

Internal Revenue Service

Department of the Treasury

Number: **200324013**
Release Date: 6/13/2003
Index Number: 1042.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EB:QP2- PLR-158083-02

Date:

February 13,2003

LEGEND

Individual 1 =

Individual 2 =

Company =

ESOP =

X Shares =

\$ Y =

\$ Z =

Dear . :

This responds to your letter requesting a ruling on behalf of the above-named taxpayers that, under the facts described below, the taxpayers will have substantially complied with the requirements of section 1042 of the Internal Revenue Code of 1986 (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.

Individuals 1 and 2 are husband and wife. Their filing status for their U.S. Individual Income Tax Return is "married filing joint return."

The Company is a domestic corporation with only one class of common stock outstanding at the time of the sale to the ESOP and at present. The Company has never had any stock outstanding that was readily tradable on an established securities market. The Company established an ESOP which is intended to be qualified under section 401(a) and to meet the requirements of section 4975(e)(7) of the Code.

On October 3, 2001, Individuals 1 and 2 sold X shares of common stock of the Company to the ESOP for a purchase price of \$ Y. As a result of the sale, Individuals 1

and 2 realized a gain of \$ Z. Individuals 1 and 2 had held the common stock for more than 3 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 transaction, the ESOP held more than 68.4% of the total value of the outstanding stock of the Company.

Individuals 1 and 2 represent that at all times before and after the transaction, they intended to defer recognition of the gain on the sale under section 1042. On the date of the transaction, Company executed a statement of consent pursuant to section 1042(b) whereby the Company agreed to be bound by the terms of sections 4978 and 4979A.

The attorney handling the transaction advised Individual 1 of some of the requirements for electing deferral of gain under section 1042. The attorney did not, however, advise Individuals 1 or 2 of the requirement that a statement of purchase be notarized within 30 days of each purchase of qualified replacement property.

Individuals 1 and 2 placed the proceeds from the ESOP transaction into several segregated jointly-owned accounts at various investment firms. In a series of transactions from October 3, 2001, through September 27, 2002, Individuals 1 and 2 invested the proceeds of the sale in stock of domestic operating corporations. Individuals 1 and 2 intended these shares to be qualified replacement property. However, Individuals 1 and 2 did not execute a notarized statement of purchase until the series of transactions was complete.

Individuals 1 and 2 relied on their long-standing tax return preparer to prepare their 2001 U.S. Individual Income Tax Returns. Individual 1 instructed the tax return preparer that \$ Y had been received as proceeds from the sale of Company stock to the ESOP and that it was intended to defer recognition of gain on this transaction under section 1042. The tax return preparer did not attach any of the required statements to the tax return that he prepared or advise Individuals 1 and 2 that the tax return he had prepared was incomplete without the required statements. As a result, none of the required statements were attached to the tax return that Individuals 1 and 2 filed on or about April 9, 2002.

In September 2002, Individual 1 realized that the required statements had not been attached to the 2001 tax return and that the statements of purchase had not been notarized within the required 30 day period. Upon completing the series of transactions through which qualified replacement property was acquired, Individuals 1 and 2 promptly executed a notarized statement of purchase. Pursuant to section 301.9100-2 of the Procedure and Administration regulations, as of a date on or before October 15, 2002, Individuals 1 and 2 filed an amended U.S. Individual Income Tax Return for 2001, which included the required statement of election, statement of consent and notarized statement of purchase.

You have requested a ruling that, based on the specific facts of this case, the taxpayer will be treated as having substantially complied with the requirements for an

election for the nonrecognition of gain under section 1042, and that the election will be treated as having satisfied the requirements of section 1.1042-1T 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.

Sections 301.9100-1, 301.9100-2, and 301.9100-3 of the Procedure and Administration Regulations provide the standards the Commissioner will use to determine whether to grant an extension of time to make a regulatory election. Sections 301.9100-1 and 301.9100-2 also provide an automatic extension of time to make certain statutory elections. Section 301.9100-1(b) of the regulations defines a regulatory election as 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. Section 301.9100-1(b) defines a statutory election as an election whose due date is prescribed by statute.

Section 301.9100-2(b) provides that an automatic extension of 6 months from

the due date of a return (excluding extensions) is granted to make a statutory election whose due date is the due date of the return or the due date of the return including extensions provided that the taxpayer timely filed its return for the year the election should have been made and the taxpayer takes "corrective action" as defined in paragraph (c) of this section within the 6 month period.

Section 301.9100-2(c) provides that "corrective action" means taking the steps required to file the election in accordance with the statute or the regulation published in the Federal Register. For those elections required to be filed with a return, corrective action includes filing an original or an amended return for the year the statutory election should have been made and attaching the appropriate form for or statement for making the election. Taxpayers who make an election under an automatic extension (and all taxpayers whose tax liability would be affected by the election) must file their return in a manner that is consistent with the election and comply with all other requirements for making the election for the year the election should have been made and for all affected years; otherwise, the IRS may invalidate the election.

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.

With respect to the present ruling request, because the deadline for making an election to defer recognition of gain under section 1042(a) is set by section 1042(c)(6) as the due date (including extensions) of the taxpayer's return for the year of the sale, section 1042(a) is a statutory election. Accordingly, section 301.9100-2(b) provides an automatic extension of 6 months from the due date of the return for the year in which the sale to the ESOP was made in order to make a section 1042 election provided that the taxpayers' return was timely filed for the year the election should have been made and the taxpayer takes corrective action as defined in section 301.9100-2(c) within the 6 month period. In the present case, Individual 1 and 2's tax return for the year of the sale to the ESOP was filed before the due date set forth in section 1042(c)(6) and corrective action within the meaning of section 301.9100-2(c) was taken by Individuals 1 and 2 before 6 months from such due date.

With respect to the notarized statements of purchase, Individuals 1 and 2 relied on 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, Individuals 1 and 2 completed a notarized statement of purchase for the qualified replacement property.

Therefore, based on the specific facts of this case and representations made by Individuals 1 and 2, and provided that the ESOP was qualified under section 401(a) and met the requirements of section 4975(e)(7) of the Code at the time of the sale, we conclude that Individuals 1 and 2 have substantially complied with the requirements for an election under section 1042 of the Code, and that the election will be treated as

satisfying the requirements of section 1042 and of section 1.1042-1T 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.

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 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 yours,

Robert D. Patchell
Chief, Qualified Plans Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:
Copy for 6110 purposes

CC: