

**2018 Summer Meeting
American College of Trusts & Estates Counsel
Chicago, Illinois
June 22, 2018**

**Planning for Closely-Held Businesses with
Deferred Compensation and ESOPs**

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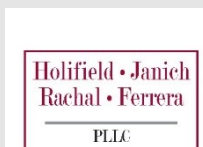
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UNDERSTANDING NONQUALIFIED DEFERRED COMPENSATION: AGENDA

- Types & Features of Non-Cash Compensation
- What is Nonqualified Deferred Compensation?
- Major Considerations When Choosing NQDC Plan:
Compensation Philosophy, § 409A
- Estate Planning Considerations

FORMS OF COMPENSATION

- Cash Compensation/Bonus Incentives
- Equity Awards
 - Full Value Awards: Stock Grants
 - Appreciation Awards: Stock Options
- Synthetic Equity Awards
 - Full Value Awards: Phantom Stock & RSUs
 - Appreciation Awards: SARs

COMPENSATION PHILOSOPHY

- What role does compensation play at company? What types of plans are favored and why?
- Influenced by company culture, industry and market conditions: reliance upon compensation surveys and consultants
- Compensation fixed or Performance based?
- Who Has Final Say on Compensation matters? CEO or Board?

DESIGN CONSIDERATIONS

- Transaction Award (CIC) or Post-Transaction Plan
- Full Value Awards or Appreciation Awards
- Short Term or Long Term
- Performance/Incentive or Retention
- Employer Provided or Participant Elective

IRC § 409A

- What is §409A?
- Applies to “deferred compensation”
- Compensation fixed or performance based?
- Broad in scope but some exemptions
 - Short term deferrals & “safe harbor” severance arrangements
- Affects distributions and elections

IRC § 409A Cont'd

- § 409A does not apply to:
- Incentive Stock Options
- Nonqualified Options or Stock Appreciation Rights granted at FMV
- § 423 Employee Stock Purchase Plans
- Restricted Stock or Restricted Stock Units
- Grandfathered plans granted and vested before December 31, 2004

PENALTIES FOR VIOLATION OF § 409A

- Penalties for §409A failure fall most heavily on employee recipient
- Noncompliance = income inclusion and ordinary income taxation at vesting
- 20% penalty tax
- Interest
- But company can be liable for potential tax withholding penalties

ESTATE PLANNING & DEFERRED COMPENSATION

- Most DCPs provide for payment of survivor benefits
- Estate plan of HCE should consider survivor benefits of DCP.
 - Estate tax consequences
 - Beneficiary elective options

ESTATE TAX CONSEQUENCES

➤ IRC § 2039 requires:

- Annuity or other payment received by beneficiary
- Payment receivable under contract or agreement entered after 3/3/1931
- Annuity or “other payment” must be payable to employee until death
- Purchase price of annuity contributed by decedent (or his employer)

§ 2039(a): DECEDENT'S ESTATE & NQDCP

- IRC § 2039(a) requires inclusion in decedent's gross estate of non qualified plan payable to employees for life and then to decedent's beneficiaries
- Payment under DCP to former employee's surviving spouse or other beneficiary, value of annuity included in decedent's estate

§ 2039 & DEATH BENEFIT ONLY PLANS

- DBO Plan only provides death benefits to survivor (no post-retirement payments to decedent)
- IRC § 2039 does not apply to DCP that only pays decedent's survivor, not to employee
- *Estate of Fusz v. Commissioner*, 46 T.C. 214 (T.C. 1966): DBO benefits not includible—no post-employment benefits to decedent

IRS RESPONSE: COMBINE NQDC + DBO PLANS

- § 2039 (a) provides annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, “*either alone **or in conjunction with another** for his life.*”
- DBO Plan + another employer payable to decedent = annuity payable to decedent under § 2039(a)

COMBINE NQDC + DBO PLANS CONT'D

- *Bahen's Estate v. United States*, 305 F.2d 827, 158 Ct. Cl. 141 (1962): DCP paid DB, but also could pay disability payments (under same plan) to employee if incapacitated before retirement. Right to receive disability payments alone enough to trigger 2039 inclusion
- *Ali v. McCobb*, 321 F.2d 633 (2nd Cir. 1963)(same result)(retirement income plan combined with DB plan)

COMBINE NQDC + DBO PLANS CONT'D

- Payments = wage continuation payments (sickness and accident income) not eligible to combine with DB payments for inclusion under § 2039(a).
- Wage continuation payments are not the same as an annuity
- Neither are qualified retirement plans
- **Open question:** how long term disability payments should be treated under § 2039

COMBINE NQDC + DBO PLANS CONT'D

- *Estate of Schelberg v. Commissioner*, 612 F.2d 25 (2nd Cir. 1979), disability plan too dissimilar from annuity and too contingent to satisfy § 2039. Disability plan treated as functional equivalent to sickness and accident payments. *Bahen* distinguished.
- Contra, *Looney v. United States*, 569 F. Supp. 1569 (M.D. Ga. 1983), disability plan qualified as an annuity. But IRS will follow *Schelberg* in all circuits.

