Issue Brief

Issue Brief #3

TAX ADVANTAGES FOR BUSINESS PLANNING

Introduction

In order to broaden the ownership of capital to provide employees with a stake in the ownership of their employing corporation and to provide a unique means of financing to corporations, Congress has granted a number of specific incentives meant to promote increased use of the ESOP concept. This is especially true for leveraged ESOPs, which through the use of borrowed funds provide a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer and can significantly improve corporate financial transactions. In 1997, Congress also created a unique tax incentive for S Corporations sponsoring ESOPs

Deductibility of ESOP Contributions

As with all tax-qualified employee benefit plans, contributions to ESOPs are tax deductible to the sponsoring corporation up to certain limits. These contributions can be either in cash (which is then used by the ESOP to buy employer securities) or directly in the form of employer securities. Where employer securities are contributed directly, the employer may take a deduction for the full value of the stock contributed. By doing so, the employer actually increases its cash profits by the value of the taxes saved through the deduction.

The deductibility of contributions to an ESOP becomes even more attractive in the case of a leveraged ESOP. Under this arrangement, an ESOP takes out a cash loan from a bank or other lender, with the borrowed funds being paid to the sponsoring employer in exchange for employer securities. Since contributions to a tax-qualified employee benefit plan are tax deductible, the employer may thereafter deduct contributions to the ESOP which are used to repay not only the interest on the loan, but principal as well. This makes the ESOP an attractive form of debt financing for the employer from a cash flow perspective. Each year, the company can deduct contributions of amounts up to 25% of covered payroll, plus any dividends on ESOP stock (see "Deductibility of Dividends" below), which are used to repay the loan. Further, any contributed amounts used to repay the interest on the loan are deductible without any limit at all. [In an S corporation structure, the deduction would be limited to 25% of the plan sponsor's eligible payroll].

C Corporation ESOP Incentives*

ESOP Tax Deferred Rollover, or I.R.C. 1042 Transaction

An additional ESOP incentive available in C Corporation allows a shareholder, or shareholders, of a closely held company to sell stock in the company to the firm's ESOP and defer federal income taxes on the gain from the sale. In order to qualify for this "rollover," the ESOP must own at least 30% of the company's stock immediately after the sale, and the seller(s) must reinvest the proceeds from the sale in the securities of domestic operating corporations within fifteen months, either three months before, or twelve months after the sale. The seller, certain relatives of the seller, and 5% shareholders in the company are prohibited from receiving allocations of stock acquired by the ESOP through a rollover. Generally, the ESOP may not sell the stock acquired through a rollover transaction for three years.

The ESOP rollover provides a substantial tax advantage that might otherwise be unavailable to current or retiring owners of C Corporations. Normally, a direct shareholder's options would be to sell shares back to the company, if such a transaction is feasible, or to sell out to another company, either for cash or for a block of shares in the other company. Selling to an ESOP, on the other hand, allows the seller to exchange interest in the company for a safely diversified portfolio of securities--or the stock of a single new company--without paying any taxes on the transaction. The seller's tax basis in the employer stock which was sold will be carried over to the replacement property. If the replacement property is held until death, however, a stepped-up basis for those securities is provided under current established tax laws.

In addition to the substantial tax advantages, selling to the ESOP preserves the company's independent identity. A sale to an ESOP also provides a significant financial benefit to valued employees and can assure the continuation of jobs. Moreover, selling to an ESOP allows the seller to sell all or just a part interest in the company, and to do this gradually or all at once.

To qualify for rollover treatment, the stock sold to the ESOP must be common or convertible preferred stock of a closely held domestic corporation and must have been owned by the seller for at least three years. Often this type of transaction is referred to as a 1042 transaction, because Internal Revenue Code Section 1042 establishes this unique tax benefit.

Deductibility of Dividends

Employers structured as C corporations are also permitted a tax deduction for certain dividends paid on ESOP stock. The deduction is available for dividends paid in cash to employee. Beginning January 1, 2002, the deduction is available for dividends on ESOP stock the individual elects to reinvest back to the plan for more company stock. This provision allows companies to share current benefits of stock ownership with their employees to complement the long term benefits of capital ownership. Dividends paid to employees are taxable as current ordinary income to employees.

A deduction is also available for dividends paid on ESOP leveraged stock to the extent that the dividends are used to reduce the principal, or pay interest on an ESOP loan incurred to buy that stock. Dividends used in this manner are not counted towards the 25% contribution limit for leveraged ESOPs. Some ESOPs have purchased convertible preferred stock rather than common stock to assure a relatively reliable stream of dividend income to be used in servicing the loan.
These tax deductible ESOP dividends are sometimes referred to as 404(k) dividends, because Internal Revenue Code section 404 (k) established this unique tax incentive.

*A C Corporation is liable for federal income tax imposed on the corporation's taxable income.

S Corporations*

Beginning in 1998, when an ESOP is a shareholder of an S Corporation, the federal tax or its share of its S Corporation sponsor's taxable income is deferred until distributions to the ESOP participants. This statutory provision means that an S Corporation owned 100% by an ESOP pay no current federal tax on its income. And, even if not 100% owned by an ESOP, the S corporation with an ESOP is able to have long-term deferral of federal taxes as its income pro-rated to the ESOP. [Note, complex anti-abuse rules govern this unique ESOP incentive, and close review is required before utilizing the incentive].

*The individual shareholders of an S Corporation are liable for federal tax on each pro-rated share of the S Corporation's taxable income – i.e. there is no federal corporate income tax on S Corporation taxable income.

The ESOP Association
1726 M Street, NW, Suite 501
Washington, DC, 20036
Phone: (202) 293-2971 • ***Fax:*** (202) 293-7568
E-mail: esop@esopassociation.org
Website: www.esopassociation.org