Sales to an Employee Stock Ownership Plan

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General

There are a number of ways for a business owner to convert a concentrated, illiquid equity position into a diversified portfolio, including an initial public offering, a venture capital investment or an outright sale. Such transactions are generally taxable. Another strategy is a management buyout strategy such as having an Employee Stock Ownership Plan (ESOP) purchase part or all of the business owner's stock in the company. An ESOP is a retirement benefit plan created to hold the corporation's own stock for the benefit of employees. The sale to an ESOP has three important features.

- First, the use of an ESOP allows employees to have an equity stake in the company.
- Second, if the requirements of Section 1042 of the Internal Revenue Code (IRC 1042) are met, the sale of the business owner's stock will not trigger capital gains tax at the time of the sale. In some circumstances, the capital gains tax can be avoided entirely.
  - IRC 1042 is, therefore, a powerful tool which can be used to reduce the risk of a concentrated, illiquid equity position by converting it to a diversified portfolio without the current payment of the capital gains tax.
- Third, employees pay no tax on the contributions to the ESOP as an employee benefit. Only the distribution of their accounts is taxable.
  - The employees can roll over their distributions in an IRA or other retirement plan or pay current tax on the distribution and subject to a 10% penalty if made before normal retirement age. The law does not allow ESOPs to be used in partnerships and most professional corporations.
- There are two sets of requirements to qualify under IRC 1042 – those applicable to the transaction and those applicable to the proceeds of sale.

The Transaction

An owner must be selling "qualified securities," which are defined as the common stock of a taxable domestic ("C") corporation with no readily tradable public stock[1]. Additionally:

- The owner cannot have acquired the shares from a qualified retirement plan or an employer grant of stock options or rights.

[1] S corporation shares are not qualified securities for the purposes of IRC 1042.

- The owner must have a holding period of at least three years with respect to the shares as of the sale date.
  - The holding period includes that of a prior owner if the shares were acquired through a gift or divorce.
- The ESOP must own at least 30% of either each class of the corporation's outstanding stock or the total value of all of the corporation's outstanding stock after the sale is complete. In other words, the sale to the ESOP must bring the ESOP's ownership interest in the company up to at least 30% after the sale
  - For example, if the ESOP already owns 20% of a company, the sale of a shareholder's 10% interest in the company can qualify under IRC 1042.
  - Multiple shareholders can also combine their holdings to meet the 30% requirement if the sales are part of an integrated transaction.
- For example, two shareholders can each sell 5% to an ESOP and qualify under IRC 1042 if the ESOP already owns 20% of the company and the sales are part of an integrated transaction (e.g., a corporate tender offer).

Therefore, the 30% requirement may not be a barrier to a shareholder who wishes to sell the ESOP less than a 30% interest in the company.

The Proceeds of a Sale

An owner must purchase "qualified replacement property" (QRP) within a 15-month period starting 3 months prior to the date of the sale and ending 12 months after it.

- The business owner will be taxed only on the gain to the extent the sale proceeds exceed the cost of the QRP.
  - Accordingly, where all sales proceeds are reinvested in QRP within the 15-month period, no capital gain will be recognized upon the sale.
- The amount of the unrecognized gain in the stock sold to the ESOP is subtracted from the cost of the QRP to arrive at the QRP's cost basis. If more than one investment is acquired as QRP, the basis of the stock sold to the ESOP is allocated pro rata to the QRP.
- The holding period of the shares sold to the ESOP carries over to the QRP (so any sale of QRP will generate long-term capital gain regardless of how long the QRP is held).

QRP is defined as a sezcurity issued by a domestic operating corporation that, for the prior year, did not receive more than 25% of its gross revenue from passive (investment type) income.

- An "operating corporation" means one in which at least 50% of the assets are used in the active conduct of a trade or business or any financial institution or insurance company.
- A "security" means stock, stock rights and registered or interest-bearing notes, bonds or indebtedness.
  - Excluded, however, are mutual funds, unit trusts, bank common trust funds, U.S. government and agency bonds, municipal bonds, commodities, general or limited partnership units, options, futures, American Depository Receipts (ADRs), some Real Estate Investment Trusts, hedge funds, bank certificates of deposits and (probably) Limited Liability Companies.
  - Also excluded is the stock of the corporation involved in the ESOP.

- Basically, U.S. corporate common stock (including Subchapter S corporation stock), preferred stock, bonds and convertible bonds (whether or not publicly traded) are all that remain as viable QRP options.

Seller's Options

The value of the sale to the ESOP depends in part on how long the capital gain on the company stock can be deferred. The capital gain deferred on the sale of the company stock is triggered on a "disposition" of the QRP. What is considered a "disposition" for purposes of IRC 1042 is not entirely clear.

- At a minimum, the sale of the QRP would be a disposition.
- It does not include:
  - Certain mergers, reorganizations, consolidations and acquisitions that are not taxable events (if taxable events, however, deferred gain would be recognized).
  - Transfers by gift (which will result in the recipient receiving the QRP at carry-over basis (the basis in the hands of the donor).
  - Another IRC 1042 transaction.
  - Death.
- Because death is not a "disposition" for purposes of IRC 1042, the capital gain deferred on the sale of the company stock can be completely avoided. Property held at death, including QRP, receives an adjustment (often called a "step-up") in cost basis to the market value of the asset at that time[2].

Generally, to achieve greater diversification, the selling shareholder could sell QRP to invest in assets that do not meet the definition of QRP, but sale of the QRP would require the selling shareholder to effectively recognize the capital gain (augmented or reduces by gain or loss, respectively, in the QRP). The tax on the gain would generally be due by April 15 of the year after the sale of the QRP and would be eligible for the preferential long term capital gains rate of up to 20% on the Federal level, and may be subject to the 3.8% tax on net investment income under the Affordable Care Act.

Alternatively, the selling shareholder may employ one or more strategies to further defer or avoid the capital gains tax, without selling the QRP.

- Transfer to a Charitable Remainder Trust (CRT). The selling shareholder can transfer the QRP to a CRT and the CRT can dispose of the assets without triggering the deferred capital gain. A CRT is itself tax exempt (but the donor is taxed on the annuity or Unitrust amount distributed to him or her).
  - While "gift" is not defined in IRC 1042, the IRS has ruled that "gift" generally means voluntary transfer of property without consideration in return. Using this logic, the IRS has indicated that transfers to a Charitable Remainder Annuity Trust (CRAT) or Unitrust (CRUT) are considered gifts and do not trigger capital gain.
  - A CRAT pays the donor a fixed dollar amount each year. The amount must be at least 5% (but not more than 50%) of the market value of the assets at the time the trust is established. A CRUT pays the donor at least 5% (but not more than 50%) of the fair market value of the trust's assets, as re-determined annually.
  - Both trusts can last for a life (or lives, e.g., that of a donor and his or her spouse) or a term up to 20 years[3].

[2] However, such property will nevertheless be included in the seller's estate for estate tax purposes.
[3] They can last the shorter of a term of up to 20 years and a life or lives.

  - The value of the charity's interest must equal at least 10% of the value of the property contributed to either trust.
  - The donor may deduct the value of the charity's interest for income tax purposes (subject to limitations based on his or her adjusted gross income).
  - After the donor's interest expires, the property passes tax free to charity.
  - The rationale for exchanging the QRP for an income interest in a CRT, usually a CRUT, is that a CRUT may return more to the donor through the income interest than a taxable disposition of the QRP because of the tax-free growth of the CRUT and the commensurate growth in the unitrust amount.
  - The risk is that the expected benefit may not materialize if the additional income generated does not outweigh the loss of the value of the remainder which passes to charity.
- The seller can purchase (as QRP) a long term floating rate note ("ESOP Floaters"), borrow additional funds using the ESOP Floaters as collateral and invest the borrowed proceeds in any manner.
  - ESOP Floaters, in general: bear a floating interest rate based on LIBOR; are issued by companies rated "AA" or better; have maturities of 40 years or more; and have call protection and give the holder put rights for varying periods of time.
    - The long duration of the bond allows sellers to potentially hold the QRP until death and entirely avoid capital gains tax on the original sale of the company stock.
    - The selling shareholder can buy and sell the investments purchased with the borrowed funds without triggering the capital gain deferred on the original sale of the company stock (because the ESOP Floater is maintained as the QRP).
    - The spread between the yield on the ESOP Floater and the interest due on any borrowing is, in essence, the cost which must be weighed against the benefits of added diversification.
- Since the asset classes that qualify as QRP are essentially only stocks and bonds of U.S. companies, both a transfer to a CRT and borrowing against a bond can improve the selling shareholder's asset allocation because both strategies allow investment in property other than domestic corporations, including precious metals, futures, options, real estate and international stocks and bonds.
  - Borrowing against a bond and, to a lesser extent, using a CRT, also allow the asset allocation to change as circumstances dictate without immediate recognition of the deferred capital gain.

The Corporation's Perspective

The ESOP can purchase the selling shareholder's stock with cash contributions made by the employer and/or with borrowed funds.

The ESOP typically borrows funds from the corporation itself (which can use its own or borrowed funds), in both cases pledging the shares received as collateral. After the initial purchase of shares by the ESOP, the corporation makes annual tax-deductible contributions to the ESOP or pays dividends to the ESOP, which the ESOP can use to repay the acquisition debt.

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