# ESOPs Encouraged but Do It Right! SECURE 2.0 ESOP Provisions and Expanded IRS Focus

Aug 17, 2023

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Publications
Tax Law Defined™ Blog

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The SECURE 2.0 Act of 2022 (SECURE 2.0), which was passed as 2022 wound down, expands on the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE 1.0) by substantially modifying rules related to qualified retirement plans. We first discussed SECURE 2.0 earlier this year and have published a few follow-up articles on specific topics, such as required Roth contributions, expanded plan corrections, and the long-term part-time employee rules. This alert discusses employee stock ownership plans, or ESOPs, with two specific focuses: (i) SECURE 2.0 rules affecting ESOPs; and (ii) an IRS news release announcing an expanded focus on ESOP compliance.

## SECURE 2.0

SECURE 2.0 included a number of provisions specific to ESOPs, expanded on more below. These changes include (i) amending Section 1042 of the Internal Revenue Code of 1986, as amended ("Code") to allow limited application of tax deferral on a sale of stock to S corporation ESOPs; (ii) amending Code Section 401(a)(35) to change the definition of "publicly traded" for diversification requirements; (iii) directing the Department of Labor (DOL) to create an Employee Ownership Initiative; and (iv) directing the DOL to release formal guidance on ESOP valuation standards.

The first change amends Code Section 1042 to expand its application. Prior to the change, Code Section 1042 permitted an owner of a non-publicly traded C corporation to defer up to 100% of capital gain on the sale of the owner's stock if (i) an ESOP owns at least 30% of the C corporation stock after the sale, and (ii) the owner invests the sale proceeds in "qualified replacement property" (stocks and bonds of U.S. operating companies). SECURE 2.0 expands this 1042 treatment to S corporation owners for sales that occur on or after January 1, 2028, but limits such treatment to 10%


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of the sale proceeds.

The second change modifies diversification rules that apply to qualified plans holding "publicly traded employer securities." The rules under Code Section 401(a)(35) only apply to ESOPs if they hold either salary deferrals or matching contributions (or both) and require such plans to offer at least three investment options (other than employer securities) to which individuals may direct the proceeds from the sale of employer securities. Plans that offer a broad range of investment alternatives according to Section 404(c) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) generally would satisfy this requirement.

The term "publicly traded employer securities" is defined to mean "employer securities that are readily tradable on an established securities market." SECURE 2.0 changed this definition for ESOPs, effective for plan years starting after December 31, 2027, to mean an employer security that (i) is subject to priced quotations by at least four dealers on a U.S. Securities and Exchange Commission-regulated interdealer quotation system; (ii) is not a penny stock; (iii) is not issued by a shell company, blank check company, or subject to bankruptcy proceedings; and (iv) has a public float with a fair market value of at least $1,000,000 and constitutes at least 10% of outstanding shares. If a security meets the above and is issued by a domestic corporation, the corporation must publish audited financial statements at least annually in order for the security to be considered publicly traded; if the security is issued by a foreign corporation, the security must either be (i) represented by a depository share or (ii) issued by a foreign corporation incorporated in Canada that meets additional requirements specific to Canadian issuers and be readily tradable on an established securities market in Canada. This updated definition is intended to allow highly regulated companies with liquid securities that are quoted on non-exchange markets to treat their stock as "public" for ESOP purposes, making it easier for these companies to offer ESOPs to their U.S. employees.

The third change under SECURE 2.0 directs the DOL to establish an Employee Ownership Initiative to promote employee ownership at the state level. This program is to be funded initially in 2025 with $4


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million and will gradually increase to $16 million in 2029. The initiative is part of SECURE 2.0's Worker Ownership, Readiness, and Knowledge (WORK) Act and will include state-level grants, having the DOL act as a clearinghouse on techniques employed by new and existing programs and existing state-level programs, and funding projects for information gathering on those techniques by groups outside the DOL. Funds can be used for educating business owners about using employee ownership for business transition, providing information on starting employee-owned companies, training employees and employers on workplace participation programs, and providing technical assistance to assess the feasibility of transactions. Funds also can be used to help pay for feasibility studies, providing materials for outreach and training, creating a data bank on where to find legal, financial, and technical advice in connection with business ownership, and creating networks of employee-owned companies.

The final change, which is also part of the WORK Act, requires the DOL to develop "acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan." This change is intended to address long-awaited guidance on a gray area in the ESOP rules, under 408(e) of ERISA. Under Section 408(e), an ESOP that purchases stock from its sponsoring company is exempt from a prohibited transaction if the ESOP pays no more than adequate consideration for the stock. "Adequate consideration" is defined as "fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary [of Labor]." The DOL identified ESOP valuations as an enforcement priority all the way back in 2005 and regularly sues over this issue, which is the most heavily litigated ESOP issue, so this highly anticipated guidance will be a welcome clarification.

## IRS News Release

Finally, on August 9, 2023, the IRS issued a news release warning businesses and tax professionals to be aware of a range of compliance issues associated with ESOPs. The announcement


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notes that the IRS is focusing on ESOP transactions "as part of the effort to ensure our tax laws are applied fairly and high-income filers pay the taxes they owe" by "spotting aggressive tax claims as they emerge" and "alerting … taxpayers to compliance issues and aggressive schemes involving complex or questionable transactions, including those involving ESOPs."

The IRS release notes that it will undertake enforcement strategies to ensure compliance with tax law requirements, including valuation issues with employee stock, the prohibited allocation of shares to disqualified persons, and failures to follow requirements for ESOP loans causing the loan to be a prohibited transaction. The IRS also sees the promotion of potentially abusive ESOP arrangements, such as schemes where a business creates a "management" S corporation whose stock is wholly owned by an ESOP for the sole purpose of diverting taxable business income to the ESOP. The S corporation purports to provide loans to the business owners in the amount of the business income to avoid taxation of that income. The IRS's position is that those loans are taxable income to the business owners and such transactions potentially jeopardize a corporation's S corporation status.

ESOPs have always been subject to a higher level of audits than other plans, and clearly the IRS is again going to step up its audits. ESOP sponsors and administrators can do a few things to reduce the risk of a problem being discovered on audit that might result in costly penalties. The employer can evaluate compliance and ask the auditor, recordkeeper, and counsel whether there is anything of concern about the ESOP. ESOP trustees, especially internal trustees, should consider the process for review of valuations of company stock and document that review.

If you have any questions about this article or your ESOP, or would like help troubleshooting, contact the author or any member of FBT's Employee Benefits & ERISA service team.

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