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THE EOT – MORE THAN JUST A HOT NEW TAX ACRONYM

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I. INTRODUCTION

This article considers the issues that arise when organizing an Employee Ownership Trust ("EOT") and the tax consequences that may result. The EOT is a relatively new business succession strategy in the United States.[1] EOTs have their roots in the United Kingdom, where they emerged as a unique form of employee ownership.[2] The concept of EOTs can be traced back to the early 20th century, and the structure has gained more attention since the 1970s, with nearly 2,000 businesses currently held in trust structures.[3] This gain of attention was influenced by the cooperative movement of the late 19th and early 20th centuries. Cooperatives, where workers owned and controlled the businesses they worked for, demonstrated the potential for employee ownership to empower workers and improve company performance. However, the cooperative model faces challenges, such as limited access to capital and difficulties in attracting and retaining talent.

EOTs provide a more flexible and adaptable form of employee ownership, allowing companies to transfer ownership into a trust that would benefit all current and future employees while maintaining the company's legal structure and operational control.[4] This approach provides a balance between employee empowerment and the needs of the business.[5] The John Lewis Partnership is a well-known EOT and is recognized as the first EOT in Britain.[6] The company is a leading retailer in the country, operating department stores, supermarkets, and other retail outlets across Britain.[7] The company has been employee-owned since 1929, where owners collectively share its profits and participate in its governance.[8]

EOTs serve several goals. First, they enable a business owner to exit on favorable terms and on a timeline that fits their succession goals. In addition, EOTs provide a way to maintain an existing business indefinitely for the benefit of its workers. By offering a means to serve these two goals jointly, EOTs address the interests of a broad range of stakeholders, including those within the local economy.

The growing popularity of EOTs could have major effects on

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[1] *See What is EO?*, EMP. OWNERSHIP ASS'N (last visited Jan. 9, 2025).

[2] *Id.*

[3] *Id.*

[4] *See* Brad Herrmann, *The Employee Ownership Trust Model: A Compelling Exit Strategy Option*, FORBES (Mar. 12, 2024, 8:30 AM).

[5] *See generally Types of EO*, EMP. OWNERSHIP ASS'N (last visited Jan. 9, 2025); *EO Benefits*, EMP. OWNERSHIP ASS'N (last visited Jan. 9, 2025); *History of the EOA*, EMP. OWNERSHIP ASS'N (last visited Jan. 9, 2025).

[6] *See generally Our History*, JOHN LEWIS P'SHIP (last visited Jan. 9, 2025).

[7] *Id.*

[8] *Id.*

economic development. As a result, EOTs have gained the attention of worker equity leaders[9] for their potential to further business retention and promote worker ownership at a time when the future of many businesses is in transition. Small, closely held businesses play a crucial role in our economy and communities, and the EOT is emerging as a desirable option among succession plans. However, unlike the more widely known Employee Stock Ownership Plan ("ESOP"),[10] EOTs do not enjoy privileged tax treatment and require organizers to navigate additional tax considerations. Therefore, the emergence of the EOT does not mean it is the proper succession planning choice for all business owners.

This article proceeds as follows: Part II explains why EOTs are becoming more popular in the United States and what may be at stake for those businesses without EOTs who fail to carry out succession plans; Part III examines the various types of succession plans that are available to business owners; Part IV gives an overview on the workings of a trust generally and discusses what a business owner should consider before establishing an EOT as their succession plan; Part V offers an operational roadmap for business owners engaged in succession planning and provides an overview of the tax consequences to this emerging option on both the buyer's and seller's side; Part VI provides a hypothetical EOT structure and the tax consequences that follow; Part VII concludes.

II. "THE SILVER TSUNAMI"

EOTs are gaining attention due to the significant number of closely held businesses across the U.S. owned by individuals who are fast approaching or past traditional retirement ages. These owners are part of a broader "Silver Tsunami"[11] happening across many sectors of U.S. society, including business retention. In 2022, Baby Boomers owned

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[9] Project Equity, a national worker ownership organization, is a leader in efforts to convert closely held businesses to employee ownership, including through the EOT. *See* PROJECT EQUITY (last visited Jan. 14, 2025).

[10] An "Employee Stock Ownership Plan" is a qualified contribution plan under IRC section 401(a) that invests in the stock of a qualified employer. Employees buy shares over time, and these are repurchased by the ESOP at retirement, usually at a profit to the employee. 26 I.R.C. § 401(a); *see Employee Stock Ownership Plans (ESOPs)*, IRS (Aug. 20, 2024).

[11] "Silver Tsunami" is a widely used phrase to describe the demographic shift caused by the increased portion of society that is aging, and the strains this phenomenon will have on various social sectors, including social security, health care, and workforce. *See generally* Lauren Henderson et al., *The Silver Tsunami: Evaluating the Impact of Population Aging in the U.S.*, 29 J. BUS. & BEHAV. SCI. 153 (2017).

more than 41 percent, roughly 12 million, of privately held businesses across the U.S., accounting for more than 25 million jobs.[12] More than 350,000 of these businesses transition to new ownership or close every year.[13] Importantly, these businesses fuel tax revenue at all levels of the government,[14] serve critical social roles in communities across the nation,[15] and provide social fabric by fostering a greater sense of connection between owners and patrons.[16] Over the last century, the growth of small businesses has been instrumental to the advent and expansion of the middle class and led to the creation of trillions of dollars in personal wealth.[17] Many appreciate the importance of keeping these businesses operating after their current owners exit.

Exiting, however, may not be as straightforward as owners, employees, and other stakeholders expect. Owners looking to exit their businesses often face the challenge of finding a strategy that realizes the business' value, occurs in a time frame that fits the owner's goals, and secures the legacy of the owner's work.[18] In many cases, even a successful business will not find the right buyer.

The authors of this piece worked with one founding owner whose story illustrates the challenge. Let's consider the hypothetical case of Widgets Co. (Widgets), a manufacturing company. Widgets has operated for over twenty-five years, producing specialized tools for the aftermarket automotive industry. Led by a careful and talented founder, the company employs fourteen full-time workers with an average tenure

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[12] Yaqub M., *Small Business Owners Statistics: A Ultimate Numbers*, BUSINESSDASHER (Sept. 30, 2024); *see ABS – Characteristics of Business Owners: 2022 Tables (Employer Businesses)*, U.S. CENSUS BUREAU (Oct. 26, 2023).

[13] Yaqub M., *supra* note 12.

[14] *See, e.g.*, Daniel Bunn, *Sources of U.S. Tax Revenue by Tax Type, 2022 Update*, TAX FOUND. (Feb. 14, 2022) (explaining that privately held businesses are commonly taxed as individual incomes, which in 2020 accounted for 41.1% of the United States tax revenue).

[15] *See, e.g.*, Anthony K. Tjan, *Why Small Companies Are Better at Customer Service*, HARV. BUS. REV. (Sept. 21, 2009) (showing that small businesses provide a better customer experience and are more likely to operate in the community where their owners live, leading to local engagement and investment from the business).

[16] *See* Margaret Fitzgerald & Glenn Muske, *Family Business & Community Development: The Role of Small Business Owners & Entrepreneurs*, 47 J. CMTY. DEV. 412 (2016).

[17] *See* BRETT THEODOS & DENNIS SU, SMALL BUSINESS OWNERSHIP AND FINANCE, A LANDSCAPE SCAN OF THE HISTORICAL UNDERPINNINGS OF CURRENT CONDITIONS, URB. INST. 1-2 (2023).

[18] Private equity ("PE") firms are stepping in to provide exit options for business owners. *See, e.g.*, Te-Ping Chen, *America's New Millionaire Class: Plumbers and HVAC Entrepreneurs*, WALL ST. J. (Oct. 12, 2024) (reporting how PE firms are consolidating mom-and-pop businesses "to create larger players and improve their margins by adding managerial knowhow, back-office efficiency and beefed-up marketing and recruiting budgets.").

of more than ten years and an annual revenue of roughly $2 million. Widgets' owner has run the business artfully, keeping debt low and using net revenues over the years to buy the land and facilities where Widgets operates. The owner is now seventy-two and plans to step back one day soon; however, his plan to do so faces challenges. He has a short runway to develop and execute a succession plan and, as with most small businesses, lacks an available outside buyer.[19] The owner is committed to Widgets' workers; simply closing the doors and walking away from something built into a successful business is not an option.

The story of Widgets isn't unique. Nearly three million small business owners are nearing or at retirement age in the U.S.,[20] and these owners account for over 30 million jobs and over $1.2 trillion in payroll.[21] Yet, 70 percent of these businesses will fail to find a buyer if put on the market. Small business owners must find efficient ways to exit their business under new leadership where it can continue to operate. Significant disruption would result from 70 percent of these businesses dissolving and ceasing operations,[22] with more than 22 million jobs displaced.[23] Sectors of the U.S. economy would be disrupted, with a particularly heavy impact on rural communities.[24]

Employee ownership has emerged as a viable strategy to retain such businesses in the communities where they started and grew.[25] The EOT is emerging as one strategy for serving owners looking to exit while securing business succession.[26]

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[19] *See* Melissa Angell, *Small-Business Owners Air Their Succession Struggles Before Congress*, INC. (Jan. 25, 2024) ("Seventy percent of [U.S.] companies that go to market don't sell, Snider pointed out, and 50 percent will face involuntary closures 'due to external elements that force a business owner to sell or close.'").

[20] *See id.* ("The Senate Committee on Small Business and Entrepreneurship heard from a quartet of business owners and succession planning experts January 24, about the challenges founders face as they exit their companies.").

[21] *Id.* ("Nearly three million U.S. businesses are owned by someone 55 or older, according to Project Equity, an Oakland, California-based nonprofit focused on economic resiliency. Those businesses employ some 32.1 million workers and are responsible for generating $1.3 trillion in payroll. Failure to prepare a succession plan could lead to an involuntary exit, jeopardizing local jobs.").

