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CLIENT ALERT

S CORPORATION ESOPS: RIGHT FOR YOUR COMPANY?

Written by:

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If your company is currently a C corporation, you might have heard of the significant tax benefits of becoming an ESOP-owned S corporation. But if becoming an ESOP-owned S corporation is such a great idea, wouldn't every ESOP company want to be one? After all, the tax benefits for an ESOP-owed S corporation are real. In a 100% ESOP-owned S corporation, the company pays *no* federal corporate tax, and income and appreciation on shares held by the ESOP are recognized only when benefits are distributed to the ESOP participants. Unfortunately, there are several challenges that may make it difficult or impossible for an ESOP company to elect S corporation status to take advantage of the ESOP tax benefits.

This article explores some key reasons that an S corporation ESOP structure may not work for some companies.

Which Companies Can Elect to be S Corporations?

All of the shareholders of a C corporation must consent to the election to be taxed as an S corporation and all of the shareholders must be eligible S corporation shareholders. C corporations, partnerships, IRAs and non-resident aliens are not eligible S corporation shareholders, and there can be no more than 100 shareholders total (the ESOP counts as a single shareholder).

S corporations may have voting and non-voting stock but not more than one *class* of stock. Some forms of executive compensation and financial deals, including notes to shareholders, discounted stock options and stock appreciation rights, may be considered to be a second class of stock, precluding an S election.

Individual minority shareholders may be resistant to an S election. In an S corporation, corporate income is attributed to the shareholders for tax purposes. Most S corporations make distributions to shareholders to facilitate the shareholder's tax payments on corporate income. Distributions must be made pro rata per share to all shareholders, even if some, such as an ESOP, do not pay taxes. The practical result is that individual shareholders will require a promise to make substantial distributions for taxes as a condition of an S election, thereby requiring equivalent per share distributions to the ESOP and perhaps defeating the ultimate purpose of the corporate S election.

Built-In Gain (BIG) Tax and other Transition Taxes

When C corporations convert to S corporations, most of the corporate income and related tax is passed through to the shareholders. But S corporations that were C corporations still have to pay corporate-level tax on some built-in gain. The built-in gain tax applies on sales of appreciated assets that take place any time during the first 10 years after the S corporation election. Imagine that

S Corporation ESOPs—Right for Your Company?

ABC Company has an asset worth $100,000 with a $10,000 basis on the day the corporation becomes an S corp. If ABC Company sells the asset 5 years after the S election for $500,000, ABC Company could be subject to built-in gains tax on the $90,000 of built-in gain in the asset as of the S election and the remaining $400,000 gain will be passed through to the S corporation shareholders.

The BIG tax also has a potentially bad result for cash basis taxpayers. A cash basis taxpayer that elects S corp status is subject to the built-in gain tax for all accounts receivable. Finally, there may be other tax transition costs, such as pick up of LIFO reserves as corporate income.

Anti-Abuse Rules

The tax savings available to ESOP-owned S corporations come with a price. In 2001, in response to abuses by some ESOP-owned S corporations, Congress passed legislation that added Section 409(p) to the Internal Revenue Code in an effort to ensure that ESOPs provide real benefits to rank-and-file employees and not only to owner employees. The rules apply whether the ESOP owns all or only a portion of the company. The law defines the term "disqualified person" as an individual deemed to own 10% of the ESOP's shares alone or 20% together with family members and imposes rules that subject the plan to severe penalties if these individuals own more than 50% of the ESOP's S corporation equity in what is called a "non-allocation year". For purposes of calculating the ownership percentage of each participant, ownership includes certain kinds of synthetic equity (including stock options, warrants and restricted stock).

Unfortunately, the consequences of non-compliance with 409(p) are dire and the rules are unforgiving. The company pays excise tax equal to 50% of the fair market value of the prohibited allocations and 50% of the fair market value of the synthetic equity owned by disqualified persons. In the first non-allocation year, the company must also pay a 50% excise tax on the fair market value of the deemed-owned shares held by disqualified persons. For the disqualified person, the prohibited allocation is treated as a distribution and the individual may be subject to taxes and early withdrawal penalties.

For the ESOP, a non-allocation year can be the death knell. The ESOP loses the prohibited transaction exemption for any exempt loans and the plan could be subject to payment of unrelated business income tax. More importantly, the plan itself could become disqualified. Even with carefully drafted plan provisions that will prospectively prevent the occurrence of a non-allocation year, you will need meticulous plan administration. There is *no way* to fix a non-allocation year once it has occurred.

Because an ESOP is a tax-qualified retirement plan, the rules regarding nondiscrimination and coverage for these types of plans also apply. The ESOP must benefit either a certain percentage of a company's non-highly compensated employees or a classification of employees that does not disproportionately benefit highly compensated employees. For companies with fewer than 20 employees, these challenges can be significant.

Other Considerations

Even assuming you get past these hurdles, it may simply not make sense for a company to take the leap to S corporation status. In professional services companies, for example, where much of the corporate income is paid out to employees, the incentive of corporate tax savings may not be a sufficient motivator. And companies with long-term net operating losses will not get the same benefits from shedding federal tax liability.

For companies that can make it work, becoming an ESOP-owned S corporation and deferring federal income taxes can be a goal well worth achieving. But it is a goal that requires a cautious path.

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Maximizing Your ESOP's Potential

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Seems like just yesterday we were at the beach (or insert favorite vacation spot here) with the family enjoying the warm days of summer. Then school started, the leaves fell, and for us northerners the snow fell shortly thereafter. Next thing you know we are taking down the holiday decorations and writing a new year on all our correspondence, wondering where the time went.

