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ESTATE PLANNING FOR
OWNERS OF CLOSELY-HELD CORPORATIONS:
EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

According to the Family Firm Institute, the probability of a family business successfully passing to the next generation is less than 35 percent.[1] The chances of it succeeding into a third generation are estimated at a mere 13 percent.[2] The American dream of owning one's own business often becomes a "rags to riches to rags" nightmare in two generations.[3] Frequently, this is because the family is forced to sell the business to raise sufficient funds to pay estate taxes when the owner dies and the estate consists primarily of stock in the closely-held business. Advance planning to avoid this result is critical.

Many estate planning options are available to owners of closely-held corporations. One unique option is the use of an Employee Stock Ownership Plan (ESOP). When the estate of a deceased shareholder consists primarily of stock in the closely-held business, and it fails to meet the requirements that allow the estate tax to be paid in installments over a period of up to 15 years, a sale of stock to an ESOP will allow the estate to raise the immediate cash it needs without having to sell to outsiders.

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[1] Francis & Kurlowicz, *Greasing the Wheels of Succession; Family-Owned Businesses,* Best's Review -- Life-Health Insurance Edition, Vol. 94; No. 1; at 92 (May 1993).

[2] Ackerman, *Planning for Ownership Succession in the Closely Held Business*, 3 DePaul Bus. L.J. 245 (1991).

[3] Groppe, *Planning for the Closely-Held Business: Tax and Non-Tax Considerations*, 201 PLI/Est 37, PLI Order No. D4-5220 (1991).

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An ESOP can be an important element of a closely-held business owner's estate plan and provide important additional benefits.[4] Various corporate employee benefit objectives and corporate financing objectives can be accomplished with an ESOP.[5] The most important of these include supplementary or replacement retirement benefits for employees of the company, a market for company stock, a technique to increase cash flow, and a means to finance a company's growth.[6] In addition, an ESOP "can facilitate a successful transition in the ownership of a closely held corporation from one generation to the next." [7]

Congress has established numerous tax incentives over the past decade designed to encourage employers to establish ESOPs. The most important are summarized as follows:

1. Employer contributions to an ESOP are tax-deductible within applicable limits, the income of an ESOP trust fund is exempt from federal income tax, and special income averaging and rollover provisions are available to minimize the tax upon distributions from ESOPs to employee-beneficiaries;

2. An individual may sell stock of a closely-held corporation to an ESOP on a tax-free basis if the ESOP owns at least 30 percent of the stock of the sponsoring company immediately

[4] Esterces & Glaser, *ESOPs Even More Attractive to Major Shareholders After Tax Reform Act of 1986*, 66 J. Tax'n 273 (1987).

[5] Ludwig, *Design and Purpose of an ESOP: Techniques, Special Features and Incentives in Utilizing ESOPs*, 344 PLI/Tax 439, PLI Order No. J4-3666 (1993).

[6] S. Krass, *The Pension Answer Book*, at 23-1 (Eighth Edition 1993).

[7] Ackerman & Howitt, *Tax-Favored Planning for Ownership Succession Via ESOPs*, 19 Est. Plan. 331, Vol. 19, No. 6 (1992).

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after the sale and the sale proceeds are reinvested in "qualified replacement property" (generally, securities of other domestic corporations);

3. If a corporation uses an ESOP to obtain a loan, it will be entitled to take tax deductions with respect to both the interest and the principal payments on the loan;

4.An institutional lender may exclude from its taxable income 50 percent of the interest received on a loan to an ESOP that owns 50 percent or more of the stock of the sponsoring employer resulting in lower interest rates on such loans; and

5. Dividends paid in cash on shares held by an ESOP will be deductible if passed through to plan participants or used to pay off a loan taken out to finance the purchase of company stock.[8]

An ESOP is a special type of tax qualified retirement plan governed by the Internal Revenue Code and ERISA.[9] An ESOP is essentially a defined contribution plan designed to invest primarily in the stock of the sponsoring employer.[10] The tax and employee benefit laws that apply to tax-qualified employee benefit plans in general also apply to ESOPs.[11] The most important of these include:

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[8]Ackerman, *Innovative Uses of Employee Stock Ownership Plans for Private Companies*, 2 DePaul Bus. L.J. 227 (1990).

[9]Employee Retirement Income Security Act of 1974 ("ERISA"), Pub. L. No. 93-406, 88 Stat. 829.

[10]I.R.C. § 4975(e)(7).

[11]ERISA, *supra* note 9; I.R.C. §§ 401 - 416.

