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Introduction to ERISA and ERISA Plans*

The employee stock ownership plan, or "ESOP," has emerged as a special qualified retirement plan that offers not only the benefits of employee ownership but additional benefits beyond what Congress ever imagined during the infancy stages of creation. ESOPs have, for the most part, proven to be a mechanism for creating not only increased wealth among employees and liquidity for private shareholders, but also the means for increased improvements of company production and growth, and, in many cases, stability and perpetuity.

A qualified retirement plan, such as an ESOP, in the context of this text means a retirement plan sponsored by an employer who may contribute to the plan on a tax-deductible basis as an ordinary and necessary business expense. The plan itself is a tax-exempt entity, and the beneficiaries pay no tax until the actual receipt of the deferred benefit—a unique subsidized system of wealth accumulation for retirement purposes.

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HISTORY OF THE QUALIFIED RETIREMENT PLAN

Pre-ERISA

Several qualified retirement plans evolved prior to the Employee Retirement Income Security Act of 1974 (ERISA) as the result of previous tax legislation. The Revenue Act of 1921 exempted the income from a trust from current tax, the Revenue Act of 1928 permitted funding of past service liabilities, and an amendment in 1942 to the Internal Revenue Code (IRC) was designed to prevent discrimination and restrict deductions for retirement plan funding. Nevertheless, since the Internal Revenue Service (IRS) regulated retirement plans on a district-by-district basis, much inconsistency prevailed. ERISA put an end to this nonconformity, and qualified plans gained their greatest advantage.

*This chapter was contributed by Don Stark.

Post-ERISA

The legislation passed subsequent to ERISA contained provisions reducing the benefits of qualified plans: the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Tax Act of 1984 (DEFRA), the Retirement Equity Act of 1984 (REA), the Tax Reform Act of 1986 (TRA '86), the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), the Revenue Reconciliation Act of 1989, the Omnibus Budget Reconciliation Act of 1990, and the Unemployment Tax Act of 1992. Contrarily, most of the legislation passed subsequent to ERISA has had a positive effect on ESOPs.

Between 1955 and 1970, the IRS approved only thirty (30) plans to invest principally in employer stock, called *stock bonus plans*. During the same period, the IRS approved 93,000 profit sharing plans. It is not possible to guess how many of those profit sharing plans invested in employer stock because no guidelines existed during this time. For example, pre-ERISA profit sharing plans could purchase equipment needed by the employer and lease the equipment to the employer and receive tax-deferred income, or purchase a stockpile of raw material needed by the employer and sell it to the employer. These investment options were not permissible post-ERISA, but the ownership of employer stock became well codified by ERISA.

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ERISA CODIFIES THE ESOP

ERISA first created a new concept referred to as a *party of interest*.[1] All individuals and entities who are associated in some way with the plan causing a conflict of interest are parties of interest. The concept is far reaching, but obviously, the sponsor[2] of the plan (i.e., the corporate employer), the stockholders, board of directors, employees, and plan trustee are parties of interest. ERISA also established the concept of the *prohibited transaction,*[3] which prohibits a plan from conducting any transaction with a party of interest, and the Internal Revenue Code (the Code) imposes a tax on prohibited transactions.[4]

If there were no exception to this rule, ESOPs would not be possible.

> However, ERISA provides an exception to the acquisition and sale of "qualifying employer securities"[5] if done by an "eligible individual account plan"[6] for adequate consideration and no commission charged.[7]

An eligible individual account plan is a profit sharing plan, or an ESOP, merely because such a plan "explicitly provides for acquisition and holding of qualifying employer securities"[8] which is "a security issued by an employer for employees covered by the plan."[9] Therefore, if the purpose of the plan with

regard to company stock is only to buy and sell such stock, the plan need only be an eligible individual account plan, thereby avoiding many of the complex and high-maintenance rules applicable to ESOPs.

There are five principal reasons why an individual account plan that is not an ESOP may not be appropriate.

1. ERISA defines an ESOP as an individual account plan that is designed to invest primarily in qualifying employer securities and meets such other requirements of IRS regulations.[10]

   What "primarily" means has not been well established, but by virtue of this aspect, it should generally be prudent for an ESOP to purchase employer stock.
2. Only a loan to an ESOP is exempt from the prohibited transaction rules.[11]
3. The nonrecognition of gain upon the sale of employer stock under IRC Sec. 1042 is available only to an ESOP.
4. Tax-deductible dividends are available to a C corporation only in conjunction with an ESOP.[12]
5. Although the Small Business Job Protection Act (1996) amended IRC Sec. 1361(c) to permit a qualified plan to be a stockholder of an S corporation, such an asset is treated as an unrelated trade or business, thereby producing a tax liability for the plan (unrelated business taxable income, or UBTI). In 1997, the code was amended exempting ESOPs from the UBTI.[13]

ERISA exempts all eligible individual account plans from ERISA diversification requirement, but such exemption would seem more applicable to ESOPs.[14] The fiduciary duties mandated by ERISA undoubtedly make the purchase of qualifying employer securities a risky proposition for an eligible individual account plan that is not an ESOP by participants who are not also principals.

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USES OF AN ESOP

An ESOP has many potential uses, some of which include the following:

- Selling the company to its employees as an exit strategy for the majority owner
- Setting up a business continuation plan
- Purchasing a competitor
- Retiring a minority interest
- Raising tax-deductible working capital
- Retiring debt principal on a tax-deductible basis

No matter what the objective, benefiting from the magic of an ESOP requires only the right fact situation and compliance with certain rules.

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