

## The Tax Benefit of An ESOP – for Company, ESOP Trust, and Employee Owners<sup>1</sup>

By: Annabelle Xue, CFA, Manager

As the tax deadline has just passed, it is a good time to reinforce our understanding of the primary tax benefits of employee stock ownership plans, for Empire (the plan sponsor or Company), the Empire ESOP trust, as well as for the employee owners.

### No income tax burden on the company or the ESOP trust level

As a result of the Small Business Job Protection Act of 1996, ESOP trusts are IRC Section 401(a) exempt organizations permitted as S corporation shareholders. Empire is an S corporation that is 100% owned by the ESOP trust. It passed through its corporate income to the ESOP Trust for federal and state income tax reporting purposes. However, the ESOP trust is a tax-exempt entity not subject to income taxes. In essence, neither the company nor the ESOP trust is required to pay the income tax. As a result, the tax savings could be used to fund business operations, capital investments, business acquisitions, purchases of additional shares, and payments on notes issued to selling shareholders, etc. This creates a powerful advantage compared to other non-ESOP companies.

In addition, dividends that are used to repay an ESOP loan, passed through to employees, or reinvested by the employees in company stock are also tax-deductible.

### Tax deferral on the individual employee level

An ESOP is recognized by the IRS as a retirement plan that allows income to accumulate tax-deferred. Employees do not pay tax at the time of contributions into the ESOP, shares allocations, or shares vesting. Ultimately, employees are taxed at the time of distributions, at potentially favorable rates. Therefore, it is important to note that the tax advantages are essentially a tax deferral, not tax avoidance. However, the ESOP distributions can be rolled into an IRA or other retirement plans accumulating gains over time taxed as capital gains later.



The discussion on the company and ESOP trust level was for Empire's ESOP plan only. Please refer to the source articles for detailed discussions on companies in other legal forms. This article is for informational purposes only and does not serve as tax advice.

<sup>1</sup>Sources: (i) One Major ESOP Taxation Advantage: An ESOP Company Pays No Federal or State Income Tax, ESOP Partners, April 13, 2021, <https://www.esoppartners.com/blog/esop-taxation-rules>; (ii) How an Employee Stock Ownership Plan (ESOP) Works, NECO, August 24, 2020, <https://www.nceo.org/articles/esop-employee-stock-ownership-plan>; and (iii) Unique Tax Advantages of ESOPs, American Bar Association, [https://www.americanbar.org/content/dam/aba/publishing/aba\\_tax\\_times/14sum/5-bauer.pdf](https://www.americanbar.org/content/dam/aba/publishing/aba_tax_times/14sum/5-bauer.pdf).