U.S.C.A. §§ 1104(a)(2), 1107(b)(1), 1107(d)(3)(A), 1108(e) (Supp. 1975). These special provisions show that Congress recognized the nature of employee stock ownership plans as incentive programs which may benefit both employees and their employers. Thus the provisions designed to minimize investment risks do not apply, to the extreme that ESOT’s may leverage their purchases of employer stock to the hilt. Apparently Congress felt that the employer’s commitment to make continuing contributions to the trust (which is a necessary part of leveraged purchases, see note 37 supra) justifies the increased risk involved with the use of leverage. Financing the ESOT purchase with borrowed funds makes the corporation’s credit available to the employees, allowing employees immediately to obtain a substantial equity interest on a non-recourse basis.
cial scrutiny by the Department of Labor and Internal Revenue Service to ensure that they primarily benefit the plan participants and beneficiaries.\textsuperscript{44}

B. Potential Advantages of the ESOT Purchase

The eventual disposition of close corporation stock will be a major estate planning problem when such stock is a significant asset in an individual's portfolio. The planning generally will have several basic goals:\textsuperscript{45} (1) the conversion of at least some portion of the stock into cash that provides liquidity and increased investment flexibility for the individual and his heirs; (2) the determination of the stock value for gift or estate tax purposes so as to avoid controversy between the shareholder or his executor and the Internal Revenue Service;\textsuperscript{46} and (3) the maintenance of continuity in the close corporation's business.

To be sure, the ESOT purchase is not the approach for disposing of close corporation stock in every situation. The shareholders may abhor the idea of employee ownership participation. The costs of establishing and maintaining a qualified stock bonus or employee stock ownership plan may be substantial. And the company payroll may not be large enough to permit sufficient deductible contributions to the trust, since contributions may generally not exceed 15 percent of payroll. But in many cases the ESOT purchase may be superior to other estate planning alternatives for the disposition of close corporation stock.

Traditional estate planning approaches for the disposition of close corporation stock consist of "outside" and "inside" sales. The shareholder may sell stock to parties outside the close corporation, through either a public offering or negotiations with a single entity such as a competitor or a diversified public corporation. Alternatively, the shareholder may arrange the future sale within the present shareholder group by means of either a cross-purchase plan (in which the other shareholders individually agree to purchase shares) or a stock redemption plan (in which the close corporation itself agrees to purchase its

\textsuperscript{44} H.R. REP. No. 1280, 93d Cong., 2d Sess. 313 (1974).

\textsuperscript{45} See D. Westfall, Estate Planning Problems 470 (1973).

Employee Stock Ownership Trusts

shares). In either of the latter cases, the terms of the plan typically are established in a mandatory buy-out agreement.47

Although the ESOT must operate as an independent legal entity, the problems normally associated with sales to other outside parties are minimized. Unlike a public offering of the company stock, the sale to the ESOT does not require registration of the securities.48 The ESOT purchase does not require the shift in control of the corporation that may be an undesirable prerequisite to an acquisition by an outside corporation or individual, because the selling shareholders can both determine the number of shares they sell and choose a cooperative, though independent, trustee.50 Most importantly, the presence of the in-house ESOT market solves the marketability problem that usually plagues shareholders, especially minority shareholders, of closely held corporations.

The ESOT purchase arrangement may have significant advantages over conventional inside sales. The corporation's ability to finance the purchase with pretax earnings reduces the cost of the ESOT purchase in most cases below the cost of a stock redemption or cross-purchase.51


48. The sale of close corporation stock to the plan trustee should be within the exemption of Securities Act of 1933, § 4(1), 15 U.S.C. § 77d(1) (1970), as a transaction “by any person other than an issuer, underwriter, or dealer.” The selling shareholder is not an “underwriter” in the ESOT purchase. This is because the transaction does not involve a “distribution.” See Securities Act of 1933, § 2(11), 15 U.S.C. §§ 77b(11) (1970). Rather, it constitutes a private sale to the representative of a narrowly limited class of individuals. Requiring registration would add little (if any) protection for the employees, who are fully protected by the adequate consideration requirement of ERISA § 408(e), 29 U.S.C.A. § 1108(e) (Supp. 1975). In negotiating the purchase, a competent trustee will have both access to all relevant information and the capacity to assimilate that information. C.f. SEC Rule 146, 39 Fed. Reg. 15261 (1974). Any sales of close corporation stock distributed from the ESOT will be in relatively small quantities on nonpublic markets. Whether or not this is the case, the transaction generally will be exempt under other provisions of the 1933 Act (e.g., the intrastate offering exemption of § 3(a)(11), 15 U.S.C. § 77c(11) (1970)).


