

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

January 4, 1999

LEGEND

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Company =

ESOP =

Dear :

This responds to your letter requesting a ruling on behalf of the above-named shareholders regarding the substantial compliance of the shareholders 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.

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The Company is a domestic corporation with only one class of common stock outstanding at the time of the sale to the ESOP. The Company has never had any stock outstanding that was readily tradable on an established securities market. The Company maintains an ESOP, which was effective as of February 1, 1996, and 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.

The shareholders of the Company (prior to the sale of their interests to the ESOP) were as follows: 1) Shareholder A held 15,300 shares; 2) Shareholder B held 15,600 shares; 3) Shareholder C held 1,100 shares; 4) Shareholder D held 1,100 shares; 5) Shareholder E held 1,100 shares.

The ESOP purchased all of the outstanding common stock of the Company from the shareholders through a transaction which occurred in two phases. Phase One was the acquisition of 10,250 shares of common stock from Shareholder A on January 31, 1997, which represented 30% of the value and 30% of the total number of shares outstanding as of that date with an option to the ESOP to purchase the remaining shares. Phase two of the transaction was the purchase of the 23,950 additional shares of common stock pursuant to the exercise of the option as follows: Shareholder B- 15,600 shares; Shareholder A- 5,050 shares; Shareholder C- 1,100 shares; Shareholder D- 1,100 shares; Shareholder E- 1,100 shares. Phase two of the ESOP acquisition occurred on May 1, 1997, after which the ESOP held 100% of the outstanding common stock of the Company.

In both Phase One and Phase Two of the ESOP acquisition, the shareholders sold, at a substantial gain, shares of Company stock representing their interests in the Company to the ESOP in a sale that taxpayers represent satisfied the requirements of section 1042(b) of the Code. Each shareholder had held such 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.

Prior to the sale, the shareholders, inexperienced in ESOP matters, contacted their legal and accounting professionals involved in the ESOP acquisition and sought their advice regarding the technical requirements of section 1042. Based on this advice, the shareholders determined that it would be prudent to retain an experienced investment counselor with respect to the election that could be made under section 1042 to defer recognition of gain from a sale of qualified securities to an ESOP.

The shareholders interviewed various brokerage firms and investment counselors with respect to the issues involved in connection with the section 1042 election and compliance with the applicable requirements set forth in the Code and regulations. Each of the brokerage firms and investment advisors represented that it

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had expertise in employee benefits matters, in general, and leveraged employee stock ownership plans, in particular, including investment counseling regarding the section 1042 election procedures.

Shortly after completion of the ESOP acquisition, the shareholders selected an investment counselor, a national trust company, where they had not previously maintained an account, in order to segregate the funds from the ESOP acquisition from other investments. The trust company, upon being retained by the shareholders to provide professional advice in connection with the section 1042 election, assumed full responsibility for the investments as well as compliance requirements associated with section 1042, including preparation of the various statements required to complete the election. The trust company represented to the shareholders that it had the expertise required to satisfy these responsibilities.

The shareholders indicated to the trust company their intention to make the election under section 1042 and defer recognition of gain from the sale. Accordingly, the shareholders deposited the proceeds of the sale with the trust company, relying on them to complete the transaction and comply with the requirements of the Code and applicable regulations.

Within the period beginning three months before each sale and ending twelve months after, the shareholders, through their professional advisors, purchased securities, in numerous transactions, that were intended to be qualified replacement property within the meaning of section 1042(c)(4) of the Code. In several telephonic conferences involving the shareholders, the trust company and the accountants, the trust company repeatedly assured the shareholders and their advisors that it was an ESOP specialist. Throughout this period of time, the accountants for the shareholders discussed compliance with the requirements of section 1042 with the trust company and were assured that the section 1042 requirements were being handled in a timely manner.

While preparing the 1997 income tax returns for the shareholders, the accountant discovered that the trust company had failed to properly advise the client as to the notarization requirements associated with the statements of purchase required by section 1.1042-1T of the Temporary Income Tax Regulations. After several conversations with the investment advisor and its counsel, in which the trust company denied that an issue had arisen, and after research undertaken by both the trust company and its attorney, the compliance problem was recognized by the trust company, which admitted its failure to satisfy the notarization requirements associated with the statements of purchase. Once the error was discovered, all future investments were properly notarized; however, since some of the purchases had been made prior to the 30 day period preceding the discovery, a portion of the statements of purchase were not executed and notarized in a timely manner.

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For the 1997 taxable year, the shareholders will be filing the appropriate income tax returns in a timely manner (all returns are on extension), to elect under section 1042 to defer the recognition of gain from the sale of the company stock to the ESOP. With the return, each shareholder will submit: i) a statement of election as described in Q&A-3 of section 1.1042-1T of the Temporary Income Tax Regulations, including a statement of the cost of the qualified replacement property purchased, the allocation of unrecognized gain to the replacement property and the adjusted basis of the replacement property; ii) notarized statements of purchase with respect to the qualified replacement property, and iii) a verified written statement of the Company consenting to the application of section 4978 and 4979A of the Code.

The shareholders represent that they have complied with all of the requirements of the Code and applicable regulations with respect to the section 1042 election, except that some of the statements of purchase were not notarized within the period prescribed by the temporary regulation, based on the shareholders reliance on their professional advisor.

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

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).

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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;

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(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 shareholders requested relief before the expiration of the time for filing the return on which the election must be made. The taxpayer relied on investment professionals experienced with ESOP transactions to advise them as to the preparation of any forms necessary to complete the section 1042 election in a timely and correct manner. Immediately upon discovering that the statements of purchase were incorrectly notarized, the shareholders requested that their professional advisors review the statements of purchase to verify compliance with the 30 day requirement and to ensure that all future statements of purchase be executed in a timely manner.

Therefore, based on the specific facts of this case and representations made by the taxpayers, we conclude that the shareholders have substantially complied with the requirements for an election under section 1042 of the Code, and that the elections will be treated as satisfying the requirements of section 1.1042-1T of the Temporary Income Tax Regulations at Q&A-3 concerning the notarized statements of purchase with respect to qualified replacement property purchased by the shareholders.

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.

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

The rulings contained in this letter are based upon information and representations submitted by the taxpayer(s) 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 purposes