Some of you may be old enough to remember the 1970's Steve Martin outlandish claim that, “You can be a millionaire and never pay taxes.” When asked how such a thing would be possible, he responded, “First get a million dollars. Now you say, Steve, what do I say to the tax man when he comes to my door and says, ‘You have never paid taxes’? Two simple words: I forgot!” (It seemed funny in the late 70’s but maybe you had to be there.)

Within the laws governing Employee Stock Ownership Plans (ESOPs), Section 1042 of the Internal Revenue Code (IRC) provides a more defensible means to accomplish the ends proposed by Mr. Martin. You must still first get a million dollars—more specifically, you must own stock in a closely held company with sufficient value to warrant the establishment of an ESOP, but rather than forgetting to pay taxes, you must follow a set of intricate rules to defer, and possibly eliminate, taxes on the sale of your stock holdings. This article will summarize these rules; however, you should obtain appropriate legal, financial, and tax counsel if you decide to pursue a 1042 transaction.

The rules
Rule #1, you must sell the stock to an ESOP that has been established by the company whose stock you own (or a member of a controlled group of corporations including that company).

Rule #2, you must then reinvest the proceeds from this sale of stock in Qualified Replacement Property (QRP).

Under Section 1042, tax on the sale of your stock to the ESOP is deferred until you sell the corresponding QRP. Of course, when you do sell the QRP, you will pay taxes. But wait! Have the good sense to die before selling the QRP et voilà, your heirs receive a step-up in basis and no tax is paid on the sale of your stock!

We are talking about the IRC, so you know there are more than two rules. With some minor exceptions, the QRP can be any security issued by a U.S. operating company. There is a 15-month window for purchasing the QRP that begins three months prior to the sale to the ESOP, and ends one year after the sale is complete. You must make an election as part of your tax return to treat the sale as a 1042 transaction.

One strategy to make holding the replacement property until death palatable is to invest in long-term floating rate notes. These are notes of large U.S. corporations with terms of 40–50 years. The notes are considered the QRP and a monetization loan is obtained against the notes. The proceeds from this loan can then be invested and assets traded as desired. No tax is due on the sale of the original stock unless and until the QRP (the long-term notes) is sold or comes due. This strategy is complex and you should employ a knowledgeable financial advisor.

More rules: selling stock to an ESOP
Company stock must fulfill certain requirements in order to be held by an ESOP—for example, it must have a combination of voting power and dividend rights equal to or in excess of the class of common stock having the greatest voting power and the class of common stock having the greatest dividend
rights. But for your stock sale to the ESOP to be eligible for 1042 treatment, it must satisfy the following additional requirements:

1. The stock you sell to the ESOP must be stock of a C corporation that is not traded on an established securities market (Section 1042 is not available to S corporations).

2. You must have held the stock for at least three years and not have acquired the stock from a tax-qualified retirement plan (for example, from the ESOP itself).

3. The ESOP must own at least 30% of the company after the sale.

4. The ESOP must hold the stock for at least three years; otherwise, the company may have to pay an excise tax. There are, however, exceptions to this three-year rule.

Restrictions on ESOP allocations

The substantial tax benefit accorded to you for taking advantage of the 1042 transaction is accompanied by significant restrictions to assure that you, your family, and other major shareholders do not reap excessive benefits from the stock sold to the ESOP. First, no allocation of stock acquired by an ESOP in a 1042 transaction can be allocated to a 1042 seller or certain family members of the seller for a 10-year period. In addition, no 1042 transaction shares can ever be allocated to 25% owners of the company (determined during the 12-month period prior to the sale of the stock to the ESOP).

While 1042 transactions have been extremely popular over the years, during periods of low capital gain tax rates, many business owners who have established ESOPs have foregone the 1042 tax benefits to avoid the allocation and other restrictions inherent in a 1042 election. The recent escalation in capital gain rates has caused a resurgence in 1042 elections.

Section 1042 in action

Let’s look at an example of how a 1042 transaction might unfold. Employees Al, Barbara, Claire, Dan and Edward each own 20% of ABCDE, Inc. ABCDE, Inc. forms an ESOP, and in Year 1, Al sells all of his shares to the ESOP. Since the ESOP owns less than 30% of ABCDE, Inc. after the purchase of Al’s stock, Al is not eligible to make a 1042 election.

In Year 2, Barbara sells all her interest in ABCDE, Inc. to the ESOP. Since the ESOP now owns 40% of ABCDE, Inc. after the purchase of Barbara’s stock, Barbara can, and does, make a 1042 election. Barbara continues to work for ABCDE, Inc. but cannot receive any allocation of the stock she sold to the ESOP (Barbara has no other family members covered by the ESOP).

In Year 3, Claire sells her stock to the ESOP. The ESOP now owns 60% of ABCDE, Inc. Claire elects 1042 treatment for her sale and retires from the company but her two children, Clarence and Clara, continue to work for ABCDE, Inc. and are covered under the ESOP. Employees Barbara, Clarence, and Clara cannot receive any allocation of the shares acquired by the ESOP from Barbara or Claire.

In perspective

So, Steve Martin was right—you can be a millionaire and never pay taxes—if you invoke the IRC Section 1042 approach; however, Findley Davies | BPS&M does not recommend or endorse the “I forgot” strategy.

1 Saturday Night Live, Season 3, Episode 9. 1978.
2 Financial advisors generally suggest that the transaction should be at least $15 million in order to take advantage of these flexible rate notes.
3 A 25% owner is defined as owning at least 25% of any class of stock.
4 Some ESOP advisors have taken the position that for unrelated sales (e.g., the sales by Barbara and Claire) the seller and family members related to one sale are not precluded from sharing in the allocation of shares acquired from the other sale (i.e., Barbara could be allocated shares sold by Claire, and Clarence and Clara could be allocated shares sold by Barbara). Be aware, however, that there is risk in such a position absent a Private Letter Ruling from the IRS.
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Ken has spent 40 years in the retirement industry, 38 as an actuarial consultant with BPS&M. His primary area of expertise is in the design, funding, administration, and regulatory compliance of qualified and nonqualified retirement plans. His clients comprise a variety of employers, including Native American tribes, governmental entities, not-for-profit, and for-profit private employers. He heads the firm’s ESOP Practice Group and has extensive experience in assessing the feasibility of establishing ESOPs, including repurchase liability studies. He has presented at the annual Enrolled Actuaries Meeting on various employee benefits issues, has written articles on retirement plan topics, and has spoken at various venues, including IRS internal training seminars. Ken is the managing principal in our Louisville, KY office.

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