

Internal Revenue Service

Department of the Treasury

Number: **200337003**
Release Date: 09/12/2003
Index Number: 1042.03-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EB:QP2- PLR-165198-02

Date:

June 6, 2003

LEGEND

Taxpayers =

Trusts =

Company A =

Company B =

ESOP =

Date D =

State G =

Dear :

This responds to the letter dated , submitted by your representative requesting a private letter ruling, and additional information dated , concerning whether, under the facts described below, the stock of a newly formed real estate corporation will constitute qualified replacement property within the meaning of section 1042(c)(4) of the Internal Revenue Code of 1986 (Code), and therefore, whether the sale of stock of the Company A to the employee stock ownership plan (ESOP) maintained by the company and subsequent purchase of qualified

replacement property will satisfy the requirements for an election under section 1042(a) of the Code.

Company A is a domestic C corporation with one class of common stock outstanding. Company A has never had any stock outstanding that was readily tradable on an established securities market. Company A established an ESOP which is intended to be qualified under section 401(a) and to meet the requirements of section 4975(e)(7) of the Code. The ESOP received a favorable determination letter from the Service, dated December 14, 2000, stating that the plan is an ESOP under section 4975(e)(7).

Until Date D, Taxpayers held 242,024 shares out of the total of 298,805 shares of Company A (80.99%). All but approximately 1% of the remaining shares were held by the ESOP. On Date D, Taxpayers established revocable trusts governed by the laws of State G and subsequently transferred all of their respective shares in Company A into the Trusts. Taxpayers are the respective grantors and trustees of the Trusts. Pursuant to the trust instruments, the trusts may be revoked, in whole or in part, before the death of either grantor. The trustees have discretion to distribute income or principal to the grantors. The grantors can direct the trustees to pay amounts out of the trust estate to any other person or organization. Sections 671 to 677 of the Code contain rules under which the grantor of a trust will be treated as the owner of all or any portion of the trust. Taxpayers represent that the Trusts are grantor trusts within the meaning of sections 671 to 677 and accompanying regulations.

The Trusts propose to sell 40,000 shares of common stock of Company A to the ESOP in a sale intended to qualify under section 1042(a) of the Code. Taxpayers 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. Taxpayers represent that after the transaction, the ESOP will own at least 30% of the outstanding stock of Company A; or at least 30% of the total value of all outstanding stock of Company A.

Taxpayers have formed Company B, a domestic corporation that will be in the business of buying, owning, leasing and managing commercial real estate. Company B will elect to be taxed for income tax purposes as an S corporation as defined in section 1361(a)(1). Trusts propose to reinvest all of the proceeds from the sale of Company A stock to the ESOP in the stock of Company B within the qualified replacement period with respect to the sale as defined in section 1042(c)(3) and that the proceeds of the sale of stock to the ESOP will be used to further the business of Company B. As a result, each trust would own 50% of all the outstanding shares of Company B following the proposed reinvestment.

Taxpayers represent that Company B has been formed and is presently engaging in an active trade or business. Taxpayers represent that Company B has engaged in the following activities in furtherance of its real estate business: filing articles of incorporation of a building management company; contracting with management company to assist with project management services; conducting visits to

potential project sites in nearby states; meeting with political leaders to discuss potential projects; received incentive package from State G for proposed real estate development; filed applicable Federal and state income tax returns; marketing of real estate management business to community.

Taxpayers represents that Company B would provide numerous services to the tenants of property that it manages. For example, it would provide management office staff from 8:00 a.m. to 5:00 p.m. Monday through Friday; on-call office staff 24 hours per day, seven days per week; janitorial (office cleaning) services; security system monitoring; security guards; pest control; repairs of common areas; window cleaning; parking garage cleaning; central mail location; refuse disposal; remodeling of office space and tenant build-outs; painting; landscaping; contracting for repairs and maintenance as required; processing of contracting for repairs and maintenance as required; processing of tenant requests and complaints; negotiation of leases; collection of rents; analysis of lease data; and providing notices to tenants regarding building matters. Company B would pay all building operating costs, including property taxes, insurance and utilities.

Taxpayers have requested the following rulings: (1) Company B qualifies as an "operating corporation" under section 1042(c)(4)(B) of the Code; (2) shares of stock in Company B received by Taxpayers upon reinvestment of the proceeds received from the sale of Company A stock to the ESOP are qualified replacement property within the meaning of section 1042(c)(4) of the Code; and (3) the sale of Taxpayers' Company A stock to the ESOP and subsequent repurchase of Company B stock will constitute a section 1042 exchange under the Code.

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.

Section 1042(c)(1) provides that the term "qualified securities" means employer securities (as defined in section 409(l)) which (a) are issued by a domestic corporation that has no stock outstanding that is readily tradable on an established securities market, and (b) 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)(C)) 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 1042(c)(4)(B) defines an "operating corporation" as a corporation more than 50 percent of assets of which, at the time the security was purchased or before the close of the replacement period, were used in the active conduct of a trade or business.

Except as otherwise provided in subparagraph (C), section 1362(d)(3)(C)(i) provides that the term "passive investment income means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations provides that "rents" means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that "rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Generally, Section 1042(c)(4)(C) provides that controlling and controlled corporations shall be treated as one corporation in the following instances:

(i) In general. For purposes of applying this paragraph, if --

(I) the corporation issuing the security owns stock representing control of 1 or more other corporations,

(II) 1 or more other corporations own stock representing control of the corporation issuing the security, or --

(III) both,

then all such corporations shall be treated as 1 corporation.

(ii) Control. For purposes of clause (i), the term "control"

has the meaning given such term by section 304(c). In determining control, there shall be disregarded any qualified replacement property of the taxpayer with respect to the section 1042 sale being tested.

Section 304(c) defines control as the ownership (including attributed ownership under section 318(a)) of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of the shares of all classes of stock.

Section 318(a)(5)(E) treats an S corporation as a partnership for purposes of section 318(a) and treats any shareholder of an S corporation as a partner of the partnership. Under section 318(a)(3)(A), all stock owned directly or indirectly by or for a partner (or S corporation shareholder) is attributed to the partnership (or S corporation), regardless of the size of the partner's (shareholder's) interest in the partnership (corporation). Because it is an S corporation, Company B would be viewed as owning all of the Company A stock owned by the Trusts and thus as being in control of Company A under the 50 percent test of section 304(c). However, section 1042(c)(4)(C)(ii) provides that, in determining control, there shall be disregarded any qualified replacement property of the taxpayer with respect to the section 1042 sale being tested. Accordingly, for purposes of section 1042(c), Company A and Company B are not treated as controlled corporations.

Therefore, based on the specific facts of this case and representations made by the taxpayer and provided that Company B engages in business activities in the manner described above for the year in which the proceeds of the sale will be reinvested, we conclude that:

- (1) Company B qualifies as an "operating corporation" under section 1042(c)(4)(B) of the Code.
- (2) Shares of stock of Company B received by the Taxpayers upon reinvestment of the proceeds received from the sale of Company A stock to the ESOP are qualified replacement property within the meaning of section 1042(c)(4) of the Code.
- (3) Provided that the taxpayers comply with the requirements of section 1042 and section 1.1042-1T of the Temporary Income Tax Regulations with respect to the requirements for making an election under section 1042, taxpayers' sale of Company A stock and subsequent purchase of Company B stock will qualify for nonrecognition under section 1042.

No rulings were requested and no opinion is expressed with regard to whether any other aspects of the transaction satisfy the requirements of section 1042 of the

Code.

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
Chief, Qualified Plans Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:

Copy for 6110 purposes

CC: