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The 1042 Rollover Resurrected Interest in Tax Benefits for Selling Shareholders in ESOP Transactions

For many business owners, the investment in their company is their most significant asset. Shareholders of closely held businesses, particularly those on the crest of the baby boom wave, are rigorously searching for exit plans to diversify their portfolios and to plan for the next stage of life. It certainly helps if the exit plan is aligned with a compelling estate and tax strategy. In this era of challenging credit conditions and economic uncertainty, interest in Employee Stock Ownership Plans ("ESOPs") is rising as sellers come to understand the varying opportunities related to transaction financing and to potential tax benefits accorded qualified sellers to ESOPs. One such potential benefit for selling shareholders is the 1042 rollover.

Internal Revenue Code Section 1042 provides beneficial tax treatment on shareholder gains when selling stock to an ESOP. Given certain conditions, capital gains tax can be deferred allowing the full transaction proceeds to be invested in Qualified Replacement Property ("QRP"). Long-term capital gains are recognized upon the liquidation of QRP securities at a future date after a required minimal holding period. If the QRP is not liquidated and becomes an asset of the seller's estate, it enjoys a stepped up basis and avoids capital gains completely.

SUMMARY REQUIREMENTS

In order for the sale of stock to qualify for a 1042 rollover, several requirements must be met:

1. The seller must have held the stock for at least three years;
2. The ESOP must own at least 30% of the total stock immediately following the sale; and,
3. The seller must reinvest the proceeds into "qualified replacement properties" within a 12 month period after the ESOP transaction.

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Qualified replacement property is defined as stocks and bonds of United States operating companies. Government securities do not qualify as replacement properties for ESOPs. The seller must invest in these properties within a 15 month period beginning three months prior to the sale and ending 12 months after the sale. The money that is invested can come from sources other than the sale, as long as that amount does not exceed the proceeds. However, not all of the proceeds have to be reinvested. If the seller chooses to invest less than the sale price, then he or she will have to pay taxes on the amount not invested in QRP. In order to meet the 30% requirement, two or more sellers may combine their sales, provided that the sales are part of a single transaction. The sponsor Company must be a C Corporation for selling the shareholder to qualify for a 1042 rollover.

The shares sold to the ESOP can not be allocated to the ESOP accounts of the seller, the relatives of the seller (except for linear decedents receiving 5% of the stock and who are not treated as more-than-25% shareholder by attribution), or any more-than-25% shareholders.

1042 ROLLOVER BENEFITS

The current federal capital gains tax is 15%, but if no legislative action is taken, on January 1, 2011, the federal (long-term) capital gains tax will revert to 20%, making the 1042 rollover option more attractive and beneficial to business owners. If an owner with a \$2,000,000 basis sells his or her shares for \$5,000,000 and realizes a capital gain of \$3,000,000, he or she would defer or save \$450,000 in capital gains taxes under today's tax structure. Given no legislative action and a 2011 reversion to previous capital gains rates of 20%, a seller would defer or save \$600,000 in federal capital gains tax on the sale as shown below.

	2010	2011
Sale Price / Proceeds	\$5,000,000	\$5,000,000
- Basis	\$2,000,000	\$2,000,000
= Long-Term Capital Gain	\$3,000,000	\$3,000,000
x Federal Long-Term Capital Gains Tax Rate	15%	20%
= Capital Gains Tax Savings	\$450,000	\$600,000

If legislative action is taken that results in an even higher capital gains tax rate, a 1042 rollover becomes even more attractive.

Leveraging the sale of stock to the ESOP can provide further financial benefit to the company and its shareholders. Sellers often use all or part of their replacement property as collateral for loans used to finance ESOP purchases. Financing costs are significantly lower for corporations that borrow to purchase owner's stock for ESOPs than for conventional stock redemption because the corporations are able to deduct the principal and interest payments on the loan when used to purchase ESOP stock. If a corporation is in the 34% tax bracket and borrows \$5,000,000 to purchase the ESOP stock, it would save \$1,700,000 in federal income taxes. Combined with the \$450,000 in savings with the current capital gains tax rate, the federal tax



Travis W. Harms, CFA, CPA/ABV
featured speaker at

**2010 Annual Conference of the
New South Chapter of
the ESOP Association**

Travis, one of the internal trustees of Mercer Capital's ESOP, will be joining Marshall Bartlett of Independence Trust Company and Chuck Morn of the North Highland Company to discuss

**"Internal vs. External ESOP
Trustee :: Pros and Cons"**



**October 6-7, 2010
St. Petersburg, Florida**

savings would be \$2,150,000 or 43% of the selling price. If capital gains tax rates revert to the previous rate of 20%, the total federal tax savings would be \$2,300,000 or 46% of the selling price.

	2010	2011
Loan for ESOP Purchase	\$5,000,000	\$5,000,000
Tax Bracket	34%	34%
Tax Savings from P&I Deduction	\$1,700,000	\$1,700,000
+ Capital Gains Tax Savings	\$450,000	\$600,000
Total Federal Tax Savings	\$2,150,000	\$2,300,000
Total Savings / Sell Price	43%	46%

S CORPORATIONS

Although S Corporations are allowed to have ESOPs, the 1042 rollover option is not available to the shareholders. In most cases, there is a 25% limit on tax-deductible contributions made by employers to ESOPs. C Corporations do not have to count interest payments on ESOP loans as part of the 25% limit, but S Corporations do. There is no required length of time during which a corporation must have C status to receive the benefits of the 1042 rollover, which means that an S Corporation can change its status and receive the deferred tax benefits without delay. However, this change in status can have negative tax effects that would cancel out any benefits gained from the 1042 rollover status due to different accounting methods, so a change in status may not always be the best option.

ESOP FINANCING

Given the corporate development criterion of most strategic and financial buyers in the markets today, relatively few small-to-medium sized business owners can achieve an exit via a transaction with an external buyer. Throw in the difficulties of financing acquisitions and many shareholders of successful and sustainable businesses may be locked out of certain exit strategies. Increasingly, sellers to ESOPs are financing their own transactions. Before the financial crisis struck, many ESOPs sellers found that continuing business involvement and loan guarantees were required by ESOP lenders. The realization: seller financing in today's market represents little incremental risk and time than in previous more favorable markets. True, many valuations may be lower than a few years back, but most good ESOP candidates have likely fared better than the markets as a whole. Absent the need for lump sum liquidity, and given a strong and early start to longer-term exit planning, seller-financed ESOPs may be a viable and preferable path for many closely held business owners.

WHAT GOES DOWN MUST GO UP

Confused? We're alluding to taxes – in the context of a nation whose thirst for government spending had been both red and blue in the past ten years and shows little sign of being quenched. The likely result, relentless tax pressures even if significant belt tightening occurs. For those business owners committed to the long-term success of their businesses, concerned

“ESOPs represent one of the few exit plans that can be timed and entered into without a change of control. In an increasingly uncertain world, throw in a healthy dose of tax advantages for qualified sellers and it is hard not to view the ESOP with increased interest.”

about the fate of their employees, and who have a desire for favorable tax treatment in the course of achieving succession and exit planning, the ESOP is a viable alternative. As taxes went down in previous years, so it seems they are going up. As ESOP formation waned in a previous market where external exit opportunities abound and have now collapsed, ESOP formation appears primed to go up. ESOPs represent one of the few exit plans that can be timed and entered into without a change of control. In an increasingly uncertain world, throw in a healthy dose of tax advantages for qualified sellers and it is hard not to view the ESOP with increased interest.

Mercer Capital has over 25 years of experience providing ESOP valuation services and is employee-owned, giving us a unique perspective. For more information or to discuss a valuation issue in confidence, give us a call at 901.685.2120.



Wendy S. Ingalls, CPA/ABV, CBA, ASA
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Business Valuation & Transaction Advisory Services

Mercer Capital is an employee-owned independent business valuation and investment banking firm. We are one of the largest business valuation firms in the nation, serving both private and public companies, as well as high net-worth families. Mercer Capital's ability to understand and determine the value of a company or financial institution has been the cornerstone of the firm's services and its core expertise since its founding.

In addition, Mercer Capital has been successfully executing mergers & acquisitions for a broad spectrum of middle-market companies since the mid-1980s. We specialize in providing merger & acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, Mercer Capital assists clients in industry consolidations, roll ups, and refinancings.

