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STEIKER, FISCHER, EDWARDS & GREENAPPLE, P.C.
SES ADVISORS, INC.

CLIENT ALERT

ACHIEVE INCOME TAX AND ESTATE PLANNING OBJECTIVES:

HAVE A FAMILY LIMITED PARTNERSHIP SELL STOCK TO AN ESOP

Written by: Mark R. Kossow, Esq.

There are a number of reasons why shareholders of closely held C corporations choose to sell stock to an employee stock ownership plan ("ESOP"). One major reason centers around the advantages of being able to sell company stock to an ESOP in a tax deferred "rollover" transaction under Section 1042 of the Internal Revenue Code of 1986, as amended (the "Code"). If the requirements of Code Section 1042 are satisfied, the selling shareholder can elect to defer capital gains taxes by reinvesting the proceeds into securities of domestic corporations which constitute qualified replacement property ("QRP") under Section 1042. Capital gains are deferred until the QRP is sold. If the QRP is held until death, capital gains are forever eliminated.

For example, if Mr. Big sells a sufficient amount of stock (with a basis of zero) to an ESOP for $10 million and reinvests those proceeds in QRP within the applicable time period (generally, the selling shareholder has 12 months measured from the date of sale to reinvest the proceeds in QRP), he will avoid having to pay $1.5 million in federal capital gains tax (15% of $10 million). Many states also exempt qualifying ESOP rollovers from state capital gains tax, so rollover tax savings often exceed 15%. If Mr. Big holds onto the QRP until death (for the sake of simplicity, we are assuming the value of the QRP at death remains at $10 million) and his estate disposes of the QRP, the estate will not have to pay capital gains tax because the estate takes the property with a stepped up basis equal to $10 million.

Even though the reinvestment of sale proceeds into QRP is an excellent way to defer or even eliminate capital gain taxes, the reinvestment does nothing to reduce the selling shareholder's estate tax liability. Under Code Section 2001, the current maximum estate tax rate is a staggering 45%. In our example, the federal estate tax will reduce Mr. Big's QRP portfolio from $10 million to only $5,500,000. The impact of estate taxes will also result in a significant loss of future income to Mr. Big's heirs. A $10 million QRP portfolio earning a 6% return would provide annual income of $600,000. After the estate tax reduces the value of the QRP portfolio to $5,500,000, a $600,000 income stream is likewise reduced to $330,000 per year, a difference of $270,000 per year. Assuming the children of Mr. Big have life expectancies of 30 years, the loss of $270,000 of annual income over 30 years amounts to an overall loss of about $8,100,000 to the children in non-inflation adjusted dollars.

In order to reduce the adverse effects of estate taxes on a QRP securities portfolio, it may be wise to do some advance planning before selling stock to an ESOP. One technique that may work in certain situations for reducing estate taxes is to have a family limited partnership (the "FLP") sell the stock

Achieve Income Tax and Estate Planning Objectives

to the ESOP. In order to have the FLP sell the stock, the selling shareholder must first contribute the stock to the FLP in a nontaxable exchange for a limited partnership interest in the FLP. The FLP thereafter sells the stock to the ESOP, makes a Code Section 1042 rollover election and reinvests the sale proceeds in QRP. The FLP will not have to pay capital gains tax and, upon the death of the selling shareholder (now a limited partner of the FLP), estate taxes will be payable based on the value of the decedent's interest in the FLP (which owns the QRP). If the rights of the limited partners in the FLP are restricted, the value of the partnership interest can be discounted. In certain cases, FLP units can be valued for estate tax purposes with discounts for lack of marketability and minority interest that total more than 30%. This discounting effect significantly reduces the estate tax bite on QRP. Please note, however, as discussed further below, this strategy is not without risk.

