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Michael C. Hollen, D.D.S., P.C., Petitioner vs. Commissioner of Internal Revenue Service, Respondent, T.C. Memo 2011-2, Dated January 4, 2011.

The Facts:

Dr. Michael Hollen operates a professional corporation employing its principal shareholder, Dr. Michael Hollen as a dentist and corporate officer. On November 1, 1986, Dr. Hollen started an Employee Stock Ownership Plan (ESOP) with Dr. Hollen as the ESOP administrator and the trustee of the related Employee Share Ownership Trust (ESOT). When the ESOP was started its plan year ended on October 31 but the ESOP plan year was changed to December 31 in the year 2001. The ESOP had 15 participants and/or beneficiaries as of December 31, 2002.

On October 12, 17, and 18, 1989, the ESOT borrowed \$416,920 and used the proceeds to purchase 130,696 shares of stock in Michael C. Hollen, D.D.S., P.C. During the ESOP plan year ended October 31, 1989, the petitioner distributed \$200,000 to the ESOT and the ESOT used the funds to repay the same amount in borrowings. The ESOT allocated \$200,000 of petitioner's common stock to the accounts of the ESOP participants with \$150,339 being allocated to Dr. Hollen's account.

The petitioner hired accountant Stephen Thielking, CPA as the ESOP's accountant. Mr. Thielking appraised the stock held by the ESOT in the years 2001, 2002, and 2003. However, the Tax Court decision was silent as to if any professional valuations of the stock in Michael C. Hollen, D.D.S., P.C owned by the ESOT were prepared prior to 2001.

The ESOP was amended with changes effective as of January 1, 2001. In December of 2002, Dr. Hollen requested a determination from the Commissioner as to the qualified status of the amended ESOP and withdrew such request in August of 2003. In May of 2008, the Commissioner issued a final non-qualification letter regarding the amended ESOP.



The Arguments:

Dr. Michael Hollen contends that the amended ESOP (amended as of January 1, 2001) and ESOT qualified under tax code Sections 401(a) and 501(a) for each year beginning October 31, 1987 and thereafter.

The Internal Revenue Service (IRS) contends that the ESOP and ESOT did not qualify under the tax code sections in question for any year beginning October 31, 1987, and going forward.

The Findings:

After a review of the relevant facts, the tax court upheld the IRS ruling that the ESOP and ESOT were not qualified under the tax code for the years beginning October 31, 1987, and each subsequent year, for the following reasons:

- The ESOP was not properly amended: The ESOP had not timely been amended to include provisions required by section 402(c)(4)(C) (eligible roller distributions: required effective date of January 1, 1999), 414(n)(2)(C) (definition of employee leasing: required effective date November 1, 1997), 414(q) (definition of highly compensated employee: required effective date November 1, 1997), 414(u) (special rules for veterans: required effective date December 12, 1994), and 415(c)(3)(D) (participant's compensation: required effective date December 31, 1997). All sections of the ESOP were subsequently amended. However, each was adopted and effective as of January 1, 2001, not as of the correct required effective dates.
- The ESOP did not follow the vesting schedule required by Section 411(a)(2)(B) of the Code: Section 401(a)(7) of the Code requires ESOPs to satisfy the vesting requirements of Section 411(a)(2)(B)(iii) which requires employees vest pro-rata in plan benefits over a period of six years. The ESOP did not properly vest in accordance with the schedule required by the plan, and Dr. Hollen did not provide any explanation as to why the vesting schedules did not properly reflect the provisions of the plan's vesting schedule.
- The ESOP failed to use an "Independent Appraiser": Section 401(a)(28)(C) of the Code provides that all employer securities which are not readily tradable on an established market must be valued by an independent appraiser. An independent appraiser is defined as a "qualified appraiser" under Section 1.170A-13(c)(5)(I) of the Income Tax Regulations. The qualified appraiser must hold himself out to the public as an appraiser and the qualified appraiser who signs the report must list his



background, experience, education, and memberships, if any, in professional appraisal associations. Mr. Thielking, the ESOP's accountant, included statements that "The undersigned holds himself out to be an appraiser" however, no signature was included under the statement and the appraisal summary was not signed and did not list the required information.

- There were excess annual additions allocated to Dr. Hollen: Section 401(a)(16) of the Code provides that a Trust is not qualified if the plan "provides for annual benefits or contributions which exceed the limitations of Section 415 (which, for the 1989 plan year was limited to the lesser of \$30,000 or 25% of the participant's compensation). Dr. Hollen's ESOT account received an annual addition in excess of the limitations set forth in Section 415(c) and the ESOP never took any corrective action in relation to this failure. Thus, the ESOP was also not qualified for plan years subsequent to 1989.

Parting Thoughts:

This was a good case which illustrates what can happen if an ESOP is implemented and does not have strong, knowledgeable advisors to make sure the Plan and Trust are compliant and remain compliant as the law changes. One item that I found odd that was left out of the Tax Court discussion was that there was no discussion as to the process for determining the value of the stock owned by the ESOT for the plan years 1989 to 2000.