

ESOP: IRC Section 1042 Transaction

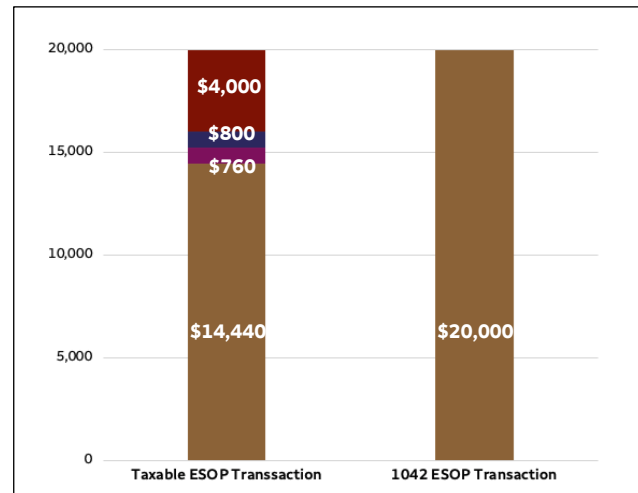
A sale to an employee stock ownership plan (ESOP) affords the business owner the option to defer the capital gains tax associated with the sale by making an Internal Revenue Code (IRC) Section 1042 election. Under this section of the Tax Code the selling shareholder may roll the original cost basis of the ESOP stock sale into qualified replacement property (QRP). If properly structured, this strategy can permanently defer the capital gain as the estate receives the QRP and the heirs receive a permanent step-up in basis under the current estate tax rules. Before making a 1042 election the seller should consider the tax benefits, qualifications, securities that qualify as QRP, mechanics, and advantages/disadvantages.

IRS Section 1042 Tax Benefits

Assuming the total sale proceeds are \$20.0 million the net benefit from an IRC Section 1042 election is \$5.56 million. The example below illustrates the benefits of an IRC Section 1042 election under current tax rates. State capital gains rates vary from state to state. We have used 4% in this example:

Sale to a C Corporation – IRC 1042 election

	Taxable ESOP Transaction	1042 ESOP Transaction
Gross Sales Proceeds (20%)	\$20,000	\$20,000
Tax Basis	-	-
Federal Capital Gains Tax	(\$4,000)	-
AHA Tax (3.8%)	(\$760)	-
State Tax Rate (4%)	(\$800)	-
Net Sales Proceeds	\$14,440	\$20,000



Qualifications for 1042 include:

- **C Corporation** Company must be a non-public C-corporation on the day of the sale (if converting from S to C in order to secure the Section 1042 tax deferral, there is a 5 year wait to convert back to S; this does not apply when converting LLC>C>S).
- **ESOP Ownership Post Sale** Following the sale, a minimum of 30% of the total outstanding shares must be owned by the ESOP trust (either 30% of total share value, or 30% of each outstanding class of stock). Several selling shareholders may collectively meet the 30% total.
- **Holding Period** The stock must have been held by the seller for 3 years prior to the sale.
- **Sale to the ESOP** Many ESOP transactions also include redemptions of ESOP stock. Sales of stock to the Company even if pursuant to an ESOP transaction do not qualify for an IRC Section 1042 election.

Qualified replacement property

Investment and Insurance Products are:

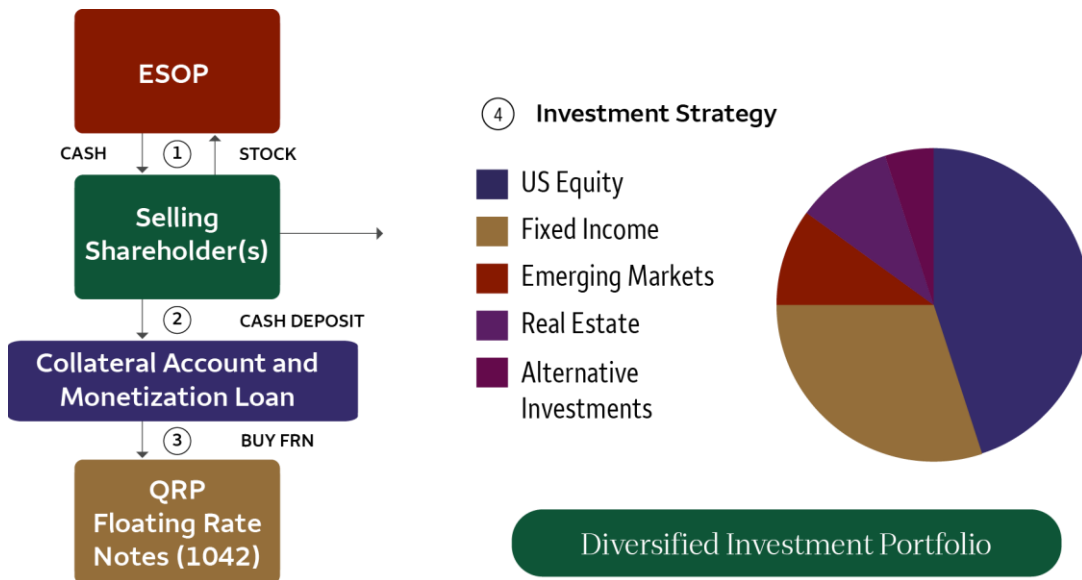
- **Not Insured by the FDIC or Any Federal Government Agency**
- **Not a Deposit or Other Obligation of, or Guaranteed by, the Bank or Any Bank Affiliate**
- **Subject to Investment Risks, Including Possible Loss of the Principal Amount Invested**

The seller must purchase Qualified Replacement Properties (QRP), within the 15-month period ending 12 months after the sale to the ESOP. Certain investments do not qualify. Qualified purchases must meet these standards:

- Must be debt or equity securities of a U.S. domiciled operating company
- No more than 25% of the income of the issuer from passive sources
- 50% or more of assets of the issuer are used in the active conduct of a trade or business

Mechanics of leveraged QRP strategy using 1042 Floating Rate Notes

1. Seller receives cash and/or seller note from the ESOP transaction.
2. Seller deposits cash into a collateral account and takes a monetization loan to buy Floating Rate Notes (FRN) for the qualified replacement property (QRP).
3. QRP securities (Floating Rate Notes) are purchased equal to total transaction amount.
4. Seller diversifies and invests with no restrictions, with all remaining cash.



Floating Rate Notes (FRN’s)

Floating rate notes are designed to meet the terms of QRP and many times are issued with a tax opinion to support the qualification. The terms of the floating rate notes are specifically designed to accomplish the shareholder’s dual objectives of being able to defer the capital gain but actively trade the investment portfolio as follows:

- **Long term** Expected to be included in the seller’s estate.
- **High quality** Ability to borrow at low rates.
- **Putable by the holder** Protects from downside risk.
- **Limited call rights by the issuer** Avoids triggering the capital gain.

Advantages of the FRN strategy

- Deferral of capital gains taxes
- Reduced portfolio risk

Disadvantages of the FRN strategy

- May be a cost in low interest rate environments
- Issuer’s credit quality decline

Michael G McCarthy, CFP®
 Managing Director – Investments
 847-944-7920

Meredith Fiocchi
 Associate Vice President - Investments
 847-944-7921

Joseph Gilbert
 Associate Vice President - Investments
 301-280-3402

Wells Fargo Advisors

This material is not a solicitation or an offer to buy any security or instrument or to participate in any strategy. It is based on tax information and legislation as of January 2021. The examples presented are hypothetical and provided for informational purposes only. The strategies discussed may not be suitable for your personal situation, even if it is similar to the example presented. Since each person’s situation is different you should review your specific investment objectives, risk tolerance and liquidity needs with your financial, tax and legal professionals before taking any action that may have tax or legal consequences. Wells Fargo Advisors is not a legal or tax advisor. Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC, Member SIPC, a registered broker-dealer and non-bank affiliate of Wells Fargo & Company. CAR 0322-01829