POINTS TO REMEMBER

# Unique Tax Advantages of ESOPs

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Employee stock ownership plans, or ESOPs, are tax-qualified retirement plans designed to invest primarily in employer securities. Their unique tax advantages make them attractive vehicles for transferring ownership of privately held businesses and a valuable tool of corporate finance.

This article highlights some of the significant tax advantages available for companies that maintain ESOPs and their shareholders. While these tax advantages are significant, whether an ESOP is a right fit for any business also depends on a number of non-tax related considerations.

## Ability to Defer Income Tax on Qualifying Sale to ESOP

Section 1042 allows a shareholder of a C corporation to defer the gain on a sale of stock to an ESOP where certain conditions are met. First, the selling shareholder must have owned the stock for at least three years before the date of sale. The shares sold to the ESOP must have been issued by a domestic C corporation and may not have been acquired in a distribution from a qualified plan or pursuant to an option or other right to acquire stock to which section 83, 422, or 423 applied (or to which section 422 or 424 as in effect prior to the Revenue Reconciliation Act of 1990 applied). Second, the employer or any member of its controlled group may not have any stock outstanding that is readily tradable on an established market. Third, after the sale (or series of related sales), the ESOP must own at least 30% of each class of the corporation's outstanding stock other than certain noncallable preferred stock or at least 30% of the total value of all such stock. Finally, the selling shareholder must purchase "qualified replacement property" (essentially securities in domestic operating corporations and certain insurance companies and financial institutions), within the fifteen-month period ending twelve months after the sale. I.R.C. § 1042(b)(2).

To defer the gain under section 1042, the selling shareholder must make a timely election and file with the Service a verified written statement by the employer. I.R.C. § 1042(a)(1), (b)(3). The gain is taxed when the selling shareholder sells or exchanges the qualified replacement property. The selling shareholder does not recognize income tax upon a subsequent gift or testamentary transfer of the qualified replacement property. In the case of a testamentary transfer, the selling shareholder's heirs take a stepped-up basis equal to the property's fair market value as of the date of death.

Shares purchased in a section 1042 transaction (or any amount allocable in lieu thereof) may not be allocated for the benefit of the selling shareholder or certain other parties, including relatives under section 267(b) and any other person who, after the application of modified attribution rules under section 318(a), owns more than 25% of (i) any class of outstanding stock of the corporation (or of any member of its controlled group, as defined in section 409(l)(4)), or (ii) the total value of any class of outstanding stock of any such corporation. I.R.C. § 409(n). A prohibited allocation results in an excise tax on the employer equal to 50% of the value of the shares allocated in violation of section 409(n). I.R.C. § 4979A.

Although nonrecognition treatment is limited to C corporations, an S election can be terminated to accommodate a section 1042 transaction. The Service has ruled that the shareholder's holding period includes the period that an S election was in effect for purposes of the three-year holding period under section 1042(b)(4). *See* PLR 200003014. If an S election is terminated, the corporation must wait at least five years before it can reinstate its subchapter S status unless the Service consents otherwise. I.R.C. § 1362(g). Entity-level taxes during this five-year period can be minimized or avoided, with certain non-tax related tradeoffs, through the special deductions available to C corporations highlighted below.

## Enhanced Deductions Available to C Corporations

C corporations that maintain ESOPs are entitled to certain tax deductions which are generally not otherwise available under the Code.

A C corporation with a leveraged ESOP can effectively deduct payments, up to 25% of participants' wages (up to the section 401(a)(17) limit but excluding elective deferrals), for ESOP contributions used to repay principal on an ESOP stock acquisition loan described in Regulation section 54.4975-7 and an unlimited deduction for contributions used to pay interest. I.R.C. § 404(a)(9)(A) & (B). The 25% limit for principal payments is separate from the regular deduction limit for contributions to a qualified defined contribution plan under section 404(a)(3). *See* PLRs 9548036, 200436015, 200732028.

C corporations may also deduct "applicable dividends" paid on shares of employer stock held in an ESOP. "Applicable dividends" are dividends which are (i) paid directly to participants or beneficiaries or to the ESOP and then distributed not later than 90 days after the end of the plan year in which they are paid; (ii) as chosen by the participant

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or beneficiary, paid as described above or to the plan and reinvested in qualifying employer securities; or (iii) used to repay an ESOP loan. If a cash dividend paid on shares in a participant's account is used to repay a loan, shares having a fair market value of at least the amount of the dividend must be allocated to such participant's account. I.R.C. § 404(k).

The deduction for applicable dividends is not without limitations. The Service has the power to disallow the deduction if it constitutes, in substance, an avoidance or evasion of taxation. I.R.C. § 404(k)(5); *see also* Notice 2002-2, 2002-2 I.R.B. 285 (providing guidance). In addition, section 162(k) generally denies a deduction "for any amount paid or incurred by a corporation in connection with the reacquisition of its stock," even if the proceeds are distributed in the form of an applicable dividend. Regulation § 1.162(k)-1(a); *see also* Regulation § 1.404(k)-3, Q&A-1(a) (stating that payments to reacquire stock are not "applicable dividends" and that such treatment would constitute an avoidance or evasion of taxation within the meaning of section 404(k)(5)). Thus, the deduction under section 404(k) is not available for dividends paid to redeem stock held by an ESOP.

Finally, the deduction limit based on annual additions to a defined contribution plan within the meaning of section 415 is relaxed where broad-based allocations are made to an ESOP maintained by a C corporation. For purposes of applying this limit, contributions used to pay interest on an ESOP loan and forfeitures of shares acquired with the proceeds of an ESOP loan are disregarded if no more than one-third of the contributions deductible under section 404(a)(9) are allocated to accounts of highly compensated employees. I.R.C. §§ 404(j), 415(c)(6).

## Tax Advantages of S Corporation ESOPs

Perhaps the most significant tax benefit for maintaining an ESOP is available for S corporations. Unlike S corporation stock held in other types of qualified plans, employer stock held in an ESOP does not result in unrelated business taxable income. I.R.C. § 512(e)(3). This allows an ESOP's share of S corporation income to escape income taxation altogether. Taken to its extreme, with limited exceptions for former C corporations, an S corporation that is 100% owned by an ESOP operates without any income taxes. Amounts that would otherwise be paid as taxes become available to fund business operations, capital investments, business acquisitions, purchases of additional shares, and payments on notes issued to selling shareholders in seller-financed transactions.

Because of the potential for abuse, section 409(p) ensures that ESOPs maintained by S corporations provide broad-based employee coverage rather than serve as a tax shelter for "disqualified persons." The rules under section 409(p) are complex and beyond the scope of this article, but care should be taken to evaluate its impact given the severe consequences that result from a violation.

In addition, ESOPs maintained by S corporations are not required to distribute shares of stock to participants and beneficiaries, which would otherwise potentially jeopardize the corporation's S election by exceeding the 100 shareholder limit under section 1361(a). Should an ESOP distribute S corporation stock to a person or that person's IRA, the ESOP may require that the shares be immediately sold back to the corporation or the ESOP under a fair valuation formula. The momentary ownership by an IRA of employer stock does not terminate the corporation's S election if the shares are distributed in a direct rollover transaction and are immediately purchased by either the plan sponsor or the ESOP. *See* Rev. Proc. 2003-23, 2003-11 I.R.B. 599; Rev. Proc. 2004-14, 2004-7 I.R.B. 489.

## Conclusion

ESOPs provide significant tax advantages generally not otherwise available under the Code. By decreasing or avoiding tax altogether, these tax advantages increase the amount of cash available to fund all aspects of business operations and growth. ■