[22] *See* Diana Farrell et al., *Talkin' 'Bout My Generation: The Economic Impact of Aging US Baby Boomers*, MCKINSEY GLOB. INST. (June 1, 2008).

[23] *See generally* Kara Dennison, *The Silver Tsunami Is on The Way: How Companies Can Prepare*, FORBES (Oct. 11, 2023, 11:10 AM) (discussing how retiring boomers make up a large portion of business leadership, and few transfer knowledge to the next generation of workers).

[24] *See* Elizabeth Templin et al., *The Silver Tsunami and Rural Small Business Retention: What Can Communities Do?*, 48 CMTY. DEV. 282, 282-83 (2017).

[25] Employee ownership comes in many forms—the ESOP being, perhaps, the most widely known. *See* Joseph Blasi & Douglas Kruse, *Employee Ownership and ESOPs: What We Know from Recent Research*, ASPEN INST. (Apr. 2024).

[26] The term EOT is frequently used, but it may be a bit of a misnomer. If a trust

III. EOTs in Context: A Comparison of Succession Planning Options

Small business owners have many succession planning options, each with its benefits and challenges. In some cases, the EOT can emerge as the most compelling choice.

A. Passing the Business to an Heir

A common option in business succession planning is to name an heir, most likely a child of an owner, who will eventually lead the company. While the idea is pervasive, success is rare. About 40 percent of closely held businesses survive second-generation leadership; of those, only 13 percent will last in the third generation.[27] Passing to the next generation may also create internal risks and possible punitive estate and generation-skipping tax implications between family members.[28] For example, a company owned by a founder with three children must decide who will take control or plan for joint control, which may present other complications. If the owner decides to leave control to one of the three children, a question of equity among the group arises. These options require advanced legal preparation and communication across the family, which may lead to disputes. Finally, even if all these challenges can be successfully navigated, this assumes that the small business owner has children, that the children want to work in the business, and that they are qualified to do so.[29]

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is created with employees as actual beneficiaries (that is, beneficiaries under trust law with enforcement rights), the word "ownership" would be correct. *See* ANNE-CLAIRE BROUGHTON ET AL., USING AN EMPLOYEE OWNERSHIP TRUST FOR BUSINESS TRANSITION 16 (2024). But this is most often not the case. Anecdotally, the EOT is most often created as a purpose trust with the purpose of operating the business for the benefit of the employees. *Id.* In this situation, the employees don't have an ownership interest in the trust. They benefit, and they may be involved in management or decision making, but they don't own the shares or equity. *Id.* at 17. The relationship is described as "naked in, naked out," meaning the employees enter the relationship without making an equity contribution and they leave without one as well. *Id.* at 18.

[27] *See Family Business Facts*, CORNELL SC JOHNSON COLL. BUS. (last visited Jan. 5, 2025).

[28] The estate tax is currently 18% to 40%, 26 U.S.C. § 2501 et seq., with the generation-skipping tax set at a heftier 40%, 26 U.S.C. § 2601 et seq.

[29] An heir's individual behavior, perhaps excusable in other contexts, can also prevent successful leadership by the next generation. *See* Mary Whitfill Roeloffs, *Heir to Billionaire Tyson Foods Empire Arrested for Drunken Driving Suspended from CFO Position*, FORBES (June 13, 2024, 3:20 PM).

B. Selling the Business to a Co-Owner

Where multiple owners own a business, one succession option is to sell ownership to a co-owner. Such arrangements are usually provided for with Buy/Sell agreements, which contain obligations between owners detailing what will happen upon a "triggering event," such as a death, divorce, disability, retirement, or desire to leave.[30] Buy/Sell agreements can be between business owners, requiring remaining business owners to purchase the exiting owner's shares, or between the business entity and the owner, where the business itself agrees to purchase the shares.[31] Life insurance policies will often be purchased to provide payment when one owner dies, allowing the business to move forward without a significant outlay to redeem shares.[32]

Buy/Sell agreements provide several benefits to the business owner, including ensuring there will be funds to purchase shares and providing a clear vision for future ownership that can help secure a successful transition.[33] In situations with multiple potential heirs, the Buy/Sell agreement allows shares to be redeemed by the company, which can then determine leadership, avoiding inter-family conflicts.[34] They are not, however, without concerns, particularly when the selling owner has a minority interest or when there are a large number of shareholders or owners.[35]

For some succession plans, selling to a co-owner could be initiated when the co-owner passes away, retires, or otherwise steps back from the business. Such a transaction can be streamlined, thereby lessening transaction costs and allowing capital gain treatment on redemptions.[36] Selling to a co-owner allows the exiting owner to see their legacy continue while providing an easy cash out transaction, but not without its own challenges in some instances. Common problems arise when partners try to value an exiting partner's interest, including disagreements over the appropriate valuation method, disputes over the business' market value, potential conflicts of interest, complications surrounding intangible assets including intellectual property, and complications caused by the partnership agreement's provisions for exit.[37] Assuming these issues can be successfully navigated, the

[30] *See* Joshua P. Friedlander et al., *Buy-Sell Agreements: The Accountant's Holistic Primer Part 2*, NYS SOC'Y CPAS (June 1, 2021).

[31] *See id.*

[32] *See id.*

[33] *See id.*

[34] *See id.*

[35] *See id.*

[36] *See* Martin E. Mooney, *Sale or Redemption of a Partnership Interest – Is There a Difference?*, FROST BROWN TODD (Jul. 27, 2023).

[37] *See Why Business Valuation Matters in a Partner Ownership*, QUIET LIGHT

transaction itself will require minimal legal documentation or time to develop new leadership. Concerns nevertheless remain: the owner may not want to step entirely away from the business, as needed for preferable tax treatment;[38] the valuation may be low and not produce enough cash for the exiting owner's needs;[39] and there is no certainty that the business will not one day be sold to an outside buyer.[40] This possibility is not ideal for owners seeking to continue their legacy in perpetuity.

C. Leadership Succession Planning with Existing Employee

Many business owners may look for a successor from qualified candidates within the company, which can be an effective way to pass on leadership and ensure the business's future. Succession planning with existing employees allows owners to mentor and train new leadership before giving up control, creating career advancement prospects that may increase morale and retention. To be effective, however, the plan will require a long-term investment in worker development, starting with training internal candidates to step into leadership.[41]

This may seem like a viable and even attractive option for larger companies with pools of eligible workers and resources. By contrast, the cost and loss of a worker's time poses challenges for smaller companies. In addition, even when a company has a pool of dedicated, effective workers, it is not necessarily true that any of these workers will want to take over the business or make the financial investment necessary to do so. These factors suggest that looking to internal candidates for a succession plan may not fit the needs of a smaller, closely held company.[42]

(last visited Mar. 18, 2025).

[38] Gains on a transaction where the owner redeems shares and continues to be engaged in the business will most likely be taxed as ordinary income, not receiving the favorable capital gains treatment. *See* I.R.C. § 302. This may be a disincentive for some small business owners.

[39] *See* Arvid Kahl, *Why You Shouldn't Sell Your Business*, BOOTSTRAPPED FOUNDER (Nov. 17, 2022).

[40] *See* John Koenig, *Problems That Can Occur if Multiple Owners Start a Corporation or LLC Without a Buy-Sell Agreement, Operating Agreement or Similar*, JOHN L. KOENIG L. LLC (Aug. 13, 2013).

[41] *See Succession Planning: How Professional Development Can Ease the Transition*, UNIV. MINN. (Aug. 29, 2024).

[42] *See* Ted Hamilton, *Succession Planning for Small and Mid-Sized Businesses*, WETHERINGTON HAMILTON (Oct. 9, 2015).

D. Selling to an Outside Party

Selling to an outside party provides another option whereby the owner sells the business to an investor, competitor, or management firm. In such a transaction, the owner often bases the sale price on an independent appraisal. This may be a viable and straightforward way to exit a business, enabling the company to continue to grow under new ownership.

However, this strategy presents several practical concerns. As previously mentioned, many successful and profitable businesses cannot find a buyer, particularly in the manufacturing and service sectors.[43] Additionally, arriving at a purchase price that works for the selling owner can be challenging, and in many instances, the seller will be required to finance at least part of the transaction. Once under new ownership, an outside buyer may have no incentive or interest in maintaining the business or the owner's legacy, which can lead to changes misaligned with the seller's goals.

E. Exiting to the ESOP

The ESOP offers an option for some business owners. In this transaction, the ESOP effectively purchases the business, which then operates for the benefit of the employees.[44] The ESOP gets a loan from an outside lender and signs a corresponding promissory note.[45] The employer provides a written guarantee to the bank, promising that the ESOP will repay the loan and, each year, the employer pays the ESOP enough to permit the ESOP to make its annual loan repayment.[46] The ESOP uses the funding from the loan to buy stock from the employer (or a shareholder).[47] Thus, the employer has received new capital. The loan can be secured by the pledge of the stock acquired by the ESOP.[48]

The stock is held in an ESOP suspense account and is released for allocation to participant accounts.[49] The loan is repaid with funds contributed to the ESOP by the employer and/or by using dividends on employer securities in the ESOP.[50] Each year, the employer makes a

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[43] *See* Derek A. Barnard, *Should You Sell Your Company to An Outside Third Party?*, ANDERS CPAS + ADVISORS (Jan. 7, 2014).

[44] *See* Robert C. Hockett, *Why (Only) ESOPs?*, 12 STAN. J.L. BUS. & FIN. 84, 88-89 (2006).

[45] *Id.* at 89.

[46] *Id.*

[47] *Id.*

[48] Steven James et al., *Examining Employee Stock Ownership Plans (ESOPS), Including New Developments*, IRS, 8-1, 8-13 (last visited Mar. 29, 2025).

