

Maximizing Retirement Benefits Using a Subchapter S Corporation ESOP

By Ira Langer

Ira Langer explores the benefits of using S Corporation owned ESOPs in retirement planning and addresses some frequently raised concerns.

In 1998 Congress revised the S Corporation “S Corp” rules to allow S Corp shares to be owned by Employee Stock Ownership Plans (ESOPs). The result of this change is that, in appropriate situations, owners of an S Corp can create an ESOP in place of the usual profit-sharing retirement plan arrangement to generate substantially increased retirement benefits for themselves.

There is little doubt that S Corp ESOPs are being underutilized. Putting aside the complexities of the various rules and the high front-end expenses involved in the creation of any ESOP, one of the major reasons for this underutilization is the unfounded belief that only large corporations can make use of the ESOP structure. This, combined with the fog of misunderstanding with respect to how ESOPs actually work and the benefits available from their use in different situations, results in an atmosphere of apprehension whenever the topic of an ESOP retirement plan design is raised.

This article will show the substantial financial retirement benefits to be obtained from an S Corp ESOP, will give a general description of the statutory framework together with an analysis of selected

important issues and will close with a discussion of steps to be taken to deal with the fairly new restrictions imposed by Code Sec. 409(p). We will not deal with the use of an ESOP as an “exit strategy” or as a “diversification vehicle,” topics that have been adequately covered elsewhere.

Overview

Increased Retirement Benefits for Participants of an S Corp ESOP

There is no current tax on earnings of an S Corp. Instead, all earnings are automatically deemed passed through to the S Corp shareholders and the income is taxable to them. However, where the shareholders are also tax-exempt, there is no tax whatsoever on the S Corp income. That is exactly what happens in the case of an ESOP, which is nothing more than a modified special purpose profit-sharing plan designed to invest primarily in employer securities, with accompanying special rules and restrictions.

Compound Growth of ESOP Assets

The tax deferred S Corp earnings can remain in the ESOP and continue to grow on a compounded tax-deferred basis until ultimate distribution at retirement. Even when the employee’s benefit does ultimately become subject to income tax, the amount of the participant’s retirement account fund is so much larger than would otherwise have been the case (as demonstrated below), that the after-tax amount re-

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Table 1.

	Shareholder-Owned C Corp	ESOP-Owned S Corp
Net Corporate Income	\$500,000	\$500,000
34% Federal Corp. Tax	(\$170,000)	-0-
Net Distribution to Shareholders	\$330,000	\$500,000
Tax on Shareholder's Dividends (15% Rate)	(\$49,500)	-0-
Net Available for Investing	\$280,500	\$500,000
Balance at End of 20 Years (Assume 8% Return)	\$1,307,000	\$2,330,500
15% Capital Gains Tax when Assets Sold at End of 20 Years	(\$196,000)	N/A
Net to Shareholders (After Reduction for 15% Capital Gains Tax)	\$1,111,000	N/A
Net After Tax ESOP Distribution to Participants (After Reduction for 35% Individual Federal Rate)	N/A	\$1,515,000

maining in the participant’s pocket is invariably more than under other retirement plan scenarios.

Deferral and Rollover Options

Importantly, even when the participant terminates employment or retires, the amount in the ESOP account need not become immediately subject to tax. Benefit distributions can be “spread out” over a period of time, permitting the undistributed balance to continue to increase in value (remember, the ESOP is a glorified profit-sharing plan). Moreover, Code Sec. 409(o) allows an ESOP to provide for a one-year deferral of distribution commencement in the case of normal retirement, disability or death; and a five-year deferral in the case of separation from service other than by normal retirement, disability or death. The distribution must be over a five-year period (extended somewhat in the case of a larger account balance), but the participant can elect otherwise, for example, distribution over 10 or 15 years, or indeed over the remaining life expectancy period of the participant.

Finally, instead of commencing taxable distributions, tax can be further deferred by rolling over the amount in the account either to a new employer’s plan, or to the participant’s personal IRA account. After rollover these amounts can continue to grow until the participant actually withdraws the funds for personal use or is forced to commence minimum required distributions at age 70 ½ .

Continued Asset Growth Even after Distributions Commence

A participant who has other available funds to cover annual living expenses can allow the amounts that were previously rolled over into the IRA to continue to grow even after the minimum required distribution

begins at age 70 ½. For the first five to 10 years, the mandated distribution percentage that must be paid out of the IRA account goes from 3.7 percent of the account at age 70 to only 5.3 percent of the account at age 80. (Bear in mind that the IRS minimum required distribution table is based on an assumption that allows the participant to live beyond age 115). Thus, the amount of the mandated withdrawal from the IRA in the early years is nominal in comparison to the amount that continues to remain in the IRA and continues to grow tax-deferred.

