TAX INCENTIVES FOR EMPLOYEE STOCK OWNERSHIP PLANS

Tax-Deductibility of ESOP Contributions

Non-Leveraged ESOP

Employer contributions to an ESOP are tax-deductible, subject to certain limits and restrictions under the Internal Revenue Code. Contributions to a non-leveraged ESOP can be deductible in amounts up to 25% of covered payroll. Contributions in the form of employer stock are deductible based upon the fair market value of the shares on the date the shares are issued to the ESOP.

Leveraged ESOP

For a leveraged ESOP, a deduction of up to 25% of covered payroll is allowed for contributions used to repay ESOP loan principal. Contributions by a C corporation used to pay interest on an ESOP loan are fully deductible (and not limited by covered payroll) if not more than 1/3 of the ESOP contributions are allocated to "highly compensated employees."

Tax-Deferred Sale of Stock to ESOP

A shareholder of a "closely-held" corporation may sell company stock to an ESOP and defer the taxation of gain to the extent that he reinvests in securities of other corporations. The sale must be one that would otherwise result in long-term capital gain to the selling shareholder, the shareholder's holding period for the stock must be at least three years and the shareholder must not have received the stock from a qualified employee plan (such as an ESOP), by exercising a stock option or through another employee stock purchase arrangement. The replacement securities must be purchased within the 15-month period that begins three months before and ends 12 months after the sale of company stock to the ESOP. The replacement securities must be securities issued by unrelated U.S. operating companies (more than 50% of whose assets are used in an active trade or business) whose passive investment income does not exceed 25% of gross receipts. After the sale the ESOP must own at least 30% of the common equity of the employer corporation. The employer must consent to the election of tax-deferred treatment, and a 10% excise tax is imposed on the employer for certain dispositions of stock by the ESOP within three years after the sale. The stock that is purchased by the ESOP may not be allocated under the ESOP to the seller, certain members of his family or any shareholder who owns more than 25% of any class of company stock. A prohibited allocation causes a 50% excise tax to be imposed on the employer and current income taxability to the participant receiving the allocation.

Dividend Deduction for C Corporations

Deduction for Dividends Paid to ESOP Participants

A tax incentive is provided for "passing-through" dividends on company stock to ESOP participants. A corporation will be permitted to deduct the amount of cash dividends paid on company stock held by an ESOP to the extent that participants (or beneficiaries) currently receive the dividends. The dividends must either be paid directly by the corporation to participants or be paid to the ESOP and distributed to participants within 90 days after the end of the plan year in which the dividends are paid to the ESOP. The dividends will be fully taxable to participants, but will be exempt from income tax withholding. The deduction is allowed for the taxable year in which the dividends are paid to participants. In addition, participants may be offered the opportunity to choose between a current distribution of the dividend and a reinvestment of the dividend into company stock.

Deduction for Dividends Applied to ESOP Loan Payments

A corporation may deduct the amount of cash dividends paid on company stock held by an ESOP and purchased with the proceeds of an ESOP loan (both allocated and unallocated shares) to the extent that the dividends are used by the ESOP to make payments on that ESOP loan. Special ESOP allocation rules may apply when dividends on allocated shares are used to make loan payments. The tax deduction is allowed for the taxable year in which the dividends are used for loan payments. The deduction is generally available only for "reasonable" dividends. This tax incentive significantly enhances the ability to finance ESOP transactions on a pre-tax basis.

S Corporation ESOPs

Since 1998, an ESOP has been permitted to be a shareholder of an "S" corporation. An ESOP is not subject to tax on its share of the S corporation's taxable income. The deduction for contributions to an S corporation ESOP will be limited to 25% of covered payroll even if the contributions are used for payments on an ESOP loan. In addition, dividends paid on S corporation stock in an ESOP will not be tax-deductible, and tax-deferred treatment will not be available to a shareholder who sells S corporation stock to an ESOP. The combination of the tax flow nature of S corporations and the tax exempt status of ESOPs permits a business to eliminate most if not all of its federal income tax if the ESOP becomes the 100% owner of the S corporation.