ANOTHER IRS WEAPON: § 2038 & POWER TO AMEND

- § 2038 (a)(1) provides the value of gross estate includes property decedent transferred that was subject on DOD to decedent's power (alone or in conjunction with another) to alter, amend, revoke, or terminate enjoyment thereof.
- IRS losses under § 2039 may trigger increasing use of § 2038 to argue for inclusion.

ANOTHER IRS WEAPON: § 2038 & POWER TO AMEND CONT'D

- *Estate of Siegel v. Commissioner*, 74 T.C. 613 (6/30/1980), right to disability payments not an annuity, but payment to children includible. Decedent expressly retained power to alter, amend, revoke or terminate remaining payments to children. § 2038(a)(1).
- *Estate of Levin v. Commissioner*, 90 T.C. 723 (1988), DBO includible under 2038. Decedent was controlling shareholder.

ANOTHER IRS ARGUMENT: ARE DB PAYMENTS A TAXABLE GIFT?

- *Estate of DiMarco v. Commissioner*, 74 T.C. 613 (6/30/1980), properly designed db plan does not create taxable gift on death of employee. Automatic, non-elective and fixed survivor benefit was not subject to change by employee. (*repudiating* Rev. Rul. 81-31).
- Safe Harbor: Design DBO plan that gives no control to employee of plan features

IN SUM: NQDC PLAN DESIGN CONSIDERATIONS & ESTATE PLANNING

- Cases underscore need to consider plan design when planning decedent's estate
- Does the NQDC Plan provide post-employment annuity type payments to employee? (combine with DBO - § 2039)
- Can client negotiate terms of NQDC Plan (including DBO Plan)?

IN SUM: NQDC PLAN DESIGN CONSIDERATIONS & ESTATE PLANNING CONT'D

- Can employee negotiate whether:
 - NQDC Plan must provide for lifetime payments to employee
 - Survivor's income plan can be established as a separate written plan
 - DBO plan features can be fixed, not subject to employee elections.

STEVE GORIN'S COMMENTS & MATERIALS

Deferred Compensation

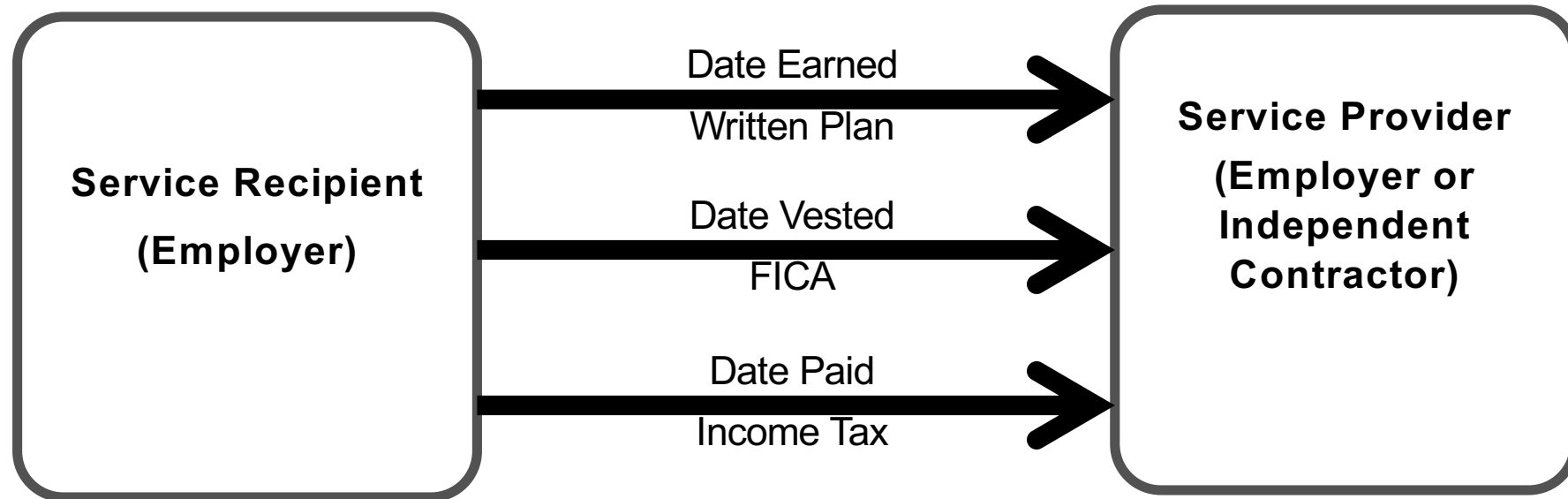
Parts II.Q.1.d. and II.M.4.d.

