

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

July 23, 1999

Corporation A =

Corporation B =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Shareholder F =

Shareholder G =

Shareholder H =

Shareholder I =

Shareholder J =

W =

Business X =

Business Y =

State A =

m shares =

n shares =

p shares = \_\_\_\_\_

q shares =

r shares =

s shares =

Dear :

This responds to your Authorized Representatives' letter dated August 3, 1998, requesting rulings concerning the federal income tax consequences of a proposed transaction. In response to our requests, you submitted additional information in letters dated October 5, 1998, November 11, 1998, November 24, 1998, March 5, 1999 and April 28, 1999. The information submitted for consideration is summarized below.

Corporation A, an accrual method taxpayer, is incorporated in State A and engaged in Business X. Corporation A has outstanding two classes of stock, Class A voting and Class B non-voting. Shareholders A, B, C, D, E, F, G, H & I plan to have all their shares in Corporation A redeemed. A owns m shares of Class A voting and n shares of Class B non-voting. B and G each own p shares of Class A voting and q shares of Class B non-voting. C, D, H and I own r shares of Class B non-voting and E and F own s shares of Class B non-voting. A is the father of B and G, the remaining redeeming shareholders are the children and spouses of B and G. The non-redeeming shareholders are also either the children of A or their children and spouses. The non-redeeming children of A actively participate in Corporation A's activities while those

redeeming their shares do not. The redeeming shareholders will have no continuing involvement with Corporation A. A's wife, W, is employed by Corporation A and has significant responsibility for its computer systems and operations but does not own any Corporation A stock. Shareholder A and his wife, W, will enter into a "property agreement", whereby all consideration paid to W in her capacity as a Corporation A employee will constitute her sole and separate property. All shareholders received shares as gifts from A within the past ten years as part of A's plan to share the Corporation with his children and their families. A also has a majority interest in Corporation B, which is engaged in business Y. Corporation B provides services exclusively to Corporation A and derives all of its revenue from Corporation A.

Shareholders B, C, D, E, F, G, H & I will redeem all of their shares in Corporation A in exchange for cash. A will receive a note (Note 1) from Corporation A in exchange for his Corporation A shares. A will sell his interest in Corporation B to shareholder J, who is A's son and a continuing shareholder in Corporation A, and will receive a note (Note 2) from J in return.

The taxpayers have made the following representations concerning the proposed transaction (all references below to Corporation denote Corporation A unless otherwise indicated):

- (a) There are no outstanding options or warrants to purchase Corporation stock, nor are there any outstanding debentures or other obligations that are convertible into Corporation stock or would be considered Corporation stock.
- (b) In no event will the last payment on Note 1, Note 2, or other obligations be made more than 15 years after the date of issuance of the Notes or other obligations.
- (c) None of the consideration from Corporation or Shareholder J (with respect to Note 2), including interest, consists entirely or partly of a promise to pay an amount that is based on, or contingent on, future earnings of Corporation A or B (with respect to Note 2), an amount that is contingent on working capital being maintained at a certain level, or any other similar contingency.
- (d) Neither the Notes nor other obligation to be issued to Shareholder A will be subordinated to the claims of general creditors of the Corporations.
- (e) A and W have entered into a written agreement that provides that any amount paid by Corporation to W in exchange for her services will be her sole and separate property and Shareholder A, W's husband, will have no community property interest in such amounts. Such agreement will remain in effect for at least 10 years from the date of A's redemption.

- (f) In the event of default on the Notes or other obligations, no shares of stock will revert to or be received by a redeemed shareholder nor will any redeemed shareholder be permitted to purchase the stock at public or private sale.
- (g) No shareholder of Corporation has been or will be obligated to purchase any of the stock to be redeemed except to the extent that the remaining shareholders (those who are not redeemed) enter into any form of agreement providing for the purchase or redemption of their shares in the event of death, disability or termination of employment.
- (h) There have been no redemptions, issuances, or exchanges by Corporation of its stock in the past five years.
- (i) Corporation has no plan or intention to issue, redeem, or exchange additional shares of its stock.
- (j) After the redemption, no redeemed shareholder will have any interest in Corporation A or B, including an interest as officer, director, or employee (other than an interest as a creditor as described in section 1.302-4(d) of the Income Tax Regulations, and constructive ownership under section 318(a)(1) of the Code.).
- (k) Each redeemed shareholder will execute and file the agreement required by section 302(c)(2)(A)(iii) of the Code with respect to the acquisition of any interest in Corporation within ten (10) years from the date of the redemption.
- (l) None of the stock to be redeemed is "section 306 stock" within the meaning of section 306(c) of the Code.
- (m) There are no declared but unpaid dividends or funds set apart for dividends on any of the stock to be redeemed.
- (n) At the time of the exchange, the fair market value of the consideration to be received by the Redeemed Shareholders will be approximately equal to the fair market value of Corporation's stock to be exchanged therefor.
- (o) The price to be paid for Corporation's stock to be redeemed will not result in a loss with respect to those shares of stock.

