

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

July 29, 1999

Legend

Taxpayer =

Company =

ESOP =

Law Firm =

X =

Y =

Dear :

This responds to a letter requesting a ruling regarding Taxpayer's substantial compliance with the requirements of section 1042 of the Internal Revenue Code of 1986 (the 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.

Taxpayer owned shares of stock in the Company, a domestic corporation with only one class of common stock issued and outstanding. The Company has never had stock outstanding that is readily tradeable on an established securities market. The Company adopted an employee stock ownership plan (the "ESOP"), as defined in Section 4975(e)(7) effective as of January 1, 1998, with respect to which the Internal Revenue Service issued a favorable determination letter.

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On June 4, 1998, shareholders, including Taxpayer, sold shares of common stock of the Company to the ESOP (the "ESOP transaction"). Taxpayer sold **X** shares of stock to the ESOP. As a result of the ESOP transaction, Taxpayer realized a gain. The Taxpayer had held **Y** shares of such common stock for more than three 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 ESOP transaction, the ESOP owned 100% of the common stock of the Company.

The Taxpayer deposited the sale proceeds from the **Y** shares with a brokerage firm. In nine separate transactions over the period July 1998, through September 1998, Taxpayer invested proceeds from the sale of the **Y** shares of stock in securities issued by domestic operating companies. The Taxpayer intended the securities to constitute QRP as defined by section 1042(c)(4) of the Code.

In connection with the ESOP transaction, Taxpayer was advised by Law Firm, the law firm that advised company when it established the ESOP and that currently represents Taxpayer. Although the firm explained generally the conditions necessary to secure the deferral of recognition of the gain from the ESOP transaction under section 1042, it failed to advise Taxpayer that Taxpayer was required to complete a notarized Statement of Purchase with respect to securities intended to constitute QRP within 30 days after the purchase of each item of QRP. In September 1998, Law Firm informed Taxpayer of the requirement that Taxpayer complete a notarized Statement of Purchase. Taxpayer completed a notarized Statement of Purchase in October 1998, immediately after learning of the requirement. With respect to QRP purchased by Taxpayer on July 1998 through August 1998, the Statement of Purchase was completed more than 30 days after the purchase dates.

You represent that Taxpayer is a cash basis taxpayer and that Taxpayer intends to file Taxpayer's 1998 income tax return in a timely manner by the due date with any applicable extensions. The Taxpayer will elect under Section 1042(a) to defer the recognition of gain from the sale of Taxpayer's stock to the ESOP. You further represent that Taxpayer will submit the following documents with Taxpayer's 1998 income tax return: (1) Statement of Election, as described in Q&A-3 of Treas. Reg. Section 1.1042-1T; (2) a notarized Statement of Purchase with respect to the QRP, as described in Q&A-3 of the Treas. Reg. section 1.1042-1T; and (3) a verified written statement of Company consenting to the application of Sections 4978 and 4979A, as described in Q&A of Treas. Reg. section 1.1042-1T.

You request a ruling that, assuming Taxpayer will properly elect the application of Section 1042(a) of the Code with respect to the sale of qualified securities on Taxpayer's 1998 income tax return and will satisfy the requirements of section 1042 and Treas. Reg. section 1.1042-1T (but for timely notarization of Taxpayer's

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Statements of Purchase), the Taxpayer has substantially complied with the requirements for an election under section 1042(a) and that the election will be treated as satisfying the requirements of Section 1.1042-1T (Q&A-3) 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).

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

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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.

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Immediately upon discovering that Taxpayer's individual notarized statements of purchase were not executed in a timely manner and prior to the timely filing of such notarized Statements of Purchase with the Taxpayer's Income Tax Return for the taxable year 1998, Taxpayer completed notarized Statements of Purchase for all the intended QRP. Taxpayer intends to attach these Statements of Purchase to the Taxpayer's timely filed U.S. Income Tax Return for 1998. These transactions were made in reliance on guidance from tax professionals as to requirements to complete the section 1042 election in a timely and correct manner.

Therefore, based on the specific facts of this case and representations made on behalf of the Taxpayer, we conclude that the Taxpayer has 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 Taxpayer.

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.

The rulings contained in this letter are based upon information and representations submitted on behalf of 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,

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