

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

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Date:

September 13, 2001

### LEGEND

Shareholders =

Company =

ESOP =

Law Firm =

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This responds to your letter requesting a ruling on behalf of the above-named Shareholders regarding their substantial compliance with the requirements of section 1042 of the Internal Revenue Code of 1986 (Code) and the applicable regulations in connection with the sale of qualified securities of the Company to the employee stock ownership plan (ESOP) maintained by the Company.

The Shareholders owned shares of common stock of the Company, a domestic C corporation that 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. Eligible employees of the Company are participants in the ESOP.

On May 21, 1999, the Shareholders sold 24,920 shares of common stock of the Company to the ESOP. As a result of the sale, the Shareholders realized a capital gain. The Shareholders had held the common stock for more than 3 years prior to the ESOP sale 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.

The Shareholders invested the proceeds from the sale in securities issued by

domestic operating companies. On March 21, 2000, the Shareholders made their only purchase of securities that they intended to constitute qualified securities as defined in section 1042(c)(4).

In connection with the ESOP transaction, the Shareholders received input from Law Firm. Law Firm advised the ESOP and the ESOP trust in the transaction. As a courtesy to the Shareholders, Law Firm explained in writing to the Shareholders, and their investment advisors and certified public accountant, the conditions necessary to secure the deferral of recognition of gain under section 1042. However, the Shareholders inadvertently did not complete a notarized statement of purchase with respect to the securities that they purchased on March 21, 2000, and that they intended to constitute qualified replacement property, within 30 days after the date of purchase. The Shareholders completed the notarized statement of purchase for the purchase of qualified replacement property on May 4, 2000, immediately after discovering their lapse and before the expiration of the replacement period.

The Shareholders completed notarized statements of purchase for the intended qualified replacement property prior to the timely filing of such notarized statements of purchase with the Shareholder's Joint Income Tax Return for 1999.

The Shareholders are cash basis taxpayers and filed their 1999 Joint Income Tax Return in a timely manner by the due date including any applicable extensions. The Shareholders elected under section 1042(a) to defer recognition of gain from the sale of qualified securities to the ESOP. The Shareholders submitted the following documents with their 1999 income tax return: 1) a Statement of Election as described in Q&A-3 of section 1.1042-1T of the Temporary Income Tax Regulations; 2) a notarized statement of purchase with respect to the qualified replacement property purchased on March 21, 2000, as described in Q&A-3 of section 1.1042-1T of the Temporary Income Tax Regulations; and 3) a verified written statement of the Company consenting to the application of section 4978 and 4979A as required in section 1042(b)(3). The Shareholders' 1999 Joint Income Tax Return is not under audit by the Internal Revenue Service.

You have requested a ruling that, based on the specific facts of this case, the Shareholders have substantially complied with the requirements for an election to defer recognition of gain under section 1042 of the Code, and that the election will be treated as satisfying the requirements of section 1042 and 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).

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.

The Shareholders received the advice of tax professionals concerning 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, the Shareholders completed a notarized statement of purchase for the qualified replacement property.

Therefore, based on the specific facts of this case and representations made by the Shareholders, we conclude that the Shareholders have substantially complied with the requirements for an election to defer recognition of gain under section 1042 of the Code, and that the election will be treated as satisfying the requirements of section 1042 and section 1.1042-1T (Q&A-3) of the Temporary Income Tax Regulations.

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. No opinion is expressed regarding whether the securities purchased by the Shareholders constitute qualified replacement property as defined in section 1042(c)(4).

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(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,  
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