ESOPs Offer
Tax-Efficient for
Business Succession
in an Estate Plan
BDO

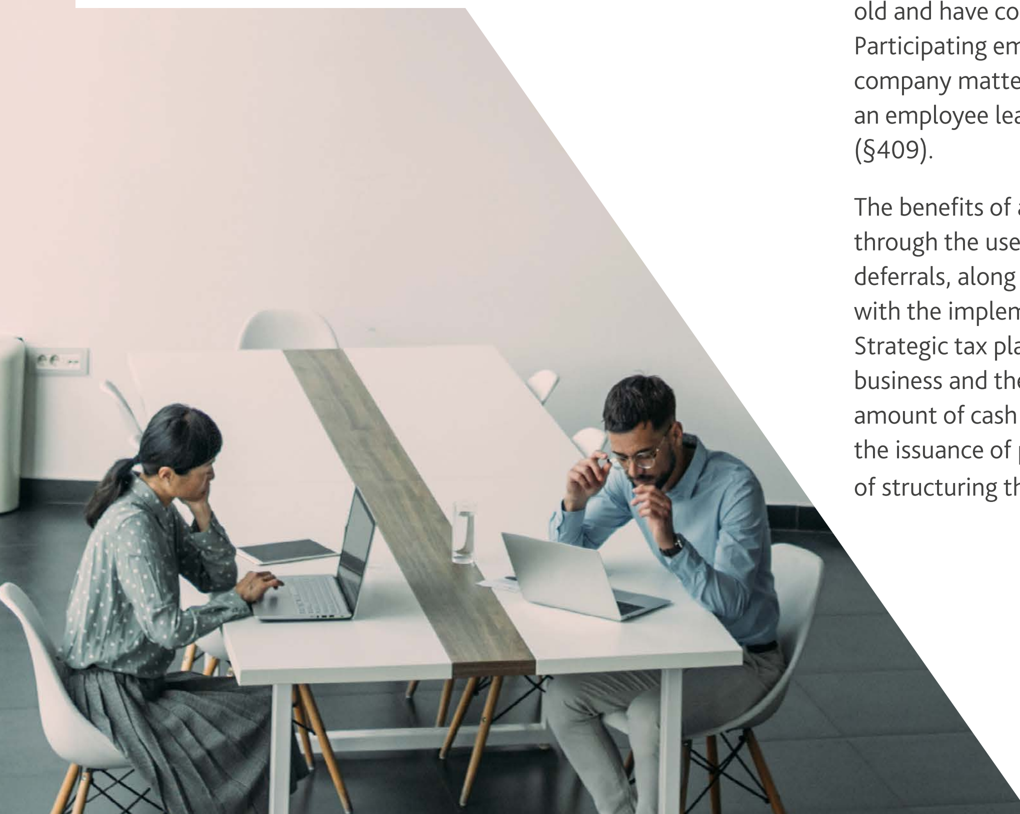
BDO USA tax practitioners and BDO Capital ESOP advisors discuss ways to maximize efficiencies for income and estate tax purposes with business succession planning before an ESOP sale transaction.

Employee stock ownership plans offer a tax-efficient estate planning opportunity for business owners to pass the wealth-generating entity to their people who own shares in it.

Typically, an ESOP transaction is a significant liquidity event for the current primary business owners. They need to create an effective succession strategy in alignment with their wishes. Planning may be done independently from and prior to any anticipated ESOP transaction to maximize potential tax savings.

BENEFITING LOYAL EMPLOYEES

Many businesses have dedicated employees whom the owners would like to reward by sharing some of the future upside of the business's success. Essentially, an ESOP is a combination of a retirement plan and an employee ownership plan. Employer plan contributions of shares vest according to plan terms, with growth paid out to the employee as a buyback of shares at qualifying events. Using an S corporation that is 100% employee-owned (through ESOPs) allows the company to grow without most of the tax drag associated with income taxes, while employees participate in the business's growth. Owners may want to pass all or some of the business to current and future employees, depending on the level of family engagement in the business.



ESOP BUYOUT STRATEGIES

Most ESOP buyouts are structured through the use of leverage. There are generally two leveraged ESOP structures a corporation will use: (a) loan of cash to the ESOP, which then uses it to purchase stock from the shareholders when potential deferral of capital gains from the sale of shares to the ESOP under I.R.C. §1042 may be desired; and (b) redemption of legacy shareholders' shares, which the corporation then sells to the ESOP through a loan.

