

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:

September 13, 2001

LEGEND

Taxpayer =

Company =

ESOP =

Brokerage Firm =

Law Firm =

This responds to your letter requesting a ruling on behalf of the above-named taxpayer that upon the timely filing of the taxpayer's 2000 U.S. Individual Income Tax Return, under the facts described below, the taxpayer will have substantially complied with the requirements of section 1042 of the Internal Revenue Code of 1986 (Code) and the applicable regulations in connection with the sale of stock of the Company to the employee stock ownership plan (ESOP) maintained by the Company.

The Company is a domestic corporation with only one class of common stock outstanding at the time of the sale to the ESOP and at present. The Company has never had any stock outstanding that was readily tradable on an established securities market. The Company maintains an ESOP which qualifies under section 401(a) and meets the requirements of section 4975(e)(7) of the Code. The ESOP has received a favorable determination letter from the Internal Revenue Service.

On June 13, 2000, the taxpayer sold 9100 shares of common stock of the Company to the ESOP for a purchase price of \$ 1,244,971. As a result of the sale, the taxpayer realized a gain. The taxpayer had held the common stock for more than 3 years and had not received the stock in a distribution from a plan described in section 401(a), or in a transfer pursuant to an option or other right to acquire stock to which sections 83, 422 or 423 applied. After the transaction, the ESOP held more than 95%

of the total value of the outstanding stock of the Company.

The taxpayer represents that at all times before and after the transaction, the taxpayer intended to defer recognition of the gain on the sale under section 1042. In May 1997, the taxpayer and the current officers of the company entered into an agreement which generally obligated the parties to use their best efforts to cause the ESOP to purchase the taxpayer's shares of the Company and stated that it was the intention of the parties that the purchase would satisfy the requirements of section 1042. On the date of the ESOP transaction, the Company executed a statement of consent pursuant to section 1042(b), whereby the company consented to be bound by the terms of sections 4978 and 4979A. The taxpayer deposited the sales proceeds that he intended to reinvest in qualified replacement property with the Brokerage Firm into an account segregated from taxpayer's other investments and designated as the taxpayer's ESOP transaction account. The Brokerage Firm was fully informed that the taxpayer intended to invest the sales proceeds from the ESOP transaction so as to comply with the requirements of section 1042.

Prior to the ESOP transaction, the taxpayer was represented by Law Firm in his business and personal affairs. Law Firm advised the Company when it established the ESOP and currently represents the taxpayer. For purposes of the ESOP transaction, Law Firm represented the Company and the taxpayer retained special counsel to avoid any potential conflict of interest.

In correspondence leading up to the ESOP transaction, Law Firm advised the taxpayer of the general requirements of a section 1042 election. While this correspondence advised the taxpayer of the requirement to complete a notarized statement of purchase for qualified replacement property (QRP), it did not specify that a separate statement of purchase must be completed within 30 days of each date on which QRP is purchased. Based on this letter, the taxpayer formed the erroneous belief that only one comprehensive statement of purchase was required within 30 days after all QRP had been purchased.

On the date of the ESOP transaction, Law Firm provided the taxpayer's special counsel the forms required for a 1042 election and advised special counsel that the taxpayer should have a separate statement of purchase form notarized within 30 days of each date on which QRP is purchased. The taxpayer's special counsel is a business lawyer who is not a ESOP specialist and did not appreciate the importance of the 30 day requirement. Further, immediately after the closing, the taxpayer advised special counsel that his representation was completed and that the taxpayer intended to resume representation by Law Firm. Therefore, special counsel did not provide the required forms or instructions to the taxpayer or maintain continuing contact with the taxpayer. Law Firm did not follow up with the taxpayer regarding compliance with section 1042, believing that special counsel was providing guidance to the taxpayer in this matter as part of his representation on the ESOP transaction.

Thus, the taxpayer relied on the earlier correspondence from Law Firm. He intended to purchase his entire portfolio of QRP by June 13, 2001, and complete one comprehensive statement of purchase within 30 days from the date of his final purchase.

In twenty-three separate transactions during August, 2000, the taxpayer purchased securities intended to be QRP at a total cost of \$839,490.38. The taxpayer advised his broker that these securities were intended to be QRP when they were purchased. The taxpayer has additional realized gain with which he intends to purchase QRP before June 13, 2001. Therefore, believing he was to wait until he purchased his entire portfolio of QRP, he did not complete a timely statement of purchase for the purchase made in August, 2000.

In anticipation of the preparation of his U.S. Individual Income Tax Return for the taxable year 2000, the taxpayer contacted Law Firm to discuss his progress in purchasing QRP. At that time, Law Firm informed the taxpayer of the requirement to complete a notarized statement of purchase within 30 days of each purchase. Thereafter, Law Firm completed this private letter ruling request on behalf of the taxpayer and the taxpayer promptly completed the statement of purchase for QRP purchased in August 2000.

The taxpayer has requested extensions of time to file his U.S. Individual Income Tax Return for the taxable year 2000 and will file timely by the extended due date. The Taxpayer will elect under section 1042 to defer recognition of gain from the sale of the Taxpayer's stock to the ESOP. The Taxpayer will submit the following documents with the Taxpayer's 2000 Income Tax Return: i) a statement of election as described in Q&A-3 of section 1.1042-1T of the Temporary Income Tax Regulations; ii) a notarized statement of purchase with respect to the qualified replacement property purchased in August 2000 as described above, and notarized statements of purchase for any other QRP purchased within the replacement period, and iii) a verified written statement of the Company consenting to the application of section 4978 and 4979A as required in section 1042(b)(3).

