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# ESOP:
# A New Tax Savings Tool for Owners of S Corporations

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# ESOP: A New Tax Savings Tool for Owners of S Corporations

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"A new dawn greets ESOP companies!"
"The Holy Grail of business opportunities beckons: ESOP companies can now operate tax free!"

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Not since 1984, when the §1042 tax-free rollover was enacted, has the ESOP community bubbled with such enthusiasm.

Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, ("EGTRRA"), the ESOP's share of S corporation earnings will not be subject to federal corporate taxation or to taxation as "unrelated business income tax," unless the ESOP runs afoul of certain "anti-abuse" provisions. Thus, in the case of an S corporation that is 100% owned by its ESOP, the company's earnings will be entirely tax exempt. Even the least ebullient of practitioners note that fiduciaries of existing ESOPs now confront a new obligation: to assess whether electing S status would benefit the company and the trust beneficiaries.

**A Bit of History**

Until the Small Business Job Protection Act of 1996 ("SBJPA"), ESOP companies were not permitted to elect S corporation status as defined in sub-chapter S of the IRC (§1361). No explicit prohibition in ESOP law precluded the S election. Rather, S corporation law limited shareholders to natural persons and certain estate trusts: ERISA trusts were not included.

S corporations seeking to establish an ESOP could do so as long as the plan was funded with cash. As soon as that cash was utilized to purchase securities of the sponsoring employer, S status was automatically lost.

The SBJPA, among several other modifications to S corporation law, permitted qualified employee benefit plans, such as ESOPs, to be shareholders in S corporations. This liberalization was not, however, without countervailing restrictions and technical deficiencies: Shareholders selling stock to an S-ESOP are not permitted to qualify the sale proceeds for tax-deferred treatment under §1042.

The "deductible dividend" provisions of IRC §404(k) available to C-ESOPs paying down a securities acquisition loan are not permitted for S-ESOPs. Moreover, interest payments on the securities acquisition loan will need to be accommodated within the contribution limits rather than in addition to those limits.

This restriction is particularly vexing because of the wide popularity of voluntary employee deferral 401(k) plans, which must also be accommodated within the 25% contribution constraint. And finally, the S-ESOP was to be responsible for paying a so-called “unrelated business income tax” (“UBIT”) on the portion of corporate income attributable to the ESOP-owned stock.

In general, S corporation profits are taxed on the personal returns of shareholders rather than at the corporate level. When corporate rates were higher than the maximum marginal personal rates, this arrangement provided a tax advantage. Many companies switched to S status. Now that the maximum personal rate (39.6%) exceeds the maximum corporate rate (34%), there is probably some disadvantage in maintaining S status. (Only some states apply the federal principle and treat S corporation income as personal income; others continue to levy tax at the corporate level. Thus it is difficult to make broadly valid generalizations concerning total tax rates.)

Upon liquidation or sale of the assets of an S corporation, however, S shareholders retain an advantage: the gain is taxed only once, in their hands, not first at the corporate level and again at the personal level, as is the case with C corporations. (This advantage is moot in the case of a stock sale such as a stock swap with another corporation, or a direct stock sale to another shareholder or to an ESOP.)

The UBIT requirement of the SBJPA initially may seem logically parallel to the tax treatment of S profits in the hands of personal shareholders. Yet several problems emerged as practitioners considered the actual implementation of the law: What if the ESOP had no funds to pay the tax? Fiduciaries cannot compel corporate management to make a contribution. Now, in the vast majority of S corporations, management does indeed distribute at least enough to pay the tax to shareholders. If such a distribution is made, it must be made to all shareholders pro rata, including the ESOP shareholder.

Yet ultimately, a non-minority shareholder cannot compel such a distribution absent a binding shareholder agreement. Would it be acceptable to “raid” participants’ Other Investment Account (“OIA”) balances in order to pay taxes? What if the OIA is insufficient? In addition, unlike ordinary shareholders, ESOP participants are liable for tax upon the eventual distribution of their ESOP account balances. Doesn’t this represent a kind of double taxation?

