Staying Calm, Cool and Collected: ESOP Accounting and Cost Basis Calculations

The 11th Annual Tri-State ESOP Conference

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Retirement plan administrative and recordkeeping services provided by
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Session B Overview and Objectives

- 75-minute educational session
- Informal and interactive; we encourage questions and open discussion
- **Accounting** - An overview of accounting for newly created ESOP transactions and annual ESOP transactions as they relate to company's financial statements
- **Tax** – How to determine tax basis changes in ESOP stock
- **Cost Basis** – Why ESOP stock cost basis is important and how best to report

How confusing is ESOP Accounting?

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Before Accounting for an ESOP… What is an ESOP?

- Employee-owned company through an employee stock ownership plan (ESOP)
- Pension Plan – Qualified defined contribution

Before Accounting for an ESOP…
What is an ESOP?

- Plan invests in sponsoring company's stock
  - Other assets in the plan (public stock, cash)
  - Limitation limits (value of company stock must be 50% of plan assets
  - Ownership by ESOP can be a portion of company up to 100%

What is an ESOP? (continued)

- Company stock held in trust for plan participants/ employee
  - ESOP trust is shareholder
  - Participants are represented by Trustee of ESOP, votes shares

What is an ESOP? (continued)

- ESOP types:
  - Leveraged
  - Non-leveraged
- The ESOP and the company are reportable and accountable
  - Internal Revenue Service
  - Department of Labor
  - Lending Institution
  - Plan participants/Employee

ESOP Candidate Profile

- Owner looking to exit/sell business
- Capable management team to remain in place
- Company has debt capacity
- Stable and predicable profitability and cash flow
- Company is of critical size (40+ employees)

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ESOP Candidate Profile (continued)

- Company has ability to have employee-owned culture/mindset
- Limited third party/strategic buyers
- Motivated by tax advantages
- Desire to buy out minority shareholder

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ESOP Limitations

- Inability to pay more than FMV
  - Strategic buyers often pay premium for company
  - ESOP must cash flow purchase
- Owner may not be able to get 100% of cash
  - Seller notes / warrants
- ESOP compliance is complex with on going administrative cost

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Guidance for ESOP Accounting

- Since issued in 1993, the AICPA Standard of Position 93-6 has governed GAAP Accounting for ESOPs

- September 15, 2009 – Accounting Standard Codification ASC 718-40 replaced SOP 93-6.

"Effectively just a name change"

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Leveraged vs. Non Leveraged ESOPs

- Non-leveraged ESOP/Transaction
  - Contribution of shares to the plan (compensation expense=FMV of shares)
  - Contribution of cash, purchase of shares
  - Accounting simple – no unreleased shares in suspense
  - Expense is recorded in year employee renders service
- Leveraged ESOP/Transaction
  - ESOP uses available cash and / or borrows proceeds to purchase shares
  - Funds can be borrowed by ESOP directly from seller/bank
  - Most common structure. Company borrows and lends to ESOP on terms
  - Accounting is the same whether the leverage is direct or indirect

Leveraged ESOP – Balance Sheet

- ESOP debt is recorded on company's financial statements
  - Contra equity account – "**Unearned ESOP Shares**"
    - "Think of it as a note receivable, only it is recorded in stockholder's equity section"
- Debt structures
  - Direct loan – Loan to ESOP trust
  - Indirect loan
    - 1st step - lender to company
    - 2nd step - company to ESOP
  - Internal loan – company lends to ESOP with no borrowing
  - Accounting is similar regardless of loan structure

Case Study
Leveraged – Indirect Loan

- **Assumptions**
  - An S-corporation sells 40% of stock to leveraged ESOP. The company has 100,000 shares outstanding.
  - FMV of shares sold is $3 million, or $75 per share (40,000 shares).
  - **Outside Loan** – the company borrows $3 million for 7 years at 4.5% interest. Annual debt service = $500,000.
  - **Inside loan** – the company loans $3 million to the ESOP for 10 years, no interest. Annual loan payment to company = $300,000.
  - ESOP buys 40,000 shares from owner for $3 million.
  - Shares will be released to employee accounts over 10 years; 4,000 shares per year.
  - As a result of the leverage created by the ESOP and company performance the FMV of stock at the end of the first year is $50. An additional $200,000 plan contribution is made.
  - FMV of stock at end of year two is $85 and the company makes a $100,000 distribution/dividend.

