

IRC Section 1042 Exchange

Corporate and Executive Services



IRC Section 1042 allows an owner of a closely held C-corporation to indefinitely defer capital gains tax on stock that is sold to an ESOP (employee stock ownership plan).

IRC Section 1042 and qualified replacement property

A 1042 ESOP Exchange allows a shareholder to exchange his or her interest in a private company for a portfolio of qualified replacement property without paying any capital gains taxes on the transaction.

Capital gains tax is deferred as long as the qualified replacement property is held. Through the use of IRC Section 1042, the Qualified Replacement Property (QRP) is assigned the basis of the original investment.

Investments that qualify for QRP:

- Common stock
- Preferred stock
- Convertible bonds
- Corporate fixed rate notes
- Corporate floating rate notes (FRNs)

If a U.S. corporation uses 50% or more of its assets in an active trade or business and does not receive greater than 25% of its gross receipts from passive income, the securities can be used as QRP.

These strategies let the business owner sell their business and defer the tax until the securities mature, are called by the issuer, or sold. Thus, a business owner might be able to defer or eliminate capital gains on the sale of their business.

Wealth management and ESOPs

Business owners can generate income from their qualified replacement property by investing in high-dividend stocks or long-term fixed income securities. This approach allows them to generate income without triggering tax consequences.

Another option is for business owners to invest in long term floating-rate notes, because they are designed specifically for ESOP sales. These securities are issued by major corporations, which have maturities of 30 to 40 years or more and offer a variable interest rate based on a short-term market index. The rate is typically monthly or quarterly, depending on the security.

The highly rated floating-rate notes are marginable for up to 90 percent or more of their market value. As a result, business owners can monetize them by borrowing a substantial portion of their market value and then reinvesting borrowed funds in a diversified portfolio of stocks, bonds and other assets. In addition, the notes have a put feature for liquidity purposes.

The investment portfolio can then be actively managed without triggering tax on the deferred capital gains resulting from the ESOP sale. Business owners will have to pay interest on their margin loan, but

the rate will be relatively low and the interest paid may be partially or fully offset by the interest earned on floating-rate ESOP notes.

Reinvesting the proceeds from an ESOP is complex and requires the assistance of a professional who is well-versed in ESOPs and qualified replacement properties. Business owners do not want to find themselves liable for taxes they thought they had deferred or unable to withdraw assets for the fear of triggering tax consequences.

BCI Wealth Management Corporate and Executive Services

The Corporate and Executive Services team specializes in providing corporations and their executives with services including employee stock option planning and administration, management of restricted stock transactions, 10b5-1 creation and execution, and concentrated stock hedging.

Corporate and Executive Services will also help connect business owners to BCI's global investment banking services to address corporate needs such as IPOs and equity capital raises, private placements, mergers and acquisitions advisory and debt capital raises.

Comparison of using section 1042

The following illustration assumes that the seller(s) have a tax basis that is nominal relative to the transaction price. This may not be applicable to seller(s) that have S Corporation retained earnings. The seller should consult with their tax advisor to determine the tax basis in their company stock. The lower the seller(s) tax basis the more beneficial the Section 1042 election.

Transaction proceeds	\$20,000,000.00
Basis	—
Federal Capital Gains Rate	20.0%
Medicare Surtax	3.8%
Average State Income Tax	6.0%
Total Capital Gains Tax	29.8%

	No 1042 Election Pay Tax Upfront	1042 Election with QRP Investment
ESOP transaction proceeds	\$20,000,000.00	\$20,000,000.00
Less basis	—	—
Total gain	\$20,000,000.00	\$20,000,000.00
Less capital gains tax	\$5,960,000.00	—
Amount available for reinvestment + equity in 1042	\$13,450,000.00	\$20,000,000.00

