



# Is an ESOP Right for You?

Omaha, NE – October 9-10, 2019



## Investing the "1042 Rollover"

Presented by: Curt Rubinas CEPA®  
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# What We'll Cover

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- What is §1042 Rollover
- §1042 Qualifications and Requirements
- Common Investment Strategies
- Case Studies



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# 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 taxpayer 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

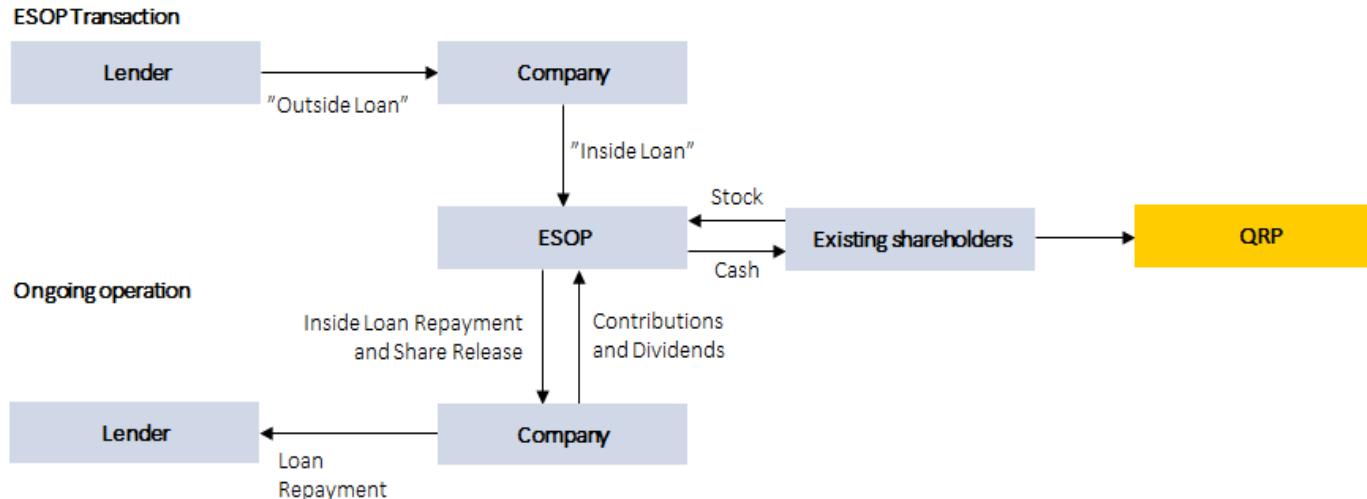
Elect 1042 exchange and purchase qualifying securities to defer capital gains indefinitely.

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# Typical ESOP Structure



An ESOP is essentially a Leveraged Buyout (LBO) that may provide several tax benefits to the company and its owners.



- Company creates ESOP
- Company borrows funds from Lender ("Outside Loan") and re-lends the proceeds to the ESOP ("Inside Loan")
- ESOP uses funds from Inside Loan to purchase shares from existing shareholders
- Company services the new debt by:
  - Making tax-deductible contributions and/or dividends/distributions to the ESOP
  - ESOP repays Inside Loan to Company
  - Company repays Outside Loan to Lender
  - As the Inside Loan is repaid, shares held as collateral for the Inside Loan are released and allocated to the employee accounts

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# What is Qualified Replacement Property (QRP)

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Security issued by a domestic operating corporation that:

- 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

Step-up in Basis:

- If the qualified replacement property is held until death of the selling shareholder, the property transfers to heirs with a stepped-up cost basis, eliminating the capital gain tax.

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# What qualifications must be met?

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- Percentage of ESOP ownership
- Stock origin
- Holding Period
- Reporting type
- Stock type
- Reinvestment window
- Reinvestment requirements
- Tax filings

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# What Securities Qualify?

