

Internal Revenue Service

Department of the Treasury

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Date:

July 17, 2002

LEGEND

Company =

State A =

Business A =

A =

B =

C =

D =

m =

n =

Date 1 =

Date 2 =

Date 3 =

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Date 4 =

Date 5 =

Decedent =

State B =

Estate =

Daughter =

Son =

Revocable Trust =

Terminating Trust =

e =v =ev =a =av =h =i =j =p =t =

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fa =fat =

Dear

This letter responds to a letter dated 28 February 2002, requesting rulings concerning the federal income tax consequences of a proposed transaction. The information submitted for consideration is summarized below.

Company is a domestic corporation engaged in Business A. On Date 3, the date of death of Decedent, Company had outstanding A shares of voting common stock, B shares of nonvoting common stock, C shares cumulative voting preferred stock (which became nonvoting at Decedent's death), and D shares of nonvoting preferred stock. On Date 3: over half of the voting common stock was held by Decedent's daughter ("Daughter"); over half of both the voting and nonvoting preferred stock (m shares voting and n shares nonvoting) was held by a revocable trust ("Revocable Trust"). All the other stock in Company is held by, or for the benefit of, Decedent's children and grandchildren, and/or persons married to the children.

Decedent, a State B resident, died on Date 3 survived by Daughter, Son, and three grandchildren. On Decedent's Form 706, United States Estate (and Generation Skipping Transfer) Tax Return, the executor of Decedent's estate ("Estate") elected to deduct the value of Decedent's qualified family-owned business interests ("QFOBI") under section 2057 of the Internal Revenue Code, and claimed the maximum allowable \$675,000 deduction. Decedent's QFOBI consisted of the Company stock (m shares of voting preferred and n shares of nonvoting preferred) held by Decedent indirectly through Revocable Trust. By a letter dated Date 4, the Internal Revenue Service accepted Decedent's estate tax return.

Revocable Trust was established on Date 1 through an agreement between Decedent (as grantor) and Decedent and his wife (as trustees). On Date 2, Decedent amended and restated Revocable Trust in its entirety, with Revocable Trust being established for the benefit of Decedent, Daughter, and other descendants of Decedent. Pursuant to Article VI, section D of Revocable Trust, the property passing under Articles III and IV bears the excess costs, including funeral and estate administration expenses, death taxes, pre-residuary gifts, and certain other charges. On Decedent's death, Revocable Trust ceased to be revocable. Daughter and an independent trustee are the two trustees of this trust.

On Date 2, Decedent executed a will. Article II of Decedent's will provides that Decedent's tangible personal property is to be distributed in accordance with any memoranda signed and dated by Decedent which disposes of any of Decedent's tangible personal property. Except as otherwise devised, Decedent gives and devises

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his tangible personal property, along with any insurance policies relating thereto, to Daughter, if she survives Decedent. Article III of Decedent's will provides that Decedent's residuary estate is to be distributed to the then serving trustees of the Revocable Trust.

Article V, section B of Decedent's will provides that any estate, legacy, succession, inheritance, transfer, excise (including any excise tax imposed under section 4980A) and other similar taxes (including any generation-skipping transfer tax) imposed by reason of Decedent's death, together with any interest and penalties thereon, referred to therein as "death taxes," are to be paid as follows: (1) All death taxes, other than any generation-skipping transfer tax imposed upon or with respect to property which passes (i) under the will, or (ii) to or under the Revocable Trust is to be paid out of Decedent's general estate as an administration expense, without proration or apportionment against any recipient thereof and without any statutory rights to recover any amounts so paid. (2) All other death taxes are to be prorated and apportioned in the manner provided by law. Article V, section C of Decedent's will provides that his funeral, medical, and administration expenses are to be paid out of his general estate. Article V, section D of the will provides that Decedent's "residuary estate" is to consist of all of Decedent's property wherever located (except any property over which Decedent had a power of appointment, it being Decedent's intention not to exercise any such power by the disposition of the residuary estate), remaining after payment of all debts, funeral and administration expenses and death taxes as provided in this article, any pre-residuary gifts and any other charges payable out of the principal of Decedent's general estate. Article V, section E of the will provides that if the assets of Decedent's general estate (exclusive of residential real property and tangible personal property) are insufficient or too illiquid to pay decedent's funeral and administration expenses or any death taxes required by this article to be paid out of Decedent's general estate as an administration expense, Decedent's personal representative is to make a written request to the trustees of the Revocable Trust to distribute to Decedent's personal representative, or pay directly from the principal of that trust, such amount as may be necessary to pay such expenses and death taxes.

Article II of the Revocable Trust, as amended, provides for the administration of the trust upon Decedent's death, with the trust then termed the Terminating Trust. Article II, section B of the Revocable Trust provides that if the Terminating Trust contains any stock of Company, then such stock is to be disposed of as follows: (1) the trustees are to distribute the Company voting preferred stock as follows: (a) if Son survives Decedent, then the voting preferred stock is to be held by trustees in a separate trust pursuant to Article III of the agreement; (2) the trustees are to distribute the Company nonvoting preferred stock pursuant to Article IV of the agreement. Article II, section C provides that the balance of the Terminating Trust remaining after the distributions directed under the preceding sections of Article II, referred to in the agreement as Decedent's "residuary estate," is to be disposed of pursuant to Article V of the agreement.

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Article III of the Revocable Trust provides for the establishment of a separate trust for the benefit of Son, Son's descendants, and Son's wife. Upon the death of the last to die of Son and Son's wife, the trustees are to distribute the principal of this trust, together with all accrued or collected but undistributed income, to Daughter, if she is then living. If Daughter is not then living, then the trust assets are to be distributed pursuant to a special power of appointment exercised by Daughter.

Article IV of the Revocable Trust provides for the establishment of a separate trust to be funded with a fractional share of the property allocated to Article IV, the numerator of which equals Decedent's unused GST exemption [see section 2631, dealing with a generation-skipping transfer tax exemption], and the denominator of which equals the value of the property allocated to this article as finally determined for federal estate tax purposes. The trustees may pay or apply all or any part of the net income and principal thereof to or for the benefit of Daughter and Daughter's descendants in such proportions as the trustees in their discretion consider advisable for any eligible beneficiary's maintenance in health and reasonable comfort, education, or support in such eligible beneficiary's accustomed manner of living. If Daughter survives Decedent, then upon Daughter's death the trustees are to distribute the remaining trust assets pursuant to a special power of appointment exercised by Daughter.

Article V of the Revocable Trust provides for the disposition of Decedent's residuary estate. Section A of this article provides that the trustees are to pay Decedent's debts, death taxes, and expenses as provided by Article VI. Section B of Article V provides for the distribution of the balance of Decedent's residuary estate as follows: (1) if Daughter or any of her descendants survive Decedent, an equal share is to be disposed of pursuant to Article IV; and (2) one equal share is to be distributed to Son, if Son survives Decedent, or if he does not survive Decedent, to Son's descendants who survive Decedent, per stirpes.

Article VI, section A of Revocable Trust provides that upon Decedent's death, the trustees are to pay to or on behalf of Decedent's executor out of the principal of the residuary estate, such amounts as the personal representative requests in writing for Decedent's funeral expenses, the expenses of administering Decedent's estate, and any estate, legacy, succession, inheritance, transfer, excise (including any excise tax imposed under section 4980A) and other similar taxes (including any generation-skipping transfer tax) imposed by reason of Decedent's death, together with any interest and penalties thereon, referred to in this article as "death taxes," that are required by Decedent's will to be paid out of Decedent's general estate as an administration expense.

Article VI, section D of Revocable Trust provides that to the extent that Decedent's residuary estate is not sufficient to pay all of the expenses and death taxes as provided in Article VI, sections A and B, then the amount of such expenses and

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death taxes described in Article VI, sections A and B, which are not paid from Decedent's residuary estate ("excess costs") are to be paid as follows: (1) the property passing under Articles III and IV of this agreement is to bear a proportionate share of the excess costs. The proportionate share of the excess costs payable from the property passing under each such article is to equal a fraction of the excess costs, the numerator of which is the fair market value of the property passing under such article as finally determined for federal estate tax purposes, and the denominator of which is the fair market value of the property passing under both Articles III and IV as finally determined for federal estate tax purposes. (2) The excess costs payable out of the property passing under Article IV of this agreement is to be paid first from the property passing under Article IV, section B, and then, to the extent that the property passing under Article IV, section B is not sufficient to pay all of the excess costs payable out of the property passing under Article IV, from the property passing under Article IV, section A.

Terminating Trust, which was created under Article II of Revocable Trust, became the holder of the m shares of voting preferred stock and n share of nonvoting preferred stock following the death of Decedent.

