How to defer (or eliminate) capital gains tax on the sale of your business

Internal Revenue Code Section 1042

The Capital ESOP Group

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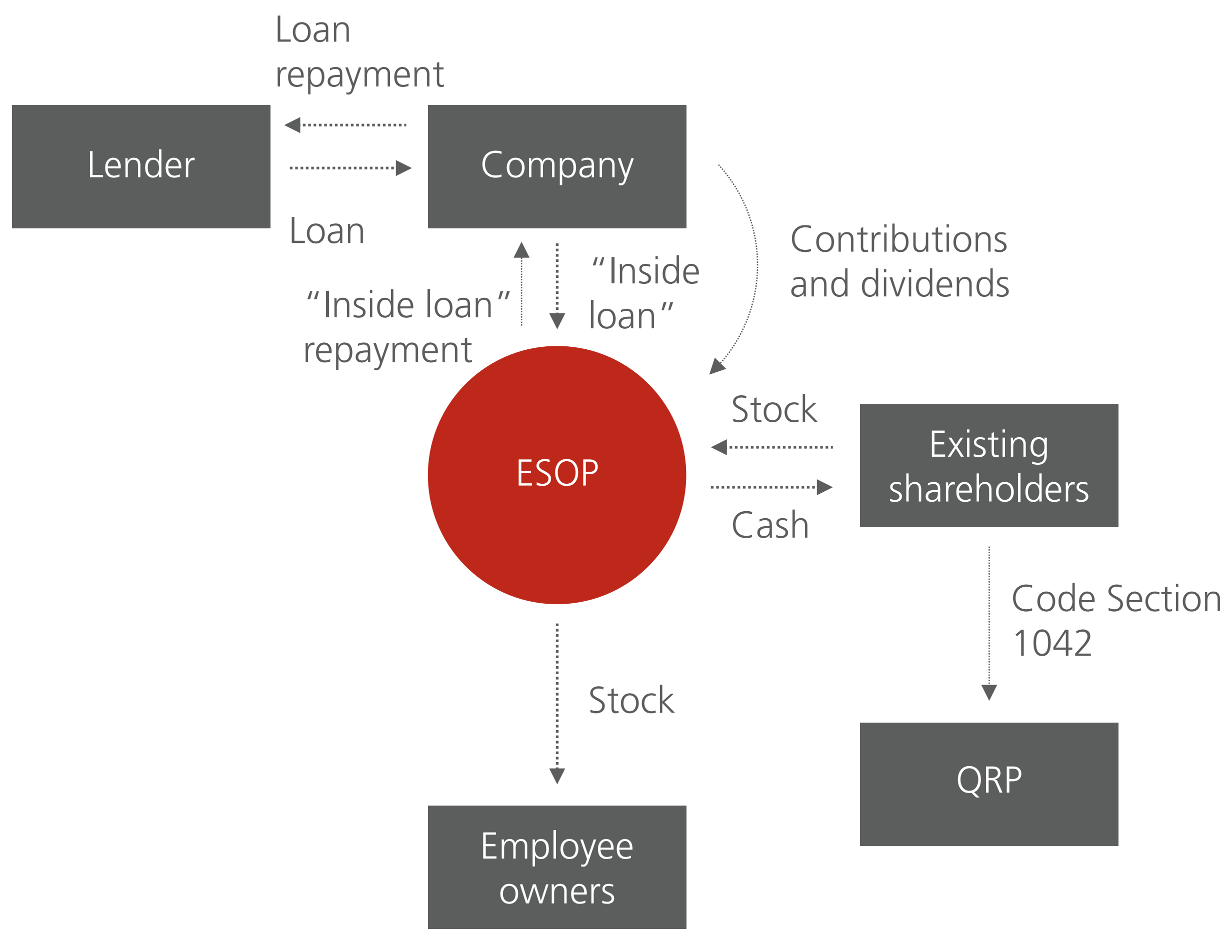
The process: From start to finish

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 Code Section 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



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Selling shareholder options*

Selling shareholder pays capital gains tax

Typically, an ESOP sale is structured as a stock sale, as opposed to an asset sale. Therefore, each selling shareholder is taxed at their individual capital gains tax rate on the sale.