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## Eligible QRP

- Stocks
- Bonds
- Convertible Bonds
- Corporate Fixed Rate Bonds
- Corporate Floating Rate Notes ("FRNs")

## Non-Eligible QRP

- Bank CDs
- U.S. Government Bonds
- Municipal Bonds
- Foreign Securities
- Exchange Traded Funds (ETFs)
- Mutual Funds
- REITs
- Master Limited Partnerships (MLPs)

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# Common diversification strategies

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## Passive Strategy

- Buy and hold stocks and/or corporate bonds

## Active/Flexible Strategy

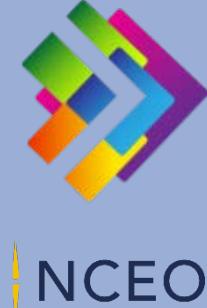
- Buy and hold Floating Rate Notes (FRNs)
- Monetize (borrow) against the value of the FRNs (does not trigger tax) to make other investments or create liquidity

## Blended Strategy

- Combination of Passive and Active/Flexible strategy

# Passive QRP portfolio

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## Structure

- Portfolio of qualifying stocks and/or bonds purchased over the reinvestment period.

## Advantages

- Low cost
- Diversified across economic sectors
- Can serve as one's core equity portfolio
- Provides low basis, high tax cost securities to fund philanthropic causes

## Disadvantages

- Cannot diversify outside of qualifying U.S. equities/bonds
- Involuntary taxable events can occur due to M&A, tax inversions, calls, redemptions or maturity of securities
- Portfolio tracking error vs. S&P 500 increases over time
- Less liquidity due to a lower loan-to-value compared to portfolio of FRNs

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# Active/ Flexible QRP portfolio

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## Structure

- Portfolio of ESOP Floating Rate Notes (FRNs) purchased over the reinvestment period.

## Advantages

- Maximum flexibility
- Ideally suited for seller financed ESOP
- Maximum amount of liquidity to the seller

## Disadvantages

- Increased complexity due to the use of leverage
- Limited availability of Floating Rate Notes (FRNs)
- Cost of carry due to margin facility

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# Sample Floating Rate Note (FRN) terms

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



## Historical FRN issuers

<b>Active Issuers</b>	
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+
<b>Inactive Issuers</b>	
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

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

\*One 1 Year Issue

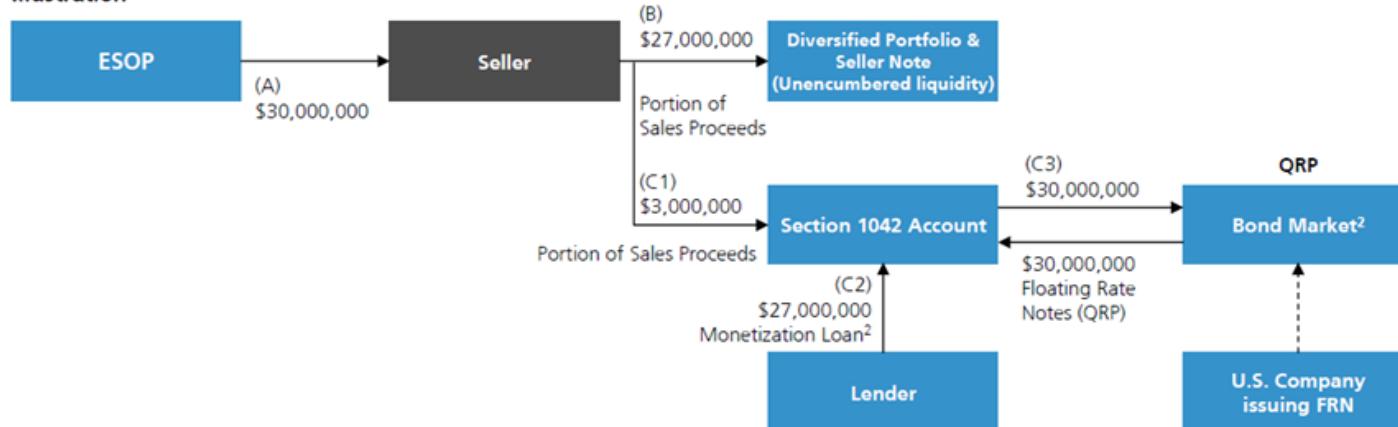
This is provided for informational purposes only and is not an offer to sell any security. Floating Rate Notes (FRNs) are sold by prospectus only which includes information on the suitability of, and the risks associated with, an investment in FRNs and other matters of interest. The issuer rating set 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.