With all the benefits of ESOPs come regulatory requirements to ensure that the plan is being administered in the best interests of the employees. ESOPs may not discriminate and must meet minimum coverage requirements of non-highly compensated employees who are at least 21 years old and have completed a year of service (§409, §401(a)). Participating employees must be able to vote on some company matters based on their number of shares, and when an employee leaves the company, it must buy the shares back (§409).

The benefits of a sale to an ESOP may be further enhanced through the use of additional income tax exclusions and deferrals, along with layering estate planning opportunities with the implementation of any business succession plan. Strategic tax planning may increase the benefits to the business and the selling owner's family exponentially. The amount of cash provided at closing to the sellers, compared to the issuance of promissory notes, is an important component of structuring the transaction and related planning.

QUALIFIED SMALL BUSINESS STOCK GAIN EXCLUSION UNDER §1202

If the business qualifies, there may be potential for income tax gain exclusion on a stock sale. **Section 1202** allows capital gains from the disposition of "qualified small business stock" (QSBS) to be fully or partially excluded from the seller's gross income. For stock to qualify as §1202 QSBS:

- The stock must have been issued after August 10, 1993, by a C corporation with assets not exceeding $50 million at any time after August 10, 1993, and immediately before and after the issuance;
- The taxpayer must have acquired the stock at its original issue or through a §1202(h)-listed transfer, such as a gift, and held it for at least five years; and
- The corporation must be engaged in an active trade or business — excluding professional services; banking and finance; farming; oil, gas, and mining; hospitality; and real estate.

The percentage of QSBS gain that can be excluded has doubled since the provision was first enacted more than 30 years ago — from half to all of it, depending on when the stock was issued (§1202(a)). For stock issued during the period from August 11, 1993, to February 18, 2009, the exclusion percentage is 50%; from February 19, 2009, to September 27, 2010, 75%; and from September 28, 2010, to today, 100%.

Any gain that is not excluded from income tax is taxed at the top capital gains rate of 28% (**§1202**(a)(1), **§1(h)(4)(A)(ii))**. The exclusion is limited to the greater of $10 million or 10 times the aggregate adjusted basis of QSBS per taxpayer (§1202(b)(1)). For taxpayers applying a 50% or 75% exclusion, the amount of eligible gain not excluded is also subject to the net investment income tax **(§1411)**; the excluded amount is also an alternative minimum tax preference item. However, taxpayers may be able to establish non-grantor trusts as separate taxpayers to allow for an additional exclusion limit.

Incorporating QSBS into an estate plan may be beneficial if:

- The grantor prefers non-grantor trusts or has few liquid assets available to pay the ongoing income tax liability associated with grantor trusts;
- The shareholder acquired the stock after September 27, 2010, and can apply a 100% gain exclusion; and/or
- The shareholder is in poor health, as the extra benefits of a grantor trust are limited to the grantor's lifetime.

An acquisition by a non-grantor trust by gift is generally allowed for §1202 purposes (§1202(h)). Grantor trusts have their own set of benefits, discussed below, so a break-even analysis may be conducted to project how long it would take for the benefits of a grantor trust to exceed those afforded by the use of a non-grantor trust. Alternatively, a combination may be possible and valuable in some situations.

INTEREST CHARGE RELIEF UNDER §453A

Section 453A assesses an interest charge on the deferred tax liability of nondealer installment obligations for property sales over $150,000 if the amount of the obligations held by the taxpayer at the end of the taxable year exceeds $5 million (§453A(a)–(b)). Stated differently, this provision allows taxpayers to avoid the interest charge on deferred tax liability from a sale to an ESOP on up to $5 million of applicable installment obligations each year.

The interest rate chargeable is calculated as the percentage of deferred tax liability multiplied by the underpayment rate under **§6621(a)(2)** — the applicable short-term federal rate plus 3% — for the last month of the taxable year. Recent short-term applicable federal rates have been around 5%, making this interest charge potentially substantial. Moreover, the interest imposed under §453A is deemed nondeductible personal interest (see **Redlark v. Commissioner**).

The timing when year-end obligations are expected to be below the $5 million threshold per taxpayer should be factored into any modeling for this provision. The relief provided by §453A is per individual taxpayer. Married shareholders should consider transferring some of their stock to their spouse before the sale to the ESOP to maximize this interest charge relief, given that the IRS has advised, in **TAM 9853002**, that, for purposes of applying the interest charge rule, spouses are treated as separate taxpayers.

If the estate plan is to use non-grantor trusts, because of grantor preferences or other factors discussed above, a potential benefit is additional §453A tax savings if projected outstanding applicable installment obligations considerably exceed the $5 million relief threshold ($10 million per couple if they each have $5 million or more of obligations from their portion of the sale). This relief is in addition to the potential §1202 gain exclusion described above for non-grantor trusts.

