



Trust 3 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

i =

A =

B =

C =

D =

E =

F =

G =

H =

I =

x% =

Church =

State X =

Date 1 =

Date 2 =

Dear :

This letter responds to your letter dated February 8, 2005 requesting a ruling that a proposed redemption by a corporation of some of its stock will constitute a “substantially disproportionate redemption of stock,” pursuant to I.R.C. §§ 302(b)(2), 302(c)(1) and 318(a), so that such redemption will be treated as a distribution in exchange for stock, rather than a dividend distribution under § 301. Additional information was submitted in letters dated May 5, June 2, June 13, June 15, July 8 and July 31, 2005. The information submitted is summarized below.

Facts:

Company is an “S” corporation that has outstanding a shares of common stock, currently owned by Trust 1 and Trust 2. Individual A is the trustee of both trusts.

Trust 1 owns b shares of Company stock. Trust 1 is composed of two separate shares of a trust (pursuant to Treas. Reg. § 1.1361-1(j)(3)). Trust 1A and Trust 1B are each considered separately to own c shares of Company stock. A is considered the owner of the Company stock held by Trust 1A, and B is considered the owner of the Company stock held by Trust 1B. A and B are siblings. C, D and E are the children of B. A and B are the life beneficiaries of Trust 1. The three remainder beneficiaries of Trust 1B are each trusts established for the benefit of C, D and E, respectively. Trust 1 terminates after the last to die of all of the children of A and B.

Currently, the remaining shares of Company stock, d, are owned by Trust 2. Prior to the death of F, a sibling of both A and B, the three income (i.e., life) beneficiaries of Trust 2 were A, B, and F. Pursuant to a Will dated Date 1, F, exercising his power of appointment over his interests in Trust 2, directed that his share of the income of Trust 2 be distributed upon his death as follows: (1) the portion of the income attributable to the Company stock to Church, and (2) the balance of the income to C, D and E equally. Also pursuant to his Will, F further directed that his share of the corpus of Trust 2 be distributed upon the termination of Trust 2 as follows: (1) a total of j shares of Company stock to unrelated parties G, H and I, (2) a total of i shares of Company stock to C, D and E, and (3) the remaining shares of Company stock, h shares, to Church. In the case of the distributions of corpus described in (1) and (2) of the preceding sentence, F’s Will stipulated that each beneficiary had to survive F, A and B in order to receive his or her share distribution of corpus. F’s Will further stipulated that: (1) if any of these

beneficiaries was not living at the time of the distribution of corpus, his or her shares of Company stock shall be distributed to his or her Qualified Spouse (as defined in F's Will), or (2) if there is none, to that beneficiary's then-living issue, and (3) if any beneficiary is not then living and has left neither a Qualified Spouse nor any issue then living, his or her shares will be distributed to the Church. F has since died.

Originally A contemplated having some of the Company stock held by Trust 2 redeemed and then segregating the cash received in the redemption from the remaining Company stock held by Trust 2. However, the parties determined that a redemption under those facts would cause adverse tax consequences to Trust 2. Accordingly, as approved under a State X court order dated Date 2, Trust 2 will be split into two trusts. Trust 2 will continue to own e shares of Company stock (as well as its other assets), while new Trust 3 will own the remaining f shares.

Trust 2 is currently composed of two separate shares of a trust (pursuant to Treas. Reg. § 1.1361-1(j)(3)), Trust 2A and Trust 2B, that are each currently considered to own f shares of Company stock. The three remainder beneficiaries of Trust 2B are C, D, and E.

Trust 3 will have the following beneficiaries: C, D and E (the "related parties"), G, H, I and Church (the "unrelated parties"). Church will be the income beneficiary of Trust 3 and will receive all income from Trust 3 until it terminates, which will not occur, as indicated above, until the death of both A and B. Upon the termination of Trust 3, a total of g shares would have been distributed to the unrelated parties and a total of i shares would have been distributed to the related parties.

Company plans to redeem a number of shares of Company stock that would have eventually been distributed to the unrelated parties. Thus, Company plans to redeem g shares of its stock to be owned by Trust 3. Upon the termination of Trust 3, it will distribute the proceeds from the redemption to the unrelated parties, proportionately. The remaining assets of the Trust, i shares of Company, will subsequently be distributed to the related parties according to the terms of F's Will.

#### Representations:

In connection with the proposed redemption, the taxpayer makes the following representations:

- a) There are no outstanding options or warrants to purchase Company stock, nor are there any outstanding debentures or other obligations that are convertible into Company stock or would be considered Company stock.
- b) No shareholder of Company has been or will be obligated to purchase any of the Company stock to be redeemed.

- c) The redemption, described in this ruling request, is an isolated transaction and is not related to any other past or future transaction.
- d) Company has no plan or intention to issue, redeem or exchange additional shares of its stock.
- e) There are no declared or unpaid dividends, or funds set apart for dividends, on any of the Company stock to be redeemed.
- f) At the time of the exchange, the amount of cash to be received by the redeemed shareholder will be approximately equal to the fair market value of the Company stock to be exchanged therefor.
- g) The price paid for the Company stock to be redeemed will not result in a loss with respect to any such shares of stock.
- h) The redeeming shareholder will transfer solely Company stock to Company solely in exchange for cash from Company.
- i) The redeeming shareholder has no plan or intention to purchase or otherwise acquire Company stock.