After due consideration of these issues, Congress included provisions in the Tax Reform Act of 1997 (“TRA’97") which revoked the UBIT requirement for ESOPs (though not for other qualified plans holding S corporation employer securities). In 1999, however, the Clinton Administration proposed restrictive legislation that was designed to eliminate perceived abuses that could occur if the ESOP had only one or a few employees. In response to this proposal, Senator John Breaux and Congressman Jim Ramstad drafted much more limited anti-abuse provisions, which were subsequently included in EGTRRA 2001.

**As a result, it is now clear that a 100% ESOP-owned S corporation can indeed operate free of annual corporate or personal income tax, subject to compliance with the anti-abuse provisions of EGTRRA.**

**Should You "Go S"?**

Many readers of this treatise are managers and fiduciaries of existing ESOPs, and thus necessarily of C corporations—except for prefunded S corporation ESOPs discussed below. They confront a different set of issues from the managers of existing S corporations who may be contemplating an initial ESOP transaction. Since January 1, 1998, it has been feasible for such companies to elect S status. Is this advisable?

Many considerations beyond the scope of this article must concern anyone contemplating a new S election. Total S shareholders are now limited to 75. The ESOP trust counts as one, irrespective of the number of participants. S corporations may use only one kind of stock (with an exception for voting vs. nonvoting common). This may, in some cases, preclude the use of significant shareholder or outside debt. Companies with existing preferred shares or divergent sorts of common stock may need to simplify their capital structure before converting to S status. The convertible preferred or super-common stock issues sometimes utilized in complex ESOP transactions would, of course, also be precluded.

The conversion itself may subject a corporation to certain incremental taxes. For a period of ten years after the conversion, the company is liable for taxes on the "built-in gain" upon disposition of appreciated C corporation assets that had been transferred to the S corporation. If the S corporation has (a) accumulated earnings and/or gross receipts attributable to the former C corporation and (b) more than 25% of these items are passive investment income, a tax at the highest corporate rate is imposed on the "excess net passive income."

Potentially mandated changes from LIFO to FIFO inventory accounting (LIFO recapture tax payable in four annual installments), from the cash basis to an accrual basis (tax on accrued receivables), and from a discretionary fiscal year to a calendar year may render the conversion financially prohibitive.

Shareholders too may be subject to additional taxation over and above the rate differential between corporate and personal rates. Certain fringe benefits are taxable to 2% or more shareholders of S corporations, while they are deductible for C corporations.

State tax treatment of S corporations varies. Regulations of the state in which the corporation is domiciled and the state in which shareholders reside must both be considered. In Connecticut, Michigan and Tennessee, S corporations are taxed as C corporations. California, Arizona, Maryland and Minnesota follow the federal pattern. Kansas, Ohio and Pennsylvania impose no tax on S corporations.

Depending on the way various states categorize S distributions, individual shareholders may or may not use them to offset losses incurred in other states. Only local advisors with a firm grip on S conversion issues can provide adequate guidance on these matters.

With regard to ESOP issues, the situation is much clearer. What changes will occur if an existing C corporation with an ESOP elects S status?

**Loss of §1042 Tax-free Rollover Potential**

Future sales to the ESOP cannot be qualified for tax-deferred treatment.

**Loss of "Deductible Dividends"**

If the Company had been accelerating its amortization of a securities acquisition loan by paying down principal with "deductible dividends" under §404(k), this will no longer be possible. Yet in many corporate situations, these apparent barriers to the S election may be irrelevant.

Under the new 15% capital tax gains rate, sellers may actually prefer to recognize the gain upon sale of stock immediately, rather than subjecting sale proceeds to the restrictions of reinvestment in qualified replacement property. This is particularly true if sellers have a relatively high basis in some of their shares.

Employee-sellers may consider themselves further compensated for foregoing the tax-free rollover because they will remain eligible to receive their share of the sold stock in their ESOP accounts just like any ordinary participant. Under a §1042 rollover, sellers, 25% or more shareholders, and certain other participants may not receive any of the rollover shares in their ESOP accounts.

(An old rule, still operative, does limit shareholders and their family members, taken together, from receiving more than 20% of the stock they have sold in their ESOP accounts, even in a taxable transaction. Any additional contributions to which they are entitled may, however, be invested in the OIA.)

