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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B02-PLR- 162210-02
Date:
September 22, 2003

Legend:

X =

A =

B =

Son =

Daughter =

Son Trust =

Daughter Trust =

Business Activity =

$c =

State =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

Cite 1 =

Cite 2 =

Dear :

This responds to your letter dated November 8, 2002, and subsequent correspondence, submitted on behalf of Daughter Trust, requesting rulings on the tax consequences of a proposed transaction.

The information submitted states that X is a corporation that is involved primarily in Business Activity. X's shareholders consist of A's family members, the Son Trust and the Daughter Trust. A died in Year 1. The Son Trust and the Daughter Trust were formed on Date 1 pursuant to the Last Will and Testament of A. Date 1 is prior to September 25, 1985.

X elected S corporation status effective on Date 2. On Date 3, Son elected under § 1361(d)(2), as current income beneficiary of the Son Trust, to treat the Son Trust as a trust described in § 1361(c)(2)(A)(i), a Qualified Subchapter S Trust ("QSST") with respect to stock held by that trust in X. Also on Date 3, Daughter elected under § 1361(d)(2), as current income beneficiary of the Daughter Trust, to treat the Daughter Trust as a trust described in § 1361(c)(2)(A)(i), a QSST, with respect to stock held by that trust in X.

The shareholders and board of directors of X now propose to split X into three separate business entities. The Business Activity would remain with X and the shareholders of X would form two new limited liability companies (LLCs), each of which would engage in different business activities. Each LLC would have ownership identical to the ownership of X. Daughter, as trustee of the Daughter Trust, represents that the principal business purpose of the division of the businesses is to protect each business from potential future liabilities of another business. Other business purposes include enhancing productivity, by allowing management to concentrate on a primary line of business, and by enabling each entity increased access to additional capital.

In order to accomplish the proposed division, X will distribute cash pro-rata to its shareholders, including the Son Trust and the Daughter Trust (together, the "QSSTs"), in exchange for a pro-rata portion of each shareholder's stock in X (the "Redemption"). The shareholders of X will then form two new LLCs intended to be treated as partnerships for federal income tax purposes. The shareholders will contribute the cash received in the Redemption to the LLCs. Immediately after the proposed transaction, each shareholder of X will hold the same percentage interest in each LLC as the shareholder now holds in X.

X has no accumulated earnings and profits. X has an accumulated adjustments account (AAA) in excess of the amount of the proposed distribution. At the end of Year 2, X's AAA exceeded $c.

Section 1371(a) provides that except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, subchapter C applies to an S corporation and its shareholders.

Under the rules of subchapter C, a redemption is generally treated either as a sale or exchange or as a distribution of property subject to § 301. Section 302(a) provides, in part, that if a corporation redeems its stock, and if section 302(b)(1), (2), (3), or (4) applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock. Section 302(d) provides that except as provided in subchapter C, if a corporation redeems its stock (within the meaning of § 317(b)), and if § 302(a) does not apply, the redemption will be treated as a distribution of property to which § 301 applies. Thus, if the Redemption fails to meet one of the four tests for exchange treatment in § 302(b), it will be treated as a § 301 distribution.

Section 302(b)(1) provides that § 302(a) will apply if the redemption is not essentially equivalent to a dividend. Section 302(b)(2) provides that § 302(a) will apply if (in addition to other requirements) the distribution is substantially disproportionate with respect to the shareholder. Section 302(b)(3) provides that § 302(a) will apply if the redemption completely terminates the shareholder's interest in the corporation. Section 302(b)(4) provides that § 302(a) will apply if the redemption is in partial liquidation of the distributing corporation and the shareholder is not a corporation. Section 302(e) provides that a distribution will be treated as in partial liquidation of a corporation if the distribution is not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level) and the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

The Redemption fails all of the tests set forth in § 302(b). The Redemption is not essentially equivalent to a dividend under § 302(b)(1) because after the transaction each shareholder will have the same respective voting rights and proportionate share of the earnings and profits and liquidation proceeds of Corporation that such shareholder held before the Redemption. Accordingly, the Redemption will not result in a meaningful reduction of any shareholder's proportionate interests in Corporation. For the same reasons, the Redemption is not a substantially disproportionate redemption under § 302(b)(2). The Redemption will not completely terminate any shareholder's interest under § 302(b)(3). Finally, the Redemption is not a redemption from noncorporate shareholders in partial liquidation under § 302(b)(4) because, based on the facts at hand, the transaction is essentially equivalent to a dividend (determined at the corporate level).

Since none of the provisions in § 302(b) apply, the Redemption is treated, under § 302(d), as a distribution of property to which § 301 applies.

Section 1368(a) provides that a distribution of property made by an S corporation with respect to its stock to which (but for § 1368(a)) § 301(c) would apply is treated in the manner provided in § 1368(b) or (c), whichever applies. Since X has no accumulated earnings and profits, § 1368(b) applies.

Section 1368(b) provides that, in the case of a distribution described in § 1368(a) by an S corporation that has no accumulated earnings and profits, the distribution is not included in gross income to the extent that it does not exceed the adjusted basis of the stock. If the amount of the distribution exceeds the adjusted basis of the stock, the excess is treated as gain from the sale or exchange of property.

