

SHOULD YOUR ESOP SPONSOR COMPANY ELECT S CORPORATION STATUS?

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The larger the percentage of the sponsor company stock that is owned by the ESOP, the more compelling it is for the employer corporation to consider S corporation status. However, there are a number of issues that are outside of the employee benefits arena which may affect this taxpayer status consideration. This discussion summarizes those concerns. They fall into two categories (1) S corporation tax rules and (2) corporate/structural issues.

SUBCHAPTER S CONVERSION DETAILS

The first subchapter S conversion issue relates to the “built-in gain” on corporate assets. The appreciation of corporate assets and the depreciation taken on corporate assets is what makes up built-in gain.

At the date of an S corporation election, the built-in gain must be quantified. A corporate level tax is imposed on this built-in gain measured at the date of conversion from C status to S status, if the gain is “recognized” due to sale of the company’s assets, within ten years of the conversion to subchapter S status.

Therefore, a corporation considering a complete sale to a third party, or a disposition of certain assets of the corporation which make up the built-in gain, would not benefit from the subchapter S election to that extent if the event occurs within ten years of the conversion.

Corporations that earn more than 25 percent of their gross receipts from “passive investment income” may be subject to an additional S corporation tax after conversion. If an S corporation has earnings and profits from when it was a C corporation, then a tax will be imposed on the corporation’s excess net passive investment income.

Also, if the 25 percent limit on net passive investment income continues for three consecutive years, and the corporation still had earnings and profits left over from being a C corporation at the end of those three years, then the corporation’s S status will be terminated.

Any corporation that is accounting for inventory on the last-in-first-out (LIFO) method must include in income for its last year as a C corporation the difference between the

inventory (1) on a LIFO basis and (2) on a FIFO (first-in-first-out) basis. The resulting additional income tax for this LIFO-FIFO adjustment must be paid in equal installments over a four-year period.

Certain tax attributes from being a C corporation, such as net operating losses, capital loss carryovers, and minimum tax credits, are not permitted to be carried over from C corporation status to S corporation status. For example, if the taxpayer corporation is just becoming profitable, then any net operating loss will be lost if the corporation elects subchapter S status.

Also, alternative minimum tax credit carry-forwards, which may be due, for example, from dividends deducted under Code Section 404(k) on payments on ESOP shares, would also be lost.

Therefore, it is better to use up the operating losses and credit carry-forwards as a C corporation before converting to subchapter S status.

One attractive aspect of S corporation status is that the S corporation can avoid what is called “accumulated earnings tax” problems. This is because it is not subject to the accumulated earnings tax. Therefore, if the corporation is, for example, a 100 percent ESOP-owned company, it may accumulate cash in the corporation without being subject to this C corporation penalty tax.

However, a C corporation that elects S corporation status may wish to distribute any C corporation earnings and profits during the first two-and-one-half months of its initial S corporation tax year (1) to obtain a dividends paid deduction and (2) thus limit or avoid the accumulated earnings tax for its final year as a C corporation.

THE TAXPAYER CORPORATE STRUCTURE

ESOP sponsor companies that want to convert to subchapter S status must also take care of corporate structural issues on or before the conversion date. For example, if the ESOP was capitalized with more than one class of stock, the second class of stock must be eliminated to elect subchapter S status.

It was not uncommon for corporations to use preferred classes of stock in ESOP transactions for the sake of deductible dividends used to fund those transactions. An S corporation must have only one class of stock.

In these situations, ESOP fiduciaries will face two fiduciary issues:

- First, the issue of whether to convert the preferred shares to common stock under the terms of the agreements in place and the value of the relative classes of stock.
- Second, whether to consent to the subchapter S election. It may be the case that under ERISA, the ESOP fiduciaries should bargain for special consideration to make the conversion most advantageous for the participants, where the difference in value between the classes of preferred and common have not worked themselves out at the date of the conversion.

In short, ESOP fiduciaries should not assume that they should necessarily convert the shares or elect subchapter S status. Financial due diligence is required to support such a decision.

