LEVERAGED ESOPs: TAX ADVANTAGES

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Employee stock ownership plans (ESOPs) offer significant tax benefits. This article discusses the tax benefits of leveraged ESOP transactions on a stakeholder-by-stakeholder basis.

Since the passage of the Employee Retirement Income Security Act of 1974 (ERISA), employee stock ownership plans (ESOPs) have been intertwined with the U.S. tax code. Subsequent legislation has expanded the modern ESOP's value proposition, creating a unique benefit program with tax advantages for all stakeholders: shareholders, their companies, and employee owners.

This suite of incentives has increasingly caught the attention of middle-market companies. A renewed focus on continuity and independence has elevated the ESOP's profile as an alternative to third-party sales and private equity exits. A well-crafted employee ownership sale can help maintain a company's autonomy, yield tax-advantaged liquidity events, build working-class wealth, and optimize corporate cash flows.

To maximize these benefits, businesses and their advisors often build leveraged ESOP strategies. These transactions are effectively stock sales. A sponsor company loans money to an employee stock ownership trust (ESOT) so that it can purchase company shares at fair market value. Employees do not pay out of pocket for stock. Instead, sponsor companies repay the financing on the ESOT's behalf using pre-tax dollars.

This detail foreshadows the broader tax mechanics of an ESOP. There are a number of moving parts to consider in order to appreciate the entire slate of potential deductions and deferrals. It is best to examine these benefits on a stakeholder-by-stakeholder basis, as discussed in this article.

SPONSOR COMPANIES: STATE AND FEDERAL CORPORATE INCOME TAX DEDUCTIONS

When stock is sold to an ESOT, the sponsoring company receives tax deductions equal to the fair market value of the equity transferred. For instance, if a company sells $10 million worth of stock to an employee trust, it gains $10 million in deductions to reduce future state and federal income tax liabilities.

Sponsor companies gradually utilize these tax incentives. As mentioned earlier, an internal loan between the plan sponsor company and its employee trust is central to a leveraged ESOP sale. When a transaction closes, employee shares are initially held in a suspense account and released over time. Stock is only allocated to employees as the internal loan between the sponsor and ESOT is repaid. As shares are allocated to employees, a sponsor company earns a portion of its anticipated income tax deductions.

An ESOP sponsor facilitates the loan repayment process by making an annual cash contribution to its employee trust. Upon receipt, the employee trust returns that cash to the sponsor company as a partial repayment on its internal ESOP loan. This creates a non-cash income tax deduction equivalent to the contribution amount.

These contributions are made over a multi-year period and limited by ERISA guidelines. An employee-owned company can annually contribute up to 25% of its ESOP-eligible payroll (total W-2 wages paid to plan participants). For example, a company with an eligible payroll of $8 million can contribute a maximum of $2 million each year and receive a corresponding income tax deduction.

Interest payments on an internal ESOP loan and optional dividend payments to an employee trust are tax-deductible. Once an income tax deduction is earned, it can be rolled forward for future use. Both ESOP-owned C and S corporations qualify for these incentives.

ESOP ownership of an S corporation carries additional tax benefits. Since S corporations are pass-through entities and ESOTs are tax-exempt entities, an S-ESOP combination can create significant, enduring tax advantages for profitable companies.

Consider an S corporation that is entirely owned by an ESOP. The company's earnings and related tax obligations are transferred to the sole shareholder, an employee trust. Since the trust is tax-exempt, any potential income taxes are eliminated.

S corporations that are partially employee-owned can also benefit from this tax incentive. However, only the earnings related to the ESOP-owned equity are exempt from income taxes. Therefore, if an employee trust owns 49% of an S corporation's equity, the individual shareholders are responsible for paying income taxes on the remaining 51%.

Some states and localities still impose minor tax burdens on S-ESOPs (such as California's franchise tax). But even in the most heavy-handed jurisdictions, an employee-owned S corporation can still achieve considerable, perpetual income tax savings. In certain cases, these advantages can double a company's cash flow.

SELLING SHAREHOLDERS: CAPITAL GAINS TAX DEFERRAL

It is often noted that a leveraged ESOP transaction cannot command the same

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purchase price as a strategic third-party sale. And that is true. ERISA mandates that an employee trust can pay no more than the IRS's definition of fair market value (FMV) for a sponsor company's equity. While that may seem like a deal breaker for some, an ESOP-exclusive benefit can typically close this pricing gap or eliminate it altogether.

