Tax Benefits of Employee Ownership

Although the process of transitioning to employee ownership can seem complex or daunting at times, it carries significant tax benefits, particularly when transitioning to an ESOP specifically. Everyone involved in the transition process can reap these benefits, a key reason for why the decision to convert to employee ownership can be advantageous for every relevant stakeholder. Outgoing owners, new employee-owners, and even the company itself all stand to receive significant tax breaks from participating in the process, providing each with distinct advantages.

Benefits for outgoing owners

First, ESOPs provide selling owners with several notable tax breaks. These are particularly important, as the owner is the one who decides how (and to whom) to sell the company. As such, these tax advantages provide a clear and tangible reason for the owner to sell the company to its employees, instead of simply retiring through a traditional buyout. The most significant tax-based incentive for outgoing owners to sell into ESOPs is that, assuming they meet a few (relatively lax) provisions, they are able to defer capital gains tax on the proceeds (this means that owners can allow their investments to accumulate tax-free and are only taxed when they withdraw money from their account).[1] This can net selling owners tens of thousands of dollars — and for assets sold for more than $500,000, the long-term capital gains tax is 20%, saving owners a significant chunk of the sale profits via tax deferrals.[2]

In order to meet the requirements for deferment, outgoing owners must simply sell more than 30% of their shares into the ESOP and reinvest their earnings from the sale into domestic stocks or bonds (this includes a wide range of options, and information on qualifying investments is readily available online) anywhere from 3-12 months after the sale.[3] By simply meeting these requirements, which owners would likely meet by selling into an ESOP anyway, outgoing owners can obtain a significant tax break. This is particularly relevant because transitioning to an ESOP aids the owner in receiving a fair price, but does not guarantee more than they could obtain through a conventional sale. Because of this, the ability to reinvest the proceeds from the sale and avoid taxes may be a meaningful incentive which can actually make selling the company for below market value more financially advantageous in the long term.[4] This, combined with an owner's desire to preserve the company and its legacy, makes selling the company into an ESOP trust a desirable and rewarding option.

Benefits for the ESOP itself and employee-owners

Similarly, ESOPs also provide employee-owners and the company itself with several key tax benefits, helping them accumulate capital during the transition and get off to a strong start under their new ownership. The first and most concrete tax advantage which ESOPs provide is that companies sponsoring ESOPs can deduct dividends paid out to employee-owners from company profits. ESOPs can

---

[1] Julia Kagan. December 2021. "What Does Tax-Deferred Mean?" Investopedia.

[2] Kenkel, Phil. August 2019. "Cooperative Taxation." Cooperatives.

[3] February 2018. "ESOP Tax Incentives and Contribution Limits." National Center for Employee Ownership.

[4] February 2018. "ESOP Tax Incentives and Contribution Limits." National Center for Employee Ownership.

accomplish this in several different ways. They can pay co-owning members in cash or apply their dividends to the ESOP's leveraged loan payments, and payments are also deductible when employees (voluntarily) choose to reinvest their dividends back into the company's stock.[5] These benefits allow the company to take advantage of generous tax provisions and strengthen the ESOP itself by paying less in taxes than a conventional firm in the same situation would be required to.

In the same vein, ESOPs also provide employee-owners themselves with tax benefits, making employee-ownership an attractive option for company workers. First, ESOP employee-owners do not have to pay taxes on the stock in their ESOP accounts until they receive actual monetary distribution from it. Additionally, if employees put their ESOP stock earnings distributions directly into an IRA account or similar successor plan (retirement funding account), they again do not have to pay taxes on it; the money is only taxed when it is withdrawn from the second account.[6] These benefits make participation in an ESOP a powerful tool for saving up for retirement, since it allows employee-owners to accumulate significant savings which remain untaxed until they are ultimately withdrawn.

Tax benefits associated with Cooperatives

Finally, although co-operatives have fewer structural requirements than ESOPs, they also provide a variety of attractive tax benefits. This is quite useful, because it enables companies which want to transition to employee ownership but for whom ESOP status is infeasible to implement a model of employee ownership which still includes meaningful financial benefits. For outgoing co-op owners specifically, most of the benefits come from section 1042 of the US tax code. Under section 1042, owners who reinvest their sale profits into a qualified replacement property (stocks or bonds of domestic operating companies) are only taxed when they sell that account. Furthermore, even when owners are taxed, they are not taxed on the full value of the qualified security, but rather merely on the amount of value it has gained between when they bought and sold it.[7] Because of this, outgoing owners can profit from the sale of their company as a co-op and then reinvest those profits into the market, all while paying taxes on a small fraction of that income many years down the line. For the company itself, co-op status also provides benefits: while employee owners will have to pay income taxes on "refunds" they receive from the co-operative income, the co-operative itself will not be taxed on those distributions, strengthening its earnings.[8] Thanks to the various tax benefits afforded to both outgoing owners and the company itself, transitioning to a cooperative is an excellent option for outgoing owners whose companies do not have the size or structure to function as ESOPs.

Conclusion

Ultimately, transitioning to employee ownership provides a host of financial benefits to everybody involved, from outgoing owners to employees to the companies themselves. These various incentives can be considered as part of various smart financial strategies, and can help employee-owned firms gain

---

[5] February 2018. "ESOP Tax Incentives and Contribution Limits." National Center for Employee Ownership.
[6] February 2018. "ESOP Tax Incentives and Contribution Limits." National Center for Employee Ownership.
[7] Kenkel, Phil. August 2019. "Cooperative Taxation." Cooperatives.
[8] Kenkel, Phil. August 2019. "Cooperative Taxation." Cooperatives.

distinct advantages over their competitors. Laws can change, so companies should therefore act to take advantage of these benefits while they are available.