[49] *Id.* at 8-11.

[50] *See id.* at 8-56.

tax-deductible payment to the ESOP, which in turn enables the ESOP to repay its annual debt to the bank.[51] As the debt is repaid, employer securities in the ESOP suspense account are released to the participants' accounts.[52] The employer can repay the acquisition indebtedness of the ESOP out of the earnings from its new capital.[53] Since the employer's contributions to the ESOP are deductible within the I.R.C. § 404(a)(9) limits, a leveraged ESOP allows the company to repay the entire loan on a tax-favored basis.[54]

As this description suggests, the ESOP is a sophisticated structure, requiring accompanying costs and fees associated with lawyers, accountants, and technical assistance providers.[55] ESOPs can be expensive to form and maintain due to legal fees, valuation, and other professional costs.[56] Cash flow requirements, which are needed to pay debt and maintain employee benefits, may limit available funds for reinvestment.[57] ESOP repurchase obligations may also require share buybacks by the employer or by the ESOP itself.[58] While the ESOP may be an attractive option for somewhat larger companies,[59] the costs, complexity, and need for specialized professional advice means the option will not effectively accommodate many business owners.

F. Exiting to Employee Ownership and a Worker Cooperative

In this scenario, the business owner sells the business to the workers employed by the company. The transaction is most often structured as an asset sale, with the workers creating a new entity to negotiate and close the transaction, assume the assets, and continue the business operations, but with the crucial difference that the workers themselves now own the business.[60]

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[51] *Id.* at 8-13.

[52] *Id.*

[53] *Id.*

[54] *See* IRM, 4.72.4.1.1.1 (Apr. 1, 2006).

[55] *See* Corey Rosen, *Twelve Bogus Reasons Not to Do an ESOP (and Seven Good Ones)*, NCEO (last visited Jan. 13, 2025).

[56] *See id*. (stating that, on average, annual compliance cost for the ESOP will exceed $150,000).

[57] *See* Mark D. Welker, *Anatomy of an ESOP*, HUSCH BLACKWELL (last visited Feb. 14, 2025).

[58] *See ESOP Repurchase Obligation Liability*, NCEO (last visited Feb. 14, 2025).

[59] *See id.*; *Infographic: ESOPs by the Numbers*, NCEO (last visited Jan. 13, 2025) (emphasizing that the average enterprise operated as an ESOP has revenue in excess of $90 billion); Stephanie Ferguson Melhorn et al*., Small Business Data Center*, U.S. CHAMBER COM. (May 20, 2024) (noting that small businesses comprise 99.9% of businesses in the U.S.).

[60] The worker cooperative is a fairly well-known way to organize a business, although it is perhaps better understood as a business that is grown from a start-up

A key element of the worker cooperative is that it is organized and operated by the person who performs the labor for the enterprise. Here, ownership by the individuals performing profit-generating labor distinguishes the worker cooperative from other forms of business ownership, where workers are accounted for as an input that opposes ownership.[61] Several states have adopted worker cooperative statutes that recognize this unique form of ownership and, by necessity, governance.[62]

Several components define the worker cooperative as a form of ownership. Under this form of ownership, each member has only one vote.[63] This means that each member stands equal to all others in governance.[64] In addition, members share in profits in proportion to the work they contribute to the enterprise.[65] Such governance and dividend distribution requirements are contained in the articles of incorporation and bylaws, which precisely detail membership criteria, voting rights, capital accumulation, distributions, and tax elections.[66]

Exiting to a worker cooperative offers several benefits to both the seller and buyer and promises additional community benefits.[67] The option may, nevertheless, face challenges as success depends on an established group of workers who must be willing and able to move from employee to owner status and assume all obligations that come with that transition. In many instances, it will also be the case that employees lack assets to finance the transaction, falling short of providing a personal guaranty on the transaction. This places the selling owner at higher risk than may be comfortable or expected,[68] which often makes selling to a worker cooperative unattractive.

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instead of assuming ownership through a conversion process. *See generally* CASE STUDIES: BUSINESS CONVERSIONS TO WORKER COOPERATIVES, PROJECT EQUITY 5-6 (2015).

[61] *See id.* at 4.

[62] *See, e.g.*, Cal. Corp. Code § 12200 et seq. (1982).

[63] *What Is an Employee Co-Op?*, EMP. OWNERSHIP FOUND. (last visited Feb. 14, 2025).

[64] *Id.*

[65] This is the notion of "patronage" and is provided for under Subchapter T of the Internal Revenue Code. *See* I.R.C. §§ 1381-1388.

[66] *See* Lewis D. Solomon & Melissa B. King, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 268-270 (1994).

[67] *See id.* at 235.

[68] The worker cooperative provides an excellent tool for asset development among working people. *See id.* at 260. The articles or bylaws of a capital account cooperative may authorize the assignment of a portion of retained net earnings and net losses to an unallocated capital account. *See id*. The unallocated capital account in a capital account cooperative shall reflect any paid-in capital and retained net earnings not allocated to individual members. *See id.*

G. Exiting to an EOT

While the EOT is not a fit for all small business owners looking to sell their business, it does offer a reasonable option for some. The EOT does not require an available heir or internal candidate for ownership and does not encounter the problems that can come up with co-owner buyouts. The EOT offers low transaction and ongoing costs compared to the ESOP,[69] and is significantly less complicated—as far as ownership and management are concerned—than a conversion to a workers cooperative. Finally, selling owners also have a higher chance of realizing the full value of their business when compared to selling to an outside party, while also securing the business for the future.

Aside from these comparative benefits of the EOT transaction, business operations continue without interruption, allowing the company to maintain relationships with customers and suppliers. Moreover, the business often retains its current management for a period after closing, which helps safeguard the owner's legacy. The EOT promises a succession plan that avoids potential conflicts among interested parties while recognizing and valuing employee contributions. The operations of an EOT are further discussed below.

IV. MOVING TO THE EOT

The EOT is one form of a trust. Trusts offer tremendous flexibility for designing relationships that serve a property owner's interest over time, as may be shown by the many specialized trust instruments that have developed over the past few centuries to serve a grantor's interest.[70] In addition to potential tax advantages, the benefits available to grantors who transfer their property into a trust include the influence the grantor may exert, in some cases, into perpetuity.

A. A Trust

A trust is "[t]he right . . . to the beneficial enjoyment of property to which another person holds the legal title; a property interest held by one person (the *trustee*) at the request of another (the [*grantor*]) for the benefit of a third party (the *beneficiary*)."[71] The trust must also have

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[69] *See ESOPs vs. Employee Ownership Trusts (EOTs): Which is Right for You?*, NCEO (last visited Feb. 14, 2025).

[70] *See, e.g.*, Alexander A. Bove, Jr. & Melissa Langa, *The Perpetual Business Purpose Trust: The Business Planning Vehicle for the Future, Starting Now*, 47 ACTEC L.J. 3, 3 (2021) (noting the prevalence of GRITs, GRATs, QPRTIs, SLATs, CRUTs, and ILITs, among others).

[71] *Trust*, BLACK'S LAW DICTIONARY (12th ed. 2024).

assets, which may include shares of stock or a membership interest in a limited liability company, which are held and managed subject to the terms of a trust instrument, the legal document that establishes the trust and outlines its terms and conditions.[72]

While there are many types, trusts essentially fall into two broad categories: revocable trusts (a grantor trust) and irrevocable trusts. A "revocable trust" allows the grantor to change or dissolve the trust at their discretion.[73] In a revocable trust, the grantor retains ownership and control over the trust assets.[74] This means the grantor can modify or terminate the trust at any time. Essentially, the grantor and the trustee are the same person; consequently, the grantor remains liable for the income tax on the trust's earnings.[75] The grantor also continues to own the assets held in the trust for tax purposes.[76] Grantor trusts are frequently used as part of an estate plan, allowing the grantor to transfer assets to beneficiaries without incurring gift taxes during the grantor's lifetime.[77]

A revocable grantor trust allows the grantor to retain control and modify the trust after it is created.[78] In contrast, an "irrevocable trust" cannot readily be changed or terminated once established,[79] meaning that the assets placed in an irrevocable trust are beyond the grantor's reach, cannot be used for their benefit, and, in most cases, are dedicated to benefit someone other than the grantor.[80] Irrevocable trusts are

[72] The trust instrument is usually called a "trust agreement," but other terms are also used, such as "indenture." This agreement contains extensive provisions detailing the creation, management, and uses of income or property held in trust.

[73] *See Revocable Trust*, WEST'S TAX L. DICTIONARY § R2670 (2024).

[74] *Id.*

[75] *See* I.R.C. § 671.

[76] *Id.*

[77] *See generally* BRANDON D. HAMM AND ALEXANDER J. WOLF, A PRIMER ON GRANTOR TRUSTS, KOLEY JESSEN (2016). In some cases, trusts may be used to qualify for Medicaid benefits. Medicaid has strict income and asset limits. Medicaid Asset Protection Trusts ("MAPT") allow a person to transfer assets into the trust, removing them from ownership and making the grantor eligible for Medicaid. *See Medicaid Qualifying Trusts*, HENSSLER FIN. (2025). Assets placed in a MAPT are protected from being counted towards the grantor's income and asset limits, shielding them from Medicaid estate recovery. *Id.*

[78] *See* HAMM & WOLF, *supra* note 77.

[79] *See* Susan T. Bart & Stacy E. Singer, *Can I Change My Irrevocable Trust?*, ACTEC (last visited Jan. 13, 2025).

[80] Some irrevocable trusts do benefit the grantor. For example, a Medicaid trust is designed to help individuals qualify for Medicaid benefits by transferring assets to a trust. By transferring assets into the trust, the individual's countable assets may fall below Medicaid eligibility requirements. This is because the trust may be considered a "qualified income trust" or "qualifying asset trust," which can protect assets from being counted towards Medicaid eligibility. The irrevocability of Medicaid trusts can vary depending on state laws and the specific terms of the trust agreement. Some states

generally taxed as separate taxable entities,[81] meaning they must file independent tax returns and pay income taxes on their earnings.[82] However, specific tax treatment can vary depending on the type of irrevocable trust and its beneficiaries. In certain cases, relevant to the EOT, an irrevocable trust may be treated as a grantor trust for tax purposes,[83] which means that the grantor remains liable for the trust's income tax, which can happen if the grantor retains certain powers or benefits over the trust.[84]

EOTs should be structured as irrevocable trusts. The irrevocable nature is a key feature that allows an EOT to provide certain tax benefits and protect the interests of employees. By making the trust irrevocable, the business owner can transfer ownership interests to the trust, ensure that the employees' interests are protected, and that the trust is used solely for the benefit of the employees.

B. Creating the EOT

The "trust agreement" memorializes the decision made by the grantor upon establishing the trust. With an EOT, these decisions revolve around the specific business to be held in trust and who will receive the benefit. In many ways, creating the EOT begins well before finalizing the trust document. The business owner must first address a variety of considerations that will ultimately shape the EOT's creation.

The business owner must establish what the EOT will accomplish. The common goals that apply when establishing a trust, including providing for family members, protecting assets from creditors, and minimizing taxes, aren't directly applicable to the EOT. The EOT replaces these goals with a focus on securing a fair price for the business while assuring its continued operation. The small business owner must first settle on the idea that the goal of the EOT is to maintain the business operations for current employees while also providing enhanced benefits for workers who have contributed to the company's success.

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allow for the modification or termination of Medicaid trusts under certain circumstances, while others consider them irrevocable upon creation. *See How Medicaid Planning Trusts Protect Assets and Homes from Estate Recovery*, AM. COUNCIL ON AGING (Dec. 27, 2024).

[81] *See* Tara Anne Pleat & Barbara Hughes, *A Short Primer on Trusts and Trust Taxation*, 17 SPECIAL NEEDS ALL.: VOICE 7 (Aug. 2023).

[82] The trust itself is responsible for filing an income tax return and paying taxes on its earnings, which can include interest, dividends, and capital gains. The trust may be able to deduct distributions made to beneficiaries, which can reduce its taxable income.

[83] *See* IRS, *Abusive Trust Tax Evasion Schemes – Questions and Answers* (Oct. 1, 2024).

[84] *See* I.R.C. § 671.

The business owner must also decide who the EOT will benefit and what assets will fund the EOT. Trust beneficiaries commonly include individuals, charities, broad community groups, or public interests. This is not the case with the EOT. The EOT will often not designate defined beneficiaries and instead seek to benefit the "purpose" of retaining the business over time.[85] Because the grantor's decision regarding beneficiaries carries significant tax and governance implications, the small business owner should clearly understand who the beneficiary will be and why. Additionally, trusts may receive cash, securities, real estate, and personal property. Assets in the EOT will almost always be stock in a C Corporation,[86] although a limited liability company membership interest may be held in trust by the EOT. Small businesses that elected Subchapter S treatment will revoke that election when the shares are transferred into the trust.[87]

Finally, the duration of the EOT must be established. While revocable trusts are commonly used for estate planning purposes, the EOT will most likely be organized as an irrevocable trust to avoid income attribution to the grantor.[88] The business owner may either transfer the business into the EOT in one step, moving 100 percent of the ownership to the trust and transferring a smaller amount to the trust with a contemporaneous redemption of remaining shares, or the business owner may transfer shares incrementally over time.[89] Trusts used as part of an estate plan typically distribute property at the grantor's death. Because the EOT is intended as an indefinite solution for operating the business, the Rule Against Perpetuities is implicated.[90] Fortunately, in many states, this rule has been repealed.[91] In those states

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[85] *See* Susan N. Gary, *The Changing Landscape of Business Succession: How and Why Purpose Trusts Matter*, 18 OHIO ST. BUS. L.J. 39, 43, 74-75 (2023).

[86] *See* Christopher Hartman & Katherine A. Walter, *Trusts as S Corporation Shareholders*, TAX ADVISER (May 1, 2022) (citing I.R.C. § 1361(c)(2)), ("Generally, a trust cannot hold stock of an S corporation; however, grantor trusts, testamentary trusts, voting trusts, ESBTs, and qualified Subchapter S trusts (QSSTs) are permissible S corporation shareholders.").

[87] *See* James G. Blasé, *Trusts for Holding S Corporation Interests: QSSTs vs. ESBTs*, TAX ADVISER (May 1, 2022) (listing various disadvantages of Subchapter S trusts (QSSTs) and reasons why entities may elect to revoke the QSST election).

[88] This is due to the grantor trust rules found in I.R.C. §§ 671-679 (Subpart E, Part I, Subchapter J, Ch. 1 of the Internal Revenue Code).

[89] How the business owner will be paid for their interest implicates several tax issues, including whether gains will be taxed as capital gains or as ordinary income. *See* discussion *supra* note 38.

[90] *See, e.g.*, I.R.S. P.L.R. 7511260210A (Nov. 26, 1975) (explaining that the rule against perpetuities is part of the common law, under which "the period during which vesting of interests in property may be postponed is limited to a life or lives in being and twenty-one years and ten months.").

[91] As classically stated, the Rule Against Perpetuities provides that "[n]o interest

where the restriction is retained, the small business owner and their advisors must develop plans to enable the trust well into the future.

Once the grantor has determined the EOT's goals, assets, and duration, a trustee must be identified. In many instances, the grantor serves as the trustee. Because EOT transactions are often financed with carry-back financing, the grantor may find it efficient to serve as the trustee for at least some time post-closing.[92] Even then, a successor trustee, usually a person with the financial expertise, time, and reliability needed for the role, should be identified.

A perpetual trust also requires the designation of a "trust protector."[93] A trust protector is a person or entity appointed to oversee and manage a trust agreement.[94] While the trustee is responsible for administering the trust's assets and making distributions, the trust protector ensures compliance with the trust's terms and safeguards beneficiaries' interests.[95] The trust protector's powers can vary widely depending on the terms of the trust agreement.[96] Commonly, the trust protector oversees the trustee's performance and ensures that they act in the beneficiaries' best interests. In addition, if disagreements or conflicts exist between the trustee and the beneficiaries, the trust protector can help mediate or resolve the issues. The trust protector may also have the authority to amend the trust agreement under certain circumstances, which may be helpful if the trust needs to be updated to reflect changes in circumstances or to address unforeseen issues.

With the trustee and trust protector identified, the EOT trust

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is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest." JOHN CHIPMAN GRAY, THE RULE AGAINST PERPETUITIES § 201 (4th ed. 1942). *See* Michael M. Gordon & Daniel F. Hayward, *Dynasty Trusts: Delaware Law and Policy*, GORDON, FOURNARIS & MAMMARELLA, P.A. (Dec. 6, 2019) ("[M]any jurisdictions have either abolished the common law rule against perpetuities applicable to trusts by allowing the creation of true perpetual trusts or otherwise extending the common law rule against perpetuities applicable to trusts so that trusts may stay in existence for a very long period of time. [sic] (i.e., one thousand years). For instance, Delaware abolished the common law rule against perpetuities applicable to trusts in 1986 and enacted legislation allowing perpetual trusts in 1995. 25 Del. C. § 503. Under Delaware law, a trust may have a perpetual existence. 25 Del. C. § 503. There is a limitation for real estate held by deed in trust name that applies a one hundred and ten (110) year rule against perpetuities to the real estate. 25 Del. C. § 503(b). However, the statute expressly excludes real estate held as an intangible through an entity such as a 'corporation, limited liability company, partnership, statutory trust, business trust or other entity' where the entity ownership interest is held by the trust instead of the real estate itself. 25 Del. C. § 503(e).").

[92] *See* BROUGHTON ET AL., *supra* note 26, at 30.

[93] Lawrence A. Frolik, *Trust Protectors: Why They Have Become "The Next Big Thing*," 50 REAL PROP. TR. & EST. L.J. 267, 272 (2015).

[94] *See id.*

[95] *See id.* at 275.

[96] *See id.* at 274-75.

document may be drafted. This document details the grantor's intent, identification of the trust property, trustee's power, beneficiaries, and succession plan.[97] The trust document must contain the grantor's statement intending to establish a trust and a corresponding acceptance of trust by the trustee.[98] Assets are transferred into the EOT through a deed, stock power, or other legal instruments that effectuate ownership transfer and, in the EOT context, will most likely involve the transfer of shares into the trust.[99]

C. Understanding the EOT as a Business Purpose Trust

1. Providing for Perpetuity

While the EOT may be created for the benefit of a defined group of workers, the trust, in most cases, is established to maintain the business in perpetuity as a "purpose trust." The distinction here, while perhaps understated, is significant. If a trust is established for the benefit of a particular beneficiary or group of beneficiaries, those individuals (in this case, a group of workers) have a claim to the benefits of the assets held in the trust.[100] Moreover, allocating a beneficial interest will trigger income tax considerations for the workers and employers.[101] Because of these factors, the EOT benefits from being created as a "purpose trust," that is, a trust that is established to further a specific, noncharitable purpose rather than benefit individuals or entities.[102]

A trust without beneficiaries is a modern device.[103] Before the early 20th century, establishing trusts was limited to those with

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[97] The trust document outlines the terms and conditions of the trust, including: grantor's intent, the assets that will be transferred to the trust, the trustee's responsibilities and authority, who will benefit from the trust and how their interests will be distributed. The appointment of successor trustees and provisions minimize estate taxes. Because the trust is a creature of state law, the state law that governs the trust will be included.