Increased Retirement Benefits

The following two tables provide insight into the magnitude of the increased retirement benefit amounts available from an S Corp ESOP. To avoid distracting side-issues, we will focus only on federal tax implications; but understand that the results will be even more impressive when state income taxes are factored in.

Table 1 compares C Corporation (C Corp) shareholders with participants in a 100 percent-ESOP-owned S Corp.

The above table shows that the net after tax distribution to ESOP participants is approximately \$400,000 more than the net distribution to C Corp shareholders. Moreover, the table assumes the most favorable investment options for the C Corp shareholders, namely they earned only long term capital gains taxable at the assumed 15-percent capital gains rate at the end of the 20-year period. Clearly, if their earnings were ordinary income taxable at the 35-percent assumed rate, and if they were subject to tax over the 20-year period rather than at the end, the “spread” between the C Corp shareholders and the ESOP participants would be greater.

Table 2.

	Shareholder-Owned C Corp	ESOP- Owned S Corp
Net Corporate Income	\$500,000	\$500,000
34% Federal Corp. Tax	(\$170,000)	-0-
Net Distribution to Shareholders	\$330,000	\$500,000
Tax on Shareholder's Dividends (15% Rate)	(\$49,500)	-0-
Net Available for Investing	\$280,500	\$500,000
ESOP Balance at End of 20 Years (Assume 8% Return)	N/A	\$2,330,500
Net Available to Shareholders at End of 20 Years (Assume Same 8% Return but Earnings are Taxed Annually [35% Rate] as Ordinary Income, e.g. Interest and Short-Term Gains)	\$773,000	N/A
Net After Tax ESOP Distribution to Participants (After Reduction for 35% Individual Federal Rate)	N/A	\$1,515,000

The example shown in the following Table 2 is the same as Table 1 except that the annual earnings of the C Corp shareholders are taxed annually at ordinary rates.

In the situation shown in Table 2, above, the ESOP plan participants receive a distribution that is worth \$742,000 more than their counterpart C Corp shareholders. If we assume that a real world situation averages somewhere between the 100-percent capital gain scenario in Table 1 and the 100-percent ordinary income in Table 2, we have the following: $\$1,111,000 + \$773,000 \div 2 = \$942,000$. Thus our theoretical shareholders of the C Corp would be receiving a net after tax distribution of \$942,000 compared to the \$1,515,000 received by the participants in the ESOP plan. This results in an additional \$573,000 being received by the ESOP participants as compared to their C Corp shareholder counterparts. This differential is very impressive. Multiply this by a factor representing similar growth of each future year's S Corp profits passing through the ESOP, and there is no denying that an S Corp ESOP retirement benefit program should be seriously considered when the fact pattern otherwise allows use of an ESOP.

Operative Tax Rules

Having concluded that an S Corp ESOP can provide substantial financial benefits to the ESOP participants, we turn now to an examination of how the S Corp ESOP fits into (1) the generally applicable S Corp rules of Code Secs. 1361-1379 and (2) the ESOP rules of Code Secs. 409, 512-514 and 4975(e).

ESOP Owned S Corp

Code Sec. 1361(c)(6) provides that a retirement plan qualified under Code Sec. 401(a) and exempt from tax under Code Sec. 501(a) "may be a shareholder in an S Corporation." This provision authorizes an ESOP to be a shareholder, including a 100-percent shareholder, in an S Corp. Under the general S Corp rules, the net earnings of the S Corp are not taxed at the corporate level. Instead, the earnings "pass through" to the shareholders and are taxed to the shareholders whether distributed or not.

The S Corp rules thus remove the corporate-level of tax from the tax equation. The next step is

to remove the shareholder-level of tax from the tax equation. This can be accomplished if the S Corp shareholder is a tax exempt entity, such as an ESOP. In such case, there would be no tax at the shareholder level on the S Corp income, unless the tax exempt entity is subject to the unrelated business taxable income rule (UBTI) of Code Sec. 512. In fact, Code Sec. 512(e) does provide that an organization described in Code Sec. 1361(c)(6) [*i.e.*, a retirement plan qualified under Code Sec. 401(a), which includes all profit-sharing plans, pension plans, 401(k)s, *etc.*] that holds shares in an S Corp is subject to the UBTI tax rules. Fortunately, however, Congress amended Code Sec. 512(e) effective 1998 to add the following provision:

(3) Exception for ESOPs—This subsection shall not apply to employers securities ... held by an employee stock ownership plan described in Section 4975(e)(7) [*i.e.*, an ESOP].