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Leveraged ESOP

Financing Source (Indirect Loan)

"Outside" loan $3 million

↓

Company

"Inside" loan $3 million

↓

ESOP

Cash $3 million

↓

Shareholder

FMV of stock $3 million

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Leveraged ESOP – Stock Purchase

Indirect Loan

Corporate Debt	
Cash	$3,000,000
Long-term Debt	$3,000,000

Company ← **Lender**

ESOP Debt	
Unearned ESOP Shares	$3,000,000
Cash	$3,000,000

ESOP Trust

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Indirect Loan – Company borrows and loans to ESOP

ASSETS				
		ESOP Loan Entries		
	Pre-ESOP	Company Debt Outside	ESOP Debt Inside	Post-Transaction
Current Assets				
Cash	$ 100,000	3,000,000	(3,000,000)	$ 100,000
Accounts receivable	1,750,000			1,750,000
Inventories	2,300,000			2,300,000
Total Current Assets	4,150,000			4,150,000
Property and Equipment	5,400,000			5,400,000
Less: Accumulated depreciation	(3,800,000)			(3,800,000)
Total Property and Equipment	1,600,000			1,600,000
Total Assets	$ 5,750,000			$ 5,750,000

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Indirect Loan – Company borrows and loans to ESOP

LIABILITIES AND STOCKHOLDERS' EQUITY	Pre-ESOP	Company Debt Outside	ESOP Debt Inside	Post-Transaction
Current Liabilities				
Accounts payable	$ 2,100,000			$ 2,100,000
Line of credit	500,000			500,000
Total Current Liabilities	2,600,000			2,600,000
Long-Term Debt	200,000	(3,000,000)		3,200,000
Total Liabilities	2,800,000			5,800,000
Stockholders' Equity				
Common Stock	250,000			250,000
Additional paid-in capital	300,000			300,000
Retained earnings	2,400,000			2,400,000
	2,950,000			2,950,000
Unearned ESOP Shares			3,000,000	(3,000,000)
Total Stockholders' Equity	2,950,000			(50,000)
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 5,750,000			$ 5,750,000

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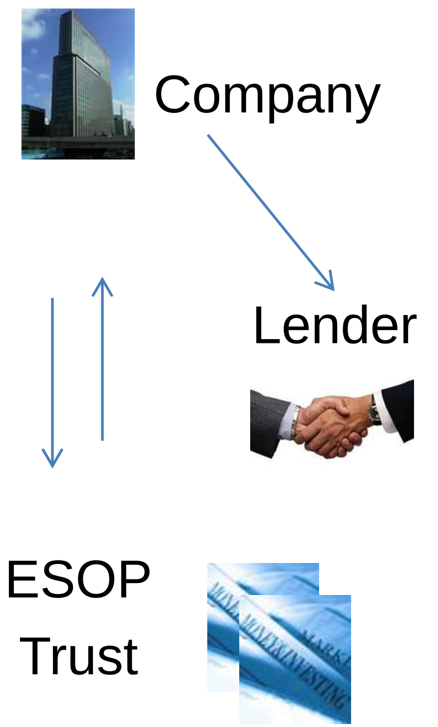
Release of Shares, Employer Contribution & Debt Payment – Year 1

Indirect Loan



Bank Loan Repayment – Year 1

Debt	$500,000	
Interest Expense	125,000	
Cash		625,000

Employer Contribution / ESOP Loan Repayment – Year 1

Release of 4,000 shares at $50 per share

Compensation Expense	$200,000*	
Additional Paid-in Capital	100,000	
Unearned ESOP Shares		300,000

** Note $100,000 is a book/tax difference and is deducted for tax purposes*

** Assumes share value has decreased*

Employer makes additional contribution to plan

Contribution	$200,000	
Cash		200,000

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Indirect Loan – Release of Shares, Loan Payment and Plan Contribution - Year 1

ASSETS					
		ESOP Entries			
	ESOP Prior to Release	Company Debt Payments	Company Plan Contribution	ESOP Release of Shares	End of 1st Year
Current Assets					
Cash	$ 1,305,000	(625,000)	(200,000)		$ 480,000
Accounts receivable	1,750,000				1,750,000
Inventories	2,300,000				2,300,000
Total Current Assets	5,355,000				4,530,000
Property and Equipment	5,400,000				5,400,000
Less: Accumulated depreciation	(3,800,000)				(3,800,000)
Total Property and Equipment	1,600,000				1,600,000
Total Assets	$ 6,955,000				$ 6,130,000

