

Just Rewards for the Enlightened Capitalist

Estate Planning for the New Generation of ESOP Acquisition Techniques

By Stephen P. Magowan

Most estate planning attorneys are vaguely familiar with the existence, if not the operation, of employee stock ownership plans (ESOPs). ESOPs were first sanctioned by Congress in the mid-1970s as part of the Employee Retirement Income Security Act (ERISA) and have become an increasingly popular vehicle for business owners to diversify their assets, keep jobs rooted in a community, and reward employees for their contributions to a business's success. The ESOP is also a means by which a company and its key shareholders can maximize tax planning opportunities.

One of the more common personal planning techniques a selling shareholder can undertake in connection with the sale to an ESOP is capital gains tax deferral (and potential elimination) through an election under Code § 1042 (the "1042 Election"). As described more fully in the body of this article, the 1042 Election requires that the ESOP own at least 30% of the target company after the transaction, that the selling owner invest his or her sale proceeds in individual U.S. corporate stocks and corporate bonds, and that the ESOP follow certain allocation restrictions after the election. The target company must also be a C corporation at the time of the sale.

In recent years ESOPs have also become popular because of the unique attributes of an ESOP-owned Subchapter S corporation. Since the late 1990s, an ESOP does not pay federal income taxes on its attributed share of the profits from the S corporation. Indeed, the indirect owners of the ESOP stock, for example, the ESOP participants, only recognize taxable income on receipt of distributions from the ESOP as with any distribution from any qualified retirement plan, thus potentially postponing the taxation of income from the S corporation for many years.

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The emergence of wholly and partially ESOP-owned S corporations has coincided with and contributed to ever more intricate financing arrangements for all size ESOP sales transactions from \$10 million transactions involving, for example, an engineering consulting firm, to the widely reported \$8 billion acquisition of the Tribune Company through an ESOP-owned S corporation.

These new financing arrangements create new estate planning opportunities. With proper advance planning, individuals who sell all or part of their companies to an ESOP can accomplish significant family goals while also lowering the estate tax bite through the use of family limited partnerships (or limited liability companies), irrevocable trusts, grantor retained annuity trusts, and sales to intentionally defective grantor trusts.

This article explores several significant estate planning opportunities that arise when an owner decides to sell to an ESOP. It begins with a brief summary about ESOPs and ESOP transactions. It explores in some detail the financing of ESOP transactions. Finally, it reviews the planning ideas that practitioners should consider for clients "doing" ESOPs. To keep this article at a manageable length, a working knowledge of family limited partnerships (and their pitfalls), grantor retained annuity trusts, and intentionally defective trusts is presumed.

What Is an ESOP?

An ESOP is a qualified retirement plan sanctioned by the Code and ERISA that is designed to invest primarily in "employer securities." An ESOP is also a "defined contribution" retirement plan, meaning that the benefits received by retirees are derived from the value of the retiree's retirement plan account rather than from a promise to pay the retiree an amount certain over a period of time. In an ESOP, this market value is determined primarily on the basis of the value of the employer stock. Unlike a 401(k) plan, an ESOP is not focused on acquiring mutual funds; rather it holds the stock of the company sponsoring the plan.

As a qualified retirement plan, the ESOP must follow Code rules concerning coverage, participation, allocation of benefits, and vesting. ESOPs usually cover all employees, allocate benefits according to the relative compensation of plan participants, and vest benefits either 100% after three years of service or 20% a year from the second to the sixth year of service.

ESOPs also provide participants with certain unique distribution and diversification rights. If an employer adopts an ESOP, it must also agree to grant the ESOP participants a “put” right, allowing each participant to sell the stock in his or her ESOP account to the employer when the participant separates from service. In general the employer will have five years to pay off this put right and can postpone the payment further in the case of some leveraged ESOP transactions involving C corporations. A participant may also elect to diversify 25% of his or her company stock balance in an ESOP on achieving age 55 and 10 years of service under the ESOP. This diversification right increases to 50% of the company stock balance when the participant attains age 60 with 15 years of service under the ESOP.

ESOPs must also comply with the ERISA rules. An ESOP is the only qualified retirement plan that may buy assets from a disqualified person—for example, the owner and his or her family—and also engage in financing with a disqualified person—for example, the owner can take a note from the ESOP in exchange for his or her stock and the plan sponsor can lend money to the ESOP so that it can buy stock from the owner. This exception from the general prohibited transaction rules of ERISA is narrowly construed and subject to stringent regulation.

In an ESOP purchase transaction, the trustee of the ESOP determines the value of the stock to be purchased by consulting with an independent appraiser who represents only the interests of the ESOP. The trustee must act solely for the benefit of plan participants and be fully independent of the company and its shareholders. Once an ESOP holds employer stock, that stock must be valued on an annual basis by the trustee and its valuation advisor, and employees will receive annual notices of the value of their stock holdings in the ESOP.

Why Would an Owner Do This?

Considering the foregoing tax and ERISA concerns, the cautious counselor might think, “Why bother?” What follows are a few of a host of financial, tax, and social reasons why business owners become interested in ESOPs.

Asset Diversification

An ESOP creates an opportunity for the owner to diversify his or her assets away from the concentration in company stock while keeping a toe, a foot or, indeed, the whole body in the door. Through this diversification, the owner can set up investment accounts for, among other things, his or her retirement, gift or estate transfers to children not in the business, and transfers to charity. The owner can do this while remaining active in the business, continuing to draw

a salary, and making sure the next generation of leadership can run the company.

Tax Incentives

An ESOP also brings significant tax incentives to the table. As discussed below, the Code § 1042 Election is unique in that it allows a business owner to sell stock to an ESOP for cash and still enjoy capital gains tax deferral and perhaps capital gains tax elimination. Further, ESOP-owned S corporations do not pay federal income taxes on profits allocable to the share owned by the ESOP, thereby creating significant competitive advantages for the company with an ESOP over its non-ESOP competitors. This is particularly true for businesses that must engage in competitive bidding such as government contractors.

Social Issues

Many owners also focus on ESOPs for what might be called “social” reasons. ESOPs can be used to empower employees and reward them for adding value to the company. As noted earlier, the ESOP trustee is required to value the shares in the ESOP on an annual basis. The value of the shares year to year will depend on how the company is doing in its business market. ESOP companies can use this valuation cycle to educate employees about, for example, how the company makes money and what drives profit generation. This can empower employees to think like owners and create an environment in which the majority of employees are rowing in the same direction. Thousands of ESOP companies are already doing this, and they are a remarkably different breed of business. ESOPs also can root jobs in a community, and recent studies have demonstrated that ESOP companies do better in a host of measurable outcomes than their non-ESOP competitors.

ESOPs do not, however, grant employees direct ownership in the company; rather the employees become beneficiaries of the trust (the employee stock ownership trust or “ESOT”) that holds the employer shares. Employee rights to vote shares are generally limited to voting the shares actually allocated to the employee’s accounts and only in connection with a sale or restructuring of the business.

How Are ESOP Transactions Structured?

This section reviews a few basic transaction structures for ESOP purchases of owner stock. As with any corporate deal structure, there are many variations to what is presented below, but, for purposes of this article and its focus on planning issues for owners, this summary suffices.

Facts

For purposes of this review assume the following facts:

- POM Construction (“Company”) is a successful contracting firm with two shareholders, John Papel and Danielle Ortiz, and 1,250 employees. The Company is a C corporation.
- John and Danielle do not have family members

working in the Company.

- The Company is worth \$25 million. The Company has a good balance sheet with a good deal of borrowing capacity.
- John and Danielle wish to sell their shares to an ESOP, and the ESOP trustee has concluded that a purchase price of \$25 million is fair and appropriate.

Basic Leveraged Transaction with Bank Financing

Figure 1 below shows a basic structure of a “leveraged ESOP transaction.” The basic leveraged ESOP transaction is constructed as follows.

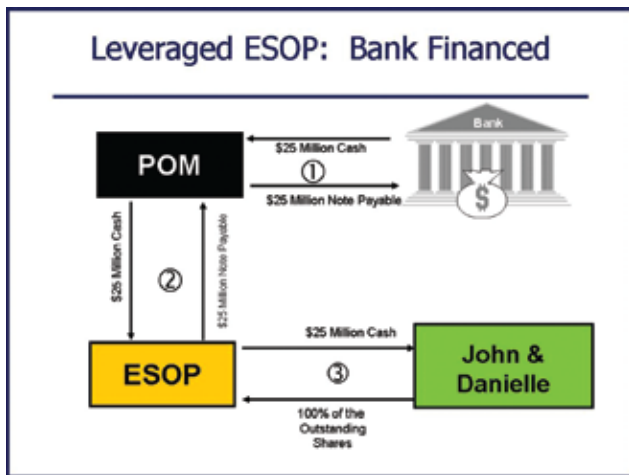


Figure 1

In step 1, Company borrows \$25 million from the bank and, in step 2, lends the \$25 million to the ESOP. The ESOP uses these funds to buy the stock from the selling shareholders (step 3). The ESOP then pledges the purchased shares to the Company as security for the Company’s loan, and the Company makes a general pledge of its assets to secure the bank loan.

