Tax deferral on the sale of stock to employee stock ownership plans

Frequently asked questions

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Q. What are the general requirements to receive tax deferral?

A. Tax deferral is allowed under section 1042 if (1) the selling shareholder elects this treatment upon the sale of C corporation stock to an employee stock ownership plan (ESOP) that owns at least 30 percent of the C corporation following the sale, and (2) the proceeds from the sale are reinvested in qualifying replacement securities. In addition, the shareholder must have (1) acquired the stock other than through an employer's plan providing an option to purchase the stock, and (2) held the stock for at least three years prior to the sale.

Q. What is the value of tax deferral?

A. If the shareholder makes the election to defer tax on the sale, the basis in such stock is carried over to the replacement securities and the gain is recognized in the future when the replacement securities are disposed. Therefore, the deferral is generally temporary, and the effective benefit needs to measure the value of earnings on the reinvested proceeds over the deferral period compared to the earnings that would have been realized on the after-tax proceeds if the election were not made. However, if the replacement securities are held until the selling shareholder's death, the normal step-up in basis is received upon death. In this case, tax is permanently

deferred on the appreciation (i.e., the difference between the shareholder's original basis in the stock and the fair market value at his or her death).

Example: Joe owns 40 percent of a C corporation's stock, which he purchased in 2005 for $100,000. Today, the corporation is worth $5,000,000, so Joe's stock would sell for approximately $2,000,000. If Joe sold his stock in a taxable sale, he would pay capital gains tax on $1,900,000 of appreciation, or roughly $380,000 of tax. If Joe met all of the requirements and instead elected tax deferral under section 1042 and reinvested all $2,000,000 in qualifying replacement securities, he would pay no tax on the sale. Then, if Joe were to sell those replacement securities five years from now, Joe would have only a $100,000 basis in them. Thus, the $1,900,000 gain that existed at the time of sale to the ESOP would get taxed in five years. Therefore, the value of the tax deferral would approximately equal the value of the earnings on the additional $380,000 Joe would be able to invest for five years. Of course, Joe would need to compare that value to the earnings he could have made if he had left his investment in the C corporation for the five years.

Alternatively, if Joe still held the replacement securities at his death, no tax would ever be paid on the $1,900,000 of appreciation. His beneficiaries would inherit his stock with a basis equal to the fair market value on Joe's date of death. If the corporation continued to grow, the stock would likely be worth more than $2,000,000 at his death, and his heirs would take that new basis, effectively permanently deferring the full appreciation (i.e., the difference between $100,000 and the value at Joe's death).

Q. What factors should be considered prior to electing tax deferral?

A. Perhaps the first factor to consider is whether a section 1042 election will have an effect on the sales price of the stock. While the election itself is an individual investor decision that normally would be separate from sale negotiations, the existence of a tax-deferral opportunity may still play a role in the overall sales price. A potential outside buyer may use the ESOP structure as a bargaining chip. For example, if the selling shareholder's company does not currently have an ESOP and the buyer does, the buyer may use the potential tax-deferred sale to an ESOP as a way to make the purchase price offered look more attractive. A structure like this can get complicated but can be a valuable strategy when selling or buying a company.

A more common way that sales price may be affected is if selling shareholders decide to set up an ESOP at the company, without any transaction with an outside buyer. An ESOP can only pay fair market value for the stock, and fair market value must be set by an independent third-party appraisal. In general, the fair market value standard is the price to which an unrelated buyer and seller would agree when neither is compelled to buy or sell and both have knowledge of the relevant facts. In the economic marketplace, however, some buyers may be willing to pay more than other buyers if they believe great synergies will result from the acquisition. If such a strategic buyer exists, the fair market value that an ESOP can pay may be less than another buyer is willing to offer.

As the example above shows, the investment horizon of the replacement securities will affect the value of tax deferral. The longer the replacement securities are held, the more valuable the tax deferral becomes. Similarly, the requirement to reinvest the proceeds is a major factor, because the shareholder is required to recognize gain up to the amount of any proceeds not reinvested. Therefore, in order to realize the benefit of tax deferral, the selling shareholder generally must not need access to the proceeds from the sale.

The floating rate note can in some instances provide a solution to this liquidity issue. In general, qualified replacement securities are stocks and bonds of domestic operating companies, which means the seller must reinvest in U.S. corporations that meet certain thresholds for nonpassive income and assets. Certain institutions have created floating rate notes that qualify as replacement securities. Floating rate notes are bonds with interest rates tied to a benchmark, such as LIBOR (London Interbank Offered Rate). Such notes work by allowing the taxpayer to reinvest all of the proceeds in such notes in order to qualify for tax deferral. These floating rate notes generally have long maturities of 40 years or more, and because the interest rate floats with the market, their value remains relatively stable. The notes earn relatively low returns, but the upside to sellers wanting section 1042 deferral is that the low risk means that some banks will loan money (often up to 90 percent of the value of the notes) with these notes as collateral. The taxpayer then achieves tax deferral but gets 90 percent of the proceeds in cash to use with more flexibility. The cost of this option is any excess of interest paid on the loan over the amount earned on the floating rate note. Nonetheless, it is an option worth exploring if tax deferral is attractive. One other factor to consider with a floating rate note strategy is the availability of qualifying notes in the market. In the past, very few corporations have issued these qualifying notes each year, and they generally offer them in the third and fourth quarters of the calendar year. Therefore, an individual planning to use this strategy may be limited to the floating rate notes available, and the normal 15-month window for reinvestment may practically be shorter because it could be limited to when the notes are on the market.

Another factor to consider is the anticipated future tax rate on capital gains. Today, capital gains are taxed at a maximum of 20 percent compared to a maximum of 39.6 percent on ordinary income. If the preferential rate on capital gains were to be removed in the future, a shareholder would be better off paying 20 percent today than 39.6 percent when the replacement securities are sold in the future. Again, this factor is only important if the taxpayer plans to dispose of the replacement securities. In all events, no tax would be paid if the replacement securities were still held at death. Or, alternatively, if the preferential rate is removed before the initial sale to the ESOP, a higher capital gains rate may make the

deferral election more attractive, regardless of the anticipated duration of reinvestment.

The corporation's status as a C corporation is another factor to consider. Many corporations have elected S corporation status to remove the double level of taxation associated with C corporations. S corporation shareholders can elect tax deferral, but only if the corporation revokes its S status prior to the transaction. If the corporation makes the revocation, it must remain a C corporation for at least five years before electing S corporation treatment again. Therefore, the double level of taxation would be present for five years, and the selling shareholder may need to consider the cost to the corporation and its shareholders.

Stock acquired by an ESOP for which a section 1042 election was made cannot be allocated to the selling shareholder, his or her family members, or 25 percent shareholders of the corporation. Therefore, the continued employment of any of these parties by the company would need to be considered. Generally, all employees would receive stock allocations in the ESOP. Thus, to the extent these parties are employees, they should be aware of the prohibited allocations to them.

One other tax factor is the capital loss carryforwards that may be held by selling shareholders. Many taxpayers suffered large capital losses on investments during the Great Recession. Under current tax rules, a maximum of $3,000 per year in net capital losses can be recognized by an individual. Therefore, absent large capital gains to offset the losses, large net capital losses carry forward but can only be used very slowly. A sale to an ESOP may be an opportunity to realize capital gains without paying any tax if capital loss carryforwards exist to offset the gain. In these cases, section 1042 deferral is not necessary because tax will not be paid anyway. Even if the capital loss carryforwards do not cover the capital gain, the selling shareholder may choose to reinvest a portion of the proceeds appropriately to allow the shareholder to both use up the capital loss carryforward and defer tax under section 1042 on any remaining capital gain. In this split approach, capital gain is recognized as the greater of capital gain realized or the amount of the proceeds not reinvested, rather than recognizing a pro rata proportion of the gain based on the amount not reinvested.

Q. Who should consider tax deferral on the sale to an ESOP?

A. Note that the section 1042 election is specific to each selling shareholder and can be made by one or all sellers that participate in a sale to the ESOP. Shareholders should first consider whether their business is a good candidate for implementing an ESOP, if the corporation does not already sponsor one. A good ESOP candidate is generally a profitable, closely held business of almost any size with good management, employees and market position. Because the ESOP will be maintained by the corporation after the selling shareholder exits, the corporation's management team and owners need to be comfortable with the ESOP.

Shareholders of closely held businesses may struggle finding buyers for their stock, and an ESOP can create a market that allows them to begin transitioning the business and diversifying their personal portfolio. In most cases, diversifying their portfolio would require a taxable sale. In addition, most sales to outside parties may preclude the shareholder from participating in the business going forward if the acquirer replaces management, board members, etc. An ESOP allows selling shareholders to stay involved in the business since the management and board generally remain, and section 1042 allows them to defer tax on the sale (although the ESOP stock cannot be allocated to them, as explained above) perhaps permanently if they hold the replacement securities through their death.

If you are considering the tax benefits provided by a sale to an ESOP, you should discuss the option with your tax advisor during your business succession and estate planning process to ensure all of the requirements could be met and to analyze the value the opportunity may provide you.

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