Revisiting ESOP Sales

By Robert W. Wood • Wood LLP • San Francisco

An Employee Stock Ownership Plan (ESOP) is a strange animal. It is a special type of employee benefit program—a defined contribution plan—designed to invest in the employer's stock. It is set up to benefit employees, and in that sense it can increase morale and help achieve incentive goals. An ESOP gives employees a direct stake in the business and a voice, yet doing so without the risks and problems of individual employees holding stock directly.

However, it must be acknowledged that the prime beneficiaries are the owners of the business. In effect, the owners of a closely held business may seek to sell some or all of their shares in the company. If they cannot find an appropriate buyer *outside* the company, an ESOP can be created to make the buyout. How does one fund the consideration for the deal?

Debt, of course. The operating profits from the business itself will go to make the payments of interest and principal on the buyout loan. And the tax benefits are even better than most leveraged buyouts.

Taxes Predominate

The tax advantages of an ESOP are significant. Code Sec. 1042 allows the seller to defer taxes on the sale by reinvesting the proceeds in a pool of qualified securities. In effect, before the transaction, the business owner has an illiquid and concentrated position in a private company.

By creating an ESOP and selling the company to it, the owner can swap an illiquid privately held business for public company securities. The conditions to this outsize treatment include that the ESOP's acquisition of stock must be of at least 30 percent of the company. While selling to an outsider almost invariably requires the seller to sell 100 percent, the ESOP facilitates the owner retaining anywhere between zero percent and 70 percent of the company.

In fact, the seller may have its cake and eat it too by selling a *portion* of the company to an ESOP, paying no tax, diversifying his investments and *still* remaining at the helm of the business. To defer the tax on the sale, the reinvestment must occur within 12 months of the sale and must be of qualified replacement property. Although the owner will take a carryover basis in the replacement securities, the owner can then hold them indefinitely or can sell them off piecemeal when needed and pay capital gain tax at that time.

From an estate planning viewpoint, an ESOP can nicely resolve issues and provide liquidity. Succession planning for the business can also be facilitated. The gain is rolled over into the replacement securities and will not be taxed until they are sold. What's more, if the shareholder still holds the replacement securities upon death, there should be no income tax. Even so, the replacement securities should receive a stepped-up basis for income tax purposes.

In the case of S corporations, further tax benefits are available. Since the ESOP is a tax-exempt entity, the ESOP shareholder of an S corporation receives its share of the income on a tax-free basis.

Deductible Dividends

Corporations generally pay dividends from their after-tax earnings. That makes dividends nondeductible by the corporation that pays them. Yet for a corporation that is wholly or partially owned by an ESOP, there's an important exception from this nondeductibility.

The corporation can deduct dividends that:

- are paid to employees in cash within 90 days after the close of the plan year;
- pay down the debt incurred to acquire stock for the ESOP; or
- are voluntarily reinvested by plan participants back to the ESOP for more stock. [Code Sec. 404(k).]

Conclusion

ESOP buyouts can provide tax and liquidity benefits to owners. Yet there can also be employee relations and productivity benefits. These specialized employee benefit plans can help a company retain and motivate key employees as well as attract new ones. These transactions can be expensive and are not simple to implement, but their benefits can be well worth the effort.