Investing the § 1042 Rollover

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What we'll cover

- What is a §1042 rollover?
- §1042 qualifications and requirements
- Common investment strategies and best practices
- Case studies

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The big picture

Internal Revenue Code of 1986, as amended (Code), section 1042 allows an owner of a closely-held C corporation to defer or potentially eliminate capital gains taxation on “qualified securities” he or she sells to an employee stock ownership plan (ESOP) if the seller reinvests the sale proceeds into “qualified replacement property” (QRP).

Transaction

Business Owner sells $10mm of qualifying company stock with cost basis of $0 to an ESOP.

Post-Sale Options

Pay capital gains tax

Elect 1042 exchange and purchase qualifying securities to defer capital gains indefinitely.

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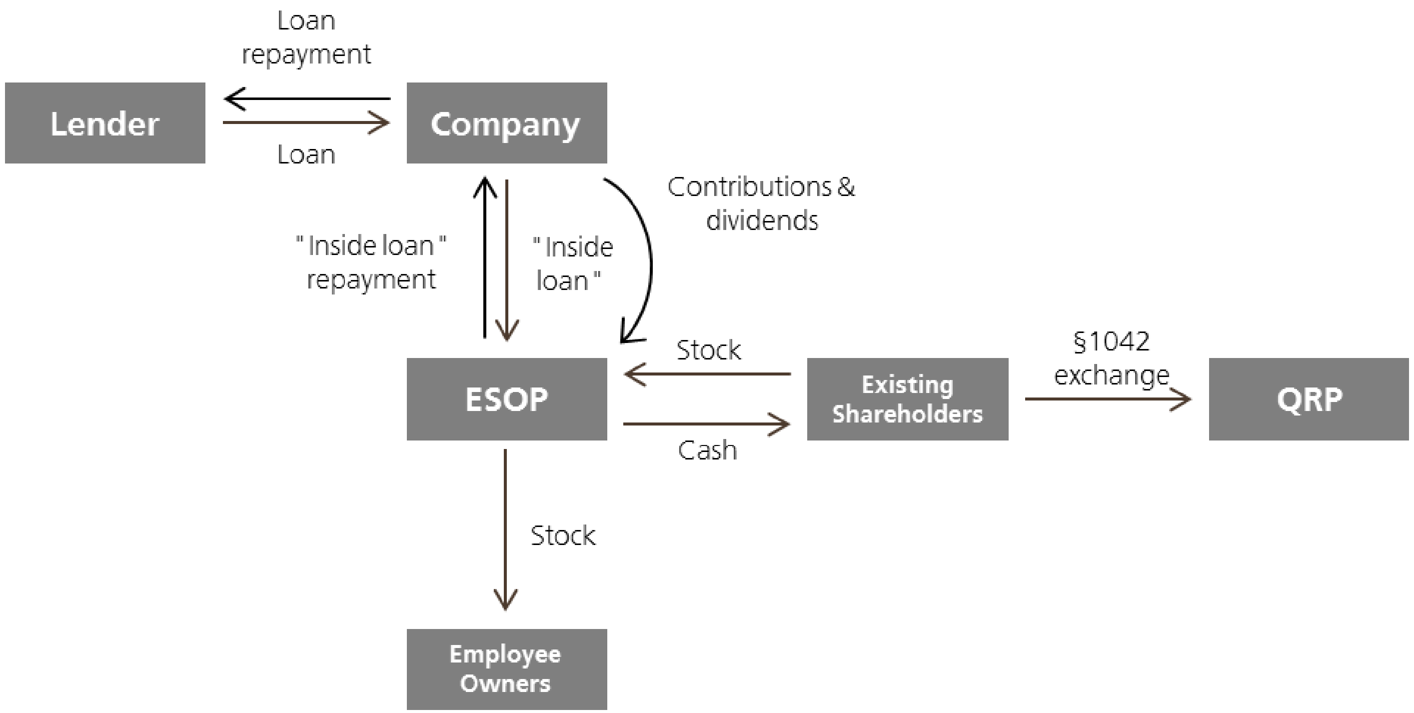
Typical ESOP Structure

1. Company creates Employee Stock Ownership Plan (ESOP)
2. Company borrows funds from Lender
3. Company lends the proceeds to the ESOP through an "inside loan"
4. ESOP uses proceeds to purchase shares from existing shareholders
5. Existing shareholders have the option to elect §1042 and purchase QRP
6. Company makes tax-deductible contributions to the ESOP
7. ESOP repays the "inside loan" to the Company using the contributions and dividends
8. Company repays the Lender
9. Shares held by the ESOP are released to employee accounts as the "inside loan" is repaid



What is §1042?

