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ESOPs and estate planning after 2017 tax reform

The Capital ESOP Group

Keith Apton, CEPA®
Managing Director–
Wealth Management
keith.apton@ubs.com

Nick Francia, CEPA®
Senior Vice President–
Wealth Management
nick.francia@ubs.com

UBS Financial Services Inc.
1501 K Street NW, Suite 1100
Washington, DC 20005
202-585-5358

ubs.com/team/capitalesopgroup

As a business owner, it is important to understand how tax reform impacts you and your company. This piece provides general estate planning education as well as details on the unique opportunities specific to ESOPs.

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Unique estate planning opportunities with ESOPs

This paper will speak to the unique opportunities that apply to a business owner who is going through an employee stock ownership plan (ESOP) transaction. For a broader education on estate planning, please reference the "Estate planning after 2017 tax reform" piece by the UBS Advanced Planning Insights team. The convergence of the capital gains tax deferral offered by Section 1042 of the Internal Revenue Code of 1086, as amended (Code), the unique aspects of an ESOP and its effect on value of retained stock ownership, and the structure of the proceeds received upon the sale to the ESOP will offer significant estate and transfer tax planning opportunities to a business owner and his or her family.

A shareholder in a closely held C corporation who is an individual, trust, estate, partnership or LLC (taxed as a partnership) can sell some or all of their closely held stock to an ESOP. So long as the requirements of Code Section 1042 are met, the shareholder can defer (and potentially eliminate) the capital gains tax otherwise due on such a sale. A principal requirement of Code Section 1042 is that the shareholder reinvest the proceeds received from the ESOP in qualified replacement property (QRP). The holder of the QRP will then be taxed for capital gains purposes on the subsequent disposition of the QRP, so the holder only gets the tax deferral for so long as he or she holds the QRP. However, there are various transfers of QRP that are not treated as a disposition and thus do not trigger capital gains taxation. In particular, a disposition is not deemed to occur and capital gains tax is not triggered on a transfer of the QRP by gift, by transfer into a trust, or in the case of the holder's death.

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In this section, we will examine the following concepts: the step-up in basis achievable through QRP investment; transferring retained ownership following an ESOP transaction to family limited partnerships (FLPs) and limited liability corporations (LLCs) at significant valuation discounts; philanthropic planning with QRP; and transfer techniques used in conjunction with seller notes and warrants.

Preserving the "stepped up in cost basis" on qualified replacement property

As discussed earlier, QRP held in the name of the individual taxpayer at death receives a step-up in cost basis, for tax purposes, to its fair market value at the time of death. This is important because the tax basis of the stock sold to the ESOP (and thus the transfer basis in the QRP) held by the taxpayer is often very low. Thus, if the QRP is held by the taxpayer at death and passed through their estate, the QRP could then potentially be sold without any federal and, in many cases, state capital gains tax. It is for this reason that one should consider leaving QRP titled in the name of the taxpayer or the taxpayer's revocable living trust rather than transferring such QRP to a FLP or LLC, as such a transfer would result in the forfeiture of the step-up in cost basis at death of the taxpayer because the asset would not be owned by the taxpayer at time of death. In light of this, one should consider QRP monetization. One such technique would be for the taxpayer to purchase floating rate notes (FRNs) which qualify as QRP. The taxpayer would continue to hold the FRNs as QRP and borrow against them. He or she would transfer these borrowed funds and/or assets purchased with the borrowed funds to the FLP or LLC.

Under the estate and gift tax laws, spouses enjoy unlimited lifetime transfers between each other. If one spouse's life expectancy is considerably shorter than the other's, it may make sense to transfer QRP into the name of the spouse likely to die first. This technique is not needed for married couples in community property states, as all community property assets owned at the death of the first spouse will receive a step-up in cost basis.

Planning with family limited partnerships (FLPs) and limited liability corporations (LLCs)

As is often the case, owners of stock in closely held companies do not sell all of their stock to the ESOP and instead retain some ownership in the now ESOP-owned company. Following the ESOP transaction, the value of the retained shares is considerably lower due to the recapitalization of the balance sheet (i.e., the swapping of equity for debt) and because the remaining stock typically represents a minority interest subject to both marketability and minority interest discounts. This may present an ideal time to make significant transfers of wealth through the gifting of this discounted stock.