50. The trustee of the ESOT should be a party independent from the corporation because of the potential conflicts in the interests of the controlling shareholders and the ESOT beneficiaries and the responsibilities of plan fiduciaries. See, e.g., ERISA §§ 404, 406, 29 U.S.C.A. §§ 1104, 1106 (Supp. 1975). But the trustee in making his discretionary decisions will normally cooperate with those who have put him in office. The trustee will likely vote the stock held by the ESOT. But cf. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301(d)(9) (Mar. 29, 1975) (requiring employee voting of stock held by employee stock ownership plans of corporations qualifying for elective 11 percent investment credit).

The new shareholders resulting from the ESOT purchase likely will not oppose existing management. And many corporations and shareholders will welcome employee participation even though corporate control may eventually shift into employee hands.

51. In the cross-purchase at least some portion of the purchase funds usually will be taxable to both the corporation and the purchasing shareholders; the stock redemption
The lower cost in turn makes it more likely that shareholders will obtain full value for their stock; the shareholders can then avoid the uncertainties of low purchase price buy-out agreements.\textsuperscript{52}

The availability of the ESOT market alleviates the problem of determining stock value for estate and gift tax purposes. Sales to the ESOT by the decedent, his estate, or other shareholders within a reasonable period before or after the shareholder's death will strongly influence the estate tax valuation.\textsuperscript{53} The ESOT purchase thus obviates mandatory buy-out agreements designed to set a predetermined purchase price. ESOT purchases may also solve the problem of disputes over gift tax valuation of the stock.\textsuperscript{54}

Since the ESOT, not the corporation, accumulates any amounts required for a planned purchase of a shareholder's stock, the ESOT purchase approach avoids the accumulated earnings tax\textsuperscript{55} problem is therefore the more popular plan. See Kahn, supra note 47, at 11, 13-14. Even the stock redemption plan requires that nearly two dollars be earned (assuming a 48 percent corporate tax rate, see INT. REV. CODE OF 1954, § 11) for each dollar to be paid out to the selling shareholder or his estate. Life insurance funding does not solve the cost problem since the premiums are not deductible. Id. § 264(a)(1). Furthermore, the cost of maintaining term life insurance over a long period of time may be prohibitive. Kahn, supra note 47, at 26.

52. If the corporation and the other shareholders cannot finance the acquisition at full value, a shareholder may agree to sell or to have his executor sell at a low price. The low price may represent a gift to the remaining shareholders. Alternatively, if other shareholders are entering similar agreements requiring future sales of their own stock, the low price may reflect a gamble in which each shareholder hopes to outlast the other shareholders in order to win what amounts to a tontine. If the agreement's low price fixes the estate tax value, the decreased estate tax liability will partially offset the loss on such a below-value sale.

53. Sales to an ESOT representing employees outside the selling shareholder's family are by their nature arm's length transactions for adequate consideration, and the price on such sales will be persuasive for estate tax valuation. But if many of the ESOT's participating employees are related to the selling shareholders there may be a gift element in the sale, and the sale price may not determine the estate tax valuation. If the shareholder is a key employee whose death diminishes the corporation's value, his estate may assert that sales during his lifetime do not reflect this loss.

54. Cross-purchase and stock redemption agreements must establish the value of the stock for estate tax purposes in order to avoid both wasteful valuation disputes with the IRS and the disaster of an estate tax assessment based upon an amount greater than that which the estate actually receives for the stock. To make the purchase price determinative for estate tax purposes, the agreement must be an arm's length bargain that restricts the shareholder's transfer of the stock during his life and obligates his estate to sell after his death. See, e.g., Treas. Reg. § 20.2031-2(b) (1958); C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 483-89 (2d ed. 1962); Kahn, supra note 47, at 5-6. Selling shareholders therefore must submit to the imposition of possibly undesirable restrictions on the transferability of their stock.

But even the use of these inflexible agreements does not foreclose the possibility of a valuation dispute. See Treas. Reg. § 20.2031-2(h) (1958). And an agreement having effect at the shareholder's death does not determine the value of the stock for gift tax purposes. See Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946); Commissioner v. McCaun, 146 F.2d 399 (2d Cir. 1944); Krauss v. United States, 140 F.2d 510 (5th Cir. 1944). However, ESOT purchases may establish a "fair market value" figure that allows shareholders to make gifts of other shares without fear of an unexpectedly high gift tax assessment.

