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Understanding Employee Stock Ownership Plans

A tax-efficient exit path for business owners — and a way to keep the company you built in the hands of the people who built it with you.

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Introduction

For many business owners, the question of how to eventually exit their company ranks among the most consequential decisions they will ever face. After years or decades of building something meaningful, the prospect of simply selling to an outside buyer can feel unsatisfying — particularly when it means uncertain futures for loyal employees who helped make the business successful.

An Employee Stock Ownership Plan, commonly known as an ESOP, offers an alternative worth serious consideration. This federally authorized retirement plan structure enables owners to transfer partial or complete ownership to their workforce while potentially securing significant tax advantages in the process.

This guide walks through how ESOPs work, the tax treatment available to selling owners and to the company itself, how much control an owner actually retains, and the questions worth answering before you decide whether this path fits your situation.

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What Exactly Is an ESOP?

At its core, an ESOP functions as a qualified retirement benefit program with a distinctive characteristic: rather than holding diversified investments, the plan primarily invests in stock of the sponsoring company. A trust is established to hold these shares on behalf of participating employees, who receive allocations to their individual accounts based on their compensation levels.

Unlike a 401(k) where workers contribute their own funds, ESOP participants typically pay nothing out of pocket. The company makes contributions to the plan, and employees gradually become vested in their allocated shares over time. When they eventually leave the company or retire, they receive the value of their accumulated account balance.

> *According to the National Center for Employee Ownership, over 6,400 companies across the United States currently maintain ESOPs, covering millions of employee-participants.[1] New plans continue to be formed each year as owners discover the unique benefits this structure provides.*

[1] National Center for Employee Ownership, “A Statistical Snapshot of ESOPs” (2026 update, based on 2023 data), esop.org/infographics/statistical-snapshot-esops.php.

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How the Ownership Transfer Process Works

Implementing an ESOP involves several coordinated steps. First, the company establishes the plan and creates an associated trust to hold shares. An independent appraiser determines the fair market value of the business — a critical requirement, ensuring that transactions occur at legitimate prices.

The ESOP trust then acquires shares from the selling owner(s). This can happen in one transaction or through multiple sales over time, giving owners flexibility in their exit timeline. Financing typically comes through a bank loan to the ESOP or through seller financing arrangements where the owner receives payment over several years.

The company subsequently makes annual contributions to the ESOP, which uses these funds to repay any acquisition debt. As shares are released from the loan collateral, they get allocated to individual employee accounts based on relative compensation.

WHAT THIS MEANS FOR YOU

Because shares can be sold in tranches rather than all at once, an ESOP lets you set the pace of your own exit — rather than having a transaction timeline set for you by a buyer.

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Tax Advantages for Selling Owners

Perhaps the most compelling aspect of ESOPs for departing owners involves the potential tax benefits. Under Internal Revenue Code Section 1042, shareholders of C corporations who sell to an ESOP can defer — and potentially eliminate entirely — capital gains taxes on the transaction.

To qualify for this favorable treatment, certain conditions must be satisfied:

- The ESOP must own at least **30% of the company** immediately following the sale.
- The seller must reinvest proceeds into **Qualified Replacement Property** (stocks and bonds of U.S. operating companies) within a specified window.
- The company must be structured as a **C corporation** at the time of the sale.

> *When properly structured, this tax deferral can persist indefinitely during the seller's lifetime. Upon death, heirs may receive the replacement property with a stepped-up cost basis, potentially eliminating the deferred gain permanently.*

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Benefits at the Corporate Level

The tax advantages extend beyond just the selling shareholders. Companies that sponsor ESOPs enjoy favorable treatment that can meaningfully improve cash flow and accelerate debt repayment.

For C Corporations

C corporations can deduct contributions made to the ESOP for purposes of acquiring shares. This means the entire cost of buying out an owner — both principal and interest on any acquisition financing — gets paid with pre-tax dollars. Additionally, dividends paid on ESOP-held shares can be deductible under certain circumstances, further enhancing the plan's efficiency.