We provide the following services:

- » Valuations for tax compliance
- » ESOP valuation services
- » Corporate valuation services
- » Litigation support services
- » M&A representation services
- » Fairness opinion services
- » Transaction advisory services

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Survey Results

The Future of the Estate Tax

In June, 2010 we surveyed hundreds of estate planners on the question of “how likely do you think it is that Congress will let the current estate tax law sunset, returning us to pre-2001 provisions?” The results were interesting.

Of the members of ACTEC (the American College of Trust & Estate Counsel) surveyed, 58.4% thought it was either very likely or somewhat likely that Congress will let the current estate tax law sunset. Comments from survey participants included “I’ve been predicting to clients that Congress will not get anything actually passed until after the November elections.” Other comments included what one might suspect: “clarification is badly needed,” “these are interesting times that make it tough to advise clients,” “terrible mess,” “inaction by Congress is unconscionable,” “we are in this awful situation due to Congressional malpractice,” and our personal favorite “God help us.”

Of the broader group of estate planners surveyed (estate planning attorneys, CPAs, CFPs, and other advisors to business), 63.1 % thought it was either very likely or somewhat likely that Congress will let the current estate tax law sunset.

Comments from this group included “Most congressmen own a house in DC and at home that are worth more than \$1 million combined, so I don’t think they will go back to that level,” “vote responsibly,” “plan for preservation of wealth as well as reduce taxes,” “uncertainty is making clients uneasy and unlikely to take needed actions until final legislation is passed,” “taxes will go up and the IRS will become increasingly aggressive and unreasonable in their demands,” “it is easier than ever for clients to put off planning in the current economic and political landscape absent compelling personal desire,” and we think a wise comment, “expect the worst.”

A recent article from *Investment News* discusses the possible directions the estate tax could go as we enter this election season and move towards 2011. Those quoted in the article appear to agree that Congress will not let the current estate tax law sunset but will agree on a level between \$3.5 and \$5.0 million phased in over time.

Joseph Hahn, author of the very informative blog, *Hahn’s Estate Planning Attorney Blog* (www.hahnestateplanning.com), said on August 9, 2010 in response to this article “I think that may be optimistic. There seems to be no room for compromise in the Republican caucus, with most stuck in an ideologically-pure position of demanding a total repeal. That position was repudiated in a Senate vote last month, but that doesn’t appear to have given Republican members any greater room for flexibility. They may be holding out hope that election gains this year will breathe life back into their quest for total repeal. In the meantime, such an approach guarantees a stalemate in the Senate and no action for the foreseeable future. Many members in the Democratic caucus would be happy to allow the 2011 rules to take effect both for policy reasons as well as deficit reduction. Where we end up, nobody knows.”

“Comments from survey participants included ‘clarification is badly needed,’ ‘these are interesting times that make it tough to advise clients,’ ‘terrible mess,’ ‘inaction by Congress is unconscionable,’ ‘we are in this awful situation due to Congressional malpractice,’ and our personal favorite ‘God help us.’”

While there has been much speculation, in our planning, we remember a year ago when it seemed inconceivable that Congress would let the estate tax lapse in 2010. Every pundit or “in the know” person we monitored predicted that Congress would surely “fix it” before January 1, 2010. Why? Revenue was needed. Clarity was needed. It was the seemingly logical thing to do.

No “fix” came.

Then, for the first three months of this year, many of those same pundits thought surely Congress would “fix it” and make that fix retroactive to January 1, 2010. As we end September, 2010, no “fix” has happened and more and more people are seriously entertaining the thought that on January 1, 2011, we could find ourselves with pre-2001 provisions. Given the folly of the “certainty” of last year, it seems that the prudent course is to believe that nothing is certain and prepare accordingly.

Which brings us to the question of “how aggressive are you currently in advising your clients to take active gift/estate tax planning steps?”

Half of the ACTEC member survey respondents were very or somewhat aggressive in advising their clients to take active gift and estate tax planning steps this year. They also reported that 70.9% of their clients were responsive to their suggestions.

Of the broader group of estate planners surveyed, 55.8 % were very or somewhat aggressive in advising their clients to take active gift and estate tax planning steps this year. 64.6% of their clients were responsive to their suggestions.

The estate tax landscape is uncertain at best. We will continue to monitor the situation and report our findings to you. In the meantime, follow the blog *Future of the Federal Estate Tax* (<http://mhs.typepad.com/threepointfive-45/>) for many of the latest updates.

