

IRS Rules That Holding Period in Shares of Company Stock Being Sold to an ESOP Should Include Holding Period in Company's Predecessor

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The IRS recently issued a private letter ruling that makes it easier to qualify for the deferral of taxes in connection with the sale of stock to an employee stock ownership plan (ESOP). In Private Letter Ruling 200827018, the IRS ruled that for purposes of deferring tax under Section 1042 of the Internal Revenue Code (the Code), a shareholder's holding period in the company's stock includes the period during which the shareholder held membership interests in a limited liability company that was the company's predecessor.

Code Section 1042 allows a shareholder to defer long-term capital gains tax on the sale of stock to an ESOP if the following requirements are met: (a) the shares of stock being sold to the ESOP are "qualified securities"; (b) the selling shareholder has held the qualified securities for at least three years; (c) immediately after the sale, the ESOP owns at least 30% of the outstanding shares of each class of stock or 30% of the value of all of the stock; and (d) the selling shareholder purchases "qualified replacement property" during the 15-month period commencing three months before and ending 12 months after the sale of the shares of stock to the ESOP. The question addressed in this private letter ruling relates to the holding period requirement set forth in (b) above.

"Qualified securities" are employer securities (x) that are issued by a C corporation that does not have any stock that is tradable on an established securities market and (y) that were not received by the taxpayer via a transfer from a qualified retirement plan or pursuant to certain options and rights to acquire stock in connection with the performance of services. "Qualified replacement property" is generally a security issued by an unrelated domestic operating company that did not have passive investment income in excess of 25% of gross receipts during the preceding tax year.

In this private letter ruling, the shareholders owned all of the membership interests in a limited liability company (LLC). The LLC created a new wholly owned corporation (NewCo), and the LLC was merged into NewCo in a tax-free reorganization under Code Section 368(a)(1)(F), with NewCo being the surviving entity. The shareholders received shares of stock in NewCo in the same proportions as their membership interests in the LLC, and the basis of their stock in NewCo was the same as the basis of their membership interests in the LLC. The shareholders desired to sell 30% of their shares in NewCo to an ESOP sponsored by NewCo and to defer capital gains tax on the sale under Code Section 1042.

The IRS ruled that, since the tax basis of the shareholders' stock was the same as their basis in their LLC membership interests prior to the reorganization, the shareholders' holding period in the NewCo stock would include the holding period in their LLC membership interests for purposes of Code Section 1042. Thus, the shareholders met the requisite holding period (described in (b) above) needed in order to take advantage of the tax deferral provisions of Code Section 1042.

While private letter rulings are only directed to the specific taxpayers requesting the rulings and are not to be used or cited as precedent, this ruling should provide comfort to those taxpayers electing to defer capital gains tax under Code Section 1042 under similar circumstances, and its reasoning would likely apply to other entities (e.g., partnerships) converted into C corporations.

For more information on the subject matter discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Chicago

David Ackerman	312.324.1170	dackerman@morganlewis.com
Theodore M. Becker	312.324.1190	tbecker@morganlewis.com
Brian D. Hector	312.324.1160	bhector@morganlewis.com
Elizabeth S. Perdue	312.324.1180	eperdue@morganlewis.com
Louis L. Joseph	312.324.1726	louis.joseph@morganlewis.com

Dallas

Riva T. Johnson	214.466.4107	riva.johnson@morganlewis.com
John A. Kober	214.466.4105	jkober@morganlewis.com
Erin Turley	214.466.4108	eturley@morganlewis.com

Los Angeles

Scott E. Adamson	213.612.7365	sadamson@morganlewis.com
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San Francisco

Marc R. Baluda	415.442.1399	mbaluda@morganlewis.com
Nicole A. Diller	415.422.1312	ndiller@morganlewis.com
D. Ward Kallstrom	415.422.1308	dwkallstrom@morganlewis.com

Washington, D.C.

Gregory C. Braden	202.739.5217	gbraden@morganlewis.com
Daniel L. Hogans	202.739.5510	dhogans@morganlewis.com
Gary B. Wilcox	202.739.5509	gwilcox@morganlewis.com

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