New Audit Targets: IRS Focuses on Employee Stock Ownership Plans (ESOPs)

by Sandra Brown and Philipp Behrendt

I. Introduction:

In a recent announcement, titled: "IRS cautions plan sponsors to be alert to compliance issues associated with ESOPs" (IR-2023-114, dated August 9, 2023), the Internal Revenue Service (IRS) highlighted its expanded efforts to ensure high-income taxpayers pay their fair share of taxes. The focus of this announcement is on compliance issues associated with Employee Stock Ownership Plans, so-called ESOPs. We discuss the key takeaways from the IRS's warning and the implications for businesses and individual taxpayers.

II. Taxpayer's Questions

This announcement naturally raises some question for taxpayers.

1. What are ESOPs?

ESOPs are retirement plans that offer employees an ownership stake in their employer's company. For employees, ESOPs provide retirement benefits and the opportunity to accumulate wealth for the future. ESOP contributions made by the employer are tax-deductible, reducing the company's taxable income. Additionally, employees who receive distributions from the ESOP may be eligible for favorable tax treatment, such as the ability to roll over the distribution into an Individual Retirement Account (IRA) and defer taxes.

ESOPs are regulated as employee benefit plans under the tax code and federal benefit law. Companies can deduct cash and stock contributions made to the ESOP, providing tax benefits. S-corporations, in particular, can avoid taxation on the portion of their earnings allocable to the ESOP. The recently passed SECURE Act 2.0 aims to encourage more ESOPs by providing tax deferrals and clearer standards for stock valuations.

2. Are ESOPs Legitimate Retirement Plans?

Yes, if set up according to the rules, ESOPs are legitimate and widely recognized retirement plans in the United States. ESOPs are established under the guidelines and regulations set forth by the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). These laws outline the requirements and provisions for ESOPs, ensuring their legitimacy and providing safeguards for both employees and employers.

ESOPs have been in existence for several decades and are utilized by numerous companies across various industries. They are a well-established and respected means of providing employees with an ownership stake in their company and offering retirement benefits.

These plans can be complex, involving arrangements where the ESOP borrows funds from the employer or a third party to purchase shares. Implementing and managing an ESOP requires careful adherence to the regulatory framework and compliance with applicable laws. Employers and plan administrators must ensure that ESOPs are structured and operated in accordance with legal requirements to maintain the associated tax advantages.

The IRS's crackdown on ESOPs comes in response to ongoing issues faced by employee-owned companies. ESOPs have been targeted by the Labor Department investigations and lawsuits for the past 18 years according to claims by employee ownership advocates. These challenges have led to concerns about limited involvement of third-party evaluators and companies becoming cautious about transferring ownership. The IRS's recent notice aims to address these challenges and ensure high-income taxpayers pay their fair share.

3. What are the Compliance Issues Identified by the IRS

In the recent release, the IRS has identified several compliance issues associated with ESOPs, including:

- Valuation Issues: The valuation of employee stock is crucial for determining tax obligations. Taxpayers must accurately assess the value of stock allocated to employees to avoid underreporting taxable income.
- Prohibited Allocation of Shares: ESOPs must adhere to specific rules regarding the allocation of shares. Disqualified persons should not receive shares, and failure to comply with these requirements can lead to penalties.
- ESOP Loan Requirements: ESOP loans must follow tax law requirements to avoid being classified as prohibited transactions. Failure to meet these requirements can cause a loan to be a “prohibited transaction” that can lead to the imposition of excise taxes under IRC section 4975.

4. Does the IRS Suspect Potentially Abusive ESOP Arrangements?

The IRS has expressed concerns about promoted arrangements involving ESOPs that may be abusive. One such scheme involves the creation of a "management" S corporation wholly owned by an ESOP. This arrangement aims to divert taxable business income to the ESOP by providing loans to the business owners, effectively avoiding taxation. The IRS considers these purported loans as taxable income to the business owners. Taxpayers should be cautious of such schemes and seek guidance from independent and trusted tax professionals if they believe they might have gotten involved in a potentially abusive ESOP arrangement.

5. What is the IRS Enforcement Strategies?

To address compliance issues associated with ESOPs, the IRS plans to employ various compliance tools, including education, outreach, but also additional examinations. The agency aims to close the gap in tax compliance by high-income filers, using part of the $80 billion additional funds through the Inflation Reduction Act to raise the number of audits.

And indeed, the recent enforcement announcement fits into a long array of Employment Plans the IRS found to be noncompliant retirement plans (see EP Abusive Tax Transactions). IRS Commissioner Danny Werfel emphasized the agency's commitment to taking swift and aggressive action to address compliance issues associated with ESOPs.

III. Conclusion

With the IRS's increased focus on compliance issues associated with ESOPs, businesses and tax professionals must remain vigilant. ESOPs are complex retirement plans, and understanding the intricate tax law requirements is crucial to ensure compliance.

The IRS's recent announcement regarding compliance issues with ESOPs underscores the agency's commitment to audit high-income taxpayers. Increased audits involving ESOPs will potentially ensnare all taxpayers whether they are compliant or noncompliant, emphasizing the importance of proactive measures and expert guidance to navigate this complex landscape effectively and to avoid even the mere appearance of non-compliance.

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