The 1042 Rollover

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Why sell to your employees?

Owner of closely-held companies who are concerned about their retirement succession plans can use an Employee Stock Ownership Plan (ESOP) to create a ready market for their shares. ESOPs are often used to buy out the retiring owners interest or the interest of another retiring stockholder. This may be an attractive alternative to selling your business to outsiders, especially where there is a desire to keep control of the business within a family or employee group. If the funds needed to purchase your or another retiring stockholder's interest need to be borrowed, an ESOP can be used to reduce the financing costs.

Retiring owners often have a substantial amount of their wealth tied up in the stock of their business and may want to diversify their investment portfolios well before retirement. Section 1042 of the Internal Revenue Code provides a tax-favored avenue for doing this.

Owners of closely held business has several options to choose when planning for retirement succession. One option is that they could sell the business to a competitor or third party. Although this would provide the owner with security, there would be no guarantee of employment security for the company's long term employees. In addition, the owner would be subject to significant federal capital gains and state taxes.

Another alternative would be to have the corporation buy back the retiring owner's stock. However, in this scenario the corporation would most likely need a sizable bank loan. This would be expensive because the owner's stock would have to be repurchased by the corporation with "after-tax" dollars. Moreover, the owner would still be subject to a large tax upon the sale of his stock back to the corporation.

A third alternative would be for the owner to sell his or her stock to an ESOP. As long as the owner sells 30% or more of the company stock to the ESOP, the sale would qualify for the tax-free (1042) rollover. For example, if the owner sells 30% of the business for $1,000,000, he or she would save $280,000 in federal capital gains tax (based on a 28% rate for individual capital gains) as long as the proceeds are "rolled over" into stock and bonds of other operating domestic companies.[1]

Finally, if the corporation borrows to purchase the owner's stock for an ESOP, its financing costs would be significantly less than if it borrowed funds for a conventional stock redemption. This is because corporations that borrow to purchase ESOP stock are able to deduct both the principal and interest repayments on the loan. If the corporation is in the 34% tax bracket and it borrows $1,000,000 to purchase ESOP stock, the result is a tax savings of $340,000 over the life of the loan. If you combine the $340,000 with the $280,000 the owner will save in capital gains tax deferment, the total federal tax savings would be $620,000 or 62% of the total selling price.[2]

How does the 1042 rollover work?

The tax-rollover provisions in Section 1042 of the Internal Revenue Code are beneficial for owners of closely

[1] Akerman, David. How to Cash Out Tax-Free, Yet Keep Your Business... *Go ESOP: A Practical Guide For Business Owners and Their Advisors.* pp. 18.

[2] Akerman, David. pp. 18.

held corporations. These provisions allow owners to diversify their portfolios without incurring tax. This is especially beneficial for the owner who is considering retirement. If the owner sells 30% or more of his or her company to the employees and reinvests the proceeds of the sale in other U.S. companies, the seller can then defer the capital gains tax from this sale. It is important to note that Section 1042 operates to provide a tax deferral, **not** a complete avoidance of tax. The gain deferred on the sale of the stock to the ESOP will be taxed when you sell the replacement property. However, the capital gain is completely avoided if the replacement property is passed to your estate upon death. The following is a summary of the requirements that must be met to take advantage of the 1042 rollover:

- The company stock must have been held by the selling stockholder for at least three years.

- Immediately after the sale, the ESOP must own at least thirty percent (30%) of the total value of the common stock of your company.
- Sales proceeds must be reinvested within twelve months in "qualified replacement properties."[***] This "reinvestment period" begins three months before the date on which the sale occurs and ends twelve months after the date of the sale. As a result, you are provided with a fifteen month period. Furthermore, you must purchase the "qualified replacement property" with a cost equal to the amount of the sale to the ESOP. You will be taxed if the sale of the ESOP exceeds the cost of your replacement property. Moreover, the gain deferred on the sale of your stock to the ESOP will be taxed when you sell the replacement property. However, even this deferred tax can be avoided if you hold the replacement securities until death. At that time, your heirs will be entitled to the replacement properties equal to their fair market value. Your heirs could then sell the replacement properties without incurring any capital gains tax.

- Stock sold to the ESOP may not be allocated back to you, any member of your family, or any other person who owns more than twenty-five percent (25 %) of the outstanding stock of the company.

Initial steps in setting up an ESOP

The ESOP must be established as a qualified retirement benefit plan according to Employee Retirement Income Security Act (ERISA) and United States Department of Labor (DOL) regulations. One such regulation is that the business must be a "C" corporation. Most trusts, including an employee stock ownership trust, are not eligible to hold stock of a "S" corporation. Therefore, if the company initially selected an "S" election, its status will need to be change to a "C." Careful consideration must be given to setting up the plan and the owner should seek the assistance of an attorney experienced with ERISA & DOL regulations, employee benefits, and ESOPs. It is important that the ESOP plan be written to support the firm's long-term human resources strategies, corporate governance, business goals, mission and management style. Once the decision to become employee-owned has been made, it is important for the company to orient the employees to the new culture of ESOPs and employee-ownership through education.

In order to create a market for stock in closely held companies, an initial valuation must be performed with a subsequent valuation each year by an independent appraiser. The appraiser must be "qualified to make appraisals of the type of property being valued." To be considered independent, the appraiser must not have a financial interest in the company or a relationship with any party to the transaction.

[***] "Qualified replacement property" is defined to mean stocks and bonds of U.S. operating companies. Government securities and shares in mutual funds do not qualify as replacement property for the purposes of the ESOP rollover.

Further, in setting up an ESOP, a trust must be established to hold the employer securities and other assets of the plan. This trust must be held outside of the company and administered for the exclusive benefit of the participants in the plan and their beneficiaries. Participation in the plan must be available to a broad cross-section of employees, not to just a select group of key executives. The plan and the trust both must be administered in compliance with the general fiduciary rules applicable to all retirement plans.

Advantages of having your employees as partners for a period of years.

Selling to the employees enforces their long term commitment in the spirit of the business. After all, who knows the business better than its employees? The General Accounting Office's (GAO) recent survey of ESOP firms found that "the combination of employee ownership and employee participation did yield substantial improvements in firm performance." There are numerous research studies that indicate this direct and positive correlation between employee participation on the shop floor in employee owned companies and increased performance and production. This is because employee-owners know that their performance could have a direct impact on the value of their stock. As a result, employee-owned companies that encourage employee participation typically experience less absenteeism, less turnover, fewer grievances and higher productivity.