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# Example of FRN Flexible Strategy

## Section 1042 Election—Active Reinvestment Strategy

### Illustration



### UBS section 1042 Solution

- Seller receives total proceeds from ESOP sale of \$30,000,000 in cash and seller note
- Seller has cash proceeds, less § 1042 deposit, of \$27,000,000 of unencumbered liquidity
- Seller deposits 10% of total proceeds (\$3,000,000) into a brokerage account with margin
- Lender provides a monetization loan for \$27,000,000<sup>1</sup>
- Seller uses the \$3,000,000 of sale proceeds combined with the \$27,000,000 of proceeds from the monetization loan<sup>2</sup> to purchase \$30,000,000 of Floating Rate Notes (FRN) as QRP<sup>2</sup>

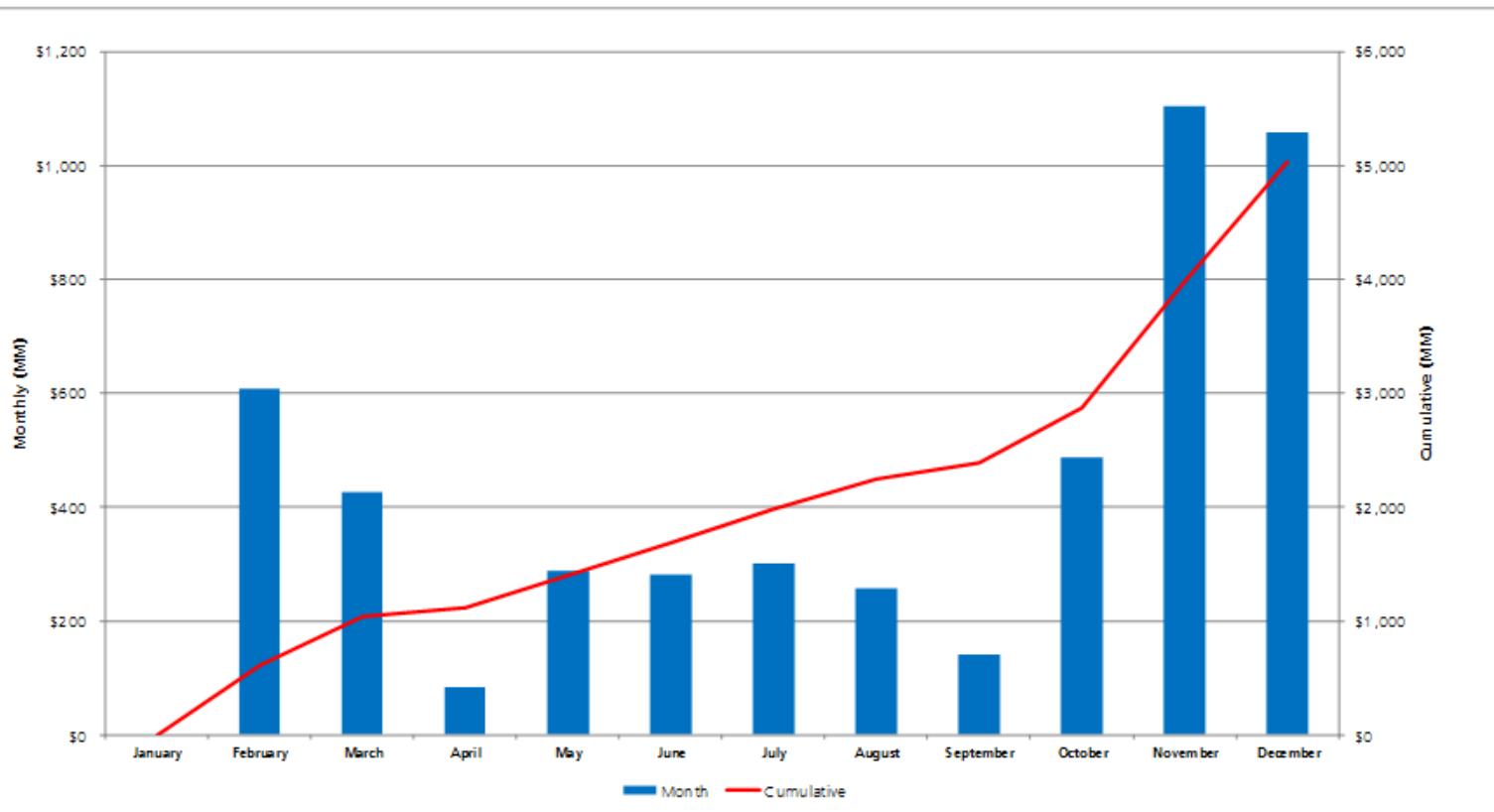
<sup>1</sup> Subject to credit approval if UBS or Affiliates are the Lender.

