Biden's Tax Plans and Implications to ESOPs

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Agenda

1. Current Biden tax proposals
2. What is an ESOP?
3. Section 1042 and impact of tax proposals
4. Application to ESOP owned companies
5. ESOP Transaction Structuring

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American Jobs Plan and Made in America Tax Plan

- In March 2021, the American Jobs Plan and the Made in America Tax Plan were introduced.
- Corporate tax rate increase from 21% to 28% (TCJA of 2017 reduced the corporate tax rate from 35% to 21%).
- Numerous foreign income tax provisions to increase the tax rate on foreign income.
- Minimum tax (perhaps 15%) on corporations with “large” book profits but with no current federal income tax liability or too low of a regular tax.
- Repeal of certain tax incentives/benefits for extractive industries.
- Add incentives for renewable and alternative energy sources.

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Tax Gap

- Administration believes that for 2019 the Tax Gap (Taxes owed vs Taxes paid) was almost $600 billion and perhaps will be $7 trillion over the next 10 years.

- The administration's proposal is to increase IRS activity with an $80 billion investment and require financial institutions to report to the IRS gross inflows and outflows of virtually all financial accounts on Form 1099.

- Could begin for tax year 2023.

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American Families Plan

- Increase top individual tax rate to 39.6% (from 37%). The 39.6% rate was the top rate prior to the TCJA of 2017.
- Increase the long-term capital gain and qualified dividend rate to 39.6% (from 20%) for those with adjusted gross incomes of $1 million or more.
- Eliminate “step- up in basis” for inherited property.
- Eliminate like kind exchange treatment for real estate gains greater than $500,000 and for which the closing takes place after 12-31-21.
- Apply the self-employment tax and the net investment income tax more uniformly/consistently for those making over $400,000.
- Eliminate the carried interest loophole.
- Permanently extend the excess business loss limitation (now extended through 2026).

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POLLING QUESTION

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Capital Gains and Qualified Dividends

- Assume Taxpayer has $1.1M of adjusted gross income comprised of $900,000 of wages and $200,000 of long-term capital gains.
- $100,000 of the long-term capital gain would be taxed at 20% and $100,000 would be taxed at 39.6%.
- Effective Date – ? Per the “Green Book” – “Date of Announcement” (which could be April 28,2021 (date of plan), or perhaps May 28, 2021 (date of Green Book), or ……….

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What is Not in the Administration's Proposals (for the time being)

- No increase in the state and local tax deduction (limited to $10,000 in the TCJA of 2017).
- No removal of Section 199A which provides a 20% "haircut" to the tax rate on certain types of income from flow through entities.
- No itemized deduction limitations.
- No decrease to the lifetime exemption (currently approx. $11.7M per person) and the estate tax rate of 40%. These are set to go back to their pre-existing (2009) amounts and rates of $3.5M per person and a 45% rate after Dec. 31, 2025.
- No "wealth" tax.

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Step Up in Basis

- Capital gains are currently taxable only when there is a recognition/realization event.
- Gifts – basis carries over and it is not considered a recognition/realization event.
- Inherited assets – basis is stepped up to the FMV at the date of death.
- <u>Proposal would treat transfers of appreciated property by gift or death as a realization/recognition taxable event.</u>
- <u>Donor or decedent would realize/recognize a taxable capital gain at the time of the transfer.</u>
- The recipient's basis in the property would be the property's fair value at the time of death.

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Step Up in Basis (con't)

- For transfers of a partial interest there appears to be no discounting.
- Transfers to trusts, partnerships or other non-corporate entities (other than certain grantor trusts) would be a recognition event.
- 90 year rule – Gain on unrealized appreciation would be recognized by a trust, partnership or other non-corporate entity that is the owner of that property if that property has not been subject to a recognition event within the prior 90 years (Jan. 1, 1940). First such time then would be 12-31-2030.

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Step Up in Basis (con’t)

- Tax at death on capital gains 43.4% (39.6% + 3.8%).
- 56.6% remaining is taxed at 40% in the estate resulting in a 22.6% tax.
- Total tax- 66% (post 2025 this tax could be 69% as estate tax increases to 45%).

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Step Up in Basis (con't)

- Exclusions:
  - Transfers to charity
  - Transfers to a U.S. spouse
  - Personal residences ($250,000 or $500,000)
  - Personal property but not collectibles
  - Section 1202 small business stock
  - $1 million per person exclusion
  - Family owned and operated businesses/farms
- 15 year payment plan for tax on appreciated assets other than liquid assets.
- Proposed effective date – January 1, 2022 (gifts or decedents dying after December 31, 2021).

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What is an ESOP?