1. Contributions must be made to a trust administered for the exclusive benefit of the plan participants and their beneficiaries;[12]

2. Participation in the ESOP must be available to a broad cross-section of employees, not just a select group of key executives;[13]

3. Benefits under the ESOP may not be provided in a manner that discriminates in favor of officers, shareholders, or highly compensated employees;[14]

4. The ESOP must comply with minimum participation and vesting standards;[15] and

5. The plan and trust must be administered so as to comply with general fiduciary rules applicable to all retirement plans.[16]

These are only the major requirements. There are other requirements which must be met and special provisions that apply only to ESOPs. These special provisions include rules concerning voting rights of

[12]I.R.C. § 401(a)(1),(2).

[13]I.R.C. §§ 401(a)(3),(6), 410.

[14]I.R.C. § 401(a)(4),(5).

[15]I.R.C. §§ 401(a)(7), 411.

[16]ERISA § 404(a).

plan participants,[17] special distribution rules,[18] the right of plan participant to demand that benefits be paid in the sponsoring employer's securities (the "put option"),[19] and the right of plan participants to require the employer, as opposed to the ESOP, to repurchase any employer stock distributed to them under a "fair valuation formula." [20]

The general fiduciary rules applicable to tax-qualified employee benefit plans include a prohibition against loans from the plan sponsor to the plan.[21] With some restrictions, however, loans to an ESOP by the plan sponsor, and guarantees of bank loans to an ESOP by the plan sponsor, are allowed where the loan proceeds are used to acquire common stock of the sponsoring employer.[22] The advantage of using the ESOP to obtain a loan is that the corporation will receive a tax deduction for both the interest and the principal payments on the loan. The tax deduction for principal payments is possible because the employer receives a deduction for plan contributions used to repay the ESOP loan.[23]

The following is an example of a leveraged ESOP transaction:

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[17] I.R.C. §§ 409, 4975(e)(7).

[18] I.R.C. §§ 409(o)(1), 4975(e)(7).

[19] I.R.C. §§ 409(h), 4975(e)(7).

[20] I.R.C. §§ 409(h)(1)(B), 4975(e)(7).

[21] I.R.C. § 4975(c)(1)(B); ERISA § 406(a)(1)(B).

[22] I.R.C. § 4975(d)(3); ERISA § 408(B)(3).

[23] Ackerman & Howitt, *supra* note 7.

1. The ESOP borrows funds from an institutional lender and the loan is guaranteed by the plan sponsor. Alternatively, some lenders prefer the ESOP borrow the funds from the plan sponsor, which in turn borrows from the institutional lender;

2. The ESOP uses the loan proceeds to purchase shares of the plan sponsor. If the purchased shares are not readily tradable and fall within the definition of "qualified securities," gain will be deferred if the proceeds are reinvested in "qualified replacement property." The ESOP must own at least 30 percent of the outstanding stock of the corporation after the sale and other requirements of § 1042 must also be met; and

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3. The corporation then makes annual tax-deductible cash contributions to the ESOP in amounts sufficient for the ESOP to amortize loan principal and to pay interest. Although deductions for contributions to stock bonus plans are normally limited to 15 percent of the participants compensation, § 404(a)(9), regarding leveraged ESOPs, allows for the deduction of up to 25 percent of compensation for contributions used to pay loan principal. There is no limit for contributions used to pay interest and the deduction for dividends paid on ESOP stock may be available without regard to the limitation on contributions.

In addition, and subject to certain requirements, banks and certain other lending institutions may exclude 50 percent of the interest received on certain ESOP loans from their taxable income. This encourages them to make loans to ESOPs and to do so at reduced interest rates. However, recent legislation has substantially limited the availability of this exclusion. To qualify:

1. The plan must own more than 50 percent of each class of outstanding stock or 50 percent of the total value of all stock;

2. Plan participants must be entitled to direct the plan in voting securities acquired with loan proceeds and allocated to their accounts; and

3. The loan term may not exceed 15 years and the exclusion is generally limited to 7 years.[24]

Although corporations are generally not permitted to deduct dividends to shareholders, there is an exception for dividends paid on shares held by an ESOP.[25] Dividends paid on shares held by an ESOP may be deducted by the corporation if they are:

1. Paid in cash to plan participants;

2. Paid to the plan and passed through to the participants within 90 days of the end of the plan year; or

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[24] I.R.C. § 133.

[25] I.R.C. § 404(k).