Under § 1042 of the Internal Revenue Code ("IRC"), eligible shareholders can defer capital gains taxes on eligible stock sold to an ESOP if the proceeds of the sale are reinvested in qualified replacement property ("QRP").

Taxes will not be owed until the taxpayer has a disposition of the QRP. If structured properly, the taxpayer will avoid paying all long-term capital gains taxes.

IRC § 1042 is similar to the real estate provision, IRC § 1031, and the life insurance provision, IRC § 1035.

What is Qualified Replacement Property (QRP)?

Qualified Replacement Property (QRP) includes common stock, preferred stock, bonds, and convertible bonds of "operating companies" incorporated in the United States.

An operating company must be a U.S. domiciled company with the following characteristics:

- At least 50% of its assets must be used in active conduct of a trade or business
- No more than 25% of its gross receipts can come from passive sources

QRP does not include:

- Securities issued by U.S. government agencies, non-U.S. entities, U.S. subsidiaries of non-U.S. parents, FDIC-insured certificates of deposit, mutual funds, municipal bonds, or hedge funds.

If the QRP is sold, redeemed, or matures, the taxpayer must recognize a capital gain (or loss) on the difference between the amount received and the tax basis in QRP.

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What is Qualified Replacement Property (QRP)?

Eligible investments

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

Ineligible investments

- Bank CDs
- US government bonds
- Municipal bonds
- Foreign securities
- Exchange traded funds (ETFs)
- Mutual funds
- Real estate investment trusts (REITs)
- Master Limited Partnerships (MLPs)

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What are my reinvestment options?

There are several reinvestment strategies available for the selling shareholder to fulfill the obligations of the § 1042 election, including a passive (hold) strategy and an active reinvestment strategy.

The investment strategy should ultimately be decided based on consideration of the following factors:

- Treatment of other investment assets
- Overall business succession plan
- ESOP transaction design
- Liquid net worth of the seller
- The seller's estate plan
- Philanthropic goals

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What are my reinvestment options?

Passive (hold) reinvestment strategy: Purchase a portfolio of QRP securities that will be held constant over the lifetime of the selling shareholder. The selling shareholder can then choose to recognize the capital gain from the ESOP transaction through the disposition of some or all of the QRP. This strategy often generates income for the selling shareholder and provides the flexibility to decide whether to use margin.

Active reinvestment strategy: Invest a portion of the proceeds at closing (typically 10% of the total amount received in the sale to the ESOP) and enter into a monetization loan for the remaining amount. Then, use the proceeds of the monetization loan to purchase FRNs that satisfy §1042 requirements. This strategy enables selling shareholders to reinvest the remaining proceeds from the sale in other investments that may or may not qualify as QRP, but that can be traded freely without triggering capital gains taxation.

Blended reinvestment strategy: Combines both the passive and active strategies to further accommodate the selling shareholder's investment goals and objectives.

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Post-sale reinvestment strategies

Passive

- Portfolio of qualifying stocks and/or bonds designed to remain constant over the selling shareholder's lifetime
- Provides flexibility to use margin
- Capital gains realized on the ESOP transaction only if/when QRP is sold. QRP can be passed on to heirs—with a step up in cost basis—upon death of the selling shareholder
- Often generates income / yield for the selling shareholder

Blended

- Combines both the passive and active strategies to further accommodate the selling shareholder's investment goals and objectives

Active

- Leveraged floating rate notes (FRNs) enables selling shareholder to diversify into a flexible portfolio
- Capital gains realized on the ESOP transaction only if/when QRP is sold. QRP can be passed on to heirs—with a step up in cost basis—upon death of the selling shareholder
- Provides the selling shareholder with greater liquidity and flexibility
- Use of leverage increases complexity and incurs higher expenses

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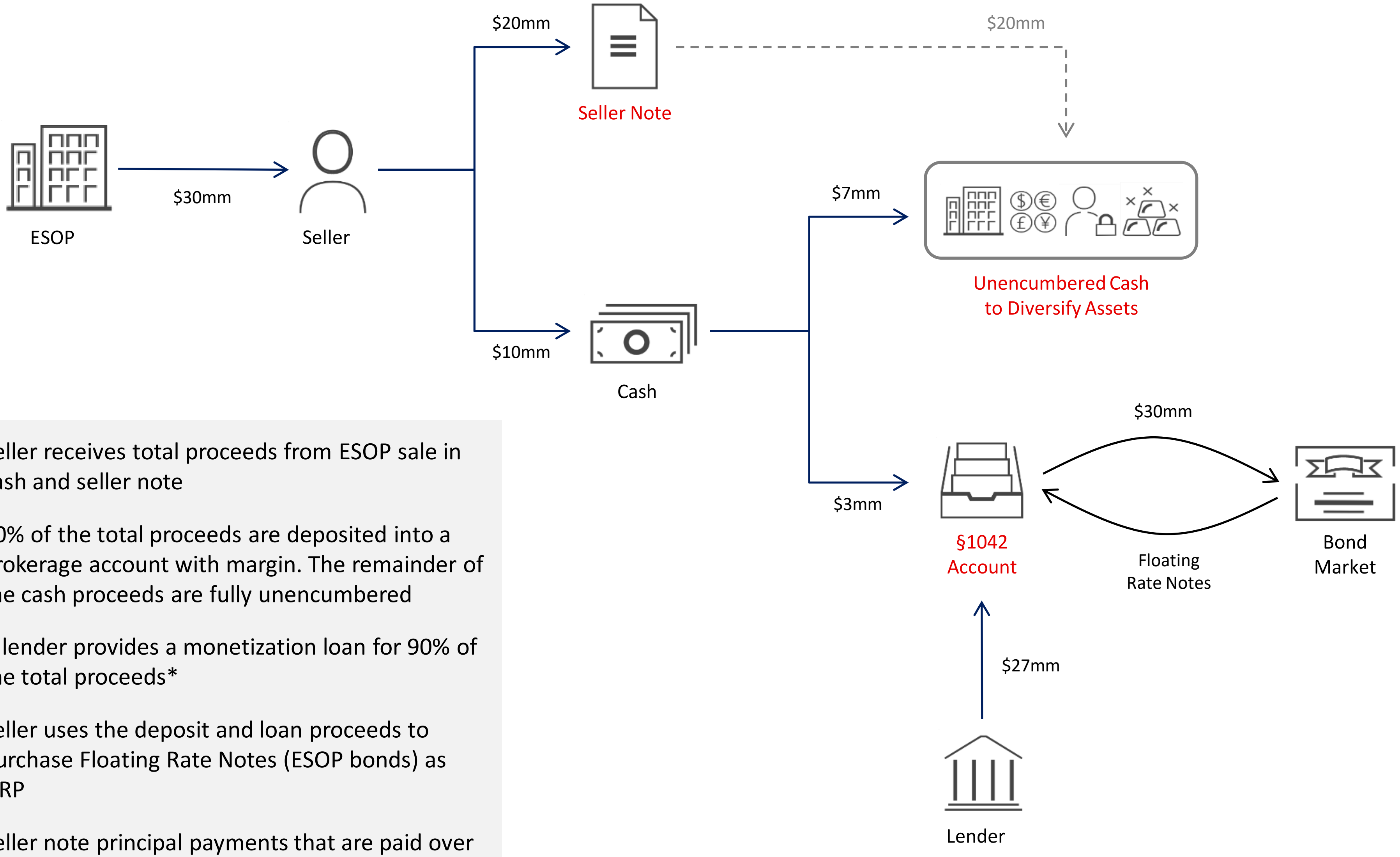
Example: FRN Flexible Strategy



1. Seller receives total proceeds from ESOP sale in cash and seller note
2. 10% of the total proceeds are deposited into a brokerage account with margin. The remainder of the cash proceeds are fully unencumbered
3. A lender provides a monetization loan for 90% of the total proceeds*
4. Seller uses the deposit and loan proceeds to purchase Floating Rate Notes (ESOP bonds) as QRP
5. Seller note principal payments that are paid over time are also unencumbered**

What is a floating rate note?

A floating rate note, also known as an "FRN," "floater," or "ESOP bond" is a senior secured corporate debt instrument. Simply put, they are corporate bonds. What differentiates them from other corporate bonds is the combination of their long maturities, floating rate structure and put provisions.