- ESOP is an Employee Stock Ownership Plan
- Defined contribution employee benefit plan
- Invests primarily in stock of employer
- Tax advantages for the selling shareholder and company

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Benefits of an ESOP

Seller	Company	Employees
✓ Receive fair market value ✓ Flexible exit strategy ✓ Beneficial tax treatment ✓ Preserve legacy of company	✓ Tax advantaged financing ✓ Potential for income tax free entity ✓ Potential to enhance employee morale, increase productivity and reduce turnover	✓ Non-contributory retirement account ✓ Incentive for employees ✓ Ability to impact value of company and therefore, value of accounts

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Section 1042 –Benefits to Selling Shareholder

- Section 1042
  - Allows a selling shareholder a deferral of the capital gains tax on the sale of their stock to an ESOP if:
    - The Company is a "C corporation" at the time of the sale; AND
    - The ESOP owns at least 30% of the Company's stock post-transaction; AND
    - The selling shareholders reinvest the proceeds in "Qualified Replacement Property" within 12 months
- What is Qualified Replacement Property ("QRP")?
  - Stocks and bonds of U.S. corporations, public or private, that derive no more than 25% of their gross income from passive sources
  - Floating rate notes
  - NOT mutual funds
  - NOT government bonds
- Opportunity for permanent tax deferral under current tax law

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Section 1042 – Example

- Sales price = $10,000,000
- Shareholder stock basis = $2,500,000
- Ignore state tax implications for simplicity

	Biden Tax Law	*Current Tax Law*	
	Sell to 3rd party	**Sell to 3rd party**	**Sell to ESOP w/ 1042 Election**
Sales Price	$ 10,000,000	$ 10,000,000	$ 10,000,000
Tax Basis	$ 2,500,000	$ 2,500,000	$ 2,500,000
Gain on sale	$ 7,500,000	$ 7,500,000	$ 7,500,000
Federal Tax Due	$ 3,255,000	$ 1,785,000	$ -
Net Proceeds Available	$ 6,745,000	$ 8,215,000	$ 10,000,000

*Assumes tax rate of:

- Biden tax law: 43.4% (39.6% capital gains + 3.8% NIIT)
- Current tax law: 23.8% (20% capital gains + 3.8% NIIT)

** Pennsylvania does not currently recognize Section 1042

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Section 1042 – Impact of Biden Tax Proposals

- Biden tax proposals make Section 1042 much more attractive. As tax rates increase so does the value of a tax deferral.
- Tax deferral may allow selling shareholder to unwind QRP in more favorable capital gain environment or in tranches.
- Biden tax proposals seek to tax the unrealized appreciation. The gain deferral can no longer be made permanent under the Biden tax proposals.
- Charitable giving of qualified replacement property is more valuable.
- No current proposals to remove section 1042 deferral.

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Impact on ESOP C Corporations

Increased tax expense → Negatively impacts cash flow → Decreased value of business → Decreased value in employee ESOP accounts → Decreased repurchase obligation

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C Corporation Tax Planning

Company receives income tax deductions for payment of principal and interest

After tax cost to company	
Sale to ESOP	$6,200,000
Sale to non-ESOP	$10,000,000
Differential	$3,800,000

* Assumes combined effective Federal/State rate of 38%

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The holy grail of taxation

What hasn't changed….

S Corporations that are wholly owned by an ESOP continue to pay **<u>no</u>** Federal income taxes!

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Sale of S Corporation Stock to ESOP

	Current Capital Gain Rate Structure	Proposed Capital Gain Rate Structure
Gross Proceeds	$10,000,000	$10,000,000
Basis	$0	$0
Net Taxable Gain	$10,000,000	$10,000,000
Federal Tax Rate	**20%**	**39.6%**
Federal Tax	$2,000,000	$3,960,000
DIFFERENCE		**$1,960,000**

ASSUMPTIONS:

Other Income sources over $1 million
No consideration of net investment income tax (3.8%)

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Installment Sales

- Installment sales allow a seller to report the gain on the sale of an asset/stock ***over time***
- If proceeds paid out over 10 years, the capital gains are stretched out over 10 years as the payments are received
- Default method
- Installment sales may be used to smooth out income over number of years
- Possibility to elect out of installment sale reporting in 2021

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Transaction Structuring

- S corporation ESOPs may become more attractive – Federal income tax savings on company income
- ***Possibility*** to structure deals prior to enactment of tax increases?
- Effective dates?

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In closing…

- ESOPs, and related tax elections, are complex
- Transaction planning takes months to accomplish
- ESOPs continue to have bi-partisan support in Washington

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Questions?

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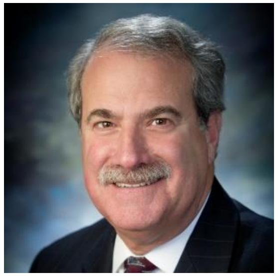

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Larry is a trusted advisor for a broad range of clients including mid-market and private companies. He has extensive experience with a wide range of complex tax matters relating to his clients' businesses. He has advised on many transactions and provided both tax due diligence and tax structuring advice. Larry is also a member of the firm's ESOP Group.

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Katrina provides a variety of tax services including tax compliance, tax planning and tax research for corporations, multi-state companies, partnerships, trusts and high-net-worth individuals. Katrina has a diversified range of experience providing tax services to a variety of distribution, construction, manufacturing and service industries. As a member of Kreischer Miller's Manufacturing Industry Group, she assists in the development and instruction of in-house professional training on topics relating to the manufacturing industry. She is actively involved with the firm's Employee Stock Ownership Plan "ESOP" Group. She works with several companies who are ESOP owned and has experience with the unique tax attributes and reporting for ESOP-owned companies.

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