You have requested a ruling that, based on the specific facts of this case, the taxpayer will be treated as having substantially complied with the requirements for an election for the nonrecognition of gain under section 1042, and that the election will be treated as having satisfied the requirements of section 1.1042-1T of the Temporary Income Tax Regulations upon the filing of his 2000 Individual Income Tax Return.

Section 1042(a) of the Code provides that a taxpayer or executor may elect in certain cases not to recognize long-term capital gain on the sale of "qualified securities" to an ESOP (as defined in section 4975(e)(7)) or eligible worker owned cooperative if the taxpayer purchases "qualified replacement property" (as defined in section 1042(c)(4)) within the replacement period of section 1042(c)(3) and the requirements of section 1042(b) and section 1.1042-1T of the Temporary Income Tax Regulations are

satisfied.

A sale of "qualified securities" meets the requirements of section 1042(b) if: (1) the qualified securities are sold to an ESOP (as defined in section 4975(e)(7), or an eligible worker owned cooperative; (2) the plan or cooperative owns (after application of 318(a)(4)), immediately after the sale, at least 30 percent of - a) each class of outstanding stock of the corporation (other than stock described in section 1504(a)(4)) which issued the securities, or (b) the total value of all outstanding stock of the corporation (other than stock described in section 1504(a)(4)); (3) the taxpayer files with the Secretary a verified written statement of the employer whose employees are covered by the ESOP or an authorized officer of the cooperative consenting to the application of section 4978 and 4979A with respect to such employer or cooperative; and (4) the taxpayer's holding period with respect to the qualified securities is at least 3 years (determined as of the time of the sale).

For taxable years beginning after December 31, 1997, section 1042(c)(1) provides that the term "qualified securities" means employer securities (as defined in section 409(l)) which are issued by a domestic C corporation that has no stock outstanding that is readily tradable on an established securities market; and were not received by the taxpayer in a distribution from a plan described in section 401(a), or in a transfer pursuant to an option or other right to acquire stock to which section 83, 422 or 423 applied.

The taxpayer must purchase "qualified replacement property" within the "replacement period" which is defined in section 1042(c)(3) as the period which begins 3 months before the date on which the sale of qualified securities occurs and ends 12 months after the date of such sale.

Section 1042(c)(4)(A) defines "qualified replacement property" (QRP) as any security issued by a domestic operating corporation which did not, for the taxable year preceding the taxable year in which such security was purchased, have passive investment income (as defined in section 1362(d)(3)(D)) in excess of 25 percent of the gross receipts of such corporation for such preceding taxable year; and is not the corporation which issued the qualified securities which such security is replacing or a member of the same controlled group of corporations (within the meaning of section 1563(a)(1)) as such corporation.

Section 1.1042-1T (Q&A-3) of the Temporary Income Tax Regulations states that the election shall be made in a "statement of election" attached to the taxpayer's income tax return filed on or before the due date (including extensions of time) for the taxable year in which the sale occurs.

Section 1.1042-1T (Q&A-3) of the Temporary Income Tax Regulations states that the "statement of election" shall provide that the taxpayer elects to treat the sale of securities as a sale of qualified securities under section 1042(a), and shall contain the following information:

- (1) A description of the qualified securities sold, including the type and number of shares;
- (2) The date of the sale of the qualified securities;
- (3) The adjusted basis of the qualified securities;
- (4) The amount realized upon the sale of the qualified securities;
- (5) The identity of the ESOP or worker-owned cooperative to which the qualified securities were sold;
- (6) If the sale was part of a single interrelated transaction under a prearranged agreement between taxpayers involving other sales of qualified securities, the names and taxpayer identification numbers of the other taxpayers under the agreement and the number of shares sold by the other taxpayers.

Section 1.1042-1T (Q&A-3) of the Temporary Income Tax Regulations further provides that if the taxpayer has purchased qualified replacement property at the time of the election, the taxpayer must attach as part of the statement of election a "statement of purchase" describing the qualified replacement property, the date of the purchase, and the cost of the property, and declaring such property to be qualified replacement property with respect to the sale of qualified securities. The statement of purchase must be notarized no later than 30 days after the purchase.

Literal compliance with procedural directions in Treasury regulations on making elections is not always required. See *Hewlett-Packard v. Commissioner*, 67 T.C. 736, acq. in result 1979-1 C.B. 1. Regulatory requirements that relate to the substance or the essence of the statute, on the other hand, must be complied with strictly.

With respect to the present ruling request, the taxpayer requested relief before the expiration of the time for filing the return on which the election must be made. The taxpayer relied on tax professionals to advise him as to the requirements necessary to complete the section 1042 election in a timely and correct manner. Promptly upon discovering that the statements of purchase were not notarized in a timely manner, and prior to the expiration of the time to file the taxpayer's 2000 Income Tax Return, the taxpayer completed a notarized statement of purchase for QRP purchased in August, 2000.

Therefore, based on the specific facts of this case and representations made by the taxpayers, we conclude that the taxpayer will have substantially complied with the requirements for an election under section 1042 of the Code, and that the election will be treated as having satisfied the requirements of section 1042 and of section 1.1042-1T of the Temporary Income Tax Regulations upon the timely filing of the taxpayer's 2000 U.S. Individual Income Tax Return.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely yours,
Robert D. Patchell
Acting Chief, Qualified Plans Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:

Copy of this letter

Copy for 6110 purposes