

1042 Rollover

Deferring capital gains taxes in an ESOP sale



What is a Section 1042 Rollover?

Section 1042 of the Internal Revenue Code allows eligible business owners to defer capital gains tax when selling stock to an Employee Stock Ownership Plan (ESOP), provided the proceeds are reinvested into Qualified Replacement Property (QRP) within a specified timeframe.

Why Owners Use 1042

- Defer capital gains taxes at the time of sale
- Preserve more after-tax value
- Protect company culture and legacy through employee ownership
- Convert a concentrated private asset into a diversified portfolio
- Potential elimination of deferred tax at death via step-up in basis

Who Qualifies for 1042 Rollover

Company Requirements	<ul style="list-style-type: none"> • C-Corp at time of sale
Seller Requirements	<ul style="list-style-type: none"> • Must have held the stock for at least 3 years
Transaction Requirements*	<ul style="list-style-type: none"> • Sale must be to a qualified ESOP trust • Stock deal (not sale of assets) • ESOP must own at least 30% of company stock immediately post-transaction

*All Avid transactions qualify for 1042 Rollover

How it Works

- 1 At closing:** The ESOP purchases the seller's stock, the seller receives the sale proceeds, and no capital gains tax is paid at that time.
- 2 Election:** The seller elects Section 1042 treatment, signaling intent to reinvest the proceeds into Qualified Replacement Property (QRP).
- 3 Reinvestment:** Within 12 months, the seller reinvests proceeds into QRP, carrying over their tax basis and deferring capital gains tax.
- 4 Ownership & liquidity:** The seller owns the QRP portfolio and can access liquidity through income, borrowing, or partial sales.

Qualified Replacement Property (QRP)

Eligible investments:

- Stocks or bonds of U.S. operating companies
- Issued after 1983
- Active (non-investment) businesses

Sellers typically invest in diversified, professionally structured QRP portfolios designed for 1042 compliance



Illustrative Example

Assumptions: \$10M Sale price, 30% combined federal and state capital gains tax

	With 1042 Rollover	Traditional Sale
Sale Price	\$10,000,000	\$10,000,000
Cost Basis	\$(500,000)	\$(500,000)
Capital Gains Tax	Deferred	\$(3,000,000)
Net Proceeds	\$10,000,000	\$6,500,000

As illustrated, Section 1042 results in approximately \$3 million of additional investable capital at closing, with the seller maintaining access to liquidity through the investment portfolio.

FAQ

- > Since I have to reinvest the proceeds, do I lose access to my money?**
No. You continue to own the invested assets and can access liquidity through income, borrowing against the portfolio, or partial sales over time.
- > Does a 1042 rollover eliminate capital gains taxes?**
Section 1042 *defers* capital gains taxes, often indefinitely, and in some cases the deferred tax may be eliminated at death through a step-up in basis.
- > Is this more complicated than a traditional sale?**
It is more structured, but it is a well-established process handled largely by experienced advisors and is often comparable in complexity to a stock sale to a financial buyer.
- > What happens if I want to access cash later?**
Selling QRP will trigger tax on the portion sold, but many owners access liquidity without triggering capital gains by using income distributions or borrowing against the portfolio.

Who Section 1042 Is Best For

- Long-tenured founder-owners
- Sellers seeking tax efficiency and legacy protection
- Owners planning retirement or estate transitions
- Businesses suited to employee ownership

Questions?

To learn more about Section 1042 and whether your agency may qualify for an ESOP transaction, please contact:

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Confidential conversations welcome.