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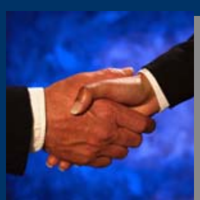

S Corporation Vs. C Corporation ESOPs

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S Corporation Vs. C Corporation ESOPs

Characteristics	C Corporations	S Corporations
Limits on Contributions Used to Pay Exempt Loans	Section 404(a)(9) – 25% of includible compensation if used to pay principal; no limit on contributions used to pay interest. It appears a C corporation may also deduct up to 25% of compensation for contributions to another defined contribution plan.	Section 404(a)(9)[1] does not apply to S corporations; therefore, contributions are limited to 25% of compensation. [1] All references to "Section" are to Sections of the Internal Revenue Code of 1986, as amended.
Limits on "Annual Additions" Under section 415(c)	The limits on "annual additions" under Section 415(c) do not include contributions to pay interest on an exempt loan or forfeitures **if** not more than 1/3 of the total allocations for a limitation year are made to the accounts of "highly compensated employees".	The special rule available for C corporations does not apply to S corporations.
Right to Demand Distribution in Company Stock	Section 409(h)(1) requires C corporation ESOPs to provide that participants can "demand" their ESOP accounts be distributed only in company stock. However, under Section 409(h)(2), if the employer's charter or by-laws restrict ownership of "substantially all" outstanding shares of company stock to employees or a tax-qualified plan, the ESOP can require participants to take cash.	Section 409(h)(2) allows ESOPs sponsored by S corporations to distribute only cash or distribute stock, subject to the requirement that the shares be immediately re-sold to the employer. The IRS has approved ESOP provisions that require distributed shares to be immediately re-sold to the ESOP.

[1] All references to "Section" are to Sections of the Internal Revenue Code of 1986, as amended.

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"Put Option" Requirements	Section 409(h)(1) also requires C corporation ESOPs to provide that participants who do not exercise their right to receive shares but who receive a distribution of shares which are "not readily tradable on an established market" to be able to "put" the shares to the employer for immediate purchase.	Section 409(h)(1) technically applies to S corporation ESOPs.
Use of Cash Dividends to Pay Exempt Loans	Section 404(k)(5)(B) allows a C corporation ESOP to use cash dividends on allocated and unallocated shares to pay an exempt loan. Section 404(k)(1) entitles the employer to deduct such dividends, subject to certain limits.	Section 4975(f)(7) (as added by the American Jobs Creation Act of 2004), allows dividends on allocated shares to be used to pay the exempt loan the proceeds of which were used to purchase the shares. Dividends on allocated shares may also be used for this purpose.
Deferral of Gain on Sale of Shares to ESOP	If specified requirements are met, individuals who are shareholders of C corporations can elect to defer the recognition of gain on the sale of shares to an ESOP.	S corporation shareholders cannot elect to defer gain on the sale of shares to an ESOP. However, a "S" election can generally be made for taxable years beginning after the date of sale to a "C" corporation; and, S corporation shareholders can receive a tax free distribution of "AAA" prior to the sale.

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Deduction of cash Dividends	C corporations that pass through cash dividends to participants can deduct the dividends under Section 404(k), subject to certain limits. Such dividends can be "sheltered" through re-investment in company stock or through "dividend switchback" mechanisms.	Dividends on S corporation shares do not qualify for deduction; the ability of ESOPs to pass through dividends are severely constrained as they are treated as taxable payments (and subject to the 10% penalty tax and participant consent in certain cases).
Non-Allocation Requirements	Section 409(p) does not apply to C corporations. However, Section 409(n) prohibits the allocation of shares with respect to which an election has been made under Section 1042. The prohibition applies to the selling shareholder, members of his or "family" and 25% or greater shareholders.	Section 409(p) contains strict rules which prohibit the allocation of "shares" (both real and synthetic") to "disqualified persons" during a "non-allocation year." **See Separate Outline.**
Delay of Distribution of Leveraged Shares	Section 409(o)(1)(B) allows an ESOP to suspend the time by which distributions must commence until the loan which was used to purchase the shares is fully paid.	It is unclear whether this special exception applies to S corporation ESOPs.

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