3. Used to repay a loan incurred to purchase the sponsor's stock with respect to which the dividends are paid.[26]

Much of the recent interest in ESOPs has resulted from the tax incentive available under Code § 1042 which provides for the "tax-free rollover" of the proceeds of a sale of closely-held stock to an ESOP.[27] If the requirements of § 1042 are met, the seller defers payment of tax on the sale of stock to the ESOP.[28] The requirements include an election by the taxpayer or executor, the purchase of "qualified replacement property" within the "replacement period," and various other requirements of § 1042(b). The stock must generally have been held for at least 3 years and not have been received as compensation. Further, the deferral only applies to the extent the gain would be recognized as long term capital gain. If the "qualified replacement property" is disposed of by gift, death, subsequent sale to an ESOP, or in certain corporate reorganizations, the deferred gain will never be recaptured.[29]

The tax-free rollover provisions of § 1042 provide very attractive estate planning opportunities to owners of closely-held corporations. An ESOP can be used to buy out the interest of retiring stockholders on a tax-favored basis. As an alternative to selling to outsiders, this option allows for continued control of the business within a family or key-employee group. If the funds to purchase these shares must be borrowed, the use of an ESOP can significantly reduce the financing costs. Section 1042 also provides a

[26] *Id.*

[27] Ackerman & Howitt, *supra* note 7.

[28] The non-recognition of gain is not available for the sale of any qualified securities includible in the gross income of a C corporation. § 1042(c)(7).

[29] I.R.C. § 1042(e)(3).

tax-favored method for executives of closely-held corporations to diversify investment holdings with "qualified replacement property" rather than having all their wealth tied up in the stock of the closely-held corporation. Even where the owner of a closely-held corporation fails to take advantage of these tax benefits, the executor of the owner's estate can often do so.[30]

An ancillary benefit that can be achieved with an ESOP is closely-held stock valuation. Valuing the stock of a closely-held corporation before the owner's death is very important. If the value is not determined before death, an arbitrary value, based upon a compromise between an IRS valuation expert and the estate's expert, may be used to determine the estate taxes due.[31] Where the fair market value of the stock acquired by an ESOP is determined by an independent appraiser before death, the chances of a valuation dispute with the IRS are reduced.[32] A Buy-Sell Agreement is more commonly employed for this purpose.

The tax advantages offered by ESOPs make them attractive to owners of closely-held corporations for a number of reasons. ESOPs have become an important form of employee benefit and a useful tool of corporate finance. As an estate planning tool, "when the opportunity for owners of closely held businesses to sell some or all of their stock to an ESOP on a tax-deferred basis is combined with the opportunity for the company to borrow the funds to purchase the stock on a fully-deductible basis, the ESOP concept presents tax saving advantages for (owners of closely-held corporations) that can not be matched by any other planning technique." [33]

[30]I.R.C. § 1042(a)(1).

[31]*See* Gaynor, *Valuation of the Closely Held Corporation and Its Importance in Estate Tax Planning*, 210 PLI/Est 167, PLI Order No. D4-5228 (1992).

[32]S. Krass, *supra* note 6, at 24 -13.

[33]Ackerman & Howitt, *supra* note 7.

Still, an ESOP will not always be an appropriate tool for estate planning. The primary purpose of an ESOP is "ownership sharing" with employees. The tax benefits are incentives to accomplish that objective.[34] These tax incentives may cause planners to overlook potential disadvantages of an ESOP. The potential disadvantages of an ESOP must be considered and weighed against the advantages. Considerations include:

1. The IRS and DOL have recently increased their scrutiny of ESOPs;

2. The estate planning and corporate finance objectives of an ESOP must be coordinated with the fiduciary standards of ERISA;

3. Federal and state securities and corporate law may apply to an ESOP transaction;

4. There is relatively little in the way of guidance from the IRS regarding ESOP transactions;

5. IRC § 1361 precludes an ESOP (or any qualified plan) from owning shares of an S corporation;

6. The potential for loss of control by the original shareholder(s);

7. Cash flow problems relating to the stock repurchase requirement; and

[34] Ludwig, *supra* note 5.

8. The possibility that earnings will be diluted.

Estate planning for owners of closely-held corporations presents unique challenges and opportunities. The use of an Employee Stock Ownership Plan is one possibility available to the estate planner. As an estate planning tool, the use of an ESOP is relatively new. A well designed ESOP can provide significant benefits to the sponsoring company, its shareholders, and employee-owners. These benefits must be weighed against the potential disadvantages of using an ESOP to accomplish a specific objective. Given the significant tax advantages available from the use of an ESOP, the possibility should certainly be explored.