

Internal Revenue Service

Department of the Treasury

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Date:

March 22, 2000

State X =

Date 1 =

Date 2 =

Date 3 =

Corporation X =

Corporation Y =

Business A =

Shareholder 1 =

Shareholder 2 =

a =

M =

Dear :

We respond to your letter dated October 8, 1999, in which you requested rulings under section 302(b)(3) of the Internal Revenue Code on a proposed redemption. The information submitted in that letter and later correspondence is summarized below.

Corporation X was incorporated on Date 1 and elected to be taxed as a Subchapter S corporation on Date 2. Corporation X was engaged in Business A. On Date 3, Corporation Y was incorporated as a Subchapter S corporation and acquired all of the stock of Corporation X from the two shareholders of Corporation X, Shareholder 1 and Shareholder 2, who received all of the stock of Corporation Y in exchange for their Corporation X stock. Corporation Y elected to treat Corporation X as a qualified Subchapter S subsidiary under section 1361(b)(3)(B) of the Code.

Shareholder 1 is the mother of Shareholder 2 and has never been active in the day-to-day management of either Corporation X or Corporation Y. Shareholder 2 has been continuously employed on a full-time basis by the corporations since graduating from college and is the current President and CEO of Corporation Y. Shareholder 1 received all of her stock in Corporation X under the final will of her deceased husband during the ten years immediately preceding the proposed redemption. Shareholder 2 acquired his shares of stock in Corporations X and Y from purchases from Shareholder 1 and other parties during the ten years immediately preceding the proposed redemption. Corporation Y currently has 900,000 shares of voting common stock outstanding which are owned as follows:

<u>Shareholder</u>	<u>Number of shares owned</u>	<u>% owned</u>
Shareholder 1	455,000	50.56
Shareholder 2	445,000	49.44

Shareholder 1 desires to withdraw from ownership of Corporation Y and to transfer complete control of the corporation to Shareholder 2. Accordingly, the following transactions are proposed:

- (1) Shareholder 1 will sell a shares of her Corporation Y stock to Shareholder 2 solely in exchange for cash at a price determined by an independent appraisal.
- (2) Corporation Y will redeem all of Shareholder 1's remaining shares of Corporation Y stock solely in exchange for cash at a price determined by an independent appraisal.

Following the redemption, all of the outstanding shares of Corporation Y stock will be held by Shareholder 2. Shareholder 1's continuing relationship with Corporation Y will be her occasional use of the corporation's M. It is estimated that such use will not exceed 15 hours per year and Shareholder 1 will pay for such use at a fair market value price.

The following additional representations have been made in connection with the proposed transactions:

- (a) There are no outstanding options or warrants to purchase Corporation Y stock nor are there any outstanding debentures or other obligations that are convertible into Corporation Y stock or would be considered Corporation Y stock.
- (b) None of the consideration from Corporation Y, including interest, consists entirely or partly of the corporation's promise to pay an amount that is based on, or contingent on, future earnings of Corporation Y, an amount that is contingent on working capital being maintained at a certain level, or any other similar contingency.
- (c) No shareholder of Corporation Y has been or will be obligated to purchase any of the stock to be redeemed.
- (d) There have been no redemptions, issuances, or exchanges by Corporation Y of its stock in the past five years.
- (e) Corporation Y has no plan or intention to issue, redeem, or exchange additional shares of its stock, except that it may, in the future, establish an employee stock option plan.
- (f) After the redemption, no redeemed shareholder will have any interest in Corporation Y, including an interest as officer, director, or employee (other than an interest as a creditor as described in section 1.302-4(d) and constructive ownership under section 318(a)(1)).
- (g) Shareholder 1 will execute and file the agreement required by section 302(c)(2)(A)(iii) with respect to the acquisition of any interest in Corporation Y within 10 years from the date of the redemption.
- (h) The redemption of Corporation Y stock (i) is not a disposition of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan and (ii) is not a disposition of personal property of a kind required to be included in the inventory of any redeemed shareholder at the close of the taxable year.
- (i) None of the stock to be redeemed is "Section 306 stock" within the meaning of section 306(c).
- (j) There are no declared but unpaid dividends, or funds set apart for dividends, on any of the stock to be redeemed.
- (k) Shareholder 1 and each related person will agree to be jointly and severally liable for any deficiency (including interest and additional tax) resulting from an acquisition of an interest in Corporation Y within 10 years from the date of the

redemption.

- (l) At the time of the redemption, Shareholder 1 will owe no debt to Corporation Y, and Shareholder 1 will not become indebted to Corporation Y as a result of the redemption.

Based on the information submitted and on the representations set forth above, we rule as follows:

- (1) The acquisition by Shareholder 1 of shares of stock in Corporation X within the 10 years preceding the proposed redemption did not have as one of its principal purposes the avoidance of federal income taxes within the meaning of section 302(c)(2)(B). (Rev. Rul. 79-67, 1977-2 C.B. 91).
- (2) The sale by Shareholder 1 of Corporation X and Corporation Y stock to Shareholder 2 within the 10 years preceding the proposed redemption did not have as one of its principal purposes the avoidance of federal income taxes within the meaning of section 302(c)(2)(B) (Rev. Rul. 57-387, 1957-2 C.B. 225).
- (3) Provided Shareholder 1 executes and files the agreement described in section 302(c)(2)(A)(iii) in accordance with section 1.302-4(a), the redemption by Corporation Y of all the shares of its stock held by Shareholder 1 will constitute a complete termination of interest within the meaning of section 302(b)(3). The redemption will be treated as a distribution in full payment in exchange for the stock to be redeemed as provided in section 302(a). Pursuant to section 302(c)(2), section 318(a)(1) will not apply to the proposed transaction.
- (4) As provided in section 1001, gain will be realized and recognized by the redeeming shareholder measured by the difference between the redemption price and the adjusted basis of Corporation Y surrendered (as determined under section 1011). Provided section 341 (relating to collapsible corporations) is not applicable and Corporation Y stock is a capital asset in Shareholder 1's hands, the gain, if any, will constitute capital gain subject to the provisions and limitations of Subchapter P of Chapter 1. Pursuant to the provisions of section 267, no loss will be allowable.
- (5) Under section 311(a), no gain or loss will be recognized to Corporation Y upon the redemption of its stock as described above.
- (6) Shareholder 2 will not receive a constructive dividend upon the redemption of Corporation Y stock from Shareholder 1. (Rev. Rul. 58-614, 1958-2 C.B. 920).

We express no opinion about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any

conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6610(k)(3) provides that it may not be used or cited as precedent. Each affected taxpayer should attach a copy of this letter to its federal income tax return for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By _____
Mark S. Jennings
Acting Chief, CC:DOM:CORP:1