This financial due diligence may also include: (1) commitments from the corporation on how it is going to manage its cash flow and (2) the purported income tax advantages of being an S corporation.

EFFECT OF S CORPORATION ELECTION ON TAXPAYER CORPORATION CASH FLOW

A corporation should also consider the effect of the increase of individual income tax rates on corporate cash flow prior to electing subchapter S status.

For example, if a corporation is paying federal income taxes at the rate of 34 percent and the shareholder's individual federal income tax rate is 40 percent, then the conversion to subchapter S status would require an additional 6 percent cash flow cost to the corporation—to make distributions so as to permit the shareholders to pay their share of income taxes on the S corporation income.

If the S corporation is in a high tax rate state like California, there would be a deduction for state taxes paid, but the additional cash flow cost still would be in the 5

percent to 6 percent range. This has to be balanced against the cash flow strategies regarding those funds distributed to the ESOP that it does not use to pay taxes.

On the positive side, conversion to S corporation status will permit those shareholders who do not sell their shares to the ESOP immediately, to start accumulating basis in their shares as S corporation shareholders. This accumulation is due to the tax treatment of earnings each year. This tax treatment would reduce or contain their future taxable gain if and when the shareholders sell their stock. This tax effect is illustrated in Exhibit 1.

As one can imagine, the most compelling situation for S corporation conversion exists where an ESOP is approaching total ownership of the corporation and a selling shareholder can sell the remainder of his shares, using Code Section 1042 to defer the gain, and permit the ESOP to elect subchapter S status once it owns 100 percent of the sponsor company.

WHAT TO DO

ESOPs for subchapter S corporations appear to be a compelling alternative, assuming that you are engaged in long-term succession planning or capital planning for an S corporation. However, there is no substitute for “running the numbers.”

Due to issues such as reconciling distribution policy, profitability, the nature of the business, and whether it is capital intensive or not, employee benefits practitioners will have to work closely with CPAs in their tax planning for their S corporation clients to make an ESOP work well for any S corporation.

Overall, it appears that the S corporation finally has an exit vehicle for succession planning on a tax-favored basis that puts them close to par with C corporations.

Although all of the tax incentives available to C corporation ESOPs are not available to S corporation ESOPs, those that are not available may be more than offset by (1) the realities of most S corporations and (2) their unique shareholder planning concerns.

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Exhibit 1
Illustrative Example of a
Hypothetical ESOP Sponsor Company
C Corporation vs. S Corporation Stock Sale
With an S Corporation Basis Assumption

Illustrative Example Assumptions

- Let's assume a \$5,000,000 current value sponsor company that generates \$500,000 in taxable income and cash flow each year.
- At the end of 10 years, let's assume that the sponsor company has doubled in value to \$10,000,000.
- Let's compare 10 years of sponsor company operations as both a C corporation and an S corporation, considering the eventual stock sale of the employer corporation stock.

<u>Assumed Annual Sponsor Company Operating Results</u>	Sponsor Company as a <u>C Corporation</u>	Sponsor Company as an <u>S Corporation</u>
Taxable income	\$ 500,000	\$ 500,000
Corporate income tax	215,000	0
Shareholder income tax	0	235,000
Difference in income-tax-related cash flow	+ 20,000	0
Addition to the stock basis	<u>0</u>	<u>265,000</u>
Assumed sale of the sponsor company in year 10 at its then fair market value	\$10,000,000	\$10,000,000
Shareholder's basis in the stock	<u>0</u>	<u>2,650,000</u>
Gain on the sale	<u>10,000,000</u>	<u>7,350,000</u>
Capital gain tax	2,700,000	1,984,000
Tax savings related to the S corporation election	<u>0</u>	<u>715,000</u>
<u>Less 10 years of higher tax/cash flow</u>		
Difference in the sponsor company operating income	\$ 0	\$ 200,000
Net after tax savings	<u>\$ 0</u>	<u>\$ 515,000</u>