

IRC Section 1042

Nonrecognition of Gain on Sale of Stock to an ESOP

Overview

The general rules of §1001 provide that a capital asset sold at a gain results in a capital gain. However, an election under Section 1042 allows for nonrecognition of gain on the sale of qualified securities to an Employee Stock Ownership Plan ("ESOP") (or an eligible worker-owned cooperative) to the extent that qualified replacement property is purchased within the replacement period and if the plan holds at least 30% of the stock of the corporation immediately after the sale. The election may not be made by a C corporation. If a §1042 election is made, gain is recognized only to the extent that the amount realized on the sale exceeds the taxpayer's cost of the qualified replacement property. Once made, the election is irrevocable.

Section 1042 contains many definitions and requirements which must be met for a taxpayer to qualify for the election. While each of these rules should be reviewed in detail before making the election, a summary of some of the key terms is as follows:

Qualified securities -- employer securities issued by a domestic corporation that does not have any stock outstanding that is readily tradable on an established securities market.

Qualified replacement property -- any security of a domestic operating corporation which:

does not have passive investment income of more than 25% of gross receipts for the year preceding the year of purchase; and

is not the corporation which issued the qualified securities or a member of the same controlled group of corporations.

Holding period -- the taxpayer must have held the securities at least three years as of the date of sale.

Replacement period -- three months before the date of sale and 12 months after such sale.

Statute of limitations -- §1042(f) provides special rules relating to the statute of limitations.

If qualified replacement property is purchased at the time the election is filed, the taxpayer must attach a statement of purchase describing the property, the date of purchase, the adjusted basis and declaring the property to be qualified replacement property. The statement must be notarized within thirty days of the purchase. In addition, the taxpayer must file with the election statement a verified statement of the domestic corporation whose employees are covered by the plan or any authorized officer of the qualified worker-owned cooperative consenting to the application of §§4978 and 4979A with respect to such corporation or cooperative. Sections 4978 and 4979A impose 10% and 50% taxes if the corporation or cooperative disposes of the stock within a specified period, and if there is a prohibited allocation of qualified securities, respectively. If the qualified replacement property has not been purchased at the time the election is filed, the election will not be considered to have been made unless the notarized taxpayer statement is filed with the tax return for the year following the year such election was originally filed.

When to File

The election should be made by the taxpayer (or executor) by attaching the required statements to the timely filed income tax return for the year in which the sale occurs. The election must be made no later than the due date, including extensions, of the taxpayer's return for such year.

Where to File

The election is made by attaching the required statements to the taxpayer's timely filed income tax return, which is mailed to the designated Internal Revenue Service Center. If the required statement was not filed in the year of the original election because qualified replacement property had not been acquired, the notarized statement of purchase must be filed with the district director or the director of the regional service center with whom such election was filed, if the return is not filed with such director.

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1. Code Section: 1042; 409; 4978; 4979A
2. Topic: Gain/Loss
3. Return Type: 1040, 1065

Authorities

IRC §1042; §1042(c)(6); Reg. §1.1042-1T