GAIN ON SALE TO ESOP DEFERRAL UNDER §1042

Section 1042 allows eligible shareholders to defer long-term capital gains from the sale of eligible stock to an ESOP if the proceeds are reinvested in qualified replacement property (QRP). The ESOP must own at least 30% of the outstanding company stock after the transaction and provide written consent to the selling taxpayer's election for §4978 and §4979A purposes, as applicable (§1042(b)).

For the selling shareholder to qualify for this deferral, the stock sold to the ESOP must have been held by the individual, trust, partnership, or other qualified taxpayer for three years before the sale, and the sale proceeds must be reinvested in QRP during the time period starting three months before the sale and ending 12 months after (§1042(c)). QRP includes stocks and bonds of domestic corporations with no more than 25% of their gross receipts from passive sources and at least 50% of the assets used in the operation of an active trade or business (§1042(c)(4)).

Section 4978 imposes a tax on certain of ESOPs' (and some cooperatives') dispositions of securities to which §1042 applies. If the shares are disposed of within the three-year period from the acquisition date, a 10% tax is imposed on the amount realized, determined under §4978(b). Conversely, there is no adverse impact to the ESOP or cooperative if it doesn't sell the shares within three years or allocate to the selling shareholders and family members. In addition, **§4979A** imposes on certain prohibited allocations a 50% excise tax within a limitations period that expires three years after the date on which the IRS receives notice of such violation under **§409(n)**. Both of these taxes — under §4978 and §4979A — may be assessed, if applicable.

There are various passive and active strategies to investing ESOP sale proceeds in QRP. Some shareholders prefer to passively invest in publicly traded stock or directly purchase bonds that satisfy the QRP requirements. An active option is corporate floating rate notes (FRNs), which qualify as an eligible QRP investment by a taxpayer with a monetization loan. In turn, the shareholder is free to invest the loan proceeds however they wish, unencumbered by the §1042 restrictions. The taxpayer's risk tolerance should be assessed to determine if the FRN method is appropriate. While it allows for more investment control, changing interest rates may impact net return. Note that a taxpayer may choose a mix of strategies as well.

Section 1042 is a tax deferral provision, as opposed to a gain exclusion provision, so if the reinvested sale proceeds ever become disqualified, the deferred gain will be recognized. There are some limitations on transfers that may accelerate gain, so plan ahead to avoid this and to best achieve the seller's goals. If the reinvested proceeds are still qualified and still held by the seller at death, it will get a full basis step-up pursuant to **§1014(a)**. Also, if stock is owned by a limited liability company (LLC) or limited partnership (LP) before the sale to the ESOP, the seller may be able to later gift interests in the LLC or LP without it being disqualified from §1042 (see **PLR 9846005**). Gain deferral through §1042 may be a great option for sale proceeds to an ESOP for amounts that exceed the seller's current liquidity needs and may be structured to pay the tax over time as the seller requires additional resources.

There are tax benefits to each of these provisions in a sale to an ESOP. Each I.R.C. section has limitations that must be modeled with overlapping taxpayer goals and estate planning strategies, discussed below, to improve tax efficiencies. There may also be time restrictions, family dynamics, or shareholder health issues to bear in mind. Overall, implementing any of these potential planning options should benefit the shareholder and succeeding generations.

ESTATE PLANNING

Timing and Disclosure

If the business's ownership may change in the future, it is important that any prior estate planning transfers be recorded as independent transactions. Business valuations involve a significant amount of subjectivity, and are based on current data and anticipated events, such as a potential business sale, discounted future cash flow modeling, expansion of production, or other valuation considerations. The IRS, conversely, has the benefit of hindsight when reviewing returns and related transfers. Having proper documentation, separated timing and autonomy in transactions, and adequate disclosure on a timely filed return are ways to start the statute of limitations and contribute to a positive audit outcome (Reg. **§301.6501(c)-1**).

Use of LLCs & LPs

As in other types of estate planning, a taxpayer may contribute assets or business interests to a family investment entity, most commonly an LLC, and then gift some of the entity membership interests to family or trusts for their benefit. This allows the taxpayer to retain some managerial and investment responsibilities through a managed option and/or the use of voting and non-voting interests. When these structures are used, consideration must be given to concerns that the taxpayer may retain too much control, to make sure the assets are not brought back into the grantor's estate through **§2036**. For example, the taxpayer should be subject to a fiduciary duty to the LLC members, and there should be limitations to the taxpayer's discretion to make member distribution decisions (except for formula distributions, such as tax distributions), amend the operating agreement, and dissolve the entity or liquidate the assets.