Section 1042 of the Internal Revenue Code allows shareholders to defer, and potentially eliminate, capital gains taxes on stock sales to ESOPs. To access this benefit, sellers must reinvest their sale proceeds into qualified replacement properties (QRPs). This process, known as a 1042 rollover (or 1042 exchange), is akin to a Section 1031 real estate exchange.

QRPs represent a range of assets, including common stock, convertible bonds, corporate fixed-rate bonds, corporate floating-rate notes, and other securities issued by U.S. operating corporations. There are some limitations, though, as mutual funds and U.S. Treasury Bonds do not qualify for QRP reinvestment.

Many types of QRPs can be purchased on margin. By doing so, selling shareholders can keep a meaningful portion of their sales proceeds without tying up those funds in a long-term investment. This allows QRP investors to access most of their newfound liquidity without incurring capital gains taxes. The remainder of the proceeds outside of QRPs can be used at the selling shareholder's discretion, including reinvestment in more active strategies.

To be eligible for a 1042 rollover, sellers must have owned their company shares for at least three years before completing an ESOP transaction. Post-sale, an employee trust must own at least 30% of the company's stock. Additionally, sellers and their immediate families are not allowed to participate in the sponsor's employee stock ownership plan. Selling shareholders have 12 months post-sale to reinvest their proceeds in QRPs.

For a selling shareholder to take full advantage of the 1042 benefit, their company must close its ESOP transaction as a C corporation. Although recent federal legislation extended the incentive to S corporation shareholders, their QRP reinvestment is limited to 10% of their sale proceeds. The remainder of their sale proceeds are still subject to standard capital gains taxes.

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Most qualified replacement properties are not actively traded. If a QRP is sold during an investor's lifetime, capital gains taxes on the initial ESOP transaction may be triggered and owed. However, if a qualified replacement property is held until death, the investment receives a step-up in basis and can be sold without incurring taxes. Gifts of QRP and transfers related to divorces are not considered taxable dispositions. As a result, a well-crafted 1042 rollover can enhance estate planning strategy.

1042 rollovers are clearly nuanced but undoubtedly valuable. A selling shareholder in a high-tax jurisdiction, such as New York, can leverage the benefit to sidestep a combined federal and state capital gains burden of approximately 35%. Compared to other M&A transactions, it is a massive advantage.

EMPLOYEE OWNERS: TAX-DEFERRED RETIREMENT BENEFITS

At its core, an ESOP is a defined contribution plan. Although it differs from a 401(k) by investing primarily in employer securities, an employee stock ownership plan shares many of the same attributes. Both plans are intended to be utilized as a retirement benefit and share the same standard ERISA vesting schedules and tax-deferral rules. In other words, ESOP rollovers are common.

Typically, when an ESOP participant retires or leaves a sponsoring company, their shares are repurchased by the plan's sponsor. These shares are valued at the current market rate, and the transaction is managed by the employee stock ownership trust. Exiting participants have the option to transfer their proceeds into another qualified retirement plan, such as a 401(k) or IRA.

A former employee owner must complete their rollover within 60 days of receiving a plan distribution. If not, the distributions and dividends will be subject to regular taxes and early withdrawal penalties.

Although the tax incentive conferred to employee stock ownership plan participants is not necessarily novel, a tax-deferred retirement account is a tried-and-true wealth-building tool. It is worth noting that ESOP benefits are entirely funded by a sponsor company and do not impact an employee's take-home pay. Furthermore, employee owners are often the beneficiaries of multiple ERISA-authorized plans, as new ESOPs are commonly paired with existing 401(k) plans.

This compounding of benefits, combined with the strong historical performance of ESOPs, can have a meaningful impact on retirement outcomes. A 2023 study by the National Center for Employee Ownership (NCEO) notes that average ESOP account balances are over 2.5x higher than those of standard 401(k) plans. And overall, employee owners have 92% higher median household net worth than their peers, according to a 2017 NCEO study.

CONCLUSION: EARNED, ALIGNED TAX BENEFITS

As far as government incentives are concerned, employee stock ownership plans are a bit of a rarity. All three major ESOP stakeholder groups can access meaningful tax incentives when they take specific, intended actions. Multi-party alignment—reflected by the stability, productivity, and performance of an employee-owned company—enhances those benefits.

In a world of third-party and private equity sales, where one or multiple stakeholders generally get the short end of the stick, leveraged ESOPs stand out as compelling shareholder liquidity and business transition alternatives. Employee ownership is not always the right strategy, but in terms of tax efficiency, ESOP strategies are unparalleled. ■