



WRMarketplace

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TOPIC: Did You Know: ESOPs Present Powerful Estate Planning Opportunities: Planning with Qualified Replacement Property (QRP).

MARKET TREND: With employee stock ownership ("ESOP") transactions seeing a resurgence due to increasing tax rates, it's worth understanding their unique planning opportunities for business sellers.

SYNOPSIS: Optimizing a seller's results in an ESOP transaction can be relatively easy if estate planning becomes a part of the conversation. ESOPs can offer a unique exit option, deferring the taxable gain from the sale of the business while providing an enhanced legacy to the seller's heirs. For example, C corporation sellers in ESOPs can use Internal Revenue Code ("Code") §1042 to defer gain on the proceeds by reinvesting in QRP and enhance their planning by making gifts of the QRP. The IRS has ruled that several types of gifts do not constitute a disposition of QRP that would otherwise trigger gain recognition, including legacy planning using charitable remainder trusts, grantor retained annuity trusts, and gifts to grantor trusts.

TAKE AWAYS: Using ESOPs for business succession can provide unique benefits for the seller. When the ESOP involves the sale of C corporation stock and reinvestment in QRP, it can be used in conjunction with common estate planning approaches to enhance the deferral of gain, as gifts of QRP do not trigger gain recognition according

to longstanding and appropriate tax principles. With these attributes, ESOPs are an important option for consideration in business succession planning for closely-held business owners.

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ESOPs, as qualified plans,¹ can provide an effective business succession plan for the sponsoring company's current owners or founders by creating a market for their shares and providing them with unique benefits, including the potential deferral of gain. In special circumstances, the sellers of stock in a C corporation to an ESOP may delay recognizing any gain for capital gains tax purposes under Code § 1042 if certain requirements are met. This deferral is an additional estate planning tool for sellers (see *WRMarketplace #2015-25* for a more general discussion of ESOPs).

CODE §1042 ELECTION

In certain situations, a C corporation shareholder can defer capital gains tax on the sale of stock to an ESOP if a Code §1042 election is made by the selling shareholder.² Requirements for making the election include:

- The ESOP must own at least 30% of the company stock after the sale;
- The selling shareholder must have held the stock for at least 3 years before the sale; and
- The seller must reinvest the sale proceeds in QRP within a 15-month replacement period (which ends 12 months after the sale to the ESOP). QRP generally consists of common and preferred stock in U.S. corporations, corporate fixed rate bonds, and corporate floating rate notes.³

If eligible, the corporation may elect to convert to Sub-Chapter S Status immediately following the close of the ESOP sale without voiding the seller's Code §1042 election.

At death, any QRP held by a decedent will receive a basis step-up to its then fair market value.⁴ Thus, a decedent's beneficiaries will not pay income tax, but the QRP's full value will be included in a decedent's estate for estate tax purposes. This liability could be addressed by acquiring life insurance in an irrevocable life insurance trust ("ILIT").

ESTATE PLANNING & THE §1042 ELECTION

While a disposition of QRP generally results in taxable gain, a gift of QRP does not.⁵ Accordingly, to the extent a seller of C corporation stock to an ESOP has made a valid

Code §1042 election (“Seller”), he or she may consider various gift and estate planning opportunities without triggering gain recognition, including:

Charitable Remainder Unitrusts (CRUTs)

With a CRUT, the Seller makes a gift of QRP to an irrevocable trust while reserving for the Seller and/or another non-charitable beneficiary the right to annual distributions of a fixed percentage of the net fair market value of the trust principal (revalued annually). These annual distributions may be paid: (1) over the lifetimes of the designated non-charitable beneficiaries, (2) for a term of up to 20 years, or (3) the shorter or longer of the lives of the non-charitable beneficiaries or 20 years. Upon expiration of the selected term, the remainder interest in the CRUT passes to a qualified charity designated by the Seller (see *WRMarketplace #2013-05* for a general discussion of philanthropic planning with CRUTs).

The CRUT’s annual distributions will be taxable to the Seller (or other non-charitable beneficiary). The Seller, however, will receive an upfront income tax charitable deduction for the contribution to the CRUT equal to the present value of the remainder interest that will pass to the charity at the CRUT’s termination. Further, even though a sale of the QRP by the CRUT constitutes a disposition for purposes of Code §1042, there is no immediate gain recognition for capital gains tax purposes due to the CRUT’s tax-exempt status.

Example: Seller, age 45, gifts QRP valued at \$5 million to a CRUT in March 2016, retaining the right to receive, for life, 8.132% of the \$5 million fair market value of the trust principal, revalued annually, for his life, with X Charity designated as the remainder beneficiary. Seller is entitled to an upfront federal income tax charitable deduction of \$500,100 (the present value of X Charity’s remainder interest). During the CRUT term, if the CRUT assets have annual 3% growth and 2% income, Seller will receive \$8,260,414 in total taxable distributions from the CRUT over his 34-year life expectancy. Upon Seller’s death and termination of the CRUT, \$1,537,890 will pass to X Charity.

- **Life Insurance Planning:** CRUTs may be implemented in conjunction with an ILIT to compensate for the potential loss of CRUT payments in case of Seller’s premature passing and to replace the family wealth passing to the charitable beneficiary.