Importantly, even when the participant terminates employment or retires, the amount in the ESOP account need not become immediately subject to tax.

Moreover, the legislative history makes it clear that an ESOP is treated as representing only “one” shareholder in the S Corp, regardless of the number of participants in the ESOP. This puts to rest any possible concern over the 100 shareholder limit on S Corps of Code Sec. 1361(b).

An interesting note on the UBTI exemption for ESOPs is that other qualified plans, such as profit-sharing or 401k plans, which are also permitted to hold S Corp stock by virtue of Code Sec. 1361(c)(6), are not exempt from the UBTI tax regime. Thus, the strategy discussed here for ESOPs would not apply to any other type of qualified retirement plan.

Distributions in Cash or in Kind

Under Code Sec. 409(h), a qualified ESOP must allow the participant to “demand that his benefits be distributed in the form of employer securities.” Employees who wish to convert their employer securities into cash are also given a “put option” by Code Sec. 409(h) that requires the employer to repurchase employer’s securities distributed from the plan under a fair market valuation formula. If there were no exception to this rule for ESOPs holding S Corp stock, the S Corp election could be invalidated if, over the course of time, distributions of S Corp stock were made to more than 100 participants, or if employees receiving benefits from the ESOP rolled over their S Corp stock into a rollover IRA, since IRAs are not eligible to hold S Corp shares under Code Sec. 1361(b).

Again Congress came to the rescue with Code Sec. 409(h)(2), which provides that an ESOP may provide that benefit distributions shall be made “in cash or in the form of employer securities.” The result is that the S Corp can protect its S Corp election status by providing in the ESOP document a distribution requirement that benefits be distributed in the form of cash (the FMV equivalent of the S Corp shares that would have been distributed). Alternatively, the trustees could be instructed to distribute cash in lieu of S Corp shares.

Distributing cash instead of securities requires that the ESOP trustees plan ahead for sufficient liquidity within the ESOP to make such cash distributions. In general, the ESOP can obtain such needed liquidity: (a) by tendering some of its shares back to the S Corp for redemption by the corporation in exchange for their current fair market value in cash, or (b) by retaining some portion of the employer’s annual “profit-sharing” contribution into the ESOP, which is generally made in the form of cash, and using that

cash for purposes of paying benefits to terminating participants. The latter option requires coordination between the plan trustees and the S Corp with respect to the timing and amount of the employer contribution into the plan, since the plan may need some portion of such contributions for any required loan repayment installment on any borrowing that the ESOP may have made from a financing institution in connection with the original ESOP transaction.

Frequently-Raised Objections to S Corp ESOPs

Since 1998, when Congress first allowed ESOPs to be shareholders in an S Corp, various commentators have raised three issues that were thought to be valid reasons to avoid implementing an ESOP in the S Corp arena. These issues relate to specific tax benefits that are otherwise available when a C Corp sponsors an ESOP, but which are *not available* when an S Corp sponsors an ESOP. These are:

1. The Code Sec. 1042(c) tax deferral on the sale of corporate stock to an ESOP is not available to S Corp shareholders. Code Sec. 1042(c)(1)(A).
2. Certain increased tax deductions for contributions used to cover repayments on an ESOP loan are not available in the S Corp situation. Code Sec. 404(a)(9)(C).
3. S Corp dividends paid to the ESOP are not deductible as they are in specific situations when they are paid by a C Corp. Code Sec. 404(k)(1).

We will address these three issues as follows:

1. Code Sec. 1042 Tax Free Exchanges

There is no question that one of the major incentives for a sole shareholder of a closely held corporation to establish an ESOP has always been the ability to dispose of the shareholder’s shares in the company without incurring a current capital gains tax. As mentioned, this Code Sec. 1042 tax deferral is not applicable to the sale of S Corp stock to an ESOP. There are a number of ways around this roadblock:

- The Code Sec. 1042 benefits can be obtained by arranging for the sale to the ESOP while the corporation is still a C Corp, and then electing the S Corp status in a later year. As long as the C Corp Code Sec. 1042 stock sale is not directly dependent upon a later S Corp election, or, put another way, as long as the decision to make an S Corp election might or might not be revoked at anytime in the following year without having any impact at all on the Code Sec. 1042 stock sale,

there appears to be agreement that the IRS could not challenge the subsequent S Corp election.