These securities are used primarily by individuals who have sold stock to an ESOP and are looking to defer, or with proper planning, permanently avoid paying long-term capital gains taxes connected to the sale. These ESOP bonds are not readily available in the market, historically; they are available by new issue four to six times per year or very selectively in the secondary market.

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What is a floating rate note?

What are some of the companies that have issued floating rate notes in the past?*

- P&G, Colgate, UPS, Wells Fargo, Merck, 3M, US Bank, DuPont, and General Electric.

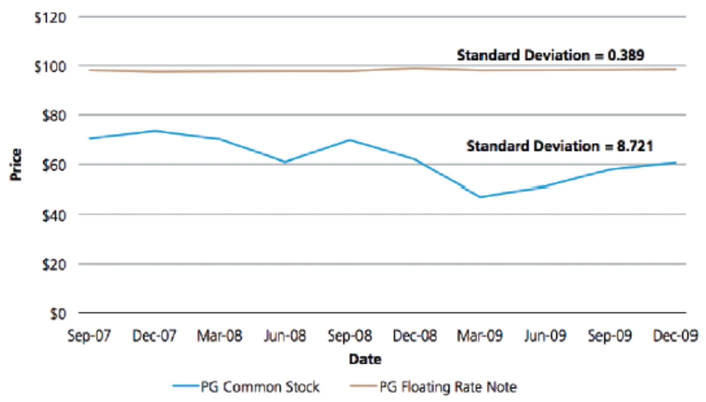
Why is UBS comfortable lending up to 90% of the value of FRNs?

- FRNs usually have a rating of AA-/Aa3 or A+/A3 (investment grade). With most structures, the interest rate resets every 90 days, mitigating the interest rate risk. Typically, the bonds have a put feature, allowing the holder (owner) of the FRN to force the issuer to repurchase the note anywhere between 98% to 100% of the purchase price, helping to reduce liquidity risk.

How long of a maturity do these notes usually have?*

- Maturities typically range from 40 to 50 years.

Price movement of Proctor & Gamble common stock vs. floating rate note



Year	PG Common Stock	PG Floating Rate Note
9/28/07	70.34	98.08
12/31/07	73.42	97.55
3/31/08	70.07	97.66
6/30/08	60.81	97.74
9/30/08	69.69	97.73
12/31/08	61.82	98.85
3/31/09	47.09	98.03
6/30/09	51.10	98.10
9/30/09	57.92	98.20
12/31/09	60.63	98.37

*Source: Bloomberg terminal

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Sample FRN Terms

FRNs are designed to provide lower price volatility and a higher loan to value

Historical FRN issuers

Active Issuers	
Bank of America	A3/A-
Citigroup	BBB+
Florida Power & Light	A1/A-
Goldman Sachs	BBB+
J.P. Morgan Chase	A3/A
Procter & Gamble	Aa3/AA-
US Bancorp	Aa3/AA-
United Parcel Service	Aa3/A+
Inactive Issuers	
AIG	BBB+
Bank of New York	Aa2/A+
Colgate	AA-
DuPont Nemours	A2/A
Emerson Electric	A2/A
GE Capital	AA-
Merck	A1/AA
MMM	Aa2/AA-
PNC Bank	A2/A
Wells Fargo NA	Aa3/AA-