In many instances the loans from the bank to the Company (step 1) and from the Company to the ESOP (step 2) are mirrored, meaning they are drafted to contain the same payment terms. Thus, if the bank loan requires principal payments of \$5 million a year over five years, then the Company loan to the ESOP will require the same annual payments.

The effect of this mirroring is to convert the principal payments to the bank into deductible annual expenses for the Company. Why? The ESOP payments to the Company are funded by the Company’s contributions to the ESOP, that is, the ESOP’s \$5 million payment to the Company equals the Company’s tax-deductible contribution to the ESOP. The return of principal to the Company is not taxable income, and although the payment of interest to the Company is a taxable event, it is offset by the payment of interest to the bank.

The effect of converting principal payments of debt into deductible expenses is to make the buyout of the

shareholder subject to only one level of tax—capital gains at the shareholder level. Even so, if the shareholder makes the 1042 Election, described more fully below, it is possible to defer or even eliminate even this single level of tax. So we have the potential for a business transition accomplished without the imposition of income tax.

Also, if the C corporation converts to an S corporation following the transaction, 100% of the Company’s profits are no longer subject to tax by virtue of the ESOP ownership. This tax savings can be used to pay off the debt to the bank. If it is not needed for that purpose, then the tax savings is available for any other corporate purposes.

It should be noted that this is something of a home run from a business transition perspective. First, the sellers have the potential of deferring and possibly eliminating income on the sale, even if they get all cash. Second, following the transaction the S corporation can avoid tax on its profits, thereby freeing up cash flow for corporate needs. Third, if the sellers do pay tax, it is at the lower capital gains rates, and the purchase is with pre-tax dollars. Finally, the sellers are able to accomplish this through a stock sale rather than an asset sale, and thereby avoid double taxation on the sale.

Basic Leveraged Transaction with Seller Financing

A variation on the foregoing structure is to substitute seller notes (that is, a promissory note from the ESOP to the seller) for all or part of the sales consideration. For example, John and Danielle could decide to take \$18 million in seller notes and \$7 million in bank-financed cash. See Figure 2.

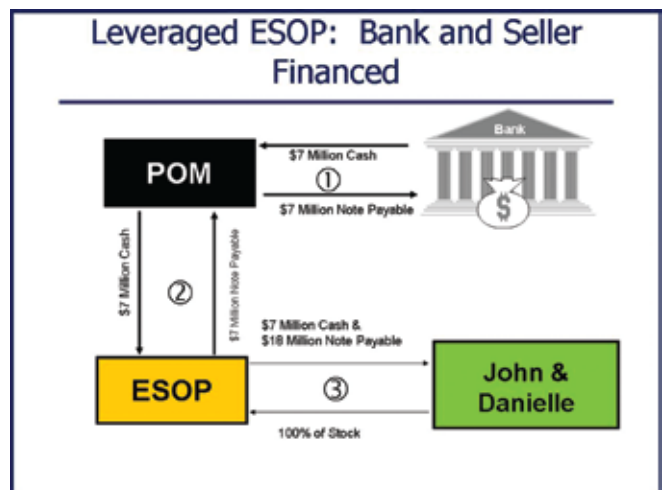


Figure 2

A number of variables can drive the decision to use seller notes. One, the bank may not be willing to lend money for the full amount of the transaction. Two, the sellers may desire to have the interest paid to them. Because the notes are likely to be deeply subordinated to the bank financing, it will be appropriate for the ESOP to pay an interest premium above the bank debt, perhaps 11%–12% or higher

depending on market conditions. Finally, the sellers may prefer to have the ability to renegotiate their debt from the ESOP if the Company hits hard times, rather than have to deal with a bank in such times.

