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ESOP taxes

ESOP tax treatment, how are ESOPs taxed, ESOP tax deduction

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One Major ESOP Taxation Advantage: An ESOP Company Pays No Federal or State Income Tax

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When company leadership evaluates whether an ESOP is a good fit, they must carefully consider how transitioning to an ESOP may impact a company's tax obligations — and how ESOP taxation rules may provide a competitive advantage to the company.

The portion of a company owned by an S corporation ESOP is not subject to federal or state income taxation.

This means that an S corporation that is 100% ESOP-owned is not subject to any federal or state income taxes.*

Practically speaking, in terms of running the business, this primary ESOP tax benefit can result in increased cash flow and a clear competitive advantage for the company.

To provide further clarification, we're answering some of the most-asked questions about ESOP taxes:

- [How are S corporation ESOP companies not subject to income taxes?](#)
- [What are the benefits of an ESOP's federal and state income tax-exempt status?](#)
- [Are ESOP tax advantages an unintended loophole in the Internal Revenue Code?](#)

- [How can the government afford the ESOP tax benefits? Doesn't the IRS stand to lose revenue?](#)
- [How does the government regulate ESOP tax benefits to prevent abuse?](#)

What is an ESOP?

An employee stock ownership plan (ESOP) is a business transition tool, an employee ownership vehicle, and a qualified retirement plan.

Most often, departing owners of profitable, closely held companies choose [an ESOP as an exit strategy](#) as they transition toward retirement. An ESOP creates a way for the owner to get the benefit of selling the business while maintaining company control, upholding company culture, and extending ownership benefits to employees.

In short, the company sets up a trust and contributes shares (or cash to buy shares) into the trust. In the case of a leveraged ESOP, this cash can be borrowed from a bank. Within certain limits, company contributions to the trust are tax-deductible.

Company stock shares in the ESOP trust are [allocated to individual employee accounts](#) according to a formula determined by the ESOP, typically based on pay, seniority, or more equal factors. As employees remain with the company, their right to the value of shares in their account increases until they are 100% vested.

When employees leave the company, the company purchases their stock allocations back at fair market value — as determined by an annual valuation performed by an outside third party.

How are S corporation ESOP companies not subject to income taxes?

[S corporations](#) are pass-through entities. This means that they pass through their corporate income to their shareholders for federal and state income tax reporting purposes. Each year, the shareholders receive an IRS Form K-1 and report the income flow-through on their personal tax returns based on their individual federal and state income tax rates.

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.

What does that mean?

The ESOP trust is an S corporation shareholder that is a tax-exempt entity and therefore not subject to income taxes.

The [Taxpayer Relief Act of 1997 and IRC Section 512\(e\)](#) repealed the application of unrelated business taxable income (UBTI) for ESOPs effective for taxable years beginning on or after January 1, 1998.

Also Read: [9 Effective Ways to Reduce Taxes on Your Small Business](#)

What are the benefits of an ESOP's federal and state income tax-exempt status?

The exemption from federal and state income taxes creates a powerful tax advantage that provides the cash flow for an ESOP to purchase the company from the selling shareholder(s).

Once the stock purchase has been completely funded, the cash flow resulting from the tax savings provides an ESOP company with a competitive advantage over their non-ESOP counterparts.

Are ESOP tax advantages an unintended loophole in the Internal Revenue Code?

No. In short, ESOP tax advantages are intentional — not an oversight error.

ESOP tax benefits are specifically cited in legislation. Congress considers selling to an ESOP to be good public policy and has specifically created these tax advantages to further incentivize ESOPs and employee ownership.

Studies show that ESOP companies achieve stronger performance, provide higher compensation, and deliver a range of positive outcomes. These benefits often result in greater wealth being shared across more individuals, which can lead to increased overall tax revenues and reduced dependence on government-funded entitlement programs.

How can the government afford the ESOP tax benefits? Doesn't the IRS stand to lose revenue?

It is important to note that the tax advantages are essentially a tax deferral, not tax avoidance. As a [qualified retirement plan](#), an ESOP is recognized by the IRS as a retirement plan that allows income to accumulate tax-deferred.

Ultimately, ESOP employees pay taxes [when they receive their distributions](#).

In addition, an S corporation ESOP can actually contribute to overall tax revenue through:

1. **Economic activity boost:** ESOP tax savings create additional value for the company, which often translates into increased economic activity. In turn, increased economic activity generates more federal and state income tax revenue.
2. **Deferred taxation of ESOP benefits:** While ESOP participants enjoy tax-deferred growth in their accounts, they ultimately pay taxes upon distribution at retirement or other separation from the company. This deferred taxation ensures that the government still collects revenue, often at a time when the account value has grown significantly.

How does the government regulate ESOP tax benefits to prevent abuse?

ESOP tax benefits are significant. To prevent abuse, Congress established [IRC Section 409\(p\) Anti-Abuse Testing](#) requirements ensuring an S corporation ESOP company provides broad-based ownership and coverage that benefits rank-and-file employees.

Learn more about the potential business benefits of an ESOP

The tax advantages described here are just a few of the many potential benefits an ESOP can offer you and your employees now and well into the company's future. Multiple studies indicate that ESOP companies perform well above medians for sales, productivity, and growth. Other demonstrated benefits include improved outcomes for employees of color, lower likelihood of going out of business, overall higher employee compensation, and more.

Taken in total, the business benefits of an ESOP are attractive. Gain a better understanding of if and how they align with your goals by taking our free quiz, [Is an ESOP Right for Your Company?](#)

<FOOTNOTE>

**Is a 100% S corporation ESOP company exempt from ALL taxation?*

No. The ESOP shareholder is a tax-exempt entity, not the corporation. To the extent the corporation is directly subject to taxation, such as property taxes, the corporation is still responsible to satisfy the tax obligations. In addition, if a state has an income tax on S corporations, the corporation is still responsible for that income tax. For example, under California law, S corporations are subject to a 1.5 percent tax on their net income.

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Does an ESOP company pay federal and state income taxes? We answer this and other most-asked questions to separate fact from fiction.

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Explore how ESOP taxation can fuel cash flow, growth, and long-term success for your company.

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Could tax savings drive your company's growth? 100% ESOP-owned businesses enjoy unique tax advantages that fuel cash flow and create lasting success. Here's how it works.

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Learn how ESOP taxation benefits could unlock cash flow and a competitive edge for your company.