ESOPs in S Corporations

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Originally, S corporations could not have ESOPs because a nonprofit trust (like an ESOP trust, which is the actual owner of ESOP-held stock) could not be an S corporation shareholder. In legislation passed in 1996 and 1997, however, Congress allowed ESOPs and other employee benefit trusts to own stock in an S corporation, effective January 1, 1998. The law provides that any profits attributable to the ESOP's ownership of stock in an S corporation are not subject to federal income tax; most states follow this provision in their own tax laws. A 30% ESOP pays no tax on 30% of its income; a 100% ESOP pays no tax at all (again, this is true for federal taxes and often state taxes). This is not an unintentional loophole; it was specifically created by Congress to encourage ESOPs. S corporations do not receive all the same tax benefits that C corporation ESOPs do, however, most notably the ability of sellers to ESOPs owning at least 30% of the stock in a C corporation to defer taxation on the gain.

Responding to abuses of the law by promoters who created ESOPs that provided few if any benefits for other than one of a few well-paid people in companies, in 2001 Congress enacted provisions urged by ESOP advocates that prevent S corporations from operating ESOPs designed to benefit just a few people, often in situations where an S corporation management company was set up to manage a larger C corporation operating company.

Background

The S corporation is a form of business ownership in which the corporation does not pay tax on its earnings. Instead, owners of an S corporation pay taxes on their proportionate share of the company's earnings at their own individual tax rates. S corporations often pay a distribution to these owners equal to the amount of taxes they owe. When owners of an S corporation sell their ownership interest, they pay capital gains taxes on the gain, but the gain is adjusted upward for any interim distributions they have received and decreased by any allocations of earnings on which they paid taxes. S corporations allow owners to avoid the double taxation on corporate earnings that applies to C corporations (the company pays taxes on profits; the owners pay taxes when the profits are distributed). Top C corporation tax rates are marginally lower than top individual rates, however, and 2%-or-more owners in an S corporation must include fringe benefits as taxable income. S corporations can only have one class of stock and no more than 100 owners.

Tax Issues

As mentioned above, S corporations sponsoring ESOPs do not have to pay federal (and usually state) income tax on the percentage of their profits attributable to the ESOP. No other type of corporation has this kind of blanket exemption from taxation. The result has been a rapid growth in S corporation ESOPs, often from ESOPs that have bought shares from an exiting owner converting to S status after buying out all remaining shares.

S corporation ESOPs do not qualify for all the same benefits as C corporation ESOPs, however:

- Sellers cannot defer gains made from the sale of stock to an ESOP.
- Both C and S corporations can deduct contributions of up to 25% of the eligible payroll in an ESOP to repay an ESOP loan, but C corporations base this calculation only on the amount of principal paid, while S corporations must count interest as well.
- In a C corporation, when participants leave before vesting and forfeit their accounts, and their shares are reallocated to other participants,

any shares bought with a loan do not count toward the maximum amount that can be added to an individual's account each year so long as that reallocation takes place while the loan is still being repaid and not more than one-third of ESOP contributions are allocated to highly compensated employees. In S corporations, however, such reallocated forfeitures apparently do count toward the maximum annual addition, although the law is unclear. Given that the limit in 2009 is $49,000 or 100% of pay, whichever is less, however, this is not usually an issue.
- In C corporations, dividends paid on ESOP-held company stock are tax-deductible if they are used to repay an ESOP loan or passed directly to employees. In S corporations, however, distributions (the equivalent of C corporation dividends) paid on ESOP-held stock are not deductible.

Operational Issues

Other than taxes, there are many operational issues in choosing between a C corporation or S corporation ESOP, but the most important issues generally arise from the S corporation distribution rules. If S corporations make distributions, usually to enable shareholders to pay taxes, a pro-rata distribution must be made to the ESOP as well. Distributions on allocated shares must be made relative to account balances; distributions on unallocated shares (shares held in the ESOP but not yet paid for when the ESOP borrows money to purchase stock) can be based either on allocated shares or the company's normal contribution formula (typically relative compensation). These distributions can, in turn, be used to buy additional shares from owners if the plan fiduciary determines it is fiduciarially sound to do so.

These distributions to the ESOP raise two issues. First, they may mean the company is putting more into the ESOP than it wants to, especially if the ESOP owns a high percentage of the shares (which is why there are very few S corporation ESOPs owning more than 50% but less than 100% of the stock). Second, it means people with existing account balances may see their accounts grow disproportionately compared to newer employees. Again, this is mostly a problem where the ESOP is a major, but not 100%, owner (100% ESOPs often do not pay distributions because there is no tax).

S corporations can require that departing employees take their benefits in the form of cash rather than stock, thus avoiding the potential disqualification that could occur if an employee put the stock into an IRA, which is not a qualified S corporation owner. Finally, distributions paid on ESOP-held company stock can be used to repay an ESOP loan and operate in much the same way as do dividends on stock in a C corporation ESOP, releasing additional shares from the suspense account (the unpaid-for shares) to existing accounts.

Issues in Setting Up an ESOP in an S Corporation

For S corporation owners considering setting up an ESOP, the ability to avoid taxation on the ESOP's share of earnings is a powerful tax incentive. Where the goal of the ESOP is simply to provide a benefit to employees, there may be no reason to convert to C status. Similarly, if the ESOP is meant to cash out an owner, and the owner does not need or want the tax deferral treatment available to C corporation owners, the ESOP can be an attractive vehicle. This may often be the case in an S corporation because the sellers may have a very high basis in the stock if they have not "distributed out" a lot of the company's earnings. Sellers may also believe that capital gains rates are at historic lows, and deferring taxes in a sale to a C corporation ESOP could simply mean deferring until a time when rates are higher. Other owners may have family members who they want to participate in the ESOP (they cannot get an allocation of shares subject to the deferral in a C corporation ESOP) or not be comfortable with requirement that the deferral be reinvested in stocks and corporate bonds, as opposed to real estate trusts, mutual funds, municipal bonds, and similar investments.

On the other hand, an S corporation ESOP has lower contribution limits than an C corporation ESOP, which may require a slower cashout of the seller's interest than in a C corporation ESOP. Also, if the goal of the ESOP is to use it as a financing tool to make a major purchase, these lower limits may be a problem.

Where the deferral is desired, companies can convert to C status, sell to the ESOP, then reconvert to S status five years later (S corporation law prohibits earlier reconversion). During that period, payments on the loan used to buy out an owner often eliminate or substantially reduce corporate taxes in any event.

Issues for C Corporations with ESOPs Converting to S Status

Many C corporations with ESOPs have converted to S corporation status. Especially where the ESOP owns a substantial part of the company's stock, this can provide a substantial tax benefit, even reducing taxes to zero where the ESOP owns 100% of the shares. Indeed, it is arguably a duty of ESOP fiduciaries to consider such a switch.

Several issues must be kept in mind, however:

- The election requires the consent of all shareholders.
- An S corporation can only have 100 shareholders (the ESOP counts as one). S corporations can only have one class of stock, with the one exception that it can have voting and nonvoting common shares. Some C corporation ESOPs use convertible preferred or super-common stock for various reasons. These may or may not be sufficiently compelling issues to warrant remaining a C corporation.
- After conversion to S status, corporations that were using last-in, first-out (LIFO) accounting are subject to a LIFO recapture tax of the difference between LIFO and FIFO (first-in, first out). This excess must be recaptured based on the FIFO value of inventory over the LIFO value at the close of the C corporation's last tax year. In addition, appropriate adjustments shall be made to the basis of the inventory to take into account the amounts included in gross income.
- For a 10-year period after conversion, if the company sells any asset it held on the day of its S corporation election, it will have to pay "built-in gains" tax on that sale. This tax is in addition to taxes paid by shareholders.
- In S corporations, some fringe benefits paid to 2% or more owners are taxable.

- Net operating losses incurred as a C corporation are suspended while an S corporation. These losses may be applied against LIFO or built-in gains taxes, however.
- State laws vary, and some states may not track federal laws. In California, for instance, ESOPs are subject to state unrelated business income tax.
- S corporations must operate on a calendar year.

Anti-Abuse Rules

As mentioned above, the 2001 tax bill included provisions to discourage the use of ESOPs in S corporations for the primary benefit of just a few employees. The rules are somewhat complicated. The law includes a two-step process to determine whether the S corporation ESOP will not be subject to punitive tax treatment.

The first step is to define "disqualified persons." Under the law, a "disqualified person" is an individual who owns 10% or more of the "deemed-owned shares" or who, together with family members (spouses or other family members, including lineal ancestors or descendants, siblings and their children, or the spouses of any of these other family members) owns 20% or more. "Deemed-owned shares" include stock allocated to that person's ESOP account; a proportionate amount of shares bought by the ESOP but not yet released to participant accounts; and synthetic equity, broadly defined to include stock options, stock appreciation rights, and other equity equivalents.

The second step is to determine whether disqualified individuals own as a group at least 50% of all shares in the company. In making this determination, ownership is defined to include:

1. shares held directly
2. shares owned through synthetic equity
3. allocated or unallocated shares owned through the ESOP

If disqualified individuals own at least 50% of the stock of the company, then they may not receive allocations of company stock in the ESOP or any other tax-qualified plan that year without a substantial tax penalty. Under IRS regulations issued in 2004, a tax penalty also attaches to "accruals" during that year, referring to any company stock held in the account, distributions paid on such stock, or the proceeds from the sale of such stock. If such an allocation or accrual does occur, it is taxed as a distribution to the recipient, and a 50% corporate excise tax applies to the fair market value of the stock allocated. If synthetic equity is owned, a 50% excise tax applies to its value as well. In the first year in which this rule applies, there is a 50% tax on the fair market value of shares allocated to or accrued by disqualified individuals even if no additional allocations are made to those individuals that year (in other words, the tax applies simply if disqualified individuals own 50% or more of the company in the first year).

For more information on S corporation ESOPs, see our book on the subject.

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