

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:EBEO:Br5-PLR-115539-99
Date:
January 27, 2000

Legend

- Taxpayer =
- Company =
- ESOP =
- A =
- X =
- Y =
- Z =

Dear :

This responds to a letter sent on your behalf requesting a ruling regarding the 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 that had no stock outstanding that was readily available on an established securities market at the time of your sale of stock to the ESOP. The Company maintains ESOP, which qualifies under section 401(a) of the Code 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.

On **A**, you sold **X** shares of your common stock of the Company to the ESOP (the "ESOP transaction"). In exchange, the ESOP paid a total of **Y** for the stock. As a result of the ESOP Transaction, you realized a gain of **Z**. You had held the common stock for more than three years and had not received the stock in a distribution from a plan described in Code section 401(a) or in a transfer pursuant to an option or other

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right to acquire stock to which Code section 83, 422 or 423 applied. After the ESOP transaction on **A**, the ESOP held more than 90% of the total value of the outstanding stock of the Company.

On the date of the ESOP transaction, the Company executed its Statement of Consent pursuant to Code section 1042(b), whereby the Company consented to be bound by the terms of Code sections 4978 and 4979A. Also on the date of the ESOP transaction, you executed your Statement of Election. You were informed by your attorney and by your accountant that the Statement of Consent and Statement of Election would need to be filed along with your timely filed 1998 Form 1040 U.S. Individual Income Tax Return in order for you to properly elect to have section 1042 of the Code apply to the ESOP Transaction.

Prior to depositing the sale proceeds into segregated accounts with three different investment advisory firms, you discussed with your accountant your intention to make a Section 1042 election and to defer the recognition of the gain from the ESOP transaction. The accountant spoke with you concerning the general details necessary for a valid Code section 1042 election to be made. The accountant did not discuss the need to have a notarized statement of purchase executed at the time that any replacement property was to be purchased because he erroneously thought that you did not intend to make any such purchases until September or October of 1999.

Contrary to the accountant's understanding, beginning on November 2, 1998, upon the recommendations of your investment advisors, you began to reinvest the ESOP Transaction sale proceeds into certain investments which would be suitable as qualified replacement property. You periodically reinvested the sale proceeds into certain securities until September 2, 1999, well within twelve months from the ESOP Transaction. As you were unaware of the requirement, you did not complete notarized Statements of Purchase within thirty days of the purchases as required by Temp. Treas. Reg. Section 1.1042-1T Q&A-3(b).

Prior to the end of the replacement period, the accountant followed up with you to discuss the purchase of replacement property. At that time, you informed the accountant that you had purchased a significant number of securities starting in November 1998 with the intention to elect to hold these securities as qualified replacement property. You were then advised to and did execute notarized Statement of Purchases covering the securities purchased between November 2, 1998, and September 2, 1999. At that time you also timely filed an amended 1998 U.S. Individual Income Tax Return to include the appropriate notarized Statements of Purchase.

A ruling has been requested that you have substantially complied with the requirements for making an election under section 1042 of the Code with respect to your sale of Company stock to the ESOP on **A**, and that the election, together with the executed Statements of Purchase covering property purchased between November 2,

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1998 and September 2, 1999, will be treated as having satisfied the requirements of section 1.1042-1T of the Temporary Income Tax Regulations so that the property covered by the Statements of Purchase can be treated as qualified replacement property within the meaning of Code section 1042.

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

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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.

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You relied on tax professionals to advise you 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 notarized statements of purchase were not executed in a timely manner, statements of purchase were notarized and were attached to your timely filed amended U.S. Individual Income Tax Return for the taxable year 1998.

Therefore, based on the specific facts of this case and representations made by you and your representative, we conclude that the you 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 you.

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 representatives.

The rulings contained in this letter are based upon information and representations submitted by the your representative 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)