



Section 1042: A tax deferred sale to an ESOP

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The "§ 1042" Rollover

Under § 1042 of the Internal Revenue Code ("IRC") eligible shareholders can defer capital gains tax on eligible stock sold to an ESOP if the proceeds of the sale are reinvested in qualified replacement property ("QRP").

Taxes will not be owed until the taxpayer has a disposition of the QRP. If structured properly, the taxpayer will avoid paying all long-term capital gains taxes.

Similar to the real estate provision IRC § 1031 and life insurance IRC § 1035.

Example of tax benefits

Assumptions:

- Transaction proceeds: \$10,000,000 (cash)
- Basis: \$0
- Federal Tax Bracket: 39.60%
- Federal Capital Gains Rate: 20%
- Medicare Surtax: 3.8%
- Washington DC Tax: 8.95% (Total Capital Gains Tax: 32.75%)

	No 1042 Election Pay Tax Upfront	1042 Election w/QRP Investment
ESOP Transaction Proceeds	\$10,000,000	\$10,000,000
<i>Less Basis</i>	\$0	\$0
Total Gain	\$10,000,000	\$10,000,000
<i>Less Capital Gains Tax</i>	\$3,275,000	\$0
Amount Available for Reinvestment + Equity in 1042	\$6,725,000	\$10,000,000

- Upon the taxpayer's sale of the QRP, the taxpayer will owe taxes on the entire amount in excess of basis plus any further growth associated with the QRP investment
- If QRP is held until death, the investment will receive a step-up in basis, eliminating taxes on the sale of stock to the ESOP.

Section § 1042 Requirements

Taxpayer must...

- be an individual, a trust, an underwriter selling securities, or a partnership
- hold stock in an eligible corporation that meet certain requirements
- have held the company stock for at least 3 years prior to the sale
- sell the shares of company stock to an ESOP sponsored by the “C corporation” that (after the sale) owns at least 30% of the issued and outstanding stock
- reinvest transaction proceeds into “qualified replacement property” either 3 months prior to the sale or within 12 months after the sale.
- meet certain tax filing requirements

Administration Considerations - § 1042

§ Section 409(n) of the Code

No portion of the assets of the ESOP attributable to (or allocated in lieu of) employer securities acquired by the Plan in a sale where § 1042 applies may accrue or be allocated during the non-allocation period for the benefit of any taxpayer who makes an election under § 1042(a), or any individual who is related to the taxpayer under the attribution rules of § 267(b). The non-allocation period begins on the date of the sale and ends on the later of the date 10 years later, or the date on which the final payment is made on the loan used to acquire such securities.

- except lineal descendants of the taxpayer if the allocations to descendants during non-allocation period do not exceed 5% of the total shares sold to the Plan by any person related to the lineal descendants.

- > 25% shareholders (directly or indirectly under § 318(a) attribution rules and any class of stock) are precluded from sharing in the allocation. The prohibition on allocations to > 25% shareholder usually extends indefinitely.

Administration Considerations - § 1042

§ Section 409(n) continued

Prohibited § 1042 group includes:

- Selling shareholders, individual who is related (5% total is allowed), and > 25% shareholder.

This group is prohibiting from getting:

- Allocation of shares in the § 1042 transaction, allocation in lieu of 1042 share allocations or earnings on the § 1042 shares.

§ 1042 shares must be tracked separately in the plan administration process. This separate tracking is needed to ensure that not only are the 1042 shares allocated correctly when first purchased or released from the unallocated suspense account but also that the shares are allocated correctly when reallocated either as forfeited shares or recycled shares. Separate tracking of the cash or other investment accounts within the ESOP is also recommended to ensure that allocations of items such as dividends or other earnings on the 1042 shares are not allocated to the accounts of the prohibited group.

Qualified Replacement Property

QRP includes the common stock, preferred stock, bonds, and convertible bonds of “operating companies” incorporated in the United States

- 50% of the company’s assets must be used in active conduct of a trade or business, and
- No more than 25% of its gross receipts can come from passive sources
- Note: QRP can be stock of another corporation that, though controlled by the selling shareholder, is not a member of a controlled group that includes the ESOP company

QRP does not include

- Securities issued by U.S. government agencies, non- U.S. entities, or U.S. subsidiaries of non-U.S. parents, FDIC insured certificates of deposit, mutual funds
- Securities issued by the corporation that issued the stock sold to the ESOP sale and/or its controlled group members

Qualified Replacement Property

Eligible¹

- Common Stock
- Convertible Bonds
- Corporate Fixed Rate Bonds
- Corporate Floating Rate Notes (FRN)

Not Eligible

- Municipal Bonds
- U.S. Government Bonds
- Mutual Funds
- Foreign Securities
- REITs
- Bank CDs

¹ More than 50% of its assets used in the active conduct of a trade or business at the time QRP is purchased or before the close of the 15 month period and no more than 25% of its gross receipts from passive sources for the taxable year preceding the taxable year in which such security was purchased.

§ 1042 Reinvestment Options

Passive Strategy

- Buy and hold a select portfolio of high-quality stocks and/or corporate bonds that will remain constant over the taxpayer's lifetime.

Active Strategy

- Purchase "leveraged" high-quality Floating Rate Notes (FRN) with a "monetization" loan.

