

SELLING PRIVATE COMPANY STOCK WITHOUT PAYING TAXES IT IS POSSIBLE!

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A valuable opportunity afforded to sellers of privately held company stock to an Employee Stock Ownership Plan (“ESOP”) is the ability to defer the capital gains tax on the sale of their company stock. This article will provide a basic overview of the requirements that must be met by a company and its selling shareholders in order to determine whether the sale of company stock to an ESOP, and the selling shareholder’s election to defer recognition of capital gains on the sale under section 1042 of the Internal Revenue Code (the “IRC”), would be both feasible and desirable.

In recent years, the higher Federal long-term capital gains tax rate has made the sale of privately held company stock a much greater tax planning concern for private business owners and their advisors. The current maximum long-term capital gains tax rate is 20%. In addition, the Net Investment Income Tax applies at a rate of 3.8% to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts. Therefore, a high wage earner will be looking at a long-term capital gains rate at approximately 25%, plus any additional state capital gains tax that might apply. Additionally, many shareholders in closely held companies have a low basis in their stock, and thus a sale results in significant gain recognition equal to most, if not all, of the purchase price of their stock, which is then subject to capital gains taxes. So for example, if the selling shareholder(s) of a privately-held company sold \$5,000,000 worth of stock to a newly formed or existing ESOP they could potentially defer under Code Section 1042, \$1,250,000 of capital gains tax ($\$5,000,000 \times 25\%$).

ELIGIBLE FOR IRC 1042 TAX-DEFERRED ROLLOVER (“1042 DEFERRAL”)

First, it is important to know that the 1042 Election is only for C corporation stock sold to an ESOP and does not apply to S corporation stock. Only voting common stock or convertible preferred that is convertible into voting common stock is eligible for the 1042 Deferral. The selling shareholder must have a three-year “holding period” in the stock, which is generally met by holding the stock for three years prior to the date of the sale. Immediately after the sale, the ESOP must own at least 30% of either the total value of all outstanding shares or 30% of each class of outstanding shares. Also, shares of private company stock acquired in connection with employment are generally not eligible for 1042 Deferral treatment. For instance, stock purchased by an employee from an employer’s stock option plan is not eligible. In addition the 1042 Deferral is not available to publicly traded companies sponsoring an ESOP.

OTHER IMPORTANT CONSIDERATIONS

If a selling shareholder is eligible and elects the 1042 Deferral, certain other shareholders and family members may not be eligible to receive ESOP allocations of the stock sold to the ESOP and subject to the 1042 Deferral. This would include the immediate family members of the selling shareholders and any 25%-or-greater shareholders, with such ownership determination subject to a one-year “look back” period. Family attribution rules may also apply. For example,

the daughter of a shareholder holding 25% or more of the company's stock is deemed to own 25% or more of the company's stock by attribution and will be ineligible to receive ESOP allocations of the stock sold to the ESOP and subject to the 1042 Deferral.

ELECTION OF THE 1042 DEFERRAL

In order to make the 1042 Deferral election, the company must sign a consent to acknowledge the restrictions that result from the 1042 Deferral, which must be filed with the selling shareholder's tax returns. There will be a 10% excise tax levied on the corporation if within 3-years of the sale the total ESOP ownership percentage of company stock falls below the 30% minimum threshold. There are also additional forms that must be filed with the selling shareholder's tax returns for the year of the sale. The selling shareholder electing the 1042 Deferral must invest the sale proceeds in qualified replacement property ("QRP") within a 15-month period; which includes the 3 months prior to the sale of company stock to the ESOP and ends no later than 12 months after the sale transaction date. The QRP must meet certain qualifications under IRC 1042. The QRP generally must be stocks, bonds, and convertible bonds of "operating companies" incorporated in the United States. These investments in U.S. domiciled operating companies must consist of companies with at least 50% of their assets used in the active conduct of a trade or business. Further, no more than 25% of its gross income for the preceding tax year can be from passive sources. Certain securities do not qualify as QRP, including; securities and bonds issued by the U.S. government or its agencies, non-United States companies, or U.S. subsidiaries of non-U.S. parent corporations. Also investments not qualifying as QRP, include bank certificates of deposit, mutual funds, general or limited partnerships, options, and REITs.

SELLING SHAREHOLDER QRP REINVESTMENT STRATEGIES

While an in-depth analysis of the possible reinvestment strategies that are available to a selling shareholder

electing treatment under the 1042 Deferral is beyond the scope of this article, the following will summarize a few of the main options available.

PASSIVE REINVESTMENT STRATEGIES

The passive reinvestment strategy occurs when the selling shareholder reinvests the proceeds subject to 1042 Deferral into a portfolio of QRP designed to be held for the long-term over the shareholder's lifetime. Careful selection of QRP to be held long-term is vitally important to the success of this strategy to ensure early capital gains recognition doesn't occur, and an experienced investment professional familiar with the required QRP should be consulted. Any portion of the QRP that is liquidated prior to the selling shareholder's death will have that portion of the capital gains tax recognized in the tax year of the disposition.

ACTIVE REINVESTMENT STRATEGIES

The active reinvestment strategy occurs when the selling shareholder purchases corporation issued Floating Rate Notes ("FRNs"). The FRN is typically purchased using leverage from a credit facility called a monetization loan. Since the FRN is issued from a U.S. operating company the FRN qualifies as QRP. FRN's are special securities specifically designed for the 1042 Deferral strategy. FRNs will have maturity lengths of 30 or more years and will normally have put rights and call protection. This will allow the active investment of a portfolio, giving the selling shareholder greater liquidity and flexibility. The selling shareholder can still choose at any time to recognize capital gain by the disposition of some or all of the securities.

COMBINED REINVESTMENT STRATEGY

A mixture of both an active and passive reinvestment strategy may be designed for the selling shareholder. This strategy provides some of the liquidity and flexibility of the active reinvestment strategy while

also providing some passive portfolio attributes that can be designed to meet the selling shareholder's investment goals and objectives.

ESTATE TAX BENEFIT OF 1042 DEFERRAL

Because death is not considered a "disposition" under IRC 1042, the deferred recognition of capital gains and the resulting tax can be eliminated by the selling shareholder holding the QRP until death. At death the tax basis of the QRP is "stepped up" to its market value and thus none of the capital gains tax from the 1042 Deferral will be recognized.

SUMMARY

A properly structured ESOP transaction which qualifies for 1042 Deferral treatment can be an ideal business succession strategy for many closely held business owners. Further, a leveraged ESOP not only provides the selling shareholder(s) with a capital gains tax deferral/elimination strategy, it also provides the company with a means to purchase the selling shareholder's shares using tax deductible loan payments, and the company's employees with an equity based retirement plan. While the rules for IRC 1042 can be complex, careful planning with experienced ESOP advisors can ensure a smooth and successful ESOP transaction.

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