New Legislation Enhances the Benefits of a Section 1042 Tax-Deferred Sale

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Recent legislation increased the income tax rates imposed on the gross incomes of U.S. taxpayers. Shareholders of privately held businesses who are seeking to diversify their wealth or exit their business should carefully consider how recent changes in the law will impact their diversification and exit planning strategies. This discussion explains how a tax-deferred sale to an ESOP is even more advantageous to shareholders than in recent years.

Introduction

The enactment of the Health Care and Education Reconciliation Act of 2010[1] and the American Taxpayer Relief Act of 2012[2] resulted in increases in the tax rates imposed on the gross incomes of millions of U.S. taxpayers. As a result, many shareholders of privately held businesses should reevaluate their financial and succession plans.

Thoughtful financial planning will give rise to a number of questions, including how to diversify wealth and how to monetize the value that has accumulated within the privately held business. The tax consequences of the answers to these questions should be at the forefront of taxpayers' minds.

New income taxes and income tax rates mean new challenges. Tax efficiency will be a significant factor affecting the wealth diversification and exit planning strategies adopted by these business owners.

Shareholders of privately held businesses should consider the benefits afforded by selling all, or a portion, of their equity to an employee stock ownership plan (ESOP). A leveraged ESOP transaction offers shareholders a market in which to sell any portion of their equity for full fair market value.

The buyer for the ESOP is a trustee appointed to act on behalf of the ESOP. The trustee may acquire any portion of the capital stock of the privately held business in exchange for the fair market value of the capital stock sold.

Another significant advantage offered by a leveraged ESOP transaction is the ability of the selling shareholder to adopt a structure to defer, and potentially eliminate, the federal (and most likely even state) long-term capital gains tax liabilities incurred in connection with the sale of stock through a tax-deferred sale.

Internal Revenue Code Section 1042 is a nonrecognition provision, which provides the taxpayer with the option not to recognize the long-term capital gain realized in connection with the sale of stock for federal income tax purposes. Instead, the recognition of the capital gain is deferred until a future point in time, or even eliminated.

Health Care and Education Reconciliation Act of 2010

On March 30, 2010, Congress and President Obama enacted the Health Care and Education Reconciliation Act of 2010. This legislation made several changes to the Patient Protection and Affordable Care Act and added Section 1411 to the Code.[3]

This new tax provision imposes a surtax on the "net investment income" of certain taxpayers. Referred to as the "Medicare surtax," this levy was intended to offset costs incurred in connection with health care reform legislation. However, the Medicare surtax may have a significant impact on the after-tax proceeds received in connection with the sale of stock of a privately held business.

The Medicare surtax applies to individuals, estates, and certain trusts. With respect to individual taxpayers, the Medicare surtax is imposed on the lesser of (1) net investment income and (2) the amount by which modified adjusted gross income exceeds the thresholds presented in Exhibit 1.

Net investment income includes interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from businesses involved with the trading of financial instruments and commodities, and passive income (net of profits and losses).

Net investment income does not include wages, unemployment compensation, operating income from a nonpassive business, social security benefits, alimony, tax exempt interest, self-employment income, and distributions from certain qualified plans (such as distributions from an IRA account).

It is important to note that the income subject to the Medicare surtax may be offset by certain allocable expenses, including investment interest expense, investment advisory fees, brokerage fees, expenses related to rental and royalty income, and state and local taxes.

American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 (ATRA) was passed by Congress on January 1, 2013. President Obama signed the bill into law the next day. The ATRA was designed to avert the fiscal cliff by addressing the expiration of the Bush-era tax cuts.

Without the ATRA, marginal tax rates on individual taxpayers in all brackets would have increased automatically, tax preferences for capital gains and qualified dividend income would have ended, and the federal estate tax would have reverted to a maximum rate of 55 percent.

The ATRA made permanent the Bush-era ordinary income tax rates and added a new top marginal rate of 39.6 percent that applies to individual taxpayers based on filing status and income thresholds. For taxpayers filing as single individuals (not heads of households), Exhibit 2 provides the rate schedule.

For married individuals filling joint returns and surviving spouses, Exhibit 3 provides the rate schedule.