Rev. Rul. 95-14, 1995-1 C.B. 169, holds that when an S corporation shareholder receives proceeds in a redemption that is characterized as a distribution under § 301, the entire redemption is treated as a distribution for purposes of § 1368 that reduces the corporation's AAA.

Under these facts, § 1368(b) applies to the entire distribution, and therefore, X's AAA is reduced by the full amount of X's distribution in redemption of each shareholder's stock. In addition, the amount of gross income to the QSSTs from the proposed distributions is determined under § 1368(b). B, the Tax Director of X, represents that the proposed distribution to each shareholder will not exceed each shareholder's basis in the shareholder's X stock.

Section 1361(d)(1) provides that in the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under § 1361(d)(2)- - (A) such trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and (B) for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of such trust which consists of stock in an S corporation with respect to which the election under § 1361(d)(2) is made.

Section 1361(d)(3) provides that the term "qualified subchapter S trust" means a trust- - (A) the terms of which require that- - (i) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and (B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(1)(i) of the Income Tax Regulations provides that one of the requirements for a QSST is that all of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States.

Section 643(b) provides that for purposes of subparts A, B, C, and D, the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

Section 1.643(b)-1 provides that for purposes of subparts A through D, part I, subchapter J. chapter 1 of the Code, the term income when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose.

State's Uniform Principal and Income Act (Act), the governing law of the QSSTs, provides that a corporate distribution is principal if the distribution is under (1) a call of shares; (2) a merger, consolidation, reorganization, or other plan by which assets of the corporation are acquired by another corporation; or (3) a total or partial liquidation of the corporation. Cite 1. You have represented on behalf of X, that State case law has not addressed Cite 1 in any manner. State law provides, under Act, that a trustee may rely upon the statement of the distributing corporation as to any fact concerning the source or character of distributions of corporate assets. Cite 2.

X represents that it will represent to its shareholders, including the trustees of the QSSTs, that the proposed distribution by X constitutes a redemption or call of shares of X. The trustees of the QSSTs propose to allocate the proceeds received from X's anticipated distribution to principal. Subparagraph (d)(3) of Paragraph FIFTH of A's Last Will and Testament provides that the trustees of each trust are authorized "to determine what is principal and income; . . ."

As indicated above, the Last Will and Testament of A gives the trustees broad discretionary power to allocate trust receipts between income and principal. Moreover, X represents that under State law the distribution should be allocated to principal. Accordingly, the distribution proceeds received by the QSSTs will not constitute fiduciary accounting income within the meaning of § 643(b). In addition, the QSSTs' treatment of the distributions as principal rather than income will not cause the QSSTs to violate the current income distribution requirement of § 1361(d)(3). Provided that X continues to meet the requirements of § 1361(b), the proposed distribution will not terminate X's election to be taxed as an S corporation under §1362(d)(2).

Section 2601 imposes a tax on every generation-skipping transfer (GST), which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, provide that the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer was not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of section 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under section 26.2601-1(b)(1), (b)(2), or (b)(3), will not cause the trust to lose its exempt status. The rules of section 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. A modification that is administrative in nature that only indirectly increases the amount transferred will not be considered to shift a beneficial interest in the trust.

In this case, the Son Trust and the Daughter Trust were irrevocable on September 25, 1985. It is represented that no additions to the Son Trust or the Daughter Trust have been made since September 25, 1985.

Under the transaction proposed, the Son Trust and the Daughter Trust will each receive a pro-rata distribution of cash in partial redemption of each shareholder's stock in X. Subsequent to receipt of the distribution, the Son Trust and the Daughter Trust will contribute the cash to two newly formed LLCs. Immediately after the proposed transaction, the Son Trust and the Daughter Trust will hold the same percentage interest in each LLC as the Son Trust and the Daughter Trust now hold in X.

The proposed transaction effectuates a change in the form of investment or interests held by the Son Trust and the Daughter Trust and is administrative in nature. The beneficiaries and the terms of the Son Trust and the Daughter Trust will remain unchanged. Accordingly, the proposed transaction will not shift any beneficial interest in either the Son Trust or the Daughter Trust to a lower generation or extend the time for vesting of any beneficial interest in any of the trusts beyond the period of time provided for in the original trusts. Similarly, the proposed transfers will not be deemed to be additions to the trusts for generation-skipping transfer tax purposes.

We conclude that the proposed transaction will not affect the exempt status of the Son Trust or the Daughter Trust under § 2601, provided that there are no additions to either trust after September 25, 1985.

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident. Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money(s) worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift, that is included in computing the amount of gifts made during the calendar year.

The transactions will cause a change in the form of investment or interests held by the Son Trust and the Daughter Trust. Upon the transfer by the Son Trust and the Daughter Trust of the cash to the two LLCs, each trust will receive an interest in each LLC. Based upon the information submitted and the representations made, we conclude that the proposed transactions will not result in a taxable gift by any beneficiary of the Son Trust or the Daughter Trust.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the foregoing transactions under any other provisions of the Code or regulations. In particular, we neither express nor imply an opinion on whether X's initial S corporation election is valid, or whether the Son Trust or the Daughter Trust qualify as QSSTs. We also express no opinion on whether any distributions that exceed basis are taxable to the QSSTs or to the QSSTs' beneficiaries.

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

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

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to Daughter Trust.

Sincerely yours,

J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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