

ESOP Sales and Section 1042: A Powerful Tax Deferral Opportunity (Part 1)

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For owners of closely held corporations who want to exit on their own terms, a sale to an employee stock ownership plan (“ESOP”) can provide a path to monetize ownership while deferring capital gains tax. Internal Revenue Code (“IRC”) section[1] 1042 allows an eligible seller to defer long-term capital gain on a sale of stock to an ESOP if the seller purchases qualified replacement property (“QRP”) within the statutory replacement period.[2] In practice, that means a seller may transition ownership to employees, preserve the company’s independence, and avoid immediate tax cost, provided the transaction is structured carefully.[3]

This article will be the first of three, and is intended to explain the fundamentals of ESOPs, section 1042 and QRP. Parts 2 and 3 will discuss in greater detail some of the planning opportunities, and some of the pitfalls, in the ESOP space in an effort to debunk some of the “myths” that seem to prevail and protect company owners from inadvertently running afoul of the applicable restrictions.

What is an ESOP?

An ESOP is a tax-qualified defined contribution plan designed to invest primarily in qualifying employer securities.[4] ESOP assets are held in a tax-exempt trust. Unlike other retirement plans, an ESOP can function as both an employee benefit arrangement and a corporate finance tool. As an employee benefit arrangement, the ESOP is a qualified defined contribution plan that must satisfy section 401(a), hold employer stock for the benefit of participants under a written plan, and allocate stock or other plan benefits to participant accounts in accordance with the IRC and applicable regulations.[5]

As a corporate finance tool, an ESOP can purchase stock from a selling shareholder at fair market value while providing significant tax advantages to the sponsoring company. In a

leveraged ESOP, the ESOP borrows to acquire employer stock,[6] and employer contributions to the ESOP can then be used to service that debt. For C corporations, contributions used for principal repayment are deductible, subject to statutory limits (e.g., 25% of employee compensation), and dividends paid on ESOP-held stock may also be deductible.[7] For an S corporation owned entirely by an ESOP, there are no federal taxes on its taxable income because the ESOP trust is a tax-exempt retirement plan.[8]

ESOP transactions are often attractive to founders who want an exit but are not prepared to sell to a strategic buyer or private equity fund. Of course, it also does not hurt that, when all requirements of section 1042 are met, the seller may defer tax on capital gain.

Requirements for Section 1042 Eligibility

The section 1042 rules are exacting:

- First, the stock sold must be “qualified securities,” meaning common stock issued by the U.S. employer corporation that (a) is not readily tradable on an established securities market, (b) has been held by the seller for at least three years, and (c) was not acquired through certain compensatory options or qualified plan distributions.[9] The employer must be a C corporation at the time of the sale; stock of an S corporation does not qualify under current law.[10] However, Congress has enacted a narrow future expansion S corporations.[11]
- Second, immediately after the sale, the ESOP must own at least 30% of each class of outstanding stock or at least 30% of the total value of all outstanding stock of the corporation. [12]
- Third, the seller must make a timely election and file the required written statements with the return for the year of sale.[13]

Qualified Replacement Property and Timing Rules

The reinvestment requirement is equally important. For section 1042 capital gain deferral, the seller must purchase QRP within the replacement period.[14] The replacement period begins three months before the ESOP sale and ends twelve months after it.[15] If the QRP is purchased for less than the seller’s total amount realized on the original sale to the ESOP, the difference is recognized as taxable gain.[16]

QRP generally means securities of a domestic operating corporation.[17] These securities include stock or certain debt instruments issued by a U.S. corporation that is not the issuer of the sold stock (or in that issuer’s controlled group). There is both an income test and an active asset test: the U.S. corporation (a) cannot have had more than 25% passive income in the year prior to

purchase, and (b) at the time of the QRP acquisition or by the end of the twelve month reinvestment period, more than 50% of its assets must be in the active conduct of a trade or business.[18] As a result, common stock, preferred stock, and corporate notes of qualifying domestic operating companies may work, while mutual funds, REITs, government bonds, and foreign securities generally do not.

Gain is Deferred, Not Eliminated

Section 1042 is technically a gain deferral regime, not a gain forgiveness regime.[19] The seller's basis in the QRP is reduced by the amount of gain not recognized on the ESOP sale, such that the deferred gain is built into the QRP, to be recognized upon any disposition.[20] Moreover, if the seller later disposes of QRP, the deferred gain is generally triggered notwithstanding other nonrecognition provisions.[21] For example, a contribution of QRP to a partnership causes recognition of the built-in gain even though section 721 would otherwise have applied to defer the gain further.[22] Certain additional recognition rules apply to prevent an end run around the tax-on-disposition rules where the issuer of QRP controlled by the taxpayer sells a substantial portion of its assets.[23]

Related Person Restrictions and Anti-Abuse Provisions

Section 1042 also contains important related-person limitations designed to prevent the seller from deferring gain while effectively retaining the economic benefit of the stock through the ESOP.[24] During the "nonallocation period," stock acquired by the ESOP in a section 1042 sale may not be allocated to the seller, certain family members, or other disqualified persons owning more than 25 percent of the employer corporation.[25] In general, the nonallocation period begins on the date of the section 1042 sale and ends on the later of (a) ten years after the sale or (b) the date the ESOP loan incurred in connection with the acquisition is repaid.[26] The disqualified-person rules are broad and take into account constructive ownership concepts, which may apply even where the seller does not appear to control the company directly. Furthermore, an excise tax may apply if the ESOP disposes of the stock within three years after the sale, absent a statutory exception.[27] Together, these rules are designed so that a section 1042 transaction functions as a genuine employee-ownership transfer rather than a tax-advantaged recycling of ownership back to the seller or a related ownership group.

