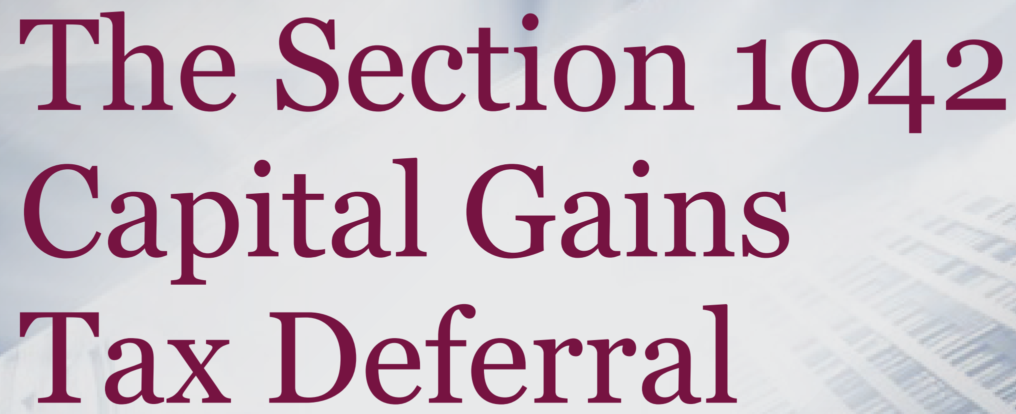

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The Section 1042 Capital Gains Tax Deferral

There can be significant tax benefits for owners of privately held businesses who sell all or part of their business to the employees and implement an Employee Stock Ownership Plan (“ESOP”) and take advantage of the Section 1042 Capital Gains Tax deferral. These benefits can provide meaningful value to the selling shareholder(s), the company and the employees participating in the ESOP.

The impact of this Long Term Capital Gains Tax deferral strategy can be significant. As an example, a seller with a built-in capital gain of $20 million can defer and, in some cases, eliminate capital gains taxes approaching $6 million. Tax issues should not drive the decision to sell a business, but once the decision is made, the tax benefits of the ESOP make it a viable alternative to selling to a strategic or financial buyer.

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Sale of Stock to an ESOP

Background and Applicability

What is the Section 1042 Capital Gains Tax deferral provision of the Internal Revenue Code? Simply put, it is the most significant tax benefit available to business owners who sell to an ESOP. Generally speaking, Section 1042 allows selling shareholders to defer capital gains taxes on shares they sell, given that certain guidelines and requirements are met. Under certain circumstances, capital gains taxes may be avoided entirely.

Prior to 2003, when the Long Term Capital Gains Tax was higher, it was fairly common practice for business owners to incorporate a Section 1042 Capital Gains Tax deferral strategy when selling their business to an ESOP. During this period, the Long Term Capital gains rate was higher and the ability to defer capital gains taxes had significant value to the seller.

In more recent years, with Federal Capital Gains Taxes at a relatively low 15%, the benefit of the deferral was significantly less and under these conditions, most sellers elected to pay the tax and move on, figuring taxes would never be lower. We concurred with this strategy and advised clients to take advantage of this historically low capital gains tax rate.

The situation has changed again, and not for the better from a taxpayer perspective. Under legislation approved by Congress in 2014 to avoid the "Fiscal Cliff," capital gains taxes have increased to 20% from the previous 15% level. Additionally, there is now an "Obamacare" tax of an additional 3.8% on top of the statutory 20% tax. The seller of a business or portion of a business now faces a Federal capital gains tax of 23.8%. To make matters worse, there are still state taxes to pay. In a high tax state like California, with its 12.3% tax, this means that a seller is facing a tax burden in excess of 36% vs. the previous 20% Federal and state burden on the sale of a business or portion thereof. As a result, business owners are again looking to the Section 1042 Capital Gains Tax deferral as an important factor with respect to the sale of their business.

The difference in the “actual money in the bank” the owner receives at the end of the sale is significant.

Why don’t more sellers take advantage of this situation?

Sadly, the professional community just hasn’t done a very good job creating awareness of this opportunity.

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Section 1042 Further Defined

The Section 1042 election is basically a "like-kind" exchange in that the seller is able to defer the proceeds from the sale of stock by reinvesting the proceeds in similar assets. These similar assets are referred to as Qualified Replacement Property ("QRP"). By investing sale proceeds in QRP the sale is completed on a tax-deferred basis. Even more significant, if QRP is structured appropriately, capital gains taxes may be avoided completely for the seller and his or her estate. The provision is intended to incentivize business owners to sell the business to employees, providing them with a stake in the upside of the company going forward.

The basic requirements for Section 1042 eligibility are as follows:

- The business must be organized as a C-Corporation
- At least 30% of the value of the business must be sold in the initial transaction. This is an aggregate value. Multiple shareholders may sell shares in order to meet the 30% threshold.
- In order to defer capital gains taxes, proceeds must be invested in QRP. QRP is defined as debt or equity instruments of domestic operating businesses, publicly or privately held. It does not include mutual funds, government debt, real estate or municipal securities.
- The dollars invested in QRP do not have to be the actual sale proceeds, but rather a dollar amount equal to the amount of the proceeds on which the seller desires to defer capital gains taxes.
- The investment in QRP must be made within a 15-month period beginning three months prior to closing and ending 12 months following closing of the ESOP transaction.

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- The selling shareholder(s) must have held the stock for at least three years prior to the sale to the ESOP. Additionally, the seller cannot have received the stock through the exercise of stock options or certain other employee stock arrangements.

There are other provisions that govern the use of Section 1042 of which sellers should be aware. If selling shareholders take advantage of the Section 1042 deferral, none of the shares in the ESOP may be allocated to ESOP accounts of the seller, relatives of the seller, non-selling shareholders of more than 25% of the company's stock or family members of more than 25% shareholders, if they own the stock by what is referred to as attribution, i.e., they are a spouse of a 25% shareholder. There is one exception to this regulation. Lineal descendants of the selling shareholder(s) may be allocated a total of 5% of the stock as long as they are not treated as more than 25% shareholders by attribution.

As you can see there are many technical aspects that need to be addressed by business owners and their advisors when implementing an ESOP and effecting Section 1042. Our affiliates at the ButcherJoseph & Co. family of companies has deep experience in structuring these transactions, making sure the guidelines and regulations are met, and that the business owner receives maximum value when selling all or part of their business.

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Utilizing a Margin Loan to Create Liquidity

As most ESOP transactions are done to create liquidity for the selling shareholder(s), the next question is, how does the process actually work? It might seem that the reinvestment requirements would make it difficult to realize liquidity from a sale. However, this is not the case as a market has developed around what is referred to as the “monetization” of the proceeds. Using this strategy, a seller has the ability to use a portion of the proceeds from the sale as collateral on a margin loan that allows him/her to meet the reinvestment requirement while generating significant liquidity. Here is a hypothetical example of how it works.

Shareholder A sells 100% of her stock in Widget Co. for $20 million and wants to take advantage of the Section 1042 tax deferral. She also wants to generate significant liquidity out of the transaction. During the period leading to closing, Shareholder A initiates discussions with a financial institution or brokerage firm that specializes in Section 1042 rollover transactions. She is told that by pledging approximately 10% of the proceeds, she can use a margin account to purchase the full $20mm of QRP required to take full advantage of the tax deferral. In this case, $2 million allows her to purchase $20 million on margin, leaving her with $18 million in liquidity from the transaction.

Using this technique, there may be what is referred to as “negative carry” on the margin loan. This means that the interest expense on the margin loan may exceed the interest rate paid on the QRP securities. If the interest rate on the margin loan is 2% and the interest rate paid on QRP is 1%, there would be negative carry of 1% on the $18 million loan. This equates to an out of pocket cost of $180,000 annually on the loan. Keep in mind that the amount of negative carry, and whether it would even exist, is a function of the current interest rate environment. In some cases, when the interest rate on the investment approximates the interest on the margin loan, there may not be a negative carry on the investment.

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Floating Rate Notes as QRP

A major concern of most investors in QRP is how to protect the principal value of the investment, given the value of the financial assets will fluctuate as interest rates and market conditions change. One possible solution to this concern is the use of long-term floating rate notes ("FRNs"). These FRNs are long-term floating rate note (debt) obligations of very highly rated entities. Because the interest rate floats with changes in market conditions, the principal value will approximate 100% of par value at all times.

The exception to this rule of thumb is when the credit profile of the underlying issuer changes. In that case, it is possible for the principal value to decline if rates increase to the level that investors believe there is a concern. If the issuer's financial performance declines to the point where investors believe its continued existence is at risk, the normal rules will not apply and the principal value of the securities will decline.

