

## Internal Revenue Service

Department of the Treasury

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### LEGEND

Taxpayer =

Company =

ESOP =

d1 =

x =

y =

z =

Dear :

This responds to your letter requesting a ruling on behalf of the above-named Taxpayer concerning the application of section 1042 of the Internal Revenue Code of 1986 (Code) to the transaction described below.

The Company is a domestic corporation incorporated on d1. The authorized capital stock of the Company consists of x shares of common stock of which y shares are outstanding. The Company has never had any stock outstanding that was readily tradable on an established securities market. The Taxpayer was one of the original shareholders of the Company. Although other persons have owned stock in the Company, the Taxpayer (including a revocable trust established by the taxpayer the

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income of which is taxable to the taxpayer under the grantor trust provisions of the Code) has owned all of the outstanding stock of the Company for at least the past eight years. Although the Company was originally a C corporation, an election was made pursuant to section 1362(a) of the Code, to be taxed as a Subchapter S corporation effective for the 1984 taxable year. Both the Taxpayer and the Company use the calendar year for tax and accounting purposes.

The taxpayer is z years old and unmarried. He has children but they are not involved in the business. The taxpayer has, therefore, been reviewing plans for the ultimate disposition of the Company. The taxpayer has considered a sale of the Company to a third party and has evaluated the possibility of an employee purchase. The taxpayer believes that the employees are important to the further growth and long term prosperity of the Company and that some form of employee ownership could be expected to have a positive impact on morale and ensure continued loyalty.

In order to implement employee ownership, the Taxpayer proposes to have the Company establish an employee stock ownership plan (ESOP) meeting the requirements of section 4975(e)(7) of the Code. The Taxpayer would then cause the termination of the Company's Subchapter S election under section 1362(d) of the Code by transferring a portion of the stock to a person not described in section 1361(b)(1)(B). The Taxpayer would then sell a portion of his remaining stock to the ESOP in a transaction that the Taxpayer represents would satisfy the requirements of section 1042 of the Code and applicable regulations at section 1.1042-1T of the Temporary Income Tax Regulations. The actual amount of stock to be sold to the ESOP has not been determined at this time and would depend on the amount of financing that the ESOP could obtain and the fair market value of the stock.

The Taxpayer has requested a ruling that the stock of the Company will constitute "qualified securities" as defined in section 1042(c)(1) of the Code and that the Taxpayer's holding period for purposes of section 1042(b)(4) will include the time during which the Company's subchapter S election was in effect.

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

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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) under section 1042(b)(4).

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.

Section 409(l)(1) provides that "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market. Section 409(l)(2) provides that if there is no common stock which meets the requirements of section 409(l)(1), "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of: i) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, or ii) that class of common stock of the employer (or of any other such corporation) having the greatest dividend rights.

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.

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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.

With respect to the present ruling request, the Company has only one class of common stock outstanding. The Company's stock has never been publicly sold. The Taxpayer did not acquire his shares of Company stock as a distribution from a retirement plan or pursuant to the exercise of an option or other right to acquire stock to which section 83, 422 or 423 applied. The Taxpayer represents that before the sale to the ESOP the corporation will have terminated its subchapter S election and will be a C corporation. The Taxpayer will have held the Company stock for more than three years at the time of the sale to the ESOP.

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Therefore, based on the specific facts of this case and representations made by the taxpayers, and provided that the ESOP is qualified under section 401(a) of the Code and meets the requirements of section 4975(e)(7), we conclude that: 1) the stock of the Company will constitute "qualified securities" as defined in section 1042(c)(1) of the Code; and, 2) that the Taxpayer's holding period for purposes of section 1042(b)(4) will include the time during which the Company's subchapter S election was in effect.

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(s) 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,

James L. Brokaw  
Chief, Branch 5  
Associate Chief Counsel  
(Employee Benefits and  
Exempt Organizations)

Enclosures:

Copy of this letter

Copy for 6110 purpose