Mercer Capital has over 25 years of experience providing objective valuations for tax compliance. Our opinions of value are well-reasoned and well-documented, which provide critical support for any potential challenge. The overwhelming majority of the time, our work has resulted in quiet acceptance by the IRS, state, and local taxing authorities.

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“Of the members of ACTEC surveyed, 58.4% thought it was either very likely or somewhat likely that Congress will let the current estate tax law sunset.”

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How to Know Your Agreement Will Work
Without Triggering It



BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

Z. Christopher Mercer, ASA, CFA, ABAR

Foreword by Tom Deans, Ph.D.
Author of *Every Family's Business*

BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

“The business owner’s self-defense manual”

– Stephan R. Leimberg, Leimberg Information Services, Inc.

Chris Mercer’s book on buy-sell agreements is a grand slam. Because it uses plain language to explain complex terminology related to buy-sell agreements, attorneys and CPAs will find it to be a very helpful resource when advising their clients about buy-sell agreements, especially the pitfalls of various agreements. I was so impressed with the book that I ordered additional copies and sent them to tax attorneys who we work with on a regular basis.

James A. Koerber, CPA/ABV, CVA, CFE, CFF

The Koerber Company, PA.

This book is very well-researched, easy to understand, and contains numerous helpful examples. It reminds us in great detail how many of the components of a buy-sell agreement cause more problems than they solve. I particularly liked the charts that succinctly presented the advantages and disadvantages of the important elements of a good buy-sell agreement. Also, this book is not just for valuation analysts. Business owners should read it too. It is also a must-read for CPAs, financial planners, attorneys, and anyone else who advises business owners.

James R. Hitchner, CPA/ABV/CFF, ASA

Managing Director, Financial Valuation Advisors
Chief Executive Officer, Valuation Products and Services
President, Financial Consulting Group

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NOW
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How to Know Your Agreement Will Work
Without Triggering It



BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

Z. Christopher Mercer, ASA, CFA, ABAR

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Author of *Every Family's Business*

BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

by **Z. Christopher Mercer, ASA, CFA, ABAR**

Buy-sell agreements are among the most common yet least understood business agreements, and many are destined to fail to operate like the owners expect. Many, in fact, are ticking time bombs, just waiting for a trigger event to explode. If you are a business owner or are an advisor to business owners, this book is designed to provide a roadmap for business owners to develop or improve your buy-sell agreement.

WHAT IS THE DIFFERENCE BETWEEN THIS BOOK & CHRIS MERCER'S LAST BOOK ON BUY-SELL AGREEMENTS?

This book is written specifically for business owners. It is conversational in tone, straight to the point, and contains resources and recommendations every business owner subject to a buy-sell agreement requires.

If you are a business owner, you need a copy of this book. If you advise business owners, purchase copies as gifts for them as a way to begin a conversation about their buy-sell agreement. It will mean more business for you and will be of great benefit to your clients by potentially saving them from a buy-sell agreement that won't work.

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NEW ARTICLE

New Article – 5 Things to Know About Proposed Changes to ASC Topic 820

The FASB issued an exposure draft regarding a broad range of proposed amendments to Topic 820 on June 29, 2010, with a comment period extending through September 7, 2010. The exposure draft is part of the ongoing convergence project and is intended to more closely align fair value measurements under U.S. GAAP and IFRS. For the sake of our busy friends and colleagues who may not have reviewed the exposure draft yet, we offer a quick overview of some of the more significant proposed changes. [READ THE ARTICLE HERE.](#)

NEW PUBLICATION

Valuation for Impairment Testing: 2nd Edition

For auditors and financial statement preparers, recent market activity suggests that the goodwill reported on many corporate balance sheets may be impaired. This book demystifies the steps involved in performing a goodwill impairment test, discussing the pros and cons of performing the analysis in-house, the expectations of company management, the steps involved in completing a valuation, and offering some suggestions on how to ensure a smooth impairment testing process. [ORDER HERE.](#)



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INDUSTRY PUBLICATIONS

Mercer Capital's Value Focus Industry Publications

The 2nd Quarter 2010 issues of Mercer Capital's industry publications, *Value Focus*, are available now. They include the asset management industry, the medical device industry, the insurance industry, the beverage industry, and the construction industry. Each issue of *Value Focus* includes a segment focus, market overview, mergers and acquisitions review, and more. [VIEW THE ISSUES AND/OR SUBSCRIBE HERE.](#)

