Qualified Replacement Property
Rules for Reinvestment

One of the unique features of an Employee Stock Ownership Plan (ESOP) is the potential for a sale of stock by the owner of the privately-held company shares to defer [and possibly avoid] taxation on the sale transaction. An ‘election’ is made under this Code Section 1042 permitting this tax deferral.

Section 1042 of the Internal Revenue Code provides the rules to be followed in order to effectively comply with a deferment of taxation for a sale of privately-held company stock to an ESOP Trust. Listed below are some of the highlights from Section 1042 that give some further guidance on the tax-deferral and reinvestment strategies.

These rules should be reviewed by your tax advisor for applicability to your individual and corporate tax situation. The list below is not the complete listing of requirements under IRC Section 1042 and this letter should not be used as the basis for your individual or corporate tax strategy and planning. For further information on this reinvestment topic and other strategies related to ESOPs feel free to contact our office for a discussion of your particular needs.

The language of section 1042 is included, in part, in italics below:

Sec. 1042. Sales of stock to employee stock ownership plans or certain cooperatives

(a) Nonrecognition of gain if -

(1) the taxpayer or executor elects in such form as the Secretary may prescribe the application of this section with respect to any sale of qualified securities,

(2) the taxpayer purchases qualified replacement property within the replacement period, and

(3) the requirements of subsection (b) are met with respect to such sale,

then the gain (if any) on such sale which would be recognized as long-term capital gain shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of such qualified replacement property.

(b) Requirements to qualify for nonrecognition

A sale of qualified securities meets the requirements of this subsection if -

(1) Sale to employee organizations

The qualified securities are sold to -

(A) an employee stock ownership plan (as defined in section 4975(e)(7)), . . .
The 30% Rule

Section 1042 requires that a minimum of 30% of ‘each class of outstanding stock of the corporation’ be held by the ESOP.

(2) Plan must hold 30 percent of stock after sale
The plan or cooperative referred to in paragraph (1) owns (after application of section 318(a)(4)), immediately after the sale, at least 30 percent of -

(A) each class of outstanding stock of the corporation (other than stock described in section 1504(a)(4)) which issued the qualified securities, or

(B) the total value of all outstanding stock of the corporation (other than stock described in section 1504(a)(4)).

The Replacement Period

There is a ‘window’ of time that must be complied with for the reinvestment property to be purchased in order to comply with Section 1042. The clock begins ticking – technically – 3 months prior to the sale of stock to the ESOP – and continues for 12 months after the closing date of the sale of stock.

(3) Replacement period

The term "replacement period" means the period which begins 3 months before the date on which the sale of qualified securities occurs and which ends 12 months after the date of such sale.

Qualified Replacement Property

In order to comply with Section 1042, the selling shareholder must purchase securities that meet certain criteria.

Generally, as stated below, the ‘replacement securities’ need to be a corporation more than 50 percent of the assets of which [are] . . . used in the active conduct of the trade or business, and [does] not . . . have passive investment income in excess of 25 percent of [its] gross receipts.

Code sections are offered below:

(4) Qualified replacement property

(A) In general
The term "qualified replacement property" means any security issued by a domestic operating corporation which –
(i) did not, for the taxable year preceding the taxable year in which such security was purchased, have passive investment income (as defined in section 1362(d)(3)(C)) in excess of 25 percent of the gross receipts of such corporation for such preceding taxable year, and

(B) Operating corporation
   For purposes of this paragraph -
   (i) In general

The term "operating corporation" means a corporation more than 50 percent of the assets of which were, at the time the security was purchased or before the close of the replacement period, used in the active conduct of the trade or business.

What does all of this mean?

Essentially, Section 1042 provides a time period for reinvestment, a minimum amount of stock sold to the ESOP trust, and certain limitations on the types of securities that can be repurchased in the transaction. Types of securities that cannot be purchased include real estate, government or municipal securities, mutual funds or certificates of deposit (CDs).

The exiting/selling business owner is empowered to purchase a diversified portfolio of U.S. securities representing ‘operating companies’. The larger point is that an exiting business owner who sells shares to an ESOP can achieve diversification for their wealth by, effectively, trading their concentrated and illiquid shares of privately-held stock, for a diversified portfolio of liquid investments.

Avoiding the Triggering of the Capital Gains Tax

The investor who follows these steps can defer paying tax on the sale of stock to the ESOP. However, it should be noted that a simple purchase of a diversified set of investments will not provide complete liquidity – at least not without triggering the tax consequences that were looking to be avoided.

(1) In general
If a taxpayer disposes of any qualified replacement property, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such qualified replacement property.

So, when the shareholder who purchased the qualified replacement property sells certain holdings, the gain is recognized as described above. Under this scenario, an investor purchases a static or passive portfolio of investments.
An Alternative Option – Purchasing an Actively Traded Portfolio of Investments

An alternative option for an exiting owner’s reinvestment is an active portfolio of investment created through the use of Floating Rate Notes.

Under this strategy, an investor would purchase a specific type of qualified replacement property known as Floating Rate Notes (FRNs). These FRNs are long-dated bonds, issued by [mostly] highly-rated corporations, that have limited or no ‘call’ provisions. This means that the bonds cannot be recalled by the issuing corporation. This is a significant point because a recall of the bonds would trigger the tax that is looking to be avoided.

Once the FRNs are purchased, they serve as strong enough collateral for a lending institution to provide a loan-to-value against this collateral of up to 92% of the value of the bonds. The proceeds of loan that is issued against these bonds can then be used for any purpose at all – including the reinvestment into an actively-traded and diversified portfolio of publicly-traded, liquid, securities.

Under this strategy, the tax-payer has avoided taxation on the sale of stock to the ESOP, and now has up to 92% of their money free to spend or invest as they like. And, interestingly enough, these funds may permanently avoid taxation if the holding of the bonds outlasts the lifespan of the exiting owner. In that case, under current estate tax laws, the assets receive a step-up in basis [in part or in whole] when they transfer to the owner’s heirs. Again, the details of each exiting owner’s situation will vary, so guidance from your tax advisor is highly encouraged for this type of strategy.

If you have any questions regarding this strategy or any other ESOP related questions, feel free to contact our office at 617-367-5772 – or e-mail john@pinnacleequitysolutions.com and someone from our team will get back to you.

This document is not intended to be, nor should it be relied upon, as a representation of tax advice. Any tax strategies being considered should be discussed and approved by your tax advisor.