- In many situations, the S Corp owner(s) may not be seeking a tax deferred sale of their stock. This would be the case, for example, where the owners are focused primarily on substantially increasing their retirement benefits by way of the ESOP rather than avoiding the capital gain on the stock sale. Increased retirement benefits would be available for the owner group, as well as those family members who are employees of the S Corp and are participants in the ESOP plan.
- The S Corp stock may have built up substantial tax basis over the years. This would occur where the company has retained its earnings to reinvest in the company to aid in the growth of the business. Alternatively, the S Corp stock may have been inherited, in which case the shares received a *basis step up* to fair market value on the decedent's date of death. In such cases, the S Corp shareholder can afford to sell the shares to the ESOP without the tax deferral benefit of Code Sec. 1042 because the amount of the realized gain is reduced by the basis in the S Corp stock, and the remaining gain would only be taxed at the low current 15-percent capital gains rate.

Distributing cash instead of securities requires that the ESOP trustees plan ahead for sufficient liquidity within the ESOP to make such cash distributions.

2. Code Sec. 404(a)(9) Contributions Used to Repay the ESOP Loan

The inability to use certain *increased tax deductions* at the corporate level is a minor item in the overall scheme of things. In the example we used in Tables 1 and 2, the S Corp was 100-percent owned by the ESOP. In such a situation, deductions play no role because the S Corp pays no tax and the sole shareholder is the ESOP, which also pays no tax. Entities that pay no tax have little interest in tax deductions.

Even when we look at a situation where the S Corp is owned partly by the ESOP and partly by individual shareholders, loss of the Code Sec. 404(a)(9) increased tax deduction is of little impact. It is not the deduction we are interested in, it is the need to provide a sufficient cash flow into the ESOP to permit the orderly repayment of outstanding ESOP financing, and that cash flow need may be handled

by additional S Corp distributions as explained in the next paragraph.

The Code Sec. 404(a)(9) increased tax deduction is only an issue in a “leveraged ESOP” situation; where the planning goal is to substantially increase retirement benefit amounts rather than use leveraged financing for the sale/purchase of company stock, the issue does not arise at all. Moreover, given the current 25 percent of compensation overall annual maximum contribution level that is permitted since The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), employers should have less of a problem obtaining the level of sought-after tax-deductible contributions into the ESOP. Finally, if in fact we were dealing with a leveraged ESOP situation where the annual repayments on the loan

exceeded the 25-percent contribution limit, additional distributions of income would have to be made by the S Corp to the ESOP, and if there were any other S Corp shareholders, the distribution would be done on a prorated basis.

3. Code Sec. 404(k)(1) Nondeductibility of S Corp Dividends Paid to the ESOP

The fact that an S Corp is not allowed a separate deduction for dividends paid to the ESOP that are used to repay the ESOP loan can be simply dealt with. As mentioned in the preceding discussion under Code Sec. 404(a)(9), a 100-percent ESOP-owned S Corp does not need deductions. The real issue is cash flow to pay off the ESOP financing. For this, the S Corp simply pays the dividends without receiving a deduction and no one has been harmed.

If necessary, the ESOP will simply initially negotiate a longer loan repayment period. For example, instead of having the ESOP financing loan repaid over the first five years of the life of the ESOP, the loan could be repaid over a seven to ten year period. This allows for lower annual repayment installments, which eliminate the need for the additional cash dividends, *etc.* that would otherwise be paid into the ESOP to provide additional cash for the loan repayment. This, coupled with the 25-percent overall contribution level discussed in section two above, generally should resolve this issue.

Dealing with the Code Sec. 409(p) Prohibitions

Up to this point, we have seen the substantial benefits that can be obtained by way of an S Corp ESOP. We turn now to Congress' concern that the S Corp ESOP could be used in a way that would result in tax abuse. In 2001, as part of EGTRRA, new Code Sec. 409(p) was added to the Code to eliminate perceived areas of tax abuse.

The *first issue* that concerned Congress involved situations where the company had only a small number of employees, where an ESOP might be used to defer substantial amounts of income for the S Corp owners without benefiting a larger number of nonowner employees. Congress felt that the ESOP benefits in the S Corp arena should be made available only where the ESOP constituted broad-based employee ownership of the business. A *second area* of potential abuse existed where an S Corp issued "synthetic equity", *i.e.*, stock options, warrants, restricted stock, phantom stock or similar corporate ownership rights that would give the holder the ability to acquire additional S Corp stock in the future. Issuance of large amounts of synthetic equity would ultimately mean that the ESOP's ownership of the S Corp would be seriously diluted when the synthetic equity matured into actual ownership interests in the company.