Law:

I.R.C. § 301(a) provides that, except as otherwise provided in this chapter, a distribution of property made by a corporation to a shareholder with respect to its stock shall be included in gross income, to the extent that such distribution is treated as a dividend. In the case of an "S" corporation, the distribution would be treated under I.R.C. § 1368.

I.R.C. § 302(a) provides that if a corporation redeems its stock and if paragraph (1), (2), (3), or (4) of I.R.C. § 302(b) applies, then such redemption shall be treated as a distribution in exchange for such stock.

I.R.C. § 302(b)(2)(A) provides that subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder. I.R.C. § 302(b)(2)(C) provides that the distribution is substantially disproportionate if the shareholder reduces his ownership of voting stock in the corporation after the redemption to an amount of voting stock that is less than 80% of what it was before the redemption. I.R.C. § 302(b)(2)(B) provides that I.R.C. § 302(b)(2) shall not apply unless immediately after the redemption the shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote.

I.R.C. § 302(c)(1) provides that, except as provided in I.R.C. § 302(c)(2), I.R.C. § 318(a) shall apply in determining the ownership of stock for purposes of this section.

I.R.C. § 318(a)(2)(B)(i) provides that stock owned, directly or indirectly, by or for a trust shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

I.R.C. § 318(a)(3)(B)(i) provides that stock owned, directly or indirectly, by or for a beneficiary of a trust shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

Analysis:

The taxpayer has requested a ruling that the redemption by Company of a portion of its stock to be owned by Trust 3 (that is allocable to the unrelated parties) will constitute a "substantially disproportionate redemption" pursuant to § 302(b)(2). If no Company shares (that are directly owned by Trust 1 and Trust 2) are attributed to Trust 3 through the related parties, the redemption qualifies because Trust 3's ownership of Company stock would go from f shares to h shares. Thus, Trust 3's percentage ownership of h shares after the redemption would represent less than 80% of Trust 3's percentage ownership of Company stock prior to the redemption and less than 50% of the total voting power of all of the outstanding Company stock held by Trust 3.

No Company shares (that are directly owned by Trust 1 and Trust 2) can be attributed to Trust 3 through the related parties because each of them has a "remote contingent interest" in Trust 3, pursuant to § 318(a)(3)(B)(i), under the facts presented. First, each of the related parties is considered to be a "contingent" beneficiary within the meaning of Rev. Rul. 76-213, 1976-1 C.B. 92. Rev. Rul. 76-213 holds that for the sole purpose of § 318(a)(3)(B)(i) a beneficiary's interest in a trust is contingent because it will terminate in the event that the beneficiary does not survive the life tenant. In the case of each related party, F's Will stipulates that: (1) a related party will not receive his or her stock interest in Company unless he or she survives both A and B, the life tenants, (2) if that party does not survive both A and B, that party's stock interest will instead be distributed to his or her Qualified Spouse, and (3) if there is no Qualified Spouse to his or her then-living issue, and (4) if there is no such issue, that party's stock interest will instead be distributed to the Church. Thus, because each related party must survive both A and B to receive his or her stock interest, each such related parties has a contingent interest in Trust 3.

Second, the taxpayer has provided information that the interests of each of these contingent beneficiaries, computed actuarially, is "remote" for purposes of § 318(a)(3)(B)(i). As noted above, that clause provides that a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest,

computed actuarially, is 5 percent or less of the value of the trust property. According to information provided by the taxpayer, the value of the interest of each of the related parties, computed actuarially, is x% of the value of the trust property. Such x% is well below 5%. Therefore, the Company stock held by Trust 1 and Trust 2 that is attributed to each of the related parties will not be reattributed to Trust 3.

Rulings:

Based on the information, submitted, and the representations provided, we rule as follows with respect to the redemption by Company of the g shares of Company stock owned by Trust 3:

- 1) The reduction in the number of shares of Company stock held by Trust 3 from g to h will constitute a “substantially disproportionate redemption” pursuant to § 302(b)(2) and therefore the redemption will constitute an exchange pursuant to § 302(a).
- 2) As provided in § 1001, any gain realized by Trust 3 from the redemption of Company stock will be recognized, with any such gain measured by the difference between the amount of cash received by Trust 3 for each share of its Company stock and its adjusted basis, as determined under § 1011, in that share of stock. Provided the stock is a capital asset in the hands of Trust 3, any gain will constitute capital gain subject to the provisions and limitations of Subchapter P of Chapter 1.
- 3) Trust 1 and Trust 2, the remaining shareholders of Company, will not receive a constructive dividend as a result of the redemption by Company of its stock held by Trust 3. Rev. Rul. 58-614, 1958-2 C.B. 920.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The above rulings are effective to the extent that the amount deemed to be distributed to Trust 3 in exchange for the Company stock equals the fair market value of the Company stock redeemed. No opinion is expressed about the tax treatment of the amount, if any, by which the distribution to Trust 3 exceeds, or is less than, the fair market value of Trust 3’s redeemed stock. The determination of the fair market value of the stock redeemed has been reserved until the Federal income tax return for the taxpayer involved has been filed for the taxable year in which the transaction is consummated.

No rulings have been requested or are provided relating to the Federal income tax consequences, if any, to the beneficiaries of Trust 2 or Trust 3 resulting from the division and transfer of a portion of Trust 2 to a new trust, Trust 3.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

*Steven J. Hankin*

Steven J. Hankin  
Senior Technician Reviewer, Branch 6  
(Corporate)

cc: