Internal Revenue Code Section 1042

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What is an Internal Revenue Code Section 1042 ESOP rollover?

Internal Revenue Code of 1986, as amended (Code), Section 1042, allows an owner of a closely-held C corporation to defer, or potentially eliminate, capital gains taxation on "qualified securities" he or she sells to an employee stock ownership plan (ESOP) if the taxpayer reinvests the sale proceeds into "qualified replacement property" (QRP). QRP includes certain stocks, bonds and/or other securities of operating companies incorporated in the United States and meeting other tests. If the QRP is held until the death of the taxpayer, the QRP transfers to the taxpayer's heirs with a stepped-up cost basis, thus the gain on the stock sale to the ESOP has favorable tax treatment for federal capital gains taxation purposes and for many state capital gains taxation purposes. Code Section 1042 provisions are similar to the tax provisions that exist under other "like-kind" exchanges, most notably Code section 1031 used for real estate transactions and Code section 1035 for annuity exchanges.

What requirements must be met in order to elect the Code Section 1042 ESOP rollover?

In order for a taxpayer to elect Code Section 1042 ESOP rollover treatment, there are several criteria that must be met.

1. The ESOP can only acquire "qualified securities," which generally means common stock issued by the employer/plan sponsor of the ESOP, subject to certain requirements.
2. The "qualified securities" sold by the taxpayer cannot be publicly traded, nor can any member of the employer/plan sponsor's controlled group be publicly traded. There are notable exemptions for over-the-counter or "pink sheets" traded securities.
3. The taxpayer must have held the "qualified securities" for at least 3 years prior to the sale.
4. The "qualified securities" may not have been acquired by the taxpayer as a result of a distribution from a retirement plan or as a result of an exercise of an employer-granted option or issuance of restricted stock.
5. The ESOP must own at least 30% of the employer/plan sponsor of the ESOP after the completion of the transaction.
6. The taxpayer must reinvest his or her proceeds in QRP no earlier than 3 months prior to the ESOP transaction or no later than 12 months after the ESOP transaction (this period is called the "replacement period").

The primary objective of the 1042 rollover is the deferral or possible elimination of capital gains tax.

What is qualified replacement property (QRP)?

In order for a security to qualify as QRP, it must be a security of a domestic operating corporation. It can be common stocks, preferred stocks, convertible bonds, corporate fixed rate bonds or corporate Floating Rate Notes (FRNs). The QRP must be securities of a corporation that (i) is incorporated in the US, and (ii) uses more than 50% of its assets in the active conduct of a trade or business. Furthermore, the corporation cannot have passive income that exceeds 25% of its gross receipts for the year preceding the purchase. Investments that do not qualify as QRP include municipal bonds, US government bonds, mutual funds, foreign securities, real estate investment trusts and bank CDs. Similarly, stock of the employer/plan sponsor which issued the qualified securities sold to the ESOP or any member of its controlled group is also an ineligible investment. Special care must be taken when assembling a portfolio composed of QRP to ensure all requirements are met, and the taxpayer is successfully able to defer capital gains on the proceeds received in the ESOP transaction.

What if the taxpayer, individually, is not selling at least 30% to the ESOP?

The Code recognizes the "integrated transaction" doctrine in the Code Section 1042 rollover context. The "integrated transaction" provides for the sale of qualified securities by two or more taxpayers to be treated as a single sale if they are made as part of a single, integrated transaction under a prearranged agreement between the taxpayers, subject to certain conditions. This allows two (or more) taxpayers, neither of which is selling 30% individually to the ESOP, to combine their sales to the ESOP to satisfy the 30% requirement set forth above. In such a case, the Statement of Election (discussed below) submitted to the IRS must contain the names and taxpayer identification numbers of each other seller involved in the integrated transaction. However, the integrated transaction doctrine does not require that both sellers make an election under Code Section 1042. It should also be noted that if the ESOP already owns 30% or more of the employer/plan sponsor of the ESOP, the sale of additional qualified securities to the ESOP will always meet the 30% ownership requirement.

