The shareholder of a C corporation can defer or eliminate capital gains taxes when he or she sells stock to an employee stock ownership plan (ESOP). To accomplish this, the selling shareholder must elect Section 1042 of the IRS Code and meet all the requirements therein. One of the requirements of the 1042 election is that the seller reinvest (rollover) the sale proceeds into qualified replacement property (QRP). This article will define and detail QRP and its requirements. Future articles will tackle other 1042 rules and requirements.

In general, once a portfolio of QRP is selected the securities cannot be traded, sold, or redeemed without triggering the deferred capital gains taxes. However, the selling shareholder can eliminate the capital gains taxes altogether by passing the QRP to their heirs through their estate. They can also eliminate the taxes by donating the QRP to charity. Given these stringent requirements it is important that any purchased QRP be integrated into a broader wealth management plan.

Additionally, if the seller wants liquidity with the sale proceeds there are portfolio investment options that can provide them with that liquidity while still qualifying as QRP. For instance, floating rate notes (FRN) can provide flexibility to the shareholder while still meeting the 1042 election requirements. The FRNs can be purchased on margin, which affords the seller access to the remaining sale proceeds. The downside is that there is an ongoing cost associated with purchasing FRNs on margin.

**What is Qualified Replacement Property?**

An investment will be QRP if it consists of securities of a corporation domiciled in the United States— the domestic operating company rule. The securities can be either equity or debt: common stock, preferred stock, corporate fixed-rate bonds, convertible bonds, or FRNs. Securities of privately held corporations can also constitute QRP as long as the other requirements are met.
Securities that do not qualify include: federal and local government bonds, mutual funds, bank CDs, real estate investment trusts, ownership through means other than a security, and securities from the company that established the ESOP or any member of a controlled group with the ESOP sponsor.

In order to be considered a domestic operating company the corporation must meet both an asset test and an income test. Specifically, the corporation must use more than 50 percent of its assets in the active conduct of a trade or business and cannot have passive income exceeding 25 percent of its gross receipts in the year preceding the purchase. For example, American companies such as telecommunications giant Qualcomm and fast food retailer McDonald's do not meet the above QRP requirements due to the passive nature of their licensing and franchise fees respectively.

It should be noted that securities purchased as QRP only need to meet the QRP requirements in the year they are purchased. For example, if Proctor & Gamble common stock is purchased as part of a portfolio of QRP, but at a later date the company no longer met the income and/or asset test, the shareholder would still maintain their tax deferred status. One exception occurs if a merger takes place and the security, in this case P&G common stock, is sold for cash. This kind of transaction is viewed as a sale of the QRP security and would trigger capital gain taxes for that security, even if the shareholder wanted to reinvest in other QRP.

**Timeframe**
Proceeds from the sale to the ESOP must be reinvested in QRP during the defined "replacement period." The replacement period can be as early as three months prior to the transaction but no later than 12 months after the transaction.

Additionally, most advisors will recommend that the proceeds of the sale are immediately placed in temporary QRP until a portfolio of final QRP can be established and declared to the IRS no later than 12 months after the transaction. Placing the proceeds in temporary QRP ensures that their tax advantaged status is not lost in the event that the selling shareholder passes away prior to final QRP selection.

**Documentation and Procedural Requirements**
There are three primary documents that must be filed with the selling shareholder's tax returns. (1) The statement of election is to be completed upon the sale of stock to the ESOP. The statement must then be attached to the seller's tax return for the filing year when the transaction takes place. (2) The seller must also file a statement of consent with their tax return. The statement of consent is signed by an officer of the company that established the ESOP, and it consents to the imposition of excise taxes if a prohibited ESOP allocation is made or if the three-year holding period of purchased shares is violated. (3) Finally, for every QRP security purchased, the seller must file a notarized
statement of purchase. These documents must be completed on time and properly to avoid paying the capital gains.

**Is 1042 Right For Me?**

Whether a selling shareholder should elect Section 1042 is dependent on many factors, foremost of which is the shareholder’s personal situation and objectives. There is additional time and costs associated with electing Section 1042, such as accounting, legal, and advisor fees. If the cost basis of the shares sold to the ESOP is very low and the capital gains taxes are relatively high, 1042 election can result in substantial growth and optimize wealth transfer. However, if the cost basis is closer to the selling share price or the seller has no heirs, then electing 1042 may not be optimal.

In conclusion, if Section 1042 is elected it is also critical that care be given when composing a portfolio of QRP to ensure all requirements are met, and the shareholder is successfully able to defer capital gains on their proceeds. Lastly, the purchase of QRP should always be integrated into a broader wealth management plan.

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*Damien Vira, 2015 Rady MBA candidate*