During these past busy months, your ESOP may have been the last thing on your mind. Especially if your ESOP has been running smoothly (and we hope it has). But at the beginning of another year (and for those of you with a calendar year plan, another plan year), it is worth taking some time to think through the operation and design of your plan and ask yourself, "Is my ESOP the best it can be?" Following are just a few suggested areas to review.

Distributions: Distributions in any qualified plan can be a complex and time-consuming process. ESOPs, like all qualified plans, are subject to the general ERISA distribution rules that require distributions to begin no later than certain life events such as retirement, death, and attainment of age 70 ½. However, ESOPs are also subject to section 409(o) of the Internal Revenue Code ("Code") which usually accelerates the timing of distributions to be earlier than otherwise required under ERISA. And since ESOPs by definition are designed to invest primarily in employer stock, they must also be concerned about the form of distribution, whether it is in stock, cash, or both. Code section 409 (h), which contains rules regarding the right of the participant to demand employer securities and the obligation of the employer to follow the put option requirements, does allow certain ESOPs to avoid distributing in the form of stock. Depending on the form of distribution, additional decisions must be made including deciding where the shares will end up (back in the plan or with the employer), and where the cash will come from to make the cash distributions.

Confused yet? Overwhelmed? What if your plan has leveraged and non-leveraged assets, pre-87 and post-86 assets, participants eligible for diversification, or QDROs? If by some miracle you are able to understand all the rules and know which apply to your plan, many of the rules dictate only the outer parameters that the ESOP must follow. While this flexibility is a necessity for an ESOP, it further complicates things as the ESOP company tries to balance corporate, employee, and ESOP concerns when designing distribution guidelines. For example, you may want to pay distributions out immediately to prevent terminated employees from sharing in the growth of the company via the shares in their ESOP account. However, since your distribution requirements must be nondiscriminatory, these same distribution provisions could apply to longer term participants with large balances and you are worried this might encourage participants to terminate just to receive a distribution. And let's not forget the effect any decision has on your repurchase obligation.

If you have not done so already, one of your first steps should be to have a repurchase obligation study done. Based upon this study and after prioritizing your objectives, decisions can be made regarding your ESOP distribution provisions. These decisions can be specified in your plan document or your document may contain only the statutory language with the specifics in a separate distribution policy. One advantage to having a separate distribution policy is the ability to make changes to the policy, because of changing objectives or your repurchase obligation, without having to amend your document.

Compliance testing: If in addition to your ESOP you sponsor another qualified plan, such as a 401(k) plan, care must be taken in the coordination of the two plans, especially in the area of compliance testing. Two tests which are required to ensure that deferral and matching contributions do not discriminate in favor of highly compensated employees are the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test. For employers who have difficulty passing these tests, a safe harbor provision is one solution. With a safe harbor employer contribution of 3%, the ADP test is deemed to pass. With a safe harbor matching contribution (generally a tiered formula which works out to 4%), both the ADP test and ACP test are deemed to pass. Also, the safe harbor rules allow that another plan besides the 401(k) plan can be designated as the recipient of the safe harbor contribution. By contributing the safe harbor match to the ESOP instead of the 401(k), other problems beyond compliance testing may be resolved. For example, let's say your ESOP is leveraged and required loan payments are significant. You are already bumping up against the contribution limits. In addition, you feel you are already at the desired benefit levels for your participants. By designating a portion of the existing loan payments as a safe harbor match contribution, no additional contributions are required, so benefit levels and amounts counted towards contribution limits remain the same.

Implementing a safe harbor provision in the ESOP is not without its price tag - immediate vesting, notice requirements, and coordinated eligibility provisions between the plans to name just a few. Careful review of both plans and all of the safe harbor rules is recommended before implementing a safe harbor plan. If designed right and communicated well to the employees, a safe harbor provision can be a great solution. However, if you decide that a safe harbor ESOP is not for you, an ESOP can always receive matching contributions, whether or not it is part of a safe harbor plan. While the ADP test and ACP test must still be performed and passed, other objectives may still be met.

<u>Dividends:</u> With employer contributions usually the primary funding source for an ESOP, dividends can be an overlooked tool. Code section 404(k) allows a C corporation a deduction on dividends paid on employer securities held by an ESOP as long as certain requirements are met. Because of this deduction, dividends can play a strategic role in your ESOP. Dividends are deductible if paid in cash directly or through the ESOP to participants, or reinvested in employer securities if participants have been given the option to receive the dividends in cash. An advantage to "passing through" dividends to participants is that they get a check in hand. If you are struggling with making the ESOP valuable and real to your employees, this might be the way to go. Dividends are also deductible when used to repay an ESOP loan as long as certain rules are followed. Dividends do not count against deduction limits and annual addition limits. So in a leveraged ESOP with significant loan obligations, dividends can be used to make loan payments without causing problems with the various limitations.

Code section 404(k) is not available to S corporations so dividends (earnings distributions in the S corporation world) paid to an ESOP by an S corporation are not deductible. So what role can earnings distributions play in an S corporation? They can still be passed through to participants. However, they will be treated the same as any plan distribution so are subject to all the consent, rollover and mandatory withholding rules, and the excise tax on early distributions. S corporation earnings distributions can also be used for loan payments. And since the American Jobs Creation Act of 2004, S corporations can use earnings distributions on both allocated and unallocated shares to pay down the ESOP loan. Since S corporations have lower deduction limits than C corporations, using earnings distribution for loan payments is a valuable option for an S corporation.

If no deduction for the corporation is needed (or in the case of the S corporation even an issue), the dividends may stay in the plan to be used for other purposes such as funding your repurchase obligation and future stock purchases, or paying plan expenses.

Should you have any questions, please contact Tina Fisher at (330) 722-6111 or tfisher@sesadvisors.com.