Sample ESOP Transaction

This section contains a diagram of a Section 1042 tax deferred sale of stock to an ESOP along with a list of the steps in the transaction, the benefits of the transaction, and a comparison of the financial advantages of the ESOP sale vs a non-ESOP sale.

In this example we are assuming that a shareholder with an effective zero basis sells $10,000,000 of privately held stock to an ESOP under the parameters of Section 1042 and defers the capital gains tax in the transaction. We assume the seller is in the combined Federal and State capital gains tax bracket and that the corporation is in the 40% tax bracket.

Benefits To The Selling Shareholder:

Section 1042 Comparison of Benefits

	Non-ESOP Sale	ESOP Sale
Gain on sale of the stock by seller	$10,000,000	$10,000,000
Seller's capital gains tax at 25%	$2,500,000	0
Net sale proceeds to the seller	$7,500,000	$10,000,000

Additional Income Generated To Seller From Investment Of The Tax Savings

Additional tax savings available to invest	0	$2,500,000
After tax yield on invested tax savings	5%	5%
Additional annual investment income generated	0	$125,000
Remaining years to life expectancy	20	20
Additional lifetime income generated on tax savings	0	2,500,000

Benefits To The Corporation For Deduction Of Principal Payments

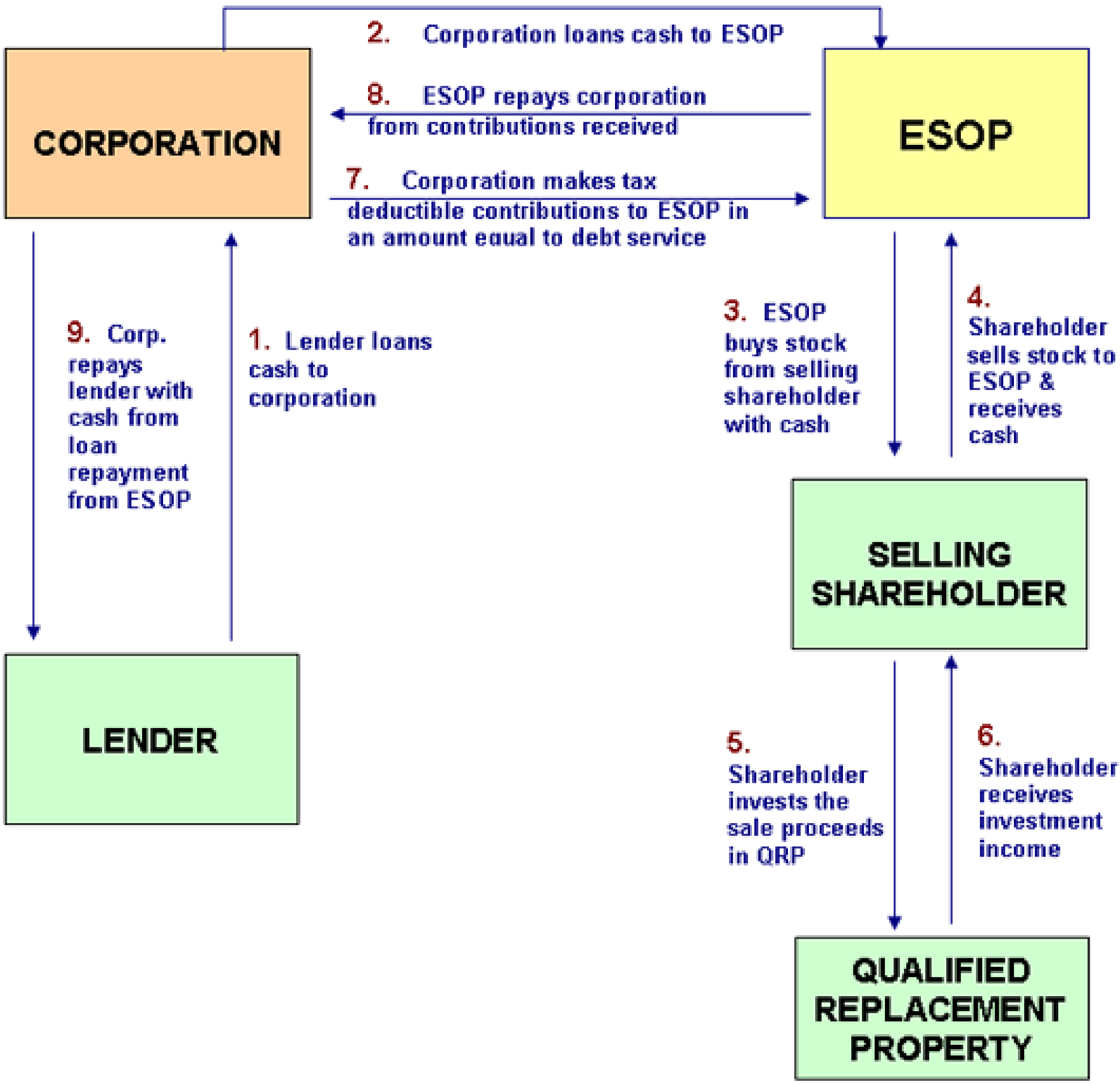
Both principal and interest payments are tax deductible by the corporation on ESOP loans.

