

The Business and Exit Planning Advisors – IRC Section 1042 Exchange



Wealth
Management

The Business and Exit Planning Advisors

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IRC Section 1042 allows an owner of a closely held C-corporation to defer capital gains tax on stock that is sold to an ESOP (employee stock ownership plan).

IRC Section 1042 and qualified replacement property

A 1042 ESOP Exchange may allow a shareholder to exchange his or her interest in a private company for a portfolio of qualified replacement property while paying minimal capital gains taxes on the transaction.

Capital gains tax can be deferred as long as the qualified replacement property is held. Through the use of IRC Section 1042, the qualified replacement property (QRP) can be assigned the basis of the original investment.

Some investments that may qualify for QRP:

- Common stock
- Preferred stock
- Convertible bonds
- Corporate fixed rate notes
- Corporate floating rate notes (FRNs)

If a U.S. corporation uses 50% or more of its assets in an active trade or business and does not receive greater than 25% of its gross receipts from passive income, the securities can be used as QRP.

These strategies may allow the business owner to sell their business and defer the tax until the securities mature, are called by the issuer, or sold. Thus, a business owner might be able to defer or eliminate capital gains on the sale of their business.

Wealth management and ESOPs

Business owners can generate income from their qualified replacement property by considering a range of income-generating securities. This approach may allow them to generate income with minimal tax obligations.

Reinvesting the proceeds from an ESOP can be complex and requires the assistance of a professional who is well-versed in ESOPs and qualified replacement properties. Business owners do not want to find themselves liable for taxes they thought they had deferred or unable to withdraw assets for fear of triggering tax consequences. We can work directly with your tax professional to help find the right strategy for you.

Comparison of using section 1042

The following illustration assumes that the seller(s) have a tax basis that is nominal relative to the transaction price. This may not be applicable to seller(s) that have S-corporation retained earnings. The seller should consult with their tax advisor to determine the tax basis in their company stock. The lower the seller(s) tax basis the more beneficial the Section 1042 election.

Potential Impact of Federal and State Taxes on a 1042 Transaction		
Transaction proceeds	\$20,000,000.00	
Basis	—	
Federal capital gains rate	20.0%	
Medicare surtax	3.8%	
Average state income tax	6.0%*	
Total capital gains tax	29.8%	
	No 1042 election pay tax upfront	1042 election with QRP investment
ESOP transaction proceeds	\$20,000,000.00	\$20,000,000.00
Less basis	—	—
Total gain	\$20,000,000.00	\$20,000,000.00
Less capital gains tax	\$5,960,000.00	—
Amount hypothetically available for reinvestment and equity in 1042	\$13,450,000.00	\$20,000,000.00

This chart is for illustrative purposes and not intended to be representative of any specific investment vehicle. The chart does not necessarily represent the experiences of other clients, and it does not indicate future performance. Results may vary. This material is based on data obtained from sources we consider to be reliable; however, it is not guaranteed to accuracy and does not purport to be complete.

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Nothing in this assumption constitutes legal, accounting or tax advice or individually tailored investment advice. Past performance is no guarantee of future results, future returns are not guaranteed, and a loss of original capital may occur.

* Source: www.taxfoundation.org; tax rates thru 2023