[98] *See* UNIF. TR. CODE § 402 (UNIF. L. COMM'N 2022).

[99] The "typical" EOT transaction involves the transfer of a nominal number of shares into trust followed by a series of redemptions. *See* discussion of this structure's implications *infra* Section IV.C.4.; Christopher Michael, *The Employee Ownership Trust, an ESOP Alternative*, 31 PROB. & PROP. 33, 38 (2017).

[100] The beneficial interest is held by the workers in this case, and in addition to their right to the beneficial use of the trust assets, the trustee is obligated to maintain the trust for the benefit of these individuals, and with that, the beneficiaries have a claim against the trustee for violations of fiduciary duties. *See* UNIF. TR. CODE § 105 (UNIF. L. COMM'N 2022).

[101] *See* Ellen K. Harrison, *Purpose Trusts and Steward Ownership*, TAX NOTES (May 20, 2024).

[102] *See id.*

[103] *See id.*

identifiable beneficiaries. A gradual shift began roughly 100 years ago as settlors conceived of trusts designed to fulfill specific objectives rather than merely benefiting designated individuals.[104] The innovation of the purpose trust enables the EOT.

Unlike traditional trusts designed to benefit individuals, a purpose trust is established to fulfill a specific objective.[105] Purpose trusts have been created to serve objectives such as caring for a family pet and maintaining family homes, vacation properties, or cemetery plots.[106] In each case, these trusts lack a defined individual beneficiary. Initially, this absence of beneficiaries in purpose trusts posed a significant challenge for their founders.[107] There was no precise individual to enforce the trust's terms, and they were not recognized in many jurisdictions.[108] To remedy this problem and accommodate a beneficial development in trust law, the notion of a trust protector emerged.

Because the EOT intends to hold and maintain an operating business, a mechanism for governing the company as part of the purpose trust structure is needed. This is addressed by establishing a governance committee composed of stakeholder representatives from the employee group, potentially the grantor or grantor's family, individuals from aligned businesses, and others with expertise in relevant areas.[109] This committee provides guidance and direction to the trustee and may have the power to direct the trustee, subject to the trust protector's powers, in some areas.[110] The purpose trust document may empower the governance committee to modify aspects of the trust, such as altering its jurisdiction or appointing members to the committee or board.[111] In most cases, a purpose trust is structured to prevent the sale or disposition of trust property unless under exceptional circumstances.[112] The governance committee will also serve in this role if such powers are provided.

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[104] *See* RESTATEMENT (FIRST) OF TRUSTS § 124 (AM. L. INST. 1935).

[105] *See* Harrison, *supra* note 101.

[106] *See* Richard C. Ausness, *Non-Charitable Purpose Trusts: Past, Present, and Future*, 51 REAL PROP. TR. & EST. L.J. 321, 327 (2016).

[107] *Id.*

[108] *Id.*

[109] David A. Diamond et al., *Seminar D: Taking Care of Business: Why (and How) a Purpose Trust Might Be the Answer to Your Client's Business Succession Challenges*, ACTEC 21 (Mar. 20, 2025).

[110] *See id.*

[111] *See* Akram Krayem, *Board Governance Committee: Purpose, Roles, Best Practices*, GOVERNANCE WORK (last visited Mar. 24, 2025).

[112] *See* George F. Bearup, *Purpose Trusts – Proceed with Caution*, GREENLEAF TR. (Apr. 22, 2022).

2. *In "Perpetuity" and Selecting a Jurisdiction*

A significant obstacle to the widespread use of purpose trusts in the U.S. is the limited duration of twenty-one years imposed by many states that have adopted Uniform Trust Code ("UTC") Section 409.[113] UTC Section 409 establishes the requirements for creating noncharitable trusts that do not have specific or identifiable beneficiaries.[114] In jurisdictions that adopted Section 409, a trust can be created for a noncharitable purpose without a defined beneficiary or for a purpose selected by the trustee. A trust enforcer holds the power to enforce the trust's terms, including any restrictions on the use of trust property or income.[115]

While offering many benefits, UTC Section 409 limits the trust's duration to twenty-one or ninety years, depending on the state where adopted.[116] Even at ninety years, these time limitations can be seen as inconsistent with a desire to maintain a business indefinitely. A handful of jurisdictions, including Delaware, New Hampshire, South Dakota, and Oregon, have demonstrated foresight by permitting purpose trusts to continue indefinitely.[117] Oregon and South Dakota are the only states to have enacted specific statutes governing "perpetual purpose trusts."[118]

In jurisdictions with unfriendly duration limits, traditional trusts are still an option. These traditional trusts may have much longer periods of duration depending on their state rule against perpetuities. Compared to purpose trusts, a disadvantage to using traditional trusts for EOTs is the expansion of the pool of possible plaintiffs.[119]

While beyond the scope of this article, skillful drafters may be able to take advantage of both types of trusts with flexible drafting, which could include things like decanting provisions and flee clauses. Flee clauses have been used in the asset protection trusts for years. These clauses provide that if the trust is attacked in a foreign haven, the location of the trust will switch to another jurisdiction.[120] Decanting

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[113] UNIF. TR. CODE § 409 (UNIF. L. COMM'N 2024).

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] *See* Harrison, *supra* note 101.

[118] *See* OR. REV. STAT. § 130.193 (2024) (intending to serve perpetual business purpose trusts, distinguishing itself as the sole jurisdiction, both domestically and internationally, where it cannot be applied to non-business purposes. Oregon, at present, thus becomes the preferred jurisdiction for business owners seeking to ensure the growth and success of their businesses indefinitely into the future); *see* S.D. CODIFIED L. § 47-14A-35 (2024).

[119] *See* UNIF. TR. CODE § 105 (UNIF. L. COMM'N 2022).

[120] *See* Matthew Howson, *How to Use a Flee Clause in a Trust*, HARNEYS (May

clauses are also well established and allow trustees to make distributions to trust beneficiaries by distributing trust assets to new trusts created by the trustee.[121] While the new trusts are for the same beneficiaries as the old trust, the new trusts contain slightly different terms, so as to meet the original trust objectives in a new environment.

3. *Preserving the Trust Estate*

Business owners considering a purpose trust may also be concerned with the court's power to reduce the trust estate under some circumstances. In the EOT context, the business owner is motivated by personal values and a desire to seek an outcome for their business and employees. Such grantor-focused motivations stand outside the traditional beneficiary-regarding interpretation of the trust agreement, which compels the trustee to act in the beneficiaries' financial interests.[122] An owner who intends to keep a business in trust for non-financial reasons is designing the EOT around concerns that may not be sustained. In most states, courts retain the power to strike down a trust or reduce the amount of property held in trust if the court determines that the trust estate is excessive for its intended purpose or serves no social value.[123] Under this power, a court may remove assets from the trust even if the trustee and trust protector believe the assets are needed to operate or grow the business. The uncertainty of whether and under what circumstances a court may invoke this power can create discomfort for the business owner considering the purpose trust.

D. Transferring the Business into the EOT

The transfer of ownership to the trust involves an assignment of stock or membership interest and acceptance of the property into the trust. The transfer into trust triggers valuation considerations and requires planning how the transferring owner will be compensated for their interests. In many cases, the transferring owner will receive a note for the stock's price, which must be paid from operation revenue over time.[124] The transferring owner may also receive non-voting preferred shares of stock, which pay a high dividend.[125] In that case, once the

4, 2020).

[121] *See* Audrey Young, *The Mechanics of Decanting*, TAX ADVISOR (Apr. 1, 2014).

[122] *See* John H. Langbein, *Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments*, 90 B.U. L. REV. 375, 379 (2010).

[123] *See* RESTATEMENT (SECOND) OF TRUSTS § 124 (AM. L. INST. 1959).

[124] Christopher Michael, *Grantor Trusts: A Path to Employee Ownership*, 149 TAX NOTES 2 (Oct. 12, 2015); *see* Gary, *supra* note 85 at 83-84.

[125] *See* Gary, *supra* note 85 at 81-82.

dividend payments equal the expected purchase price, the preferred shares are called by the company and canceled.[126]

While a straightforward transaction, the transfer to trust implicates tax consequences. The value of the transferred company is generally excluded from the transferor's estate, provided the transferring owner relinquishes exclusive control.[127] In many cases, however, the transferring owner in an EOT transaction will retain some control over the company, such as part of an incremental transition plan to the new management or as the trust protector.[128] This potential should be taken into account. The value of remaining proceeds from the transfer at the time of death will be subject to estate taxes, requiring strategic tax planning to minimize potential tax burden.[129] Based on these concerns, the transferring owner should avoid retaining control over the shares that are going into the EOT.[130]

V. TAX PLANNING FOR EOTS

On the surface, EOTs seem simple. The owner sells the company to the EOT and finances the sale. The EOT receives income from the company it bought and then uses that income to pay off the owner's debt. However, beneath the surface, EOT tax planning (like any other business sale) has many moving parts, including corporate income taxes, corporate payroll taxes, employee payroll taxes, individual capital gains taxes, individual ordinary income taxes, trust income taxes, and estate taxes. Compared to the traditional sale, however, the owner has more control and flexibility with an EOT because the owner controls the timing and the terms for both buyer and seller. With this added control comes added decisions that are detailed below.

[126] *See* Morshed Mannon & Nathan Schneider, *Exit to Community: Strategies for Multi-Stakeholder Ownership in the Platform Economy*, 5 GEO. L. TECH. REV. 1, 22 (2021).

[127] This assumes the selling owner receives a note in exchange for part of the company's value at the time the EOT is created. If the owner of a promissory note dies, the value of that note must be included in the estate for estate tax purposes, and the executor of the estate is responsible for reporting the value of the note on the federal estate tax return if required. *See* I.R.C. § 2033 (requiring that the value of a decedent's gross estate shall include the value of all property to the extent of the decedent's interest therein at the time of death).