The use of FLPs and LLCs in estate planning to achieve valuation discounts is not without risk by any means. In recent years, the IRS has successfully challenged discounts taken on transfers of partnership interests in many court cases. While the results of these cases might be deemed to arise from "bad facts," e.g., partnerships formed on the death bed with little or no substance, the cases have established important principles. In general, for the FLP or LLC to work, it must have a business purpose independent of the mere reduction of estate or gift taxes, and planners must wade into these waters with care.

Both FLPs and LLCs can provide powerful transfer possibilities if used prudently.

Nonetheless, both FLPs and LLCs can provide powerful transfer possibilities if used prudently. A potential planning technique which preserves the step-up in cost basis on retained stock or on QRP involves contributing other assets, preferably non-marketable assets such as real estate and ESOP seller notes and warrants. The individual or entity that contributes the assets becomes the General Partner, in the case of FLPs, or Managing Member, in the case of LLCs, allowing one to exercise control over the assets. Ownership of these FLP and/or LLC interests can be transferred or gifted into a trust or directly to beneficiaries, often with additional discounts given the illiquid nature of these assets and the minority interest they hold in the FPC or LLC.

Philanthropic planning and transfers

What is the ideal asset to give to a charity, your private foundation, or a public foundation? A typical answer would likely be a low-tax basis asset; an asset that, should it be sold, would incur a high tax cost. Some may conclude that it is best to gift interests to a charity prior to a sale to the ESOP and simply allow the charity to sell the asset. This may be the case, but it's likely not the best answer and certainly not the best result when dealing with stock in a closely held company. Any gift to another entity, especially an entity from which one expects to claim a charitable tax deduction, must first be valued for transfer purposes.

Stock in a closely held company is likely subject to both a lack of marketability discount and minority interest discount, making a gift of such stock inefficient prior to the sale to the ESOP. The better choice may be to first sell the stock to the ESOP, reinvest the sale proceeds in QRP and then gift the QRP, which is typically a publicly traded non-discounted asset, to the charity. A note of caution for those planning to gift to a private foundation is that gifts of QRP which qualify as "qualified appreciated stock" are tax-deductible at market value. However, it appears that gifts of QRP that are not qualified appreciation stock, i.e., bonds, are deductible at cost basis, which is typically very low or nonexistent. Consequently, transferring bonds instead of qualified appreciated stock may result in an undesirable outcome.

Opportunities with ESOP seller notes and warrants

Oftentimes a sale to an ESOP involves the receipt of seller notes and possibly warrants. This occurs most often in connection with sales in which senior financing is not sufficient to fund the entire transaction and mezzanine lenders are not willing to lend more to fill the gap—at least not at acceptable pricing and/or terms. As a result, the seller agrees to take back a note from the company, expecting payment of principal and interest over many years and often after the senior lender is repaid in full. This may create a dilemma, as seller notes are often priced at below-market rates, providing little or no consideration to the seller for subordinating their interests behind that of the senior lender. To compensate for this, detachable warrants are often negotiated and issued to the seller. If the company does well, then the warrants appreciate. If not, the warrants may become worthless. Both forms of consideration—the seller notes and warrants—are uniquely suited for powerful transfer planning strategies. For instance, detachable warrants, nearly always valued at or close to zero at the time of the sale, make an ideal asset to transfer outright or to a GRAT (grantor retained annuity trust). Though described below in more detail, any appreciation over the IRS mid-term applicable federal rate (AFR) remains outside of the seller's taxable estate.

Another powerful transfer technique involves the use of a type of grantor trust known as an intentionally defective grantor trust, or IDGT.

With respect to an interest-bearing seller note, or for that matter any appreciating asset one wishes to remove from their taxable estate, another powerful transfer technique involves the use of a type of grantor trust known as an intentionally defective grantor trust, or IDGT. An IDGT is an irrevocable trust for the benefit of family heirs. The grantor trust is purposely drafted to intentionally violate one of the grantor trust rules by giving the grantor the power to substitute assets of equivalent value for those held in the IDGT. By making the grantor trust "defective" for income tax purposes, the taxpayer will be treated as the owner of the IDGT. This means that the taxpayer is responsible for the taxes due on any income or capital gains realized by the IDGT. Interestingly, the payment of taxes serves to reduce the taxpayer's taxable estate even further—an additional benefit not embraced often enough.

