The ESOP-Owned S Corporation: Bringing Ownership to Life with Synthetic Equity

By Martin Staubus

As regular readers of *Leading Companies* know, the “ESOP-Owned S corporation” structure offers truly remarkable advantages that can transform a business into a tax-exempt, for-profit entity. An S corporation whose stock is held in an ESOP, of course, pays no federal income tax (and little or no state income tax) at the corporate level. That is true of every S corporation. But most S corporations still suffer a tax-related drain on their cash flow because the net earnings of the business are attributed to the shareholder(s), who will typically need to pull money out of the company to pay their resulting personal tax liability – leaving the company with no more after-tax cash than if it had been a conventional C corporation.
But what if the sole shareholder is a tax-exempt qualified retirement plan – that is, an ESOP? In that event, neither the company nor its shareholder pays taxes on the company’s net earnings, so no cash needs to leave the company in favor of the IRS.

The financial advantages of this structure are considerable. Depending on the applicable state corporate tax rate, the combined federal and state income taxes on conventional S corporation earnings is likely to run in the neighborhood of 40 percent. Thus, a profit of $100,000 will produce a tax bill of $40,000, leaving just $60,000 in after-tax income for the company. In comparison, if that S corporation’s sole shareholder is an ESOP, the company will retain virtually the whole $100,000 – a 67 increase in net after-tax profits relative to the $60,000 alternative.

Still, there are some challenges to operating effectively as an employee-owned company under the ESOP-owned S corporation structure. And a major part of that challenge stems from the fact that, in its basic form, the system of ownership distribution relies entirely on a single vehicle: the ESOP.

A truism of employee ownership is that a variety of legal structures, or vehicles, are available for putting company equity in the hands of employees – and each one of them has its own problematic set of limitations. In the case of an ESOP, the powerful and compelling advantages are obvious. But so, too, are some limitations. Two limitations in particular stand out. These are:

The limited flexibility that is available to the company when it comes to determining “who” among the participating employees should have “how much” ownership. To say that stock in an ESOP must be apportioned solely in proportion to the participants’ W-2 pay is overstating the case a bit. The law that governs the terms by which an ESOP will operate actually allows for a modest amount of room to depart from that rigid standard. Even recognizing this bit of flexibility, however, the terms of an ESOP simply do not permit a sponsoring company to evaluate the merits of each participating employee on a case-by-case basis. As a practical matter, this means that a company whose only employee ownership vehicle is

an ESOP cannot offer a special equity incentive as a tool to, for example, recruit a key candidate who is in high demand and may be considering competing employment offers. It also means that there is only a very limited opportunity to consider issues of performance and other “merit-based” criteria in determining how much equity to award to individuals.

The second fundamental limitation of an ESOP is that participants can access the cash value of their equity only after leaving the company. It is, after all, a retirement savings plan. Once again, purists will point out that the “access only after separation” description isn’t strictly true; ESOPs can make so-called “in-service” distributions. But such distributions (which would trigger excise taxes for those under age 59 ½) are clumsy at best. This retirement focus limits an ESOP’s attractiveness to young participants. The accumulating value in an employee’s ESOP account cannot be accessed to meet the needs that are the pressing priorities for younger employees: saving up to make the down payment on their first house; and later, dealing with the joys of paying college tuition for their children.

The Synthetic Equity Solution

To add real dynamism to an ESOP-based program of employee ownership, a sponsoring company should consider supplementing the ESOP with additional vehicles of equity ownership – vehicles that will enable the company to award additional equity in ways that will contribute to company success and allow participants an opportunity to liquidate some equity prior to retirement. Possible approaches are summarized below.

Stock Options

A stock option plan allows a company to grant to individual employees a contractual right, or option, to buy a certain number of the company's shares at any time during a specified time period, paying a price that is specified at the time of the grant. The specified time period (or “term” of the option) is typically 10 years, and the specified purchase price is usually based on the fair market value of the shares at the time of the grant. The concept underlying options is that, if the value of the company's stock goes up in the years following the grant, the employee can then benefit by buying the stock at the lower price that prevailed at the time of the grant and then selling it for the higher, post-appreciation price. The value of a stock option to an employee is therefore inherently tied to the future performance of the company. Importantly, there are no “non-discrimination” rules associated with stock options. A company (subject only to the approval of its own board of directors) is free to choose who it will issue options to, and how many it will issue on a case-by-case basis.

