THE ESTATE PLANNER

July/August 2024

EMPLOYEE STOCK OWNERSHIP PLAN
A versatile business exit and estate planning tool

What happens to debt after a person dies?

Using your annual gift tax exclusion is an easy way to reduce your estate's value

Estate Planning Red Flag
You haven't made arrangements for your pets

Grossberg Company LLP
Certified Public Accountants

6500 Rock Spring Drive, Suite 200
Bethesda, MD 20817
(301) 571-1900
FAX (301) 571-1932
www.grossberg.com

Employee stock ownership plan

A versatile business exit and estate planning tool

If you own a closely held business, a significant portion of your wealth may be tied up in it. So, to prepare for retirement and provide for your loved ones, you need an exit plan. One option, if your business is a corporation, is to establish an employee stock ownership plan (ESOP).

These plans allow you to provide valuable employee benefits, generate significant tax savings for yourself and the company, and create a market for your stock. In addition, you can better meet your liquidity needs while remaining in control of the business.

Defining an ESOP

An ESOP is a qualified retirement plan, similar to a 401(k) plan, that invests primarily in your company's stock. ESOPs must comply with the same rules and regulations as other qualified plans, and they're subject to similar contribution limits and other requirements.

One requirement that's unique to ESOPs is the need to have the stock valued annually by an independent appraiser. Also, by definition, ESOPs are available only to corporations. Both C corporations and S corporations are eligible, but the two entity types are subject to different rules (see below).

In a typical ESOP arrangement, the company makes tax-deductible cash contributions to the plan, which uses those funds to acquire some or all of the current owners' stock. Alternatively, with a "leveraged ESOP," the plan borrows the money needed to buy the stock and the company makes tax-deductible contributions to cover the loan payments.

As with other qualified plans, ESOP participants enjoy tax-deferred earnings. They pay no tax until they receive benefits, in the form of cash or stock, when they retire or leave the company. Participants who receive closely held stock have a "put option" to sell it back to the company at fair market value during a limited time window.

Explaining the benefits

ESOPs offer many benefits for owners, companies and employees alike. Benefits for owners include:

- **Liquidity and diversification.** An ESOP creates a market for your stock. By selling some or all of

An added ESOP benefit for employees: Net unrealized appreciation

Employees who participate in an employee stock ownership plan (ESOP) may be able to take advantage of the net unrealized appreciation (NUA) rules. Typically, distributions from a traditional qualified plan are taxable as ordinary income. But, depending on the ESOP's provisions, the NUA rules may allow employees to elect to defer tax on the appreciation in value of employer stock until those shares are sold, and then pay tax on that appreciation at more favorable long-term capital gains rates.

To qualify, an employee must take a lump sum distribution of his or her entire ESOP account because of a "triggering event," such as separation from employment, disability or reaching age 59½. Employer stock held in the account must be distributed in kind (that is, as actual stock rather than its cash value). If the NUA rules are followed, the employee pays ordinary income tax on the stock's cost basis but defers capital gains tax on the stock's appreciation in value until it's sold.

your stock to the plan, you can achieve greater liquidity and diversification, enhancing your financial security and estate planning flexibility. Acquiring a wider variety of nonbusiness assets can make it easier to share your wealth with loved ones, especially those who aren't interested in participating in the business.

- **Tax advantages.** If your company is a C corporation and the ESOP acquires at least 30% of its stock, it's possible to defer capital gains on the sale of your stock by reinvesting the proceeds in qualified replacement securities. You can even avoid capital gains tax permanently by holding the replacement securities for life.
- **Control.** Unlike certain other exit strategies, an ESOP allows you to tap your equity in the company without immediately giving up management control. You can continue to act as a corporate officer and, if you serve as the ESOP's trustee, you'll retain the right to vote the trust's shares on most corporate decisions.

The company can benefit because its contributions to the plan are tax deductible. With a leveraged ESOP, the company essentially deducts both interest and principal on the loan. And, of course, both the company and its employees gain from the creation of an attractive employee benefit, one that provides a powerful incentive for employees to stay with the company and contribute to its success.

An ESOP is a qualified retirement plan, similar to a 401(k) plan, that invests primarily in your company's stock.

Exploring S corporation ESOPs

There are pros and cons to establishing an ESOP for an S corporation. A disadvantage is that S corporation owners, unlike their C corporation counterparts, cannot defer gain on the sale of their shares.