In the context of an ESOP, the taxpayer could sell the seller note to an IDGT for its appraised fair market value in exchange for a note back from the IDGT that bears the appropriate applicable federal interest rate. This type of note is often structured with a balloon repayment schedule, requiring annual interest payments with principal due at the end of the note term. Prior to the issuance of the IDGT note, the IDGT should be adequately capitalized, typically done through a separate gift of assets to the IDGT.

It is important to structure the IDGT note term to maximize the chances that the note will be paid in full prior to the taxpayer's death in order to avoid the possibility of gain recognition on the note at death. The trustee may choose to leverage assets in the IDGT by using a portion of the IDGT income to purchase life insurance on the taxpayer's life. The policy proceeds can be used to provide liquidity for the payment of estate taxes at the taxpayer's death. Should the taxpayer die during the term of the IDGT note, death benefits will be available for the IDGT to repay the balance of the IDGT note. The sale to the IDGT freezes the appraised value of the seller note in the taxpayer's estate, allowing any increase in value of the sold assets to avoid estate taxation and increasing the amount ultimately passing to heirs and trust beneficiaries. The IRS has privately ruled that transfers of QRP directly to a grantor trust would not be considered a disposition of the QRP.[1]

The importance of interdisciplinary planning in the ESOP transaction

What should be clear in all of this is that the financial advisors, the ESOP transaction lawyers and the estate planning lawyers need to communicate.

It is crucial to implement any structures at or very near to the time of the ESOP transaction, because that is when the warrants and the stock will have their lowest value. The ESOP rules are complex, and planners need to ensure that the estate planning does not create more problems than it solves. As with any transaction planning, advisors must keep an eye out for regulatory and legislative changes. Finally, fiduciary issues abound in ESOP transactions, and ESOP transaction structures must create a meaningful benefit for the ESOP participants.

Conclusion

We are currently in one of the more favorable historical environments for transferring wealth. With the current generous exemption levels and relatively low transfer tax rates, families may transfer significant amounts of wealth to younger generations. Although we finally have some degree of permanency in the tax laws, tax policy is constantly evolving and impossible to predict. We encourage you to take advantage of current opportunities by working with a team of advisors to develop a flexible but customized plan that takes into account your wealth transfer objectives.

Please contact Keith J. Apton at keith.apton@ubs.com or Nick J. Francia at nick.francia@ubs.com or 202-585-5358 for additional information or with any questions regarding ESOPs or the availability of Code Section 1042.

See important notes and disclosures on the next page.

The Capital ESOP Group
UBS Financial Services Inc.
1501 K Street NW, Suite 1100
Washington, DC 20005
202-585-5358
202-585-5329 fax

ubs.com/team/capitalesopgroup

Keith J. Apton, CEPA®
Managing Director–
Wealth Management
keith.apton@ubs.com

Nick J. Francia, CEPA®
Senior Vice President–
Wealth Management
nick.francia@ubs.com

Joanne Pronk
Senior Wealth Strategy Associate
joanne.pronk@ubs.com

Susan Ghanem, CFP®
Financial Advisor
susan.ghanem@ubs.com

Steve Brinckhaus
Senior Client Service Associate
steve.brinckhaus@ubs.com

Sarah Bothner
Wealth Strategy Associate
sarah.bothner@ubs.com

Gregory Marcus, CFP®
Managing Director–
Wealth Management
gregory.marcus@ubs.com

Robert H. Allred, CFP®
Senior Vice President–
Wealth Management
rob.allred@ubs.com

Sean P. Howe, CFP®, CDFA®
First Vice President–
Wealth Management
Portfolio Manager
sean.howe@ubs.com

Kleo Curry, CRPC®
Financial Advisor
kleo.curry@ubs.com

Jordan Binder
Client Service Associate
jordan.binder@ubs.com

Additional resources

Gerardo "Jerry" Castro
Market Head

Robert E. Madden
Senior Wealth Strategist

Bill Sutton
Senior Strategist
Family and Philanthropy
Advisory Americas

[1] See Private Letter Ruling 200709012, 1 November 2006.

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