



13 of 21 DOCUMENTS

Notice of Proposed Rulemaking

Notarized Statements of Purchase Under Section 1042

2003-2 C.B. 550; 2003 IRB LEXIS 1551; 2003-37 I.R.B. 550

September 15, 2003

[*1]

RELATED-REFS:

REFERENCE: REG-121122-03

TEXT:

AGENCY:

Internal Revenue Service (IRS), Treasury.

ACTION:

Notice of proposed rulemaking.

SUMMARY:

This document contains proposed amendments to the temporary regulations under *section 1042 of the Internal Revenue Code of 1986*. The proposed regulations would affect taxpayers making an election to defer the recognition of gain under *section 1042* on the sale of stock to an employee stock ownership plan. The proposed regulations provide guidance on the notarization requirements of the temporary regulations.

DATES:

Written and electronic comments and requests for a public hearing must be received by October 7, 2003.

ADDRESSES:

Send submissions to: CC:ITA:RU (REG-121122-03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-121122-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations, John T. Ricotta at (202) 622-6060 (not a [*2] toll-free number); concerning submissions or hearing requests, Sonya Cruse, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the requirement of §1.1042-1T, A-3 (b) of the Temporary Income Tax regulations that a statement of purchase for qualified replacement property be notarized within 30 days of the date of purchase of the property (30-day notarization requirement).

The temporary regulations under *section 1042* were published in *T.D. 8073, 1986-1 C.B. 45*, on February 4, 1986 (EE-63-84) (*51 FR 4312*) as part of a package of temporary regulations addressing effective dates and other issues under the Tax Reform Act of 1984. The text of the temporary regulations also served as a notice of proposed rulemaking (EE-96-85, *1986-1 C.B. 697 [51 FR 4391]*). A public hearing was held on June 26, 1986, concerning the proposed regulations.

Explanation of Provisions

Overview

Section 1042 (a) 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 employee stock ownership plan (ESOP) (as defined in *section 4975 (e) (7)*) or eligible worker owned [*3] cooperative (as defined in *section 1042 (c) (2)*) 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 § 1.1042-1T of the Temporary Income Tax Regulations are satisfied.

Section 1042 (c) (1) provides that the term *qualified securities* means employer securities (as defined in *section 409 (1)*) which are issued by a domestic C corporation that has no stock outstanding that is readily tradable on an established securities market and which 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.

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 [*4] *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 *sections 4978 and 4979A* (which provide for excise taxes on certain dispositions or allocations of securities acquired in a sale to which *section 1042* applies) with respect to such employer or cooperative; and (4) the taxpayer's holding period with respect to the qualified securities is at least three years (determined as of the time of the sale).

The taxpayer must purchase *qualified replacement property* within the *replacement period*, which is defined in *section 1042 (c) (3)* as the period which begins three 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* as any security issued by a domestic operating corporation which did not, for the taxable year preceding the taxable year in which [*5] such security was purchased, have passive investment income (as defined in *section 1362 (d) (3) (C)*) 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) (4) (B) defines an *operating corporation* as a corporation more than 50 percent of the assets of which, at the time the security was purchased or before the close of the replacement period, were used in the active conduct of a trade or business.

Section 1.1042-1T A-3 (a) of the Temporary Income Tax Regulations states that the election is to 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 A-3 (b) states that the *statement of election* must provide that the taxpayer elects to treat the sale of securities as a sale of qualified securities under *section 1042 (a)* and must contain the following information: [*6] (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 eligible worker-owned cooperative to which the qualified securities were sold; and (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 1.1042-1 T, A-3 (b) 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 [*7] purchase. The purpose of the statement of purchase is to identify qualified replacement property with respect to a sale of qualified securities. The qualified replacement property will have its cost basis reduced under *section 1042 (d)* to reflect the gain on the sale of qualified securities that is being deferred by the taxpayer. Upon subsequent disposition of the qualified replacement property by the taxpayer, the deferred gain will be recognized by the taxpayer under *section 1042 (e)*. Under *section 1042 (f)*, the filing of the statement of purchase of qualified replacement property (or a statement of the taxpayer's intention not to purchase replacement property) will begin the statutory period for assessment of any deficiency with respect to gain arising from the sale of the qualified securities. The purpose of the 30-day notarization requirement is to provide a contemporaneous identification of replacement property.

However, the 30-day notarization requirement leads to frequent mistakes by taxpayers and their advisors. Taxpayers are often unaware of this requirement and become aware of it only when they prepare their tax returns for the year of sale to the ESOP. By this time, the 30-day [*8] period is typically past because purchases of replacement property may have been made up to one year before. A number of private letter rulings have been issued granting relief to taxpayers in these situations as long as the statements were notarized shortly after the taxpayer became aware of the requirement and it was represented that the property listed was the only replacement property purchased for this sale.

A number of commentators on the temporary and proposed regulations criticized this requirement as without statutory authority, a trap for the unwary, and inconsistent with the definition of the qualified replacement period in *section 1042 (c) (3)*.

Proposed Amendment to the Regulations

In order to facilitate taxpayer compliance with the temporary regulations concerning identification of qualified replacement property through notarization of the statements of purchase, the proposed amendment to the temporary regulations would modify §1.1042-1T, A-3 (b) to provide that the notarization requirements for the *statement of purchase* are satisfied if the taxpayer's statement of purchase is notarized not later than the time the taxpayer files the income tax return for the taxable year [*9] in which the sale of qualified securities occurred in any case in which any qualified replacement property was purchased by such time and during the qualified replacement period. If qualified replacement property was purchased after such filing date and during the qualified replacement period, the statement of purchase must be notarized not later than the time the taxpayer's income tax return is filed for the taxable year following the year for which the election under *section 1042 (a)* was made.

Proposed Effective Date

The proposed amendments to the temporary regulations would apply to taxable years of sellers ending on or after the date of publication of the Treasury decision adopting these amendments as final regulations in the **Federal Register**. However, taxpayers may rely upon these proposed regulations for guidance with respect to all open taxable years pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action [*10] as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553 (b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C.

chapter 6) does not apply. Pursuant to *section 7805 (f) of the Internal Revenue Code*, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the [*11] date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is John T. Ricotta of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from The IRS and Treasury participated in their development.

* * *

Proposed Amendments to The Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1-INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.1042-1T, A-3, in the undesignated paragraph following paragraph (b) (6), the penultimate sentence is removed and three sentences added in its place to read as follows:

§1.1042-1T Questions and Answers relating to the sales of stock to employee stock ownership plans or certain cooperatives (temporary).

* * *

Q-3. * * *

A-3. * * * Such statement of purchase must be notarized not later than the time the taxpayer files the income tax return for the taxable year in which the sale of qualified securities occurred in any case in which any qualified replacement property was purchased by such time [*12] and during the qualified replacement period. If qualified replacement property is purchased after such filing date but during the qualified replacement period, the statement of purchase must be notarized not later than the time the taxpayer's income tax return is filed for the taxable year following the year for which the election under *section 1042 (a)* was made. The previous two sentences apply to taxable years of sell-

ers ending on or after the date final regulations are published in the **Federal Register.** * *

*

* * *

Robert E. Wenzel,

Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 9, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 10, 2003, 68 *F.R.* 41087)