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Tax Incentives for Employee Stock Ownership Plans

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Tax incentive enacted by Congress to promote increased use of employee stock ownership plans include advantages for the sponsoring company and the participating employees. This article reviews some key incentives.

Tax-Deferred Sales of Company Stock

A shareholder of a “closely held” C corporation may sell company stock to an employee stock ownership plan and trust (“ESOP”) and defer the taxation of gain to the extent that he or she reinvests in securities of other corporations (“replacement securities”).

The sale must be one that would otherwise result in long-term capital gain to the shareholder, the shareholder’s holding period for the stock must be at least three years, and the shareholder must not have received the stock from a qualified employee plan (such as an ESOP), by exercising a stock option, or through an employee stock purchase program.

The replacement securities must be purchased within the 15-month period that begins three months before and ends 12 months after the sale of company stock to the ESOP. The replacement securities must be securities of unrelated U.S. operating companies whose passive investment income does not exceed 25% of gross receipts.

After the sale, the ESOP must own (on a fully diluted basis) at least 30% of the common equity of the employer that sponsors the ESOP. The employer must consent to the election of tax-deferred treatment, and a 10% excise tax is imposed on the employer for certain dispositions of stock by the ESOP within three years after the sale.

The stock purchased by the ESOP generally may not be allocated to the seller, certain members of his family, or any shareholder who owns more than 25% of any class of company stock. A prohibited allocation causes a 50% excise tax to be imposed on the employer and adverse income tax consequences to the participant receiving the allocation.

Dividend Deduction

Deduction for Dividends Paid to ESOP Participants

A tax incentive is provided for “passing-through” dividends on company stock to ESOP participants. A C corporation may deduct the amount of cash dividends paid on company stock held by an ESOP to the extent participants (or beneficiaries) currently receive the dividends. The dividends must be paid directly to participants or be paid to the ESOP and distributed to participants (or beneficiaries) within 90 days after the end of the plan year in which the dividends are paid.

The dividends will be fully taxable to participants (or beneficiaries), but will be exempt from income tax withholding. The deduction is allowed for the taxable year in which the dividends are paid to participants (or beneficiaries).

For taxable years beginning after December 31, 2001, this deduction also is available for dividends that, at the election of ESOP participants (or their beneficiaries), are paid to the ESOP and reinvested in company stock.

Deduction for Dividends Applied to Loan Payments

A C corporation may deduct the amount of cash dividends paid on company stock held by an ESOP and purchased with the proceeds of an ESOP loan (both allocated and unallocated shares) to the extent the dividends are used by the ESOP to make payments (of principal or interest) on that ESOP loan. Special ESOP allocation rules may apply when dividends on allocated shares are used to make loan payments. The deduction is allowed for the taxable year in which the dividends are used for loan payments. This provision enhances the ability to finance ESOP transactions on a pre-tax basis.

Tax Deductibility of ESOP Contributions

Employer contributions to an ESOP currently are tax deductible, subject to certain limits under the Internal Revenue Code of 1986, as amended (the “Code”). Contributions to an ESOP generally may be deductible in amounts up to 25% of covered payroll (*i.e.,* the covered compensation of all participants eligible to receive allocations under the ESOP). Contributions in the form of company stock are deductible based upon the current fair market value of the shares.

For a leveraged ESOP, an additional deduction of up to 25% of covered payroll in a C corporation may be allowed for contributions used to make principal payments on an ESOP “acquisition loan” (*i.e.,* a loan incurred to acquire qualifying employer securities).

Contributions used to pay interest on an ESOP acquisition loan are fully deductible (and not limited by covered payroll) so long as not more than one-third of the ESOP contributions are allocated to “highly compensated employees” and the plan sponsor is a C corporation.

S Corporation ESOPs

Under current law, S corporation ESOPs are exempt from the unrelated business income tax (UBIT). Thus, if an ESOP owns all of an S corporation, no current tax is imposed on the company’s income. (That income is eventually taxed because ESOP participants in S corporations are taxed on ESOP distributions, just as C corporation ESOP participants are so taxed.)

The law restricts the abuse of this provision by plans designed to benefit only a small number of employees, whether in a very small company or where a small number of employees set up an S corporation ESOP to benefit themselves while operating a larger company whose employees are not covered by the ESOP.

The law permits S corporation ESOPs to apply S corporation distributions received on qualifying employer securities (allocated or not) to make share acquisition loan repayments, provided employer securities with a fair market value of not less than the amount of the distributions are allocated to participant accounts for the year in which the distributions would have otherwise been allocated to their accounts. However, S corporations currently are not entitled to deduct these distributions to an ESOP.

ESOP Participants

Unless an ESOP participant has reached age 701/2, distributions of vested benefits from the ESOP to participants (or their beneficiaries) are considered eligible rollover distributions. If the ESOP participants (or beneficiaries) elect to roll over their distribution of vested benefits to an individual retirement account or annuity (*i.e.,* an "IRA") or another eligible retirement plan, such distribution recipients are not taxed on the distribution from the ESOP until they later receive such funds from their rollover institution. If ESOP participants roll over their distribution to a Roth IRA, the distribution is includible in their gross income for the year of receipt; however, the ESOP is not required to withhold income tax amounts from the distribution.

Since 2004, the IRS has ruled that a rollover to an IRA of S corporation qualifying securities distributed from an ESOP will not involuntarily terminate the S election.

Read also: Description and Purpose of an ESOP - Employee Stock Ownership Plan

Read also: An Introduction to Employee Ownership and Selling to an ESOP

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