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ESOPs: The Tax Law Provides a Buyer for Your Business

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As baby boomer business owners begin to retire, many will want to monetize the value they have created in their businesses. An employee stock ownership plan (ESOP) is one alternative. The ESOP alternative, authorized by the Internal Revenue Code of 1986, allows a business owner to form a retirement plan for the employees of the corporation, or add an ESOP feature to an existing retirement plan such as a 401(k) plan. The ESOP can be the buyer of some or all of the owner's stock in the corporation, normally in one of two principal ways. If a third-party lender to the ESOP can be found, the owner may receive all cash at the time of sale. If the owner finances the sale, the owner will receive a promissory note from the ESOP, and perhaps some cash, in payment of the purchase price. In any case, both ESOP structures provide these benefits, subject to several limitations in the tax law. The basic process is as follows:

- The owner sells stock in the corporation to the ESOP for an independently-appraised fair market value.
- The owner receives cash (generally from money borrowed by the ESOP) and/or a promissory note to the extent the purchase is seller-financed.
- The purchased shares are initially held by the ESOP in a suspense account, to be released from such suspense account and allocated to employee accounts as the acquisition debt is paid.
- The corporation makes periodic contributions to the ESOP, in amounts at least sufficient to service the ESOP debt. These contributions are generally tax-deductible by the corporation.
- The corporation's contributions "free up" shares of stock from the suspense account to be allocated by the ESOP to employee accounts. The corporation becomes beneficially employee-owned to the extent the ESOP acquires company stock without the employees having to fund the purchase price. However, ESOPs which have 401(k) features may allow employees to direct the investment of their own 401(k) contributions into corporation stock, thereby helping to pay down the acquisition debt. Matching contributions on employee 401(k) contributions also can be used for debt service. Subject to certain limitations, dividends paid on the corporation stock may be used to service the debt, and may then be deductible.
- The owner who sells 'C' corporation stock to the ESOP in a sufficient number of shares can timely reinvest the sales proceeds received from the ESOP in qualified replacement property (QRP) without paying current capital gains taxes on those sales proceeds. Dispositions of QRP before death or transfer by gift will generally require recognition of gain on the sale to the ESOP. If the QRP is held until the owner's death, approximately the first $10,500,000 of those investments will also be estate tax free, effectively converting the tax-deferred sale to the ESOP into a tax-free sale (i.e., in addition to no estate tax, no capital gains tax is ever paid on the gain realized upon the sale).
- An ESOP's income on 'S' corporation stock generally escapes federal income taxation altogether, because the income is passed through to a tax-exempt shareholder (i.e., the ESOP). This, again, provides additional liquidity to fund the ESOP and to pay the lender's promissory note. Because of the ability to avoid corporate income taxes entirely, special anti-abuse rules apply to 'S' corporation ESOPs.
- The prior owner can retain operational control over the corporation after the sale, and serve on its board of directors, subject to shareholder rights, including those of the ESOPs on shares it holds.

Whether all or only some of the corporation stock is sold to an ESOP, the opportunity to monetize illiquid value is available. In any potential case, the specific facts and circumstances of the corporation must be evaluated to determine an appropriate fit. A lender, who will finance the sale, is of significant importance, but even without a third-party lender, a corporation with an adequate ongoing cash flow can successfully complete an ESOP sales transaction.

If we can assist you in evaluating whether an ESOP sales transaction is a means to monetize your holdings in your corporation, please contact any one of the attorneys in the firm's Tax Group.