

Internal Revenue Service

Department of the Treasury

Number: **200052014**
Release Date: 12/29/2000
Index Number: 1042.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EB:QP2-PLR-114782-99

Date:

September 27, 2000

LEGEND

Company A =

Plan X =

This is in response to a request for a private letter ruling, dated August 6, 1999, which was submitted by your authorized representative and later supplemented by letters dated March 7, 2000, and May 2, 2000. Your request involves the applicability of sections 409(l) and 1042(c)(1)(A) of the Internal Revenue Code to certain common stock.

Company A, a domestic C corporation, has two classes of common stock outstanding. Its Class A Common Stock ("Class A Stock") is quoted on the Over The Counter Bulletin Board ("OTCBB"). The Class A Stock trades only infrequently and sporadically and is non-voting, except in limited circumstances. Company A's other class of outstanding common stock is the Class B Common Stock ("Class B Stock"), which is also eligible to be quoted on the OTCBB. Class B Stock is the only class of common stock that is generally entitled to vote. The dividend rights of the two classes are identical.

Company A intends to establish Plan X, which will be an employee stock ownership plan as described in section 4975(e)(7) of the Internal Revenue Code (Code), and which will hold Company A Class B stock pursuant to the application of section 409(l)(2). Company A anticipates that Plan X will engage in transactions described in section 1042.

Based on the above facts and representations, your authorized representative has requested a ruling that neither Company A Class A nor Class B Stock is considered to be "readily tradable on an established securities market" within the meaning of sections 409(l)(1) and 1042(c)(1)(A).

Section 4975(e)(7) defines an ESOP as a defined contribution plan which is a

PLR-114782-99

stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and which is otherwise defined in regulations prescribed by the Secretary.

Section 4975(e)(8) defines the term "qualifying employer security" as any employer security within the meaning of section 409(l). Section 409(l)(1) generally defines "employer securities" as common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market. Where there is no readily tradable common stock within the meaning of section 409(l)(1), section 409(l)(2) states that the term "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of (A) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, and (B) that class of common stock of the employer (or of any other such corporation) having the greatest dividend rights. Section 409(l) also provides that preferred stock may be issued in certain cases.

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

PLR-114782-99

transfer pursuant to an option or other right to acquire stock to which section 83, 422 or 423 applied.

The Service has previously ruled that until regulations are issued defining “readily tradable on an established securities market” under section 409(l), this term would be considered to have the same general meaning as “publicly traded” under section 54.4975-7(b)(1)(iv) of the Excise Tax Regulations (T.D. 7506, August 30, 1977). Section 54.4975-7(b)(1)(iv) states that the term “publicly traded” refers to a security that is listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 or that is quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act.

On February 8, 1971, the National Association of Securities Dealers, Inc. (“NASD”) formally commenced public operations of its automated quotations system (“Nasdaq”). Article XVI of NASD’s by-laws, which was adopted effective December 16, 1968, describes the system and lays down rules with respect to it. Schedule D of Article XVI sets forth the standards for authorized securities and other standards and procedures. The following discussion of Schedule D refers to the version published in the NASD Manual dated September 1, 1976. Schedule D states that Nasdaq is operated under the direction and control of NASD, which retains various powers, including the power to decide what securities may be quoted on Nasdaq. Part II of Schedule D describes the qualifications for authorized securities, both domestic and foreign. Domestic securities must meet certain registration and/or issuance requirements. An eligible security will not be authorized, and an authorized security shall be subject to suspension of authorization, if any one of various events occurs. Some of these events include, in general, the following, as in effect during the years immediately preceding the issuance of section 54.4975-7(b)(1)(iv) of the regulations:

- ▶ suspension from being traded over-the-counter by the Securities and Exchange Commission pursuant to section 15(c)(5) of the Securities Exchange Act;
- ▶ failure by the issuer promptly to disclose to the public through the press any material information which may affect the value of its securities or influence investors’ decisions;
- ▶ failure to comply with any obligation of any person regarding filing or disclosure of information material to the issuer or the security, whether the obligation arises under a federal or state statute or rule and the NASD determines that the public interest requires suspension;
- ▶ in the case of a security not yet authorized, fewer than two market makers registered, one of which may be a market maker entering a stabilizing bid; in the case of an authorized security, fewer than one market maker registered;

PLR-114782-99

- ▶ less than 100,000 “publicly held” shares;
- ▶ in the case of a convertible debt security eligible but not yet authorized, a principal amount outstanding of less than \$10,000,000 (or \$5,000,000 in the case of an authorized convertible debt security);
- ▶ in the case of an eligible security not yet authorized, total issuer assets of less than \$1,000,000 (or \$500,000 in the case of an authorized security);
- ▶ in the case of an eligible security not yet authorized, total issuer capital and surplus of less than \$500,000 (or \$250,000 in the case of an authorized security); or
- ▶ less than 300 persons holding the security, with special rules for rights, warrants or units.

Schedule D further states that in particular instances where the NASD deems it necessary and appropriate in order to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to protect investors or the public interest in fair and orderly markets, or to assure adequate trading interest and the likelihood of a competitive market, the NASD may suspend the authorization of a security and may make exceptions to the application of the criteria described above and set forth in Schedule D, or apply additional or more stringent criteria.

The OTCBB was created by the NASD in 1990 and is a regulated quotation service that displays real-time quotes, last-sale prices, and volume information in Over The Counter (“OTC”) equity securities. An OTC equity security generally is any equity that is not listed or traded on Nasdaq or a national securities exchange. The OTCBB is a quotation medium for subscribing members (securities brokers and dealers). The OTCBB is unlike Nasdaq in that it does not, among other things, impose listing standards; does not provide automated trade executions; and does not maintain relationships with quoted issuers. Except in limited situations, the NASD does not have rules to permit it to halt trading on the OTCBB. There are no minimum quantitative standards that must be met by an issuer for its securities to be quoted on the OTCBB. Rule 6530 of the OTCBB Service Rules describes categories of securities that are eligible for quotation on the OTCBB. The primary requirements for domestic equity securities are generally as follows:

- ▶ the security is not listed on Nasdaq or a registered national securities exchange in the United States, with certain exceptions; and,
- ▶ the security meets one of the following conditions:
 - ▶ the issuer of the security is required to file reports pursuant to

PLR-114782-99

section 13 or 15(d) of the Securities Exchange Act of 1934 (“Act”) or the security is described in section 12(g)(2)(B) of the Act [pertaining to certain investment companies], and the issuer is current in its reporting obligations;

- ▶ the security is described in section 12(g)(2)(G) of the Act [pertaining to insurance companies] and the issuer is current in its reporting obligations; or,
- ▶ the issuer of the security is a bank or savings association that is not required to file certain reports.

In addition, among the other categories eligible for quotation on the OTCBB is any equity security that meets all of the following criteria:

- ▶ the security is undergoing delisting from either the New York Stock Exchange, Inc. (NYSE) or the American Stock Exchange, Inc. (AMEX) for non-compliance with maintenance-of-listing standards;
- ▶ the security is subject to a trading suspension imposed by the NYSE or AMEX preceding the actual delisting; and,
- ▶ the security satisfies the conditions described in general above and set forth in Rule 6530(a)(2) or (3) or (4).

Issuers are required to register a class of equity securities under section 12 of the Act, and thereby become subject to the reporting requirements of section 13 of the Act, if there were at any fiscal year end more than 500 shareholders and more than \$10 million in assets. Issuers who meet these tests are required to register under section 12 of the Act. However, section 12(g)(1) of the Act states that any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. Accordingly, issuers without any revenue, net worth, or profits must file certain reports under section 13 of the Act if they have voluntarily registered under section 12 of the Act.

At the time that section 54.4975-7(b)(1)(iv) of the regulations was being formulated, the only entity that was a quotation system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act was Nasdaq. As described above, Nasdaq had, and continues to have, standards that must be met before a security can be listed, and maintenance standards that must be satisfied to permit a security to continue to be quoted. In addition to these standards, the NASD exercises broad discretionary authority over the initial and continued inclusion of securities in Nasdaq. We believe that section 54.4975-7(b)(1)(iv) of the regulations was written to include a quotation system because of the comprehensive standards of Nasdaq and the broad powers retained by its sponsor. These factors

PLR-114782-99

serve to protect the benefits of plan participants and also make the listed securities more marketable. Therefore, we interpret this regulation as applying only to those quotation systems sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act which have comprehensive standards and protections. Since the OTCBB does not offer investors comparable standards and protections, a security that is quoted on the OTCBB will not be considered to be “publicly traded” within the meaning of section 54.4975-7 of the regulations. This conclusion makes it unnecessary to determine whether the sponsorship requirement of the regulation is satisfied with respect to the OTCBB.

Accordingly, with respect to your requested rulings, we conclude that neither the Company A Class A Stock nor the Company A Class B Stock is considered to be “readily tradable on an established securities market” within the meaning of sections 409(l)(1) and 1042(c)(1)(A) of the Code.

These rulings are based on the assumption that Plan X will meet the requirements of section 401(a) of the Code and will be an ESOP as described in section 4975(e)(7).

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.

Sincerely,
James L. Brokaw
Chief, Exempt Organizations Branch 1
Office of Division Counsel/
Associate Chief Counsel
(Tax Exempt and Government Entities)