Employee Stock Ownership Trusts

confronting stock redemption plans. State corporate law restrictions on a corporation's purchase of its own shares similarly are not a problem.

Perhaps the most important advantage of the ESOT purchase for purposes of estate planning is the tax treatment of the selling shareholder. The Internal Revenue Service, in private letter rulings, has accepted the view that the shareholder's sale to the ESOT should be treated for income tax purposes as a sale rather than as a redemption by the corporation. If the Service maintains this view, the shareholder can sell to the ESOT any number of shares of stock during his lifetime, allowing him both to diversify his investment portfolio and to realize a portion of his interest in the corporation at capital gains rates without the necessity of significantly diminishing his interest in the corporation. Furthermore, if shares remain in the shareholder's estate, his executor or legatee can sell stock to the ESOT at little if any income tax cost.

Despite the private letter rulings on this question, caution is still in order; the IRS has not taken a position publicly with respect to the taxation of shareholder sales to the ESOT. The tax treatment of the selling shareholder may therefore be subject to dispute, even when the employees participating in the ESOT are unrelated to the selling shareholder. The IRS might contend that the ESOT is a mere conduit or strawman used to funnel disguised dividends to the shareholder and that the shareholder should therefore be taxed on those divi-

56. The question of the applicability of the accumulated earnings tax to accumulations for future stock redemptions is unsettled. See B. BITTER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.07, at 8-25 to 8-26; Kahn, supra note 47, at 22. Compare Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), cert. denied, 356 U.S. 958 (1958) (sur-tax applied to accumulations for redemption of 80 percent interest) with Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 757 (4th Cir. 1960).


58. Menke, supra note 5, at 35; Blackman, supra note 5, at 277. Since the ESOT (and not the corporation) acquires the stock, the ESOT purchase does not fit the statutory definition of a redemption of stock. See INT. REV. CODE OF 1954, § 317(b).

59. This is because shares included in the shareholder's gross estate take a "stepped-up" basis at his death. INT. REV. CODE OF 1954, § 1014.

60. The following discussion assumes that the selling shareholder and his family are not among the participating employees.
dends. Alternatively, the Service might argue that the ESOT purchase transaction is in substance a stock redemption followed by the corporation's contribution of the stock to the ESOT and that the transaction should be taxed accordingly.

Even if the Service advances these arguments, however, the taxpayer should prevail. The ESOT does not act as a conduit or strawman to pay disguised dividends to the selling shareholder in the ESOT purchase transaction. An independent trustee acquires the stock for the beneficial ownership of, and eventual distribution to, the corporate employees or their beneficiaries. The ESOT has the valid business purpose of supplying work incentives and benefits to the corporate employees, and must operate consistently with that purpose to maintain its qualified status. The ESOT therefore constitutes a separate legal entity, not a conduit or strawman, under the tax law.

Although a direct redemption of the shareholder's stock followed by the corporation's contribution of stock to the ESOT has the same end result as the ESOT purchase transaction, the Commissioner has


62. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (corporation's sale of its sole asset called off at the last minute; the corporation was then liquidated and the asset sold by the former shareholders individually; held, corporation taxable on gain realized since the transaction was in substance the corporation's sale); Higgins v. Smith, 308 U.S. 473 (1940) (taxpayer's loss deduction on sale of stock to his wholly-owned corporation disallowed); Gregory v. Helvering, 293 U.S. 465 (1935).

63. See note 58 supra.

64. See note 50 supra.

65. The shareholders cannot rely on the ESOT purchase and a subsequent redemption from the ESOT to accomplish a gradual redemption of their stock. In such a scheme the stock redemption from the ESOT would frustrate the purpose of the stock bonus or employee stock ownership plan, thus disqualifying the ESOT. See Treas. Reg. § 1.401-1(b)(5) (1956).

66. Existence of some business activity or purpose strongly supports the recognition of a separate legal entity for tax purposes. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943) ("so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity"). Cf. Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance, 77 Yale L.J. 440, 468-69 (1968) (noting Judge Hand's unvarying respect for the corporate entity which has some nontax goal).