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Indirect Loan – Release of Shares, Loan Payment and Plan Contribution – Year 1

LIABILITIES AND STOCKHOLDERS' EQUITY	ESOP Prior to Release	Company Debt Payments	Company Plan Contribution	ESOP Release of Shares	End of 1st Year
Current Liabilities					
Accounts payable	$ 2,100,000				$ 2,100,000
Line of credit	500,000				500,000
Total Current Liabilities	2,600,000				2,600,000
Long-Term Debt	3,200,000	500,000			2,700,000
Total Liabilities	5,800,000				5,300,000
Stockholders' Equity					
Common Stock	250,000				250,000
Additional paid-in capital	300,000			100,000	200,000
Retained earnings	2,400,000				2,400,000
Current year income	1,205,000				680,000
	4,155,000				3,530,000
Unearned ESOP Shares	(3,000,000)			(300,000)	(2,700,000)
Total Stockholders' Equity	1,155,000				830,000
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 6,955,000				$ 6,130,000

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Indirect Loan – Release of Shares, Loan Payment and Plan Contribution – Year 1

Year 1 – Income Statement

	ESOP Prior to Release	Company Debt Payments	Company Plan Contribution	ESOP Release of Shares	End of 1st Year
Net Sales	$ 25,000,000				$ 25,000,000
Cost of Sales	22,500,000				22,500,000
Gross Profit	2,500,000				2,500,000
Selling, General and Administrative Expenses	1,300,000				1,300,000
Contribution to employee benefit plan, net of adjustment for difference in stock cost & stock value			200,000	200,000	400,000
Operating Income	1,200,000				800,000
Other Income (Expenses)					
Interest income	5,000				5,000
Interest expense	10,000	125,000			135,000
Other income	10,000				10,000
Total Other Income (Expenses)	5,000				(120,000)
Net Income	$ 1,205,000				$ 680,000
				Book/Tax difference related to compensation expense	(100,000)
				Taxable Income	$ 580,000

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Release of Shares, Loan Repayment & Distribution – Year 2

Indirect Loan

Company

Lender

ESOP
Trust

Bank Loan Repayment – Year 2

Debt	$390,000	
Interest Expense	110,000	
Cash		$500,000

Company makes a $200,000 Dividend

ESOP receives 80,000 of Distribution (40%)

Retained Earnings	$128,000	
Compensation Expense	72,000	
Dividend Payable		8,000
Cash		$192,000

Employer Contribution Loan Repayment – Year 2

Release of 4,000 at $85 per share

Compensation Expense	$332,000*	
Dividends Payable	8,000	
Additional Paid-in Capital		40,000
Unearned ESOP shares		$300,000

**Assumes share value increase*

Note $104,000 is a book/tax difference and is not deducted for tax purposes

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Indirect Loan – Release of Shares, Loan Payment and Dividend – Year 2

ASSETS					
		ESOP Entries			
	ESOP Prior to Release	Company Debt Payments	Dividend	ESOP Release of Shares	End of 1st Year
Current Assets					
Cash	$ 5,185,000	(500,000)	(192,000)		$ 4,493,000
Accounts receivable	1,750,000				1,750,000
Inventories	2,300,000				2,300,000
Total Current Assets	9,235,000				8,543,000
Property and Equipment	5,400,000				5,400,000
Less: Accumulated depreciation	(3,800,000)				(3,800,000)
Total Property and Equipment	1,600,000				1,600,000
Total Assets	$ 10,835,000				$ 10,143,000

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Indirect Loan – Release of Shares, Loan Payment and Dividend – Year 2

LIABILITIES AND STOCKHOLDERS' EQUITY

		ESOP Entries			
	ESOP Prior to Release	Company Debt Payments	Dividend	ESOP Release of Shares	End of 1st Year
Current Liabilities					
Accounts payable	$ 2,100,000				$ 2,100,000
Line of credit	500,000				500,000
Dividend payable			(8,000)	8,000	-
Total Current Liabilities	2,600,000				2,600,000
Long-Term Debt	2,700,000	390,000			2,310,000
Total Liabilities	5,300,000				4,910,000
Stockholders' Equity					
Common Stock	250,000				250,000
Additional paid-in capital	200,000			(40,000)	240,000
Retained earnings	3,080,000		128,000		2,952,000
Current year income	4,705,000				4,191,000
	8,235,000				7,633,000
Unearned ESOP Shares	(2,700,000)			(300,000)	(2,400,000)
Total Stockholders' Equity	5,535,000				5,233,000
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 10,835,000				$ 10,143,000