Code Sec. 409(p) was enacted as part of EGTRRA, and became effective in 2005 to prevent these perceived abuses. Code Sec. 409(p) accomplished this by imposing severe tax penalties whenever an ESOP allocates, holds or accrues employer securities on behalf of "disqualified persons" during a "non-allocation year."

"Disqualified persons" are (i) individuals who own (*without* attribution) at least 10 percent of the "deemed-owned" shares of the company (in general, shares allocated or potentially allocable to the individual under the ESOP; excluding shares actually owned outside the ESOP but including synthetic equity under Code Sec. 409(p)(5)), or (ii) individuals who own (*with* family attribution and constructive ownership) *at least 20 percent* of the total "deemed-owned" shares. A "non-allocation year" is any year in which disqualified persons own or are deemed to own through attribution, including attribution from

the ESOP, at least 50 percent of the outstanding shares of the S Corp.

The net result of passage of Code Sec. 409(p) is that an S Corp that wishes to establish an ESOP to obtain the benefits described earlier in this article, must be structured (and must structure the ESOP) so that disqualified persons do not own, after attribution, 50 percent or more of the stock of the S Corp. Where the S Corp (and hence the ESOP it establishes) has a large employee population, Code Sec. 409(p) does not present any problem at all, since no single ESOP participant will have an ESOP account allocation of S Corp shares representing at least 10 percent of the total S Corp shares held by the plan.

Thus, Code Sec. 409(p) is only an issue where there are not sufficient plan participants to ensure that no one person is allocated 10 percent or more of the S Corp shares in the plan. Taken in its simplest terms, Code Sec. 409(p) means that where 50 percent or more of the S Corp stock is owned by a group of disqualified persons, those persons should

be excluded from participation in the ESOP. Indeed, ESOP documents often contain "fail-safe" provisions to ensure that these restrictions are satisfied.

When a business is owned by a single owner or a small group of owners, those individuals generally are interested primarily in the tax-deferred diversification offered by a Code Sec. 1042 sale. As explained previously, use of Code Sec. 1042 is restricted to a C Corp, and generally prevents use of an S Corp ESOP, which coincides with the goal of Code Sec. 409(p). On the other hand, where the ownership of the S Corp is sufficiently dispersed or the percentage of ESOP participation by the S Corp owners is sufficiently low to allow steps to be taken to avoid the 10-percent or 20-percent tests for a "disqualified person", appropriate advance planning can allow for satisfaction of the Code Sec. 409(p) requirements so as to have an S Corp ESOP without incurring any Code Sec. 409(p) penalties. In appropriate situations this may involve any of the following:

- Transferring some of the S Corp stock held for an owner participant in the ESOP out of the ESOP. This can be accomplished either *with* or *without* the assistance of Reg. §1.409(p)-1(b)(2)(v) that contains rules for this type of transfer. [The regulation also points out that transfers of S Corp shares to a non-ESOP qualified plan will subject the receiving plan to UBTI tax under Code Sec. 512(e)(1)].

Congress has placed roadblocks in the path of a successful S Corp ESOP, but for the most part, they are not insurmountable.

- Selling some portion of the S Corp stock held in the participant’s ESOP account and reinvesting the proceeds in non-S Corp securities.
- Reducing the percentage of S Corp shares being allocated to the owner(s) so as to keep each individual below the 10-percent threshold. One way to do this is to use “per capita” allocation of contributions rather than the usual “pro-rata to compensation” allocation method. [This would be done only as a short term measure to allow time to implement other corrective steps.]
- Reducing the amounts of outstanding “synthetic equity” held by the participants, either through a sale to an unrelated party or by simply canceling the interests.

Conclusion

Congress has placed roadblocks in the path of a successful S Corp ESOP, but for the most part, they are not insurmountable. The Code Sec. 409(p) restrictions now make it more difficult for S Corp owners to participate in the ESOP. However, in situations where the owners are more interested in the tax-deferred diversification options available only to a C Corp ESOP, they would not be using an S Corp ESOP in any event. Where the plan can be structured to avoid having any Code Sec. 409(p) “disqualified persons” as plan participants, substantially increased retirement dollars can be generated by use of an S Corp ESOP.

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