You are thinking about setting up an employee stock option plan (ESOP) for your business.
Are there any tax benefits to you as a business owner?

ASK THE TAX GUYS

Q: What is an employee stock option plan (ESOP)?

Hart: An ESOP is a type of employee benefit plan. It's similar in some ways to a profit-sharing plan. An ESOP is formed by setting up a trust fund to acquire shares of a company's stock for employees. The shares acquired by the ESOP are allocated to individual employee accounts.

The ESOP can acquire shares in several ways. One way is to have the company issue new shares of its stock directly to the ESOP. The second way is to have the company contribute cash to the ESOP to buy existing shares (e.g., from a departing owner of a closely held company). The third way is to have the ESOP raise money by borrowing from an external source, such as a bank or the company, and then buy the shares. Frequently, a bank will lend to the company, and the company will then lend the proceeds of the loan to the ESOP.

Q: What are some compelling reasons to have an ESOP as a business owner?

Hart: An ESOP surpasses other types of benefit plans, because it provides tangible and intangible benefits to a cross-section of constituents: employees, owners, and the company.

At the most basic level, an ESOP can serve as an employee incentive plan that fosters a sense of ownership among employees. When employees have an ownership stake in a company, they tend to be motivated to work harder, stay with the company longer, and help it succeed. Morale improves and staff turnover is minimized.

For owners, an ESOP can be a tax-efficient way to liquidate their ownership interest in a company. An owner who is retiring after many years has no better way to sell his/her shares than through an ESOP. By selling shares to the ESOP, the owner is transferring ownership to people who will have a vested interest in the long-term welfare of the company – the employees. The ESOP can help perpetuate the company's existence long after the owner/founder leaves the company.

An ESOP can also be used by companies to raise capital to fund growth. Under this arrangement, the ESOP borrows money from an external source and uses the proceeds to buy newly issued shares of a company's stock. Because of the tax benefits associated with financing an ESOP, ESOP financing can be a less expensive way for companies to raise capital.

Q: What are some of the tax benefits associated with financing the ESOP?

Kessel: In general, companies can deduct dividends paid to an ESOP with certain limitations. If the ESOP has a loan, such dividend payments can be used by the ESOP to pay the interest and principal on the loan. Thus, the effect is that the company gets to deduct the full cost (principal and interest) of using the proceeds from the ESOP loan.

Q: What tax benefits are available to closely-held C corporations?

Hart: With some restrictions, shareholders of a closely-held C corporation who sell shares to an ESOP will pay no tax on the gain from the sale. To take advantage of the tax provision under I.R.C. § 1042, the ESOP must own at least 30 percent of the company's stock. Further, the selling shareholders must reinvest the proceeds in "qualifying securities" of other U.S. domestic corporations (public or private) within 12 months after the sale to the ESOP.

Q: What tax benefits are available to S corporations?

Kessel: Unfortunately, shareholders of an S corporation cannot take advantage of the tax-free reinvestment provision available to shareholders of a C corporation. However, the S corporation's income that is allocated to the ESOP is exempt from federal income tax; the ESOP is responsible for the income tax. If the ESOP owned all of the S corporation's shares, the ESOP would not have to pay any federal income tax attributable to the S corporation.

Q: Who controls the ESOP?

Kessel: The terms of the ESOP document determine who controls the ESOP and how the shares in the ESOP are to be voted. Frequently, the trustee of the ESOP has the right to vote the shares in the ESOP. In closely held companies, employee shareholders generally have the right to vote for significant events, such as a merger of the company. It is fairly common for the management of a company to remain in place after an ESOP is established.

Q: What types of companies would benefit most by establishing an ESOP?

Hart: Companies that benefit most are those that can use the tax benefits offered by the ESOP. These are typically companies that are very profitable with excellent cash flows that can take advantage of the tax benefits of the ESOP. The cash flow is necessary to be able to service the bank-financed debt previously discussed. These companies typically have a strong management team that offers the selling shareholder an alternative to selling to an outside party or passing the business on to their heirs.

Q: How does a company go about setting up an ESOP?

Kessel: Compared with other retirement plans, such as a 401(k) plan, an ESOP tends to be a little more difficult to set up and maintain. An owner should seek professional legal and tax advice when setting one up.

Q: What are some of the administrative and compliance considerations in maintaining an ESOP?

Hart: As noted above, an ESOP is similar to a profit sharing plan and has many of the same administrative and compliance considerations associated with maintaining a qualified profit sharing plan. For example, the ESOP must satisfy discrimination requirements under the Internal Revenue Code and file an annual report (Form 5500) with the IRS. If the ESOP has more than 100 participants, the ESOP must be audited each year. In addition, if the stock held by the ESOP is not publicly traded, the stock must be appraised each year by a qualified independent appraiser.

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