Unique Tax Deferral Opportunity with an ESOP Sale

By Mark R. Kossow / Feb 06, 2019

Under a specific set of facts, a C-corporation sale to an ESOP may be able to utilize the tax provision benefits of combining Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code") and Code Section 1042. If those facts are present, a seller of stock in a leveraged ESOP transaction may be able to receive some proceeds tax-free while deferring the remaining tax on the sale.

The best way to demonstrate how a leveraged ESOP transaction works is by example. Assume a business owner ("John") is looking to sell 40% of his company (a subchapter C corporation) to an ESOP for $15 million. Once the company, John and the ESOP negotiate the terms of the deal, the company will lend $15 million (the company obtains this money from either a commercial bank, company cash on hand, seller notes or a combination thereof) to an ESOP in exchange for a promissory note. The ESOP, in turn, uses the $15 million loan proceeds it just received from the company and purchases 40% of the company's stock from John. John formed the company on January 1, 2011, and received all of his stock in exchange for a capital contribution of $100,000. As such, John's tax basis in the stock being sold to the ESOP is $40,000 (40% of $100,000).

The sale of stock by John to the ESOP constitutes a sale or exchange by John generally taxable under Code Section 1001. In this example, John's realized gain would be $14,960,000 (15,000,000 – (100,000 x 40%). The resulting gain will be taxable as a capital gain.

There is potentially good news for John though. If the stock is "qualified small business stock" (QSBS) that he has held for more than 5 years, then, under Section 1202 of the Internal Revenue Code, John will be permitted to exclude a significant portion of the gain recognized on the sale to the ESOP. If John acquired the stock as a transfer by gift, by bequest or as a partner of a partnership, he may be entitled to count the holding period of the party that transferred the stock to him.

Generally, a taxpayer may exclude 50% of the gain from the disposition of QSBS that was held for at least 5 years. If the stock was acquired after February 17, 2009 but before September 28, 2010, a 75% exclusion applies. If the stock was acquired after September 27, 2010 the exclusion rate is 100%. The amount so excluded, however, will be capped at the greater of $10,000,000 (in the aggregate for all sales of such issuer's QSBS by the holder) or ten times the adjusted tax basis of the QSB stock of such issuer disposed of by the holder during the tax year.

There are five requirements that must be met in order for John's stock to meet the definition of "qualified small business stock":

1. The stock must have been originally issued after August 10, 1993
2. The issuing company must be a domestic C-Corp that is not a DISC, a cooperative, a regulated investment company or one for which a Section 936 election has been made (relating to Puerto Rico and Possessions tax credits).
3. The stock must have been acquired by John as an "original issuance" in exchange for money, property, or certain services performed. Note, however, that stock originally issued within a certain window of redemptions or reissuances by the corporation may not qualify, and stock received by gift, bequest or in a partnership distribution may qualify if the stock was originally issued by the company to the transferor.
4. The company must be a "qualified small business"

    - The corporation must have aggregate gross assets of $50,000,000 or less at all times on or after August 10, 1993 and before the issuance of the stock for which the exclusion is sought.
    - Immediately after the issuance of the stock, the aggregate gross assets (including amounts received in the issuance of the stock) must not exceed $50,000,000.
    - All corporations which are members of the same parent-subsidiary controlled group are treated as one corporation. Note, that a parent need only own greater than 50% of a subsidiary under this code section.

5. The company must conduct an active trade or business, meaning,

- at least 80% (by value) of the assets are used by the corporation in the active conduct of one or more qualified trades or businesses, which includes all but the following:
    - Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or one where the principal asset of the business is the reputation or skill of one or more of its employees;
    - Banking, insurance, financing, leasing, investing
    - Farming;
    - Oil and gas-related business;
    - Hotel, motel, restaurant or similar business
- No more than 10% of the company's assets (by value) may consist of real property which is not used in the active conduct or a qualified trade or business (i.e., dealing in and renting real property is not a qualifying business).

If the foregoing requirements of Section 1202 are met, John would be permitted to exclude $10,000,000 of his gain from the sale proceeds.

John (under certain circumstances and after the application of Code Section 1202 may be able to defer having to pay capital gains tax on the additional

$5 million in the sale proceeds.

Unlike private equity sales in which the additional $5 million in sale proceeds is subject to federal and state capital gains tax, with a sale to an ESOP John has the ability to defer capital gains tax by making a Code Section 1042 election. In order to have tax deferral treatment apply under Code Section 1042, the following criteria must be satisfied:

1. The company must be a subchapter C corporation. As of now, current law does not permit sellers of S corporations to effectuate a tax deferral election(1).
2. The ESOP must purchase qualified employer securities which means the stock sold to the ESOP must possess the best dividend and voting rights of all classes of stock(2) .
3. The selling shareholder must have held the stock for at least three years prior to the sale.
4. The ESOP must own at least 30% of the company following the sale.
5. The stock sold by the owner to the ESOP cannot have been acquired through the exercise of stock options or under some other form of employee benefit plan.
6. The selling shareholder cannot participate in the ESOP(3).
7. The selling shareholder must purchase qualified replacement property (QRP) within 3 months prior to the sale to the ESOP or within 12 months after the sale to the ESOP. QRP is essentially stocks, bonds, debentures or notes issued by domestic operating corporations. Investments in mutual funds or in foreign corporations will not qualify as QRP, thereby triggering capital gains tax.

In summary, it may be possible to stack the benefits of Code Section 1202 and 1042 whereby (as depicted in the above example) the first $10 million of gain is tax free and the remaining gain on the sale is tax deferred. It should be noted that the IRS has yet to explicitly bless this arrangement. As such, there is some element of risk associated with taking such a position.

About the Authors

Mark R. Kossow, a member of Clark Hill PLC, supports clients from banks and trustees to directors, shareholders and corporations on ESOP-related issues, encompassing both transactional and non-transactional matters. Mark also represents private and public ESOP companies. His transactional background includes representing clients in leveraged and non-leveraged ESOP transactions, consisting of stock purchases, mergers, leveraged buyouts, acquisitions and corporate reorganizations.

Mark's ESOP experience also expands to non-transactional issues in which Mark advises companies with regard to corporate governance issues, ESOP plan design and compliance, succession planning, and ERISA fiduciary issues. He is actively involved in representing ESOP clients in IRS and Department of Labor audits, and correction programs offered through these agencies (EPCRS and VFCP).

Tiffany Donio is a partner in the law firm of Archer & Greiner, P.C. Tiffany advises clients on a wide range of income tax matters, including planning, structuring and negotiating the tax aspects of M&A transactions. Tiffany serves as the Second Vice Chair of the Tax Section of the New Jersey State Bar Association.

Mark Flinchum is the partner-in-charge of Katz, Sapper & Miller's ESOP Services Group. Mark counsels clients on the unique opportunities and potential tax benefits of creating an ESOP, and provides guidance throughout the many stages of an ESOP transaction. Mark is a member of The ESOP Association and serves as a chapter officer of the Indiana Chapter and the National Center for Employee Ownership (NCEO).

Stephen Schnelker is a manager in Katz, Sapper & Miller's Tax Services Group. With a strong background in analytical research, Stephen brings his extensive tax law knowledge to help clients minimize tax liabilities and ensure tax compliance.

Endnote

1. On July 19, 2017, the bill entitled the Promotion and Expansion of Private Employee Ownership Act (S. 1589) was introduced. This bill, in part, would extend the deferral of capital gains tax to qualified sellers of subchapter S corporation stock.
2. Under Code Section 409(l)(3), convertible preferred stock may be able to qualify as employer securities in certain circumstances.
3. Moreover and pursuant to Code Section 409(n), any individual who is related to the selling shareholder (within the meaning of Code Section 267(b) cannot participate in the ESOP; and any other person who owns (after application of Code Section 318(a)) more than 25% of (a) any class of outstanding stock of the corporation or any member of the same controlled group, or (b) the total value of any class of outstanding stock of any such corporations, likewise cannot participate in the ESOP.