The entity should also be run as a formal business, without commingling personal assets, and the taxpayer should retain enough assets to live on outside of the business (§2036(a)). This should also help maintain creditor protection if the entity is in compliance with all formal requirements, and any transfers to it are not part of a fraudulent conveyance. If an existing business entity is used for estate planning, all organizational documents, buy-sell agreements (or other documents with transfer restrictions), business assets, and tax returns should be reviewed to help prevent unintended consequences or void assignments because of violations of transfer restrictions. If the entity structure is appropriately set up, then the grantor may retain some investment authority and managerial duties over family assets, while interests gifted or passing through their estate may receive minority and marketability discounting.

The estate planning use of an entity for a sale to an ESOP may be combined with §1042 deferral. Support for this conclusion is found primarily in the above-mentioned PLR 9846005, which, as a private ruling, cannot be cited as precedent but nonetheless shows the IRS's thinking given certain facts. The facts here involve an owner who contributed shares to a limited partnership before a sale to an ESOP. The sale proceeds were invested in QRP pursuant to §1042. The shareholder planned to make gifts of the limited partnership interests, which the IRS deemed allowable under §1042(e)(1). Shareholders may wish to obtain a PLR that applies to their specific set of facts, keeping in mind that this will add significant time and expense to the planning process.

One of the limitations of §1042 and the use of an entity is that if liquidity is needed, the member basis for distributions may be limited to interest income from any outstanding installment note, unless the structure uses a recourse monetized loan that would provide additional basis for distribution purposes (**§731, §752**). Even with debt basis for distributions from recourse debt, distributions will likely bring the tax basis capital account negative, which would limit ongoing gifting options. If the interest is held until the death of the member and receives a basis step-up, then this may be a non-event. A transfer to a non-grantor trust or to a grantor trust that during the lifetime of the grantor releases grantor powers would not be advisable, because it would likely trigger a gain in excess of basis from the pro rata debt assumption by the transferee (Reg. **§1.1001-2(a)**).

Using an entity structure with §453A will likely have a minimal impact on interest charge relief, as each taxpayer is limited to the exclusion of deferred tax liability on $5 million of installment obligations outstanding at the end of the taxable year, as discussed previously. This includes flow-through amounts from pass-through entities to the individual taxpayer.

Finally, §1202 gain exclusion is not allowed for corporate shareholders and is allowed for owners of a pass-through entity only if the owner had entity interests when the qualifying corporation issued the QSBS to the entity (§1202(g)). Therefore, it is usually best for the shares that qualify for gain exclusion to be retained in the shareholder's name until the transaction is completed, or to be gifted to a non-grantor trust before the sale transaction and independently of it, as explained below, without the additional LLC layer.

Trusts

Incorporating the use of trusts into business succession planning provides additional tax efficiencies while allowing assets to pass consistent with the grantor's intent through beneficiary distribution provisions. When establishing a multigenerational trust, one should consider trust situs carefully. Trust law varies greatly among states. While income taxes are a significant factor, there are many long-term considerations such as allowed trust duration, flexibility with available trust modification and decanting statutes, creditor protection, and related state laws for specific asset types (for example, digital currency).

Irrevocable Defective Grantor Trusts

Irrevocable grantor trusts allow for a variety of flexibility and tax benefits. When structured properly, irrevocable defective grantor trusts (IDGTs) or spousal lifetime access trusts (SLATs) are excluded from the grantor's estate for estate tax purposes, but the trust income is allocated to the grantor. The income tax paid by the grantor is not deemed a gift, so it reduces the grantor's taxable estate while permitting the trust to grow without the encumbrance of income tax. One of the common provisions used in trust drafting to create an IDGT is the grantor's retention of the ability to substitute assets with the trust (**§675**). This substitution power provides future income tax strategies because of the ability to substitute the grantor's retained high-basis assets with low-basis trust assets. This results in income tax savings by increasing the overall basis step-up on assets in the estate when the grantor passes.

Many IDGTs also include a provision — depending on the trust's situs and the applicable state law — that grants an independent party the ability to make discretionary tax reimbursements to the grantor for taxes associated with trust income. This allows the grantor the advantages of an IDGT without necessarily having to pay the income tax on the trust assets every year. However, there should be no prearranged plan of income tax reimbursement to the grantor and the distributions should vary depending on each year's circumstances.

Another method of providing a cash flow stream to the grantor is to have the grantor sell assets to the trust for a promissory note, usually at the applicable federal rate, without this becoming a taxable event. The note payments may provide resources to the grantor to pay the income tax on trust income. The IDGT should have adequate principal (typically 10% of the purchase price) to support the leveraged transaction. Grantors may choose to release the powers that create a grantor trust after the sale note has been paid off if they no longer wish to pay the income taxes for the IDGT.