<sup>2</sup> Depending on structure, UBS and Affiliates may or may not be the underwriter or the Lender—Pursuant to SEC Rule 11(d) UBS cannot be both lender and issuer on a new FRN issuance.

**Please note:** This illustration is hypothetical and the results shown are intended for demonstration purposes and are not actual results. No representation is made that the shareholder will achieve results similar to those shown. These results may not reflect certain economic and market factors which may impact the results achieved by the strategy.

# Historical FRN seasonality

FRN seasonality since 2000



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# Borrowing against FRNs

Impact of interest rates and the importance of your loan spread



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Net cash flow for hypothetical Floating Rate Note portfolio and loan

Rollover Amount:  
\$1,000,000

Loan Amount:  
\$(900,000)

Loan Spread	1 Month LIBOR					
	0%	2%	4%	6%	8%	10%
0.75%	(6,750)	(7,750)	(5,750)	(3,750)	(1,750)	250
1.00%	(9,000)	(10,000)	(8,000)	(6,000)	(4,000)	(2,000)
1.25%	(11,250)	(12,250)	(10,250)	(8,250)	(6,250)	(4,250)
1.50%	(13,500)	(14,500)	(12,500)	(10,500)	(8,500)	(6,500)
1.75%	(15,750)	(16,750)	(14,750)	(12,750)	(10,750)	(8,750)
2.00%	(18,000)	(19,000)	(17,000)	(15,000)	(13,000)	(11,000)

\* assumes Floating Rate Notes pay 1 Month LIBOR - 30bps with 0% floor

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# Disposition of QRP

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A disposition of QRP triggers capital gains tax



- A “disposition” includes a sale but does not include
  - Certain tax-free transactions that QRP issuer company enters into with another company
  - A gift of the QRP
  - Transfer upon the death of the QRP holder
  - Transfer of the QRP in connection with divorce
  - Transfers to a grantor trusts including charitable remainder unitrusts (CRUT)
  - Borrowing against QRP—which allows for the Active Reinvestment Strategy

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# Tax filing requirements

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A taxpayer must file three documents with the IRS in order to obtain section 1042 capital gains deferral upon sale of the stock to an ESOP.

- Statement of Consent (filed by taxpayer and by company)
- Statement of Election (filed by taxpayer )
- Statement of Purchase (filed by taxpayer )

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# Case Study 1:

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## 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.

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# Case Study 2:

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## 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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# Questions ?

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## Curt Rubinas CEPA® Private Wealth Management



Curt joined the team in 2014, and brings 17 years of experience advising investors on all aspects of wealth management. Before joining UBS in 2006, Curt worked in San Francisco and New York as Vice President of Sales for Structured Investments at Merrill Lynch. He began his career with Merrill Lynch in New York in the structured investments group where he gained a deep understanding of complex derivative transactions.

Curt's deep knowledge base across all asset classes and investment vehicles provides the team with the perspective to leverage the global capabilities of UBS to find the appropriate investment solutions for clients. His primary area of focus has been portfolio construction and implementation, with a specialty in non-traditional investments. In that capacity he worked on many of the firms most complicated investment mandates, and frequently published articles internally on portfolio construction and investment strategies.

Curt holds Series 7 and 66 securities licenses as well as the CEPA (Certified Exit Planning Advisor) designation. Curt has a B.A. in economics from Vanderbilt University.

His personal interests include golf, tennis, college football, and spending time with his family.



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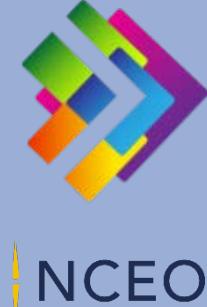
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ESOP laws are complex; specific recommendations on courses of action are dependent on a thorough review of the facts and circumstances relative to a particular company and its shareholders. In particular, any use of ESOP assets is subject to ERISA's fiduciary standards and must be carefully reviewed in light of those rules.

In addition, shareholders who sell into an ESOP should understand the applicable rules of the Internal Revenue Code, including requirements for Qualified Replacement Property ("QRP"), and should also understand the potential risks associated with obtaining QRP including whether sufficient QRP will be available in the future, availability of QRP with features such as put options and whether diversification can be obtained from the available QRP. The foregoing is a general description of potential risks. Shareholders who sell into an ESOP must consult their tax and legal advisors regarding their personal circumstances.

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