INSIGHT: Stock Ownership Plans Can Minimize Tax on Liquidity Event

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Qualified small business stock and employee stock ownership plan transactions can reduce or completely eliminate federal income tax on a liquidity event. Eric Bardwell of Jeffer Mangels Butler & Mitchell and Jeremy Huish of Business Transition Advisors explain how two frequently overlooked tax provisions work.

Two often overlooked tax code provisions may allow business owners to avoid a common scenario when selling a company—losing over one-third of the proceeds to taxes. With proper planning, selling to an employee stock ownership plan (ESOP) or a qualified small business stock (QSBS) sale could help business owners defer and potentially eliminate the long term capital gain tax.

Employee Stock Ownership Plans

A tax code Section 1042 election for companies selling to an ESOP is similar to the popular Section 1031 exchange available to defer income taxation on real estate gain. The Section 1042 election allows a business owner to sell the stock of the business and defer the federal and state capital gains tax if the proceeds are rolled over to stocks and bonds of another U.S. company, and if certain other requirements are satisfied.

At a high level, those requirements are:

- At least 30% of the company's stock is sold to an ESOP.
- The seller has owned the company for at least three years prior to the sale.
- The company is a C-corporation, or can convert to be a C-corporation, at the time of the sale, and the stock is not publicly traded.
- The seller "rolls over" the proceeds of the sale by reinvesting them in qualified replacement property (QRP) within a 15-month period ending one year after the

date of sale. Mutual funds and government securities do not qualify as replacement property.

- The seller, the seller's children and certain other relatives, and shareholders who own 25% or more of the outstanding shares of the company, are prohibited from receiving allocations of the stock acquired by the ESOP.
- The rollover must be elected in writing on the seller's income tax return.

If these and other requirements are met, then federal and, in most states, state income taxes are deferred until the QRP is subsequently liquidated. However, if the seller is still holding QRP at his or her death, then the QRP will receive a step-up in basis and the taxation on the gain will be avoided entirely.

Qualified replacement property generally includes securities (debt or equity) issued by a domestic operating corporation which does not have passive investment income in excess of 25% of the gross receipts of the corporation, uses more than 50% of the assets in the active conduct of a trade or business, and is not in the same controlled group of companies as the business being sold.

Qualified Small Business Stock

Section 1202 allows taxpayers to exclude up to 100% of the federal capital gains they realize on the sale of QSBS held for at least five years. Many entrepreneurs and investors, as well as their tax advisors, are not aware that they may be eligible for this benefit.

In order for stock to qualify as QSBS, the following requirements must be satisfied:

- The stock must be issued by a U.S. C corporation any time after Aug. 9, 1993.
- The stock is issued by a corporation whose aggregate gross assets must not exceed $50 million at any time from Aug. 9, 1993, through the date of issuance of the QSBS.
- The stock is issued by a corporation in which at least 80% of its assets are used in an "active business" for "substantially all" of the shareholder's holding period of the QSBS.
- The stock is held by the shareholder for more than five years (although as long as a shareholder holds the eligible stock for more than six months, there is an option for a rollover).
- The stock is acquired by the shareholder directly from the corporation, but–

- QSBS can be gifted during life or transferred at death by the original shareholder and still be eligible (in which case the date of acquisition by the donor/decedent is the acquisition date).
- QSBS can be acquired by a partnership and distributed to its partners if they were partners on the date the entity acquired the QSBS and they receive a pro rata share of the QSBS benefit equal to the percentage of the partnership they owned when it was acquired.
- QSBS can also be held by a partnership or S corporation, and the partners or shareholders may exclude their share of any capital gain they recognize on the sale of the QSBS if they held their interests on the date the QSBS was acquired.
- QSBS can be acquired if an entity formed and taxed as a partnership later converts to a C corporation in a Section 351 nonrecognition transaction.
- QSBS can also be acquired by exercise of an option, exercise of a warrant, or conversion of a convertible note, in which case the exercise or conversion is treated as the acquisition date.