Bank Financing Plus Company Notes Coupled with Warrant

The next and final variant on an ESOP transaction structure presents some significant estate planning opportunities. The structure outlined, although complex, is not at all uncommon. The structure builds on the basic financing routines previously described.

As in the first transaction variant, the ESOP will purchase the shares from John and Danielle for \$25 million, and a bank will loan the whole purchase price to the Company, which in turn will lend it to the ESOP. Next, some time after the closing date, say three days, the sellers will loan \$18 million to the Company in return for the *Company's* subordinated notes (described below). The Company will use the proceeds of this loan to repay \$18 million of the bank loan.

The subordinated notes John and Danielle receive from the Company will be subordinated to the bank debt. These notes will bear interest at a very low rate, perhaps only marginally above the applicable federal rate. Because the sellers are so subordinated, however, they are entitled to a premium return rate to account for their risk of lending. To accomplish this return, in connection with these subordinated notes the sellers will receive warrants to purchase, let's say, approximately 20% of the Company's equity on a fully diluted basis.

The warrants attached to the subordinated notes (the "Warrants") will permit the sellers to purchase shares of the Company's common stock for a price equal to the estimated fair value of a share of the Company's common stock immediately following the transactions (the "Floor Value"). In all likelihood, because of the highly leveraged nature of the transaction, this value will be close to zero.

The Warrants will be exercisable on an all-or-nothing basis during a period, perhaps three years, following repayment in full of the subordinated notes. The Company will have the option to call and purchase the Warrants on its receiving notice of exercise. The call option requires payment of the difference between the Floor Value and the fair market value of each share of the Company stock held by the ESOP as determined by the independent appraiser on behalf of the ESOP as of the exercise date. Payment may be in immediately available funds 90 days following the exercise date or in a note payable, let's say, over five years with interest payable at the prevailing prime rate of interest plus 100 basis points.

It is important to recognize that under this structure if the sellers do not elect under Code § 1042, they will be subjected to tax on the full \$25 million purchase price, even though they will only receive cash of \$7 million. Also, for income tax purposes under the original issue discount rules, the initial value of the Warrants will be treated as

ordinary income, recognized over the expected life of the subordinated notes. Any additional gain would be taxed as capital gain.

What Are the Planning Opportunities Available for Lowering Capital Gains Taxes Under Code § 1042?

In connection with their ESOP transaction, John and Danielle may consider several planning opportunities to reduce income and estate taxes associated with the transaction. These include using the tax deferral offered by Code § 1042, disposing of the Warrants in an estate and gift tax efficient manner, and structuring life insurance premium payments with the proceeds of seller financing. These opportunities are unique to ESOP transactions and are an added bonus to the owner using an ESOP for asset diversification and business transition planning.

Use of Code § 1042 to Diversify Portfolio in a Tax Efficient Manner

Under Code § 1042, the sellers can elect to defer capital gain taxes by reinvesting the proceeds from their sale within 12 months following the closing in qualified replacement property (QRP), defined as corporate stock and corporate bonds of domestic operating corporations. An "operating" corporation must use 50% or more of the corporation's assets in the active conduct of business, and passive revenue cannot exceed 25% of total revenue.

For the sellers to have the opportunity to make the 1042 Election, the ESOP must own at least 30% of the value of all of the company following the ESOP purchase transaction. The Company must be a C corporation at the time of the sale (it can convert to subchapter S following the sale). Also, the stock sold must have been held for three years before the ESOP transaction.

The sellers' tax basis in their Company shares carries over to their QRP. Thus, if John and Danielle had a combined tax basis of \$0.00 in their Company stock, that would also be their tax basis in their QRP, even though they paid \$25 million for the QRP. Under Code § 1042, the capital gains from the ESOP purchase are deferred only until QRP is sold. For example if John invested \$1 million of his proceeds in Johnson & Johnson stock, and then three months later decided to sell the Johnson & Johnson shares, he would recognize capital gains of \$1 million.

There is, however, an opportunity for complete elimination of capital gains taxation of the ESOP transaction. If the QRP is held until death, capital gains are forever eliminated because the tax basis in the property is adjusted to its then value as with any other asset in the decedent's estate. Further, it is important to note that if the taxpayer disposes of the QRP other than in a corporate reorganization, by death, by gift, or in another transaction to which Code § 1042 applies, the taxpayer must recognize gain on the sale to the extent of the gain excluded under Code § 1042.