67. In Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), aff'd 52 T.C. 888 (1969), the taxpayers sold stock to trusts created for their children in exchange for installment notes from the trusts, and were allowed to report the gain on their sale on the installment basis under INT. REV. CODE OF 1954, § 453. In treating the trusts as separate entities, the court emphasized the independent duties and responsibilities of the trustee. 441 F.2d at 597-98. Cf. Cromwell Corp., 43 T.C. 313 (1964), acquiesced in, 1965-2 CUM. BULL. 4 (newly organized corporation respected as a separate legal entity when used in the leveraged acquisition of an operating company to avoid dividend taxation to the new investors); Arthur J. Kobacker, 37 T.C. 882 (1962), acquiesced in, 1964-2 CUM. BULL. 6 (newly formed corporation held not a sham or subterfuge on facts analogous to Cromwell Corp.); Milton F. Priester, 38 T.C. 316 (1962) (corporation redeemed the shares of an individual investor who had assumed the taxpayer's obligation to purchase those shares from the widow of taxpayer's brother; held, no dividend to the taxpayer because the individual was an investor, not a strawman).
Employee Stock Ownership Trusts.

no authority to reorder the ESOT purchase so as to create a transaction taxable to the selling shareholder as a stock redemption. The step transaction doctrine requires that an integrated transaction not be broken into independent steps in attaching tax consequences. See B. Bittker & J. Eustice, supra note 56, at 1-13, at 1-19 to 1-20, § 14.51, at 14-101 to 14-102. The doctrine looks to the end of the chain of events; it does not seek to reorder the links in that chain. See id. § 14.51, at 14-102. The ESOT purchase results in employee ownership of the purchased shares. Assuming that the selling shareholder and his family members are not among the participating employees, the ESOT purchase (as opposed to a stock redemption) creates new ownership interests. A stock redemption would not result in new ownership interests in the employees. Therefore, the step transaction doctrine does not support taxation as a stock redemption since the end result, absent impermissible reordering of intermediate steps, is not the same. Different considerations arise when the selling shareholder and his family are participating employees in the ESOT. See p. 1537 infra.

68. See, e.g., United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950) (different tax consequences follow different methods of structuring transactions); Helvering v. Gregory, 69 F.2d 809, 810 (1934) (per L. Hand, J.), aff'd, Gregory v. Helvering, 299 U.S. 465, 469 (1936) (“Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes...”).

69. In so-called “bootstrap acquisitions” of stock, tax treatment of both buyers and sellers depends upon the order established by the parties. See Zenz v. Quinlian, 213 F.2d 914 (6th Cir. 1955), acquiesced in, Rev. Rul. 608, 1969-2 CUM. BULL. 43; Jassy, The Tax Treatment of Bootstrap Stock Acquisitions: The Redemption Route vs. the Dividend Route, 87 HARv. L. REV. 1459 (1974). Compare Wall v. United States, 164 F.2d 462 (4th Cir. 1947) and Television Indus., Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960) with Ray Edenfield, 19 T.C. 13 (1953), acquiesced in, 1953-1 CUM. BULL. 4. In leveraged purchase transactions, where the corporation serves as a guarantor of the ESOT’s promissory note, the corporation’s secondary liability generally is irrelevant, since tax consequences attach on the basis of the parties’ primary liabilities to make payments. See Ray Edenfield, 19 T.C. 13 (1953) (buyer’s secondary liability irrelevant in bootstrap acquisition); Rev. Rul. 608, 1969-2 CUM. BULL. 43. Consequently, when the corporation assumes the purchasing shareholder’s (ESOT’s) liability to the lender upon a default by the ESOT, a constructive dividend, if uncovered, is taxed to the purchaser (ESOT). See, e.g., Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972), rev’d, 95 55 T.C. 441 (1970) (dividends result only as the corporation actually makes payments on the purchaser’s obligation). But the ESOT is a tax exempt entity under INT. REV. CODE OF 1954, § 501(a).

70. Taxpayers have donated close corporation stock to tax-exempt organizations and then caused their corporations to redeem the donated stock for cash without incurring any income tax liability, although taxable dividends would have resulted from a direct redemption from the taxpayers. See, e.g., Carrington v. Commissioner, 476 F.2d 704 (5th Cir. 1973), aff’g 30 CCH TAX CT. MEM. 950 (1971); Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973), aff’g 31 CCH TAX CT. MEM. 387 (1972); cf. Sheppard v. United States, 361 F.2d 972 (Cl. Ct. 1966). INT. REV. CODE OF 1954, § 4941 imposes a penalty tax on sales or exchanges of property between “private foundations” and “disqualified persons” (defined by § 4946 to include certain individual and corporate contributors and related persons). However, the definition of “private foundation” does not include qualified employee trusts, which are tax-exempt under § 501(a) rather than § 501(c). See id. § 509.
holder’s corporation controls the establishment of the ESOT and may initiate any ESOT purchases, the purchase transaction itself represents an arm’s length bargain\textsuperscript{71} that the IRS cannot rearrange after the fact.\textsuperscript{72}