- Using nonqualified deferred compensation to facilitate a sale
- Introduction to Code § 409A nonqualified deferred compensation rules

Deferred Compensation (II.Q.1.c.i., II.M.4.d.)

- Provides income security when client transfers business by gift or sale to family
- Balance sheet effect (II.Q.8.b.ii.(e). Contrast against profits interests and Code § 736(a)(1) payments.)

Timeline for FICA and Income Taxation of Deferred Compensation (II.Q.1.d.iii.)



Deferred Compensation

- Code § 409A Violation Incurs (II.M.4.d.)
 - Acceleration of income taxation
 - 20% penalty
 - Interest on previously deferred tax

Deferred Compensation

- Written plan when legally binding
- Reasonable compensation overlay
- § 409A applies with impermissible triggers, acceleration, or re-deferral

Deferred Compensation – Permissible Delay (Part II.M.4.d.ii.)

- \$150,000 per Year Current Compensation
- \$100,000 Annual Retirement Payments 2020-2029
- End of 2019, Wants to Push Back Retirement

Deferred Compensation – Permissible Delay (Part II.M.4.d.ii.)

- Agree in 2019
 - 2020 Work Will Generate \$50,000 Compensation Paid in 2020 and \$100,000 Compensation Paid in 2030
 - 2020 Cash Paid \$150,000
 - \$100,000 Previously Scheduled Deferred Compensation
 - \$50,000 from 2020 Work
 - 2020-2029 Stream of Payments Stays Intact
 - 2030 Retirement Payment Added

Profits Interest

Part II.M.4.f.

- No Income on Issuance of Profits Interest
- No Balance Sheet Liability
- No Code § 409A Concerns

Profits Interest

Part II.M.4.f.

- Annual income taxed to partner
- Partnership makes tax distributions
- Balance can be paid whenever makes sense for the business

Profits Interest

- Revaluation required
- Code § 2701 if controlled by one family (III.B.7.b., III.B.7.c.)
- Under 2017 tax reform, certain sales of compensatory partnership interests recharacterized from long-term to short-term gains (II.M.4.f.ii.(b).)
 - More than 3-year holding period
 - Taxpayer may net the gains and losses unless sale to a related party.

Providing Equity to Key Employees (II.M.4.a.i., II.M.4.a.ii., and II.M.4.e.)

- Bonus vs. Equity
- Equity vs. Synthetic Equity
- Issuing Stock to an Employee

Additional Equity (II.M.4.f. and II.M.4.g)

- Issuing a Profits Interest to an Employee (already discussed)
- Options to Acquire Equity

ESOP AGENDA

- Introduction (Client Dialogue)
- Business Succession Planning and “Baby Boomers”
- ESOPs as Business Succession Vehicles (Suitability)
- ESOP Advantages and Income Tax Considerations
- Typical ESOP Structures

ESOP SCENARIO: CLIENT CONVERSATION WITH ESTATE PLANNING ATTORNEY

- Client, age 55, is successful small business owner with 44 employees
- Starting to think of how and to whom he will transition his business
- Business has solid revenues and stable customer base
- Owner's children too young to assume leadership role in business
- Financial advisor suggested owner look into establishing an ESOP to transition the company's ownership, but client never heard of ESOPs and knows nothing about them
- As the estate planning attorney, what should you tell him about ESOPs?
- What should the estate planning attorney know about ESOPs?

WHAT ESTATE PLANNING ATTORNEYS SHOULD KNOW

- What basics should the estate planning attorney know about ESOPs?
 - The increasing need for development of a business succession plan: Baby Boomers now retiring
 - What is an ESOP?
 - Common ESOP misconceptions
 - ESOP suitability, benefits to parties, and income tax & ERISA implications

WHY BUSINESS OWNERS NEED A SUCCESSION PLAN

- Family owned businesses constitute 60% of total U.S. employment; 70% do not last more than one generation
- Baby boomers own approximately 7 million closely-held businesses. >2.5 million are age 55 or older
- Need for strategic plan (a formal written business succession plan) to facilitate succession with minimum of business interruption

BUSINESS SUCCESSION PLANNING

- What should the business succession plan address?
 - Ownership transfer (who buys the company?)
 - Management succession
- What are the business ownership transition alternatives?
 - Pass on to Family
 - Partner Buyout (buy sell agreements)
 - Management Buyout
 - Third Party Sale
 - IPO
 - ESOP

BUSINESS SUCCESSION PLANNING CONT'D

Excuses for inaction:

- Fear loss of control
- Concern about complexity of developing succession plan
- No clear line of succession. Concern about who should take over
- Fear causing family friction

WHAT IS AN ESOP?

