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ESOP vs Private Equity Sale: The Alternative Buyer

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Published by Docket · 2026-10-29 · esop vs private equity · employee stock ownership plan sale · sell business to employees · esop succession

Original article: https://docket.capital/articles/esop-vs-private-equity-sale-alternatives



In this article

1. Two buyers, one succession decision
2. What an ESOP is
3. How many ESOPs exist
4. S corporation ESOPs
5. Section 1042 deferral: the conditions in the statute
6. Where ESOPs and sponsors compete (and where they do not)
7. Employee ownership beyond ESOPs
8. What this means for origination outreach

Two buyers, one succession decision

An owner selling a private company usually hears about the private equity sponsor first. The employee stock ownership plan (ESOP) is the other institutional buyer in the same conversation. Both can be financed with debt and both turn up in the same lower-middle-market industries, but they are different kinds of buyer with different rules.

This article sets out what primary sources say about ESOPs: the federal definition, how many exist, and the conditions Section 1042 of the Internal Revenue Code attaches to a sale to one. It then covers what that means for a sponsor's origination team. This is a description of public rules and data, not tax, legal or valuation advice.

Nothing here ranks one route above the other. Which buyer suits an owner depends on facts this article cannot see: price, financing, the owner's role after closing, the workforce, and the owner's tax position. For the wider context, see Docket's notes on succession and ownership and the glossary entry on succession planning.

What an ESOP is

The IRS defines an ESOP as "an IRC section 401(a) qualified defined contribution plan that is a stock bonus plan or a stock bonus/money purchase plan," which "must be designed to invest primarily in qualifying employer securities" (IRS). The same page notes that "the IRS and Department of Labor share jurisdiction over some ESOP features" (IRS).

The statutory definition sits in 26 U.S.C. 4975(e)(7). It describes a defined contribution plan "which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities" (26 U.S.C. 4975, LII). A plan must also meet listed requirements of section 409 to be treated as an ESOP (26 U.S.C. 4975, LII).

Two points follow:

- **An ESOP is a retirement plan.** It is not an operating company or a management buyout vehicle. The buyer in an ESOP sale is the plan.
- **It is regulated twice.** Tax qualification falls to the IRS; the Department of Labor shares jurisdiction over some features (IRS).

How many ESOPs exist

The National Center for Employee Ownership (NCEO) analyzes the Department of Labor's Private Pension Plan Research Files, built from Form 5500 filings. Its "ESOPs by the Numbers" page, "Updated January 2026," reports for 2023, the most recent year available (NCEO):

Measure (2023)	Figure
Plans identified as ESOPs	6,609
Total plan assets	over $2 trillion

Measure (2023)	Figure
Unique companies with an ESOP	6,411 (5,993 private, 418 publicly traded)
Plans in privately held companies	6,098
Plans in publicly traded companies	511
Total participants	15.1 million
Active participants	over 10.9 million
New ESOPs reported in 2023	309, adding 56,663 active participants

Source: NCEO.

Company and plan counts differ because "a company may sponsor multiple plans" (NCEO). NCEO's Table 1 shows 6,098 plans in privately held companies with $363,395 million in total plan assets, against 511 plans in public companies holding $1,693,119 million (NCEO). Most of the "over $2 trillion" headline sits in public-company plans; the private ESOP universe is much smaller by assets and much larger by plan count.

The trend is roughly flat: NCEO shows 6,669 ESOPs in filing year 2015, a low of 6,467 in 2020, and 6,609 in 2023; new ESOPs ran from 203 (2020) to 309 (2023) a year (NCEO).

Industry mix overlaps heavily with sponsor target lists. NCEO puts 20% of ESOP companies in manufacturing, 19% in professional, scientific and technical services, 17% in construction, 13% in finance, insurance and real estate, and 9% in wholesale trade (NCEO).

The timing lag

These are 2023 figures in a 2026 update. Form 5500 filings "are due seven months after the end of each plan year, or nine and a half months if an extension is requested," the Department of Labor "takes up to a year to process and clean the data," and NCEO then adds its own analysis, so "there is typically a time lag of up to two years" (NCEO). The upside, per NCEO, is "close to perfect coverage of every ESOP" (NCEO).

How NCEO decides a plan is an ESOP

NCEO classifies plans by the characteristic codes on line 8 of Form 5500: 2O ("ESOP other than a leveraged ESOP"), 2P ("Leveraged ESOP"), and, unlike the DOL, plans carrying code 2Q ("The employer maintaining this ESOP is an S corporation") even without 2O or 2P (NCEO).