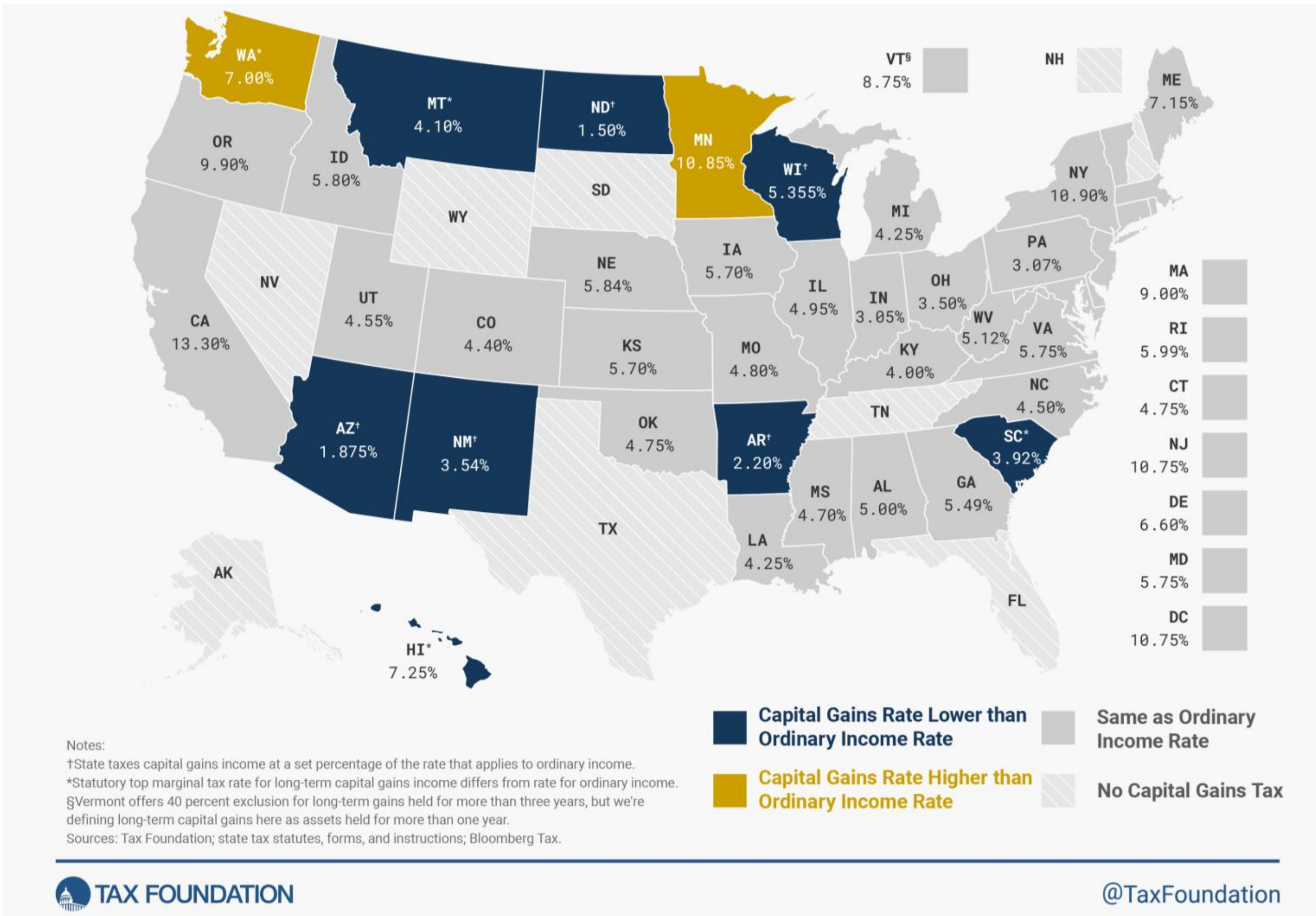
Selling shareholder elects Section 1042 treatment

Under Code Section 1042 of the Internal Revenue Code ("Code"), eligible shareholders can defer capital gains tax 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 QRP. If structured properly, the taxpayer will avoid paying all long-term capital gains taxes, similar to the real estate provision Code Section 1031 and life insurance Code Section 1035.

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

State tax rates on long-term capital gains, 2024

Effective top marginal state individual income tax rates on long-term capital gains as of January 1, 2024.



Loughead, Katherine. "State Tax Rates on Long-Term Capital Gains, 2024." Tax Foundation, April 2, 2024, https://taxfoundation.org/data/all/state/state-capital-gains-tax-rates-2024. Accessed December 13, 2024.

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Can I elect Code Section 1042 for the sale of my business?

In order to elect Code Section 1042, the company that is sponsoring the ESOP must be a C corporation on the date of the stock sale. An S corporation can convert to C status to enjoy the tax advantages of the Code Section 1042 election; however, there is a minimum 5-year waiting period before the company can convert back to an S corporation.

Publicly-traded corporations are *not eligible* to elect Code Section 1042. However, the following taxpaying entities are qualified to elect Code Section 1042:

- Individual
- Trust
- Partnership

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Can I elect Code Section 1042 for the sale of my business?*

If you meet the previous qualifications, you may be able to elect Code Section 1042 for the sale of your business. The following conditions must also be met:

- The ESOP must own at least 30% of the company after the transaction
- The selling shareholder must have held the stock for at least three years prior to the sale and must not have received the stock sold to the ESOP from:
  - A retirement plan
  - Pursuant to a stock option
  - As restricted stock
  - As a form of compensation
- Must be common stock having the highest voting and dividend rights or preferred stock convertible into such common stock
- The sale proceeds must be reinvested into QRP during the window starting three months prior to the sale and ending 12 months after the sale
- The company must be a non-publicly traded C corporation

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

What is 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 US-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 US government agencies, non-US entities, US subsidiaries of non-US 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. This basis is the purchase price of the QRP reduced by the amount of gain not recognized as a result of the Code Section 1042 election.

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

What is Qualified Replacement Property?*

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)

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

What are my options as a selling shareholder?

The selling shareholder may want to consider “staggering” the sales of stock to better participate in the growth of the company while phasing out of ownership. This approach could considerably widen the one-year reinvestment window by creating a sequence of multiple reinvestment periods.

While Code Section 1042 does not technically allow for partial election, the same result can be obtained if the taxpayer makes a full election, reinvests all proceeds from the ESOP transaction in QRP and then later divests a portion of the proceeds to trigger immediate taxation.

If a taxpayer does not reinvest an amount equal to all sale proceeds in QRP, there will be a current tax applied to the non-QRP invested amounts, and the capital gain on this amount cannot be reduced by any basis component.

What are my reinvestment options as a selling shareholder?

There are several reinvestment strategies available for the selling shareholder to fulfill the obligations of the Code Section 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

What are my reinvestment options as a selling shareholder?

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.

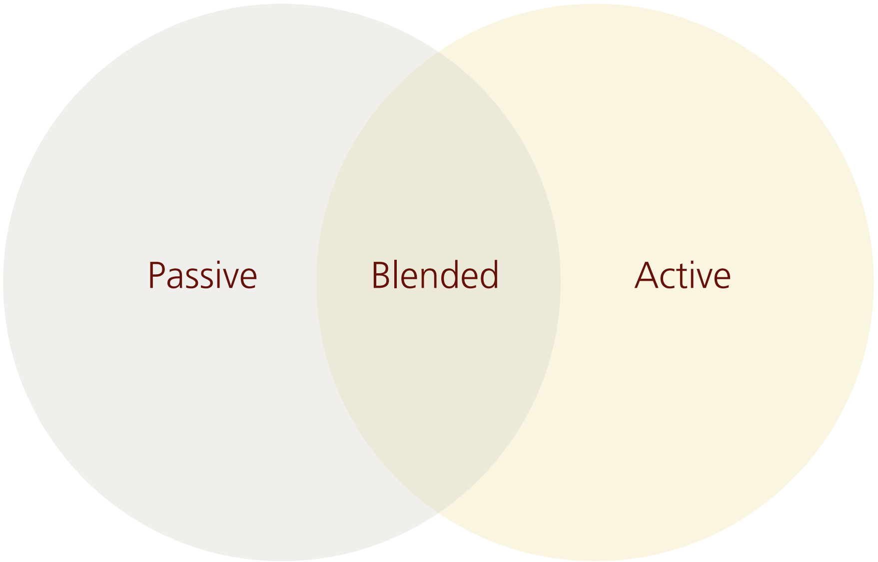
Active reinvestment strategy: Invest a portion of the proceeds at closing (typically 10% of the total amount received in the sale to the ESOP) and enter into a monetization loan for the remaining amount. Then, use the proceeds of the monetization loan to purchase FRNs that satisfy Code Section 1042 requirements. 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.

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



Active

- Leveraged Floating Rate Notes (FRNs) enable 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

Blended

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

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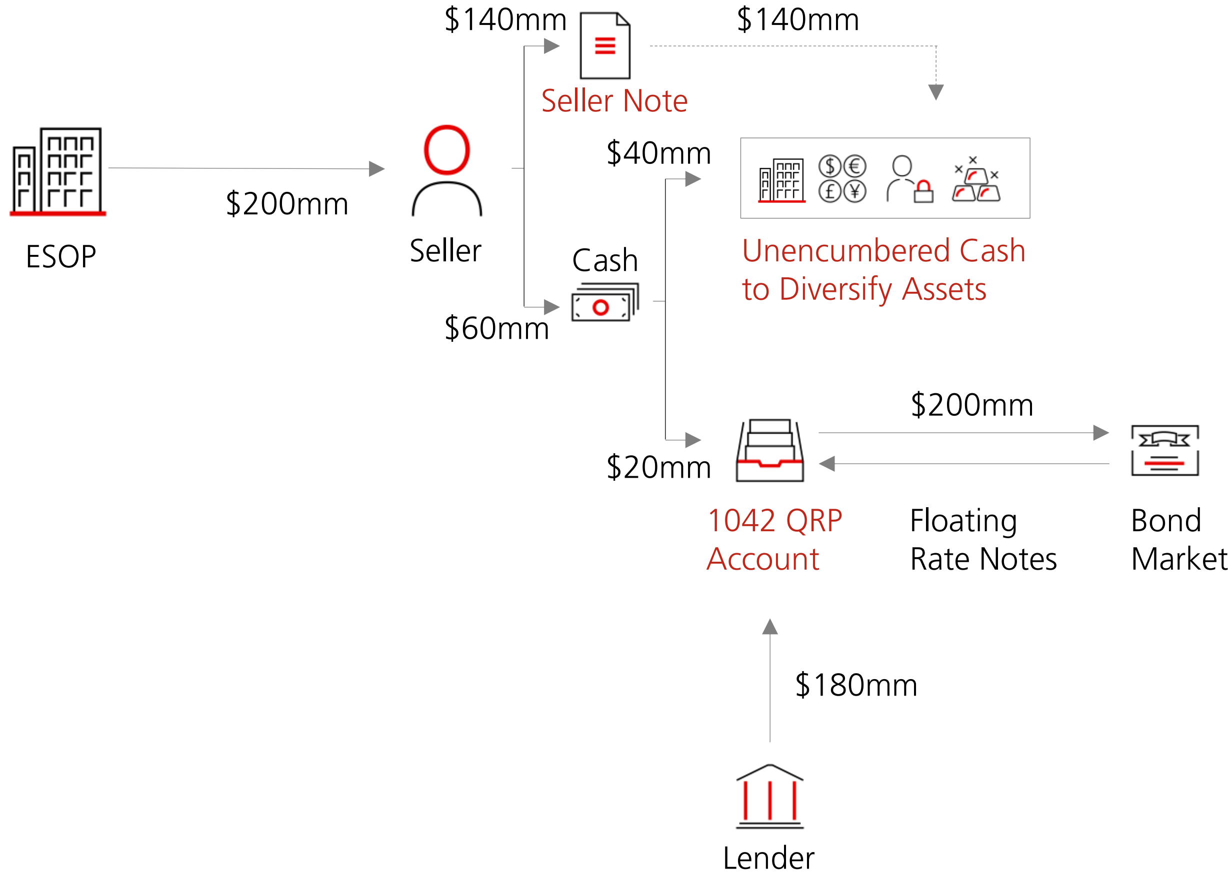
How active reinvestment works ($200mm example)

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**



* Subject to credit approval.
** Interest from the Seller Note is subject to applicable taxes.
This illustration is for demonstration purposes only. No representation is made that the shareholder will achieve results similar to those shown.

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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.

What is a floating rate note?

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

Procter & Gamble, Exxon Mobil, JP Morgan, Colgate Palmolive, United Parcel Service, Bank of America, Duke Energy, US Bank, Florida Power & Light, Merck.

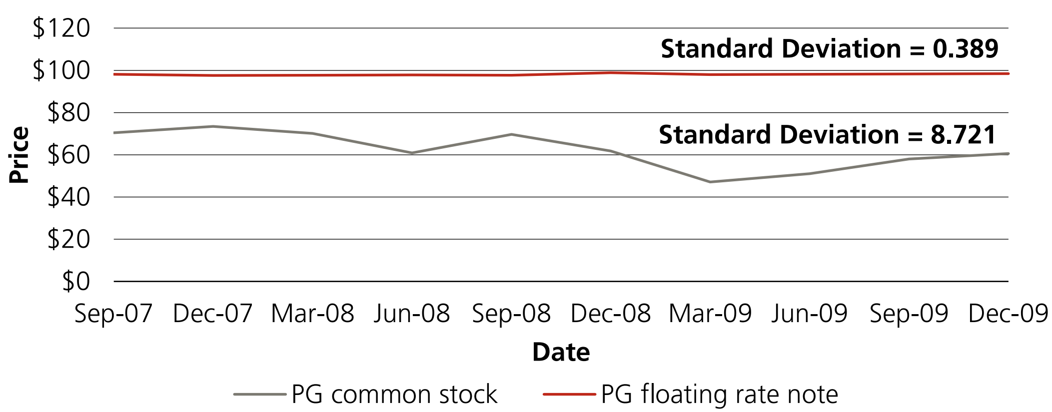
Why is UBS comfortable lending up to 90% of the value of FRNs?

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 97% 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