The ESOT purchase may be compared with an ordinary sale of stock from a shareholder to corporate employees. In such a case, the shareholder generally would receive capital gains treatment, even though the employees use cash provided by the corporation (their salaries) to pay for the stock. The ESOT purchase arrangement differs from the ordinary sale in three respects: (1) the employees do not directly control the purchase decision; (2) a trust holds the purchased stock;\textsuperscript{73} and (3) taxation of income to the employees is deferred. Both the status of employees as “captive” purchasers, and the holding in trust of the assets of qualified plans, are authorized by the Internal Revenue Code and ERISA.\textsuperscript{74}

The deferral of taxation to the employees is provided by Internal Revenue Code § 402(a)(1). Thus, the features distinguishing the ESOT purchase from the ordinary sale of stock from shareholder to employees are expressly authorized under provisions of the Internal Revenue Code and in large part benefit the employees, not the selling shareholder or the employer corporation. There is thus little basis for different tax treatment of the selling shareholder in the two transactions.

Taxation of the shareholder’s sale to the ESOT as the sale of a capital asset is consistent with the basic structure of the Internal Revenue Code.\textsuperscript{75} The purchase funds come from tax-deductible compensation paid to the employees who are eventually taxed with respect to those compensation payments. The selling shareholder is subject to capital gains taxation on the transfer for value of his claims to both the undistributed and future earnings and profits of the corporation; the new shareholders or their transferees are subject to taxation on the eventual distribution of those earnings and profits. Consequently, the

\textsuperscript{71} See ERISA § 408(e), 29 U.S.C.A. § 1108(e) (Supp. 1975).

\textsuperscript{72} The Commissioner generally lacks authority to recharacterize arm’s length transactions between the selling shareholder and an unrelated purchaser. See Chirelstein, supra note 66, at 469-70; cf. Commissioner v. Brown, 380 U.S. 563 (1965) (seller received capital gain treatment in arm’s length sale to tax-exempt organization); note 68 supra.

\textsuperscript{73} In addition, vesting of each individual employee’s interest in the ESOT may be postponed. See ERISA § 1012, Int. Rev. Code of 1954, § 411(a)(2). However, the corporation’s contributions to the ESOT are irrevocable. Treas. Reg. § 1.401-1(a)(3)(iv) (1956); Rev. Rul. 149, 1971-1 Cum. Bull. 118.


\textsuperscript{75} Int. Rev. Code of 1954, § 304, does not apply to the ESOT purchase transaction because the ESOT cannot under the statutes be considered a “corporation.” Cf. Treas. Reg. § 301.7701-4 (1960) (distinguishing between entities recognized as trusts and those that are associations taxable as corporations).
Employee Stock Ownership Trusts

Service should continue to accept the view that the shareholder’s sale to the ESOT is taxable as a sale rather than as a redemption by the corporation.

II. Problems in the Use of the ESOT as an Estate Planning Device

The previous discussion has assumed both that the shareholder sold unrestricted common stock to the ESOT and that the employees participating in the stock bonus or employee stock ownership plan did not include the selling shareholder or members of his family. When these assumptions are inapplicable, however, the previous conclusions with regard to the qualified status of the ESOT and the tax treatment of the shareholder selling stock to the ESOT are thrown into question.

A. Restrictions on the Stock Acquired by the ESOT

The shareholders of the closely held corporation may be quite willing to bestow stock ownership on individuals who are closely connected with the business, and thus the idea of employee ownership participation may appeal to them. But they may not want to extend stock ownership or elements of corporate control beyond the company group consisting of the employees and existing shareholders. In many situations there will be practical reasons that alleviate this concern; frequently the ESOT’s participating employees or their beneficiaries will want to sell the stock distributed to them back to the ESOT. For example, on receipt of the stock, they will be faced with an immediate tax liability with respect to the stock distribution and a need for cash with which to pay the tax. Furthermore, they may not want to hold for investment stock which produces little or no dividend income and for which there is no willing buyer other than the ESOT.

Shareholders may desire additional assurances (for what may be entirely legitimate business reasons) that stock ownership and corporate control will remain in the hands of those close to the business. Consequently, the shareholders prior to the ESOT purchase may either impose restrictions on the transferability of the stock that is to be passed to the ESOT, or create a class of nonvoting common or preferred stock for sale to the employee benefit trust. Either action may cause problems concerning both the qualified status of the ESOT and the taxation of the selling shareholder.