The QRP Liquidity Decision

The decision the seller faces is whether to pay the potential negative carry (net out of pocket cost on the margin loan, defined as the interest paid on the margin loan compared to the interest income received on the investment) on the margin loan or pay the capital gains tax on the proceeds from the sale. Assuming zero basis in the stock, the capital gains tax on a $20 million sale, at the previous 20% combined Federal and state tax rate level, would be $4 million. Under the current combined Federal and state tax rate of approximately 30%, the capital gains tax would be $6 million. To put the comparison in perspective, at the 30% capital gains tax level, the seller could pay a negative carry of 1.5% for over 22 years before it exceeded the amount of the capital gains tax that would be due at closing without the Section 1042 deferral. As a result of the increase in capital gains tax rates, we expect the use of Section 1042 to increase significantly going forward.

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When is Section 1042 Appropriate?

As outlined previously, the Section 1042 deferral is available only to selling share-holders of C-Corporation stock, where the initial sale transaction involves at least 30% of the value of the company. It is most appropriate where the seller has the ability to utilize the sale proceeds or a portion of them to invest in QRP without creating personal illiquidity. The margin loan structure is one way of implementing the structure while still creating liquidity.

It is also important to understand that the decision to take advantage of Section 1042 is not an "all or nothing" proposition. The seller may elect to take Section 1042 treatment for all or some of the proceeds resulting from the sale of the business. There is nothing that would prohibit a seller from electing Section 1042 treatment for half of the sale proceeds and paying the appropriate capital gains taxes on the other half. This hybrid structure can provide increased flexibility with respect to the use of proceeds, but at a higher cost to the seller in terms of taxes paid.

One of the more powerful uses of the Section 1042 capital gains tax deferral is the elimination of capital gains taxes in their entirety. This requires planning, but in certain circumstances, the seller may be able to entirely eliminate capital gains taxes on the sale of their business.

Elimination of Capital Gains Taxes under Section 1042

We mentioned earlier that the deferral of capital gains taxes using Section 1042 could be turned into the elimination of capital gains taxes in their entirety. This occurs when the seller holds the investment in QRP until death. At that time, the QRP passes on to the seller's heirs with a step up in basis. As the basis in the assets is now equal to the value of the investments, there is no capital gain to tax and, therefore, no capital gains taxes due. Please note that the overall estate, including the QRP, may be subject to Federal or state estate taxes, unless some other exemption exists. Still, avoiding a 30% or more in capital gains tax remains attractive and offers significant savings.

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C-Corp vs. S-Corp Sale and Section 1042

Under current law, the Section 1042 deferral is not available to sellers of S-Corp stock to an ESOP. If the seller believes there would be a significant benefit to the Section 1042 deferral, but the company is currently organized as an S-Corp, one option is to convert to C-Corp status and then sell to the ESOP. In doing so, the seller can then take advantage of the deferral. The potential downside to this strategy deals with the Federal income tax ramifications for the company.

An S-Corp is a pass-through entity with respect to Federal income taxes. What this means is that there is no Federal income tax at the corporate level. All taxable income is allocated to the owners of the business proportionate to their ownership percentage. An ESOP trust is a tax-exempt entity. When the trust owns 100% of an S-Corp's stock, all income is attributable to it and there is no Federal income tax payable. This is not the case with a C-Corp ESOP structure. With a C-Corp ESOP structure, there is Federal income tax potentially payable at the corporate level, before any distributions are made to the trust or other shareholders. Thus, the traditional double taxation situation will apply.

This doesn't mean the conversion to C-Corp status should be rejected out of hand. There is still the potential to minimize or eliminate taxable income at the corporate level through the deductibility of the payments made to the ESOP.

In conclusion, the sale of all or part of a C-Corporation to an ESOP may provide an opportunity for the seller to defer or eliminate capital gains taxes on the sale. Structuring this type of a transaction requires planning and an advisor well versed in the requirements for successfully implementing these structures. At Laffer Tengler Investments, and at our affiliates at ButcherJoseph & Co., we know ESOPs. The principals at our affiliate, ButcherJoseph & Co., have closed almost $2 billion in ESOP transactions over the last 12 years. More importantly to our clients, we are transaction agnostic. We look at all of the alternatives and present clients with the pros and cons of each option so they can make a fully informed decision as to the best option for their situation.

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