The ATRA imposes a new top rate of 20 percent on certain adjusted net capital gain. Under the Bush-era tax cuts, the adjusted net capital gain of an individual taxpayer was taxed at a maximum rate of 15 percent. This provision was scheduled to sunset at the end of 2012.

The ATRA repeals the sunset provision and makes the 15 percent rate permanent. However, the legislation also adds a new 20 percent capital gain rate for certain taxpayers.

Adjusted net capital gain that would be taxed at the new 39.6 percent if it were ordinary income will now be taxed at the 20 percent rate. Because the 3.8 percent Medicare surtax applies to most capital gains starting in 2013, the overall capital gain rate for certain taxpayers may be 23.8 percent plus the capital gain rate imposed under applicable state law.

The ATRA also imposes a new top 20 percent tax rate on certain qualified dividend income, which was taxed at a maximum rate of 15 percent during the Bush administration. Qualified dividend income consists of dividends received from domestic corporations (and certain foreign corporations) if certain holding period requirements and exclusions apply.

An individual's qualified dividend income is effectively treated as adjusted net capital gain for federal income tax purposes. The Bush-era tax of 15 percent was scheduled to sunset at the end of 2012, at which time qualified dividend income was to be taxed at ordinary income rates.

The ATRA repealed the sunset provision and made permanent the treatment of qualified dividend income the same as adjusted net capital gain.

Beginning in 2013, the net investment income tax applies to dividends. Thus, the combined tax rate on qualified dividend income for some taxpayers may be 23.8 percent plus rates imposed under applicable state law.

Who Can Take Advantage of the Code Section 1042 Benefit?

New taxes and new tax rates mean new tax planning opportunities. However not all taxpayers may avail themselves of the benefits afforded by a tax-deferred sale to an ESOP. Generally, a taxpayer selling shares of a privately held business will recognize gain to the extent the amount realized by the taxpayer exceeds the taxpayer's adjusted basis in the shares sold.

Section 1042 provides U.S. taxpayers an exception from this general rule provided the taxpayer sells "qualified securities" to an ESOP sponsored by the company.

Exhibit 1
Medicare Surtax for Individual Taxpayers

Filing Status	MAGI Threshold
Married individuals filing joint returns and surviving spouses	$250,000
Unmarried individuals and Heads of households	$200,000
Married individuals filing separate returns	$125,000

Exhibit 2
American Taxpayer Relief Act of 2012
Rate Schedule for Individual Taxpayers

If taxable income is:	The tax will be:
Not over $8,925	10% of taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25, plus 28% of the excess over $87,850
Over $183,250 but not over $398,350	$44,603.25, plus 33% of the excess over $183,250
Over $398,350 but not over $400,000	$115,586.25, plus 35% of the excess over $398,350
Over $400,000	$116,163.75, plus 39.6% of the excess over $400,000

Exhibit 3
American Taxpayer Relief Act of 2012
Rate Schedule for Married Taxpayers Filing Joint Returns

If taxable income is:	The tax will be:
Not over $17,850	10% of taxable income
Over $17,850 but not over $72,500	$1,785, plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50, plus 25% of the excess over $72,500
Over $146,400 but not over $223,050	$28,457.50, plus 28% of the excess over $146,400
Over $223,050 but not over $398,350	$49,919.50, plus 33% of the excess over $223,050
Over $398,350 but not over $450,000	$107,768.50, plus 35% of the excess over $398,350
Over $450,000	$125,846, plus 39.6% of the excess over $450,000

The term "qualified securities" is defined in Section 409(l) of the Code. In short, "qualified securities" are employer securities that are either:

1. the "best common" (i.e., common stock with voting and dividend rights at least equal to the class of common stock with the greatest dividend rights and the greatest voting rights) or
2. noncallable preferred stock which is convertible into such common stock.

Another element of the definition of "qualified securities" is that the securities must be issued by a domestic C corporation that has no stock outstanding that is readily tradable on an established securities market.[5]

The taxpayer making the Section 1042 election must have owned the securities for at least three years prior to the sale to the ESOP.[6]

In addition, the securities cannot have been received in a distribution from a qualified retirement plan or a transfer under an option or other right to acquire stock to which Sections 83, 422, 422A, 423, or 424 of the Code apply. Finally, the securities must otherwise qualify for long-term capital gain treatment in the hands of the taxpayer selling the securities.[7]

A taxpayer selling shares of an S corporation to the company's ESOP is ineligible to make a 1042 election. Recall that "qualified securities" must be issued by a domestic C corporation. However, the shareholders of an S corporation may cause the company to revoke its S election and thus become taxable as a C corporation.