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Indirect Loan – Release of Shares, Loan Payment and Plan Dividend – Year 2

YEAR 2 INCOME STATEMENT

		ESOP Entries			
	ESOP Prior to Release	Company Debt Payments	Dividend	ESOP Release of Shares	End of 1st Year
Net Sales	$ 40,000,000				$ 40,000,000
Cost of Sales	34,000,000				34,000,000
Gross Profit	6,000,000				6,000,000
Selling, General and Administrative Expenses	1,300,000				1,300,000
Contribution to employee benefit plan, net of adjustment for difference in stock cost & stock value			-	404,000	404,000
Operating Income	4,700,000				4,296,000
Other Income (Expenses)					
Interest income	5,000				5,000
Interest expense	10,000	110,000			120,000
Other income	10,000				10,000
Total Other Income (Expenses)	5,000				(105,000)
Net Income	$ 4,705,000				$ 4,191,000
				Book/Tax difference related to compensation expense	104,000
				Taxable Income	$ 4,295,000

Post ESOP Financial Statements
Differences and Challenges

- Additional debt leverage
- Negative equity as result of **“Unearned ESOP Shares”**
- Financial ratios impacted
- Lack of ESOP understanding by suppliers, bankers and shareholders require explanation

Financial Statement Footnote Disclosures

- Description of the ESOP plan
- Summary of the ESOP transaction if it occurred in the year presented, sometimes longer
- Terms of ESOP debt to purchase shares
- Schedule of prior shares released, current year shares released and unallocated shares
- Fair value of shares unreleased as of reporting year
- Funding source for ESOP loan repayments, such as future company contributions
- The method for releasing shares
- Company contribution amount for each year presented
- Computation of compensation expense as it relates to released shares

ESOP Tax Benefits and Notables

- Taxable income of an S-Corporation attributed to the ESOP's ownership is not subject to federal and state income taxes.
- Many states impose activity taxes and/or excise taxes – ESOP companies are subject to these taxes.
- C-Corporation ESOP are subject to federal tax – some planning opportunities with newly formed ESOPs.
- Distributions made to ESOP to pay debt are not deductible.
- Adjustments to compensation expense due to value changes in released shares impact taxable income.
- Future acquisitions with an ESOP can be tax advantages.
- ESOP, like individual shareholders still need to track S-Corporation tax basis.

Cost Basis

By Jackie J. Salmon, A.S.A., M.A.A.A.

Field Vice President Consulting Services

McCready and Keene (a OneAmerica Co.)

Agenda

- Importance of Cost Basis for an ESOP
- Distributions - tax treatment and NUA
- Cost basis for S corporation ESOP shares
  - Rev. Rule 2003-27
  - KSM Review of S-Corporation stock basis calculation
  - Best Practice for Adjustment of Cost Basis
  - Best Practice for Reporting Income on Form 5500
- Cost basis for C corporation ESOP shares
- Participant Statements - cost basis reporting

Importance of Cost Basis

- Important if ESOP makes distributions in form of shares.
- Even if distributions in shares not currently allowed, changes can occur later and it can be difficult to recreate the cost basis.
- Can also change corporate status.
- In 2003, IRS released Revenue Ruling 2003-27 that held that an S Corporation ESOP must adjust the cost basis in the ESOP in the same manner as any other shareholder (before was unclear).

Distributions

- C Corporation ESOPs are generally required to offer distributions in stock as an option.
- An ESOP does not have to permit distributions in stock if it is sponsored by a corporation that has a restriction on ownership in their articles of incorporation or corporate by-laws
- S Corporations have a 100 shareholder limit so many S Corporation ESOPs to not offer stock distributions.

Distributions – Tax Treatment & NUA

- The cost basis can have significant tax implications for a participant that receives a distribution in stock.
- This information must also be reported by the ESOP on the participant's 1099-R.