Active Strategy Pros and Cons

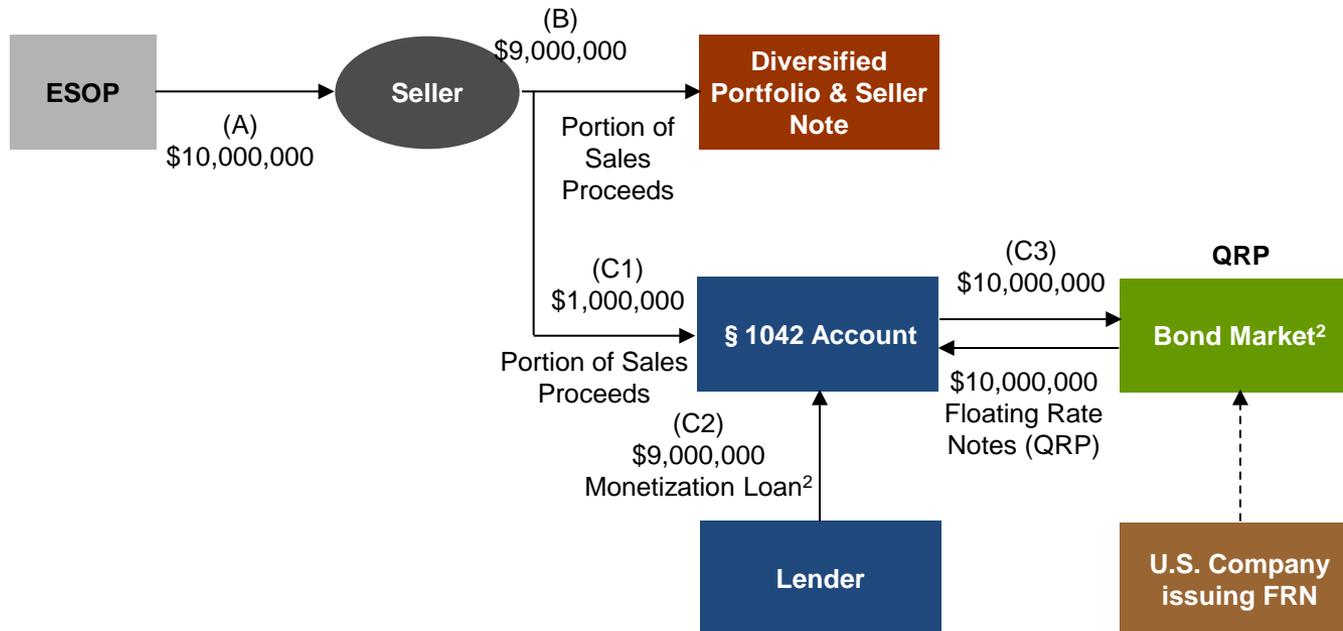
Advantages

- Deferral of capital gains tax
- Maximum amount of proceeds available for active investment and working for the benefit of the Selling Shareholder
- Investment flexibility through the use of the monetization loan that eliminates limits on permissible investments and frequency of trading

Disadvantages

- Interest rate environment may affect the cost to carry of the 1042 transaction
- Investor may experience a general higher degree of leverage
- Investor subject to credit quality of FRN issuers and any negative change may adversely impact the value of the underlying security
- A negative differential between investment interest income and investment interest expense (from the monetization loan) could result

Example of a § 1042 Active Reinvestment Strategy



UBS § 1042 Solution

- A. Seller receives total proceeds from ESOP sale of \$10,000,000 in cash and seller note
- B. Seller invests cash proceeds, less § 1042 deposit, of \$1,000,000 into a diversified portfolio
- C1. Seller deposits 10% of total proceeds (\$1,000,000) into a brokerage account with margin.
- C2. Lender provides a monetization loan for \$9,000,000¹
- C3. Seller uses the \$1,000,000 of sale proceeds combined with the \$9,000,000 of proceeds from the monetization loan to purchase \$10,000,000 of Floating Rate Notes as QRP²

¹ Subject to credit approval if UBS or Affiliates are the Lender.

² Depending on structure, UBS and Affiliates may or may not be the underwriter or the Lender. – Pursuant to SEC Rule 11(d) UBS cannot be both lender and issuer on a new FRN issuance
Please note: This illustration is hypothetical and the results shown are intended for demonstration purposes and are not actual results. No representation is made that the shareholder will achieve results similar to those shown. These results may not reflect certain economic and market factors which may impact the results achieved by the strategy.

§ 1042 Election Requirements

Filing Requirements

- Statement of Election (Taxpayer)
- Statement of Purchase (Taxpayer)
- Employer must execute a consent to the 1042 election

Disposition of QRP

Disposition of QRP triggers capital gains tax (based upon the taxpayer's basis in the original shares sold to the ESOP)

A “disposition” includes a sale but does **not** include

- Certain tax-free transactions that QRP issuer company enters into with another company
- A gift of the QRP
- Transfer upon the death of the QRP holder

Because death is not a “disposition,” the amount of the deferred tax can be completely avoided by holding the QRP to death because at death the tax basis of the QRP is stepped up (i.e., increased to the market value of the QRPs at date of death)

- Transfer of the QRP in connection with divorce
- Transfers to a grantor trusts including charitable remainder unitrusts (CRUT)
- Borrowing against QRP – which allows for the Active Reinvestment Strategy

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In addition, shareholders who sell into an ESOP should understand the applicable rules of the Internal Revenue Code of 1986, as amended ("Code"), including requirements for qualified replacement property as defined by Code section 1042 ("QRP"). Shareholders should understand the potential risks that may be associated with obtaining securities as QRP, sufficiency of available QRP in the market that satisfy the shareholder's investment objectives, limitations on UBS' ability to offer margin or financing for the purchase of a new-issue QRP where UBS has participated in the underwriting of such new issue, availability of QRP with put features and whether available QRP offers appropriate diversification. The foregoing is a general description of potential risks. Shareholders who invest in QRP should consult with their tax and legal advisors regarding their personal circumstances.

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