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Selling to an ESOP

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What is an ESOP?

Employee stock ownership plan (ESOP)

An employee stock ownership plan (ESOP) is a type of qualified employee retirement benefit plan that allows the company's employees to participate in the ownership of company stock through the plan. To establish an ESOP for your company, you must have employees. Two common uses of ESOPs are to provide an employee retirement benefit tied to the value of the company's stock and to provide a buyer for the stock of an owner of a closely held business.

ESOPs, like other forms of qualified employee retirement plans, are highly regulated under specific provisions of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA). As a result, they can be complicated to establish and maintain, but they offer significant tax advantages that may make them worthwhile. Therefore, you are strongly advised to consult a qualified attorney with experience in the formation and maintenance of qualified employee retirement plans to determine the appropriateness of establishing an ESOP in your situation.

ESOPs may provide important operating advantages

Proponents of ESOPs believe that they result in improved productivity among employees through the realization that their ultimate retirement benefit may be greatly enhanced if the company does well. It is in the employee's interest to help insure the company's success, beyond the weekly or monthly paycheck.

ESOPs provide tax deduction

Under the rules of the Internal Revenue Code and ERISA, ESOPs are designed to invest their assets primarily in company stock rather than investing in the public markets. Annual cash contributions are made to the ESOP that the ESOP then uses to purchase stock from the company, or the company may contribute the stock directly. In either case, the company gets a tax deduction for the value of each year's contribution, while the cash stays with the company (i.e., a cash contribution is returned to the company through the purchase of company stock and the direct stock contribution doesn't involve cash at all). In this way, the plan results in an annual cashless deduction for the company.

ESOPs are allowed to borrow

ESOPs, unlike all other qualified retirement plans, are permitted to borrow money for the purpose of purchasing company stock. When the ESOP borrows money to buy company stock, the company makes annual contributions to the ESOP in the amount equal to the ESOP's principal and interest payments on the loan. The ESOP then uses the contributions to pay back that debt service. Since the company's contribution as a whole is deductible, that makes the interest and the principal on the loan deductible. In addition to borrowing from the company itself, ESOPs may also borrow from an owner of the company who wants to sell.

Why would you want to sell your business to an ESOP?

ESOP may represent ready buyer

An ESOP can serve two purposes in your closely held business. First, it provides an incentive and a benefit for the employees. Second, because of its unique ability to borrow, the ESOP can represent a potential buyer for your share of the business when you want to retire or leave the business.

Sale of your interest to ESOP can provide you with tax advantages

The most significant tax advantage occurs when you sell your stock to the ESOP, and the ESOP owns at least 30 percent of the company after the sale. You can defer the tax on your gain on the sale by reinvesting the proceeds in qualifying domestic U.S. securities ("qualified replacement property"). No tax is paid until you dispose of the replacement securities. If you hold the replacement securities until you die, then as a result of the estate tax rules that give the securities a stepped-up basis, no tax is ever paid on the original gain. This is a very powerful tax incentive for you to sell your interest in your closely held business to an ESOP potentially tax free, rather than to another buyer. Other conditions may apply and are listed in the following sections.

Example(s): *You own shares in your closely held business that you originally paid $200,000 for. The current value is $2 million. Assuming a combined federal and state tax rate of 32 percent, you would be subject to taxes of $640,000, leaving you with proceeds of $1,360,000 if you sold your business to a third party or another company. If you sell your shares to an ESOP and reinvest the proceeds in qualifying securities, (and other conditions apply), you are not subject to federal income taxes on the sale.*

What are the conditions for selling to an ESOP and deferring taxes on the sale?

For you to be able to defer your taxes on the sale of your business interest to an ESOP, the following conditions must be met:

- The ESOP was established by a C corporation (not an S corporation, per Section 1042 of the Internal Revenue Code).
- You did not receive your stock from a qualified retirement plan (e.g., an ESOP or stock bonus plan), by exercising a stock option, through an employee stock purchase program, or as compensation for services.
- Your holding period in your stock is for at least three years.
- The stock sold to the ESOP is voting common stock or is preferred stock that is convertible to voting common stock.
- You will reinvest your proceeds from the sale to the ESOP in qualified replacement property. Qualified replacement property means any securities issued by publicly traded or closely held domestic corporations with more than 50 percent of their assets used in an active trade or business during the 15-month period that begins before the sale to the ESOP, and whose passive investment income doesn't exceed 25 percent of gross receipts for the preceding year. Municipal bonds, certificates of deposit (CDs), mutual funds, or U.S. Treasury securities are not considered eligible reinvestment vehicles. You must reinvest within a 15-month period that begins 3 months before the sale to the ESOP and ends 12 months after the sale.
- The ESOP must own at least 30 percent of the company immediately after the sale.
- For the 12 months preceding the sale to the ESOP, the company that established the ESOP did not have any class of stock that was readily tradable on an established securities market.
- Stock bought by the ESOP may not be allocated to the seller or certain members of the seller's family, or to any shareholder of the company establishing the ESOP who owns more than 25 percent of any class of company stock. If this is violated, the company would be subject to a 50 percent excise tax, and the person receiving the allocation would also be subject to tax consequences.
- An election statement must be filed with the Internal Revenue Service.

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