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ESOPs: Estate and Charitable Planning Opportunities

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An Employee Stock Ownership Plan (ESOP) offers estate and charitable planning opportunities that often are overlooked. When the tax subsidies created by these estate and charitable planning opportunities are combined with an ESOP's basic income tax benefits, the total tax subsidies can exceed 100% of the value of an ESOP transaction.

INCOME TAX BENEFITS

An ESOP provides two very significant income tax benefits. First, the owner of a closely held business may sell all or a portion of his or her stock to an ESOP and receive the proceeds income tax deferred, or through use of a monetization transaction, income tax-free. By eliminating the capital gains that otherwise would be due, the owner saves 28%.

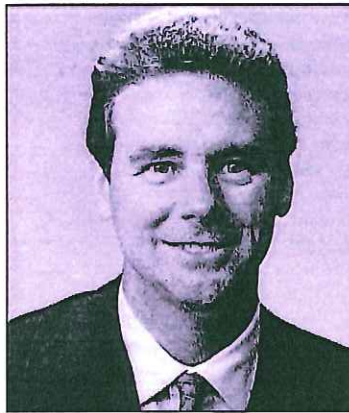
The second ESOP income tax benefit inures to the company. With an ESOP, a company makes a tax deductible contribution of cash to a qualified retirement plan (the ESOP). The ESOP then uses the cash it has received to service the ESOP debt. Thus, through an ESOP, the financing used to purchase the shareholder's stock is completely tax deductible by the Company. Without an ESOP, the Company would only be able to deduct the interest and not the principal. Thus, using the ESOP saves the company 34%.

At this stage, the ESOP's tax subsidy is 62% of the purchase price (28 + 34 = 62). Generally, this is the point at which most ESOP planning traditionally has stopped. However, valuable estate and gift tax planning opportunities are still available.

ESTATE TAX BENEFITS

Perhaps the best way to quickly explain these estate and charitable planning opportunities is by reference to an example. Assume that the enterprise value of the subject company is \$10M, and further, that the shareholder wants to sell 51% of his stock to the ESOP so that he can avoid a minority interest discount on the sale.

The pre-ESOP value of the shareholder's asset is \$10M—the enterprise value of the company. Immediately following the sale of 51% of his stock, he has two types of assets: The securities he purchased with his ESOP sales proceeds and his remaining 49% interest in the company. For estate tax purposes the 49% interest will be valued at substantially less than \$4.9M, due to the minority interest discount now available and due to the fact that the company now has the ESOP debt on its balance sheet as a liability. As a result of the minority



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interest discount and the ESOP loan, the estate tax value of the 49% interest may be valued at \$1.9M.

This "devaluation" of the stock represents an excellent transfer tax planning opportunity. If the shareholder creates a Family Limited Partnership to which he gifts this 49% interest, the Family Limited Partnership related discounts could reduce the value of the stock to \$1.2M -- the value of two unified credits. If the shareholder and his or her spouse have not used any part of their unified credits, they may be able to gift the stock to the Family Limited Partnership with no federal transfer tax consequences.

CHARITABLE OPPORTUNITY

Another estate planning technique to be considered is the gifting of all, or a portion, of the \$5.1M ESOP replacement securities to a Charitable Remainder Trust (CRT). The IRS recently released its third private letter ruling that permits someone who holds ESOP replacement securities under IRC section 1042 to transfer the stock to a tax-exempt Charitable Remainder Trust without triggering taxable gain. (PLR 9715040) Assuming the shareholder gifts \$1M of his replacement securities to the CRT, consider the gift tax leverage he has created; the \$1M gift he has made is directly traceable to 10% of the value of his closely held company. However, if he had wanted to make a \$1M gift of his closely held stock to a CRT without using an ESOP, he would have had to gift 20-25% of his stock. Using the ESOP replacement securities as the CRT gifting asset avoids the minority interest discount and minimizes the discount for lack of marketability, thereby creating significant gift tax leverage.

The total tax benefit created by the ESOP is over \$5.5M on a \$5.1M sale—a tax subsidy of over 100% of the value of the transaction. This is a powerful tax planning opportunity.

ESOPs are qualified retirement plans, akin to 401(k) plans. However, ESOPs are not subject to three prohibited transaction rules that are applicable to all other qualified plans: (1) ESOPs are allowed to borrow money, (2) ESOPs may purchase stock from the sponsoring company's shareholders, and (3) ESOPs are required to be primarily invested in the stock of the sponsoring company. These three unique ESOP features, combined with the tax benefits available to shareholders who sell to an ESOP, make ESOPs more than retirement plans and create the estate and gift tax planning opportunities described above.