ESOP Tax Reference Guide

Employee Stock Ownership Plan ("ESOP") - Selling Shareholder Tax Advantages

- Section 1042 of the Internal Revenue Code allows for the deferral of federal capital gains taxes
  - Eligibility requirements and considerations for the selling shareholder's deferral of capital gains:
    - C-corporation status
    - Minimum of a 30% sale to an ESOP
    - Reinvestment of ESOP sale proceeds into qualified replacement property within 12 months of the close of the ESOP transaction
      - Qualified replacement property includes domestic stocks and bonds; additional financing products available for those who wish to get a loan against their domestic stocks and bonds portfolio in order to retain cash or invest in ineligible property
    - Selling shareholder may not have received the C-corporation stock as part of an employee benefit plan or stock option plan
    - Selling shareholder must have held the C-corporation stock for 3 years prior to the ESOP transaction
    - Selling shareholder and certain family members are ineligible to receive allocated ESOP shares
  - Many states allow for a similar treatment for state capital gains taxes
  - No capital gains deferral is available to S-corporations

Characteristics of a Good ESOP Candidate

Shareholder Tax Implications:	Stock Transaction	1042 C-corp ESOP Transaction (1)
Sales Price	$50,000,000	$50,000,000
Basis	$5,000,000	$5,000,000
Capital Gain	$45,000,000	$45,000,000
Federal Income Tax at 20% (2)	$9,000,000	$0
Net Proceeds (3)	$36,000,000	$45,000,000

(1) IRC 1042 allows for the deferral of capital gains and may be deferred indefinitely.
(2) Only federal income taxes considered for simplicity. State capital gains taxes may be deferred in certain states.
(3) Non-ESOP or S-corp ESOP transactions have unencumbered net proceeds whereas the 1042 C-corp must reinvest in qualified replacement property.

S-Corporation ESOP Tax Advantages

- No federal income taxes as an S-corp is a pass through entity and an ESOP is a tax-exempt entity
- Most states treat ESOPs as state income tax-exempt
- Principal payments on a ESOP loan are deductible
- May not utilize last in, first out method of inventory accounting
- Distributions are not tax deductible
- Contributions to the ESOP, in combination with any other qualified benefit plan, are deductible

C-Corporation ESOP Tax Advantages

- Dividends are tax deductible when utilized to repay an ESOP loan or paid to the participants
- Contributions may be deductible up to 50% for leveraged ESOPs. Contributions up to 50% of the total compensation of ESOP participants may be deductible based upon two buckets of 25% limitations:
  - ESOP contributions for the repayment of the ESOP loan principal and interest; and
  - Employer contributions to any other defined contribution plan or contributions not utilized for the repayment of the ESOP loan or interest

For further questions on ESOPs, please contact **Jennifer Krieger**
Oklahoma City: 405.594.9195 **Houston:** 832.320.3414
Email: jennifer.krieger@weaver.com
ESOPs at weaver.com | LinkedIn

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