SELECTED LIST OF RECENT & UPCOMING SPEAKING ENGAGEMENTS

October 3, 2010

“Demystifying Distributorship Valuation: Translating and Understanding Your Valuation in an Evolving Market”

National Beer Wholesalers Association Annual Convention
Chicago, Illinois

Timothy R. Lee, ASA

October 4, 2010

“The Market vs. the Income Approach”

ASA/CICBV 2010 Annual Conference
Miami Beach, Florida

Z. Christopher Mercer, ASA, CFA

October 6, 2010

“Issues for the Management of an International Business Valuation Assignment”

International Business Valuation Summit
Miami Beach, Florida

Z. Christopher Mercer, ASA, CFA

October 7, 2010

“Internal vs. External ESOP Trustee :: Pros and Cons”

New South Chapter of the ESOP Association Annual Conference
St. Petersburg, Florida

Travis W. Harms, CFA, CPA/ABV

October 22, 2010

“Buy-Sell Agreements”

Tennessee Society of CPAs Business Valuation Conference
Nashville, Tennessee

Z. Christopher Mercer, ASA, CFA

November 7, 2010

“Using Methods Under the Cost Approach and Market Approach to Fair Value”

AICPA 2010 National Business Valuation Conference
Washington, D.C.

Travis W. Harms, CFA, CPA/ABV

To see a complete list, visit the Speaker's Bureau section of our web site at www.mercercapital.com. To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at priceb@mercercapital.com, or by calling 901.322.9724.

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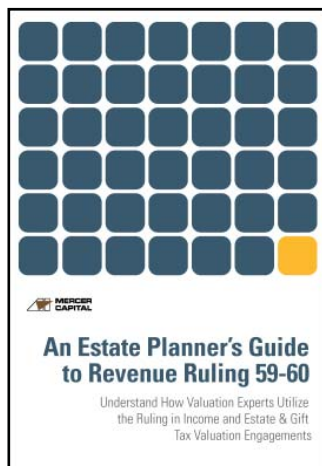
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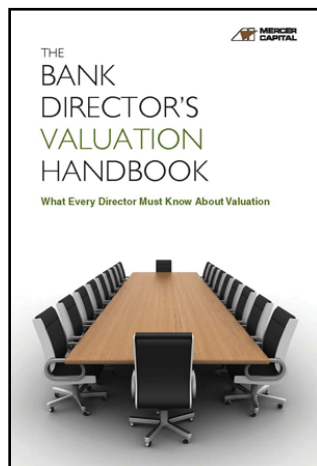
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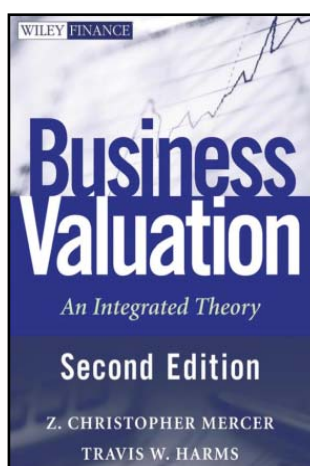
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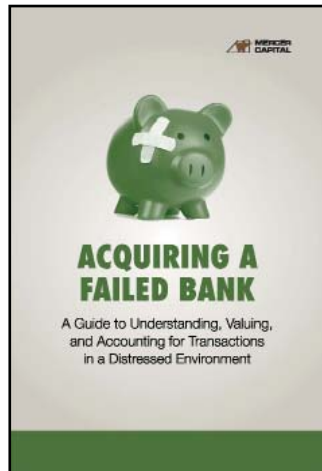
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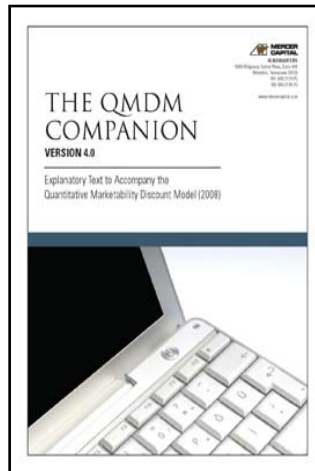
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