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CASE OF THE WEEK
ESOP tax-advantaged 1042 Exchange

ERISA Consultants at the Learning Center Resource Desk, which is available through Columbia Threadneedle Investments, regularly receive calls from financial advisors on a broad array of technical topics related to IRAs and qualified retirement plans

A recent call with a financial advisor in Illinois is representative of a common question regarding an employee stock ownership plan (ESOP). The advisor asked:

"I have a client who is retiring from a company with an ESOP, and will be selling his shares in his company. This could subject him to a large tax bill. Do you have any suggestions on how he might lessen the tax hit?"

Highlights of discussion

- Yes, if your client qualifies for a *tax-free* "1042 Exchange" he can defer capital gains tax on "qualified securities" sold to an ESOP if the proceeds of the sale are reinvested in "qualified replacement property" (QRP) as defined in IRC §1042(c)(4). Stockholders interested in a 1042 Exchange should discuss the option with their attorneys and/or tax advisors before proceeding.

    - ✓ Qualified securities for this purpose are employer securities of a C corporation that are either 1) 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.

    - ✓ QRP includes common stock, preferred stock, bonds, and convertible bonds of operating companies incorporated in the U.S., where 50% of the company's assets are used in active conduct of a trade or business and no more than 25% of its gross receipts can come from passive sources.

- The seller will not owe taxes until he later sells the QRP. If the 1042 Exchange is structured properly, the seller could avoid paying all long-term capital gains taxes in certain circumstances. If the selling shareholder dies before liquidating the QRP, thereby leaving the funds as an asset of the estate, the property receives a stepped-up basis and can avoid capital gains all together.

- Generally, for the sale of stock to qualify for the special tax treatment allowed under IRC 1042, certain criteria must be met.

    - ✓ The qualified securities must be sold to an ESOP
    - ✓ The selling shareholder must have held the stock for at least three years to qualify
    - ✓ Following the sale to the ESOP, the plan must own at least 30% percent of each class of stock or the total value of all outstanding stock of the corporation.
    - ✓ The seller must reinvest the proceeds into QRP within 12 months following the sale to the ESOP.

- Treasury Regulations Section 1.1042-1T prescribes the requirements of a proper 1042 Election. The taxpayer must make a written statement of election, attach it to his income tax return, and file on or before the due date (including extensions) for the taxable year in which the sale occurs. The domestic company must consent. Taxpayers who fail to make a timely election cannot subsequently make it on an amended return. And once made, elections are irrevocable.

Conclusion

Properly executed, a 1042 Exchange with an ESOP can be a tax-advantaged way for certain shareholders to sell their stock and delay and, potentially, avoid long-term capital gains tax. Stockholders interested in such a transaction should discuss the option with their attorneys and/or tax advisors.

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