Advanced 1042 Planning with “Floating Rate Notes”

Not surprisingly, the QRP strategy has led to the creation of certain financial instruments to take advantage of the opportunity to avoid capital gains taxation. One of these is the “floating rate note” or FRN. Remember that tax deferral under Code § 1042 is offered for investments in certain active U.S. corporation-issued stocks *and* bonds. An FRN is a special kind of bond issued by an active “gold-chip” U.S. corporation like 3M, Colgate, or GE, for instance.

FRNs are long-term (30–50 years) high credit-quality (“AA” or “AAA”) bonds with interest reset monthly or quarterly by reference usually to LIBOR and are designed to always trade at or near par based on credit quality and absence of interest rate risk. In addition, FRNs also contain call protection so that the seller who invests in the FRN would not be subject to an unexpected tax event by redemption of the bonds. Because the FRN is so stable, banks are typically willing to lend up to 85% or more of the face value of the bond.

In our fact situation, the sellers’ strategy most likely would be to invest their \$25 million in a portfolio of FRNs issued by anywhere from 5 to 10 companies depending on what is available in the market. Then, to achieve further diversification, the sellers would borrow against the FRNs to invest in a more broadly diversified portfolio, perhaps through mutual funds. There is slightly negative carry in connection with this borrowing as the interest paid on the monetizing loan (typically about LIBOR *plus* 50 basis points) will usually exceed the interest received on FRNs themselves (typically about LIBOR *minus* 25 basis points). The goal is to make up this carry from the investments made with the borrowing against the FRN.

1042 Elections with Seller Notes

The 1042 Election is fine and good for a seller receiving all cash (because of bank financing), but can it be done if John and Danielle want to use seller financing, for example, to get the benefit of Warrants? The answer is “yes,” and the reason is because of the stability of the FRNs.

As noted above, banks are typically willing to lend up to 85% or more of the face amount of an FRN. Just the same, the sellers can borrow up to 85% or so of the face amount to *buy* the FRN. In our example, John or Danielle can turn his or her \$3.5 million of cash into \$12.5 million of FRNs by borrowing \$9 million to finance the FRN purchase. Note that if John and Danielle wanted to play with more cash, by buying a boat or vacation home, they could do so as long as they had sufficient cash to support the borrowing to purchase the FRN. What John or Danielle would be betting on in that case is that they could earn enough over time to make up for the assets they took out.

In this case, what happens as the seller note is paid off? The interest from the seller note is taxable as interest income, but the principal payments are not taxed—the principal payments are protected from capital gains taxation by virtue of the 1042 Election.

What Are the Transfer Tax Planning Opportunities for the Owner in an ESOP Transaction?

The convergence of the capital gains shelter offered by the 1042 Election and the future appreciation of the Warrants on the seller notes offers some significant transfer tax planning opportunities to an owner and his or her family. In this section, the following concepts will be examined: gifting stock following a partial leveraged ESOP transaction, using family limited partnership and charitable remainder trusts in connection with the 1042 Election, transferring seller notes at a discount and using the tax-free cash flow from the seller notes to support a program of diversification and to support an insurance premium purchase program, and planning with the seller Warrants.

Gifts and “Gift-Like” Transactions Following the Partial Leveraged ESOP Transaction

Not every owner chooses to sell all of his or her shares to an ESOP. For example, consider an owner, Rosalita, who has one daughter in her business, Magic Consulting, Inc., and two daughters who are not involved in the business. Rosie’s assets are tied up in Magic, but she wants her two daughters not involved in the business to share in her estate without having to own business stock. In this instance, she could do a leveraged ESOP sale for part of Magic and earmark the assets from the sale toward the non-active daughters.

Immediately following this transaction, the value of Rosie’s company will go down because Magic will be adding leverage in connection with the ESOP purchase. This, then, presents Rosie with several planning opportunities.

First, following the ESOP transaction, she could gift shares to the daughter who is active in the business. These will be at a discount to the value of the shares immediately before the ESOP transaction because of the leverage. The amount of discount will depend on other factors as well.

Next, Rosie could transfer shares into a grantor retained annuity trust (GRAT) for the ultimate gift of the shares to that daughter. This kind of planning is especially indicated if the company is an S corporation, if cash flow from S corporation distributions will be used to pay off the ESOP financing (thereby creating cash flow for all the S corporation shares), and if the business’s cash flow is such that S corporation distributions alone might support the required annuity payment under the GRAT.