But as pass-through entities, S corporations have a big tax advantage: Because ESOPs are tax-exempt, corporate income passed through to the plan as

an owner of S corporation shares avoids federal and often state income taxes. That means an S corporation that's 100% ESOP-owned avoids income tax altogether.

Considering the costs

An ESOP can be a powerful estate planning tool for closely held business owners, but it's important to consider the costs. In addition to the usual costs associated with setting up and maintaining a qualified plan, there are also annual stock valuation costs. Employees' put options also create potential repurchase liabilities for the company.

Typically, companies prepare for this liability by setting aside reserves or purchasing key person life insurance. Contact your professional advisors for additional information. ▮

What happens to debt after a person dies?

When the time comes to administer a person's estate, family members typically focus on distributing property according to the deceased's wishes. But it's also critical to deal with any debt the deceased has left.

Debt doesn't disappear after a person dies (with some exceptions, such as certain student loan debt). And managing it can be complicated, especially if the estate is insolvent — that is, its debts exceed the value of its assets. Here are answers to some common questions about the process.

Who's responsible for handling debt?

An estate's executor is responsible for managing the deceased's assets and debts. A personal representative can also carry out this task.

> *An estate's executor is responsible for managing the deceased's assets and debts.*

With respect to debt, the executor should take inventory of the deceased's debts, evaluate their validity and order of priority, and determine whether they should be paid in full or allow them to continue to accrue during the estate administration process. In some cases, debt that's tied to a particular asset — a mortgage, for example — may be assumed by the beneficiary who inherits the asset.

Are executors or beneficiaries personally liable for the debt?

Generally, no. The estate itself is legally liable for the deceased's debt. However, executors or beneficiaries may be personally liable if they co-signed for a loan, jointly owned a credit card or bank account, or otherwise assumed joint liability for a debt. Also, executors may potentially be held liable if, for example, their mismanagement of the estate's assets caused them to lose value or if they paid low-priority creditors at the expense of high-priority creditors.

Note that in community property states, a surviving spouse may have to satisfy the deceased's spouse's debts out of any community property.

Which assets can be used to satisfy debt?

Generally, a deceased's debt must be paid by the estate. This is true regardless of whether the estate goes through probate or a revocable (or "living")

trust is used to avoid probate. Contrary to popular belief, assets held in a revocable trust aren't shielded from creditors' claims.

Certain assets are exempt, however. These include most retirement plan accounts, life insurance proceeds received by a beneficiary and jointly held property with rights of survivorship that passes automatically to the joint owner. Also, assets held in certain irrevocable trusts, such as domestic asset protection trusts, may be shielded from creditors' claims. The extent of this protection depends on the type of trust and applicable law in the jurisdiction where the trust was created.

Assuming the deceased had a will, the estate's assets generally are used to pay any debts in this order:

1. Assets that pass under the will's residual clause — that is, assets remaining after all other bequests have been satisfied,
2. Assets that pass under general bequests, and
3. Assets that pass under specific bequests.

Note that some states have established homestead exemptions or family allowances that prohibit the sale of certain assets to pay debts. These provisions are designed to give a deceased's loved ones a minimal level of financial security in the event the estate is insolvent.

Which debts have priority?

If an estate's debts exceed the value of its assets, certain debts have priority and must be paid first. Although the rules vary from state to state, a typical order of priority is as follows:

- Estate administration expenses (such as legal and accounting fees),
- Reasonable funeral expenses,
- Certain federal taxes or obligations,
- Unreimbursed medical expenses related to the deceased's last illness,
- Certain state taxes or obligations (including Medicaid reimbursement claims), and
- Other debts.

Secured debts, such as mortgages, usually aren't given high priority. This is because the recipient of the property often assumes responsibility for the debt and the creditor can take the collateral to satisfy its claim.

Get professional help

Managing debt in an estate can be complex, especially if the estate is insolvent. Executors should consult an advisor to guide them through the process and help avoid personal liability.

Using your annual gift tax exclusion is an easy way to reduce your estate's value

It's fair to say that federal gift and estate tax laws can be complex. However, ironically, one of the most effective techniques to reduce the size of your taxable estate is also the simplest: leveraging your annual gift tax exclusion.

And more good news: the exclusion amount has increased for the third straight year. The IRS raised the exclusion amount for 2024 to $18,000, up from $17,000 per recipient in 2023. Prior to 2022, adjustments were more sporadic — often going several years before an increase.

By using the annual gift tax exclusion judiciously, you can transfer assets to your loved ones and reduce the size of your taxable estate without eroding your federal gift and estate tax exemption.