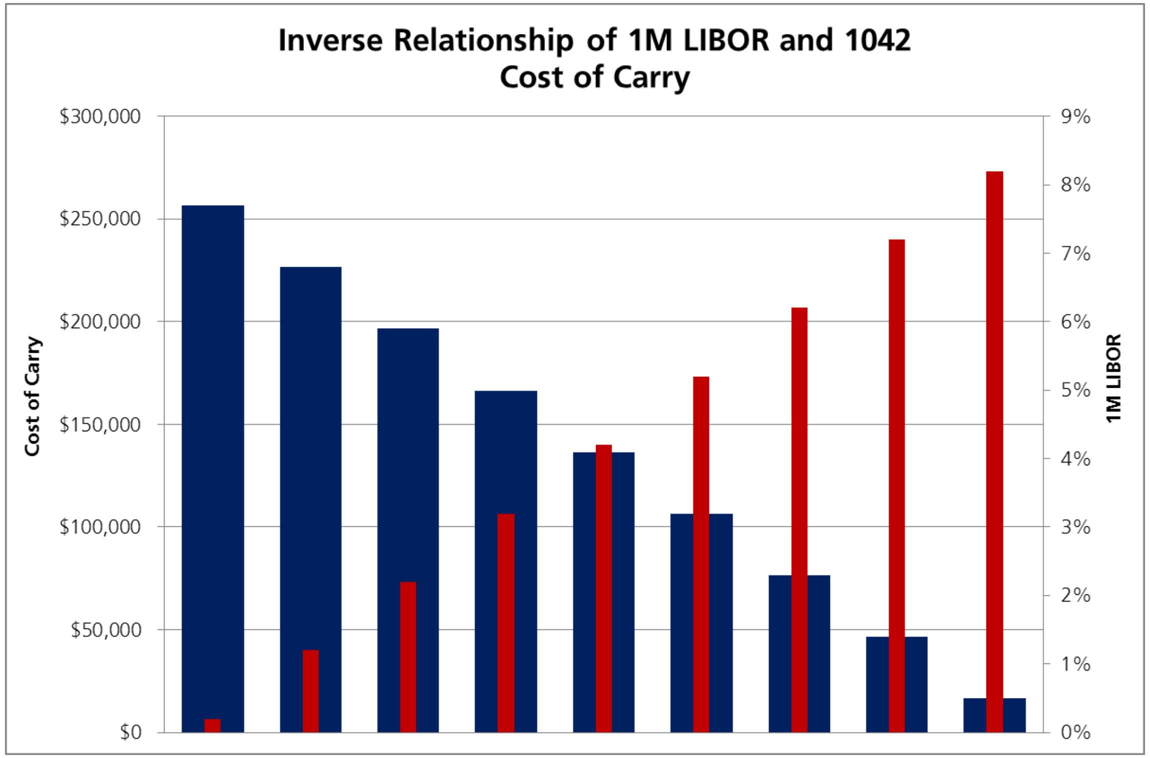
Example FRN and key attributes

Issuer:	Colgate Palmolive Company	Blue-Chip company
Rating:	Aa3/AA	High degree of safety / credit quality
Coupon:	3-month LIBOR minus 30%	Low interest rate sensitivity
Reset:	Calculated quarterly and paid quarterly	Frequent payments
Maturity:	40 years	Long maturity Unlikely to mature while living
Call Option:	Non-callable for 30 years	Eliminates risk of early call and involuntary taxable event
Put Option:	Years 1-5 @ 98.00 Years 6-10 @ 99.00 Thereafter @ 100	Critical for price stability

*One 1 Year Issue

This is provided for informational purposes only and is not an offer to sell any security. Floating Rate Notes (FRNs) are sold by prospectus only which includes information on the suitability of, and the risks associated with, an investment in FRNs and other matters of interest. The issuer rating set forth above is as of 7/7/2017 and subject to change. Any offerings of FRNs, if made, may vary in size, terms (including yield level), or availability subject to market conditions when and if made.

Impact of LIBOR rates on the §1042 cost of carry



Assumptions:	
Floating Rate Note Amount	$30,000,000
Loan Amount	$27,000,000
UBS Monetization Loan	0.75%

1m LIBOR	0.20%	1.20%	2.20%	3.20%	4.20%	5.20%	6.20%	7.20%	8.20%
3m LIBOR	0.30%	1.30%	2.30%	3.30%	4.30%	5.30%	6.30%	7.30%	8.30%

Income from FRNs	$0	$300,000	$600,000	$900,000	$1,200,000	$1,500,000	$1,800,000	$2,100,000	$2,400,000
Interest Expense	($256,500)	($526,500)	($796,500)	($1,066,500)	($1,336,500)	($1,606,500)	($1,876,500)	($2,146,000)	($2,416,500)
Cost of Carry	$256,500	$226,500	$196,500	$166,500	$136,500	$106,500	$76,500	$46,500	$16,500

Illustrative example of the relationship between LIBOR and the cost of carry in a 100% ESOP bond portfolio

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How do I elect § 1042 ?

The selling shareholder must reinvest sale proceeds within the "replacement period" – no earlier than 3 months before the ESOP transaction and no later than 12 months after.

