# "S" Corporations + ESOP: A Powerful Tax Advantaged Exit Strategy

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Employee Stock Ownership Plans (ESOPs)

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Several years ago, Congress permitted S corporations to sponsor employee stock ownership plans ("ESOPs"). That change permitted S corporations to utilize ESOPs to significantly reduce or totally eliminate taxes paid by the shareholders of the S corporation, while at the same time providing an exit strategy for owners of closely held businesses.

An ESOP is a specially designed qualified plan, the sole purpose of which is to purchase stock of the sponsoring company while providing significant tax advantages to the company, shareholders, selling shareholders and employees.

An ESOP may be established by either an S corporation or a C corporation. Briefly stated, the company generally establishes the ESOP as part of an exit strategy for existing shareholders. ESOP purchases are often funded by “leveraging” the ESOP (i.e., borrowing funds from a bank) to provide funds for the ESOP purchase from the owners. Due to the current economy, many ESOP transactions are being “seller financed” providing significant flexibility to the company as well as a tax advantage to the selling shareholder.

S corporations are able to take advantage of tax treatment not available to ESOPs established by C corporations. S corporations are not taxed under the federal tax law at the corporate level, but rather at the shareholder level. The ESOP trust, as a shareholder in the corporation, is exempt from tax. Therefore, any corporate income tax attributable to the ESOP results in significant federal income tax savings for the S corporation shareholders. For example, if an ESOP owns 50% of an S corporation, 50% of taxable income attributable to the ESOP is not taxed. It is not unusual that an ESOP becomes a 100% owner of an S corporation thereby eliminating all federal taxes at the shareholder level. These tax savings serve as “found money” which can be used to fund the selling shareholder exit without putting any additional cash flow pressure on the company.

By implementing an ESOP, the shareholders establish an exit strategy, the management team sees that a perpetuation plan is put in place, and employees also benefit by having company stock allocated to their respective accounts in the ESOP trust.

An ESOP does not fit every circumstance. However, an ESOP has several business and tax advantages for both C and S corporations. These advantages should be carefully reviewed whenever an owner of a company is developing an exit and perpetuation strategy.