Finally, it is possible for sellers to consummate a final §1042 transaction under the C corporation rules and then elect S status. This option may encourage some sellers to complete the sale of all their stock to the ESOP, given the advantages of operating tax-free as a 100% ESOP-owned S corporation.

As for the §404(k) dividend deduction, it appears that this method of accelerating amortization of the ESOP loan can be replaced, as it were, by the normal distributions most S corporations make to shareholders to help them meet their tax liabilities. Even though the ESOP is not liable to pay tax, it would receive the same pro rata distribution as any other shareholder.

These distributions all come from the pretax cash flow of the company. Moreover, the American Jobs Creation Act of 2004has clarified the fact that S corporations sponsoring an ESOP may use distributions on both allocated and unallocated ESOP stock to make payments on the loan used by the ESOP to acquire stock for employees.

Menke reads the original ESOP regulations to preclude the application of distributions made with regard to allocated shares to service ESOP debt. Such distributions may, however, provide liquidity for the repurchase liability or be used to purchase shares directly from shareholders.

Let it also be mentioned that since the lapse of the requirement that ESOP securities acquisition loans (usually between the corporation and its ESOP) must mirror substantially all the terms and conditions of the loan between a company and its lender(s), allocation of the loan within the ESOP may proceed at a different—usually slower—pace than amortization of the actual bank loan. Corporations sponsoring S-ESOPs might thus forsake the time value of a portion of their ESOP debt service, but over several years, the entire debt service could be excluded from taxable income.

For all these reasons, loss of the expanded limits for contributions and deductible dividends may present no problem for a company contemplating repayment of a substantial loan and election of S status. As always, the individual case must be analyzed in advance.

**When Should You "Go S"?**

Four issues confront the manager considering the proper timing of an S election. Three are regulatory, the fourth, financial.

First and obviously, there is no established body of law or regulations detailing the operation of ESOPs in S corporations. While the situation seems generally clear, early adopters undeniably confront greater uncertainty than those who defer the S election until others have tested the waters. We may expect many requests for IRS letter rulings as companies approach more complex S-ESOP transactions.

Secondly, corporations that converted from S to C status may not return to the S status for five years after the conversion without special permission from the IRS commissioner.

Third, instant conversion immediately after a §1042 transaction may not be possible. In switching from C status to S status, the corporation may be required to complete its existing C corporation fiscal year and file on a full year basis. The first S corporation year would then, potentially, be a short year extending from the end of the last fiscal year until the next December 31$^{st}$. S corporations must generally adopt the calendar year for reporting purposes so as to correspond with the personal tax year. When more than 50% of shares are owned by an individual or entity, such as an ESOP, with a different fiscal year, however, it is possible to operate an S corporation on a fiscal year basis.

**Switching to S Will Increase Corporate Cash Flow**

Assume that a company obtains a loan of $1.5 million payable with level annual payments of $392,000 (including interest at 9.5% per annum) over a period of five years. Assume further that the company loans this money on the same terms to its ESOP, and the ESOP then purchases 30% of the outstanding stock.

In the case of a C corporation, the entire loan repayment to the company would be made out of annual company contributions. In the case of an S corporation, on the other hand, a portion of the loan repayment to the company can be made with the ESOP's share of the S corporation distributions.

As shown by Table A, for example, the S corporation will have a slightly larger cash flow, since all of the ESOP's share of S corporation distributions can be applied to the loan payment.

**TABLE A**

## C Corporation vs. S Corporation

Comparative Net Cash Flow, Assuming Equal ESOPs
(Total Market Value, $5 Million, 30% ESOP)
5 Year Loan to the ESOP @ 9.5%, Level Amortization)

| C Corporation | | S Corporation | |
|---|---|---|---|
| Earnings | $1,000,000 | Earnings | $1,000,000 |
| ESOP Contribution | ($ 392,000) | ESOP Contribution* | ($ 310,000) |
| Taxable Earnings | $ 608,000 | Taxable Earnings | $ 690,000 |
| | | Distributions @ 39.6% | ($ 273,000) |
| Tax @ 34% | ($ 207,000) | To Outside Shareholders (70%) | ($ 191,000) |
| | | To the ESOP (30%) | ($ 82,000) |
| Net Cash Flow | $ 401,000 | Net Cash Flow | $ 417,000 |

* Note: Sum of "Contribution and "ESOP Distribution = $392,000, as in a C corp.