76. See note 60 supra.
77. See INT. REV. CODE OF 1954, § 402(a).
I. Transferability Restrictions

The Internal Revenue Service will likely object to any transaction in which the ESOT acquires stock that cannot be sold to the highest bidder after it is distributed to the employees or their beneficiaries.\textsuperscript{78} The Service may also deny qualified status to the ESOT when the stock bonus or employee stock ownership plan requires that the stock be sold back to the ESOT immediately after distribution.\textsuperscript{79} Thus the shareholder and his corporation must be extremely careful in placing any contractual restrictions on the participants' ability to market the stock distributed to them. In addition, if the participants are required to sell the distributed stock back to the trust soon after they receive it, the ESOT purchase arrangement appears much more like a device to pay disguised dividends to the selling shareholder. The Internal Revenue Service could argue that such restrictions deny the employees any real ownership rights and that there is no real sale of the stock transferred to the ESOT.\textsuperscript{80}

On the other hand, restrictions on the transferability of the stock of closely held corporations are often considered beneficial to the corporation and consequently may benefit all shareholders.\textsuperscript{81} Thus there should be no prohibition of agreements among the shareholders (or potential shareholders), including the employees, to offer their stock first to members of the company group. Restricting outside transfers does not deny any benefits to employees if the employees or their beneficiaries are assured of receiving full value for those shares. The shareholders therefore may be able to provide in the articles of incorporation a first refusal option\textsuperscript{82} to the corporation or its designee.

\textsuperscript{78} In Rev. Rul. 372, 1957-2 CUM. BULL. 256, 257, the IRS announced its “established policy” to require that employer stock contributed to a qualified employee benefit trust have “unrestricted marketability.” That policy apparently derives from the exclusive-benefit-of-employees rule.

Transferability restrictions which may depress fair market value of the stock must also be considered in setting the price of stock to be purchased by the ESOT. See ERISA § 408(e)(1), 29 U.S.C.A. § 1103(e) (Supp. 1975) (requirement of adequate consideration on the sale).

\textsuperscript{79} The IRS has insisted that qualified stock bonus plans distribute only actual stock of the employer and not other property having the same value as that employer stock. See Rev. Rul. 256, 1971-1 CUM. BULL. 118; Rev. Rul. 195, 1962-2 CUM. BULL. 125. Thus the Service might object to devices that require distributees to sell shares back to the ESOT, contending that such distributees did not actually receive “stock.”

\textsuperscript{80} See John D. Gray, 56 T.C. 1032 (1971); E. Keith Owens, 64 T.C. No. 1 (Apr. 2, 1975).

\textsuperscript{81} Devices such as shareholder agreements, voting, trusts, and first refusal options are widely used to protect close corporations and their shareholders. See 2 F. O’NEAL, CLOSE CORPORATIONS §§ 7.01-29 (1958). Such devices may prevent the development of irreconcilable conflicts among the shareholders, promoting harmony that is beneficial to all concerned. See id. § 7.02, at 2-4.

\textsuperscript{82} For example, the option might give the corporation or its designee the right to purchase the stock on a proposed outside sale at the outside offer price and on a proposed
Employee Stock Ownership Trusts

(viz., the ESOT) on any proposed outside transfers of the stock. This limited restriction on transferability does not conflict with the purposes of qualified stock bonus and employee stock ownership plans, nor does it violate the exclusive-benefit-of-employees rule. Furthermore, it does not affect the tax treatment of the selling shareholder, since imposition of a first refusal option is consistent with the position of the ESOT participants as investors.83

2. Voting Restrictions

As long as the stock is held in trust, the problem of passing voting control outside the company group (or those cooperative with that group) does not present itself.84 Shareholders can keep corporate control in the hands of the company group after stock is distributed from the ESOT by recapitalizing the corporation to create a class of nonvoting common or preferred stock for sale to the ESOT. In the sale of such a potentially inferior class of stock to the ESOT, the seller and the ESOT trustee must take great care to ensure that the adequate consideration requirement of ERISA § 408(e)(1) is not violated.85 And since the newly issued stock may constitute “section 306 stock,” gain realized on its sale may be taxed as ordinary income to the selling shareholder.86 Nevertheless, use of preferred stock may be a feasible means of retaining voting control in the company group if the ESOT purchases the stock from a shareholder’s executor or legatees at its fair market value.88

Full equity participation in the corporate enterprise, however, involves sharing in the control and future growth (or demise) of the business. Stock with a fixed rate of return or without voting rights gives the employees only a limited proprietary interest. Although pre-