- Tax-qualified defined contribution retirement plan
- Offers flexible tax efficient exit strategy possibly allowing business owners to achieve liquidity
- Invested primarily in company stock
- Diversification rights allowed at age 55 with 10 years of ESOP participation
- Deferring and/or eliminating owners/sellers tax liability
- Retaining operational control

WHAT IS AN ESOP? CONT'D

- ESOPs prevalent in certain industries:
 - construction
 - government contracting
 - manufacturing and distribution
 - professional services
- ESOPs may not be right in every situation (even business would qualify). Role of ownership culture
- ESOPs are complex (professional advisors range from valuers to lenders to legal counsel)

ESOPs AND US ECONOMY: HOW PREVALENT ARE THEY?

- As of 2015, there were approximately 9,300 ESOPs in US, employing 15 million employees
- 92% of ESOPs are sponsored by private companies
- Over 10% of US employees of privately held companies are ESOP participants
- \$1.3 trillion total estimated assets held by ESOPs

ESOP TYPES

- Leveraged ESOP
 - Partial (< 50%)
 - Majority (> 50%) or 100%
- Financed by:
 - Debt (Senior or Seller)
 - Potential other sources: existing qualified plan assets
- Non-leveraged ESOP
 - No loans involved

LEVERAGED ESOPs

- Most common type of ESOP.
- Here's how it is set up:
 - Company creates ESOP
 - Lender lends funds to Company ("Outside Loan")
 - Company re-lends funds to the ESOP ("Inside Loan")
 - ESOP purchases shares from Owner(s)/shareholders
 - ESOP repays Inside Loan to Company
 - Company repays Outside Loan to Lender

LEVERAGED ESOPs CONT'D

- As the Inside Loan is repaid, shares held as collateral for the Inside Loan are released (from Suspense account) and allocated to employee accounts
- Employees receive cash at retirement or when they leave the Company subject to a vesting schedule

NON-LEVERAGED ESOPs

- Less common than leveraged ESOPs
 - Usually used when company wants to transition ownership at slower pace
 - No loan involved for purchase of shares
 - Non-leveraged ESOPs can convert to leveraged ESOPs
 - Leveraged ESOPs can convert to Nonleveraged ESOPs

WHAT BUSINESSES ARE SUITABLE TO SPONSOR AN ESOP?

➤ General Eligibility Criteria:

- Business profitability/business value greater than \$5M/Revenue growth potential
- \$1M minimum annual payroll
- 30+ employees/Strong management
- Ability to handle debt
- Strong management team that could be incentivized by equity-based compensation
- Current selling owner interested in staying involved with the business after sale
- Company culture of teamwork: “we” rather than “me”

BENEFITS OF AN ESOP

➤ Owner Sellers:

- Obtain fair market value (FMV) for shares
- Flexibility – may sell as much or as little of their ownership as they want to the ESOP
- Deferred capital gains tax (C corp) on §1042 Rollover
- Management continuity/legacy
- Family employees may participate in ESOP

BENEFITS OF AN ESOP CONT'D

➤ Company:

- Potential improved employee performance due to incentivized ownership culture
- Management continuity
- ESOP contributions may be deductible
- Ability to repay acquisition loans with pre-tax dollars/improved cash flow

BENEFITS OF AN ESOP CONT'D

➤ Employees:

- “Employee-owners” benefit from share appreciation in ESOP account (ownership stake in company profits)
- ESOP value appreciates tax-free
- Enhanced potential retirement plan funds
- Executives may still have separate equity-based incentive plans

INCOME TAX IMPLICATIONS

➤ Owners/Sellers:

- Capital gains treatment on sale proceeds
- C corp: may elect Section 1042 capital gains tax deferral

➤ Company:

- 100% ESOP-owned S Corp structure
- Tax deductible contributions to ESOP

INCOME TAX IMPLICATIONS CONT'D

➤ Company

- S Corp distributions used for internal loan repayments - tax exempt
- Dividends paid to the ESOP used for internal loan repayments are tax deductible (C Corp)

➤ Employees:

- ESOP contributions and stock appreciate tax-free

ESOP STOCK PURCHASE TRANSACTIONS – ERISA AND IRC REQUIREMENTS

➤ ERISA Fiduciary Requirements:

- Prudence
- Solely in the interest of plan participants (exempt from diversification rules)

➤ Stock purchased by ESOP:

- Stock must be “qualifying employer security”
- Pay no more than “adequate consideration” (no PT)
- FMV as determined in good faith by ESOP trustee

ESOP STOCK PURCHASE TRANSACTIONS – ERISA AND IRC REQUIREMENTS CONT'D

➤ ESOP loan

- Non-recourse at a reasonable rate of interest
- Secured only by purchased shares
- Shares released from suspense account as loan is repaid
- Put rights on distributed shares
- No other puts or calls on shares (but company can have a right of first refusal)

QUESTIONS?