



ISSUE BRIEF #3

ESOP TAX ADVANTAGES FOR BUSINESS PLANNING

Introduction

In order to broaden capital ownership in the U.S by providing employees with a stake in the ownership of their employer's corporation and to provide a unique means of financing to corporations, Congress has granted a number of potent incentives designed to increase the use of ESOPs. 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.

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 contribution. 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 to the payment of principal on the loan of amounts up to 25% of eligible 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 also deductible.

full value of the stock

ESOP "1042 Rollover"

A significant tax advantage of an ESOP allows a shareholder, or shareholders, of a closely held company to sell stock in the company to the firm's ESOP and defer federal and state 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. 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.

The seller, certain relatives of the seller, and 25% shareholders in the company are prohibited from receiving allocations of stock from a selling shareholder that elected IRC 1042 tax treatment. Prohibited allocation rules are addressed in Internal Revenue Code Section 409(n). Generally, the ESOP may not sell the stock acquired through a rollover transaction for three years. IR Code Section 1042 governs the tax regulation regarding shareholder sales of stock to an ESOP.

The ESOP rollover provides a substantial tax advantage that might otherwise be unavailable to current or retiring closely held company owners. Normally, a shareholder interested in selling their interest would sell their shares back to the company, if such a transaction is feasible, or sell directly to another company, either for cash or stock in the other company. A cash sale will require the seller to pay state and federal capital gains taxes on the transaction, commonly reducing the seller's net proceeds by 15 to 25 percent. In addition, the final terms of the sale would be determined by the negotiation skill of the seller and many times the seller will be required to take a note in lieu of cash for some or all of the sales proceeds.

Selling to an ESOP, on the other hand, allows a shareholder to exchange their interest in the company, at fair market value (determined by a third party appraisal) for a 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 their previously owned shares will be carried over to the new replacement property. If the replacement property is held until death, however, a stepped-up basis for those securities is provided under current tax laws. Moreover, selling to an ESOP allows the seller to sell all or just a part interest in the company. How many buyers do you know who would be interested in buying less than 50% of a private company? The ESOP gives the business owner added flexibility to sell his/her interest all at once, or in phases over time.

In addition to the substantial tax advantages for the company and its owners, professional advisors, local community leaders and employees appreciate the fact that the ESOP helps preserve the company's independent identity. CPAs and attorneys benefit because it preserves their valued relationship with the company. Local community leaders benefit because it helps them retain valued

employers in the community. And, the ESOP increases job security for the employees.

Deductibility of Dividends

Employers are also permitted a tax deduction for cash dividends paid on stock which has been purchased in a leveraged ESOP, to the extent that the dividends are passed through to the employees. This provision allows companies to share current benefits of stock ownership with their employees to complement the long-term benefits of capital ownership. The dividends 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. This feature is particularly useful when the eligible payroll by itself is not sufficient to generate the required ESOP loan payment. 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.

ESOP Advisors Group provides one stop ESOP design formation and implementation services. Visit the ESOP Advisors Group website at www.esopadvisorsgroup.com. Or call Mel Duffey (650) 468-5465.

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