84. Cf. note 50 supra. However, if the ESOT holds corporate control, deductibility of the contributions to the trust might be questioned. Cf. C.F. Mueller Co. v. Commissioner, 479 F.2d 678 (3d Cir. 1973) (disallowing corporate charitable deductions for contributions to controlling tax-exempt organizations).
85. Preferred stock with a secure rate of return may actually be more easily valued than common stock; but under present law the corporation cannot deduct the dividends paid on such preferred stock.
86. INT. REV. CODE OF 1954, § 306(c). However, neither preferred stock included in the corporation’s original capital structure nor nonvoting common stock are within the definition.
87. Id. § 306(a)(1).
88. Stock included in a shareholder’s estate loses any § 306 taint. Treas. Reg. § 1.306-3(e) (1955). Thus it could be sold to the ESOT at capital gain.
ferred stock with a fixed rate of return may provide the employees a more certain income source, the underlying purposes of stock bonus or employee stock ownership plans are best fulfilled if the employees have full equity participation. Congress might well provide that non-voting common and preferred stock not exceed a certain share of an ESOT’s total assets. 89

B. The ESOT as a Family Trust

Shareholders who are bona fide employees of a corporation may participate in the corporation’s qualified stock bonus or employee stock ownership plan in the same manner as other employees. 90 In some closely held corporations, however, an ESOT may resemble a “family trust” that principally benefits employees who are family members. The Service could argue that, despite its formal compliance with the statutory provisions for qualification, the family trust ESOT becomes a subterfuge for the distribution of profits to the selling shareholder in the ESOT purchase transaction. This would violate the regulations, 91 and the plan would lose its qualified status.

The “subterfuge” argument for disqualification of the family trust has much force. Nevertheless, under the present law it probably will not succeed. Given the general principle that shareholder-employees can fully participate in nondiscriminatory qualified plans, any attack on the qualified status of an ESOT in formal compliance with the statutory provisions for qualification must focus on the peculiar effect of the ESOT purchase transaction. The specific congressional approval of ESOT purchases from parties in interest (including holders of 10 percent, or greater, interests in the employee benefit plan) 92 precludes such disqualification of a plan when the conditions of ERISA § 408(e) are met. 93

93. An ESOT purchase transaction within ERISA § 408(c) does not violate the exclusive-benefit-of-employees requirement. See note 32 supra. A plan may become discriminatory because of the disposition of forfeitures, but this is a possibility with all types of qualified employee benefit plans. See Int. Rev. Code of 1954, § 401(a)(4); Treas. Reg. § 1.401-7 (1963).
It also is difficult to find a statutory basis for taxing a constructive dividend to the selling shareholder in the sale to the family trust ESOT, even though the transaction effects no shift of stock outside the family circle. For example, the constructive ownership rules of § 318 do not attribute to the ESOT beneficiaries constructive ownership of the shares held by the trust. It thus seems immaterial that the shares sold to the ESOT remain in the family or, indeed, in the seller's beneficial ownership. Moreover, the general rule is that an individual may sell property to a related entity in an arm's-length transaction at capital gain.

The Service may nonetheless apply nonstatutory principles of constructive ownership to tax a constructive dividend to the selling shareholder. This approach would treat as dividends amounts received with respect to any purchased shares returned to the beneficial ownership of the seller or his family. If the selling shareholder is himself an ESOT participant, constructive dividend treatment of amounts received in payment for those shares allocated to the seller's ESOT account becomes particularly appropriate.

94. There are several sets of constructive ownership rules in the Internal Revenue Code. See INT. REV. CODE OF 1954, § 1563(c)(3)(C) (no attribution from § 401(a) trusts); §§ 267(c)1, 544(a)(1) (stock owned by trusts considered as owned proportionately by trust beneficiaries). Those found in § 318 are the rules applicable in the context of corporate distributions (which are here involved). See, e.g., id. § 302(c)(1).


96. See B. Bittker & J. Eustice, supra note 56, ¶ 7.05, at 7-23. The rule is subject to limited exceptions (e.g., INT. REV. CODE OF 1954, § 1229), none of which are applicable here. See Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), aff'g 52 T.C. 888 (1969).

97. See, e.g., Helvering v. Clifford, 309 U.S. 331 (1940) (held that taxpayer continued to be owner of property he transferred to a trust which he dominated); Higgins v. Smith, 308 U.S. 473 (1940) (nonstatutory principle of constructive ownership applied to deny loss deduction on shareholder's sale to his wholly owned corporation); Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1940).

98. Since dividend distributions are not deductible by the corporation, the constructive dividend treatment results in disallowance of the corporation's deduction for funds transferred to the ESOT. Cf. Rev. Rul. 65-8, 1968-2 CUM. BULL. 119 (corporation's deduction for charitable contribution to shareholder's private charity disallowed, since contribution was constructive dividend to shareholder).