Grantor Retained Annuity Trusts (GRATs)

With a GRAT, Seller also gives QRP to an irrevocable trust, reserving the right to receive fixed annual annuity payments from the GRAT for a specified period (e.g., a

term of years), based on the federally-set, monthly adjusted interest rate under Code §7520. At the end of the annuity term, any remaining trust assets pass to Seller's designated non-charitable remainder beneficiaries (e.g., the Seller's children).⁶ If the Seller survives the GRAT term and the GRAT assets appreciate more than the applicable Code §7520 rate,⁷ the appreciation will pass to the GRAT remainder beneficiaries, generally without gift or estate tax according to longstanding and appropriate tax principles (see *WRMarketplace #2014-08* for a general discussion of planning with GRATs).

Seller's contribution to the GRAT will not be a taxable gift if Seller "zeros-out" the gift tax value of the GRAT's remainder interest (i.e., makes the present value of the annuity stream equal to the fair market value of the QRP transferred to the GRAT).⁸ In addition, since the GRAT is a grantor trust with regard to Seller for federal income tax purposes, the annuity payments to Seller do not generate income tax. However, Seller must pay the GRAT's income and capital gains tax liability, including any capital gains tax triggered by the GRAT's disposition of any QRP.

Example: Seller, age 45 (life expectancy of 34 years), gives QRP valued at \$5 million to a zeroed-out GRAT in March 2016 (§7520 rate of 1.8%), retaining the right to annuity payments for 6-years. Each annuity payment increases by 20% relative to the prior year's annuity. Trust assets remaining at the end of the GRAT will pass to a trust for Seller's children. During the annuity term, if the GRAT assets have annual 3% growth and 2% income, Seller receives a total of \$5,369,490 from the GRAT. Upon expiration of the GRAT term, \$775,085 will pass to the trust for Seller's children. If the children's trust is treated as a grantor trust with respect to the Seller for the 28-year balance of Seller's 34-year life expectancy, \$3,038,433 will pass to his children without gift or estate tax.

- **Life Insurance Planning:** Seller may also want to acquire life insurance to protect against the potential mortality and estate inclusion exposure if Seller dies during the GRAT term.

Gifts to Irrevocable Grantor Trusts

Seller can give QRP to an irrevocable trust for the benefit of descendants and use available gift and generation-skipping transfer ("GST") tax exemptions in regards to potential transfer taxes. The trust also can be funded with other property, such as warrants or promissory notes received by Seller in the ESOP transaction and for which a valuation discount might be available in determining the value of the taxable gift.

Since the trust is a grantor trust with regard to Seller for federal income tax purposes, Seller must pay the trust's income and capital gains tax liability, including any capital gains tax triggered by the trust's disposition of any QRP. This payment of the trust's income tax obligations, however, does not result in additional taxable gifts to the trust. Further, if the trust provides Seller with a non-fiduciary power of substitution, Seller can exchange assets of equivalent value for trust assets, including QRP. The substitution will not constitute a disposition of the QRP for purposes of gain recognition and should allow Seller to obtain a basis step-up for the QRP, while any assets and appreciation remaining in the trust at Seller's death after expiration of the GRAT term should not be includible in the Seller's estate.

Example: Assume the same Seller from the GRAT example creates a "dynasty" irrevocable trust for the benefit of his descendants and gives QRP and/or other assets valued at \$5 million to the trust. Seller allocates his available gift and GST exemptions to these gifts. The trust anticipates annual 3% growth and 2% income. At Seller's death in 34 years (end of his life expectancy), the trust will hold \$26,266,740 for Seller's descendants. If, before his death, Seller exercised his non-fiduciary substitution power to obtain the QRP held by the trust, it should receive a basis step-up in Seller's estate.

- **Life Insurance Planning:** The grantor trust could also acquire life insurance on Seller, using income/growth from the other trust assets to pay premiums. The death benefits could provide an additional source of liquidity for Seller's estate.

TAKE AWAYS

Using ESOPs for business succession can provide unique benefits for the seller. When the ESOP involves the sale of C corporation stock and reinvestment in QRP, it can be used in conjunction with common estate planning approaches to enhance the deferral of gain, as gifts of QRP do not trigger gain recognition. With these attributes, ESOPs are an important option for consideration in business succession planning for closely-held business owners.

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NOTES

¹ ESOPs are tax-exempt, defined contribution retirement plans governed by Code §401(a) and ERISA, but which have certain unique characteristics compared to other types of qualified plans.

² Code §1042(b). This prevents selling shareholders in S corporations from obtaining gain deferral, although in certain situations, the S corporation could seek to revoke its “S” election and revert back to C corporation status.

³ It excludes mutual funds, municipal bonds, deposit certificates, foreign securities, and government bonds.

⁴ Code §1014. Note that if a seller passes away with sale proceeds in “temporary” QRP (i.e., awaiting selection of a final investment portfolio), the Code §1042 election benefits will be preserved.

⁵ See PLR 9438021 (IRS ruled that ESOP proceeds reinvested in QRP with a §1042 election that are then transferred to a charitable remainder trust does not cause recapture of deferred gain as the disposition constitutes a transfer “by gift” for Code §1042(c)(3) purposes); PLR 9234023 (same analysis).

⁶ Generally, to transfer wealth to the trust’s remainder beneficiaries, the assets must appreciate more than the Code §7520 rate set for the month of the GRAT’s creation. The grantor also must survive the GRAT term to avoid inclusion of some or all of the GRAT assets in his or her taxable estate.

⁷ The Code §7520 rate set for the month of the GRAT’s creation.

⁸ Note that the grantor does not need to pre-fund or “seed” the GRAT with a separate gift, unlike installment sale transactions to grantor trusts, which may require a gift of “seed” money (typically 10% of the value of the assets sold) to evidence the trust’s ability to make payments under the installment note.