

PLR-134148-03

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

\$X =

State =

Court =

Cite1 =

Cite 2 =

Dear :

We received a letter, written on your behalf, on June 2, 2003, requesting rulings regarding the consequences of allocating the proceeds from a stock redemption to the principal, rather than the income, of qualified subchapter S trusts (QSSTs), the consequences of partitioning the redemption proceeds portion of the QSSTs from the corporate stock portion of the QSSTs, and the consequences of merging the redemption proceeds portion of the QSSTs with separate pre-existing trusts which have identical terms and beneficiaries. This letter responds to the requested rulings.

FACTS

On Date 1, after September 25, 1985, Settlor created an irrevocable trust, Trust , for the primary benefit of his three children, A, B, and C. Under the terms of Trust, Trust was divided into separate trusts, one for each child (Trust A for child A, Trust B for child B, and Trust C for child C). Under the terms of Trust, each child is to receive all trust income for life and such corpus as the trustee, in the trustee's discretion, may deem necessary or advisable for the child's maintenance, health, and support in reasonable comfort. Article III Section Two of the Trust provides that if at any time the child is subject to income tax with respect to all or any part of the trust income, whether or not the child actually receives such income, the trustee shall, upon the written request of the child distribute trust principal to the child in a sufficient amount to satisfy the federal or state income tax liability.

In addition, under Article III Section Two, each child is granted a right to withdraw a portion of each contribution made to the trust, subject to certain limitations. Upon the death of each child, the portion of the trust that could have been withdrawn by the child at the date of death pursuant to the withdrawal power contained in Article III Section Two, is to be distributed as the child appoints pursuant to a general power of appointment. The remaining principal is to be distributed as the child appoints pursuant to a special power of appointment. In default of appointment, the trust property is held in further trust for any living children of a deceased child.

Trusts A, B, and C were each funded with \$X. Settlor filed a Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," allocating sufficient GST exemption to the trusts, so that each trust has an inclusion ratio of zero for generation-skipping transfer (GST) tax purposes. On Date 2, each trust invested \$X in Company. The three trusts were the sole shareholders of Company. Company elected under § 1362 of the Internal Revenue Code to be treated as a subchapter S corporation. No other contributions have been made to the trusts.

Article IV of Trust sets forth the trustee's powers. Paragraph (H) of Article IV of Trust provides the trustee with "the power (i) to determine the manner in which items should be credited or charged to or between income and principal, regardless of whether any item is credited or charged contrary to the provisions of any statute."

On Date 3 and Date 4, the trustee of Trusts A, B, and C requested private letter rulings concerning a redemption of a portion of the Company stock and a proposed partition of the trusts. Pursuant to favorable rulings and a Consent Judgment by Court, the trustee partitioned Trusts A, B, and C. As a result, Trust A was partitioned into Trust A1 and A2; Trust B was partitioned into Trust B1 and B2; and Trust C was partitioned into Trust C1 and C2. Trusts A1, B1, and C1 retained the shares of stock of Company, while the other assets (including the redemption proceeds) were distributed to Trusts A2, B2, and C2. It is represented that Trusts A1, B1, and C1 qualify as QSSTs under § 1361(d) and that elections were filed under § 1361 to treat them as QSSTs.

Company proposes to redeem a pro rata portion of its stock held by Trusts A1, B1, and C1. It is represented that the total amount of money and property to be distributed to the Trusts A1, B1, and C1, as a result of the proposed transaction will be greater than 20% of the Company gross assets. After the redemption, each shareholder will own the same percentage of Company stock as before the redemption. It is represented that since Date 5, Company has distributed approximately 60% of its net earnings to Trusts A1, B1, and C1. The trustee of Trusts A1, B1, and C1 has classified these distributions as fiduciary accounting income and has distributed all of the income of each trust to each trust's current sole beneficiary.

With respect to each trust, the trustee proposes to allocate the proceeds received from the redemption to principal. Under State's Principal and Income Act, in general, money received from an entity is allocated to income. However, a corporate distribution

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in excess of 20% of corporate assets is to be treated by a trustee as a “partial liquidation” and allocated to principal. Cite1.

Pursuant to the approval of a State court of the proper jurisdiction, the trustee also proposes to divide the trust property of Trust A1 into two trusts (Trust A1 and new Trust A2), Trust B1 into two trusts (Trust B1 and new Trust B2), and Trust C1 into two trusts (Trust C1 and new Trust C2). The trusts will be divided on a fractional basis. Each partitioned trust will be funded on a non pro-rata basis, based on the fair market value of the assets on the date of funding. Trusts A1, B1, and C1 will be funded with Company stock and new Trusts A2, B2, and C2 will be funded with the redemption proceeds. In all respects the terms of the trusts as severed, will be identical to the terms of the trusts prior to severance. The trusts holding the redemption proceeds (new Trusts A2, B2, and C2) will then be merged into Trusts A2, B2, and C2, respectively.

