More Ways to Save with ESOP Rollovers

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One of the truly great provisions of the now-distant Deficit Reduction Act of 1984, still with us, is the rule that allows a seller to elect not to recognize gain from the sale of stock to an employee stock ownership plan ("ESOP"). Apart from meeting some technical requirements, all the seller has to do is purchase qualified replacement property within a 15-month period (commencing three months prior to the sale of stock, and ending 12 months after it). Qualified replacement property is defined to include the securities of most domestic public companies. As a result, the seller may be seen as effectively trading the stock of his or her company for a portfolio of public company securities on a tax-free basis.

While Section 1042 has been assailed from time to time, its future seems relatively secure at this moment. It has accounted for many favorable transactions, giving many business owners a built-in buyer for the business (or part of it) on an extremely tax-favored basis.

Sell Now, Pay Later

The seller of stock to the ESOP takes a carryover basis in the securities bought with the sales proceeds, so that a later disposition will produce taxable gain. But such dispositions can be strung out over a long period of time. Furthermore, if the securities purchased with the ESOP sale proceeds are held on the seller's death, they achieve a step-up in basis for income tax purposes, so the gain on the sale is *never* subject to income tax.

It now appears that another type of transaction also will not be considered a "disposition" of the replacement securities, and therefore will not generate taxable gain to the person who has sold to the ESOP and purchased the replacement securities. In *Ltr. Rul.* 9234023, the IRS considered a contribution of such securities to a charitable remainder trust. The trust qualified as a charitable remainder unitrust ("CRUT") under Section 664, and so was exempt from federal income tax.

Thus, assets sold by the CRUT—including the securities received via contribution from the ESOP seller—could be sold tax free. The IRS concluded that the contribution of the securities to the CRUT could be viewed technically as a "disposition," but nevertheless, it would not result in a recapture of the gain deferred under Section 1042(a).

Sopping Up ESOP Gain

What does all this mean? It means that someone who sells stock to an ESOP and defers the gain under Section 1042 can contribute the qualifying replacement securities to a CRUT (or presumably, to a charitable remainder annuity trust) without triggering the gain inherent in the securities. The individual will annually receive the unitrust amount from the trust, which will be a percentage of the fair market value of the trust's assets.

Obviously, *Ltr. Rul.* 9234023 does not mean that every ESOP seller should rush out and establish a charitable remainder trust, contributing all or a part of the portfolio of securities acquired with the ESOP sale proceeds. But it does mean that there is yet another favorable planning opportunity that reconfirms the extraordinary benefits of Section 1042. ■