



# The Advantages of an Employee Stock Ownership Plan to a Closely Held Corporation and its Shareholders

By Vernon P. Saper



Employee stock ownership plans (ESOPs) have been available for more than 30 years. However, not all attorneys are familiar with the advantages an ESOP offers to a closely held corporation and its shareholders. To test your ESOP IQ, let's take a little quiz:

1. Can a shareholder of a closely held corporation sell some or all of his or her stock to an ESOP at fair market value without incurring current federal or state income tax on the realized gain?
2. Can an ESOP give shareholders in a closely held corporation a ready market for sale of their stock?
3. Can employees effectively purchase their employer using fully tax-deductible dollars?
4. Can an ESOP motivate employees of a closely held company to deliver their best performance for the company, thereby maximizing the company's profits and the value of their investment in the company?
5. Can current federal income tax be avoided on income of an S corporation to the extent that stock in the corporation is owned by an ESOP?

If you answered "No" to any of these questions, you may want to brush up on the advantages of ESOPs to closely held corporations and their shareholders.

## What is an ESOP?

An ESOP is a qualified retirement plan, similar in structure to a 401(k) or profit-sharing plan. Each ESOP participant has an account that accumulates benefits to be paid at retirement or other termination of employment. However, unlike its cousins, an ESOP is designed to invest primarily in stock of the sponsoring employer.<sup>1</sup>

As with other qualified retirement plans, ESOPs must meet general rules concerning eligibility to participate, vesting, and non-discrimination.<sup>2</sup> However, several special rules apply only to ESOPs. One special rule is that an ESOP may borrow funds to purchase stock of the employer.<sup>3</sup> This "leveraging" capability leads to many creative uses unique to ESOPs.

ESOPs are subject to the Employee Retirement Income Security Act of 1974 (ERISA) and its regulatory regime. ESOP administrators owe participants fiduciary duties to administer the ESOP in participants' best interests. Company managers may at times find these duties nettlesome and inconvenient. For example, company stock must be a prudent investment for the ESOP,<sup>4</sup> and the ESOP must not pay more than fair market value for it.<sup>5</sup> And, at least annually, a qualified appraiser must determine the fair market value of company stock.<sup>6</sup>

The general tax attributes of an ESOP are the same as for other qualified retirement plans: contributions to the ESOP are tax deductible, employees accumulate benefits under the plan without

paying current income tax on them, the plan assets are held in an income tax-exempt trust, and cashed-out participants may roll over proceeds of their ESOP account to an individual retirement account and continue the income tax deferral.

## Special ESOP Tax Incentives

In addition to the general tax benefits of qualified retirement plans, Congress has provided major tax incentives to encourage the creation of ESOPs, including:

- **Fully deductible loan repayments.** Employer contributions to the ESOP are fully deductible for federal income tax purposes. The contributions may be used by the ESOP to repay a loan.<sup>7</sup> Thus, tax deductions are available for payment of loan principal as well as interest.
- **Avoidance of capital gains and state income tax on sale of stock.** An owner who sells stock of a closely held C corporation to an ESOP may defer, or completely avoid, income tax on the realized gain if (1) immediately after the sale, the ESOP owns at least 30 percent of the employer's outstanding stock and (2) within 12 months, the sale proceeds are reinvested in securities issued by other U.S.-operating corporations (qualified replacement property).<sup>8</sup> The individual's basis

in the employer stock carries over to the qualified replacement property. Upon selling the qualified replacement property, the owner will incur federal and state income tax on the excess of the net sale proceeds over his or her basis in the property. But if the owner holds the qualified replacement property until death, and the federal estate tax is in effect at that time, then the owner's beneficiaries or heirs will take the property

at a basis equal to its fair market value on

the date of the owner's death (or an optional date six months later), forever avoiding income tax on pre-death appreciation in the property.

- **Cash dividends paid on ESOP stock are deductible.** A corporation may deduct for income tax purposes cash dividends that it contributes to an ESOP. The ESOP can pay the dividend directly to participants or use it to pay an ESOP loan.
- **Reduction or elimination of corporate income tax.** An ESOP may own stock in an S corporation, and to the extent that it

### Fast Facts:

An ESOP can be a tax savings tool for the sponsoring corporation, the employees, and the selling shareholder.

An ESOP should be considered as an alternative whenever one or more shareholders of a closely held corporation desire to sell some or all of their stock.

does, the income of the S corporation escapes current income taxation.<sup>9</sup> The unrelated business taxable income rules do not apply to S corporation stock owned by an ESOP.<sup>10</sup> An S corporation may not, however, have more than one class of stock.

