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# The Purchase Requirement in Section 1042 Transactions: Are Seller Notes "Cash or Its Equivalent"? (Part 2)

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Owners of closely held corporations who sell stock ("sellers") to an employee stock ownership plan ("ESOP") can defer long-term capital gains tax under Internal Revenue Code ("IRC") section 1042 by reinvesting the full amount realized in qualified replacement property ("QRP").[1] The general mechanics of these transactions are explained in Part 1of this three-part series of articles, for any readers who would like a refresher on those fundamentals. This Part 2 addresses certain specific issues involved in how to pay for that QRP.

To qualify for gain deferral, sellers must purchase QRP within a statutory replacement period beginning three months before the sale and ending twelve months after.[2] In an ideal world, a seller will have ample cash with which to purchase the QRP. However, in a typical leveraged ESOP transaction, the seller receives only a portion of the purchase price in cash at closing. The balance is paid with a promissory note issued to the seller (a "seller note"). As a result, unless the seller had a great deal of cash on hand before the sale to the ESOP, there will be a liquidity-timing problem, because section 1042 requires that the entire amount realized, including the value of the illiquid seller note, be used to *purchase* the QRP.

This Part 2 and Part 3 of this article series will explore whether a seller can solve this liquidity-timing problem by using a seller note to purchase QRP and still satisfy the purchase requirement. This question typically arises in the context of taxpayers attempting to use seller notes to acquire QRP in closely-held corporations, although the tax analysis is not limited to this form of QRP.

## The Section 1042 Purchase Requirement

Section 1042 defers gain only to the extent the seller purchases QRP whose basis is determined by reference to its cost to the taxpayer. The temporary regulations state the test as follows:

> For purposes of section 1042(a), there is a "purchase" of qualified replacement property only if the basis of such property is determined by reference to its cost to the taxpayer. If the basis of the qualified replacement property is determined by reference to its basis in the hands of the transferor thereof or another person, or by reference to the basis of property (other than cash or its equivalent) exchanged for such property, then the basis of such property is not determined solely by reference to its cost to the taxpayer.[3]

Obviously, cash purchases easily satisfy this test, as the seller acquires QRP with a section 1012 cost basis equal to the cash paid. Using cash from borrowed funds to acquire QRP also constitutes a cash purchase. For example, in Berman v. Commissioner, selling shareholders acquired floating-rate notes ("FRNs" qualifying as QRP) by funding roughly 25 percent with their own cash and the balance with margin debt advanced by their broker as part of the purchase settlement.[4] Similarly, a seller may purchase QRP using the equivalent of cash.

## Cash Equivalency Considerations for Typical ESOP Seller Notes

The threshold question is whether a seller note may be treated as "cash or its equivalent" under Treas. Reg. § 1.1042-1T Q&A-1(e), potentially allowing a direct, straightforward application of the section 1042 purchase requirement. Because the regulation does not define "cash or its equivalent," the threshold question can only be answered by analyzing related tax principles that help define the boundaries of cash-equivalent treatment for promissory notes. As the following analysis shows, however, typical ESOP seller notes almost never fall within those boundaries.

### *"Cash Equivalents" Defined*

Section 1042 does not define a "cash equivalent." Accounting guidance treats cash equivalents as highly liquid investments readily convertible to known cash amounts with original maturities of three months or less, including Treasury bills, commercial paper, and money market funds. Other IRC sections define the term more broadly, however. For example, in 2017, Congress enacted section 965 to tax deferred foreign earnings held as cash, net accounts receivable, and "cash-equivalent assets" at a higher rate than other earnings, treating items such as short-term obligations, publicly traded property, commercial paper, certificates of deposit, government securities, foreign currency, and certain derivatives as cash-equivalent assets.[5] Regulations define a "short-term obligation" as an obligation with an original term of less than one year, or a loan repayable on demand or within one year of demand, excluding accounts receivable.[6]

Separately, and for purposes of the unidentified-cash presumptions used in termination and jeopardy assessments, cash equivalents are defined to include foreign currency, bearer obligations, and certain checks, money orders, collectible coins, stamps, and precious metals.[7] These definitions help show what lawmakers viewed as sufficiently cash-like to qualify as cash equivalents, but none of these definitions is broad enough to cover typical seller notes. That is not, however, the end of the inquiry.

