THE 1042 EXCHANGE

TAX INCENTIVES

FOR SELLING YOUR BUSINESS TO A COOPERATIVE

Worker-owned cooperatives are a powerful solution.

Worker cooperatives are a lower cost employee-ownership solution than transitioning to an Employee Stock Ownership Plan (ESOP) and have built-in profit-sharing. By selling the company to your employees through a coop conversion, you can craft a flexible exit strategy and realize market rate while preserving your legacy in the community. In addition, you can qualify for a potential lifetime deferral of capital gains and gain peace of mind knowing you have rewarded your hard-working employees in a way that retains your company's independent ownership after your transition. Your retirement is secure and your workers will have gained equity in the business, profit sharing and a democratic say in strategic decisions.

ONLY **15%** of businesses succeed to the next generation

66% of privately held businesses in the US are owned by baby boomers.

85% of business owners do not have succession plans.

Learn how to preserve these businesses and jobs in our communities!

VISIT US AT **PROJECT-EQUITY.ORG**

How do I qualify for the tax exemption?

You must sell a minimum of 30% of your company stock in the first year to a worker-owned cooperative and reinvest the proceeds into a Qualified Replacement Property (QRP)* within 12 months of the sale. If you hold the QRP stock for life, your heirs will not pay federal capital gains taxes. The remaining 70% of the stock can be sold to the worker coop over time. You must hold the reinvested QRP stock for at least 3 years. To qualify, the new worker cooperative must be subject to Subchapter T of the IRS Code and cannot be taxed as a partnership. Consult a financial planner and attorney to assess the pros and cons of the 1042 exchange for your situation.

project {EQUITY}

*QRP is stock in domestic (US) operating companies that pass both the asset test (<50% assets in active trade) & income test (>25% passive income of gross receipts in year preceding sale). Generally, any publicly traded stock will be considered a QRP.

Businesses

Experience higher productivity & growth.
Lower employee turnover.
Improved lifespan.

Communities

Retain good businesses & jobs.
Experience greater civic engagement.
Circulate more money locally.

Workers

Enjoy better pay & benefits.
Build assets & equity.
Have a voice in key decisions.
Grow leadership skills.

1042 Tax Exchange

Defer or eliminate federal capital gains tax by selling your business to a worker-owned cooperative.

Section 1042 of the IRS code allows you to sell your C-Corp to a worker-owned cooperative, then elect not to recognize the long-term capital gains realized in connection with the sale. By following the Section 1042 guidelines, you can defer, or even eliminate federal capital gains tax from the sale of your business.

- You must sell a minimum of 30% of the company stock in the first year to a worker-owned cooperative. The remaining 70% can be sold to the worker coop over a period of time.
- You can sell the entire company stock or convert it from a C-Corp to a cooperative corporation all at one time, if that is the best option.
- You must be a C-Corporation at the time of the transaction. (It is possible to convert to a C-Corp from an S-Corp, LLC or partnership prior to the sale of stock.)
- You must reinvest the proceeds in a Qualified Replacement Property (QRP)* within 12 months of the sale of stock (this includes sales in any subsequent years). Because of this, the seller must receive a lump sum payment for the first year. This means that the seller cannot hold a personal note for this portion of the sale, and thus may require involvement of an outside lender unless the employees or the worker coop have sufficient funds to make the purchase. Seller-backed financing for the remaining 70% is possible.
- You can remain an employee and even an officer of the company after a sale, helping with the transition to employee ownership. If you stay on as an employee-owner, you receive allocations of patronage dividends like all other owners, usually based on hours worked (or some other equitable formula).

Additional stipulations:
1. You must hold the reinvested QRP for at least 3 years.
2. If you purchase QRP in another corporation in which you own controlling interest, a sale of any of that corporation's stock (not just the stock purchased as QRP) will automatically be treated as a sale of QRP and become subject to capital gains tax.
3. If you hold the QRP for life, your heirs will not pay capital gains taxes; they will inherit the stock at a step up basis and can sell the QRP stock with no capital gains tax.
4: In order to qualify for a 1042 deferral, the new worker cooperative must be subject to Subchapter T of the Internal Revenue Code and cannot be taxed as a partnership.

Be sure to consult a financial planner and attorney to assess the pros and cons of the 1042 exchange for your situation. Some financial institutions or brokerage firms may allow you to borrow against the QRP portfolio to give you access to a portion of the capital for retirement income. Cash flow needs, investment risk and other factors need to be carefully considered. For more information visit PROJECT-EQUITY.ORG.

*QRP is stock in domestic (US) operating companies that pass both the asset test (<50% assets in active trade) & income test (>25% passive income of gross receipts in year preceding sale). Generally, any publicly traded stock will be considered a QRP.

This is not intended to be legal or tax advice. Be sure to consult a legal or tax expert as every situation is different.

Thank you to Linda Phillips of Phillips Law Offices for her help developing this document.

project {EQUITY}