Finally, Rosie could sell shares of the post-ESOP transaction company to an intentionally defective grantor trust (IDGT). This kind of planning should be considered in the same instances the GRAT is considered.

Using FLPs in Connection with the 1042 Transaction

In the earlier fact pattern involving John Papel and Danielle Ortiz, before the transaction occurs their company was a C corporation. Because of this, either or both John and Danielle might be able to enhance their planning by contributing their shares in the Company to an FLP before the transaction.

If they do this (and, please note, it is not required that both undertake the same or even similar planning), the FLP will obtain a tacked-on holding period for the shares and it can engage in the 1042 Election in connection with its sale to the ESOP. Following the ESOP transaction, the FLP will own the QRP (likely FRNs). The owner can then gift FLP interests on a discounted basis or perhaps transfer FLP interests to a GRAT or sell them to an IDGT. The IRS has privately ruled that the transfers of the underlying FLP interests in a transaction such as this will not be considered a disposition of the QRP, thus preserving the tax deferral. See PLR 200243001. Note also that the IRS has further privately ruled that transfers of QRP directly to a GRAT that was considered a grantor trust would not be considered a disposition of the QRP. See PLR 200709012.

A sale of an FLP interest to an IDGT is also likely not to be considered a disposition. First, the QRP is not being disposed of in any event—the FLP is continuing to hold the property. Second, the sale to the IDGT is disregarded, at least for as long as the IDGT is considered a grantor trust for the owner. Support for this position can be found in PLR 200239035, in which the IRS privately ruled that a transfer of QRP into an irrevocable grantor trust did not trigger a disposition under Code § 1042.

John or Danielle might also want to try a variant of the foregoing. Assume John decides not to create an FLP before his transaction but receives \$3.5 million in cash and \$9 million of seller notes with Warrants. He makes the 1042 Election for all of his sale proceeds.

Now, John possesses a \$9 million deeply subordinated note along with a separate set of Warrants. John might now decouple the two and transfer the \$9 million note to an FLP. Because the note is decoupled from the Warrants and because it is deeply subordinated to the bank debt, it may be appropriate to value the note below its face amount for gift purposes (though any valuation will have to consider the original issue discount implications and should be legally consistent with the valuation of the warrants for original issue discount purposes); further, the FLP envelope may allow a further discount. Finally, the principal payments received on this note will be tax free (remember that this note arose out of lending to the corporation).

What should John do with the Warrants? Remember that the Warrants in this 100% fully leveraged transaction are likely of little value on the day after the transaction. John might consider:

(1) transferring them to a separate FLP, (2) making an outright gift of the Warrants to his children, (3) making a gift in trust to his grandchildren, or (4) holding on to them to replace the value he is giving up in the sale and gifting transactions to pay down the margin he is incurring to buy the FRN.

Assuming John gifts the Warrants, at the end of the day, John has in his hands an FRN with a face value of \$12.5 million and margin debt of \$9 million. His FLP holds a discounted subordinated note with a face amount of \$9 million. He can then consider (1) gifting FLP interests, (2)

transferring FLP interests to a GRAT, or (3) selling FLP interests at a discount to an IDGT.

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 transfers of partnership interests in many court cases. Although the results of these cases might be deemed to arise from “bad facts,” for example, partnerships 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, and planners must wade into these waters with care.

Using Charitable Remainder Trusts in Connection with the 1042 Transaction

An owner might also consider using a charitable remainder trust in (CRT) connection with a 1042 Election. Following the ESOP transaction, the owner can gift the QRP to a charitable remainder trust and get a charitable income tax deduction to shelter other income. The CRT does not pay taxes when it disposes of the 1042 property and the donor only pays taxes as the property comes out of the CRT. The CRT can control when income comes out by investing in non-income producing property like municipal bonds, growth stocks, or deferred annuities. Then when income is produced, the years without income can be “made up.”

Seller Notes, the 1042 Election, and the Warrants—Creating a Planned Program of Diversification and Also Using the Cash Flow for Insurance

In our example involving John and Danielle, the ESOP transaction has resulted in the creation of the following assets:

(1) cash from the sale, (2) FRNs, (3) seller subordinated notes, and (4) Warrants to purchase stock in the future. What follows is a suggestion for how the owner might slice and dice the various components of the ESOP transaction to lower transfer tax liability while also creating various bundles of assets for different family members.