### *Cash Equivalence Doctrine*

The common law doctrine of cash equivalence offers more specific guidance on when promissory notes may qualify as cash equivalents. The doctrine was developed under section 451 and generally addresses whether property received by a cash-basis taxpayer is sufficiently comparable to cash to require a current income inclusion.[8] The leading authority on when a promise to pay is treated as a cash equivalent in this context is *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

In *Cowden*, the taxpayers leased oil rights in exchange for a $511,192 bonus that the payor was willing and able to pay upfront, but the taxpayers elected to receive it over three years and then assigned the second and third year payment rights to a bank at a discount. The Internal Revenue Service ("IRS") argued the full contract was taxable in year one, and the Tax Court agreed, emphasizing the payor's willingness and ability to pay. The Fifth Circuit reversed and remanded in light of its following holding: a promise to pay is a cash equivalent only if every one of the following requirements are met: (1) the obligor is solvent; (2) the obligation is unconditional (and not subject to set-offs, counterclaims, or significant contingencies); (3) the obligation is assignable (and so freely transferable to third parties without material restrictions or limitations); and (4) the obligation is of a type frequently transferred to third parties at discounts approximating prevailing interest rates (*i.e.*, it is readily marketable near face value). Under *Cowden*, failure to meet any one of these requirements is fatal for qualifying as cash equivalent.

Since *Cowden*, the IRS and other courts have often relied on this framework when evaluating whether a promise to pay is sufficiently cash-like to constitute a cash equivalent.[9] The Tax Court has recognized Cowden as "the seminal case" governing what constitutes a cash equivalent.[10] The IRS has likewise referenced Cowden as a governing framework for questions of cash equivalency.[11]

### *Installment Sale "Payments"*

The installment sale rules provide another helpful lens for evaluating when a note is treated as payment when received rather than a deferred obligation. An installment sale is a disposition of property where the seller receives at least one payment after the year of the sale.[12] For these purposes, indebtedness secured directly or indirectly by cash or a cash equivalent, such as a bank

certificate of deposit or a treasury note, is treated as a payment in the year received rather than when it is subsequently reduced to cash.[13] Similarly, a bond or other indebtedness that is payable on demand is treated as a payment in the year received rather than as an installment obligation payable in later years.[14] Whether an obligation is payable on demand depends on applicable state or local law, and promissory notes generally qualify if they (a) expressly state they are payable on demand, (b) indicate they are payable at the holder's will, or (c) omit a payment date.[15] By contrast, a note with a fixed maturity date or prescribed installment schedule ordinarily is not payable on demand.

### *Why Typical ESOP Seller Notes Almost Never Qualify*

Typical ESOP seller notes generally are not cash equivalents because their terms are designed to defer, subordinate, and condition payment rather than give the seller an immediately enforceable right to cash. Seller notes typically have multiple features that are inconsistent with the Cowden conditions, such as one or more of the following:

A) Delayed or restricted principal amortization: In leveraged ESOP transactions involving outside senior debt, seller notes typically have delayed or restricted principal amortization while the senior debt remains outstanding. Often times, seller notes are structured as interest only with a delayed principal payment (sometimes with limited permissible principal payments with excess cash flow after scheduled senior debt payments).

B) Subordination / Conditional: On a related point, seller notes are typically subordinated to senior bank debt, unsecured, and subject to conditions and restrictions, such as payments subject to covenant compliance[16], and blockage and standstill rights with the senior lender. Further, with the subordination, in any default, bankruptcy, or liquidation scenario, the senior lender receives payment priority from company assets and cash flows before the seller note holders. This contradicts the *Cowden* requirement that the promissory note be unconditional.[17]

C) Subject to offsets: In most ESOP transactions, sellers and/or sponsoring companies make various representations and covenants in the stock purchase agreement, and seller note principal balances are subject to reductions for loss indemnification. Further, in some transactions, there may be additional potential clawbacks for failure to hit stated performance metrics.

D) Restrictions on transfer: Seller notes typically contain certain transfer restrictions, such as requiring issuer consent, permitting transfers only to affiliates, or securities law-related restrictions.

E) No organized secondary market with standardized pricing near face value: Furthermore, typical ESOP seller notes also fail to satisfy *Cowden's* marketability requirement. There is no organized secondary market, dealer network, or standardized pricing mechanism for deeply subordinated seller notes. Moreover, any private sale would likely require a substantial discount to face value reflecting credit risk, liquidity risk, structural subordination, etc., not merely a time-value-of-money valuation based on prevailing interest rates.[18]

As noted above, seller notes also do not fall within the cash-equivalent categories reflected elsewhere in the IRC and the regulations thereunder, as they are not short-term, highly liquid instruments. They are also not the type of indebtedness treated as "payment" under the installment sale rules. Accordingly, a standard subordinated ESOP seller note is best understood as a deferred, illiquid payment obligation as opposed to a cash equivalent.

### *Distinguishing PLR 9321067*

Private Letter Ruling ("PLR") 9321067 (May 28, 1993) is sometimes cited for the proposition that an ESOP seller note may be used to acquire QRP. As a threshold matter, PLRs are not precedential authority. Moreover, even if PLR 9321067 were considered authoritative, it provides scant support for that position.

In PLR 9321067, taxpayers sold stock to an ESOP for the ESOP's note, then used the seller note to purchase stock in a closely-held corporation. The taxpayers represented that the corporation's stock constituted QRP. The IRS ruled that the transaction qualified for nonrecognition under section 1042, but its conclusion was expressly contingent on several assumptions, including that the seller note "constitutes a 'cash equivalent' for purposes of the Code." Thus, the IRS assumed that, rather than analyzed whether, the note qualified as a cash equivalent.