Three "statements" must be filed with the IRS to successfully complete the § 1042 election:

- **Statement of consent:** Requires the company to consent to the selling shareholder's election to defer taxes, as well as to the application of certain penalties if the shares purchased by the ESOP are sold within three years or are allocated to the selling shareholder(s) or their families.
- **Statement of election:** Confirms the intention of the selling shareholder(s) to elect non-recognition treatment with respect for the stock sale under Code § 1042.
- **Statement of purchase:** Completes tax-advantaged sale of qualified securities to the ESOP and declares that specific securities represent QRP with respect to the stock sold to the ESOP. This statement must be signed by the selling shareholder(s) and acknowledged by a notary public.

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Disposition of QRP*

A disposition of QRP will trigger capital gains tax based on the taxpayer's basis in the original shares sold to the ESOP. Sale of the QRP would be considered a disposition, but the following events would *not* qualify as dispositions:

- Gift of QRP
- Transfer upon death of the QRP holder (the deferred tax can be completely avoided by holding the QRP to death, at which point the tax basis of the QRP is stepped up to its market value on the date of death)
- Transfer of the QRP in connection with divorce
- Certain tax-free transactions between the QRP issuer and other companies

Strategies can be employed to continue deferring capital gains while diversifying into asset classes other than U.S. stocks and bonds, including:

- Transfers to grantor trusts (for example, a charitable remainder unitrust or CRUT)
- Borrowing against the QRP

**As outlined in the Internal Revenue Code §1042(a) and §1042(b)*

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Case Study #1: Bob the Baby Boomer

Background:

Bob is 55 years old and is the sole owner of a manufacturing company and he is selling 40% of his shares to an ESOP and is eligible to elect the 1042 exchange.

Value of Shares sold:	$5mm
Cash Received At Close:	$5mm
Bob's Cost Basis in Company:	$0
Income Needs:	$0
Liquidity Needs:	None
Risk Tolerance:	Comfortable with Higher Risk Investments
Long Term Goals:	Use 5mm over time to give to various charities, supplement retirement income, and leave to remainder to family

Result:

Client considered a variety of strategies, but in the end decided a passive portfolio of QRP equities combined with donor advised fund for charitable giving, best aligned with his long term goals.

Case Study #2: Jim the Engineer

Background:

Jim is 65 years old and was the sole owner of an engineering company and he sold 100% of his shares to an ESOP and was eligible to elect the 1042 exchange.

Value of Shares sold:	$50mm
Cash Received At Close:	$20mm
Seller Note Terms:	$30mm, paying 6% interest, principal paid at end of 7 years
Jim's Cost Basis in Company:	$200,000
Income Needs:	$750,000 per year
Liquidity Needs:	$3mm for second home
Risk Tolerance:	Comfortable with Moderate level of risk
Long Term Goals:	Live off income from the QRP, provide some flexibility for additional homes, real estate investments, and leave to remainder to family

Result:

After several meetings and collaboration with the clients trusted advisors, Jim decided the best strategy for his family was to invest 25% in QRP equities and 75% in Floating Rate Notes , to provide him with the flexibility he wanted to achieve his goals.

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Your presenters: Keith Apton & Nick Francia

Keith J. Apton, CEPA®
Managing Director – Wealth Management
Certified Exit Planning Advisor®

Keith has over 17 years of experience in the financial services industry, with an extensive background in corporate finance. As the founding partner of The Capital ESOP Group at UBS, Keith leverages the resources and intellectual capital of the firm to assist his clients and their families in creating personalized financial solutions. Prior to joining UBS in 2009, Keith was a financial advisor at Morgan Stanley, where he was an integral member of the team handling all of the firm's ESOP transactions. Keith's process entails a disciplined approach to help small- to middle-market business owners with sell-side advisory solutions and post-sale financial planning to include holistic wealth management and tax and estate planning.

In 2014, Keith was given the prestigious opportunity to sit on the UBS Capital Markets Advisory Committee. More recently, he became a Managing Director and member of the UBS Pinnacle Club, which consists of the top 2% of advisors nationally at UBS. As an active member in the ESOP community, Keith's total participation in ESOP transactions has exceeded $2 billion in transaction value across various sectors and industries.

Keith is a member of both the National Center for Employee Ownership and the finance committee for The ESOP Association. He co-authored the book *Selling Your Business to an ESOP*, now in its ninth edition. After becoming a CEPA himself in 2018, he was asked to teach and became an instructor for the Exit Planning Institute. Additionally, he frequently speaks at national conferences on topics including ESOPs, 1042 rollovers, and business succession planning.