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

- (1) The gifts of shares from A to his non-redeeming children and their spouses and children did not have as one of its principal purposes the avoidance of federal income tax within the meaning of § 302(c)(2)(B) (Rev. Rul. 57-387, 1957-2 C.B. 225, and Rev. Rul. 77-293, 1977-2 C.B. 91).
- (2) Provided shareholder A files the agreement described in § 302(c)(2)(A)(iii) in accordance with § 1.302-4(a) of the regulations, the redemption of all A's stock, and that of B, C, D, E, F, G, H, and I, will be a complete redemption of their interest in the Company within the meaning of § 302(b)(3). The amount distributed in the redemption will be treated as a distribution in full payment in exchange for the stock surrendered as provided in § 302(a). Pursuant to § 302(c)(2), the family attribution rule of §318(a)(1) will not apply to the proposed transaction. This ruling, however, is subject to the conditions stated in §§ 302(c)(2)(A)(i) and 302(c)(2)(A)(ii) and is also subject to the continued validity of the property agreement between Shareholder A and W, his wife, wherein it is provided that all earnings from Corporation A by W will be her sole and separate property.
- (3) As provided in § 1001, gain will be realized and recognized by Shareholders A, B, C, D, E, F, G, H, and I, measured by the difference between the redemption price and the adjusted basis of the shares of Corporation stock surrendered as determined under § 1011. Provided that § 341 (relating to collapsible corporations) is not applicable and Corporation stock is a capital asset in the hands of shareholders, the gain, if any, will constitute capital gain subject to the conditions and limitations of Subchapter P of chapter 1. Pursuant to § 267 no loss will be allowable.
- (4) Provided the redemption of the Corporation stock held by Shareholders A, B, C, D, E, F, G, H, and I is not performed in satisfaction of a primary and unconditional obligation of a nonredeemed shareholder to acquire the Corporation stock held by said shareholders (see Rev. Rul. 69-608, 1969-2 C.B. 42), the redemption will not cause any dividend income to be realized or constructively received by any nonredeemed shareholder (see Holsey v. Commissioner, 258 F.2d 865 (3<sup>rd</sup> Cir. 1958), acq., Rev. Rul. 58-614, 1958-2 C.B. 920).
- (5) Corporation will not recognize gain or loss on the distribution of cash and "Note 1" in redemption of its stock (§ 311(a)).

We express no opinion on the tax treatment of the transaction under other provisions of the Code and regulations (including the gift tax provisions) or the treatment of any conditions existing at the time of , or the effects resulting from, the transaction not specifically covered by the above rulings. In particular, no opinion is

expressed as to whether the gain, if any, recognized by Shareholder A may be reported under the installment method. We note that, if the gain is initially reportable under the installment method and the notes subsequently become unenforceable, § 453B(f) provides that the notes, which are from related parties, will be treated as being disposed of by Shareholder A (which may produce gain under § 453B(a)), and the fair market value of the obligation will be treated as not less than its face amount.

We also express no opinion about whether the notes are debt or equity because the determination is primarily one of fact (§ 4.02(1) of Rev. Proc. 99-3, 1999-1 I.R.B. 103, 111). The above rulings will be considered void if the notes are found to be equity and not debt. The above rulings are effective to the extent that the amount distributed to Shareholders A, B, C, D, E, F, G, H, and I equals the fair market value of Corporation stock redeemed from the Shareholders. We express no opinion about the tax effect of the amount, if any, by which the distribution by Corporation to Shareholders 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 federal income tax returns of the taxpayers concerned reporting any part of the proposed transaction have been filed.

This ruling is addressed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable years in which the transaction covered by this letter is consummated.

Pursuant to a power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely yours,  
Assistant Chief Counsel (Corporate)  
by \_\_\_\_\_  
Debra Carlisle  
Chief, Branch 5