The m shares of voting preferred stock and n shares of nonvoting preferred stock held by Revocable Trust prior to Decedent's death (which were included in Decedent's taxable estate) were valued at \$e and \$v (a total of \$ev) on Decedent's Form 706. On audit of the Form 706, the value of the m shares of voting preferred stock was increased From \$e to \$a. Thus, the total audit value of the Company stock included in Decedent's Estate, \$a plus \$v, was \$av.

The value of Decedent's gross estate is \$h. The amount allowable as a deduction to Estate under sections 2053 and 2054 is \$i. The value of the gross estate less the deductions (h minus i) is \$j. The \$av value of the Company stock included in Estate is p percent of the \$j total value of the gross estate less deductions.

The federal and State B estate, inheritance, legacy, and succession taxes imposed because of Decedent's death totaled \$t. The amount of funeral and administrative expenses totaled \$fa. Together the \$fa expenses and \$t taxes totaled \$fat.

It is now proposed that Company will redeem shares of voting and nonvoting preferred stock from Terminating Trust in an amount approximately equally to \$fat.

In connection with the proposed transaction, the following representation have been made:

- (a) The amount to be paid in redemption of the Company stock will not exceed the sum of the federal and State B death taxes (including interest

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collected as part of such taxes) imposed because of Decedent's death plus the amount of funeral and administration expenses allowed as deductions to Estate under section 2053. All death taxes and funeral and administrative expense expenses were paid by the trustees of Terminating Trust under Article II of the Revocable Trust.

- (b) The total of (i) the funeral and administrative expense allowable as section 2053 deductions plus (ii) the federal and State B death taxes imposed as a result of Decedent's death is \$fat.
- (c) The fair market value of Company's stock included in Decedent's gross estate for federal estate tax purposes exceeds 35 percent of the gross estate over the amounts allowable as deductions under sections 2053 and 2054.
- (d) The interest of Terminating Trust in Company will be directly reduced by the redemption used to pay the funeral expenses, administration expenses, and death taxes.
- (e) In the proposed redemption, Terminating Trust will receive cash which will be approximately equal to the fair market value of the stock in Company surrendered in exchange therefor.
- (f) Company and Terminating Trust will each pay their own expenses incurred in the transaction.
- (g) No shareholder of Company is, or will be, obligated to purchase any of the Company stock that will be redeemed.
- (h) Terminating Trust will not transfer any property to Company other than stock in Company.
- (i) The proposed redemption will be the first redemption of any stock included in Estate.
- (j) There is no plan to issue additional stock in Company and there are no outstanding warrants or options to purchases stock in Company, nor are there any outstanding debentures or obligations that are convertible into stock in Company. There is no plan or intention to issue any options, warrants, debentures, or other obligations that may be convertible into Company stock, or which would be considered to be Company stock.
- (k) There are no declared but unpaid dividends, or funds set apart for dividends, on any Company stock.

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- (l) The redemption will be completed prior to Date 5, so that it will occur in the period subsequent to Decedent's death that is specified in section 303(b)(1).

Section 2057(a) provides, generally, that for purposes of the tax imposed by section 2001, in the case of an estate of a decedent to which this section applies, the value of the taxable estate shall be determined by deducting from the value of the gross estate the adjusted value of the qualified family-owned business interests (QFOBI) of the decedent. Section 2057(a)(2) provides that the deduction allowed by this section shall not exceed \$675,000.

Section 2057(f)(1) provides, generally, that there is imposed an additional estate tax if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death: (A) the material participation requirements described in section 2032A(c)(6)(B) are not met with respect to the QFOBI which was acquired (or passed) from the decedent; (B) the qualified heir disposes of any portion of a QFOBI (other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under section 170(h)); (C) the qualified heir loses United States citizenship (within the meaning of section 877) or with respect to whom an event described in section 877(e)(1)(A) or (B) occurs, and such heir does not comply with the requirements of section 2057(g); or (D) the principal place of business of a trade or business of the QFOBI ceases to be located in the United States.

Section 2057(i)(3)(O) provides that for purposes of section 2057, rules similar to the rules in section 6166(g)(1)(B), (C), and (D) (relating to acceleration of payment) shall apply.

Section 6166(g)(1)(A) provides that if: (i) any portion of an interest in a closely held business which qualifies under section 6166(a)(1) is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from such trade or business, and (ii) the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50 percent of the value of such interest, then the extension of time for payment of tax provided in section 6166(a) shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.

