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Benefits of an employee stock ownership plan in succession planning

An ESOP can be used to finance an owner's exit from a business and has the added advantage of tax deferral on the gain from the sale of the business.

By Megan M. Burke, CPA, Ph.D.

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Employee stock ownership plans (ESOPs) provide numerous benefits for small business owners and their employees, many of which are realized while the owner is still actively engaged in the business. In addition, proper planning for the owner's exit from the business can result in sizable tax savings. Many owners take advantage of the opportunities under Sec. 1042, which permits nonrecognition (or, more accurately, deferral) of gain on the sale of stock to an ESOP (or a worker-owned cooperative) if the seller purchases qualifying replacement property. This benefit can be magnified by using either a charitable remainder trust (CRT) or a family limited partnership (FLP)

along with additional trusts. Although the IRS has recently increased its scrutiny of FLPs, owning an active business through an FLP should bolster the position that the structure has the characteristics of what the IRS considers a "good" FLP.

INTRODUCTION TO ESOPs

At their most basic level, ESOPs are employee benefit plans that allow employees to take an ownership interest in the company. From a management perspective, this is a useful tool for aligning the employees' interests with the owner's. An ESOP allows the owner to cash out of the business all at once or little by little. By selling the business over time, the owner can transition control to the management team.

This strategy also permits the company to transfer control without borrowing large sums to purchase all of the owner's shares, which otherwise would force the company to become over-leveraged. The ESOP also creates a market for the owner to sell shares when a market may not otherwise exist. The owner can take advantage of the deferral provisions under Sec. 1042 by purchasing qualified replacement property. The gain is deferred until the newly purchased, potentially diversified portfolio is sold. While S corporation owners cannot take advantage of the deferral provisions under Sec. 1042, income attributable to the shares held by the ESOP are exempt from income taxation.

Employees receive an ownership interest in the company, and the ESOP benefits are not taxed until they receive a distribution. Employees can roll over the distribution proceeds into an IRA to continue to defer tax. If an employee does not roll over the distribution, the employer contribution is taxed as ordinary income, and any gain is taxed as capital gain.

In contrast to other retirement plans, the ESOP can borrow money to purchase shares to fund itself. Typically, the company borrows money from an external lender and then loans the money to the ESOP to purchase shares. The company then makes contributions to the ESOP to repay the loan. As the loan is repaid, the shares are released from a suspense account and allocated to the participants. Unlike other debt repayments, principal and interest payments for ESOP loans are tax-deductible under Sec. 4975. This tax treatment allows the ESOP to be financed with pretax dollars. Also, any dividends paid to service the loan are partially tax-deductible, up to 25% of employee compensation.

When an employee retires or leaves the company, the ESOP must repurchase the shares at the share value established by an independent third party. A major concern for ESOPs is having enough cash available to purchase shares when an employee retires or leaves the firm. To protect against a cash crunch in the event of a death, the company can purchase life insurance policies on the lives of the owner and key managers. Upon the death of one of these individuals, the company would receive the insurance proceeds tax-free, the company would then make a tax-deductible contribution of the proceeds to the ESOP, and the ESOP would purchase the shares. This strategy provides a double tax benefit for the insurance proceeds.

ESOPs IN SUCCESSION PLANNING

An ESOP provides substantial benefits while the owner continues to take an active role in the business. Many of the plan's negative aspects can be mitigated or avoided with a strategic business succession plan. ESOPs have a plethora of advantages when implemented as an exit strategy. One of the biggest advantages is that the owner

can leverage the Sec. 1042 deferral provisions to postpone gain recognition. If the owner holds the new shares until death, the gains will escape income taxation forever because the replacement property will receive a basis stepped up to fair market value when the owner dies.

Even greater tax savings can be realized by using an ESOP in conjunction with trusts. A CRT provides additional benefits for an owner with charitable intentions who does not wish to pass the assets to the next generation. The owner defers the gain on the sale of the original shares by reinvesting in a portfolio of securities of domestic operating companies. This portfolio is then transferred to a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT). The owner receives a current charitable contribution deduction for the transfer and then receives an income stream over his or her life or the joint life of the owner and spouse. Upon the death of the donor or the donor and the spouse, the remaining assets are transferred to the charitable organization. A portion of the income stream paid to the donor may be a return of capital for the contribution to the trust. Additionally, any appreciation on the shares inside the trust will escape taxation. This strategy also keeps the assets out of the donor's estate.

Alternatively, if the owner has family members to whom he or she wants to transfer the assets, an FLP can be a good option, if it has a valid business purpose. This strategy requires the owner to transfer an interest in the original company to the FLP in exchange for general and limited partnership interests. The owner retains the general partnership interest and eventually gifts the limited partnership interests to the heirs. The donor retains the general interest, which allows the donor to retain control over the assets. The gifts to the heirs will qualify for the limited partnership and limited marketability discounts, which could push the gifts below the annual exclusion amount ($14,000 for 2015) or the lifetime exemption amount ($5.43 million in 2015).

When the owner is ready to divest from the original company, the FLP sells the shares to the ESOP and reinvests the proceeds in qualified replacement property to take advantage of the Sec. 1042 deferral provisions. Additional tax benefits can be achieved by gifting a portion of the limited partnership interest of the FLP to a grantor retained annuity trust (GRAT) and setting up an irrevocable life insurance trust (ILIT) as the GRAT's beneficiary. The ILIT then purchases life insurance on the donor's life.

Upon the donor's death, the insurance proceeds are removed from the estate and pass to the heirs free of estate tax. Depending on the value of the FLP, the amount transferred, and the annual exclusion, the gift can be made directly to the ILIT. Gifts made to the GRAT qualify for the minority, limited marketability, and grantor retained interest discounts. Gifts made directly to the ILIT qualify for the minority and limited marketability discounts. The ILIT then uses the income from the FLP to pay the insurance premiums.

When considering using an FLP in an estate and business succession plan, it is important to know that FLPs have been hotly contested by the IRS and scrutinized for tax avoidance. The IRS focuses on a number of issues, but especially on whether the FLP has a valid business purpose. Valid business purposes include centralizing family assets, simplifying gifting and estate planning, protecting assets from divorce, or avoiding family disputes. Additionally, owning shares in an active trade or business helps satisfy the valid business purpose requirement. Since the FLP owns shares in the original business, this establishes a clearly defined business purpose, thus satisfying this requirement. After the original shares are sold, investing in assets that require active management will also contribute toward establishing a business purpose. In addition to a clearly defined business purpose, the FLP should also include several additional purposes to help maintain valid business purposes after the shares are sold to the ESOP.

It is also ill-advised to create an FLP and immediately gift limited partnership interests, as the IRS views this as a

tax-avoidance structure. For example, deathbed gifts of FLP interests or gifts made shortly after formation of the FLP may make it appear as though the FLP was created for tax avoidance. The donor should wait several months after establishing the FLP before gifting ownership interests, after which the gifted interests will be removed from the donor's estate.

Another point of contention with the IRS is proper documentation and assessment of the FLP's fair value. Upon its formation, the FLP owns shares in the original company. The ESOP rules require an independent third-party appraisal to establish fair value, which should help in determining the appropriate value. In this case, a low value assessed by the appraiser will help keep the gift values low, which will help the donor make the transfer stay within the annual exclusion amount. When the gifts are made, they should be stated in terms of total dollar amounts rather than a percentage of the FLP in case the IRS imposes a different valuation in the future.

The gifts of the limited partnership interests need to be considered present interests to qualify for the annual exclusion amount for gift tax purposes. This issue was recently addressed by the Tax Court in *Estate of Wimmer*, T.C. Memo. 2012-157. For a gift to qualify as a present interest, the *Wimmer* court said, the donor must prove: (1) The partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of the income could be readily ascertained.

In *Wimmer*, the FLP was funded with publicly traded, dividend-paying stocks, which the court found easily satisfied points (1) and (3). ESOPs are generally not created for failing businesses and are not seen as a bailout measure. Therefore, sufficiently documenting that the business generates income should satisfy parts (1) and (3). Once the shares are sold to the ESOP, the proceeds will be converted into qualifying replacement property. This qualified replacement property needs to be securities in domestic operating companies, and it would be best if a portion of those securities were dividend-paying stocks, further supporting the business purpose. Additionally, the dividend payments will provide income for the ILIT's insurance premiums.

FLPs typically provide that the general partner has discretion over distributions. The fiduciary responsibility to other partners may help satisfy point (2). However, in *Wimmer*, the court found that (2) was satisfied because one donee was an irrevocable trust with no additional assets. The irrevocable trust required distributions from the FLP to pay the trust's income tax. In the structure proposed in this article, the ILIT would require distributions to pay tax as well as the insurance premiums, providing an argument that the structure satisfies item (2).

Further support for the argument that the gift is a present interest could be achieved by providing a *Crummey*-like provision (generally giving beneficiaries the right to withdraw contributions), which would allow the recipient a period of time to sell the partnership interest back to the donor. However, practitioners should be aware that, while it lost the *Wimmer* case, the IRS is likely to continue contesting FLPs.

CONCLUSION

ESOPs provide substantial benefits to employees and owners while the owner is still actively engaged in the business. Many owners take advantage of the tax-deferral provisions under Sec. 1042 upon exiting the business by purchasing qualified replacement property. Additional benefits can be realized by using trusts.

Owners who want to leave their wealth to charity should set up a CRT to provide a current charitable deduction and an income stream for life to the owner or the owner and his or her spouse. When the owner dies, the assets are transferred to the charitable organization and escape income and estate taxation.

For owners who intend to pass assets to their heirs, creating an FLP to hold ESOP shares is a good strategy. The FLP interests should be gifted to a GRAT, an ILIT, and directly to the heirs. When the owner retires, the FLP will sell the shares to the ESOP, and the FLP will purchase qualified replacement property. A portion of the property should be dividend-paying stock to ensure that the ILIT has cash to pay the insurance premiums. The FLP removes the assets from the estate, and the ILIT serves to remove the life insurance proceeds from the estate.

Of course, FLPs are an area of consternation for the IRS. Using an FLP in conjunction with an ESOP helps bolster the argument that the FLP was created with a valid business purpose. Holding an active business within an FLP provides evidence that the FLP can generate income. By including an ILIT, the donor should be able to prove that a steady flow of income would occur, as the ILIT needs cash flow to pay taxes and insurance premiums.

About the author

Megan M. Burke (megan.burke@tamuc.edu (mailto:megan.burke@tamuc.edu)) is an assistant professor of accounting at Texas A&M University—Commerce in Commerce, Texas.

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