Assuming stock qualifies as QSBS, the amount of eligible capital gain that may be excluded from federal income tax is equal to the greater of $10 million, reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior tax years for sales of QSBS in the same corporation, or 10 times the aggregate adjusted basis of QSBS that the taxpayer sold during the current tax year.

The percentage of eligible capital gain that may actually be excluded from federal income tax depends on when the shareholder acquired the QSBS. For stock acquired after Aug. 9, 1993, but before Feb. 18, 2009, 50% of the eligible capital gain is excluded from federal income tax; for stock acquired on or after Feb. 18, 2009, and through Sept. 27, 2010, 75% of the eligible capital gain is excluded from federal income tax; and for stock acquired on or after Sept. 28, 2010, 100% of the eligible capital gain is excluded from federal income tax.

The 10 times aggregate adjusted basis limitation can be used to greatly increase the amount of eligible capital gain. For example, if an entity formed as an LLC later converts to a C corporation in a Section 351 nonrecognition transaction, the C corporation stock will be considered ”issued“ as of the date of the conversion, and the basis in the stock for QSBS gain exclusion purposes will be the fair market value of the LLC interests at the time of conversion, as opposed to the basis of the LLC interests.

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Through tax planning in advance of an acquisition or sale of QSBS, the capital gains exclusion can be multiplied as the maximum amount of the exclusion applies on a per shareholder basis. In addition, taxpayers residing in high income tax states have the opportunity to reduce their exposure to state income taxes using non-grantor trusts. Examples of how a shareholder may take advantage of the ability to multiply the QSBS exclusion include:

- Gifting QSBS to one or more family members so that each of the parties would qualify for the capital gains exclusion.
- Gifting, including the possibility of an incomplete gift, QSBS to one or more non-grantor irrevocable trusts.
- A non-grantor irrevocable trust could make a distribution of QSBS to one or more beneficiaries.
- An existing non-grantor irrevocable pot trust could split into separate trusts for each beneficiary.
- A taxpayer can gift QSBS to one or more charitable remainder unitrusts.

While eligibility for the benefits afforded to those selling QSBS requires the stock be held for a period of at least five years, if QSBS is sold before this five-year holding period requirement is satisfied, a taxpayer (other than a corporation) can still retain the potential for the capital gains exclusion.

Under Section 1045, if the taxpayer has held the QSBS for more than six months before selling it, and the taxpayer rolls the amount realized from the early sale of the original QSBS into new QSBS within 60 days, the taxpayer will recognize capital gains only to the extent that the amount realized on the sale of QSBS exceeds the cost of the replacement QSBS. This may seem unattractive for one selling a business which comprises their primary source of income, but for the venture capitalist who invests in numerous start-ups, the ability to roll the QSBS holding period into future investments until the five-year holding period is met can result in significant tax savings.

Utilizing Sections 1042 and 1202

There are similar requirements in both an ESOP Section 1042 election and a QSBS transaction. While both potentially may be elected on an ESOP transaction, practically speaking a seller would likely choose one or the other as Section 1042 is applied proportionally on the transaction proceeds and cannot be itemized to a particular block of proceeds (i.e., Section 1042 cannot be itemized to cover only the non-QSBS portion of the sale).

There are scenarios where a business could utilize one strategy for a partial sale and the other on a second sale. In the following example assume all the relevant requirements are satisfied. A taxpayer wishes to gain some liquidity by selling a minority interest in his business to an ESOP. The taxpayer may take advantage of Section 1042 to defer that taxable gain. Later, the taxpayer could sell the remaining interest in the business to a private equity buyer and exclude the gain as QSBS. Alternatively, the two shareholders (taxpayer and ESOP) could sell 100% of the business to the private equity buyer, with the taxpayer potentially excluding some or all of his portion of the gain as QSBS and the ESOP as a qualified plan would not pay tax on its portion. The proceeds in the ESOP would flow into the employees qualified retirement plan accounts.

For business owners and investors contemplating the sale of a company, there are a variety of tools which may reduce, defer, or altogether eliminate their income tax exposure. Thus, when it comes to taxes, one should always keep in mind that what you don't know can't help you (and may even end up hurting you).

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