[128] *See* Herrmann, *supra* note 4.

[129] *See* I.R.C. § 2037.

[130] *See* discussion of the tax implications for the EOT purpose trust transfer *infra* Sections V, VI.

A. EOT Buyer Side Tax Issues

1. Classifying the EOT

Typically, the EOT starts with the owner creating a trust under state law. The tax treatment of trusts is inherently confusing. The same trust, depending on the language in the document, can be (1) a grantor trust taxable to the grantor, (2) a simple trust that has trust income under state fiduciary law taxed to the beneficiaries, (3) a complex trust which is taxed in some combination to the trust and the beneficiaries depending on distributions, or (4) under I.R.C. § 678,[131] a trust can be taxed to the beneficiaries.[132]

If this collection of trust options isn't confusing enough, the trust terms can occasionally cause a trust to alter its tax character from time to time.[133] Additionally, the tax options are not mutually exclusive, so parts of the same trust can be taxed under different tax classifications. Furthermore, specialty trusts can have different tax rules. In the EOT context, a corporation taxed under Subchapter S must be owned by a trust that qualifies as an S corporation shareholder.[134] The Electing Small Business Trust ("ESBT") or Qualified Subchapter S Trust ("QSST") are often used for this situation.[135] These two specialty trusts have specific tax sections covering the taxation of their Subchapter S income. An ESBT or QSST can be a stand-alone trust or a sub-trust of a different tax-flavored trust.

While the number of trust combinations can be overwhelming, the EOT transaction can help simplify the choices. If the trust is considered a noncharitable purpose trust, it will generally be taxed as a trust under I.R.C. § 641's "any kind of property held in trust" language.[136] With no beneficiaries, it would be ineligible for the complex trust's deduction

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[131] I.R.C. § 678.

[132] *See* Jonathan G. Blattmachr et al., *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106, 108 (2009).

[133] For example, the original tax classification of an income or expense item may be classified as ordinary income, while an expense item might be classified as a deductible business expense. This characterization can change when the tax classification of an income or expense item changes due to a specific event or transaction. For example, an ordinary income item might be converted into a capital gain, or a deductible expense might become non-deductible. Such a change in tax character can have a substantial impact on an individual's or entity's tax liability. This is because different categories of income and expenses are taxed at different rates, and capital gains are typically taxed at lower rates than ordinary income, while non-deductible expenses do not reduce taxable income.

[134] *See* I.R.C. § 1361(b)(1)(B).

[135] *See id.* § 1361(a)(2)(A)(i); *id.* § 1361(a)(2)(A)(v); Blasé, *supra* note 87.

[136] I.R.C. § 641.

for distributions to beneficiaries under I.R.C. § 661.[137] The current IRS form 1041 for the trust's income tax does not list an I.R.C. § 641 purpose trust as an option for the type of trust.[138] Assuming the purpose trust is not an ESBT or a grantor trust, the complex trust is the best option for trust type on the IRS form 1041. The purpose trust would never have a distribution deduction for distributing to beneficiaries.[139]

If the trust is going to benefit many wage-earner employees, requiring all EOT beneficiaries to deal with Schedules K-1 and estimate taxes will not likely be a viable option. In these cases, the beneficiary-K-1-producing trusts—the simple trust, I.R.C. § 678 trust, and QSST are off the consideration table. In these cases, the owner might want to be taxed on the trust income, but generally, the grantor trust is also off the table.[140] This leaves the complex trust or, in the case of an S corporation, the ESBT as the tax classification of choice for the EOT. In both these cases, the trust will pay income tax on the income it receives from the business and then use the income to repay the owner for the seller's financing. The ESBT will typically result in more tax than the complex trust because the ESBT pays tax at the highest income tax rate for all taxpayers, but the complex trust reaches the highest income tax rate very quickly.[141] The favorable tradeoff between these two high-tax vehicles for the EOT is the savings in tax compliance and the burden from not having each employee report shares of corporate income and make the necessary tax payments.

2. *When an Employee Becomes a Beneficiary*

Suppose the EOT is considered a purpose trust. In that case, the company employees should not be considered as receiving any compensation from an interest in the EOT, and the tax impact on the employees from funding and administering the EOT can be ignored. However, when this article was written, there were not any reported IRS

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[137] *See* Harrison, *supra* note 101 (asserting that purpose trusts have no ascertainable beneficiaries); 26 C.F.R. § 1.661(a)-2 (2024) (allowing a deduction for distribution to beneficiaries under I.R.C. § 661).

[138] *See* IRS Form 1041 (2024).

[139] *AICPA Provides Comments on the Tax Classification of Purpose Trusts*, AICPA & CIMA (May 2, 2024); *SOI Tax Stats - Definitions of Selected Terms and Concepts for Income from Trusts and Estates*, IRS (Sept. 27, 2024).

[140] An intentionally defective grantor trust ("IDGT") allows a business owner to sell a company to a grantor trust in a transaction that is respected for estate and gift tax purposes, but not for income tax purposes. *See* Rev. Rul. 85-13, 1985-1 C.B. 184. While the owner would avoid the income tax on the sale with an IDGT, the owner would continue to be taxed on trust income. *See id.* While this sounds fun, the tax aspects of combining the IDGT with the EOT are beyond the scope of this article.

[141] In 2024, I.R.C. § 1(e) taxed trust income in excess of $15,200 at a 37% rate.

rulings or cases dealing with the taxation of EOTs.[142]

If the EOT is considered a trust for the benefit of the employees, then the issue of employee compensation from becoming trust beneficiaries comes into play. Once the EOT trust is created and purchases the owner's stock,[143] it holds stock for the benefit of the employees. While not a wage, becoming an EOT beneficiary is a type of compensation to the employee. Two sections of the Internal Revenue Code instruct on how this EOT interest should be reported on employee tax returns before the employee receives anything from the EOT.

The right to receive future distributions from the trust could be nonqualified deferred compensation. The right to receive compensation from a 401(k) retirement plan is another type of deferred compensation. 401(k)s are qualified retirement plans, which means the employer company can deduct matching contributions to the retirement plan, but the employee doesn't pay income tax until withdrawal. In contrast with qualified deferred compensation, I.R.C. § 409A governs nonqualified deferred compensation. With few exceptions, employees must pay the tax plus an additional 20 percent of the deferred income "*not subject to a substantial risk of forfeiture*" when the income is deferred rather than when it is received.[144] Employees may still defer income under I.R.C. § 409A but must agree not to take distributions until certain events occur like death, disability, and separation from service.[145] The EOT will typically allow for distributions to the beneficiary while still an employee with none of these restrictions in place, and the beneficiary-employee has no power to accelerate the distribution.[146]

Fortunately, the EOT is usually for the benefit of the employees and doesn't create any permanent benefits. Treasury Regulation § 1.409A-1 was issued to clarify I.R.C. § 409A and provides that deferred compensation occurs if the facts give a service provider a legally binding right to compensation during a taxable year, which is made payable in a later taxable year.[147] The employees should not have a binding right to compensation until the EOT trustee decides to distribute to the beneficiaries. With no binding right to immediate compensation coupled with an agreement to deferred payment of the compensation,

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[142] A global search of RIA's federal tax database as of October 20, 2024 for "employee ownership trust" pulled up only a few documents dealing with ESOPs.

[143] The term "stock" used in this article refers to the ownership interest of the entity. It can include the traditional shares of stock of a corporation under state law or the membership interests of a limited liability company. Unlike a sale to a third party concerned about liabilities, the owner will normally set up the transaction to sell only the stock of the company.

[144] I.R.C. § 409A (emphasis added).

[145] *Id.*

[146] *See id.* § 409A(a)(3).

[147] *See* Treas. Reg. § 1.409A-1(b)(1).

the employees should not have an I.R.C. § 409A deferred income problem.

The other section that may apply to an employee becoming a beneficiary in an EOT is I.R.C. § 83, which imposes a tax on property transferred in connection with the performance of services.[148] I.R.C. § 83 would tax an EOT employee/beneficiary upon receiving the interest in the EOT based on "the fair market value of the property . . . at the first time the rights of the person having the beneficial interest in such property are transferable or not subject to a substantial risk of forfeiture . . . ."[149] In the typical EOT, the employee/beneficiary would never have the right to transfer their trust interest, and their interest in the trust would terminate with employment and pass to the next employee.

The employee/beneficiary could have a taxable event from receiving the trust property if the trustee ever decides to terminate the trust and distribute the company or its sales proceeds to the trust/beneficiaries without restrictions. This beneficiary tax impact could be a planning opportunity for the trustee because the employee/beneficiary tax impact comes with an offsetting deduction for the company under I.R.C. § 83(h).

B. Seller Side Tax Issues

1. S Corporation

The S corporation might be the most complicated of the seller-side tax entities. S corporations must elect to be taxed under Subchapter S of the I.R.C. and meet other criteria required under the I.R.C.[150] An owner of an S corporation has two choices on the sale to the EOT. The owner can either sell the company assets to the EOT and liquidate the S corporation, or the owner can sell the owner's stock to the EOT. In either case, the EOT usually provides seller financing and uses income from the company to repay this financing. The owner selling the stock or the company selling its assets to the EOT will elect to report the gain on the sale under the installment method and pay tax as payments are received.[151]

If assets are sold to the trust, the S corporation would usually have a gain on the sale. This gain would flow through to the owner for reporting and paying the income tax.[152] This sale gain allocated to the

[148] *See* I.R.C. § 83.
[149] *Id.* § 83(a)(1).
[150] *See id.* § 1361-63 (detailing the requirements of S corporations and elections).
[151] *See id.* § 453.
[152] *See id.* § 1366 (explaining the passing-through of items to shareholders).

shareholder increases the shareholder's basis in the shareholder's stock.[153] Next, any distributions of cash or property to the shareholder following the sale are tax-free reductions in a stock's basis until the distributions exceed the shareholder's basis in the stock.[154] This tax-free return on basis explains why S corporations are referred to as having a single level of tax. With a C corporation, the shares' basis is not reduced for distributions, and the presumption is that the C corporation will pay income tax on its income and sales gain. The owner will then pay income tax on dividends received and capital gains on liquidating distributions.[155] In either case, if relevant requirements are met, distributing the installment obligation to the owner in liquidation does not accelerate the gain under the installment method.[156]

Another advantage of the S corporation is that if it meets specific requirements under I.R.C. § 199A, it can receive a Qualified Business Income ("QBI") deduction and reduce the taxable income to the shareholder by up to 20 percent.[157] On the other hand, if the owner has a higher basis in the owner's stock than the company has in its assets, the owner may prefer to simply sell the owner's stock to the EOT.

However, S corporations have some drawbacks. First, selling S corporation stock to an EOT creates an existential threat to the S corporation. Under I.R.C. § 1361(c)(2), only certain trusts can be S corporation shareholders, and most of the trusts allowed do not work well in EOT transactions. In addition, Subchapter S corporations may only have 100 shareholders.[158] The qualifying trusts have look-through rules,[159] so whenever an EOT's S Corporation passes 100 shareholders, its S corporation election terminates.

The trusts allowed to be S corporation trusts are the grantor trust, certain testamentary trusts, voting trusts, ESBTs,[160] and QSSTs.[161] Grantor trusts are generally undesirable because someone other than the EOT must pay and report the income tax. Testamentary trusts are transitional trusts and can only hold S corporation stock for a couple of years after somebody dies. Voting trusts do not change the share ownership to the EOT.

The QSST may act as an EOT or be a sub-trust of an EOT to own

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[153] *See id.*

[154] *See id.* § 1367.

[155] *See id.* § 331.

[156] *See id.* § 453(h)(1).

[157] *See id.* § 199A(a) (stating "[i]n the case of a taxpayer other than a [C] corporation.").

[158] *Id.* § 1361(b)(1)(A).

[159] *Id.* § 1361(b)(3)(C).

[160] *Id.* § 1361(b)(2)(A)(v).

[161] *Id.* § 1361(d)(2)(A). While having its own code section, the QSST is considered an eligible grantor trust shareholder under § 1361(d)(2)(A).

stock for the benefit of an employee/beneficiary without terminating a Subchapter S election, but the QSST comes with some undesirable requirements.[162] For example, the QSST can only have one beneficiary at any time, such that the EOT would have to "spawn" a separate QSST for each employee/beneficiary. Also, the QSST must distribute all trust income to the beneficiary. Distributing all income would create a problem when the trustee is trying to use trust income to purchase company assets or stock. This scenario would likely lead to reporting and compliance issues by requiring separate QSST returns and K-1 forms for each employee's tax filing.

The ESBT also presents a viable option for an EOT. The ESBT can hold Subchapter S stock for the benefit of individuals.[163] It must meet some other requirements and file an election with the IRS. Notably, the main disadvantage of using the ESBT is that I.R.C. § 641(c)(2)(A) taxes the ESBT's S corporation income at the highest marginal rate.[164]

2. C Corporation

Compared to S corporations, C corporations seem simple. A sale of its assets to an EOT would trigger a gain taxed at the flat corporate tax rate of 21 percent.[165] The distribution of assets to the owner would also trigger a gain if the fair market value of the distributed assets exceeds the owner's tax basis in the stock.[166] Notably, the seller financing note distribution would not typically trigger an immediate gain.[167] If the owner instead sells their stock in the C corporation to the EOT, the basis of the stock remains the same and doesn't fluctuate as it would in an S corporation. If the owner holds the stock for more than one year before selling to the EOT, it should qualify for long-term capital gains treatment.[168] C corporations cannot deduct dividends when paid, but the shareholders pay tax on the received dividends.[169] However, if the owners meet the holding requirements of I.R.C. § 246 when they receive the dividends, they can pay tax on dividends at preferred capital

[162] *See id.* § 1361(d)(3) (providing QSST requirements).

[163] *See* Larry Brant, *A Journey Through Subchapter S / A Review of the Not So Obvious & the Many Traps That Exist for the Unwary: Part III – Code Section 1361(b)(1)(C)*, FOSTER GARVEY (Feb. 8, 2024).

[164] *See* I.R.C. § 641(c)(2)(A).

[165] *See id.* § 11(b).

[166] *See id.* § 1031(b).

[167] *See id.* §§ 331, 453(h)(1) (discussing liquidations of corporations; detailing deferral of gain on liquidating distribution of an installment obligation).

[168] *See id.* §§ 1(h), 1222(3) (explaining tax rates on long-term capital gains; defining long-term gain).

[169] *See id.* § 61(a)(7).

gains rates.[170]

3. *Partnership*

Pass-through allocation rules make partnerships more complicated than S and C corporations. Thankfully, in the EOT context, partnerships do not have the limitations on ownership that S corporations have, so QSSTs and ESBTs are unnecessary for partnerships. The partnership tax rules apply to all entities that are taxed as partnerships. Additionally, the default classification for limited liability companies ("LLCs") with more than one partner is a partnership.[171] In the case of an asset sale to an EOT, the tax impact on the partner owner mirrors that of an S corporation.

However, a sale of the membership or partnership interests in the LLC might have drastically different tax consequences for the selling owner. This is generally a result of I.R.C. § 751 and "hot asset" sales. The term hot assets refers to assets that, if sold, would generate ordinary income instead of capital gain income.[172] I.R.C. § 751(a) provides that if a sale of an interest in a partnership is attributed to unrealized receivables and inventory, then the consideration received by the seller attributed to those items will not be considered a sale of a capital asset but would instead generate ordinary gain.[173] In comparison, if an S corporation or a C corporation were to sell the same inventory and unrealized receivables, the shareholders would still receive capital gain treatment on the stock sale.

4. *Sole Proprietorship*

Under the "check the box" regulations, single-member LLCs are treated as sole proprietorships.[174] In these cases, the sale of a membership interest or the LLC's assets should be similar to that of a partnership without the partners.

5. *EOT Tax Caution Signs*

While every EOT is different, the I.R.C. could negatively impact an EOT in a variety of ways. So, it's important to note a few potential

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[170] If the owners are corporations, then there are additional tax breaks on the dividends received. *See id.* § 243.

[171] *See* Treas. Reg. § 301.7701-3.

[172] *See Federal Tax Coordinator* 2d (RIA) ¶ B-3920.

[173] *See* I.R.C. § 751(a).

[174] *See* Daniel S. Kleinberger & Carter G. Bishop, *The Single-Member Limited Liability Company as Disregarded Entity: Now You See It, Now You Don't*, BUS. L. TODAY (Aug. 10, 2010).

impacts. Sometimes, an owner may want to use cash in a corporation to buy some stock. This is called a redemption, and I.R.C. §302(b) polices owners from using their stock basis to recharacterize what would otherwise be a dividend into a capital gain sale.[175]

Consider once again Widgets and assume a significant portion of its stock is owned by three stockholders. Now, let's assume one of the shareholders wants to retire and sell their shares back to the company through a redemption. This may be an easy option for the shareholder as the company provides a readily available buyer and the shareholder is likely to receive a fair price for the stock.

Typically, when a company buys back its own stock from a shareholder, the IRS treats this as a "dividend."[176] This means the shareholders would have to pay ordinary income tax on the money they receive from selling shares back to Widgets. This is not an ideal outcome compared to the lower tax rates associated with capital gains treatment. I.R.C. § 302 offers a couple of potential escapes from this ordinary income tax treatment. It allows for more favorable tax treatment (often as a capital gain) under certain conditions.

Here is how I.R.C. § 302(b)(2) may work in this scenario. First, the shareholder's proportionate ownership must fall following the sale.[177] If after selling their shares, the shareholder's ownership percentage in Widgets drops significantly, I.R.C. § 302(b)(2) might apply. For example, if the ownership percentage decreases from 30 percent to 5 percent, the selling shareholder might qualify for capital gains treatment. The I.R.C. § 318 rules governing share ownership by related parties apply in the calculations. But this is not the only option for capital gains treatment.

Alternatively, the transaction may also result in a termination of the shareholder's interest.[178] If the shareholder sells *all* their shares back to Widgets, completely severing ownership ties with the company, they may also qualify for capital gains treatment under I.R.C. § 302(b)(3). Further, suppose the sale is a partial liquidation of the corporation's shares. If Widgets is genuinely downsizing or restructuring its business and the shareholder's redemption is part of this legitimate business decision, I.R.C. § 302 might also apply.[179] Ultimately, I.R.C. § 302

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[175] See I.R.C. §§ 302(b)(1), 302(d) (providing that if a redemption does not qualify as a capital gains treatment under § 302(b), it is treated as a dividend under § 301).

[176] JANE G. GRAVELLE, CONG. RSCH. SERV., R47397, THE 1% EXCISE TAX ON STOCK REPURCHASES (BUYBACKS) 11-12 (2023).

[177] I.R.C. § 302.

[178] *Id.* § 302(b)(3).

[179] *See* Eric Brauer & Patrick Phillips, *Partial Liquidations: The Forgotten Section 302(b) Redemption Category*, RSM (Oct. 22, 2022).

distinguishes between genuine business transactions where a shareholder is substantively reducing their stake in the company (such as retirement or a restructuring) and situations where the stock redemption is a tax-advantaged way for the company to distribute profits to shareholders.