	Non-ESOP Sale	ESOP Sale
Tax deduction for $10,000,000 principal on debt service	0	$10,000,000
Corporate tax savings on deductible principal (40%)	0	$4,000,000
After tax cost of principal repayment	$10,000,000	$6,000,000

Total Savings For The Selling Shareholder And The Corporation

Sec. 1042 tax savings for selling shareholder	0	$2,500,000
Shareholder's additional lifetime income generated	0	$2,500,000
Corporate tax savings on deductible principal repayment	0	$4,000,000
TOTAL ESOP Benefits Generated	0	$9,000,000

C - Corporation ESOP Schematic
Section 1042 Sale of Stock



Steps in the Section 1042 Sale Of Stock To The ESOP

An Employee Stock Ownership Plan (ESOP) is adopted by the corporation for the purpose of selling 30% or more of the stock of the shareholders to the ESOP.

1. A loan in an amount equal to the value of the stock to be sold is obtained from a lender. The loan is made by the lender to the corporation.

2. The corporation makes an identical mirror loan to the ESOP.

3. The ESOP uses the loan proceeds to purchase stock from the selling shareholders.

4. The shareholders sell stock to the ESOP under the parameters of Section 1042:

   A. A minimum of 30% of the outstanding stock is sold to the ESOP.

   B. Shareholders must have owned the stock for three years prior to sale to the ESOP.

   C. Sale proceeds are invested within 12 months into Qualified Replacement Property.

   Selling shareholder defers the capital gains tax on the sale of stock to the ESOP. If QRP is held until eventual death, QRP receives a stepped up basis and no tax is ever paid.

5. Selling shareholder invests the sales proceeds in Qualified Replacement Property (QRP), which is generally defined as stocks and bonds of domestic corporations.

6. Selling shareholder receives dividend and/or interest income from the QRP.

7. To service the loan debt to the lender, the corporation makes tax deductible contributions to the ESOP in an amount equal to the debt service of the loan.

8. The ESOP, which has a mirror loan from the corporation, receives the contribution from the corporation and uses this cash flow to service the ESOP's debt to the corporation.

9. The corporation has then used the ESOP tax qualified plan to create a deduction for the debt service and uses the loan repayment from the ESOP to the corporation to pay the lender.

The Benefits Of The Section 1042 Sale Of Stock
To The ESOP

1. The selling shareholders pay no capital gains tax on the sale of stock to the ESOP.

2. The selling shareholders receive a lifetime income from investments in QRP.

3. At eventual death, the QRP receives a step up in basis and no tax is ever paid.

4. The selling shareholders receive cash for the stock sale immediately on close of the sale.

5. The amount of company stock <u>not</u> sold by the shareholders may continue to appreciate in value as the business continues to grow and prosper.

6. The selling shareholders continue to control the corporation by voting the stock they still own outside the ESOP and, as trustees of the ESOP, by voting the stock sold to the ESOP.

7. The corporation can deduct the cost of both interest and principal payments on the loan from the lender.

8. The after tax cost to the corporation of repayment of principal is less than the original amount borrowed, including interest, as the government pays for a portion of the transaction.

9. The employee participants in the ESOP begin to think as owners even though they have no stock vote. They recognized that the more profitable they can make the corporation, the more the corporate stock will grow and this is the same stock that they have in their ESOP accounts. Stock growth also benefits the shareholders outside of the ESOP.