

Publications

IRS Warns Plan Sponsors of ESOP Compliance Risks

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On August 9, 2023, the Internal Revenue Service (“IRS”) issued a new notice ([IR-2023-144](#), the “Notice”) cautioning employers “to be alert to a range of compliance issues that can be associated with Employee Stock Ownership Plans” (“ESOPs”). Although sparse on details, the Notice indicates that the IRS is concerned that certain ESOP transactions are “aggressive tax schemes” that benefit high-income taxpayers.

ESOPs provide employees the opportunity to gradually acquire ownership of company stock. Congress has long supported employee ownership and has encouraged ESOP formation by providing favorable treatment under the Internal Revenue Code (the “Code”). However, the rules governing ESOPs can be complex, and both the IRS and the Department of Labor (“DOL”) have taken positions arguably at odds with Congress’s goal to expand employee ownership.

The IRS periodically audits ESOPs, running “compliance checks” aimed at confirming whether a plan meets the various requirements of the Code and related regulations. In some cases, the IRS has issued warnings or observations about ESOP practices the agency deems problematic. The most recent warning before the Notice was in 2004 (IR-2004-155). The IRS is now firing a warning shot by issuing the Notice to alert “higher-income taxpayers and businesses to compliance issues and aggressive schemes involving complex or questionable transactions, including those involving ESOPs.”

The Notice states that, due to substantial funding from the Inflation Reduction Act, the IRS is now focused on “ensuring high-income taxpayers pay what they owe.” The Notice does not provide much in the way of specifics, but it identifies concerns with the following:

- Valuation issues with employer stock;
- Prohibited allocations of shares to “disqualified persons”;
- Failures to satisfy the complex rules for ESOPs to borrow funds to purchase company stock; and
- Schemes where a business creates a “management” S corporation to divert taxable income to otherwise tax-exempt ESOPs.

The Notice states that the IRS will continue to use a range of compliance tools, including education, outreach and additional examinations to address compliance issues associated with ESOPs.

Notably, DOL recently [announced](#) an initiative to promote employee ownership. The initiative is DOL's attempt to implement the ESOP provisions of the SECURE 2.0 Act, which became law late last year. There is hope that the initiative can resolve longstanding disagreements between DOL and the regulated community about important ESOP valuation issues. DOL has committed to having a formal rulemaking process specifically targeted at ESOP valuation.

Groom closely monitors DOL and IRS activity in this area and has substantial experience in all areas affecting ESOPs including –

- Structuring ESOPs and ERISA-compliant company stock purchases.
- Assisting plan sponsors in IRS audits and DOL investigations,
- Conducting preemptive DOL and IRS compliance reviews, and
- Defending fiduciaries in class actions claiming breaches of the Employee Retirement Income Security Act of 1974.

For more information, please reach out to any of the authors listed on this alert or your regular Groom attorney.