**If the ESOP purchases substantially all of the outstanding stock, then an S corporation will not need to make tax payment distributions to shareholders and an S corporation will then have much greater total net cash flow during and after the loan repayment period than will a C corporation.**

### What of Existing S Corporations?

For managers of existing S corporations who may have been awaiting the new laws before implementing an ESOP or applying previously accumulated ESOP cash ("prefunding") to purchase stock, the issues are, perhaps, simpler.

Many have clung to S status because non-employee shareholders — often children of a founder — receive substantial income from the company. In some cases, owners fear that the level of earnings distributed even to shareholder-employees would exceed "reasonable compensation." Dividend distributions from a C corporation to such individuals, of course, would be doubly taxed. The new law permits a founder to maintain these tax advantages of the S arrangement.

Remember, however, that there must be parity between the distributions made to outside shareholders and to the ESOP shareholder. S corporation regulations mandate "identical rights to distribution and liquidation proceeds." As long as there are non-ESOP shareholders who must receive a distribution from the company to facilitate their payment of personal income taxes on the corporate earnings, the ESOP too must receive an equivalent distribution.

(Occasionally, it might be prudent for ESOP fiduciaries to waive their right to a dividend distribution, but frequent use of this option would almost certainly violate the fiduciary obligation to manage the trust for the exclusive benefit of participants.)

These distributions to the ESOP, on the other hand, may be utilized to purchase stock from sellers, buy stock directly from the corporation, fund the repurchase liability, or create investment diversification for the participants. In many real world cases, the same cash flow will be allocated to the ESOP as in the C corporation case, but a portion of this cash flow will be designated not as a contribution, but as a distribution or dividend.

After full amortization of the securities acquisition loan, the cash flow requirements of the ESOP may be much reduced. Managers might be less happy to allocate so much to the ESOP. By coincidence, however, distributions at the 39.6% level required to maintain parity with tax distributions to non-ESOP shareholders often correspond closely to the funding required to meet the plan's repurchase liability, buying stock back from departing employees and transferring it to new and continuing employees.

On average, contributions for management of a plan's repurchase liability may be estimated at 7% of the value of the stock in the plan. If the stock is appraised at, say, five times annual earnings capacity, 7% of the stock's value will equal 35% of the annual earnings capacity on that block of stock. This corresponds, by chance, rather nicely with the 39.6% distribution normally required by shareholders to defray their federal tax liability. (Obviously, earnings capacity may differ somewhat from earnings reported for tax purposes and price/earnings multiples vary from company to company.)

In rare cases, of course, funding the ESOP at this level may seem excessive as a percentage of covered compensation. If covered compensation is 50% of our sample company's total value, a 100% ESOP would require, on average, an ongoing contribution of about 20% of payroll to satisfy the repurchase liability. A 30% ESOP would require only a 6% contribution. Cautious fiduciaries may have a repurchase liability projection completed in advance of any transaction.

Most S corporation shareholders will have a substantially higher basis in their shares than they would have had in a comparable C corporation. As annual earnings are attributed to the shareholders for tax purposes, their basis in the company stock increases to the extent these earnings are retained for corporate use and not distributed. These previously taxed earnings are usually recorded by accountants as the “Triple A” account. In effect, these dollars may be withdrawn from the company without tax. Thus the financial advantage of the ESOP’s tax-free rollover type transaction is diminished.

Finally, shareholder-employees of an S-ESOP company will, as mentioned above, participate in the plan after a sale, thus reclaiming some of the tax they pay on their gain. A shareholder whose basis in the stock equals 75% of its value will pay capital gains tax only on the 25% gain at the new 15% rate. The total tax on his sale will thus equal 3.75% of the value of the stock sold. A shareholder-ESOP participant who earns 3.75% of total covered compensation would therefore recoup all taxes paid.

In these senses, it may be perfectly feasible for existing S corporations to establish ESOPs without converting to C status as long as the seller(s) can forgo tax-free rollover treatment.

If it appears more advantageous to adopt C status during the pay-down period of the securities acquisition loan, on the other hand, it should be noted that C status must be formally invoked. Dis-election of S status is no longer an automatic consequence of the acquisition of employer securities by an ESOP. Remember: one can switch from S to C at any time, but once a company has dis-elected S status, it may not revert to S until five years have elapsed.

