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ISSUE

Whether the transfer of qualified replacement property to a partnership in exchange for a partnership interest by a taxpayer that has elected to defer the recognition of gain under section 1042(a) of the Internal Revenue Code is a disposition of the qualified replacement property resulting in recapture of the deferred gain under section 1042(e).

FACTS

The taxpayer is a shareholder of Company A, a closely held domestic C corporation. Company A maintains an employee stock ownership plan (ESOP) that satisfies the requirements of section 4975(e)(7). Company A has one class of common stock that constitutes employer securities within the meaning of section 409(l) of the Code. The taxpayer did not receive the shares in a distribution from a plan described in section 401(a), or a transfer pursuant to an option or other right to acquire stock to which section 83, 422 or 423 applied. The taxpayer sells all of the Company A shares to the Company A ESOP and reinvests the proceeds of the sale in qualified replacement property (QRP), as defined in section 1042(c)(4), within 12 months of the date of the sale. The taxpayer makes a timely election under section 1042(a) to defer recognition of the gain realized from the sale of the qualified securities to the ESOP. Under section 1042(d), the basis of the QRP is reduced to reflect the deferred gain on the sale. After the section 1042 election, the taxpayer contributes the QRP to a partnership in exchange for an interest in the partnership.

LAW AND ANALYSIS

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 (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 employee stock ownership plan (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 employee stock ownership plan or an authorized officer of the cooperative consenting to the application of sections 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 three years (determined as of the time of the sale).

Section 1042(c)(1) provides that qualified securities are 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 a transfer pursuant to an option or other right to acquire stock to which section 83, 422, or 423 applied (or to which section 422 or 424 (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) 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 which 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" (as defined in section 1042(c)(4)(B)) 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)(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 that 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(d) provides that the basis of the taxpayer in qualified replacement property purchased by the taxpayer during the replacement period is reduced by the amount of gain not recognized by reason of such purchase and the application of section 1042(a). If more than one item of qualified replacement property is purchased, the basis of each of such items is reduced by an amount determined by multiplying the total gain not recognized by reason of such purchase and the application of subsection (a) by a fraction the numerator of which is the cost of such item of property and the denominator of which is the total cost of all such items of property.

Section 1042(e)(1) states that "[i]f a taxpayer disposes of any qualified replacement property, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such qualified replacement property."

The legislative history of section 1042(e) indicates that section 1042(e) was added to coordinate the requirement that deferred gain be recognized on the disposition of any qualified replacement property with other nonrecognition provisions of the Code. "Effective for dispositions made after the date of enactment, the Act overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time." S. Rep. 99–313, 99th Cong., 2nd Sess., 1032 (1986), 1986–3 C.B., v. 3, 1032. Thus, gain realized from the disposition of any qualified replacement property by a taxpayer who made an election under section 1042 must be recognized at the time of the disposition regardless of any other nonrecognition provisions of the Code that may otherwise be applicable.

Section 721(a) provides that generally no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Limited exceptions to the rule of section 1042(e)(1) are provided in section 1042(e)(3) which provides that the recapture rules of section 1042(e)(1) do not apply to any transfer of qualified replacement property that occurs: (1) in any reorganization (within the meaning of section 368) unless the person making the election under section 1042(a)(1) owns stock representing control of the acquiring or acquired corporation and such property is substituted basis property in the hands of the transferee; (2) by reason of the death of the person making the election; (3) by gift; or (4) in any transaction to which section 1042(a) applies.

The contribution of qualified replacement property to a partnership in exchange for an interest in the partnership is not a transfer of qualified replacement property described in any of the exceptions in section 1042(e)(3).

In the present situation, the taxpayer disposed of qualified replacement property by contributing it to a partnership in exchange for an interest in the partnership. Therefore, although a contribution of property to a partnership in exchange for an interest in the partnership is ordinarily a nonrecognition event under section 721, section 1042(e)(1) requires that any gain realized on the contribution be recognized to the extent of the gain that was deferred under section 1042(a).

HOLDING

The transfer of qualified replacement property to a partnership in exchange for a partnership interest by a taxpayer that has elected to defer the recognition of gain under section 1042(a) is a disposition of the qualified replacement property under section 1042(e). Accordingly, under section 1042(e), any gain realized on the disposition is required to be rec-

ognized by the taxpayer at the time of the transfer to the extent of the gain that was not recognized under section 1042(a) by reason of the acquisition by the taxpayer of the qualified replacement property.

EFFECT ON OTHER REVENUE RULING(S): N/A

PROSPECTIVE APPLICATION: N/A

DRAFTING INFORMATION

The principal author of this revenue ruling is John Ricotta of the Associate Chief Counsel (Employee Benefits & Exempt Organizations) (CC:EBEO:Br5). For further information regarding this revenue ruling contact John Ricotta on (202) 622-4290 (not a toll-free call).