For example, assume Mr. Big sets up a FLP and contributes his stock to the FLP in exchange for a 70% limited partnership interest in the FLP. If the FLP thereafter sells the stock to the ESOP and reinvests the proceeds in QRP, Mr. Big will avoid having to pay capital gains tax on the sale. In addition, assuming that Mr. Big's rights as a limited partner are restricted and that the FLP has a legitimate business purpose, the value of his interest in the FLP will be discounted for estate and gift tax purposes. If the FLP achieves a 30% valuation discount, Mr. Big will have effectively converted $10 million of marketable securities into an illiquid limited partnership interest valued at $7,000,000, resulting in a savings of about $1,350,000 in estate taxes upon his death.

The selling shareholder can further reduce the estate tax burden by making leveraged gifts of FLP interests to his or her children. Using the annual exclusion rules of Code Section 2503 (b) as an example, a $12,000 gift of discounted FLP units is the equivalent of about $17,143 of underlying FLP assets if the FLP achieves total valuation discounts of 30%. If Mr. Big were to make leveraged gifts of FLP interests to his children, his estate burden would be further reduced. Mr. Big might also consider using some or all of the lifetime gift exclusion or contributing the FLP interests to a grantor retained annuity trust, or selling the interests to an intentionally defective grantor trust. For example, if over time Mr. Big gifted $1,500,000 of FLP interests to his children (a combination of annual exclusion and unified credit gifts), his combined total estate tax savings from using an FLP would be an impressive $2,025,000.

The use of FLPs in estate planning to achieve valuation discounts is not without risk by any means. In recent years, the IRS has successfully challenged discounts taken on partnership interests in many court cases. While the results of these cases might be deemed to arise from "bad facts," e.g., partnership formed on the death bed with little or no substance, the cases have established important principles. In general for the FLP to work, it must have a business purpose independent of the mere reduction of estate or gift taxes, plus in our example, Mr. Big must give up direct and indirect control of the FLP, i.e., Mr. Big cannot be the general partner or have control over the general partner.

Because one of the ancillary reasons to form an FLP is to achieve valuation discounts for gift and estate tax purposes, it is absolutely necessary that the FLP general partner (usually a new corporation) hire an appraiser to value the FLP units. As noted above, FLP units can be discounted for lack of marketability and minority interest. The amount of the discount is a decision for the appraiser and is dependent on the specific design of the FLP. FLPs can be designed to be restrictive or liberal with respect to voting, income and distribution rights. The more restrictions that are placed on FLP units, the greater the valuation discount.

Done properly, the use of a FLP can be an effective technique for reducing a selling shareholder's estate taxes as it relates to his or her QRP portfolio.

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DIVERSIFICATION: THE BASICS

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One of the unique compliance requirements for ESOPs is found in IRC Section 401(a)(28). Enacted as part of the Tax Reform Act of 1986, Section 401(a)(28) imposes a requirement for ESOP "diversification." Most retirement plans have fiduciary obligations to be diversified in their investments; however, ESOPs by definition must be designed to be invested primarily in company stock. The diversification requirement for ESOPs is designed to offset the investment risk for participants if all their ESOP retirement assets were invested in a single basket full of company stock.

WHO IS ELIGIBLE

Participants who have attained age 55 and have ten years of participation in the ESOP are eligible to begin diversification as of the end of the plan year in which both requirements are met. Using a calendar year plan as an example, someone turning age 55 during 2007 and who entered the ESOP 1/1/98, would become eligible as of 12/31/07.

NOTICE AND ELECTION REQUIREMENTS

Once a participant is considered "eligible" they must receive a notice and election form within 90 days after the close of the plan year. So in our above example, participants would need to be notified of their right to elect diversification by March 31, 2008. Then the ESOP sponsor has 90 days from March 31, 2008 to actually satisfy a participant's diversification election. The annual diversification election must be offered for six consecutive years, even if the participant chooses not to exercise one of the diversification offers.