99. The IRS may take this position in advance rulings. This would have a substantial deterrent effect on sales to family trust ESOT's whether or not the position prevails in court.

100. The § 318 constructive ownership rules may hamper this approach. See note 94 supra. Even though the § 318 rules are particularly relevant in the taxation of corporate distributions, however, they do not expressly apply in connection with dividend distributions which do not involve stock redemptions. See INT. REV. CODE OF 1954, § 301. Compare § 301 with § 302(c)(1).

101. In such a case the selling shareholder retains ownership (albeit beneficial ownership) of the shares allocated to his account in the ESOT. The end result is that the shareholder receives a corporate distribution with respect to those shares. In this situation, the step transaction doctrine, which looks to the end result of the steps in an integrated transaction, supports taxation of that distribution under INT. REV. CODE OF 1954, § 301. See note 68 supra; cf. Higgins v. Smith, 308 U.S. 473 (1940).

The family trust ESOT here serves, at least in part, as a conduit to funnel to the sell-
A more dependable approach for attacking the family trust ESOT (and one with a definite statutory basis) focuses on the reasonableness of the total compensation paid to employees. Corporate deductions for contributions to qualified trusts are subject to reasonable compensation limits; the ESOT contributions on an employee's behalf are considered together with other compensation in determining their reasonableness. Therefore both salaries and ESOT contributions on behalf of shareholder-employees and their family members can be subjected to special scrutiny, and any "unreasonable" payments may be recharacterized as constructive dividends without importing the uncertainties of application of the common law constructive ownership approach.

It is not easy to justify complete avoidance of dividend treatment with respect to sales of stock by shareholder-employees to family trust ESOT's. Although such transactions may promote some arguably desirable ends (for example, the prevention of conglomerate takeovers and the preservation of productive capital in close corporations), important goals of Congress in favoring ESOT's are not served. Specifically, family trust ESOT's create no new incentives to employee efficiency; capital ownership is not expanded; and employees and their families gain no new income source. The family trust problem is aggravated by the fact that the stock held by the ESOT may be beyond the estate tax. The shareholder's sale of stock to a family trust ESOT therefore may result in an unwarranted extension of extraordinary tax benefits to the shareholders of family corporations. This problem should enliven the concern of Congress and the Service.

Conclusion

In many situations the ESOT purchase arrangement is an attractive approach for the shareholder's disposition of close corporation stock, providing a means for the corporation to fund the stock purchase involving shareholder dividends disguised as part of the purchase price paid by the ESOT for the stock. A constructive dividend might be taxed to the seller on this theory. See John D. Gray, 56 T.C. 1032 (1971); E. Keith Owens, 64 T.C. No. 1 (Apr. 2, 1973).

102. See INT. REV. CODE OF 1954, § 404(a); Treas. Reg. § 1.404(a)-1(b) (1956).

103. See B. BITTER & J. EUSTICE, supra note 56, at 7-32 to 7-33. See, e.g., Paul E. Kummer Realty Co. v. Commissioner, 511 F.2d 313 (8th Cir. 1975).

"Reasonable" salaries paid to shareholder-employees and their family members who are corporate employees are deductible by the corporation. INT. REV. CODE OF 1954, § 162 (a)(1). To the extent that these salaries are deductible, the two-tiered system of taxation of corporations and shareholders is avoided. When shareholder-employees establish and participate in qualified employee benefit plans, the two-tiered system is avoided in the same manner, with the additional benefit of a deferral of tax liability by virtue of § 402 with respect to compensation payments made to the qualified trust.

Employee Stock Ownership Trusts

with tax-deductible dollars while avoiding most of the principal problems surrounding other estate planning alternatives. The establishment of the trust under a qualified stock bonus or employee stock ownership plan solves the basic estate planning problems of the shareholders of closely held corporations by creating an in-house market for the close corporation stock.

ESOT purchases of the corporation’s common stock for corporate employees who are outside the selling shareholder’s family also fulfill the policy objectives underlying the favorable tax treatment of these transactions. But the same conclusion may not follow when the ESOT acquires preferred or nonvoting stock, since the employees then receive only a limited equity interest in the employer corporation. More serious than this problem, however, is the fact that the ESOT may be used as a family trust that furnishes a means for unjustified tax avoidance in many close corporations. It would be appropriate for the IRS and the courts to apply constructive ownership or reasonable compensation concepts in such cases to prevent circumvention of the tax structure applicable to corporations and shareholders.