Distributions – Tax Treatment & NUA

- If a distribution of stock is part of a “lump sum” distribution, the value increase while the shares were held by the ESOP (a.k.a. the net unrealized appreciation or NUA) is not taxed until the shares are later sold by the participant, but cost basis is taxed.

- If the distribution is not a “lump sum,” the taxable amount is the amount of cash received plus the fair market value of the shares received.

Lump Sum Distributions – Tax Treatment & NUA

- In general – “lump sum” is the distribution of the participant’s total account balance in one calendar year.
- The cost basis of the shares to the plan (or the current fair market value if lower) plus the cash distributed is taxed as ordinary income when received by the participant.
- Rollovers are not taxed until distributed from the IRA or other plan. There is no NUA treatment available for IRA distributions.

Lump Sum Distributions – Tax Treatment & NUA

- When a participant receives shares and the sells them, there is a taxable capital gain to the extent the net proceeds exceed the cost basis.
- The portion of the gain attributable to the time the shares were held by the ESOP (i.e. the NUA) will be taxed as long-term capital gain.
- Any gain on the shares after the distribution will be taxed as long or short-term capital gain depending on the holding period between distribution and the sale. This is usually an immediate “put” so not applicable.

Lump Sum Distributions – Tax Treatment & NUA

- The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rates for long-term capital gain to a maximum of 15%.
- On January 1, 2013, the rate will raise to 20%; but other taxes imposed will move it to a top rate of 25% for some.
- Other taxes include an obscure provision of the tax code known as PEASE increase effective tax rates on high-income taxpayers by reducing the amount of itemized deductions. On net it will add another 1.2%. (1)
- Finally health reform imposed a new tax on the net investment income of high-income taxpayers, including capital gains, adding another 3.8%. (1)

(1) Per Forbes Magazine, Donald Marron 1/24/12

Lump Sum Distributions – Tax Treatment & NUA

Example of tax treatment of NUA:

- John Q Participant has an ESOP balance consisting of 1,000 shares of stock with a fair market value of \$200/share and a cost basis of \$50/share. His total balance is \$200,000. Distributions are made in a lump sum.
- If John takes a cash distribution from the ESOP and does not rollover, his tax liability on the \$200,000 using 35% tax bracket would be \$70,000.

Lump Sum Distributions – Tax Treatment & NUA

Example of tax treatment of NUA (before tax increase):

- If John takes a stock distribution from the ESOP and sells the shares immediately back to the company using the put option, the tax liability is computed as follows:
  - The cost basis of the shares ($50 x 1,000 shares = $50,000) will be taxed at ordinary income rates of 35% or $17,500.
  - The NUA on the shares ($150 x 1,000 shares = $150,000) will be taxed at capital gain rate of 15% or $22,500.
  - Thus John's total tax liability would be $40,000. By receiving stock, John saves $30,000 in taxes.

Lump Sum Distributions – Tax Treatment & NUA

- If John does not sell the shares in the year they are distributed, he will have tax liability for that taxable year of the distribution equal to the ordinary income rates on the cost basis, which was the $17,500.
- If he sells the shares within a year of receipt, he would use the long-term rate on the NUA and the short-term rate on the appreciation between the date of distribution and the sale.
- If he sells over a year later, the long-term capital gain rate is used on all the appreciation.

Cost Basis for S Corporations

- On 2/20/2003 the IRS released revenue ruling 2003-27 (included as a handout) stating an ESOP maintained by an S corporation must adjust the cost basis in the same manner as any other shareholder.
- Ruling also specified that upon distribution of stock from the ESOP, the stock's NUA is determined using this adjusted cost basis.
- The ruling DOES NOT provide guidance on how to adjust the stock except to say do it the same as required for an S shareholder.

Cost Basis for S Corporations (non-ESOP)

- Under S corporation rules, each shareholder’s basis changes in response to the flow-through of income, credits, expenses, and losses.
- Income items are used to adjust basis only if shareholders include the income in gross income reported on tax return.
- However, for ESOPs, cost basis must be adjusted even though the S corporation ESOP does not file an income tax return.

Cost Basis for S Corporations (non-ESOP)

- After cost basis is increased for income items, the cost basis for S corporation stock is decreased for distributions received by the shareholder and contributions by the shareholder to the corporation.
- The cost basis is determined on a share-by-share basis, pro-rata to the shareholder’s portion on a per-day basis.