Having a funded IDGT will be advantageous if an ESOP transaction includes issuing seller warrants. The warrants may be sold to the IDGT at fair market value, which is normally expected to grow in value. The warrants' future appreciation will be excluded from the grantor's gross estate and the benefit is the estate tax savings on the excess growth of assets sold to the trust minus the note payments.

Sales that are done effectively to IDGTs that are allocated generation-skipping transfer (GST) tax exemption will further compound growth and protect future generations from additional layers of estate, gift, and GST tax. The GST tax is imposed at a flat 40% rate, similar, but in addition to, the federal estate tax for non-exempt assets distributed to beneficiaries who are generally more than one generation below the grantor or on the value of trust assets when the only remaining beneficiaries are more than one generation below the grantor (**§2641**, **§2612**).

The 2017 Tax Cuts and Jobs Act (Pub. L. No. 115-97) temporarily doubled the unified credit for gift and estate taxes and the GST exemption through 2025, providing a significant opportunity to protect large amounts of grantor assets from additional levels of future taxes. Under current law, assets owned by trusts that have been allocated GST exemption by the grantor will not be subject to GST tax on any asset, growth, or distribution for the duration of the trust.

Since IDGTs are grantor trusts for income tax purposes, many I.R.C. sections treat the trusts as transparent to the grantor, and not as independent taxpayers for income limitation purposes. For example, IDGTs will not offer the ability to use the additional $10 million gain exclusions pursuant to §1202 or additional interest charge relief exclusions over $5 million of outstanding tax deferral on installment obligations at the end of the tax year to the grantor. Likewise, since these trusts are not included in the grantor's estate, any §1042 deferral on trust assets will likely not receive basis step-up when the grantor passes.

Using IDGTs may be highly beneficial if:

- There is less opportunity for §1202 based on the anticipated exclusion, limited to the greater of $10 million or 10 times basis per taxpayer, and gain exclusion percentage, ranging from 50% to 100% depending on the year of the original issue stock;
- A significant sale transaction in addition to gifting may be advantageous based on the circumstances; and/or
- The grantor has the resources to absorb significant amounts of income tax liability from the trust.

Irrevocable Non-Grantor Trusts

Many grantors prefer not to incur an income tax liability on trust income, especially if their estate is primarily composed of illiquid assets or if they are highly charitable and are not too concerned with maximizing the passing of assets to family. While non-grantor trusts generally provide less flexibility and long-term tax benefits than grantor trusts, there are still many instances where they may be useful, and all grantor trusts eventually become non-grantor trusts after the grantor passes. As mentioned above, a non-grantor trust may potentially use the §453A interest charge exclusion on deferred tax from an applicable installment sale, as well as the §1202 gain exclusion because non-grantor trusts are treated as separate taxpayers for these purposes. Depending on the anticipated sale and gain from the sale of QSBS to an ESOP, tax and the forgone interest charge savings may be significant. Lifetime gift and GST exemptions should be factored in as well.

While there are numerous benefits for non-grantor trusts in these types of transactions, planning opportunities with grantor trusts are still significant, depending on the particular facts and grantor objectives. Using both trust types may be possible, primarily if some irrevocable trusts have already been well established (although those should still be reviewed for favorable situs first).

Below is a general chart of the elections that may be used in different business and estate planning entity structures.

ENTITY	§1202	§453A	§1042	LLC USAGE
Individual Shareholder	$10M/taxpayer/couple; LLCs may work when member at original issue	$5M/taxpayer/ individual	Qualifying Amounts	May work with §453A & §1042; unlikely with §1202
Grantor Trust	$10M/taxpayer/couple; LLCs may work when member at original issue	$5M/taxpayer/ individual	Qualifying Amounts	May work with §1042; no additional benefit with §453A & §1202
Non-Grantor Trust	$10M/taxpayer/couple; LLCs may work when member at original issue; each trust is a taxpayer	$5M/taxpayer/ individual	Qualifying Amounts	May work with §453A & §1042

Depending on the specific details, grantor or non-grantor trusts may be more tax efficient with or without a complementary LLC, but ultimately the decision may come down to grantor preferences. The best estate planning works backward from the grantor's priorities and objectives and then incorporates tax efficiencies within those goals. Planning in this environment takes numerous sophisticated professionals in each of these specialty areas and sufficient time to design and implement an effective plan based on professional availability and implementation of each portion of the plan design. It is imperative that any significant planning incorporating the use of the currently doubled estate, gift, and GST exemption begin without delay.

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