For S Corporations

S corporations offer an even more dramatic benefit. Because S corporation income flows through to shareholders for tax purposes, the portion of the company owned by the ESOP trust is generally not subject to federal income tax. This creates substantial additional cash flow that can be used to accelerate debt payoff, fund growth initiatives, or enhance employee benefits.

> *An S corporation that becomes 100% ESOP-owned generally operates free of federal (and often state) corporate income tax.*

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Maintaining Flexibility and Control

One common concern among owners considering an ESOP involves giving up control of the business they built. In practice, ESOPs offer considerable flexibility on this front.

Owners can sell their stake incrementally rather than all at once, allowing for a gradual transition that happens on their preferred timeline. They can remain involved in operations and retain board positions throughout the process. Even after selling 100% to the ESOP, the original owner typically maintains control of business decisions until any acquisition debt has been fully repaid — often a period of several years.

Some ESOP transactions also incorporate warrant structures that allow selling owners to participate in future value creation. If the company continues prospering after the sale, these instruments provide an opportunity to benefit from that success.

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The Employee Perspective

From the employee standpoint, ESOPs represent a distinctive benefit. Workers gain a retirement savings vehicle funded entirely by the employer with the potential to build meaningful wealth over their careers without reducing their take-home pay.

Research consistently demonstrates that employee-owned companies tend to exhibit stronger retention, higher productivity, and greater overall job satisfaction.[2] When workers have a genuine stake in organizational success, their engagement with that success naturally deepens. This alignment of interests between employees and the company can drive improved business performance over time.

As participants approach retirement, they gain the ability to diversify their ESOP holdings into other investments, helping manage risk while still benefiting from the ownership culture they helped create.

[2] National Center for Employee Ownership, “Research on Employee Ownership” (nceo.org/articles/research-employee-ownership); see also Steven F. Freeman, “Effects of ESOP Adoption and Employee Ownership: Thirty years of Research and Experience” (2007).

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Preserving Your Legacy

Beyond the financial and tax considerations, many owners find appeal in what an ESOP represents for their legacy. Selling to employees means the business remains in the hands of people who understand it deeply and care about its continued success. Customers maintain relationships with familiar faces.

> *Jobs stay in the community rather than potentially being relocated or eliminated after an outside acquisition.*

For founders who built their companies with particular values or a distinct culture, an ESOP provides confidence that these elements will persist beyond their active involvement. The business they created continues as an employee-owned enterprise rather than becoming absorbed into a larger corporate entity.

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Key Considerations Before Proceeding

While ESOPs offer compelling advantages, they are not suitable for every situation. The company should have stable earnings and a strong management team capable of operating independently. Professional services firms, manufacturing companies, and construction businesses often make good candidates due to their workforce-dependent value creation.

The structure involves meaningful administrative costs and complexity. Annual valuations are required, and fiduciary responsibilities must be taken seriously. Working with experienced ESOP advisors — including legal counsel, valuation experts, and financial advisors familiar with these transactions — is essential for success.

Additionally, the favorable Section 1042 tax treatment applies only to C corporations at the time of sale. S corporation owners cannot access this particular benefit, though they may still find the S corporation ESOP structure attractive for other reasons.

What to do now: The right time to explore whether an ESOP makes sense is typically well before you plan to leave. These transactions require careful planning and structuring to maximize their benefits. Beginning the conversation early gives you time to position the company appropriately and make informed decisions about your financial future.

Your Next Step

Schedule a Confidential Conversation With Chris

An ESOP represents a uniquely American approach to business succession — one that rewards employees, provides tax efficiency for sellers, and keeps successful companies intact within their communities. For owners beginning to contemplate their eventual exit, understanding this option deserves a place in the conversation.

No pressure. No obligation. Just a clear-eyed look at whether employee ownership fits your goals, your family, and your team.

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