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ESOP BASIS

Assumptions:

- ESOP OWNS 40% of the company stock.
- ESOP K-1 reports 40% share of taxable income is $232,000.
- ESOP K-1 reports 40% share of interest is 500.
- Non-deductible entertainment expenses are 3,000. (limited to 50% deductibility)
- Non-deductible penalties are 1,000.
- Distributions to ESOP are $100,000. Assume non-leveraged ESOP.
- ESOPs starting basis in stock is $500,000.

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ESOP BASIS

Starting Basis Year XX	$ 500,000
Taxable Income X1	232,000
Interest Income X1	500
Non-Deductibles	<4,000>
Distribution to ESOP	<100,000>
Basis at End of the Year X1	$ 628,500

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) 2011

Department of the Treasury
Internal Revenue Service

For calendar year 2011, or tax year beginning ________ ending ________

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-XXXXXXX

B Corporation's name, address, city, state, and ZIP code
Make It Big, Inc.
1234 Employee Lane
Yourtown, USA

C IRS Center where corporation filed return
E-File

Part II Information About the Shareholder

D Shareholder's identifying number

E Shareholder's name, address, city, state, and ZIP code

F Shareholder's percentage of stock ownership for tax year . . . . 40 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) 232,000	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income 500		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction	16	Items affecting shareholder basis
		C	4,000
12	Other deductions	D	100,000
		17	Other information
		A	500

* See attached statement for additional information.

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:

	Report on
Passive loss	See the Shareholder's Instructions
Passive income	Schedule E, line 28, column (g)
Nonpassive loss	Schedule E, line 28, column (h)
Nonpassive income	Schedule E, line 28, column (j)
2. Net rental real estate income (loss)	See the Shareholder's Instructions
3. Other net rental income (loss)	
Net income	Schedule E, line 28, column (g)
Net loss	See the Shareholder's Instructions
4. Interest income	Form 1040, line 8a
5a. Ordinary dividends	Form 1040, line 9a
5b. Qualified dividends	Form 1040, line 9b
6. Royalties	Schedule E, line 3b
7. Net short-term capital gain (loss)	Schedule D, line 5
8a. Net long-term capital gain (loss)	Schedule D, line 12
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions
9. Net section 1231 gain (loss)	See the Shareholder's Instructions
10. Other income (loss)	
Code	
A Other portfolio income (loss)	See the Shareholder's Instructions
B Involuntary conversions	See the Shareholder's Instructions
C Sec. 1256 contracts & straddles	Form 6781, line 1
D Mining exploration costs recapture	See Pub. 535
E Other income (loss)	See the Shareholder's Instructions
11. Section 179 deduction	See the Shareholder's Instructions
12. Other deductions	
A Cash contributions (50%)	See the Shareholder's Instructions
B Cash contributions (30%)	
C Noncash contributions (50%)	
D Noncash contributions (30%)	
E Capital gain property to a 50% organization (30%)	
F Capital gain property (20%)	
G Contributions (100%)	
H Investment interest expense	Form 4952, line 1
I Deductions - royalty income	Schedule E, line 19
J Section 59(e)(2) expenditures	See the Shareholder's Instructions
K Deductions - portfolio (2% floor)	Schedule A, line 23
L Deductions - portfolio (other)	Schedule A, line 28
M Preproductive period expenses	See the Shareholder's Instructions
N Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
O Reforestation expense deduction	See the Shareholder's Instructions
P Domestic production activities information	See Form 8903 instructions
Q Qualified production activities income	Form 8903, line 7b
R Employer's Form W-2 wages	Form 8903, line 17
S Other deductions	See the Shareholder's Instructions
13. Credits	
A Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions
B Low-income housing credit (other) from pre-2008 buildings	
C Low-income housing credit (section 42(j)(5)) from post-2007 buildings	
D Low-income housing credit (other) from post-2007 buildings	
E Qualified rehabilitation expenditures (rental real estate)	
F Other rental real estate credits	
G Other rental credits	
H Undistributed capital gains credit	Form 1040, line 71, box a
I Alcohol and cellulosic biofuel fuels credit	See the Shareholder's Instructions
J Work opportunity credit	
K Disabled access credit	
L Empowerment zone and renewal community employment credit	