Key Takeaway: Planning is Critical

Section 1042 offers an attractive tax incentive for owners of closely held businesses who want a sale path other than via a third-party buyer. The tax benefits depend on attention to detail: entity status, holding period, ESOP ownership thresholds, election mechanics, QRP diligence,

financing structure, and post-closing compliance, which all require coordinated legal and tax advice. But when the stars align properly, a section 1042 transaction can provide benefits that other exit strategies cannot match.



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Endnotes

[1] Unless otherwise indicated, references to a section ("section" or "§") are to Title 26 U.S.C., the IRC of 1986, as amended, or Treasury regulations promulgated thereunder (the Code of Federal Regulations, Title 26, "Treas. Reg.").

[2] I.R.C. § 1042(a).

[3] Additionally, many sellers plan to hold QRP until death, when a basis step-up under section 1014 may eliminate tax on the deferred capital gain.

[4] I.R.C. § 4975(e)(7).

[5] I.R.C. § 4975(e)(7); Treas. Reg. § 54.4975-11(a).

[6] In practice, the ESOP generally borrows from the company itself (and the company may have in fact borrowed from a third-party lender) before making the downpayment to the selling shareholder and issuing a "seller note" to the selling shareholder for the balance.

[7] I.R.C. § 404(a)(3), (a)(9), (k). Contributions used to pay ESOP loan interest may not be subject to those limits at all. I.R.C. § 404(a)(9)(B).

[8] Further, most states follow the federal tax law and do not tax income in an S corporation owned entirely by an ESOP.

[9] I.R.C. § 1042(b)(4), (c)(1).

[10] Under current law, only shareholders of a C corporation may sell shares to an ESOP and defer gain under section 1042. I.R.C. § 1042(c)(1)(A). For S corporations where shareholders desire to utilize section 1042, companies can terminate their S corporation election and close the transaction as a C corporation. Under IRC §1362(g), a corporation whose S election is terminated or revoked generally must wait until its fifth taxable year beginning after the first year the termination took effect before it can re-elect S status, unless the IRS consents to an earlier re-election.

[11] For sales after December 31, 2027, eligible sellers of S corporation stock may elect section 1042 treatment with respect to no more than 10% of the amount realized, rather than the full deferral potentially available in a qualifying C corporation sale. Pub. L. 117-328, Div. T (SECURE 2.0 Act of 2022), Sec. 114 (Dec. 29, 2022).

[12] I.R.C. § 1042(b)(2).

[13] I.R.C. § 1042(b)(3), (c)(6); Temp. Treas. Reg. § 1.1042-1T, Q&A-3. Those statements are not trivial. In the "statement of election" attached to the seller's return, Temporary Regulations require detailed representations concerning the sale and purchased QRP, and consents from the employer corporation and ESOP. Temp. Treas. Reg. § 1.1042-1T, Q&A-3. A common trap is the "statement of purchase" requirement for QRP. Temporary Regulations mandate a separate written statement for each purchase of QRP, and that each statement be notarized within 30 days after the purchase, not simply once at the end of the replacement period. Temp. Treas. Reg. § 1.1042-1T, Q&A-3. Proposed Regulations would relax this requirement by requiring notarization by the time the seller's income tax return is filed. Prop. Reg. § 1.1042-1T, Q&A-3. Failure to adhere to these requirements strictly may result in disallowance of the capital gain deferral. See TAM 9733001 (Aug. 15, 1997) (disallowing gain nonrecognition where taxpayer did not substantially comply with the filing requirements); see also PLR 200324013 (finding substantial compliance); PLR 200234003; PLR 200246027; PLR 200019002; PLR 9735046; PLR 9550014; PLR 199927003.

[14] I.R.C. § 1042(a)(2).

[15] I.R.C. § 1042(c)(3).

[16] I.R.C. § 1042(a) (flush language).

[17] I.R.C. § 1042(c)(4).

[18] I.R.C. § 1042(c)(4).

[19] But see *supra* note 2.

[20] I.R.C. § 1042(d).

[21] I.R.C. § 1042(e)(1).

[22] Revenue Ruling 2000-18

[23] I.R.C. § 1042(e)(2).

[24] See I.R.C. § 1042(b)(1)(A).

[25] I.R.C. § 409(n).

[26] I.R.C. § 409(n)(3)(C).

[27] I.R.C. § 4978.