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Abstract: Business owners and executives often wish their employees worked as if they owned part of the company. An employee stock ownership plan (ESOP) can make that a reality while offering tax breaks and a smoother path for succession planning. This article discusses how ESOPs work and their tax impact.

Unlocking the potential benefits of ESOPs

Wouldn't it be great if your employees worked as if they owned part of the company? An employee stock ownership plan (ESOP) could make that a reality.

Under an ESOP, employee participants take part ownership of the business through a retirement savings arrangement. Meanwhile, the company and its existing owner(s) can benefit from some tax breaks, an extra-motivated workforce and, potentially, a smoother path for succession planning.

ESOP basics

To implement an ESOP, you establish a trust fund and either:

- Contribute shares of stock or money to buy the stock (an “unleveraged” ESOP), or
- Borrow funds to initially buy the stock and then contribute cash to the plan to enable it to repay the loan (a “leveraged” ESOP).

The shares in the trust are allocated to individual employees' accounts, often using a formula based on their respective compensation. The business must formally adopt the plan and submit plan documents to the IRS, along with certain forms.

The tax effects

Among the biggest benefits of an ESOP is that contributions to qualified retirement plans such as ESOPs are typically tax-deductible for employers. However, employer contributions to all defined contribution plans, including ESOPs, are generally limited to 25% of covered payroll. There's one exception: C corporations with leveraged ESOPs can deduct contributions used to pay interest on the loans. That is, the interest isn't counted toward the 25% limit.

Dividends paid on ESOP stock passed through to employees or used to repay an ESOP loan may be tax-deductible for C corporations, so long as they're reasonable. Dividends voluntarily reinvested by employees in company stock in the ESOP also are usually deductible by the business. (Employees, however, should review the tax implications of dividends.)

Another potential benefit is that shareholders in some closely held C corporations can sell stock to the ESOP and defer federal income taxes on any gains from the sale. Several stipulations apply, including that the ESOP must own at least 30% of the company's stock immediately after the sale. Also, the sellers must reinvest the proceeds (or an equivalent amount) in qualified replacement property securities of domestic corporations within a set period.

Finally, when a business owner is ready to retire or otherwise depart the company, the business can make tax-deductible contributions to the ESOP to buy out the departing owner's shares or have the ESOP borrow money to buy the shares.

Risks to consider

The tax impact of an ESOP for entity types other than C corporations varies from what we've discussed here. While an ESOP offers many potential benefits, it also presents risks, such as the complexity of setup and, in some situations, a strain on cash flow. ESOPs generally come with a steep initial cost, plus ongoing costs that grow with the size of the plan.

Also, ESOPs can be burdensome to administer. Because they're considered a type of retirement plan, they are heavily regulated by the federal and state governments. Compliance will require hiring various professionals, including a trustee.

Is an ESOP right for you?

If you're wondering whether your company is a good candidate for an ESOP, we can help you sort through the details. Contact us for guidance.