In changing from S to C status, the company will sacrifice its exemption from payment of corporate capital gains tax on liquidation or sale of assets prior to distribution of these taxable proceeds to selling shareholders. Yet this loss may be irrelevant, if no major disposition of appreciated assets is planned and shareholders have agreed to sell shares to an ESOP, not assets to an outside buyer.

**Differences from the Participant’s Perspective**

From the perspective of the employee-participant, an S-ESOP differs slightly from a C-ESOP.

To the extent that a portion of the funds flowing into the S-ESOP are designated as “dividends” or earnings on the underlying stock, they will be allocated among participants in proportion to the amount of stock in each account. In a C-ESOP (barring the rare cases when dividends are declared), most corporate funds flowing into the plan will be classified as “contributions” and thus allocated in proportion to each participant’s share of that year’s covered compensation.

Over time, therefore, an S-ESOP would tend to increase the allocations to long-term employees. This consequence may actually suit the purposes of the employer. As a caution, however, one must monitor the plan to be sure that it is not deemed to be “discriminatory in operation” over time.

Most Menke ESOPs are designed so as to discourage distributions upon retirement or termination in the form of company stock. It is seldom desirable for a private company to convert former employees into minority shareholders. All the more so for S corporations. Not only might such shareholders gradually push the company over the 75 shareholder limit, but transfer of distributed shares by the terminee to a disqualified shareholder such as a rollover IRA might force the company into an involuntary loss of S status.

For these reasons, the law provides that S-ESOPs may preclude participant distributions in stock even when corporate bylaws or articles do not restrict ownership to current employees: all distributions should be made in cash.

Alternately, if the Company has a bylaw restriction that limits ownership to active employees, an S-ESOP may distribute stock, but require that the terminee put the stock back to the employer immediately. This provides flexibility for plans that have previously established lump sum stock distributions as their mode of distribution. Since almost all C corporation distributions are also made in cash, employees should notice little difference here.

**Anti-Abuse Provisions**

Under the provisions of EGTRRA, the ESOP's share of S corporation earnings will not be subject to federal corporate taxation or to taxation as "unrelated business income tax," unless the ESOP runs afoul of certain "anti-abuse" provisions. Thus, in the case of an S corporation that is 100% owned by its ESOP, the company's earnings will be entirely tax exempt.

In order to prevent abuse of these new S corporation provisions by small ESOPs that benefit only a small group of key employees and family members, EGTRRA imposes a 50% excise tax on any S corporation with respect to the amount of any prohibited allocation to a disqualified person. In addition, the amount of the prohibited allocation is also taxed as ordinary income to the disqualified person, even though this amount has not been distributed to the disqualified person.

A prohibited allocation occurs if, at any time during a plan year, disqualified persons own at least 50% of the S corporation's outstanding shares. A person is a disqualified person if the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20% of the total number of deemed-owned shares of the company, or if the number of deemed-owned shares of such person himself or herself is at least 10% of the total number of deemed-owned shares of the company.

"Deemed-owned shares" include (1) shares allocated to a participant's ESOP account, (2) the participant's proportion of the shares in any unallocated loan suspense account (assuming that all such shares become allocated in the same proportion as the most recent annual stock allocation under the plan), and (3) any "synthetic equity" (i.e., stock options, warrants, restricted stock, stock appreciation rights, phantom stock units, deferred compensation, or similar rights) owned by the participant. Deemed-owned shares do not include shares held outright by an individual outside of the plan.

**Conclusions**

Once shareholders have decided to sell to an ESOP, it is no longer necessary to forego the advantages of S corporation status. Yet in many cases, shareholders will find it financially advantageous to maintain or elect C status during the amortization of a securities acquisition loan. Many factors outside of pure cash flow, however, complicate this decision. If the ESOP owns so much of the company that distributions to shareholders for the payment of personal income tax may be suspended, e.g., especially if the ESOP owns 100% of the company, it will almost always provide a cash flow advantage to elect S status and avoid all tax. As with any complex decision, of course, it is incumbent on fiduciaries to secure well-informed local advice before acting.

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