Although a stock sale to a corporation treated as a capital gain transaction is possible, the shareholder must structure the deal to completely sever ties with the corporation. Achieving this for tax purposes requires meeting various I.R.C. § 302 criteria and navigating I.R.C. § 318's family attribution rules to ensure the seller has no remaining connection.[180]

Operation of the estate or gift tax is also relevant to the EOT landscape. Generally, the EOT and its stock should not be included in the owner's estate, but the note receivable from the seller financing should be included.[181] Any gain not recognized before death on the sale to the EOT would be considered income for a decedent under I.R.C. § 691 and taxed to the estate, or the estate's beneficiaries who receive the seller financing note.[182] The note successors would be taxed just as the owner was taxed when the owner received payments on the note. However, owners may often want to try to control the company following the sale. After all, the owner will be a huge creditor following the EOT sale.

Having creditors sit on the board or have a vote in the management of the company is normally a tax-neutral event. However, if the family is involved and any of the transaction is less than an arms-length sale, then I.R.C. § 2036(b) provides that the retention of the right to vote directly *or indirectly* on the stock of a controlled corporation is a retention of the enjoyment of the transferred property, and the stock will be included in the owner's estate for estate tax purposes.[183] Similarly, if the selling owner retains certain interests in the EOT or has other powers over the EOT, the value of the EOT could be taxed in the selling owner's estate for estate tax purposes. Ultimately, any business owner considering an EOT should also keep in mind other various tax implications such as passive loss rules, suspended losses, operating losses, alternative minimum tax, state taxes, cash vs. accrual accounting, the net investment income tax, and imputed interest.

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[180] *See* Edward J. Schnee, *Redeeming Closely Held Stock*, J. ACCT. (June 1, 2005).

[181] *See* Fiona Bell, *Employee Ownership Trusts: Preparing for Transition*, TAX ADVISER (Oct. 23, 2023).

[182] *See* I.R.C. § 691(a)(1).

[183] *Id.* § 2036.

VI. EXAMPLE EOT IN ACTION

EOT tax planning offers unique advantages by allowing the owner to control both buyer and seller until the transaction is complete. This means the seller entity can evolve before the sale, and the timing is generally more flexible than with a third-party buyer. Moreover, since the EOT typically compensates owners using after-tax earnings, favorable after-tax earnings projections are crucial for determining the company's value.

Assume "Owner" is a sole shareholder of Widgets and that Widgets is expected to continue earning $200,000 a year before any compensation to Owner. Owner has sufficient stock basis to avoid any capital gains tax on the stock sale, but most owners will also pay capital gains tax on the stock sale. Fortunately, owners like Owner should be able to elect installment treatment on the sale and pay their capital gains tax as they receive payments on their note. Owner's other income also puts him in a position where the Widgets income is taxed at a federal rate of 24 percent for married couples with taxable income between $201,050 and $383,900.[184] Accordingly, the following discussion contemplates Owner's tax planning.

Owners typically want to know how their retirement income will stack up against their current income. As an S corporation, owners usually take a reasonable salary and then a dividend for the remaining company earnings. If Owner's reasonable salary is $100,000 per year, Widgets would pay $7,650 in federal payroll taxes on Owner's salary.[185] After paying the $100,000 salary and the $7,650 in corporate payroll taxes, Widgets would have $92,350 available for S corporation earnings to pass to Owner on his Schedule K-1. While working, Owner would have $100,000 in wages but must match the company's Social Security and Medicare taxes of $7,650.[186] Owner would also have the $92,350 of Subchapter S income.[187] The Social Security and FICA taxes are not deductible against Owner's income taxes, so Owner's total taxable income from the company would be $192,350.[188] If Owner is married and makes less than $200,000 from other sources, his Widgets income will be subject to a 24 percent federal tax rate.[189] As of 2024, North

[184] *Id.* § 1(a).

[185] *Id.* § 3111 (establishing a 6.2% tax rate on the first $168,600 of wages and a 1.45% ceiling-less Medicare tax on wages); *see also id.* § 3101 (imposing similar tax rates on employees).

[186] *See* I.R.C. § 3111.

[187] *See id.* § 1366(a) (establishing S Corporations as pass-thru entities avoiding double taxation).

[188] This example ignores the federal income deduction for state income taxes, state payroll taxes, and the QBI deduction under I.R.C. § 199A.

[189] *See* I.R.C. § 1.

Carolina has a flat 4.5 percent individual income tax rate.[190]

So, while Owner is working, $129,880 of Widgets' $200,000 income filters down to Owner as follows:

Widgets Co. Income	$	200,000
Less Taxes		
Payroll Corporate (federal only)	7,650	
Payroll Owner (federal only)	7,650	
Income Federal (no QBI)	46,164	
Income State (no fed income deduction)	8,656	
Total Tax	$	70,120
Owner's Take Home	$	129,880

A. ESBT Analysis

Should Owner decide to sell his interest to an EOT which can continue Widgets with the same income, the EOT could continue to hold Widgets as an S corporation in an ESBT. The EOT would pay federal tax on the S corporation earnings at the top 37 percent rate,[191] along with the 4.5 percent flat North Carolina rate[192] for a total income tax rate of 41.5 percent.[193] Under this scenario, the EOT would collect $200,000 of Subchapter S income and pay $83,000 in tax, leaving $117,000 per year to pay the Owner.

B. C Corporation Analysis

Suppose Owner decides to sell his stock to an EOT that fails to make

[190] *See* N.C. GEN. STAT. § 105-153.7(a) (2024).

[191] *See* I.R.C. § 641(c)(2)(A).

[192] *See* N.C. GEN. STAT. § 105-153.7(a) (2024).

[193] This example assumes no federal tax benefit from paying state income taxes, which was limited by the "SALT" limitation changes to I.R.C. § 164(b)(6), which limited the deduction for state and local taxes for individuals for tax years 2018-2025.

the ESBT election. In that case, Widgets will not have a valid Subchapter S shareholder, and its Subchapter S status will terminate, causing it to become a C corporation.[194] The C corporation will pay federal income tax at a flat 21 percent rate[195] and North Carolina income tax at a flat 2.5 percent rate[196] on its $200,000 of income, or $47,000 per year in total income tax. That tax payment would leave Widgets with $153,000 for dividends to the EOT. The EOT would quickly reach the top federal tax bracket as a complex trust.[197] North Carolina uses the individual flat rate of 4.5 percent in 2024 for trusts.[198] If the dividends are taxed at the ordinary complex trust rates, the total federal and North Carolina trust income tax would be $61,531, leaving the trust with $91,469.50 for debt service on the stock purchase. On the other hand, most domestic C corporations would be eligible to pay qualified dividends to the EOT beginning sixty days after the sale.[199] Qualified dividends are taxed at long-term capital gains rates,[200] which would lower the total tax burden on the EOT to $37,485 and leave $115,515 available for Owner's debt service.

Admittedly, this example ignores capital gains on the stock sale and imputed interest on the seller financing and makes other assumptions. Nevertheless, the example shows the Owner how the Widgets earnings filter down to debt service under different scenarios. With Owner financing the sale to the EOT, the EOT's ability to make payments will drive the length of the loan for any given sales price to the EOT. While Owner may not clear as much from a sale to an EOT as if Owner continued to work, the same would generally hold true in an asset sale to a third party, and the EOT has the added advantage of putting ownership in the hands of Owner's employees and possibly savings sales commissions and other transaction costs.

[194] *See* I.R.C. § 1361(c)(2) (discussing permitted trusts as Subchapter S shareholders); *id.* § 1362(d)(2) (detailing termination of S status following ownership by unpermitted shareholders).

[195] *Id.* § 11(b).

[196] *See* N.C. GEN. STAT. § 105-130.3 (2024).

[197] *See* Rev. Proc. 2023-34, 2023-48 I.R.B. 1287 (see the tax rate table).

[198] N.C. GEN. STAT. § 105-160.2 (2024).

[199] *See* I.R.C. § 1(h)(11).

[200] *See* WELLS FARGO, TAX TREATMENT OF CAPITAL GAINS AND DIVIDENDS 1 (2024).

Example Tax Summary

Setup	**Tax**
Current	70,120
ESBT	83,000
C Corp	108,531
C Corp with Qualified Dividends	84,485

It is also important to note that the tax planning gets more straightforward once the EOT pays off the Owner's seller financing. With no debt service, the EOT will no longer have the cash needs from Widgets. For example, if Widgets is a C corporation following the sale, then Widgets could stop paying or cut back on dividends to the EOT and simply pay tax on its profits and award its employees with deductible bonuses.

VII. CONCLUSION

An EOT offers several benefits for both employees and the company. For employees, EOTs can provide a sense of ownership and increased motivation, as they share in the company's success. This can lead to improved productivity, reduced employee turnover, and increased job satisfaction. EOTs can also offer significant tax advantages for employees and the company, making them a financially attractive option.

EOTs can facilitate succession planning for the company by providing a clear path for ownership transition. They can also improve the company's financial performance by aligning employee interests with its own. Additionally, EOTs can enhance the company's reputation and attract and retain top talent, as employees are more likely to be attracted to companies with opportunities for a stake in the business.

While EOTs offer numerous advantages, there are also some concerns to consider. One major concern is the potential for reduced managerial flexibility. As employees gain a more significant stake in the company, they may become more resistant to changes that could impact their long-term financial interests, even if those changes are necessary for the company's overall success. This can lead to slower decision-making and a reluctance to embrace innovation or adapt to

changing market conditions.

Another concern is the potential for unintended consequences. For example, an EOT could inadvertently create a two-tiered workforce, with existing employees benefiting significantly from the trust while new hires receive fewer benefits. This could lead to resentment and decreased morale among newer employees. Additionally, the long-term success of an EOT depends on the company's continued profitability. If the company experiences financial difficulties, the value of the trust may decline, potentially leaving employees with diminished returns on their investment. Finally, EOTs face significant complexity surrounding their tax treatment. The EOTs won’t be the right solution for every case, but for some, they can make retirement dreams become reality and protect loyal employees into the future.