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Issue Brief #4

THE ESOP TAX-FREE ROLLOVER OR 1042 TRANSACTION FOR C CORPORATIONS

One of the most effective tax provisions passed to encourage the growth of ESOPs is the tax-free rollover, allowed to certain shareholders or groups of shareholders in privately-held companies who sell stock to an ESOP. Note, this tax provision is available only if the stock involved is stock of a C Corporation.

This issue brief provides a summary of the mechanics and rules of the tax-free rollover and related matters. (Often referred to as a 1042 transaction, after the Internal Revenue Code Section that governs the transaction.)

Why Sell To An ESOP?

A retiring owner, or shareholder of a privately-held C Corporation who wishes to sell his or her stock, faces some potentially unwelcome choices. Often the seller is forced to choose between selling to outside investors, if any are available; exchanging stock with another company in a merger; or selling stock back to the company, if such a transaction is feasible.

None of these options is taxed as favorably as a sale to an ESOP. And unlike a sale to an ESOP, any other choice may result in unwanted consequences for the company's independent existence and the jobs of employees. A rollover sale to an ESOP establishes a market for future selling shareholders, rewards current employees, and maintains the independence and local ownership of the business. A sale to an ESOP allows an owner to sell out gradually, withdrawing from the business to whatever extent desired, or quickly.

Structuring An ESOP Rollover

A shareholder who sells qualified securities to an ESOP incurs no taxable gain on the sale if two conditions are met. First, immediately after the sale the ESOP must hold either 30% of each class of outstanding stock of the corporation or 30% of the total value of all classes of outstanding stock issued by the corporation. Second, within a 15-month period beginning three months prior to the date of sale, the seller or sellers must purchase qualified replacement property. If the cost of the replacement property is less than the amount derived from the sale of securities to the ESOP, the difference is currently taxable.

For purposes of meeting the 30% requirement, sales of qualified securities by two or more parties may be treated as a single sale if these sales are part of a single transaction. Once the 30% requirement is met, a shareholder who sells any amount of stock to the ESOP in the future is eligible for the tax-free rollover.

The rollover must be elected in writing on a timely filed tax return for the taxable year of the sale. Temporary Treasury Regulations Section 1.1042-1T sets forth the procedure for making the "statement of election" of tax-free treatment and the "statement of purchase" of the new securities.

The seller's basis in the new securities will be adjusted by the amount of gain not recognized as a result of the election. Also, the holding period of the employer securities is "tacked on" to the holding period of the replacement securities. In other words, if the seller bought or received company's stock in year 1 at $10 per share, and sells it to an ESOP in year 10 at $100 per share, the taxable basis in the replacement property is reduced from $100 to $10, and the seller is considered to have held that replacement property for 9 years, for tax purposes. If the replacement securities purchased with that $100 then rises in value to $200 over the next six years and are sold in year 15, the taxable gain is $190, not $100, and

the seller will be considered to have held those shares for 15 years, not six years.

Thus the ESOP rollover allows a selling shareholder to defer, not eliminate, taxes on the sale, enabling the seller to invest and earn with money that would have been taxed away. If the replacement property should go into the seller's estate, however, then its basis will be "stepped up" to the property's current value, and the tax on the sale will effectively have been eliminated.

Defining Some Terms

Two technical phrases need to be defined. These are "qualified securities" and "qualified replacement property".

"Qualified securities" are those securities that may be sold to an ESOP. In a privately-held company these include common stock of a C Corporation with voting and dividend rights equal to the classes of common stock having the greatest voting and dividend rights, which is issued by a domestic corporation with no outstanding securities readily tradable on an established securities market. The securities must have been held by the seller for at least three years and cannot have been received by the seller in a distribution from a qualified retirement plan or a transfer under a stock option granted by the company.

"Qualified replaced property" includes any security issued by a domestic (or U.S.) operating corporation that is not the corporation that issued the qualified securities that were sold to the ESOP (or a member of the same controlled group of corporations), and which does not receive more than 25% of its gross receipts during the taxable year in which it is purchased from passive investment (this requirement disqualifies mutual funds). Government securities, and securities acquired by an underwriter, do not qualify. An operating corporation is one whose assets are used in the active conduct of a trade or business. Passive investment income has the same meaning as under the S Corporation rules. The replacement securities must be acquired by purchase. Securities acquired by way of gift, inheritance, or property transfer pursuant to a stock dividend don't qualify.

When qualified replacement property is sold, the gain is currently taxable, and may not be deferred by selling to another ESOP, and investing in new qualified replacement property.

Restrictions On The ESOP Stock

No portion of the assets attributable to qualified securities sold to an ESOP through a tax-free rollover may be allocated to the taxpayer seeking tax-free rollover treatment, any person who is related to that taxpayer, or any other person who owns more than 25% of the value of any class of qualified securities of the issuing corporation. If the ESOP disposes of the acquired employer securities within three years after acquiring them, a 10% excise tax is imposed on the employer. The excise tax applies if the total number of shares held by the ESOP is less than before the disposition, or if the value of the ESOP's share of the company ceases to meet the 30% requirement.

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