

Internal Revenue Service

Department of the Treasury

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Legend

X =
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Dear

This is in response to your letter dated April 26, 1999, requesting a ruling on behalf of X, a corporation, concerning the federal income tax consequences of a waiver of dividends by X.

X previously requested and received a favorable ruling (PLR-19143-96) that X's waiver of dividends declared by Y did not result in income to X under facts substantially identical to the facts presented below. Because the previously issued ruling, by its terms, ceases to be effective three years after the issuance of the letter ruling (date B), X again requests that the same ruling be issued with respect to X's waiver of dividends declared by Y.

In 1988, Z reorganized from a mutual savings bank to a mutual holding company pursuant to the laws of State A. Under the plan of reorganization, Z transferred substantially all of its assets and liabilities, including all of its deposit liabilities, to a newly created capital stock bank ("Y") in exchange for 77.7 percent of Y's common stock. The remaining 22.3 percent of Y common stock was sold through stock offerings to: (1) former

depositors of Z who became depositors of Y as a result of the reorganization; (2) individuals residing in State A; and (3) the general public. Also, as part of the reorganization, Z changed its name to X.

The purpose of the reorganization was to achieve an organizational structure that made it easier for X and Y to raise equity capital, to diversify geographically, to expand the financial products offered and to compete more effectively in the current marketplace.

Since the reorganization, Y has operated as a capital stock bank and, subject to statutory and regulatory constraints, prevailing financial conditions and future earnings, Y has declared and paid cash dividends on its common stock. The first dividend was declared and paid to the minority stockholders in the quarter following the reorganization. As one of the considerations in the decision to declare and pay dividends, the board of directors of Y looks at its capital requirements, its economic forecasts and such other factors as it deems relevant. A portion of Y's earnings will be retained by Y in order to provide capital for its operations and expansion of its banking business.

On date C, the officers and trustees of X owned, directly and indirectly, D of the E outstanding shares of common stock of Y or 1.1 percent. Y has no outstanding preferred stock at this time. In addition, the officers and trustees of X held, in the aggregate, less than .02 percent of the deposits in Y on date C.

X, as the majority stockholder, has in the past waived cash dividends declared by Y. X also anticipates that it will continue to waive, from time to time, certain of the future cash dividends declared and paid by Y.

It is represented that the waiver of dividends allows Y to make dividend distributions to minority shareholders who own the publicly traded common stock, thereby enhancing its market value and providing Y with greater access to capital markets for future equity offerings, and still permits Y to maintain adequate capital to support its operations and expand its banking business. However, the Board of Trustees of X has fiduciary responsibilities that must be considered in determining whether a dividend will be waived, and each waiver is considered independent from each other waiver of dividends. Therefore, X will waive its dividends only when its board of trustees determines that a bona fide business purpose exists for such waiver and that such waiver will enhance the value of X's investment in Y.

The following representations have also been made in regard to the dividend waiver:

- (1) Y has in the past and is expected to continue to declare and pay cash dividends on a quarterly basis;

(2) No dividend waivers will be made by X with respect to stock dividends, if any, declared and paid by Y; and

(3) Prior to the declaration of any cash dividend by Y, X will submit a written statement to Y indicating the extent of its waiver of the anticipated dividends.

Section 61(a)(7) of the Internal Revenue Code provides that except as otherwise provided in subtitle A, gross income means all income from whatever source derived, including dividends.

Generally, a majority shareholder who agrees to waive dividends while other shareholders receive theirs does not realize income if there is no family or direct business relationship between the majority and minority shareholders and the waiver is executed for valid business reasons. See Rev. Rul. 45, 1953-1 C.B. 178. However, the waiver by a majority shareholder of the right to receive a pro rata share of any dividends paid by a corporation will not be recognized for income tax purposes where such dividends are paid to the relatives as minority shareholders in the form of increased dividends, and the waiver results primarily in a benefit to the relatives. Income is realized by the majority shareholder to the extent of the increased distribution to the related shareholders resulting from the waiver. See Rev. Rul. 56-431, 1956-2 C.B. 171.

Rev. Proc. 67-14, 1967-1 C.B. 591, lists the conditions under which the Service will consider a request for a ruling on a proposed waiver of dividends transaction when the waiving and nonwaiving shareholders are individuals. The following three conditions must be satisfied: (1) a bona fide business reason must exist for the proposed waiver of dividends, (2) the relatives (e.g., brothers, sisters, spouse, ancestors, and lineal descendants) of the waiving shareholder must not be in a position to receive more than 20 percent of the total dividends distributed to the nonwaiving shareholders, and (3) the ruling is not effective if any change in stock ownership (other than death) enables nonwaiving relatives to receive more than 20 percent of the dividend.

Because X is a corporation, not an individual, Rev. Proc. 67-14 is not determinative of whether a ruling request on a proposed waiver of dividends transaction will be considered. However, some of the conditions listed in Rev. Proc. 67-14 are appropriate for determining whether the Service will consider a request for a ruling on a proposed waiver of dividends transaction when a waiving or nonwaiving shareholder is a corporation.

One condition that is applicable regardless of whether the waiving or nonwaiving shareholder is an individual or a corporation is the existence of a bona fide business reason for the proposed waiver of dividends. In this ruling request, it is represented that X has a bona fide business reason for the proposed waiver of dividends because the

waiver would allow Y to make dividend distributions to minority shareholders who own the publicly traded common stock of Y, thereby enhancing its market value and providing Y with greater access to capital markets for future equity offerings, and still permit Y to maintain adequate capital to support its operations and expand its banking business. The Board of Trustees of X has certain fiduciary responsibilities which must be considered in determining whether a dividend will be waived. Consequently, X will waive its dividends only when its Board of Trustees determine that a bona fide business purpose exists for such waiver and that such waiver will enhance the value of X's investment in Y.

As stated above, X is a corporation and, therefore, can not have "relatives" as defined in Rev. Proc. 67-14 or a family relationship as referred to in Rev. Rul. 45. However, Rev. Rul. 45 also refers to whether or not there is a direct business relationship between the waiving and nonwaiving shareholders. With respect to X and Y it is represented that as of C, the officers and trustees of X own, directly and indirectly, 1.1 percent of the outstanding common stock of Y. Y has no outstanding preferred stock. Based on these facts the officers and trustees of X do not hold a significant interest in Y, and, thus, there is no direct business relationship between the waiving and nonwaiving shareholders.

Rev. Proc. 67-14 provides for a restriction on waiver of dividends. A ruling issued on a proposed waiver of dividends transaction will not be effective for a period longer than three years from the date of the ruling. This restriction is also appropriate when the waiving or nonwaiving shareholder(s) is a corporation.

Based on the information submitted, the applicable law, and the representations made, we conclude that a bona fide business reason does exist for the proposed waiver and that there is no direct business relationship between the waiving and nonwaiving shareholders. Accordingly, the waiver by X of any part of its pro rata share of cash dividends declared by Y during the period beginning on the date of this ruling through a period of three years after the issuance of this letter ruling will not result in income to X.

If the percentage of common stock of Y held directly and indirectly by the officers and trustees of X increases significantly during the waiver period, this ruling will no longer be applicable.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that a ruling may not be used or cited as precedent.

A copy of this ruling should be attached to X's federal income tax return.

Sincerely yours,

Acting Assistant Chief Counsel
(Income Tax and Accounting)

By: _____
MICHAEL GOMPERTZ
Assistant to the Branch Chief
Branch 4

Enclosures (2)
Copy of letter
Copy for section 6110 purposes