Section 6166(g)(1)(B) provides that in the case of a distribution in redemption of stock to which section 303 (or so much of section 304 as relates to section 303) applies: (i) the redemption of such stock, and the withdrawal of money and other property distributed in such redemption, shall not be treated as a distribution or withdrawal for purposes of section 6166(g)(1)(A), and (ii) for purposes of section 6166(g)(1)(A), the value of the interest in the closely held business shall be considered to be such value reduced by the value of the stock redeemed. This paragraph shall

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apply only if, on or before the date prescribed by section 6166(a)(3) for the payment of the first installment which becomes due after the date of the distribution (or, if earlier, on or before the day which is 1 year after the date of the distribution), there is paid an amount of the tax imposed by section 2001 not less than the amount of money and other property distributed.

Section 2057(i)(1) provides that the term “qualified heir” has the meaning given to such term by section 2032A(e)(1), and includes any active employee of the trade or business to which the qualified family-owned business interest relates if such employee has been employed by such trade or business for a period of at least 10 years before the date of the decedent’s death.

Section 2032A(e)(1) provides that the term “qualified heir” means, with respect to any property, a member of the decedent’s family who acquired such property (or to whom such property passed) from the decedent. If a qualified heir disposes of any interest in qualified real property to any member of his family, such member shall thereafter be treated as the qualified heir with respect to such interest.

Section 2057(i)(2) provides that the term “member of the family” has the meaning given to such term by section 2032A(e)(2).

Section 2032A(e)(2) provides that the term “member of the family” means, with respect to any individual, only: (A) an ancestor of such individual, (B) the spouse of such individual, (C) a lineal descendant of such individual, of such individual’s spouse, or of a parent of such individual, or (D) the spouse of any lineal descendant described in section 2032A(e)(2)(C). For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood.

Section 2057(i)(3)(O) provides that rules similar to the rule in section 6166(g)(1)(B) (relating to acceleration of payment) shall apply for purposes of section 2057. Section 6166(g)(1)(B) provides that in the case of a distribution in redemption of stock to which section 303 (or so much of section 304 as relates to section 303) applies, the redemption of such stock, and the withdrawal of money and other property distributed in such redemption shall not be treated as a distribution or withdrawal for purposes of determining whether the extension of time for payment of tax shall cease to apply.

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

- (1) The proposed distribution of cash by Company in redemption of a portion of the Company stock held by Terminating Trust, as described above, constitutes a distribution in full payment in exchange for the Company stock redeemed as provided in section 303(a), to the extent that the

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amount received does not exceed the sum specified in section 303(a) and provided that the requirements set forth in section 303(b) are satisfied.

- (2) As provided in section 1001, gain will be recognized by Terminating Trust measured by the difference between the redemption price and the adjusted basis of the stock surrendered as determined under section 1011. Provided section 341 (relating to collapsible corporations) is not applicable, and the provided also that the stock is a capital asset in the hands of Terminating Trust, the gain if any, will constitute capital gain subject to the provisions and limitations of Subchapter P of Chapter 1.
- (3) The distribution in redemption of stock to which section 303 applies will not be treated as a disposition of any portion of a qualified family-owned business interest under section 2057(f)(1)(B). Provided the proposed redemption satisfies the requirements of section 303, the proposed redemption will not result in the imposition of an additional estate tax under section 2057(f)(1)(B).
- (4) Since the section 303 redemption involves the initial transfer of stock between the Estate and the qualified heirs as shareholders and is not a sale by the qualified heirs to a person other than a member of Decedent's family, there has been no disposition under section 2057(f). However, if after the redemption, the Company reissues the redeemed shares, or issues any new shares of stock in Company to a non-family member, a recapture tax will be triggered by the transaction.

The above rulings are effective to the extent that the amount distributed by Company equals the fair market value of the stock redeemed. No opinion is expressed as to the tax effect of the amount, if any, by which the distribution by Company exceeds or is less than the fair market value of the stock redeemed. A determination of the fair market value of the stock redeemed is reserved until the income tax returns of the taxpayers concerned have been filed for the year the transaction is consummated.

In addition, no opinion is expressed about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effect resulting from, the transaction that are not specifically covered by the above rulings.

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

A copy of this letter should be attached to the federal income tax returns of the taxpayer involved for the taxable year in which the transaction covered by this ruling letter is consummated.

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Pursuant to a power of attorney on file in this office a copy of this letter is being sent to your authorized representative.

Sincerely yours.

By _____
Mark S. Jennings
Branch Chief, Branch 1
Office of Associate Chief Counsel (Corporate)

cc: