

ESOPs in S Corporations - Look Out for Opportunities AND Scams

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ESOPs (Employee Stock Ownership Plans) provide an opportunity for clients to control the sale of stock in their closely held companies, whether as part of an exit strategy or to diversify their personal assets. While there are certain tax benefits available to sellers of C corporations (which all corporate sellers can access), sellers of S corporation stock also have substantial advantages, some of which may exceed the value of C corporation tax advantages. In addition, ESOP-owned S corporations hold substantial advantages for maximizing after-tax cash flow and mergers and acquisitions. Either way, ESOPs can instantly make illiquid stock liquid for your clients, which has provided an opportunity for your clients - but also for some would-be ESOP providers, who may push approaches that the IRS considers too good to be true.

Introduction

According to recent studies, there are approximately 4.5 million affluent owners of privately held business in the United States. These studies project that by 2006, an average of 350,000 of them will be seeking to retire each year.¹ With greater recognition of the potential market and the tax and other benefits available through using ESOPs (Employee Stock Ownership Plans) for these exit transactions, many advisors are taking another look at ESOPs for their clients, many of whom have taken advantage of the tax benefits of filing as an S corporation under federal and state laws in general. Some of these S corporation advantages have been extended to ESOPs in the last few years, as tax law changes have permitted ESOP-ownership of S corporations.

Putting these three facts together, it should come as no surprise that there are some new and inexperienced ESOP advisors out there looking for clients. While many of these advisors are merely novices, some are coming perilously close to pushing the envelope right out through the slot. The Internal Revenue Code has even been rewritten to add a section to prevent abuses.²

Before we take a look at protecting your clients from the potential for abuse, it is necessary to understand how ESOPs work in both C and S corporations.

A Brief Primer on ESOPs, S & C Corporations

ESOPs, or Employee Stock Ownership Plans, are qualified retirement plans set up by companies under the governance of ERISA - the Employee Retirement Income Security Act and are similar to 401(k) plans in many ways. There are similar corporate tax benefits, vesting schedules and other "functionality" in how the plans operate.

A Company will typically create an ESOP Trust, and the Trust will buy Company stock from the selling shareholders. For more information on ESOPs and this process, see my article in a recent PEPC Newsletter (Winter 2003, Volume XIII, No.2).

When a corporation elects to be treated as a Subchapter S corporation, it essentially becomes a pass-through entity for tax purposes. Although there are some extremely large S corporations, generally they are not very big because S corporations can have no more than 75 shareholders.

In an S corporation, the net income before taxes is reported as individual income for the shareholders. They receive a K-1 form detailing their share of the Company's profits/losses in direct proportion to their ownership of the company and on which they then have federal and state income tax liabilities. In a C corporation, net income is taxed at the corporate level. Cash is different from income, of course, and while a C corporation will pay its taxes and decide separately what to do with its cash, an S corporation will typically distribute to its shareholders (at least) sufficient cash to pay the taxes on their share of reported income.

For example, say a company had net income before taxes of \$1 million. If all the cash flow were to be distributed to shareholders through distributions/dividends, the effect looks something like the table below:

Table 1	C Corporation	S Corporation
Taxable income	\$1,000,000	\$1,000,000
Corporate income tax (@44%, incl. PA est.)	439,900	0
Cash flow available to shareholders	560,100	1,000,000
Individual Capital Gains Tax on Dividends (@18%, incl. PA est.)	112,020	0
Distributions to pay individual income tax (@38%, incl. PA est.)	0	382,000
Net (after-tax) cash flow to shareholders	\$ 448,080	\$ 618,000

Before the recent federal tax law changes treating dividends at capital gains rates, the difference was even more

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substantial. Even though the S corporation structure provides significant enhanced cash flow to shareholders, it will generally not be reflected as additional value for purposes of an ESOP sale.³

The advantages to a selling shareholder of a C corporation include the ability to defer federal capital gains taxes on the sale, if he sells more than 30 percent of the company.⁴ The Company also has more flexibility in designing securities to sell to the ESOP, such as dividend paying or preferred stock, and higher annual regulatory limits in deducting the repayment expense of the ESOP transaction loan. However, should the seller defer taxes, he and certain members of his family, if they are employed by the Company, are ineligible to participate in the ESOP.

Advantages of S Corporation ESOPs

There are a number of reasons that a seller may wish to retain the corporate S status for his Company as he sells some or all of it to an ESOP. Much depends upon his intentions over the long term, the extent of current and projected family involvement, and his basis in his stock. Under an S corporation ESOP, the selling shareholder - if he continues employment with the Company - and his family members can generally participate fully in the ESOP.⁵ The value of participating in the ESOP can outweigh the tax deferral opportunity. At some level, it be-

comes a question of weighing priorities and "crunching the numbers" to assess the choices.

There may also be advantages for the Company. While the Company can continue to make distributions to shareholders to pay their taxes on the Company's net income, the ESOP Trust is essentially a tax-free entity with no federal income tax obligation. Using the \$1 million figure as above, we can demonstrate the tax savings to an S corporation from an ESOP:

Table 2	S Corporation	S Corporation w/ESOP
Taxable income	\$1,000,000	\$1,000,000
Corporate income tax (@44%, incl. PA est.)	0	0
Cash flow available to shareholders	1,000,000	1,000,000
Distributions to pay individual income tax (@38%, incl. PA est.)	382,000	382,000

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Proportion of distribution to ESOP (assuming 30% ownership)		114,600
Total tax obligation on available cash flow	382,000	267,400
Net (after-tax) cash flow to shareholders	\$ 618,000	\$ 732,600
Tax savings from ESOP		\$ 114,600

The pre-tax cash distributed to the ESOP, therefore, is available for other purposes, such as paying down the ESOP acquisition loan, creating a sinking fund for future stock purchases, providing cash to the Company for fixed assets or mergers & acquisitions transactions, or paying ESOP share repurchase obligations.⁶

Abuses and Scams

The fact that the ESOP Trust shareholder of an S corporation is essentially tax-free has been a powerful incentive to many purveyors of tax loopholes. For example, many "advisors" have attempted to create 100 percent ESOP-owned S corporations as related management enterprises to the core operating companies. These structures tend to redirect the profits from the operating entity to the management (ESOP) company through substantial management fees, essentially shielding and redirecting the company's profits into a deferred compensation program for senior management.

The 2001 Tax Act included anti-abuse provisions for S corporation ESOPs, primarily to prevent ESOP transactions from being used as a tax dodge. Corrective ESOP legislation also passed in 2002. Between these tax law changes and subsequent IRS regulations, the goal has been clearly established - to prevent excessive ownership concentration in individuals by imposing significant penalties on an S Corporation if share ownership through the ESOP is or becomes highly concentrated among one or more ESOP participants.

Other variations peddled around the country have included creating a real ESOP in the company, but providing substantial deferred compensation or equivalent plans to siphon off the bulk of the profits for a select group, and even attempting to bypass the law by using shell S corporations established prior to the law in order to grandfather in the previous regulatory structure.

In addition, the IRS has made it clear that it will be pursuing schemes designed to avoid taxes, or which do not meet ERISA's requirement that ESOPs be designed to

"benefit the employees in general, although it need not provide benefits for all of the employees." It has even directly outlawed some of the schemes described above. The anti-abuse provisions lay out specific tests for this concentration; these tests essentially make it impossible for corporations with fewer than 10 employees to become S corporation ESOPs. They include synthetic equity, such as phantom stock, options, stock appreciation rights, and certain deferred compensation plans, all of which had been used to try to circumvent the regulations.

Summary

ESOPs can provide a flexible estate planning tool for owners of privately held businesses. With changes in the tax law allowing ESOPs to own shares in S corporations, your clients have additional options available in maximizing their use of the ESOP tool. In addition, the tax-free status of the ESOP brings additional advantages available to those companies. But these substantial tax benefits have also attracted a number of advisors flogging schemes that attempt to manipulate the regulations to get around the basic requirements of ERISA - that employee benefit plans benefit the employees. "If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify..." Your charge as an advisor is to guide your clients to look at the opportunities that best serve their needs, while protecting them from unacceptable levels of risk.

¹ Thanks to Boening & Scattergood for putting this information together as part of a joint presentation to RMA.

² See IRC §409(p).

³ ESOP sales require a third party appraisal of the transaction, in part to ensure that the ESOP Trust pays no more than Fair Market Value for its shares in the Company. There is significant discussion among business valuation professionals about how to treat the S corporation advantages. The predominant position currently is that, since this cash flow effect is typically a matter of corporate structure and tax planning, cash flow projections used for valuing businesses should be tax-effected to mimic C corporation structure.

⁴ Even a corporation currently filing as an S corporation can break the election before the transaction if the parties want to access the benefits of a C corporation.

⁵ Subject to anti-abuse regulations, discussed below.

⁶ ESOPs have advantages in M&A transactions beyond the additional S corporation cash from Table 2. By using the ESOP tool in acquisitions, they can offer the capital gains tax deferral to a target's sellers, allowing their offer to be lower pre-tax, but higher in net, after-tax value than other bidders. In addition, the ESOP loan used for M&A has the same deductible properties as described in my recent PEPC Newsletter article (Winters 2003, Volume XIII, No. 2) ■