# ISSUE BRIEF #4

## THE ESOP TAX-FREE ROLLOVER

One of the most effective tax provisions passed to encourage the growth of ESOPs is the tax-free rollover. The tax-free rollover allows a selling shareholder or groups of shareholders in privately held companies to sell their stock to an ESOP and defer or eliminate the capital gains tax typically due. Why is this important? With a current federal capital gains tax of 15 percent and an assumed state tax of 9 percent, a shareholder could save $720,000 in taxes on a $3 million sale of stock to an ESOP (assuming a zero cost basis). Since the future value of a tax payment is zero, tax savings should be preserved whenever possible.

This Issue Brief summarizes the mechanics and rules of the tax-free rollover (often referred to as a 1042 transaction, after the Internal Revenue Code Section that governs the transaction.) and related matters.

**Why sell To an ESOP?**

A business owner wanting to sell part of his or her company to diversify their personal holdings will find a void in the market for buyers interested in acquiring less than 51 percent of their privately held business.

A retiring owner, or shareholder of a privately held company, who wishes to sell all his or her stock, faces some potentially unwelcome choices. Often the seller is forced to choose between selling to outside investors, if any are available; exchanging stock with another company in a merger; or selling stock back to the company, if such a transaction is feasible.

None of these options is taxed as favorably as a sale to an ESOP. And unlike a sale to an ESOP, any other choice may result in unwanted consequences for the company's independent existence and the jobs of employees. A rollover sale to an ESOP establishes a market for current or future selling shareholders, rewards current employees, and maintains the independence and local ownership of the business. A sale to an ESOP allows an owner to sell out quickly or gradually, withdrawing from the business to whatever extent desired.

## Structuring an ESOP Rollover

A shareholder that sells qualified securities to an ESOP incurs no taxable gain on the sale if two conditions are met.

1. Immediately after the sale the ESOP must hold either 30 percent of each class of outstanding stock of the corporation or 30 percent of the total value of all classes of outstanding stock issued by the corporation.
2. Within 12 months after the sales (or 3 months prior to the sale), the seller or sellers must purchase qualified replacement property. If the cost of the replacement property is less than the amount derived from the sale of securities to the ESOP, the difference is currently taxable.

For purposes of meeting the 30 percent requirement, sales of qualified securities by two or more parties may be treated as a single sale if these sales are part of a single transaction. Once the 30 percent requirement is met, a shareholder that sells any amount of stock to the ESOP in the future is eligible for the tax-free rollover.

The rollover must be elected in writing on a timely filed tax return for the taxable year of the sale. Temporary Treasury Regulations Section 1.1042-1T sets forth the procedure for making the "statement of election" of tax-free treatment and the "statement of purchase" of the new securities.

The seller's basis in the new securities will be adjusted by the amount of gain not recognized as a result of the election. Also, the holding period of the employer securities is "tacked on" to the holding period of the replacement securities. In other words, if you bought or received your company's stock in year 1 at $10 per share, and sell it to an ESOP in year 10 at $100 per share, your taxable basis in the replacement property you purchase is reduced from $100 to $10, and you are considered to have held that replacement property for 9 years, for tax purposes. If the replacement securities you buy with that $100 then rises in value to $200 over the next six years and you sell some of those shares in year 15, the taxable gain is $190, not $100, and you will be considered to have held those shares for 15 years, not six years.

Thus the ESOP rollover allows a selling shareholder to defer, not eliminate, taxes on the sale, enabling the seller to invest and earn with money that would have been taxed away. If the replacement property should go into the seller's estate, however, then its basis will be "stepped up" to the property's current value, and the tax on the sale will effectively have been eliminated.

## Defining Some Terms

Two technical phrases need to be defined. These are "qualified securities" and "qualified replacement property".

**"Qualified Securities"** are securities that the privately owned business owner(s) will be selling to an ESOP. Qualified securities:

- Include common stock with voting and dividend rights equal to the classes of common stock having the greatest voting and dividend rights
- Are issued by a domestic corporation with no outstanding securities readily tradable on an established securities market.
- Must be held by the seller for at least three years and cannot have been received by the seller in a

distribution from a qualified retirement plan or a transfer under a stock option granted by the company.

**"Qualified Replacement Property (QRP)"** is securities that the privately owned business owner(s) will be buying with the cash proceeds from the sale of his/her stock to an ESOP. QRP includes:

- Stocks, bonds or other debt instruments issued by US domestic operating companies.

The replacement securities must be acquired by purchase. Securities acquired by way of gift, inheritance, or property transfer pursuant to a stock dividend don't qualify.

Certain securities that do **not** qualify as replacement property include:

- Mutual funds
- Foreign securities
- Certificate of deposits
- REITs
- Local, state and federal government taxable or tax-free bonds

QRP will "inherit" the cost basis of the shares that were sold to buy them. Since most business owners have a low cost basis in the companies they own, a significant federal and possible state capital gains tax will be due if the QRP is ever sold, mature or redeemed for cash.

## QRP Investment Strategies

Careful planning is required to maximize the tax benefits of the 1042 rollover. Asset allocation should be employed to match the appropriate risk tolerance of the investor with the investment strategy. Two basic strategies include:

**Passive/Buy & Hold.** A selling shareholder electing to defer taxes via IRC 1042 may choose to buy a diversified portfolio of stocks and bonds as QRP with the intent to hold these securities for a long time. However, if he or she chooses to sell any of the holdings in the portfolio, or if any of the QRP are redeemed or called, it will trigger the tax due on the sale of those securities back to the original basis of the stock that the shareholder sold to the ESOP.

**Active Management Using "ESOP Notes."** A selling shareholder may choose to buy an innovative debt security sometimes referred to as an "ESOP note" or floating rate note. ESOP notes are publicly traded securities issued by highly rated companies such as Ford Motor Credit and GE Capital. They are generally non-callable, mature in 40 years and bear a floating rate coupon commonly indexed to commercial paper. With careful planning, these notes can be monetized or margined up to as much as 80 percent or more of their market value allowing investors unrestricted access to their margin proceeds to spend or reinvest the borrowed funds as they choose. Since these securities are highly rated with adjustable interest payments, the risk of a margin call is limited.

## Restrictions on the ESOP Stock

**Prohibited Allocations** – A selling shareholder who elects to defer current taxation according to IRC 1042 may not be allocated in the ESOP any stock with respect to which any selling shareholder

elected IRC 1042. Further, stock with respect to which an IRC 1042 election was made may not be allocated to a family member (spouse, children, brother, sister and parents) of a selling shareholder who elects IRC 1042 treatment, or any other person who owns more than 25 percent of the value of any class of stock of the issuing corporation. Any of these individuals who are employees may, however, receive an allocation of stock with respect to which an IRC 1042 election was not made.

If the ESOP disposes of the acquired employer securities within three years after acquiring them, a 10 percent excise tax is imposed on the employer. The excise tax applies if the total number of shares held by the ESOP is less than before the disposition, or if the value of the ESOP's share of the company ceases to meet the 30 percent requirement.

**Limitation on the Tax Free Rollover -** The 1042 tax-free rollover election is limited to C Corporation stock. The election is not available to S Corporation stockholders. An S Corporation owner may convert to a C Corporation prior to the ESOP transaction and then elect the 1042 deferral or use other techniques to address this restriction. Alternative techniques to the 1042 rollover will be addressed in a future Issue Brief.

*ESOP Advisors Group provides one stop ESOP design formation and implementation services. Visit the ESOP Advisors Group website at* ***www.esopadvisorsgroup.com.*** *Or call Mel Duffey (650) 468-5465.*

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