ESOP BRIEF #3

Tax Advantages for Business Planning

By The ESOP Association

A guide to the tax advantages of ESOPs for business planning including both C Corporation and S Corporation tax advantages.

Congress has granted a number of tax incentives specifically designed to broaden the ownership of capital, provide employees with an ownership stake in their employer and provide companies with a beneficial means of financing, all through the use of an employee stock ownership plan (ESOP). This is especially true for leveraged ESOPs which, through the use of borrowed funds, provide a more accelerated transfer of ownership to employees. These incentives provide numerous tax advantages to ESOP sponsors and their employees and, as described below, can significantly improve a sponsor's corporate debt capacity. (For information on other benefits of sponsoring an ESOP, see ESOP Brief #1, What is an ESOP?)

Deducting ESOP Contributions and Dividends

Similar to other qualified retirement plans, ESOP sponsors can deduct contributions to an ESOP for federal income tax purposes, subject to certain limits established under Section 404 of the Internal Revenue Code.

Contributions to an ESOP may be made in the form of company stock or cash (which cash may then be used to purchase company stock). If an ESOP sponsor contributes company stock, the sponsor generally may deduct the full fair market value of such stock. In general, each tax year, an ESOP sponsor may deduct ESOP contributions in an amount up to 25 percent of covered payroll.

This ability to deduct ESOP contributions becomes even more attractive in the case of a "leveraged ESOP." Under this arrangement, an ESOP sponsor or third-party lender extends credit to the ESOP (known as an ESOP loan), the proceeds of which the ESOP uses to acquire company stock from the ESOP sponsor or selling shareholder(s). Thereafter, the sponsor makes annual contributions to the ESOP, and the contributions are used to repay the ESOP loan.

In general, ESOP contributions used to repay an outstanding ESOP loan are subject to the 25 percent of covered payroll limit described above. However, if an ESOP sponsor is a C corporation, the sponsor is entitled to deduct, without limit, any contributions used to repay interest on an ESOP loan. The Internal Revenue Service has further ruled that, where an ESOP sponsor is a C corporation and makes a contribution to a leveraged ESOP that is used to repay outstanding principal and interest on an ESOP loan and also provides an additional nonelective contribution to ESOP participants, the sponsor is entitled to deduct each contribution separately for purposes of Code Section 404.

This means a C corporation ESOP sponsor is entitled to deduct the following amounts each tax year:

- Contributions used to repay the ESOP loan principal up to 25 percent of covered payroll.
- One-hundred percent of contributions used to repay ESOP loan interest.
- The nonelective contribution up to an additional 25 percent of covered payroll.

This extra deduction allowed for C corporation ESOP sponsors is not available to S corporations, so contributions used to repay principal and interest payments are included in determining an S corporation's 25 percent of payroll deduction limit.

In addition, an ESOP sponsor may deduct cash dividends paid on company stock held by an ESOP to the extent such dividends are used to pay principal and interest on the ESOP loan incurred to buy such company stock. Dividends used in this manner are not counted towards the 25 percent contribution limit for leveraged ESOPs.

As a result, some C corporation ESOPs purchase convertible preferred stock—rather than common stock –to assure a relatively reliable stream of dividend income to use in servicing an ESOP loan. As this section illustrates, from a cash flow perspective, the ability to deduct cash dividends and contributions used to repay an outstanding ESOP loan make a leveraged ESOP an attractive vehicle for debt financing.

C Corporation Tax Incentives: 1042 Transactions

An additional ESOP incentive is available to shareholders who sell shares of a closely-held C corporation to an ESOP. Under Code Section 1042, these C corporation shareholders may defer (and possibly eliminate) all capital gains taxes realized in connection with the sale, if certain conditions are met. These conditions generally include:

- The company stock sold to the ESOP must be common or convertible preferred stock issued by a closely-held domestic C corporation and must have been owned by the shareholder(s) for at least three years.
- The ESOP must own at least 30 percent of each class (or total value) of the outstanding company stock immediately after the sale.
- The shareholder(s) must reinvest the sale proceeds in securities of domestic operating corporations (i.e., “qualified replacement property” or “QRP”) within the period beginning three months before and ending 12 months after the sale.

To preserve the 1042 tax deferral post-sale, the seller, certain relatives of the seller, and 25 percent company shareholders cannot receive an allocation of company stock acquired by the ESOP in the 1042 transaction. Further, if the ESOP sells company stock acquired in a 1042 transaction within a three-year period following the sale, the company will owe excise taxes in an amount equal to 10 percent of the amount of such disposition.

For tax purposes, a shareholder’s tax basis in company stock sold to the ESOP in a 1042 transaction is carried over to the QRP, resulting in the deferral of tax on the realized capital gains until the QRP is later sold. However, if the shareholder dies prior to selling the QRP, the shareholder’s basis in the QRP will be “stepped-up” to its fair market value at the time of death, which means that under current tax laws, zero taxes will be owed by the seller’s heirs on the taxes deferred as a result of the 1042 transaction.

As the above illustrates, C corporation shareholders who sell to an ESOP can recognize a significant tax advantage that is unavailable in other types of liquidity transactions (e.g., selling shares back to the company or a sale to a third-party buyer). Selling to an ESOP in a 1042 transaction allows the seller to exchange company stock for a diversified portfolio of securities—or the stock of a single new company—and defer (or possibly eliminate) any taxes on the gains from such sale.

Other C Corporation Tax Incentives: 404(k) Dividends

C corporation ESOP sponsors also may deduct dividends paid on company stock held by an ESOP when the dividends are distributed in cash to ESOP participants or their beneficiaries. Because Code Section 404(k) established this employee-friendly tax incentive, these deductible dividends are sometimes referred to as “404(k) dividends.” This 404(k) dividend deduction is also available if a sponsor provides ESOP participants an election to reinvest the 404(k) dividends back into the ESOP to acquire additional company stock.

Code Section 404(k) allows C corporation ESOP sponsors to share the current short-term benefits of stock ownership with its employees as a complement to the long-term benefits of capital ownership; 404(k) dividends are taxable to participants as current ordinary income.

S Corporation ESOP Tax Advantages

Unlike a C corporation, where federal income taxes are imposed both at the corporate and shareholder level, an S corporation does not pay taxes at the corporate level. Instead, S corporation shareholders are subject to taxation on their pro rata share of the S corporation’s taxable income.

Alternatively, as a tax-exempt trust, an ESOP is not subject to federal income tax on its share of an S corporation’s taxable income—meaning an S corporation owned 100 percent by an ESOP will owe no taxes on its otherwise taxable income. Likewise, even if it’s not owned 100 percent by an ESOP, an S corporation with an ESOP as a shareholder will not owe income taxes on that portion of its taxable income allocable to the ESOP’s ownership.

In either case, an S corporation ESOP sponsor will save money on taxes—and these savings may be retained by the sponsor for more beneficial corporate purposes, such as acquisitions or financing capital expenditures.

It is important to note that Code Section 409(p) imposes complex anti-abuse rules that govern this unique S-corporation ESOP incentive. Because the consequences of failing to comply with such anti-abuse rules are significant and punitive, close review of Code Section 409(p) is required before utilizing the incentive.