Administrative Note: Many ESOP companies do not have their shares valued and allocations completed within 90 days after the close of the plan year. There is no specific regulatory guidance on what to do in that situation. Most professionals agree that a show of good faith compliance would be to send out an initial notice within the 90-day deadline explaining diversification and then, after the year-end allocations have been finalized, to send a second notice with updated account information.

Example of How Diversification Works

	Cash (in dollars)	Pre-87 Stock (in shares)	Post-86 Stock (in shares)
Account Balance 12/31/07	Does Not Apply	Does Not Apply	2,000.0000
First Year Diversification Offer			X 25%
Shares eligible for diversification Year One			500.0000
Participant Elects to Diversify			-500.0000
New Shares Allocated to Account During 2008			1,000.0000
Account Balance 12/31/08	Does Not Apply	Does Not Apply	2,500.0000
Addback shares previously diversified			500.0000
			3,000.0000
Apply the 25%			X 25%
			750.0000
Less shares previously diversified			-500.0000
Shares eligible for diversification Year Two			250.0000

And so on, until Year Six when the percentage increases to 50% in the final year of diversification.

Diversification: The Basics

CALCULATING THE AMOUNT ELIGIBLE

The diversification eligibility period lasts six years. For the first year, the amount eligible to diversify is simply 25% of the shares of company stock held in the participant's ESOP post-86 stock account(s). For the first five years, the amount available to diversity is 25% of the sum of (1) stock held in those account(s) at plan year end PLUS (2) shares previously diversified, less the number of shares previously diversified in prior years. In effect this means that if someone takes the 25% offer in the first year, in years two through five, they are only entitled to diversify 25% of any newly allocated shares to their account. In the sixth year, substitute 50% for 25% in the formula. The chart on page four helps to demonstrate how diversification works.

Note of special interest: Diversification only applies to shares acquired by the ESOP after 12/31/86, so if you have an older ESOP, diversification may not apply to all shares in the ESOP. And if the value of the post-86 stock account is less than $500 for a participant, you do not have to offer diversification for such a small amount.

WAYS TO SATISFY DIVERSIFICATION

Permissible ways plan sponsors can satisfy the diversification requirements are as follows:

- Distribute in cash (withholding required and possible early withdrawal penalty)
- Rollover to another qualified trust or IRA of participant's choosing (avoid withholding and penalty)
- Distribute in shares (subject to the put option)
- Transfer to another plan sponsored by the company (typically a 401(k)) that has at least three investments funds
- Offer three or more investments within the ESOP (not typically done because this option can be costly and complicates the administrative and trustee responsibilities)

The plan document should specify which one (or more) of the above methods is going to be used to satisfy diversification.

PENSION PROTECTION ACT CHANGES

The Pension Protection Act of 2006 changes the diversification requirements for some ESOPs. Under the Act, for ESOPs holding publicly traded employer stock, a participant must be permitted at all times to diversify his or her employee elective contributions invested in employer securities. In addition, participants must be permitted to diversify employer contributions invested in publicly traded employer securities after three years of vesting service. Generally the Act exempts from the new diversification requirements an ESOP holding publicly traded employer stock so long as: (1) the ESOP is a stand alone plan (meaning it is not combined with any other defined contribution plan) and (2) the ESOP does not hold contributions and earnings that are subject to nondiscrimination tests applicable to employee elective deferrals, employee after-tax contributions or employer matching contributions.

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Client Q & A

Edited by Diane Fanelli, Principal and Senior ESOP Administrator

Q: How do you find a missing participant? If you can't find him/her, does the account escheat under State law?

A: The DOL has issued guidance on the steps that must be taken to locate missing participants, including using the IRS and the Social Security Administration forwarding services. Using a state's escheat law may be permissible in the case of a *terminated* defined contribution plan. For an ongoing plan, DOL has taken the position that the state law is preempted by ERISA. You should discuss with your plan advisors which alternatives are appropriate for your situation.

Look for an in-depth article on this topic in our next issue!

Submit your own questions to asimons@sesadvisors.com