

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:

Telephone Number:

In Re:

Refer Reply To:

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Date:

February 10, 2005

LEGEND

Taxpayer =

Company =

ESOP =

X Shares =

Y Dollars =

Dear :

This responds to your letter on behalf of the above-named Taxpayer requesting a ruling to treat the gain on the sale of Company stock to the ESOP as nonrecognized under section 1042 of the Internal Revenue Code of 1986 (as amended) (Code) under the facts described below.

Taxpayer is an employee and shareholder of the Company. The Company is a domestic C corporation that has only one class of stock outstanding (common stock). None of the sock of Company has ever been readily tradable on an established securities market. Company maintains an employee stock ownership plan (ESOP) as described in section 4975(e)(7). The Service has issued a determination letter stating that the ESOP satisfies the qualification requirements under section 401(a) and meets the requirements of section 4975(e)(7).

On \_\_\_\_\_, Taxpayer sold X shares of common stock of the Company to the ESOP for Y dollars pursuant to a stock purchase agreement. Taxpayer states that at all times before and after the sale of Company stock to the ESOP, Taxpayer intended to utilize section 1042 to defer recognition of gain realized on the sale to the ESOP. That intent was memorialized in the stock purchase agreement, which states that the transaction was structured so as to allow Taxpayer to benefit by making an election under section 1042. Thus, taxpayer represents that the transaction was designed to permit the Taxpayer to make an election under section 1042. After the sale, the ESOP held \_\_\_\_\_ of the Company's stock. Taxpayer states that he held the stock for more than 3 years and did not receive 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, 422A, 423 or 424 applied.

On \_\_\_\_\_, and again on \_\_\_\_\_, Taxpayer purchased securities which he represents were "qualified replacement property" within the meaning of section 1042(c)(4) with the proceeds of his sale of stock to the ESOP. Taxpayer purchased the replacement property during the qualified replacement period defined in section 1042(d)(3), which began 3 months before the date of the sale \_\_\_\_\_ and ended twelve months after the date of the sale \_\_\_\_\_.

Taxpayer represents that he completed a statement of purchase with respect to the purchase of such qualified replacement property on \_\_\_\_\_, describing the qualified replacement property, the date of purchase, and the cost of the property. Taxpayer represents that these statements of purchase also included a declaration that the property described in each statement was qualified replacement property with respect to the sale of qualified securities. Taxpayer's statements of purchase were notarized on \_\_\_\_\_, within 30 days after Taxpayer's purchase of the qualified replacement property.

Taxpayer instructed his professional tax preparer to prepare and file his 2002 Form 1040, U.S. Individual Income Tax Return. This professional preparer was aware of the ESOP transaction and of the Taxpayer's intent to elect non-recognition of gain under section 1042 with respect to that transaction. Taxpayer was not aware of the various statements required to be filed to complete an election under section 1042, nor was he advised of those requirements by his tax preparer. Taxpayer relied on his professional tax preparer to file the statements required for an election under section 1042.

Taxpayer's return preparer filed Taxpayer's 2002 Individual Income Tax Return in a timely manner on \_\_\_\_\_ (Taxpayer having been granted an extension). The taxable income reported on the return did not include gain from the sale of the Company stock to the ESOP. The return was filed as if the section 1042 election had been made but did not contain the necessary statements to complete the election under section 1042. (i.e., the tax return preparer did not attach a statement of election with respect to the sale of Company stock by the Taxpayer to the ESOP and did not attach a

verified written statement from the Company consenting to the application of sections 4978 and 4979A. Taxpayer's tax return preparer informed Taxpayer of the omission of the required statements on .

You have requested a ruling that, based on the specific facts of this case, the Taxpayer has substantially complied with the requirements of section 1.1042-1T of the Temporary Income Tax Regulations in connection with the treatment of the gain realized from the sale of stock to the ESOP under 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 section 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 member of the same controlled group of corporations (within the meaning of section 1563(a)(1)) as such corporation.

Section 1042(c)(6) provides that an election under section 1042(a) must be filed not later than the last day prescribed by law (including extensions thereof) for filing the return of tax imposed by this chapter for the taxable year in which the sale to the ESOP occurs.

Section 1.1042-1T (Q&A-3) of the Temporary Income Tax Regulations further provides 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.

Section 1042 requires that an election, in the form prescribed by the Secretary, be made by the due date (including extensions) of the return for the year of the sale of securities to the ESOP.

Sections 301.9100-1, 301.9100-2 and 301.9100-3 of the Procedure and Administration Regulations provide standards pursuant to which the Commissioner may grant a reasonable extension of the time to make a regulatory election. A regulatory election means an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin. A statutory election is an election whose due date is prescribed by statute.

Section 301.9100-2(b) provides an automatic extension of 6 months from the due date of a return (excluding extensions) for a taxpayer to make a regulatory or statutory election whose due date is the due date of the return (or the due date of the return including extensions) provided the taxpayer timely files its return for the year the election should have been made and the taxpayer takes corrective action described in paragraph (c) of that section within the 6 months extension period.

With respect to the present ruling request, Taxpayer's election to defer recognition of the gain realized on the sale of Company stock to the ESOP was required to be made on the Taxpayer's 2002 income tax return under section 1042(c)(6) and section 1.1042-1T of the Income Tax Regulations. The Taxpayer's 2002 income tax return did not show the sale of Company stock to the ESOP on Schedule D of Form 1040; the return did not include a statement of election as required by section 1.1042-1T, Q&A-3, or a statement of consent required by section 1042(b)(3) and Q&A-3 of section 1.1042-1T of the Income Tax Regulations.

The election to defer gain under section 1042(a) is a statutory election. The time for making the election is prescribed in section 1042(c)(6) of the Code. Except for the automatic 6 month extension under section 301.9100-2(b), the provisions of section 301.9100 are not applicable to the election under section 1042(a). Accordingly, since the period for taking corrective action under section 301.9100-2(b) has long since expired in this case, we conclude that no relief can be granted to Taxpayer under these provisions for the failure to make an election to defer recognition of gain from the sale of stock to the ESOP on his 2002 income tax return, nor can the Taxpayer be considered to have substantially complied with the provisions of the regulations.

Therefore, based on the specific facts of this case, we conclude that Taxpayer did not make a valid election to defer recognition of gain under section 1042 with respect to gain realized on the Taxpayer's 2002 sale of Company stock to the ESOP.

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 the taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers 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  
Chief, Qualified Plans Branch 2  
Division Counsel/Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosure:  
Copy for 6110 purposes