



## ESOPs – A VALUABLE TOOL IN THE RIGHT SITUATION

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Employee Stock Ownership Plans (ESOPs) came into existence to encourage owners of businesses to transfer stock to their employees.

An ESOP is a qualified-defined contribution employee benefit plan that invests primarily in the employer's stock. The encouragement came in the form of tax incentives. While there have been many changes to the tax law through the years, each administration has kept the tax incentives for ESOPs in place. In fact, several administrations have added additional tax incentives.

The tax incentives include the following:

- The employer can deduct (within limits) contributions to the ESOP, including both principal and interest on loans made to purchase company stock
- "C" corporation employers can deduct dividends paid on ESOP-held stock used to repay an ESOP loan
- The owner of a closely held "C" corporation can defer taxation (sometimes permanently) on his gain on the sale of his stock to the ESOP, provided the ESOP owns at least 30 percent of the outstanding shares after the sale and he invests in "qualified securities"
- "S" corporation ESOPs are not taxed on their share of corporate earnings; they are taxed when their account balances are distributed to them

Based on our experiences with ESOPs, the optimum ingredients for an ESOP include the following:

- A large, profitable company
- The major shareholder is well along in years and is thinking about diversifying his assets because too much of his wealth is represented by his company

- The owner wants to remain somewhat active in the company and to continue to share in the company's earnings

The ESOP transaction is often structured in the following manner:

- A bank lends money to the corporation
- The corporation then lends the money to the ESOP
- The ESOP then uses the money to purchase stock from the shareholder
- The company then makes annual, deductible contributions to the ESOP which uses the money to repay the loan from the corporation
- This loan repayment enables the corporation to repay the bank loan

An ESOP is not in and of itself a business succession plan. Instead, it promotes a business succession plan by making corporate stock available to the successor owners. It rewards the existing management team and encourages optimum performance from all employees who will share in the future profits of the company.

ESOPs require a team having expertise in accounting, income tax, legal issues and valuation. It is a valuable weapon to keep in your arsenal for use in the right situation.



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