Code	*Report on*
M Credit for increasing research activities	See the Shareholder's Instructions
N Credit for employer social security and Medicare taxes	See the Shareholder's Instructions
O Backup withholding	Form 1040, line 62
P Other credits	See the Shareholder's Instructions
14. Foreign transactions	
A Name of country or U.S. possession	Form 1116, Part I
B Gross income from all sources	
C Gross income sourced at shareholder level	
Foreign gross income sourced at corporate level	
D Passive category	Form 1116, Part I
E General category	
F Other	
Deductions allocated and apportioned at shareholder level	
G Interest expense	Form 1116, Part I
H Other	Form 1116, Part I
Deductions allocated and apportioned at corporate level to foreign source income	
I Passive category	Form 1116, Part I
J General category	
K Other	
Other information	
L Total foreign taxes paid	Form 1116, Part II
M Total foreign taxes accrued	Form 1116, Part II
N Reduction in taxes available for credit	Form 1116, line 12
O Foreign trading gross receipts	Form 8873
P Extraterritorial income exclusion	Form 8873
Q Other foreign transactions	See the Shareholder's Instructions
15. Alternative minimum tax (AMT) items	
A Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251
B Adjusted gain or loss	
C Depletion (other than oil & gas)	
D Oil, gas, & geothermal - gross income	
E Oil, gas, & geothermal - deductions	
F Other AMT items	
16. Items affecting shareholder basis	
A Tax-exempt interest income	Form 1040, line 8b
B Other tax-exempt income	See the Shareholder's Instructions
C Nondeductible expenses	
D Distributions	
E Repayment of loans from shareholders	
17. Other information	
A Investment income	Form 4952, line 4a
B Investment expenses	Form 4952, line 5
C Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D Basis of energy property	See the Shareholder's Instructions
E Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F Recapture of low-income housing credit (other)	Form 8611, line 8
G Recapture of investment credit	See Form 4255
H Recapture of other credits	See the Shareholder's Instructions
I Look-back interest - completed long-term contracts	See Form 8697
J Look-back interest - income forecast method	See Form 8866
K Dispositions of property with section 179 deductions	See the Shareholder's Instructions
L Recapture of section 179 deduction	
M Section 453(l)(3) information	
N Section 453A(c) information	
O Section 1260(b) information	
P Interest allocable to production expenditures	
Q CCF nonqualified withdrawals	
R Depletion information - oil and gas	
S Amortization of reforestation costs	
T Section 108(i) information	
U Other information	

Cost Basis for S Corporations (ESOP)

Assuming you are adjusting the cost basis for the ESOP, is it necessary to adjust the cost basis through date of distribution? Note that information through date of distribution won't be available until following year.

Cost Basis for S Corporations (ESOP)

Best practice – Based on the white paper (provided as a handout today), it is agreed among practitioners that since everything else is allocated annually, ok to use prior year end cost basis and adjustment for year of distribution gets allocated among remaining ESOP participants in the following allocation.

Reporting S Corporations Income on Form 5500

Issues:

- 2003-27 had statement about including the ESOP's pro-rata share of the company's income on the Form 5500.
- Raises question of how to report it.
- Instructions do not include any mention of it.
- There is no line entry for it.
- Calling it "other income" would cause failure to balance.

Reporting S Corporations Income on Form 5500

Best Practice:

- Must do something until such time as Form 5500 is revised to include an entry field for it.
- Footnote the financial statements for the audit if plan has at least 100 participants.
- Footnote to the Form 5500 Schedule I if the plan has less than 100 participants.

Cost Basis for C Corporations (ESOP)

- Cost basis for stock in a C Corporation is the amount paid by the ESOP for the stock.
- If more than one transaction to acquire stock, stock can be record-kept in separate “buckets” to maintain cost basis or basis can be a blended average.
- No other adjustments needed except for splits.

Participant Statements

- Cost basis is not required to be reported on participant statements.
- Due to decrease in value of stock that can occur for leveraged transactions, cost basis can be higher than market value for a period.
- This can either cause:
  - grumbling because the stock was bought at a higher price that it is now worth due to the debt.
  - or demonstrate where the stock is headed after paying off the debt.

