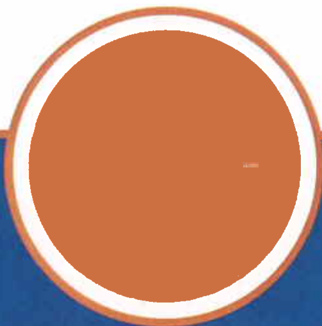

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ESTATE PLANNING

Tax Shields for Private Shareholder Succession Plans

Michael A. Coffey

The tax code is a Christmas tree where many special interest groups have hung their ornaments on the branches over several decades. The result is an array of tax laws which are poorly understood when considered from an interconnected viewpoint.

For example, estate planners are very good at vehicles such as defective grantor trusts and charitable remainder trusts. So they are not expected to be well-versed in employee benefit law—nor do they have the need. The result of practitioners in the legal, accounting and valuation communities appropriately sticking to their own knitting is a kind of professional provincialism.

The correct answer is more often an integrated plan—perhaps using a partnership in conjunction with a tax-sheltered stock market. There are few generalists with the years of experience needed to coordinate divergent aspects of the Code into an integrated business succession plan.

A pair of ideas will serve as an illustration: the coordination of an employee stock ownership plan with tax-favored charitable gifts. This is hardly the only mechanism for coordinating the disparate pieces of a solution, but is one example of a well-proven approach for certain succession planning goals. This combination can provide:

- The funding of a charitable trust with corporately tax-deductible dollars
- Elimination of estate taxation on illiquid stock
- Lifetime income for owner(s) from a corporately funded remainder trust
- Elimination of capital gains taxation on a stock sale
- A personal income tax deduction for the value of the stock gift

Note that we are not saying this combination is "the answer." Of the transactions we have designed over the years, the charitable component of the larger integrated business continuity and estate planning structure is typically 10 percent to 20 percent of the deal size.

The Employee Stock Ownership Plan

The thousands of shareholders who have sold stock to an ESOP have done so primarily

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for very simple reasons:

1. When they sell C corporation or Sub S stock to an ESOP. Both sales qualify for capital gains tax treatment. In the case of a C corporation ESOP which reaches a 30 percent ownership position, the sellers can avoid paying the capital gains taxes on the sale proceeds. This plus the corporate tax deduction can save over $400,000 per $1,000,000 in a transaction.
2. Unlike a corporate stock redemption which costs the company after-tax dollars, the ESOP allows the company to use pretax money—Instead of earning $1,600,000 to buy $1,000,000 in stock, the company only needs the $1,000,000 of pretax earnings. Annual contributions to the ESOP are tax-deductible by the company. The cash contributed or accumulated in the ESOP is used to purchase the stock.
3. C corporation dividends are deductible to the corporation when used to retire the associated ESOP debt. These are not counted in the 25 percent of eligible payroll contribution limit constraining other qualified plans.
4. Subchapter S corporations can sponsor ESOPs and use both deductible contributions and the untaxed earnings on ESOP shares to buy stock. Many S corporations become operationally tax-exempt. Again, there is a contribution ceiling much higher than 25 percent of pay.
5. The ESOP allows corporate control to be tailored to meet the needs of the owners and their families in most cases. The Trustee(s) of the ESOP may include the selling stockholder or a team of owners and key employees or family members.

Typical ESOP applications include private company owners trying to solve business perpetuation/stock transaction problems, such as:

- Buyout of minority or majority shareholder
- Retirement
- A stock sale or gift
- A buyout of another shareholder
- Acquisition of another corporation
- Retention of key employees

Why Involve a Charity?

Public charities such as IRC 501(c)(3) organizations and some private charities (family foundations), have one major characteristic: they are tax-exempt entities. When the rules are followed: (1) They can provide donors with a tax deduction equivalent to the value of any gift; and (2) They pay no taxes on transactions conducted by the charity, such as a stock sale.

When a charitable trust, foundation or other institution is involved in such cases, it can be an additional conduit for stock transactions. This provides an additional layer of tax relief for the stockholder particularly when coordinated with other succession strategies. Donations of shares to the charity, or charitable trust, which the charity or trust can sell without taxation back to the company, its ESOP (the tax-free private stock market), or family members, can result in a personal income tax deduction for the donor and real cash to the charity. Where a charitable remainder trust is used, the donor can also retain a stream of income for one or more lives in addition to obtaining a tax deduction.

If the intent is purely philanthropic, with no desire for lifetime income from the process, the transaction can simply be a direct gift to the charity funded through the employee benefit plan (ESOP). The value of any stock gift must be determined by an independent appraisal.

It is important to note that the independent valuation of shares for ESOP purchases can be

much higher than the value for family gifts. This is an area with considerable opportunity and some risk (if done incorrectly). One key idea overlooked at times is the ability of an ESOP to deliberately (and carefully) impose some debt on the corporation as part of the tax-favored stock purchase—where this debt brings an additional layer of discounting to the table for family gifts in addition to the usual lack-of-marketability and minority interest discounts.

Charitable Gift Strategies

Because an ESOP is indifferent to the source of the stock (but not the price or type of security), it can purchase private shares from a charity, a family foundation, a partnership or an estate.

While an ESOP can buy both S and C corporation stock, only C stock can be given to a charitable trust. S stock can be routed through a family foundation, but the sale to the ESOP should be contemporaneous with the gift, because the Unrelated Business Income Tax (UBIT) will apply to S shares held by the foundation. The value of the gift in this case is limited to the cost basis of the stock.

For C corporations, an effective strategy from valuation and tax perspectives, particularly when owners are looking to achieve all of the objectives noted at the beginning of this article, is the following sequence:

1. The company establishes an ESOP and borrows money to buy stock.
2. The owners sell 30 percent or more of the shares and elect the IRC 1042 tax-free rollover.
3. Some of the proceeds of the rollover, which are necessarily invested in U.S. stocks and bonds and now have the same low cost basis of the starting C shares, are then given to a CRUT.
4. The ESOP debt allows more private stock to be given to the children (typically with second tier discounts for an FLP or Family LLC) with no gift taxes.
5. The value of the gift of the now publicly traded securities is not an issue—market value applies.
6. The tax savings, when the elimination of the estate tax is considered, often exceed the dollar volume of the transaction itself.

Conclusion

As with everything involving the Internal Revenue Code, advisors must understand the interactions of the various parts being wired together. It is important to work with consultants, attorneys, CPAs and valuation specialists who have implemented such integrated strategies.

Small companies typically cannot benefit from these approaches. Unless the corporation has more than two dozen employees and a pretax income of $500,000 or more, there is limited utility due to the typically lower company value, lower estate valuation and a reduced economy of scale when considering complex transaction costs and time.

For those who want to keep the business locally owned, operated and controlled by family or other rising management, and eliminate as much taxation as possible at all estate, corporate and personal levels, the coordinated succession plan can make the difference. These approaches will be much more important in the years ahead as taxes are likely to rise and more owners want to get some skin out of the game efficiently and pass the business along to the folks who helped build it. ●

Michael Coffey, managing vice-president of Corporate Capital Resources, LLC of Roanoke, Virginia, is responsible for the design and oversight of stock transactions, business succession and executive compensation strategies for closely held corporations. A popular writer and speaker at numerous conferences dealing with issues of corporate continuity and ESOPs, Coffey can be reached by e-mail at Michael_Coffey@ccrva.com *or by phone at 800-358-2116.*

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