## Using an ESOP in Tax Planning

Ownership succession planning is critically important in a privately held business. What will happen to the company when the owner retires or dies? Are other family members active in the business, and can they afford to buy it? Are key employees willing and able to purchase the company? Is a sale to an outsider feasible and desirable? What are the tax consequences of a sale?

In reviewing these issues, the use of an ESOP should always be considered. An ESOP may be the ideal solution for the corporation and its shareholders. Let's look at some examples.

### Situation 1

Owner, age 55, owns 100 percent of the outstanding stock of Company, a C corporation (or an S corporation that terminates its S election). Owner has a low basis in the stock, and Company has grown to a current fair market value of \$5,000,000. Owner has no children active in the business, and key employees are unable to purchase Company. Owner's net worth consists primarily of Company's value. Owner would like to begin diversifying his or her personal estate, but is not ready for retirement.

1. Owner could begin diversifying his or her estate by causing Company to establish an ESOP. The ESOP could borrow



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\$1,500,000 to purchase 30 percent of Owner's stock. If Owner reinvests the \$1,500,000 in qualified replacement property, he or she will incur no current federal or state income tax on the sale proceeds.

2. The ESOP loan would be repaid with tax-deductible retirement plan contributions made by Company to the ESOP. The borrowing cost is substantially reduced because Company can deduct for income tax purposes payments of principal as well as the interest, resulting in tax savings approaching \$500,000.
3. Owner takes the qualified replacement property at a basis equal to his or her basis in the Company stock exchanged for it. If

Owner owns the qualified replacement property to his or her death, pre-death appreciation in the property forever escapes income taxation.

### Situation 2

Assume the same facts, but Owner is now age 60. The ESOP loan has been repaid. Owner is still not ready to retire, but would like to continue the diversification of his or her estate.

1. Additional stock purchases can be made by the ESOP with the same tax benefits described in Situation 1.
2. Future sales could be made with another ESOP loan, or Owner could sell a small amount of stock each year to the ESOP for cash. Company deducts for income tax purposes its contribution to the ESOP.
3. Even if the ESOP owns more than 50 percent of the outstanding stock, Owner can continue to control Company by virtue of acting as trustee of the ESOP or by controlling Company's board of directors.

### Situation 3

Assume the same facts, but Owner is now age 70. The ESOP owns 60 percent of Company's outstanding stock. Owner is ready to retire and sell the remaining 40 percent.

1. Owner could arrange for a sale to an outsider. This would provide retirement security to Owner, but Owner would be subject to capital gains and state income tax on the realized gain. And there would be no employment security for the long-term employees and key management.
2. Owner could cause Company to redeem the stock by using a commercial loan. However, the redemption would be expensive because Owner would pay federal and state income tax on the realized gain, and the corporate loan would be repaid with after-tax dollars.
3. Alternatively, the remaining stock can be purchased by the ESOP with the same tax benefits described in Situation 1. Owner can elect to pay no federal or state income tax on the realized gain, and the loan can be repaid with pre-tax dollars, significantly reducing the cost of the sale.
4. If Owner owns the stock to his or her death, the ESOP could purchase the stock from Owner's estate or trust. There would be

no income tax to defer, due to the step-up in basis to fair market value on the date of Owner's death.

#### Situation 4

Assume the same facts, but the ESOP now owns 100 percent of Company stock. The board of directors is looking to grow the business and become more competitive.

1. The board can direct the ESOP, as Company shareholder, to file an S election for Company. Since the ESOP owns 100 percent of the stock, current federal and state income tax on Company's income will be avoided.
2. This reduction in cost of doing business allows the company to retain additional cash for growth, reduce prices, increase margins, and become more competitive.

#### Conclusion

Counsel should review the advantages of an ESOP with succession-minded shareholders of a closely held corporation to determine whether an ESOP is advisable for them. ♦



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#### Footnotes

1. Internal Revenue Code (IRC) § 4975(e)(7).
2. IRC § 401 *et seq.*
3. IRC § 4975(d)(3).
4. ERISA § 404(a)(1)(B), 29 USC 1104(a)(1).
5. ERISA §§ 408(e) and 3(18), 29 USC 1108(e) and 1002(18).
6. IRC § 401(a)(28)(C).
7. IRC §§ 404(a)(3) and (9).
8. IRC § 1042.
9. IRC § 1361(c)(6)(A).
10. IRC § 512(e)(3).

