Frost Ruttenberg & Rothblatt PC
CPAs & Business Advisors
Deerfield • Chicago • International
847.236.1111 • www.frrCPAs.com

Ready to retire?

An ESOP can help pave the way

Most business owners have a lot of wealth tied up in their companies. If you're in the same boat, how can you convert some of that wealth into cash to help pay for your retirement? Many C corporation owners have found that an Employee Stock Ownership Plan (ESOP) — a qualified retirement plan, similar to a profit sharing or 401(k) plan — can help pave the way to a comfortable future.

The nuts and bolts

The main difference between an ESOP and other types of retirement plans is that, instead of investing in a variety of stocks, bonds and mutual funds, an ESOP invests primarily in the employer's own stock. So, how does it work?

The employer makes tax-deductible contributions to the ESOP, which the plan uses to acquire stock from the company or its owners. Essentially, by establishing an ESOP, you're creating a buyer for your shares.

At the same time, you provide a powerful incentive for employees, who now have an opportunity to share in the company's growth on a tax-deferred basis. When employees retire or otherwise qualify for distributions from the plan, they can receive benefits in the form of stock or cash.

Like other qualified plans, ESOPs are strictly regulated. They must cover all full-time employees who meet certain age and service requirements, and they're subject to annual contribution limits (generally 25% of covered compensation), among other conditions.

ESOPs are also subject to rules that don't apply to other types of plans. For example, an ESOP must obtain an independent appraisal of the company's stock when the plan is established and at least annually thereafter.

Also, participants who receive distributions in stock must be given the right to sell their shares back to the company for fair market value. This requirement creates a substantial repurchase liability that the company must prepare for.

The financial advantages

An ESOP provides several tax benefits. If the ESOP acquires at least 30% of your company, you can defer the gain on the sale of your shares indefinitely by reinvesting the proceeds in qualified replacement property within one year after the sale — an advantage over an outright sale. Qualified replacement property includes most securities issued by domestic operating companies.

ESOPs are unique among qualified retirement plans because they permit a company to finance the buyout with borrowed funds. A "leveraged" ESOP essentially permits your company to deduct the interest and the principal on loans used to make ESOP contributions — a tax benefit that can do wonders for cash flow. Your company can also deduct certain dividends paid on ESOP shares. Interest and dividend payments don't count against contribution limits.

The right to keep control

Another advantage of ESOPs over sales or other exit strategies is that they allow you to cash out without giving up control over the business. Even if you transfer a controlling interest to an ESOP, most day-to-day decisions will be made by the ESOP's trustee, who can be a company officer.

However, ESOP participants may have the right to vote their shares on certain major decisions, such as a merger, dissolution or sale of substantially all of your company's assets.

ESOPs can work for S corporations, too

ESOPs can work for S corporations, too. But there are some significant differences in how the ESOP rules apply to S corporations. If you own an S corporation and an ESOP is of interest to you, contact your tax, legal and benefits advisors for more information.

A good tool

An ESOP has many advantages if you wish to exit from your C corporation. It not only allows you to defer your gain indefinitely by reinvesting the proceeds in qualified replacement property, but it also allows your company to deduct the interest and the principal on loans used to make ESOP contributions.

If you're thinking about retirement, an ESOP might just be the vehicle to get you there. But be sure to work closely with your tax, legal and benefits advisors, because ESOPs are extremely technical.