Now, in the context of an ESOP-owned S corporation, it is important to understand that a stock option by definition entitles the recipient to purchase shares of stock from the company – at which point the recipient would then become a shareholder (and the ESOP would no longer be the sole shareholder). What does this mean for an ESOP-owned S corporation?

In fact, the company would not be hurt in any way should an option holder exercise their option and purchase stock. And indeed, that is quite unlikely to happen, for the following reason. Once the option-holder exercises the option and becomes a shareholder, he becomes personally liable for a portion of the taxes that are normally due on the profits of the company. So a person would generally not want to put himself in that situation; and if for some reason he did, the company would not be harmed.

In practice, what this means is that an ESOP-owned S corp that issues stock options to employee-owners must be prepared to redeem those options at some point, pursuant to some agreed-upon system, for their "in the money value" (that is, the difference between the current market value of the stock and the original exercise price) without the option holder ever actually exercising the option. The company's rules for such redemptions would be structured to assure that option holders would have reasonable access to liquidity while assuring that the company's cash flow is not over-taxed.

Stock Appreciation Rights

Stock Appreciation Rights, or SARs, are simply a contractual arrangement by which the company promises to make a cash payment to the individual at some point in the future, with the exact amount of money paid out to be determined by application of a formula tied to the appreciation in the value of the company's stock that occurs from the time the SARs are issued to the time that the payment is made.

The economic value of SARs for the employee is ordinarily exactly the same as the economic value of stock options. That is, they provide for a cash payment to the employee that is exactly equal to the "in the money value" of comparable stock options. Given that an ESOP-owned S corp would maintain a stock option plan only on the terms discussed above (in which no options are ever actually exercised, but are instead redeemed for their "in the money value"), there is very little difference between the stock options and SARs. There may be a technical difference in the accounting treatment between stock options and SARs, but even this may not be significant because: 1) a stock option program that always cashes out the options (rather than allowing them to be exercised) may have to account for the options as "liabilities" just as SARS are accounted for; and 2) for a company that pays no taxes and is not hoping or expecting to be acquired any time soon, the accounting treatment is of little consequence in any event.

Equity-Based Deferred Compensation

Another way to supplement the allocation of equity at an ESOP-owned S corp is through the use of a deferred compensation arrangement that holds synthetic equity for individual employees. A company may, for example, want to require that senior management personnel invest some of their own money in the company. Traditionally, this would be done simply by establishing a minimum stock ownership policy for those in senior management – not an unusual arrangement. At an ESOP-owned S corp, of course, all shares of real stock must be in the ESOP. To mimic this arrangement, an investment requirement for senior managers can be established in the form of a deferred compensation plan, in which managers give up some portion of their regular pay and, in exchange, are credited with "phantom stock units" that are

held for them in a deferred compensation plan. Upon the conclusion of employment with the company, the individual would receive a cash payment equal to the number of phantom stock units credited to him multiplied by the current share price of the company's stock at that time.

Limitations on the Use of the Above Devices

For 100 percent ESOP-owned S corporations, section of the Internal Revenue Code establishes an absolute limit on the portion of the total equity that any single person may own. This includes both the shares in an individual's ESOP account and any forms of synthetic equity, including stock options, SARs and phantom stock units.

The terms of section 409(p) are complex. For a 100 percent ESOP-owned S corp, however, the basic idea is that no one person should have an equity interest in the company that exceeds 10 percent of the entire equity value. In fact, the rules for making this calculation are complex. So, if in actual practice an ESOP participant might be thought to be anywhere near a 10 percent interest, consultation with an ESOP attorney would be highly advisable. Fortunately, there is actually a good deal of breathing room in this. In fact, significant penalties result only if more than 50 percent of the company's equity value is in the hands of 10 percent-plus individuals. So a single instance of one person – or even four people – slightly exceeding the 10 percent limit is not a big problem.

Conclusion

A program of employee ownership can take advantage of the remarkable financial benefits of the ESOP-owned S corporation structure while still offering meaningful flexibility and dynamism through supplementary vehicles of synthetic equity. Section 409(p) imposes strict rules on the total amount of synthetic equity that can be added to the mix. Still, for many companies there is likely to be meaningful room to add dynamism to an ESOP S corp structure through the use of equity vehicles such as stock options, SARs and deferred compensation plans.

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