Furthermore, the notes described in the ruling differed materially from typical leveraged ESOP seller notes: they were not subordinated to senior debt, were secured by the purchased stock, were fully negotiable, bore a floating market-rate interest rate, amortized significantly in the first year, could be prepaid without covenant-based restrictions, and were not described as being subject to indemnity offsets or clawbacks. Those features resemble the secured, negotiable, market-rate notes that courts have been willing to treat as cash equivalents, unlike the subordinated, illiquid, restricted seller notes typically used in leveraged ESOP transactions. Therefore, PLR 9321067 is best read as a narrow, conditional ruling, not as general support for treating ordinary ESOP seller notes as cash equivalents.

### Teaser

Once a seller note falls outside the scope of "cash or its equivalent" under Treas. Reg. § 1.1042-1T

Q&A-1(e), the analysis of whether it can be used to purchase QRP moves from a direct application of the section 1042 purchase requirement to a more complex property-for-property exchange framework, which will be the subject of Part 3 of this series.



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## Endnotes

[1] Unless otherwise indicated, references to a section ("section" or "§") are to Title 26 U.S.C., the IRC of 1986, as amended, or Treasury regulations promulgated thereunder (the Code of Federal Regulations, Title 26, "Treas. Reg.").
[2] I.R.C. § 1042(a), (c)(3).
[3] Treas. Reg. § 1.1042-1T, Q&A-1(e).
[4] *Berman v. Commissioner*, 163 T.C. 1 (2024).
[5] See I.R.C. § 965(c)(3)(B); Treas. Reg. § 1.965-1(f)(13).
[6] Treas. Reg. § 1.965-1(f)(43).
[7] See I.R.C. §§ 6851, 6861, 6867(d); Treas. Reg. § 301.6867-1(f)(2).
[8] This doctrine is related to, but analytically distinct from, the doctrine of constructive receipt, which addresses when an item of income (assuming it is in such a form that it should be recognized for tax purposes under the cash equivalence doctrine) should be deemed received by a taxpayer.
[9] *See, e.g., Joyner Fam. Ltd. P'ship*, T.C. Memo. 2019-159 (evaluating notes to purchase mobile homes under *Cowden* factors to determine notes were not the equivalent of cash); *Felt v. Comm'r,* T.C. Memo. 2009-245, aff'd 433 F. App'x 293 (5th Cir. 2011) (citing *Cowden* factors to find notes were cash equivalents); *Monico v. Comm'r*, T.C. Memo. 1998-10 (holding obligation not equivalent of cash because failed *Cowden* factor); *Watson v. Comm'r*, 613 F.2d 594 (5th Cir. 1980) (concluding under *Cowden* that receipt of a letter of credit in year one triggered income recognition, not drawing in year two); see also CCA 201334037; PLR 200836019; FSA 200151003.
[10] *Anikeev v. Comm'r*, T.C. Memo. 2021-23, at *19.
[11] FSA 200151003 (Dec. 21, 2001).
[12] I.R.C. § 453(b)(1).
[13] Temp. Reg. § 15a.453-1(b)(3)(i).
[14] I.R.C. § 453(f)(4)(A); Temp Treas. Reg. § 15a.453-1(e)(1).
[15] Temp Treas. Reg. § 15a.453-1(e)(3); Uniform Commercial Code ("UCC") section 3-108(a). All States have adopted a version of UCC section 3.
[16] Covenant conditions typically include total senior debt/EBITDA ratio and fixed charge coverage ratio (FCCR).
[17] *E.g.,* in Chief Counsel Advice("CCA") 201334037 (Aug. 23, 2013), the IRS analyzed long-term, unfunded, unsecured notes *subordinated* to senior debt with delayed principal payments, and concluded under *Cowden* that such subordinated notes fail to satisfy the cash equivalency test. *Cf. Camp Wolters Enters., Inc. v. Commissioner*, 22 T.C. 737, 750–52 (1954), *aff'd*, 230 F.2d 555 (5th Cir. 1956) (finding unsecured, subordinated promissory notes with principal payments conditioned upon repayment of senior bank indebtedness constituted securities representing a continuing investment in the business rather than cash-like payment obligations for purposes of the requirement, under the predecessor to section 351, that property be exchanged solely for stock or securities).
*[18]* See PLR 200031031 (Aug. 4, 2000) (applying *Cowden* to state lottery annuity payments and concluding the cash equivalency doctrine did not apply where, although winners could assign payments, "there are no prevailing market rate discounts applied to lottery prize payments," and discounts were "negotiated on a case-by-case basis" and "vary widely"). *Cf. Williams v. Commissioner*, 28 T.C. 1000 (1957) (holding an unsecured promissory note was not the equivalent of cash after finding it was not readily marketable to banks or finance companies due to holder's showing of 10 to 15 failed attempts to sell it).