S corporation ESOPs

Among privately held ESOPs, NCEO reports that "a majority (67%)" are in S corporations (NCEO):

Privately held ESOPs, 2023	Plans	Total participants	Total plan assets (millions)
S corporations	4,113	1,197,361	$209,567
C corporations	1,985	1,668,995	$153,828

Source: NCEO, Table 3.

The classification method matters: NCEO counts a plan as S corporation if its Form 5500 uses code 2Q, and "all others are assumed to be a C Corporation" (NCEO). S corporation plans are more numerous; C corporation plans cover more participants.

For background, the IRS lists the S corporation requirements: a domestic corporation, only allowable shareholders (individuals, certain trusts and estates), no more than 100 shareholders, one class of stock, and not an ineligible corporation (IRS). Entity type matters for the next section, because Section 1042 is written around the issuer's corporate form.

Section 1042 deferral: the conditions in the statute

Section 1042 lets a seller elect nonrecognition of gain on a sale of "qualified securities" to an ESOP or an eligible worker-owned cooperative, if conditions are met (26 U.S.C. 1042, LII). What follows paraphrases the statute's text as published by the Legal Information Institute on 2026-10-28. It is a reading of the statute, not tax advice: regulations, guidance and the seller's own facts all matter, and a tax adviser decides whether the section applies.

The result, as written. If the conditions are met, the gain that would be recognized as long-term capital gain "shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property" (26 U.S.C. 1042(a)). Subsection (d) then reduces the seller's basis in the replacement property by the gain not recognized (26 U.S.C. 1042(d)).

The conditions, in statutory order.

Provision	What the text requires
1042(a)(1)	The taxpayer or executor elects in the form the Secretary prescribes.
1042(a)(2)	The taxpayer purchases qualified replacement property within the replacement period.
1042(b)(1)	The qualified securities are sold to an ESOP as defined in section 4975(e)(7), or to an eligible worker-owned cooperative.
1042(b)(2)	Immediately after the sale, the plan or cooperative owns at least 30 percent of each class of outstanding stock of the issuing corporation, or of the total value of all its outstanding stock (excluding stock described in section 1504(a)(4), after applying section 318(a)(4)).
1042(b)(3)	The taxpayer files a verified written statement of the employer consenting to the application of sections 4978 and 4979A.
1042(b)(4)	The taxpayer's holding period in the qualified securities is at least 3 years, determined at the time of sale.
1042(c)(1)	"Qualified securities" are employer securities (section 409(l)) issued by "a domestic C corporation that has no stock outstanding that is readily tradable on an established securities market," and not received in a plan distribution or through an option or right covered by sections 83, 422 or 423.
1042(c)(3)	The replacement period "begins 3 months before the date on which the sale of qualified securities occurs and ... ends 12 months after the date of such sale."

Provision	What the text requires
1042(c)(4)	Qualified replacement property is a security of a domestic operating corporation meeting the subsection's tests.
1042(c)(6)	The election is filed no later than the due date, including extensions, of the return for the year of the sale.
1042(c)(7)	The section does not apply to gain includible in the gross income of any C corporation.

Source for every row: 26 U.S.C. 1042, LII.

The C corporation condition and the scheduled change. As the text stands today, qualified securities must be issued by a domestic C corporation (26 U.S.C. 1042(c)(1)(A)). LII also prints an amendment made by Pub. L. 117-328, div. T, section 114, "applicable to sales after Dec. 31, 2027." It replaces "domestic C corporation" with "domestic corporation" and adds a subsection (h) providing that, for a sale of qualified securities of an S corporation, the election "may be made with respect to not more than 10 percent of the amount realized on such sale" (26 U.S.C. 1042, LII, amendment note). For sales on or before December 31, 2027, the text requires a C corporation issuer. Given that NCEO puts 67% of private ESOPs in S corporations (NCEO), anyone repeating "the ESOP tax deferral" as a general selling point should check the issuer's entity type and the sale date against the statute first.

Where ESOPs and sponsors compete (and where they do not)

The table compares the two routes using only what the sources above support. Where the sources say nothing, the cell says "varies by deal."