Annual exclusion in action

Generally, gift tax is due when you give cash or property to another person. However, you can use the annual gift exclusion to cover certain gifts made during the year.

For instance, if you have three adult children and seven grandchildren, you may give each one the maximum $18,000 in 2024 for a total of $180,000.

Then you can do the same the following four years. Assuming the exclusion amount remains at $18,000 per recipient, you can pass a total of $900,000 by using this technique. And, depending on the circumstances, you won't have to file a gift tax return.

> *You can use the annual gift exclusion to cover certain gifts made during the year.*

Furthermore, the annual gift exclusion is available to each taxpayer. If you're married and your spouse consents to a "split gift," the exclusion amount is effectively doubled to $36,000 per recipient (for 2024).

Specific rules for certain gifts

The rules are a little trickier if you're gifting assets such as securities. Generally, the value of property for gift tax purposes is its fair market value. If you gift property that has appreciated in value, the recipient must use your basis (usually, the original cost) to compute the taxable gain if he or she subsequently sells the property. Nevertheless, the gain will be taxed to the recipient, who may be in a lower tax bracket than you. Thus, gifting can result in income tax savings for the family as well.

In addition, be aware that gifts made directly to a financial institution to pay for tuition or to a health care provider for medical expenses on behalf of someone else don't count toward the gift tax exclusion. In fact, they aren't even reportable gifts. You can pay tuition in excess of the annual exclusion amount of $18,000, and, in the absence of other gifts that may be reportable, you won't have to file a gift tax return.

Finally, you have one other gift tax break in your hip pocket: the lifetime gift and estate tax exemption. This exemption applies to gifts of up to $10 million, indexed to $13.61 million in 2024, after you've exceeded the annual gift tax exclusion. But using any part of this exemption erodes the available tax shelter from estate tax, so you might decide to limit your lifetime gift giving to amounts covered by the annual gift tax exclusion.

Talk to your advisor

Even though using the annual exclusion is a simple way of reducing your taxable estate, this isn't to say you should abandon other more sophisticated estate planning techniques designed to maximize the benefits of your gift and estate tax exemption. Consult with your estate planning advisor for help in developing an overall gifting strategy that's right for your circumstances. ∎

ESTATE PLANNING RED FLAG

You haven't made arrangements for your pets

If you have pets, you likely think of them as cherished family members. In the eyes of the law, however, pets are property. Unless you arrange for their care and maintenance after your death, they'll go to the residuary beneficiary in your will. If you don't have a will, they'll be transferred according to the laws of intestate succession which are unique to each state.

You don't necessarily need a legal document to provide for your pets. If you've made informal arrangements with a family member to take care of them when you die — and you don't expect anyone else to claim them — that may be sufficient. Be sure to let your executor know about your plans.

However, for greater assurances that your wishes will be carried out, you may want to consider leaving your pets to one or more trusted caretakers in your will. Although you can't use your will to leave money or other property to your pets, you can provide funds to their caretakers to cover expenses. But keep in mind that they'll have no legal obligation to use the money for your pets, so choose cautiously.

You might also consider establishing a pet trust. It's legal in all 50 states plus Washington, D.C. These trusts come at a cost, but they offer several advantages over other arrangements. For example, they allow you to leave money that the named caretaker is required to use for your pets, to provide specific instructions on how your pets should be cared for, and to provide for the care of your pets during your life in the event you're unable to do so. Plus, if necessary, your representative can go to court to enforce the terms of the trust.

If you don't have a trusted caretaker in mind, another option is to leave your pets to an animal sanctuary or rescue organization with a program designed for this purpose.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and accordingly assume no liability whatsoever in connection with its use. ©2024

Grossberg
Company LLP
Certified Public Accountants

6500 Rock Spring Drive, Suite 200
Bethesda, MD 20817
(301) 571-1900
FAX (301) 571-1932
www.grossberg.com

Established in 1924, Grossberg Company LLP is one of the Washington area's oldest and most prestigious CPA firms. Beyond the traditional services of tax, accounting and auditing, we offer special expertise in the areas of real estate, partnership taxation, information technology and estate planning. Our staff of over 50 prides itself in our innovative approach to planning and problem solving. Diligently serving our clients' needs is the foundation of the Grossberg tradition. Continuing to serve their families in subsequent generations is a testament to the confidence they have in us. Experience, innovation, and service…that's Grossberg Company LLP.

ASSOCIATED WORLD-WIDE WITH JHI