Participant Statements

- Can usually customize the statements and decide if you will show the cost basis

Cost Basis - Summary

- Best to maintain the cost basis even if shares cannot be distributed.
- If not maintained, it may be expensive, due to the time involved, to recreate it.
- It may also be difficult or impossible to recreate if adequate records were not maintained.
- For S corporations the accountant should assist in creating the ESOP's portion of the adjustment to the cost basis and reporting it to the plan sponsor and the record keeper.

Circular 230 Disclosure: IRS rules, which govern the way we conduct our tax practice, dictate that we give you the following notice: Any tax advice or opinion herein contained is not intended to be used, and cannot be used, by anyone to avoid the imposition of any federal tax penalties.

Jackie J. Salmon, A.S.A., M.A.A.A.
Field Vice President, Consulting Services

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Areas of responsibility
In the role of Field Vice President, Consulting Services, Jackie is responsible for sales and consulting on all forms of qualified and non-qualified retirement plans. She also contributes to her firm’s full- service administration of Employee Stock Ownership Plans, including consulting, recordkeeping and repurchase liability studies.

Career history
Jackie has been in the employee benefits industry since 1981. Her employment with McCready and Keene, a OneAmerica company, began in 1985. In addition, she has been working with Employee Stock Ownership Plans since 1991.

Education
Indiana University, Bachelor of Science in Education, cum laude
Indiana University, Master of Science in Education

Professional Distinctions
The Society of Actuaries, Associate
The American Academy of Actuaries, Member
The ESOP Association, Administration Advisory Committee Member
Indiana Chapter of The ESOP Association, Advisory Committee Member

About McCready and Keene
McCready and Keene, Inc., a OneAmerica company, is an actuarial and retirement benefits consulting firm that focuses on designing, installing, and administering customized retirement plans. Based in Indianapolis, IN, McCready and Keene provides trust programs that can use an open architecture investment platform for defined benefit, 401(k), 403(b), employee stock ownership, money purchase pension, and profit sharing retirement plans.

About Katz, Sapper & Miller, LLP

- Founded in 1942
- Public accounting firm with offices located in Indianapolis, Ft. Wayne and New York
- Provide a full range of auditing, accounting, tax and consulting services
- 33 partners and 250 total employees
- Became an ESOP January 1, 2001
- Named by *INSIDE Public Accounting* as one of the "Best of the Best" firms in the nation

Our Mission:

To help our clients be successful throughout our commitment to:

- Lifetime Relationships
- Integrity
- Responsiveness
- Quality
- Employee Success
- Entrepreneurship

KSM KATZ SAPPER & MILLER

Mark A. Flinchum, CPA
Partner

Profile

Mark Flinchum is a partner in Katz, Sapper & Miller's Business Advisory Group. He has been with the firm since 1987. As a business advisor to his clients, Mark is responsible for providing strategic consulting, tax and accounting support. Mark's expertise includes strategic tax planning, operational analysis, business projections, advocacy in IRS matters, and financial statement issues. Mark has been involved in assisting clients with growth opportunities and financing structure. Mark has significant experience in planning, structuring and negotiating merger and acquisition transactions. Mark represents several ESOP-owned businesses and has structured a number of business sales to existing and newly formed ESOPs.

Mark has industry experience in manufacturing and distribution, transportation and hospitality. His commitment to building long-term professional relationships has enabled him to provide proactive advice that creates true value to his clients' business operations. Mark is a member of the firm's Transportation Services Group. He has helped the firm grow the transportation practice to be recognized as the premier accounting firm representing the industry. He is also a member of the firm's Manufacturing and Distribution Services Group. Mark is the editor of the firm newsletter, *The Advisor,* and the Transportation Services Group newsletter, *Truck Times*. Mark is frequently a contributing author to industry trade publications in the manufacturing, trucking and hospitality industries.

Education

Mark received a Bachelor of Science degree in accounting from Indiana University.

Associations and Community Involvement

Mark is a member of the American Institute of Certified Public Accountants and the Indiana CPA Society. He is also a member of the Tennessee Trucking Association and participates in the American Trucking Association. Mark serves on the Noblesville City Small Business Loan Guaranty Review Committee and is a past chairman of the board of Noblesville Chamber of Commerce as well as a past board member of the Better Business Bureau of Central Indiana and Big Brothers Big Sisters of Central Indiana. He is active in coaching basketball and also provides financial mentoring to his church. Mark is a past-distinguished president of Kiwanis and has worked with Junior Achievement in an instructional capacity.

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