‘ESOP’ Spells Benefits for You, Your Employees and Your Business

If you are a family business owner, your estate probably consists primarily of your business, leaving few other assets to pay estate taxes on your death. If your children are active in the business, the question becomes how to transfer control to them and avoid selling the business to a third party, while still raising the cash to pay estate taxes and diversifying your investments for retirement. An employee stock ownership plan (ESOP) may be the solution. ESOPs offer you (and your business) significant tax savings while facilitating the change in ownership to your children. ESOPs can now even hold stock in S corporations.

Probably the easiest way to understand an ESOP is to think about it as a variation of a traditional defined contribution plan. The main difference is that an ESOP invests primarily in the sponsoring company’s stock and distributes either cash or stock to employees on their retirement.

The ESOP must give employees the right to request distribution to be made in stock if cash distributions are also allowed and provide for the employer to buy back the stock if it is not readily marketable. ESOPs are subject to the same basic tax and employee benefit laws as other qualified retirement plans, so the ESOP must meet general distribution requirements.

You can maintain control of the company by choosing appropriate ESOP trustees because the trustees vote all corporate shares, except on certain major corporate matters. And, if the plan provides for distribution of stock in kind, you generally have a means of buying back the stock from employees, thereby maintaining actual control of the corporation.

Estate Planning Advantages

You can sell stock to the ESOP and not pay any capital gains tax. How? You can roll over the basis of your stock into replacement securities, deferring any capital gains tax until those securities are sold. The tax-free treatment is available if:

1. You did not receive the stock in your company as compensation and have held it for at least three years;

2. Immediately after the sale, the ESOP owns at least 30% of either:

   a. The total value of outstanding stock, or

   b. Each class of outstanding stock;

3. You reinvest the sale proceeds in “qualified replacement property” (as defined by the tax law) within 12 months; and

4. For a specific period of time, no portion of ESOP assets attributable to the stock sold to the ESOP accrue to you, your family or any other person who owns more than 25% of the outstanding stock.

This tax-free rollover provision allows ESOPs to buy out your interests while leaving control of the company in the hands of family members. It also gives you the flexibility to diversify your investments before retirement.

Even if you don’t sell stock to the ESOP before your death, the ESOP may purchase stock from your estate while the corporation makes tax deductible contributions to the ESOP to pay for the stock, or insurance on your life can fund the purchase, rather than having the corporation redeem the shares directly from the estate using after-tax dollars.

Is an ESOP Right for You?

If you own a company that is experiencing steady or increasing profits and don’t mind sharing the future growth with your employees, you may be a perfect candidate for an ESOP. We’d be happy to explore this option in more detail with you.

Tax Benefits for Your Business

In addition to offering a valuable employee benefit that will help you attract and retain workers, your business will reap tax benefits as well. Because an ESOP is a qualified retirement plan, contributions the sponsoring employer makes are tax deductible (within applicable limits). Your business can also deduct dividends paid on shares held by an ESOP if certain requirements are met.