Keith's other accomplishments include:

- *Forbes* Best-In-State Wealth Advisor in Washington, DC, 2018 – 2020
- Barron's Top 1200 Financial Advisor, 2014 – 2019
- Barron's Top 1000 Financial Advisor, 2012 – 2013
- UBS Pinnacle Advisor, 2018 – 2019

Keith previously sat on the board of Patriot Farmers of America, a nonprofit teaching entrepreneurship and sustainability to veterans who are seeking a future in farming. Keith graduated from Virginia Tech University, where he earned a B.S. in business administration from the Pamplin College of Business. Outside the office, he enjoys traveling, fly-fishing, reading and spending time at his family farm in Berryville, VA. More than anything, he simply loves being a dad. Keith lives in Washington, DC with his wife, Kathryn, and their daughters, Lyla and Sutton.

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Your presenters: Keith Apton & Nick Francia

Nick J. Francia, CEPA®
Senior Vice President – Wealth Management
Certified Exit Planning Advisor®

Nick joined UBS in 2011. Prior to his tenure at UBS, he worked with high net worth individuals at a hedge fund in Greenwich, CT.

As a partner of The Capital ESOP Group, Nick focuses on educating business owners on tax-efficient exit strategies. He is committed to helping clients recognize their options, understand the pros and cons of each strategy and choose the best succession plan for themselves and their families. Nick also creates tailored cash flow models comparing the taxable sale of privately held businesses and a Section 1042 tax-deferred sale to an ESOP. With a consultative approach, Nick earns his clients' trust through open, transparent communication and by working with clients' tax and legal advisors to construct an overarching strategy.

In 2019, he was promoted to Senior Vice President – Wealth Management. He is frequently asked to speak on a national level regarding Employee Stock Ownership Plans and IRC Section 1042. He is an Associate Member of the Finance Committee for the ESOP Association and a member of the National Center for Employee Ownership. Nick was also appointed Vice President of Business Networking International in DC.

Nick's other accomplishments include:

- Forbes Best-In-State Wealth Advisor in Washington, DC, 2020
- *Forbes* Next-Gen Best-In-State Wealth Advisors, 2019 (Ranked #1 in Washington, DC)
- *Forbes* Top 250 Next-Generation Wealth Advisors, 2019
- UBS President's Council Advisor, 2019
- *Forbes* America's Top Next-Generation Wealth Advisors, 2018
- UBS Top 35 Under 35 Advisors, 2018

Nick graduated from the University of Mary Washington in Fredericksburg, VA, where he earned a bachelor's degree in economics. He was a dedicated member of the university's baseball team and continues to be an active member of his alma mater's Alumni Association. Outside of the office, Nick enjoys spending time with family, reading, fly-fishing and traveling with his wife, Mary Elizabeth. In June of 2019, Nick and Mary Elizabeth welcomed the newest member of their family: their son Sebastian "Baz" Calloway Francia.

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Questions?

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Important Disclosures

Information contained herein is of a general nature and is provided for informational purposes only. Laws governing ESOP transactions and the rules under section 1042 of the Internal Revenue Code of 1986, as amended ("Code"), are complex and persons considering an ESOP or section 1042 transaction should seek professional guidance from their tax and legal advisors. Specific structures and decisions can only be developed based on a thorough review of the facts and circumstances relative to a particular company and its shareholders. Neither UBS Financial Services Inc. nor its employees provide tax or legal advice.

In addition, shareholders who sell into an ESOP should understand the applicable rules of the Internal Revenue Code of 1986, as amended ("Code"), including requirements for qualified replacement property as defined by Code section 1042 ("QRP"). Shareholders should understand the potential risks that may be associated with obtaining securities as QRP, sufficiency of available QRP in the market that satisfy the shareholder's investment objectives, limitations on UBS' ability to offer margin or financing for the purchase of a new-issue QRP where UBS has participated in the underwriting of such new issue, availability of QRP with put features and whether available QRP offers appropriate diversification. The foregoing is a general description of potential risks. Shareholders who invest in QRP should consult with their tax and legal advisors regarding their personal circumstances.

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It is important that you understand the ways in which we conduct business and the applicable laws and regulations that govern us. As a firm providing wealth management services to clients in the U.S., we are registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Though there are similarities among these services, the investment advisory programs and brokerage accounts we offer are separate and distinct, differ in material ways and are governed by different laws and separate contracts.

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