ESOPs and other employee benefit trusts have been allowed to own stock in an S corporation since January 1, 1998. According to the National Center for Employee Ownership, S corporations sponsoring ESOPs have a significant tax benefit not available to C corporation ESOPs; no income tax is due on the ESOPs’ portion of corporate earnings. ESOP participants presumably pay tax when their shares are distributed to them, but participants have the option of rolling their distributions into an IRA and further deferring taxes. Since S corporations are authorized only one class of stock any distributions paid out must be paid to the ESOP as well. Because the ESOP does not pay taxes, the distributions attributable to non-allocated shares can be used to buy additional shares or reduce debt. The tax savings can be considerable where the ESOP owns a substantial part of the company’s stock, even reducing taxes to zero where the ESOP owns 100% of the shares.

S corporations do not have the same tax benefits as a C corporation ESOP. S corporation owners cannot defer tax on the gain of stock sold to an ESOP. C corporation ESOPs can deduct up to 25% of eligible salary expense to repay principal and 100% of interest expense on the ESOP loan, while an S corporation ESOP can deduct only 15% of pay for principal and interest payments. This limit can be increased to 25% when combined with a non-discretionary money purchase pension plan. C Corporation ESOPs can deduct dividends used to repay an ESOP loan or passed directly through to participants; the general consensus is that S corporations cannot, although this issue is unclear.

Keith D. Butcher, Esq., of Womble, Carlyle, Sandridge & Rice PLLC’s Charlotte, NC office has seen a large increase in ESOP activity in recent years, which he principally attributes to two issues: the strong U.S. economy and S corporation eligibility. Owners of private companies have benefited from the prolonged economic expansion and see ESOP formation as a way to diversify their wealth, which is generally neither diversified nor liquid. Owners of S corporations can now consider ESOPs, whereas in the past they would have to convert to a C corporation to be eligible. ESOPs can also be used to raise capital for acquisition or expansion, with favorable tax treatment not available to non-ESOP companies.

There are several valuation issues concerning ESOPs in S corporations, such as the marketability issue surrounding shares converted into cash prior to distribution, and whether the enhanced cash flow due to the lack of income tax expense increases the value of all of the company’s shares or only the shares in the ESOP. If you are considering forming an ESOP for your business, contact the valuation professionals at Banister Financial to discuss these critical valuation topics.

Gary R. Gerlach, ASA, is a Senior Vice President of Banister Financial, Inc., a business valuation firm in Charlotte, North Carolina. He can be reached at ggerlach@businessvalue.com.

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