The taxpayer may then consummate a tax-deferred sale to the ESOP. However, once the company revokes its S election, the company may not re-elect to be taxable as an S corporation until the expiration of five taxable periods.[8] Revocation of an S election is rarely a valid reason to shelve a Section 1042 election.

During the five taxable periods as a C corporation, the company may make tax-deductible contributions to the ESOP and pay tax-deductible dividends on the shares held by the ESOP in amounts sufficient to significantly reduce or even eliminate the taxable income of the company. Once the five taxable periods have expired, the company may re-elect to be taxable as an S corporation.

There are additional requirements that a taxpayer seeking to make its Section 1042 election must satisfy. Immediately after the sale, the ESOP must own one of the following:

1. 30 percent of the total number of shares of each class of stock (other than preferred stock)
2. 30 percent of the total value of all stock (other than preferred stock) of the corporation that issued the qualified securities[9]
3. Preferred stock that is convertible by the ESOP into either (1) or (2)[10]

"The Internal Revenue Code imposes requirements on what a taxpayer must do with its sale proceeds after the sale to the ESOP."

The Code imposes requirements on what a taxpayer should do with its sale proceeds after the sale to the ESOP. Within the "qualified replacement period" (the 15-month period commencing 3 months prior to the date of sale and ending 12 months after the date of sale) the taxpayer must reinvest its sale proceeds in "qualified replacement property" (QRP).[11]

QRP is any common stock, preferred stock, bond, or convertible bond issued by U.S. operating corporations (but not securities issued by a government or political subdivision thereof).[12]

QRP must be issued by a domestic operating corporation (i.e., more than 50 percent of the assets of which should be used in the active conduct of a trade or business at the time the securities were purchased or before the close of the qualified replacement period) other than the corporation (or its controlled group members) that issued the qualified securities that the taxpayer sold to the ESOP.

Financial institutions described in Section 581 (i.e., banks) or Section 593 of the Code (e.g., saving and loan associations) and insurance companies are treated as operating corporations.[13]

The issuing corporation cannot have "passive income"[14] exceeding 25 percent of its gross receipts for the taxable year preceding the year in which the seller purchased the security.[15]

Securities sold by an underwriter do not qualify as QRP nor do shares in mutual funds.[16]

The taxpayer's basis in the QRP is adjusted by the amount of unrecognized gain with basis allocated among multiple items of QRP in proportion to each item's cost relative to the total cost of all QRP purchased.[17] The taxpayer receives a step-up

in basis of QRP that is held by the taxpayer until death.[18]

The holding period of the employer securities sold is “tacked on” to the holding period of the QRP. Assuming a taxpayer does not reinvest all of the proceeds realized in connection with the sale to the ESOP in QRP, long-term capital gain is recognized only to the extent that the sale proceeds exceed the cost of the QRP.

Example: A U.S. taxpayer sells qualifying securities of a privately held company with a basis of $1,000,000 to an ESOP for $10,000,000. Within the qualified replacement period, the taxpayer purchases QRP for $10,000,000.

The taxpayer realizes long-term capital gain of $9,000,000. However, the taxpayer purchases $10,000,000 of QRP. Therefore, none of the taxpayer’s total $9,000,000 long-term capital gain must be recognized.

Recall that Section 1042 is a nonrecognition provision. This provision allows a taxpayer to defer recognition of the long-term capital gain realized in connection with the sale of stock to the ESOP.

Unless certain requirements discussed within this Article are satisfied, the deferral cannot be indefinite. The taxpayer must eventually recognize (and pay tax associated with) the long-term capital gain.

So what happens when QRP is sold or otherwise disposed of? In short, the taxpayer disposing of QRP must recognize the long-term capital gain, the recognition of which had been deferred by the taxpayer.

In our example, if the taxpayer had disposed of the QRP, the taxpayer would have to recognize long-term capital gain in the amount of $9,000,000. It is important to note that the taxpayer would also recognize any gain on the QRP itself.

A taxpayer is required to recognize long-term capital gain if the corporation issuing the QRP disposes of a substantial portion of its assets (other than in the ordinary course of business) and the taxpayer holding the QRP also owns sufficient stock to represent control.[19]

Recognition is not required in instances where a transfer of QRP occurs due to reorganization under Section 368 of the Code, unless the taxpayer owns stock representing control,[20] by reason of the death of the person making the election,[21] by gift[22] (including a gift to a charitable remainder trust from which the donor receives a life annuity), or due to a subsequent Section 1042 transaction.[23]

The Internal Revenue Service broadly construes what is, and what is not, a “disposition” of QRP. The IRS position is that any change in ownership of QRP that is not expressly excepted under Section 1042 constitutes a “disposition.”[24] For example, the Service has ruled that a transfer of QRP to a partnership in exchange for a partnership interest is a disposition.[25] In contrast, the Service has ruled that a transfer of QRP from a trust to its beneficiary is not a disposition.[26]

So what negative implications should a taxpayer who is evaluating a Section 1042 election consider? One important consideration is that by reinvesting sale proceeds in QRP, a taxpayer commits to a long-term investment strategy that ties up the liquidity realized in connection with the sale to the ESOP.

Disposition of QRP triggers recognition of long-term capital gains and gives rise to a significant tax bill, which defeats the purpose of the Section 1042 election.

However, this “lock-in” effect can be avoided through a monetization process involving a form of a margin loan. The strategy is selecting the appropriate securities to comprise the QRP portfolio.

This portfolio should consist of bonds with special characteristics. First, the maturity of the bonds should not be less than 40 years. Second, the bonds should not be callable and should carry a put right to provide liquidity when the bondholder needs it. Third, the bond should pay a coupon payment at a rate that floats—such as a rate that is a derivative of LIBOR.

Generally, these bonds are issued by active U.S. companies that enjoy a credit rating of AA-/A+. The prices of these bonds stay within a fraction of their par value because of the bonds’ credit rating. The stability of the bonds' price makes them attractive collateral for financial institutions.

A taxpayer may pledge these bonds as collateral for a margin loan of up to 90 percent of the aggregate value of the bonds. The taxpayer may reinvest the proceeds of the margin loan without restriction and without triggering recognition of the long-term capital gain incurred in connection with the sale to the ESOP.

A financial institution making a margin loan secured by these bonds will charge interest for the loan. However, the bond portfolio may be structured such that the difference between the coupon payment on the bonds and the interest rate on the margin loan is relatively small, varying between 0.40 percent and 1.50 percent (depending on a number of factors, including the size of the bond portfolio and the financial institution's desire to make the margin loan).

It is important to note that the amount by which the interest rate paid by the taxpayer exceeds the coupon payment received by the taxpayer may be deductible to the taxpayer.

The bond portfolio and margin loan ensemble is intended to remain in place until the taxpayer dies. Upon death, the estate of the taxpayer would dispose of the bond portfolio and use the proceeds to satisfy the taxpayer's obligations under the margin loan. As a result, the proceeds received from the margin loan are now the taxpayers.

Lessons Learned from the 2008 Financial Crisis

As discussed earlier, the bond portfolio and margin loan ensemble is intended to remain intact until the death of the taxpayer. Upon death, the estate of the taxpayer would dispose of the QRP and use the proceeds to satisfy the obligations under the margin loan. However, the 2008 financial crisis illuminated the tax harvesting benefits afforded by 1042 elections.

For example, many taxpayers across the United States realized significant long-term capital losses outside of their bond portfolios during the financial crisis.

During this period, taxpayers maintaining 1042 elections disposed of QRP (thus recognizing the long-term capital gain realized in connection with the sale to the ESOP) and used the long-term capital losses incurred through their other investments to offset the long-term capital gains recognized upon disposition of the QRP.

Conversion Issues

As discussed above, to constitute "qualifying securities" the stock that is the subject of a Section 1042 election should be issued by a company that is taxable as a C corporation at the time of the sale.

Shareholders of S corporations are often attracted to the benefits afforded by a Section 1042 election but are wary of revoking the S election of the company. These shareholders should be mindful that the deductions attributable to the ESOP will significantly reduce or even eliminate the taxable income of the company.

However, these shareholders should also be mindful of the issues that may arise in connection with a voluntary revocation of an S election.

For example, unless the company qualifies as a personal services corporation under Section 448, an S corporation revoking its S election that calculates taxable income on the cash basis method of accounting and earns revenue in excess of $5,000,000 each year must change to the accrual basis method of accounting.

This change in method of accounting may accelerate the recognition of taxable income that should be taken into account ratably over the subsequent four taxable periods.[27]

Generally, an S corporation will seek to reelect S corporation status once the company has waited the requisite five taxable periods to do so. However, the company will want to evaluate adverse tax consequences associated with built-in-gains assets[28] and LIFO recapture rules before filing its S election.[29]

Conclusion

A business owner who is evaluating wealth diversification and business succession alternatives should

consider all of the available options and compare the after-tax proceeds the business owner will receive under each alternative. Today's business owners live in a complex tax environment with significantly greater long-term capital gains tax rates relative to previous years.

As a result, few alternatives offer greater after-tax proceeds than a tax-deferred sale to an ESOP for full fair market value.

When a business owner considers all of the income tax benefits inherent with an ESOP, along with the more motivated and productive employees that are incentivized and rewarded by the ESOP, he or she may likely conclude that a tax-deferred sale to an ESOP is the best wealth diversification or business succession alternative available.

Notes:

1. Pub.L. 111–152, 124 Stat. 1029.
2. Pub.L. 112–240, 126 Stat. 2313.
3. On December 5, 2012 the Internal Revenue Service released proposed regulations interpreting this new tax provision. The proposed regulations remain subject to revision and open to comment throughout 2013.
4. The Bush tax cuts were enacted through the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 and extended by the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.
5. §1042(c)(1); See also PLR 200237026 where the IRS ruled that shares of a foreign corporation are qualifying employer securities within the meaning of §§4975(e)(8) and 409(l)(1).
6. §1042(b)(4).
7. §1042(a). See also PLR 9836022 where the IRS ruled that convertible preferred stock with equity participation and voting rights that was issued in a recapitalization was not §306 stock and was thus eligible to be sold to an ESOP in a qualifying §1042 transaction.
8. §1362(g).
9. §1042 (b)(2).
10. §1042 (c)(1).
11. §1042(a)(2).
12. §1042(c)(4).
13. §1042(c)(4). It is important to note that QRP can, however, be stock of another corporation that, though controlled by the taxpayer making the 1042 election, is not a member of a controlled group because in determining control any QRP of the taxpayer with respect to the §1042 sale being tested is disregarded.
14. "Passive income" here has the same meaning as under §1362(d)(3)(D).
15. §1042(c)(4)(A)(i).
16. §1042(c)(5); PLR 8724009.
17. §1042(d).
18. §1014.
19. §1042(e)(2).
20. §1042(e)(3)(A); however the IRS has ruled that a transfer of QRP to a partnership, that is otherwise tax-free under §721, will constitute a disposition of the QRP since a transfer to a partnership is not specifically excepted from the general rule that transfers constitute dispositions, Rev Rul 2000-18. Stock can, however, be contributed to a partnership in a tax-free exchange and the partnership can consummate a Section 1042 sale to an ESOP. While the substantive difference between this and a Section 1042 sale followed by a contribution of QRP to a partnership is slight, the tax consequences are dire. See Hyman, FLP-ESOP: It's All In The Timing, www.fed.org/onlinemag/jan01/tips.htm.
21. §1042(e)(3)(B).
22. §1042 (e)(3)(C).
23. §1042(e)(3)(D).
24. This means that a disposition is deemed to have occurred even though another section of the Internal Revenue Code specifically provides that a tax should not apply. For example, §1042 takes precedence over §1041, which provides that no gain is to be recognized on a division of property pursuant to a divorce. Accordingly, unless general tax law exempts a transaction from tax (e.g., a division of a trust among its beneficiaries), a "disposition" will be deemed to have happened and a tax becomes due.
25. Rev. Rul. 2000-18
26. In PLR 9411003, the Service concluded that the distribution of QRP by the trust pursuant to provisions in the trust agreement did not constitute a disposition for purposes of §1042(e) because the trust would not recognize gain or loss on the distribution of property to the beneficiary.
27. §481.
28. §1374.
29. See §§1374, §1375, and §1363(d).

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