Let’s focus on Danielle for this planning. Remember at the end of the transaction she has (1) cash of \$3.5 million, (2) a seller note of \$9 million, (3) FRNs of \$12.5 million, and (4) Warrants. Assume she invests \$3.5 million of cash in the FRN and finances the rest and that her carrying cost on the \$9 million of FRN borrowing is 75 basis points, or \$67,500, a year and that the Warrants are worth \$50,000 but are projected to be worth \$3 million when they are cashed out.

Danielle creates an IDGT. She uses a portion of her and her spouse’s gift tax exemption to transfer \$500,000 of assets to the IDGT and sells to the IDGT for a note (the “IDGT Note”) all the Warrants plus the junior seller notes. This sale has no income tax effect. Note also Danielle might engage in some discount planning by contributing the junior seller notes, the Warrants, and other property to an FLP and then selling the FLP interest to the IDGT. The IDGT Note pays interest only for a significant period of time (maybe 20 years) or perhaps provides that the principal is payable only at the owner’s death.

The Importance of Interdisciplinary Planning in the ESOP Transaction

What should be clear in all of this is that the ESOP transaction lawyers and the estate planning lawyers need to be talking. It is usually crucial to implement any structures at or very near to the time of the transaction because that is when the warrants and the stock will have their lowest value. Also, the ESOP rules are complex; in particular Code § 409(p) can create disasters, and planners need to make sure the estate planning does not create more problems than it solves. As with any transaction planning, advisors must keep an eye out for regulatory and legislative changes. Finally, fiduciary issues abound in ESOP transactions, and ESOP transaction structures must create meaningful and appropriate benefits for ESOP participants. ■

As the junior seller note is paid to the IDGT, the principal is not subject to tax but the interest is. The excess of the junior seller note interest payment over the IDGT Note interest payment can be used to pay down the principal on the IDGT Note and thereby assist Danielle with the carrying costs on the FRN borrowing. The IDGT can use the other interest proceeds it receives to pay the interest owed to the owner. The IDGT would use any principal it receives to invest in a diversified portfolio of assets the growth of which would, one would hope, exceed the minimal applicable federal rate paid by the IDGT to the owner.

Furthermore, it would also make sense for the IDGT to consider buying a life insurance policy on Danielle's life, especially if the IDGT Note provides for interest only to be paid during Danielle's life. In this instance it might make sense to use premium financing within the policy itself. For example, during the early period of the policy, the junior seller notes may only be paying interest and that interest in turn may largely be used to pay the interest on the IDGT Note. So, by premium financing for a period, the IDGT can get a sufficient policy and then pay down the premium financing costs as the tax-free principal payments on the junior seller note are made. The structure of the life insurance premium financing program may dictate a larger cash contribution by Danielle and her spouse when the IDGT is formed.

When the Warrants are cashed out, capital gains tax will pass through to the owner if the IDGT is still a grantor trust; otherwise capital gains tax will be paid by the trust or passed through to the trust beneficiaries. The proceeds from the Warrants can be used (1) to pay off the IDGT Note, (2) as a source of additional premium for life insurance, or (3) for other purposes under the IDGT, say, investing in other assets.

Under this structure, as noted, Danielle in our example will be holding the leveraged FRN and will be out of pocket the leveraging costs of approximately \$67,500. Some of this may be made up by payments from the IDGT. Also, if she uses IDGT payments to decrease the leverage she will lower her annual leveraging costs. If she holds on to the FRN until death, its tax basis is fully stepped up and the sale of the bond to pay off the leverage will not be a capital gains transaction.

This structure is only appropriate for owners with "other" assets. What might these other assets be? Well, in most ESOP transactions the owner stays on working. Thus, Danielle will continue to draw a salary. Further she will also continue to participate in retirement plans sponsored by the Company such as 401(k) plans and the ESOP. In addition, the economics of this structure can be customized to get to Danielle the dollar amount she feels comfortable with. The goal of the structure is to use the leverage associated with the FRN to shift the tax-free receipt of proceeds on the junior seller notes and the receipt of proceeds from the warrant down to the next generation with as minimal estate tax as possible while also leveraging those proceeds into additional tax-free life insurance.

The owner and his or her advisors need to consider carefully the actual numbers with comparisons to how the owner's assets would be treated for tax purposes without this planning. Still, it would appear this structure offers significant tax advantages to the right owner.