

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

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### Legend

Trust =

Company =

ESOP =

X =

Y =

Z =

Dear :

This responds to a letter sent on your behalf requesting a ruling regarding your 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.

The Company is a domestic corporation with only one class of common stock issued and outstanding at the time of sale of stock to ESOP. The Company has never had stock outstanding that was readily tradable on an established securities market. Company adopted ESOP, effective as of January 1, 1997. ESOP has been represented as being qualified under section 401(a) of the Code and as satisfying the requirements of section 4975(e)(7).

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You are trustee of the trust (the Trust), which is a trust established to hold assets for investment purposes. On November 1, 1997, seven (7) shareholders, including the Trust, sold **X** shares of common stock of the Company to the ESOP (the ESOP transaction). The Trust sold **Y** shares of its stock (the Stock) to the ESOP. As a result of the ESOP transaction, the Trust realized a gain of **Z** dollars. As of the date of the sale, the Trust had held the Stock for more than three years, and it had not received the Stock in a distribution from a plan described in Section 401(a) of the Code or in a transfer pursuant to an option or other right to acquire the stock to which Section 83, 422 or 423 of the Code applied. Immediately after the ESOP transaction, the ESOP owned more than 30% of the common stock of the Company.

The Trust immediately deposited the proceeds it received from the ESOP transaction from the sale of the Stock with a nationally known brokerage firm (the Brokerage Firm), which placed the proceeds in a special account (the Account). The Account was segregated from Trust's other investments. You intended to defer the gain from the ESOP Transaction. On behalf of the Trust, you made an election to defer gain pursuant to section 1.1042-1T of the Temporary Income Tax Regulations and attached the election to the Trust's 1997 tax return.

Then, from August 10, 1998 through October 26, 1998, the Brokerage Firm used funds from the Account to enter into a series of twenty-nine (29) transactions on behalf of the Trust, in which securities were purchased from domestic operating companies. The Trust intended that these securities would constitute qualified replacement property ("QRP"), as defined under section 1042(c)(4) of the Code. You were unaware that a notarized Statement of Purchase for each, individual transaction is required within 30 days of each purchase under section 1.1042-1T, Q&A-3 of the Temporary Income Tax Regulations. In November of 1998, you became aware of the misunderstanding regarding the proper completion of the Statement of Purchase and you completed one notarized Statement of Purchase for the Trust on November 25, 1998 for all the intended QRP.

The 1997 tax return for the Trust was filed in a timely manner. Attached to the return were all of the statements required for a valid section 1042 election, i.e., a statement of election and a verified written statement of the Company consenting to the application of sections 4978 and 4979A of the Code. You intend to file the notarized Statements of Purchase with the Trust's timely filed 1998 tax return, as required under Treas. Reg. Section 1.1042-1T.

You have requested a ruling that, by completing the notarization of the Statement of Purchase as discussed above and assuming all remaining requirements of section 1042 of the Code and regulations thereunder are met, the Trust has substantially complied with the requirements for making an election under section 1042 of the Code and section 1.1042-1T (Q&A-3) of the Temporary Income Tax Regulations, in order for the Trust to defer the recognition of gain realized on the sale of Stock to the

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Company.

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 before 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 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.

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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.

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.

Immediately upon discovering that the individual notarized statements of purchase were not executed in a timely manner, you attempted to correct the situation.

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Prior to the timely filing of such notarized Statements of Purchase with the Trust's U.S. Income Tax Return for the taxable year 1998, you became aware of the misunderstanding regarding the proper completion of the Statement of Purchase and you completed one notarized Statement of Purchase for all the intended QRP. You intend to attach this Statement of Purchase to the Trust's timely filed U.S. Income Tax Return for 1998. These transactions were made in reliance on tax professionals and a nationally known brokerage firm 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 by your representatives, we conclude that the Trust 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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your representative.

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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,

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