

MERGERS AND ACQUISITIONS

INFORMATION MEMO

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Sale of a Business to an ESOP – Key Tax Benefits

When the owners of an established private business wish to retire or begin to phase out of full-time responsibilities, they often consider selling the business to a family member, a member of the company's current management or an acquaintance. If a sale to an insider is not feasible, the owners must look to outside buyers, which typically include companies in the same or a related business (strategic buyers) or private equity firms (financial buyers).

Another potential purchaser that should be considered is an employee stock ownership plan (an ESOP) established and sponsored by the company. If the business operates as a corporation and the owners sold all or part of their shares to an ESOP, both the owners and the company could qualify for very significant tax benefits that would not be available if the shares were sold to a strategic or private equity buyer.

This information memo summarizes the most important tax benefits available under the Internal Revenue Code (the Code) in connection with the sale of corporate shares to an ESOP.

Deferral of Capital Gain Taxes

Generally: Under Section 1042 of the Code, a corporation's owners can sell their shares to an ESOP and defer all federal taxes on their gain from the sale by reinvesting the sale proceeds in so called "qualified replacement property" – generally, securities of U.S. domestic operating companies. All capital gain taxes that otherwise would be due upon the sale can be deferred until the former owners sell the replacement securities and, if they hold these securities until death, taxes on the ESOP sale are avoided entirely. In contrast, and as explained in more detail below, the gains from a sale to a strategic or private equity buyer would be subject to a capital gains tax of either 15% or 20%, plus the 3.8% tax on "net investment income," if applicable.

Requirements: Selling shareholders can take advantage of Section 1042 tax benefits if the following requirements are met:

- The shareholder must be an individual, partnership, LLC, trust or S corporation (but not a C corporation) and must have held the shares for at least 3 years before selling them to the ESOP.
- The shareholder must reinvest the proceeds from the ESOP sale in "qualified replacement property" (QRP) within 12 months. Qualified replacement property includes securities of U.S. domestic operating companies; it does not include mutual fund shares, governmental bonds or notes, CDs or securities of foreign corporations.
- The company sponsoring the ESOP must be a nonpublic C corporation at the time of the sale (not an S corporation, LLC or other form of business entity).
- The ESOP must own at least 30% of the company's shares immediately after the purchase and must hold the stock for at least 3 years thereafter.

Accordingly, Section 1042 tax benefits may be available whenever the individual shareholders of a privately owned corporation sell at least 30% (up to 100%) of their shares to an existing or newly established ESOP.

Tax Benefit: If the owners sold their shares to a third-party purchaser (not an ESOP), the federal capital gain tax would be equal to either 15% or 20% of the gain,¹ plus an additional 3.8% tax on the "net investment income" of higher income taxpayers that is attributable to the sale².

¹ Capital gains are taxed at 15% for single taxpayers with adjusted gross income (AGI) above \$49,450 (\$98,900 for married taxpayers filing jointly), or at 20% for single taxpayers with AGI above \$545,500 (\$613,700 for married taxpayers filing jointly). The taxpayer in the example is presumed to be in the 20% bracket.

² The 3.8 additional tax on net investment income applies to single taxpayers with AGI of more than \$200,000, or married taxpayers with AGI of more than \$250,000.

Example: The sole shareholder of a corporation sells his shares, which have a tax basis of \$100,000, to a newly established ESOP for \$20 million. Provided that the shareholder reinvests the gain in qualified replacement property (QRP) and the other requirements summarized above are met, federal taxes on the \$19.9 million gain are deferred – a tax saving of approximately \$4.7 million. If the replacement securities are held until the shareholder's death, the tax deferral would become permanent.

By selling to an ESOP and using the tax deferral opportunity provided by Code section 1042, the owners of a corporation who desire to “cash out” their investment can do so in a very tax-effective way – and potentially pay little or no taxes on the sale of their shares. Essentially, the sale price to a strategic or private equity buyer would have to be more than 20% higher than the amount paid by an ESOP in order for the selling shareholders to realize the same after tax amount at the time of sale.

Deduction of Principal Payments and Dividends

An ESOP's purchase of a corporation's shares is usually financed by a bank loan or by the selling shareholders taking a promissory note for all or part of the purchase price; such a transaction is called a “leveraged ESOP” purchase. In a typical leveraged ESOP transaction, the corporation borrows funds from the institutional lender (this is the ESOP loan or outside loan) and relends the money to the ESOP (inside loan). The ESOP uses the funds from the inside loan to purchase the owner's shares, usually in a lump sum cash payment.

When a corporation pays back a conventional loan, the interest payments are generally deductible, but the principal payments are not. But in a leveraged ESOP transaction, the ESOP repays the inside loan with funds contributed each year by the company, and these contributions, to the extent used to repay the ESOP loan principal, are deductible by the company up to an amount equal to 25% of the aggregate compensation of the ESOP participants. This limit on the deductibility of principal payments – 25% of “covered payroll” – is the limit that applies to all employer contributions to qualified retirement plans, like 401(k) plans. (Note: ESOP contributions used to pay interest on the ESOP loan are also deductible, without limit, by C corporations.)

Since the company funds the repayment of the bank loan by means of the ESOP contributions, it can, in effect, deduct the principal payments (as well as interest payments) on the loan used to acquire the former owners' shares – another significant tax benefit.

Example: In the example above, if the purchase of shares was accomplished through a leveraged ESOP transaction, the company would have been able to deduct the entire \$20 million purchase price (both principal and interest) over the term of the ESOP loan, subject to the annual “covered payroll” limit. That deduction would not be available to any non-ESOP purchaser of the shares.

Dividends paid by C corporations on shares held by an ESOP that are used to pay down an ESOP loan are also deductible, up to the 25% limit.

100% ESOP-Owned S Corporations

Laws passed in 1996 and 1997 permit S corporations to sponsor ESOPs and provide that income attributable to the ESOP's ownership of the corporation's stock is not subject to federal income tax. Thus, if an ESOP owns 30% of an S corporation's shares, 30% of the corporation's income is not subject to federal tax. A 100% ESOP-owned S corporation does not pay any federal income taxes and therefore constitutes a legal tax shelter for 100% of a business's income.

S corporations and their owners are not entitled to all the tax benefits described earlier. For example, S corporation owners who sell their shares to an ESOP cannot defer the gain from the sale under Section 1042 of the Code.³ In addition, while a C corporation can deduct 100% of ESOP contributions used to pay interest on an ESOP loan (as well as contributions used to pay principal, up to 25% of covered payroll), an S corporation must count both interest and principal contributions towards the 25% limit.

Nevertheless, a 100% ESOP-owned S corporation is the only for-profit business entity that does not have to pay any

³ Under an amendment to Section 1042 made by the SECURE Act 2.0 (P.L. 117-328, Div. T, §114), 10% of the gain on a sale of S corporation shares to an ESOP after 2027 may be deferred under that section.

federal income taxes. According to a 2022 survey, there are more than 4,000 such tax-exempt corporations in the United States.⁴

Conclusion

A sale to an ESOP should be considered whenever the owners of a corporate-owned business look to sell their shares. It is generally recommended that the company conduct a feasibility study of whether a leveraged ESOP transaction will meet the selling shareholders' objectives, given the company's borrowing ability, expected future cashflows and the nature and size of the company's workforce, among other important issues. The feasibility study should also take into account the unique tax benefits available when the owners of private business corporations sell all or part of their shares to an ESOP.

If you have any questions about employee stock ownership plans (ESOPs) or the information presented in this Information Memo, please contact [Robert W. Patterson](#), any attorney in our [employee benefits and executive compensation practice](#) or the attorney at the firm with whom you are regularly in contact.

⁴ National Center for Employee Ownership (NCEO), "Employee Ownership by the Numbers," at <https://www.nceo.org/research/employee-ownership-by-the-numbers>.