Failing to make the proper IRS and state tax filing may jeopardize the tax deferral.

What documents are required for an ESOP transaction?

There are several important documents that you will need to work with your tax advisor to complete during the course of an ESOP transaction in which Code Section 1042 ESOP rollover treatment is sought.

1. Statement of Election-completed upon the sale of stock to the ESOP. It is signed by the selling shareholder and confirms his or her intention to elect nonrecognition treatment under Code Section 1042 with respect to the stock sale. The Statement of Election is due with the taxpayer's tax return for the year in which the sale to the ESOP occurred, including any extensions. So if the taxpayer does not file an extension for filing his individual tax return, the Statement of Election is due by April 15 of the year following the year of sale. If the taxpayer does file an extension, the Statement of Election is due by October 15 of the year following the year of sale.

2. Statement of Consent-completed upon the sale of stock to the ESOP and reflects the company's consent to the taxpayer's election to defer taxes under Code Section 1042. The Statement of Consent must be signed by an officer of the company, and confirms the company's agreement to the application of excise taxes under Code Sections 4978 and 4979A to the transaction should the company be sold within a certain period of time

following the ESOP transaction and further agreeing to the prohibition on allocations within the ESOP to the selling shareholder and the selling shareholder's family members. The Statement of Consent must be filed with the taxpayer's tax return for the year in which the sale to the ESOP occurred (plus extensions, as described above). With respect to the selling shareholder, the Statement of Purchase completes the tax-advantaged sale of qualified securities to the ESOP

3. Statement of Purchase completes the tax-advantaged sale of qualified securities to the ESOP. The Statement of Purchase is a declaration that specific securities represent QRP with respect to the stock sold to the ESOP. It is important to remember that this form must be filed with the selling shareholder's tax return for the tax year in which the purchase of QRP was made. The document needs to be signed by the selling shareholder and acknowledged by a notary public. The Statement of Purchase should be notarized and provided to the selling shareholder's CPA as soon as prepared and filed with the proper tax return. This document, although simple to prepare, should not be taken lightly. If not completed accurately and timely, it could jeopardize the tax-deferral treatment of the sale.

What are the tax consequences of the Code Section 1042 ESOP rollover?

By reinvesting all proceeds in QRP, the selling shareholder defers capital gains on the sale and thus is not subject to any federal and very little state capital gains tax. Any gain that the selling shareholder defers on the sale to the ESOP reduces his or her tax basis in the QRP. If the QRP is sold, matures or is redeemed (by any call or sinking fund provision), the selling shareholder generally must recognize a capital gain (or loss) on the difference between the amount received and his or her tax basis in the QRP. Alternatively, the selling shareholder can eliminate the taxable capital gain realized as a result of the ESOP sale and deferred in the QRP by passing the QRP to his or her heirs through his or her estate. The result would be a "step up" to fair market value in tax basis and the elimination of any capital gains the selling shareholder would have recognized on the sale of the QRP. The primary objective of the Code Section 1042 ESOP Rollover is the current deferral of state and federal capital gains taxes and the realization of increased income benefits of having 100% of the ESOP sale proceeds working on behalf of the investor.

The §1042 deferral is a one-time, irrevocable election and must be structured and documented correctly.

The portfolio containing the QRP is not one to be traded, nor is it like a real estate exchange whereby real estate can continue to be swapped on a tax-free basis for other real estate. For many investors, the objective would be to hold the QRP portfolio through the investor's lifetime and pass the asset through their estate. However, if liquidity is needed, consideration can be given to strategies to maintain the QRP while providing for liquidity.

How is the taxpayer’s basis allocated to QRP?

The taxpayer’s basis in the QRP is the purchase price for the QRP, reduced by the amount of gain not recognized as a result of the Code Section 1042 ESOP rollover election. The IRS does not permit a taxpayer to track basis from shares sold to an ESOP to QRP purchases, so a taxpayer’s basis in his QRP is an aggregate number based on the total aggregate adjusted basis the taxpayer had in the shares sold to the ESOP. So if the taxpayer sold shares acquired over a number of years with multiple basis calculations, the basis in the QRP will be the taxpayer’s aggregate-adjusted basis in the entire block of stock sold. For these purposes, aggregate-adjusted basis means the taxpayer’s total adjusted basis in the shares sold and is not determined on a share-by-share or investment-by-investment basis. Consequently, the taxpayer is not able to allocate “high” basis shares to certain QRP and “low” basis shares to other QRP, as the basis in the entire QRP portfolio is the aggregate-adjusted basis in the shares sold to the ESOP.

Does the Code Section 1042 Rollover allow for a partial election?

The Code Section 1042 ESOP rollover election must be made with respect to all proceeds realized as a result of a sale of shares to the ESOP. There is no partial election ability, but taxes will only be deferred to the extent of the amount of QRP purchased. So if a taxpayer does not reinvest an amount equal to all sale proceeds in QRP, the taxpayer will be currently taxed on the non-QRP invested amounts.

The result of being taxed on the non-QRP invested amounts is that the taxpayer is unable to reduce the capital gain on such amounts by any basis component. The tax liability is calculated on the amount by which the proceeds received from the ESOP exceed the value of the purchased QRP without taking into consideration any reduction for the taxpayer’s original basis in the stock sold to the ESOP. If the taxpayer sold shares with a basis of $3,000,000 to an ESOP for a total purchase price of $15,000,000 and invested $10,000,000 of such proceeds in QRP, the taxpayer would make the Code Section 1042 ESOP rollover election for all $15,000,000 but would be taxed currently on $5,000,000 (the amount not reinvested in QRP) without any offset for basis. In instances where the taxpayer does not invest all amounts in QRP and is currently taxed on a portion of the proceeds received in the sale to the ESOP, the taxpayer’s total aggregate-adjusted basis remains with the QRP.

While Code Section 1042 does not technically allow a partial election, the same result can still be obtained by the taxpayer making a full election and reinvesting in QRP all proceeds realized from the ESOP transaction and then later divesting of a portion of the proceeds so as to trigger immediate taxation as discussed below in “Does the Code Section 1042 rollover allow for short-term deferral?”.

What happens if a taxpayer invests in QRP but does not file a Statement of Purchase as to some portion of the QRP?

The Code Section 1042 ESOP rollover election is not required to be made with respect to assets that qualify as QRP, but only those assets upon which the taxpayer wishes to defer taxation. Furthermore, the Statement of Election and Statement of Purchase are not required to be filed until the taxpayer's tax return due date (including extensions). This timing allows a taxpayer to evaluate the cost/benefits of tax deferral over taxable years. However, to do so the taxpayer should invest all proceeds received from the ESOP sale in investments that are eligible QRP, which can then simply be held as non-Code Section 1042 ESOP rollover assets or for which a Statement of Election and Statement of Purchase can be filed once a final determination as to the desire and magnitude of tax deferral is made.

Does the Code Section 1042 rollover allow for short-term deferral?

The Code Section 1042 ESOP rollover election can be made so as to result in a short-term deferral of capital gains in order to spread out the capital gain recognized over tax years and make the most efficient use of differing tax rates from year to year. For example, assume the taxpayer has a basis of $3,000,000 in qualified securities. The taxpayer sells all shares of qualified securities to an ESOP for $15,000,000, resulting in a potential capital gain of $12,000,000. In the months after the sale to the ESOP, the taxpayer buys QRP as follows:

– Stock of domestic companies – $2,000,000; and
– Long-term FRNs – $13,000,000

The taxpayer ultimately makes a Code Section 1042 ESOP rollover election for $15,000,000 and files a Statement of Purchase of QRPs as follows:

– Stock of domestic companies – $2,000,000; and
– Long-term FRNs – $13,000,000

Normally, the taxpayer's basis in the QRP would be the amount paid for the QRP, i.e., $15,000,000; however, this basis is reduced by the amount of gain not recognized on the sale to the ESOP as follows:

– Initial basis of $15,000,000 minus gain not recognized on the sale to the ESOP, i.e., $12,000,000
– So in a single QRP investment, the basis in the QRP is reduced to $3,000,000

($15,000,000 (initial basis) – $12,000,000 (gain not recognized))

If more than one item of QRP is purchased, the basis of each item is determined as follows:

Basis of each item is reduced by the gain not recognized on each item and is determined by multiplying the total gain not recognized on the sale to the ESOP, $12,000,000; by a fraction, the numerator of which is the cost of the QRP item and the denominator of which is the cost of all QRP items and reducing the initial basis by that amount.

Stock of domestic companies:
- Initial Basis = $2,000,000
- Gain Not Recognized = $1,600,000 determined as shown below ($12,000,000 X $2,000,000/$15,000,000 = $1,600,000)
- Adjusted Basis = $400,000 determined as shown below ($2,000,000 - $1,600,000 = $400,000)

Long–term FRNs - $13,000,000:
- Initial Basis = $13,000,000
- Gain Not Recognized = $10,400,000 determined as shown below ($12,000,000 X $13,000,000/$15,000,000 = $10,400,000)
- Adjusted Basis = $2,600,000 determined as shown below ($13,000,000 - $10,400,000 = $2,600,000)

Next, the stock of the domestic companies is sold in the year following the year of sale to the ESOP for $2,400,000. Taxpayer owes capital gains taxes on $2,400,000 less $400,000, or $2,000,000, and is taxed on that amount based upon the capital gains tax rates in that year. By purchasing QRP for all amounts realized in the sale even though the taxpayer wishes to recognize some income in the short term, the taxpayer is able to utilize basis from the sale even though the Code Section 1042 ESOP rollover election was a short-term election and triggered taxation in the year following the year of the sale to the ESOP as to the QRP sold in that year.

Summary

By electing the Code Section 1042 ESOP rollover, selling shareholders can potentially eliminate capital gains tax. This can result in substantial growth of an individual's net worth and help optimize potential wealth transfer. Because of the complexities of Code Section 1042 ESOP rollovers, it is important to work with legal and tax advisors that are experienced in these types of transactions.

Please contact Rebecca T. Glasgow at rebecca.glasgow@ubs.com, Curt Rubinas at curt.rubinas@ubs.com or Leslie A. Lauer at leslie.lauer@ubs.com or 877-794-1042 for additional information or with any questions regarding the availability of Code Section 1042 and the use of Floating Rate Notes in an ESOP transaction.

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Information contained herein is of a general nature and is provided for informational purposes only. Laws governing ESOP transactions and the rules under Section 1042 of the Internal Revenue Code of 1986, as amended (Code), are complex and persons considering an ESOP or Section 1042 transaction should seek professional guidance from their tax and legal advisors. Specific structures and decisions can only be developed based on a thorough review of the facts and circumstances relative to a particular company and its shareholders. Neither UBS Financial Services Inc. nor its employees provide tax or legal advice.

In addition, shareholders who sell into an ESOP should understand the applicable rules of the Internal Revenue Code of 1986, as amended (Code), including requirements for qualified replacement property as defined by Code Section 1042 (QRP). Shareholders should understand the potential risks that may be associated with obtaining securities as QRP, sufficiency of available QRP in the market that satisfy the shareholder's investment objectives, limitations on UBS's ability to offer margin or financing for the purchase of a new-issue QRP where UBS has participated in the underwriting of such new issue, availability of QRP with put features and whether available QRP offers appropriate diversification. The foregoing is a general description of potential risks. Shareholders who invest in QRP should consult with their tax and legal advisors regarding their personal circumstances.

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