Dimension	Sale to an ESOP	Sale to a PE sponsor
Who buys	A qualified retirement plan designed to invest primarily in employer securities (IRS)	Varies by deal and fund structure
Regulators of the buyer	IRS and DOL share jurisdiction over some features (IRS)	Varies by deal and fund structure
Debt financing	"Commonly financed with one or more loans" (a leveraged ESOP); 59% of private ESOPs currently leveraged (NCEO)	Varies by deal
Seller's statutory deferral election	Section 1042, if its conditions are met (26 U.S.C. 1042)	Not available under Section 1042, which requires a sale to an ESOP or eligible worker-owned cooperative (26 U.S.C. 1042(b)(1))
Minimum stake for Section 1042	30 percent after the sale, measured as the statute specifies (26 U.S.C. 1042(b)(2))	Not applicable
Who benefits from ownership	Plan participants; NCEO counts 2.1 million active participants in private-company ESOPs (NCEO)	Varies by deal
Seller's role after closing	Varies by deal	Varies by deal
Price and terms	Varies by deal	Varies by deal

The overlap is real: NCEO's industry mix of manufacturing, professional services and construction (NCEO) is the core of many lower-middle-market theses. But the rows that most decide an owner's choice (price, terms, the owner's role after closing) are the ones public sources do not settle. Anyone who says one route always wins on them is offering an opinion, not a fact.

The routes do not exclude each other: Section 1042's 30 percent threshold (26 U.S.C. 1042(b)(2)) contemplates sales of less than the whole company.

Employee ownership beyond ESOPs

The ESOP is not the only employee-ownership form. The Department of Labor's Employee Ownership Initiative says employee ownership "can take different forms, including employee stock ownership plans (ESOPs), worker cooperatives, and employee ownership trusts (EOTs)" (DOL). The initiative was launched in 2023 under the WORK provisions in section 346 of the SECURE 2.0 Act of 2022 and is run by EBSA's Division of Employee Ownership (DOL).

Two related data points from NCEO:

- **Worker cooperatives.** NCEO cites the Democracy at Work Institute's count of "at least 751 worker cooperatives" (NCEO). Section 1042 also names "eligible worker-owned cooperatives" as qualifying buyers and defines them by membership, voting and allocation tests (26 U.S.C. 1042(c)(2)).
- **ESOP-like plans.** NCEO counts 5,208 profit-sharing, stock bonus or other defined contribution plans that are not ESOPs but are at least 20% invested in employer stock (NCEO).

EOTs appear on the DOL list, but neither source above gives a count of them, so none is given here.

What this means for origination outreach

For a sponsor or independent sponsor, ESOPs show up in two ways: as companies already owned in whole or part by a plan, and as an option the owner is weighing. Both change who you talk to and what you say.

1. Check the filing before the first email. An ESOP files Form 5500, and NCEO's method shows the plan characteristic codes that flag one: 2O, 2P (leveraged) and 2Q (S corporation sponsor) (NCEO). The step-by-step lookup is in our guide to verify employee ownership using Form 5500.

2. Read the participant count, but don't overread it. The same filing reports participants, which helps with sizing; see Form 5500 headcount estimates for the method and its limits. An ESOP's participant count includes people who are no longer active: NCEO's totals separate total from active participants for exactly that reason (NCEO).

3. Mind the lag. A plan created after the latest processed filing year will not be in any dataset built on Form 5500 (NCEO). Absence of an ESOP flag is not proof that no ESOP exists.

4. Change the audience for ESOP-owned targets. When the plan holds the stock, the founder may no longer be the person who can say yes, and outreach that assumes a single owner-operator will be misdirected. Identify the board and the plan's trustee before writing.

5. Ask, don't assume. If an owner is "looking at an ESOP," the factual questions are entity type, holding period and the stake under discussion, which map to the 1042 conditions above (26 U.S.C. 1042). Whether they apply is for the owner's advisers.

Illustrative example (fictional)

A triage note on "Ridgeway Fastener Supply," a fictional distributor on a sponsor's list:

Field	Value	Evidence
Form 5500 filed	Yes, plan year 2023	Filing retained
Plan characteristic codes	2P, 2Q	Line 8 of the filing
Reading	Leveraged ESOP; sponsor is an S corporation	NCEO code definitions
Ownership share held by plan	Not stated on the filing	Gap left open
Founder still the decision-maker?	Unknown	Gap left open
Next step	Confirm board and trustee contacts before outreach; do not send the standard owner email	Analyst decision

The note records what the filing shows and leaves the rest visibly open.

Docket's Triage, Scout and Audit agents run this kind of check on a client's target list: each recorded answer quotes a retained source, and unresolved fields stay marked open.

Source links

Links cited in this article, in order of first appearance. Full addresses are provided for readers using extracted text.

1. https://www.irs.gov/retirement-plans/employee-stock-ownership-plans-esops
2. https://www.law.cornell.edu/uscode/text/26/4975
3. https://www.nceo.org/articles/esops-by-the-numbers
4. https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations
5. https://www.law.cornell.edu/uscode/text/26/1042
6. https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/programs-and-initiatives/employee-ownership-initiative

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