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S Corporation ESOPs: Creating a Tax-Free Environment for your Business

An ESOP (employee stock ownership plan) is a qualified retirement plan that invests primarily in employer securities. Typically, the ESOP does so by buying some or all of the common stock of a business from the business owner or owners.

Business owners sometimes establish ESOPs in order to incentivize their employees by allowing the employees to share in the growth of the business. Perhaps more frequently ESOPs are established by business owners as a mechanism to cash out all or a significant portion of their ownership interest without necessarily giving up effective control of their business. ESOPs are also established because of their extraordinary tax benefits which can improve the bottom line of a business.

While it was not always the case, currently, both C corporations and S corporations can establish an ESOP. S corporation status is very popular with closely held business owners because S corporations are generally not subject to federal income tax at the corporate level. Instead, shareholders are subject to tax on the corporation's income, whether or not such income is distributed.

The combined tax attributes of an S corporation and an ESOP are truly remarkable. If an S corporation is wholly owned by an ESOP, the income of the business is not subject to any federal income tax. Because of its S corporation status, all of the corporation's taxable income flows through to the corporation's sole shareholder, namely, the ESOP. The ESOP does not pay any tax because it is a tax-exempt entity. Accordingly, none of the corporation's earnings are spent on paying federal taxes.

If an S corporation is only partially owned by an ESOP (for example, the business owner sells a 40% interest to the ESOP and holds on to the other 60%), partial tax savings will still apply, but the cash flow analysis is different.

Because it is typically difficult to get bank financing for a purchase of 100% percent of a business, particularly in the current economic environment, sellers who are interested in establishing a wholly owned S corporation ESOP normally take back a note for some of the purchase price. In order to allow the selling shareholder to continue to participate in the future growth of the company, sellers often receive warrants in the transaction and continue to participate in incentive compensation programs that pay benefits based on the company's economic performance.

While ESOPs can be established by both C corporations and S corporations and are attractive in both, important differences remain. For example, an individual shareholder of a C corporation may sell his shares to an ESOP on a tax-deferred basis, provided certain requirements are satisfied. This tax break does *not* apply to a sale to an ESOP maintained by an S corporation.

Also, C corporations sponsoring ESOPs may deduct without limitation plan contributions that are used by the ESOP to make interest payments on a loan that the ESOP has taken to finance its acquisition of company stock, plus principal payments not in excess of 25% of compensation.

Further, S corporations are subject to Section 409(p) of the Internal Revenue Code. That section generally limits a selling shareholder's ability to become a participant in the ESOP.

Danziger & Markhoff LLP is experienced in establishing and servicing ESOPs for both C corporations and S corporations. If you are considering establishing an ESOP, we can assist you in weighing the benefits of making, or maintaining, the S election and structuring the transaction to achieve your tax and other business objectives. ■

Please contact Jay Fenster, Esq., or Robert B. Danziger, Esq., if you have any questions about ESOPs.

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