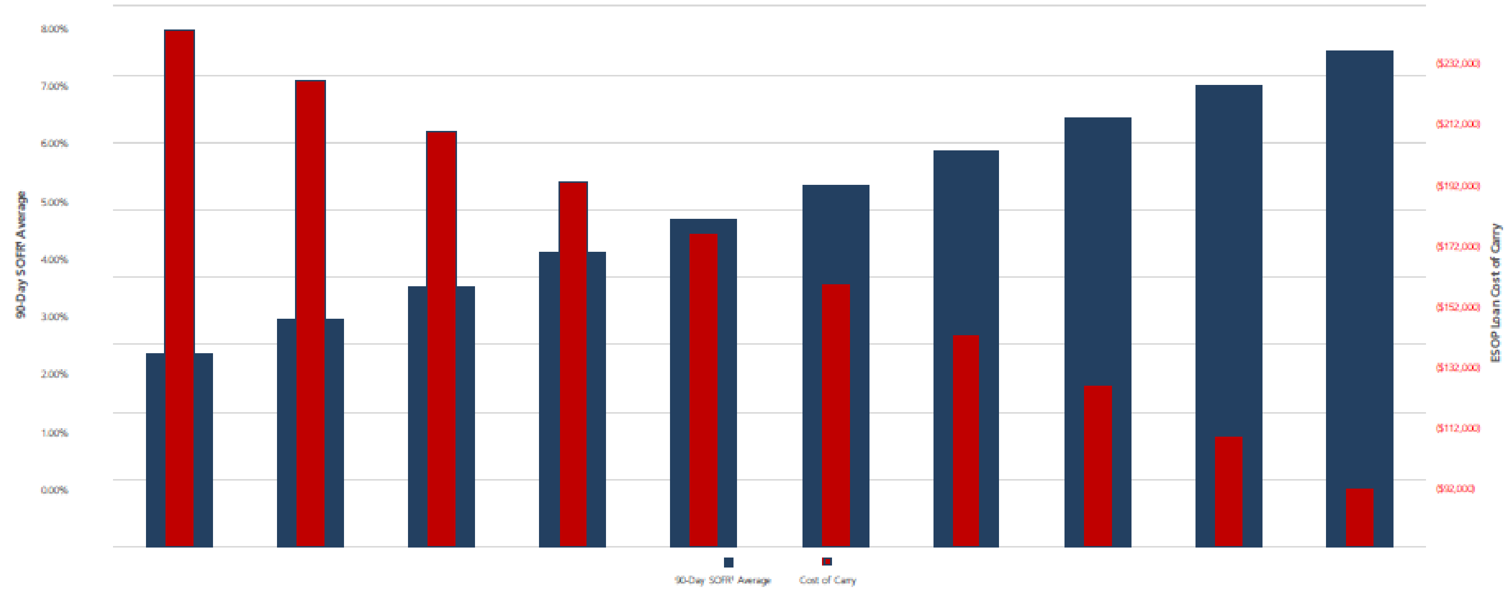


Year	PG common stock	PG floating rate note
9/28/07	70.34	98.08
12/31/07	73.42	97.55
3/31/08	70.07	97.66
6/30/08	60.81	97.74
9/30/08	69.69	97.73
12/31/08	61.82	98.85
3/31/09	47.09	98.03
6/30/09	51.10	98.10
9/30/09	57.92	98.20
12/31/09	60.63	98.37

*Source: Bloomberg terminal

Relationship Between SOFR and 1042 Cost of Carry Using Current Interest Rates
Full §1042 Deferral: 100% ESOP Bonds

Assumptions				
ESOP Bond Amount	Loan Amount	30-Day SOFR² Average	Loan Spread³	Current Loan Rate
$55,000,000	$49,500,000	5.32%	0.90%	6.22%



Illustrative example of the relationship between 90-Day SOFR¹ Average and the cost of carry in a 100% ESOP bond portfolio using current interest rates

Current Rates

90-Day SOFR¹ Average	2.86%	3.36%	3.86%	4.36%	4.86%	5.36%	5.86%	6.36%	6.86%	7.36%
30-Day SOFR² Average	2.82%	3.32%	3.82%	4.32%	4.82%	5.32%	5.82%	6.32%	6.82%	7.32%

ESOP Bond Income (SOFR¹ - 0.30%)**	2.56%	3.06%	3.56%	4.06%	4.56%	5.06%	5.56%	6.06%	6.56%	7.06%
Interest Rate on Loan	3.72%	4.22%	4.72%	5.22%	5.72%	6.22%	6.72%	7.22%	7.72%	8.22%

Income from ESOP Bonds	$1,408,000	$1,683,000	$1,958,000	$2,233,000	$2,508,000	$2,783,000	$3,058,000	$3,333,000	$3,608,000	$3,883,000
Interest Expense on Loan*	($1,841,400)	($2,088,900)	($2,336,400)	($2,583,900)	($2,831,400)	($3,078,900)	($3,326,400)	($3,573,900)	($3,821,400)	($4,068,900)
Cost of Carry (Cash Flow)	**($433,400)**	**($405,900)**	**($378,400)**	**($350,900)**	**($323,400)**	**($295,900)**	**($268,400)**	**($240,900)**	**($213,400)**	**($185,900)**
Net Add-Back (Tax)	$207,599	$194,426	$181,254	$168,081	$154,909	$141,736	$128,564	$115,391	$102,219	$89,046
Surplus / (Cost) of Carry (With Add-back)	**($225,801)**	**($211,474)**	**($197,146)**	**($182,819)**	**($168,491)**	**($154,164)**	**($139,836)**	**($125,509)**	**($111,181)**	**($96,854)**

* ESOP Bond Income has a floor or 0.00%.

[1] 90-Day SOFR average is calculated for the period of the previous 90 calendar days, as of the stated date on the title page.

[2] 30-Day SOFR average is shown as of the stated date on the title page.

The projections that follow take into account current Federal and State Income Taxes and have been prepared on the basis of information that you provided to UBS Financial Services Inc. If any information is erroneous, if expected of returns are not realized, or if tax laws change, the projections will be inaccurate. You must understand that the projections are merely estimates of the tax consequences and economic results of alternative courses of action. UBS Financial Services Inc. neither represents nor warrants that the projections will confirm to actual tax consequences or economic results of any of the alternatives provided. Further, realize that this analysis is provided for informational purposes only, with the understanding that providing this document UBS Financial Services Inc. is not providing legal or tax advice. This information should be reviewed with your legal or tax advisor before an alternative is selected.

Results of calculations may not be exact due to rounding to the nearest dollar.

* The Margin Expense amount, i.e., which constitutes interest paid on money borrowed to buy stock, can be taken as an itemized tax deduction, subject to certain limitations. The limitations are: (1) The deduction for investment interest expense is limited to the net investment income. Excess interest expense can be carried over to the next year. (2) The deduction is subject to the 2% of AGI limit on itemized deductions. (3) No deduction can be taken in excess of the actual Margin Expense. For examples purposes only: If the only taxable investment income generated by the portfolio is the ESOP Bond Income, the maximum deduction will be limited to such income. (4) UBSVR is based on 30-day SOFR2 plus a spread. (5) Assumptions and information are as of stated date on the title page and reflect current market conditions.

How do I elect Code Section 1042 treatment for the sale of my business?

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

Three "statements" must be filed with the IRS to successfully complete the Code Section 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 nonrecognition treatment with respect to the stock sale under Code Section 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 US 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).

Next steps

We are not opposed to any specific Code Section 1042 strategy or lender. We are open to discussing and implementing all Code Section 1042 strategies and can work with outside lenders and advisors.

We prefer to meet with each shareholder individually, as our goal is to evaluate the best approach for each client.

Work with selling shareholders and advisors to refine goals

- Pay the tax vs. elect Code Section 1042 treatment
- Elect Code Section 1042 treatment for the entire sale and then liquidate some portion of QRP to pay tax now

Decide whether an active reinvestment strategy, passive strategy or blended approach is suitable for each shareholder

- Meet in person with our team to develop an understanding of risk tolerance, goals and time horizon

Create execution timeline

- Timing of monetization loan
- Use of short-term commercial paper to bridge risk of premature death
- Organize syndication amongst shareholders to go to debt capital markets to market as a group
- Be opportunistic—there are unique conditions in the QRP/FRN secondary marketplace that may allow for opportunities to take advantage of price dislocations

Let us know how we can help you

The Capital ESOP Group

UBS Financial Services Inc.
1150 17th Street Northwest Fifth Floor
Washington, DC 20036
202-585-5358

advisors.ubs.com/capitalesopgroup

Keith J. Apton, CEPA®
Private Wealth Advisor
Managing Director–Wealth Management
keith.apton@ubs.com

Joanne Ferland, CFA
Senior Wealth Strategy Associate
joanne.ferland@ubs.com

Marguerite Hodgkins, CFP®
Senior Wealth Strategy Associate
marguerite.hodgkins@ubs.com

Kaveh Gilanshah, CEPA®
Senior Wealth Strategy Associate
kaveh.gilanshah@ubs.com

Steve Brinckhaus
Senior Registered Client Associate
steve.brinckhaus@ubs.com

Caroline Ryan
Registered Client Associate
caroline.ryan@ubs.com

Nick J. Francia, CEPA®
Private Wealth Advisor
Managing Director–Wealth Management
nick.francia@ubs.com

Sarah Bothner, CEPA®, CRPC®
Senior Wealth Strategy Associate
sarah.bothner@ubs.com

Breton Laubscher, CIMA®, CRPS®, AWMA®
Relationship Manager
breton.laubscher@ubs.com

Jake Pantalone
Wealth Strategy Associate
jake.pantalone@ubs.com

Alexandra Mulligan
Registered Client Associate
alexandra.mulligan@ubs.com

David Gordon
Wealth Strategy Associate
david.j.gordon@ubs.com

Robert Hobson
Registered Client Associate
robert.hobson@ubs.com

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Active Reinvestment Strategy Considerations

Legal and tax considerations: 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. In addition, shareholders who sell into an ESOP should understand the applicable rules of the Code, including requirements for qualified replacement property as defined by Code section 1042 ("QRP").

QRP Considerations: 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's 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. Further, for QRP that is a FRN, any payment on a FRN, including any repayment of principal, is subject to the creditworthiness of the issuer. Investors could lose their entire investment in the FRN if the issuer becomes insolvent. Shareholders who invest in QRP should consult with their tax and legal advisors regarding their personal circumstances. The strategies and/or investments referenced may not be suitable for all investors as the appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Investing involves risks and there is always the potential of losing money when you invest.

Margin Loan Considerations: Margin loans are demand loans and are subject to credit approval and collateral maintenance requirements. The lender can demand repayment at any time without notice. If the required collateral value is not maintained, the lender can require you to post additional collateral, repay part or all of your loan and/or sell your securities. Failure to promptly meet a request for additional collateral or repayment or other circumstances (e.g., a rapidly declining market) could cause the lender to liquidate some or all of the collateral supporting the margin loan. Any required liquidations may result in adverse tax consequences. Margin loans are subject to credit approval.

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