



ESOP Dividends

By The ESOP Association

There are various tax incentives to encourage companies to consider an ESOP. This Brief discusses the ability of the employer to use tax deductible funds to service ESOP debt and the advantages of deductible cash dividends.

Among the various tax incentives encouraging ESOP creation and expansion, the ability of the employer to use tax deductible funds to service ESOP debt is significant, as is the possibility of deductible cash dividends paid to ESOP participants.

Internal Revenue Code Section 404(k) allows a C Corporation paying dividends on employer stock held by an ESOP to take a deduction for dividends paid on the stock, if the dividends are used for certain prescribed purposes. [A company structured as an S corporation is not eligible for the 404(k) tax deduction, since an S corporation is not liable for a corporate level income tax. On the other hand, an S corporation may use income distributions (similar to C Corporation dividends) earned on leveraged ESOP stock to pay ESOP securities acquisitions debt. [\[See Issue Brief #21 for the tax advantages available to an S corporation sponsoring an ESOP.\]](#)

Normally, a corporation receives no deduction for dividends paid on its own stock. Under Section 404(k), the company obtains a deduction for dividends if the dividends are (a) paid to participants directly or through the ESOP within 90 days of the ESOP's year end; (b) at each participant's election, paid to participations (directly or through the ESOP) or reinvested in employer stock; or (c) used by the ESOP to make fund payments on the loan used by the ESOP to acquire the employer stock.

Underlying all of these possibilities is the caveat that the dividends must be considered reasonable. Furthermore, the deduction for reasonable dividends may be disallowed if the Internal Revenue Service determines that such dividends constitute, in substance, an avoidance, or evasion of taxation.

Dividends paid to participants directly or through the ESOP are known as pass-through dividends, and they are exempt from the notification and consent rules governing other distributions from qualified retirement plans. Pass-through dividends cannot be rolled over into an individual retirement account or other qualified plan, there is no withholding, and recipients are taxed on these dividends at their ordinary income tax rates.

Pass-through dividends can be paid on participants' total stock balances or on their vested stock balances. The former may allow the company to obtain a larger deduction, but it necessitates payments of cash to participants based on

stock in which they have not yet become vested. If pass-through dividends are based on only vested stock balances, the dividends earned on nonvested shares could be used to repay the ESOP loan, if one exists, (and, thus, be deductible), or they could remain in participant accounts and not be deductible.

The dividend reinvestment election gives participants the choice between receiving a pass-through dividend or having their dividend reinvested in employer stock. Again, this election can be based on total stock balances or vested stock balances only. If the election is based on total stock balances, then any dividends reinvested in employer stock are 100% vested. This mirrors the treatment those electing pass-through dividends receive when they are paid cash based on their nonvested shares.

In drafting or amending an ESOP document, consideration should be given to whether the distribution of cash dividends will be automatic or whether it will be subject to the periodic choice of the company, the ESOP participants, or even the board of directors. The plan document should also establish the procedure for obtaining elections related to pass-through/dividend reinvestment choice and the process by which dividends will be reinvested.

By granting a deduction when dividends are used to repay an ESOP acquisition loan, Section 404(k) significantly enhances the company's ability to finance ESOP transactions on a pre-tax basis. Dividends used to repay an ESOP loan are not be considered annual additions for Section 415 testing (the test that limits how much each participant can receive under all of the company's qualified retirement plans). They are also not limited by the maximum contribution amount, which is generally equal to (a) 100% of employer contributions used to fund interest payments on an ESOP acquisition loan; (b) 25% of eligible payroll for contribution used to fund principal payments on the loan; and (c) an additional 25% of eligible payroll for all other employer contributions. Thus, dividends can provide an additional deduction beyond those that can be obtained through employer contributions.

In some cases, the company would like to take advantage of the deductions mentioned above without also paying the same level of dividends, or any dividends at all, to non-ESOP shareholders. This can be accomplished if the ESOP purchases convertible preferred stock. Such stock generally

requires the company to pay a certain level of dividends into the ESOP, while dividends paid to common stock holders continue to be paid at the discretion of the board of directors.

Section 404(k) provides many valuable opportunities to C corporations that sponsor ESOPs. The use of pre-tax dollars to service ESOP debt has given companies the added ability to more easily obtain and successfully service an ESOP loan, thus making themselves a more attractive borrower to lenders. In addition, dividends on ESOP stock are a very attractive and immediate benefit to participants when passed directly through to employees or when employees can voluntarily reinvest the dividends for more company stock.