Applicable State law authorizes a trustee to divide the funds and properties constituting any trust into two or more identical separate trusts that represent two or more fractional shares of the funds and properties being divided. Funding of the new trusts created pursuant to the statute must either: (i) be carried out by pro rata allocation of the assets of the original trust; (ii) be based upon the fair market value of the assets at the date of division; or (iii) be carried out in a manner fairly reflecting the net appreciation or depreciation of the trust assets measured from the valuation date to the date of division. Cite 2.

The trustee has requested the following rulings:

1. Sections 1368(b) and 1368(c) will apply for purposes of determining the extent to which the redemption proceeds from the proposed distribution will be includable in the gross income of Company’s shareholders.
2. The treatment of the redemption proceeds as principal rather than income will not cause Trusts A1, B1, and C1 to fail to satisfy the current income distribution requirement of § 1361(d)(3).
3. The allocation of the proceeds of the redemption to the corpus of Trusts A1, B1, and C1 will not be a gift by each beneficiary to his respective trust.
4. The partition of Trusts A1, B1, and C1 as proposed will not subject the trustee, the trust assets, or the beneficiaries to the GST tax under § 2601.
5. The merger of the trusts holding the redemption proceeds into Trusts A2, B2, and C2 will not cause any distributions from or termination of any interest in Trusts A2, B2, or C2, or any successor trust to be subject to the GST tax under § 2601, or otherwise cause the assets of Trusts A2, B2, or C2 to be subject to the GST tax.
6. The partition of Trusts A1, B1, and C1 and the merger of the trusts holding the redemption proceeds into Trusts A2, B2, and C2 will not cause any of the trusts, any

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successor trust, or any beneficiary to realize gain or loss from a sale or other disposition of the redemption proceeds under §§ 61 or 1001.

7. The partition of Trusts A1, B1, and C1 will not alter the status of the assets held by Trusts A1, B1, and C1 immediately prior to the proposed split as transferred basis property under §§ 1015 and 7701(a)(43).

8. Pursuant to § 1223(2), the holding period for the redemption proceeds initially held by Trusts A1, B1, and C1 will carryover after Trusts A1, B1, and C1 are partitioned and the trusts holding the redemption proceeds are merged into Trusts A2, B2, and C2.

RULING REQUEST 1

Section 301(a) provides that except as otherwise provided in chapter 1, a distribution of property (as defined in § 317 (a)), made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in § 301(c).

Section 302(d) provides that except as otherwise provided in subchapter C of chapter 1, if a corporation redeems its stock (within the meaning of § 317(b)), and if § 302(a) does not apply, the redemption shall be treated as a distribution of property to which § 301 applies.

Section 317(a) provides, in part, that the term property means money, securities, and other property.

Section 1368(a) provides that a distribution of property made by an S corporation with respect to its stock to which (but for this subsection) § 301(c) would apply shall be treated in the manner provided in § 1368(b) or (c), whichever 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 -- (1) The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock; and (2) If the amount of the distribution exceeds the adjusted basis of the stock, the excess shall be treated as gain from the sale or exchange of property.

Section 1368(c) provides that in the case of a distribution described in § 1368(a) by an S corporation that has accumulated earnings and profits -- (1) That portion of the distribution that does not exceed the accumulated adjustments account shall be treated in the manner provided in § 1368(b); (2) That portion of the distribution that remains after the application of § 1368(c)(1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation; and (3) Any portion of the distribution remaining after the application of § 1368(c)(2) shall be treated in the manner provided in § 1368(b).

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Section 1371(a)(1) provides that except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders.

Based on the information submitted and the representations made, including the representation that the proposed distribution will qualify as a redemption under § 302(d), we conclude that the provisions of §§ 1368(b) and 1368(c) will apply in determining the extent to which the proposed distributions will be includable in the shareholders' income .

RULING REQUEST 2

Section 643(b) provides that for purposes of subparts A, B, C, and D of part 1 of subchapter J, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends that 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 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under § 1361(d)(2) such trust shall be treated as a trust described in § 1361(c)(2)(A)(i), and for purposes of § 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the 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, for purposes of § 1361(d), a QSST means a trust (A) the terms of which require that (i) during the life of the current income beneficiary there shall be only 1 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 1 individual who is a citizen or resident of the United States.

As indicated above, under the terms of the Trust, the trustee has broad discretionary power to allocate trust receipts between income and principal. Moreover, under State law, a corporate distribution in excess of 20% of corporate assets is allocated to principal. Accordingly, based on the information submitted and representations made, we conclude that the distribution of the redemption proceeds received by Trust A1, Trust B1, and Trust C1 will not constitute fiduciary accounting income within the meaning of § 643(b). In addition, the allocation of the redemption

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proceeds to the principal of Trusts A1, B1, and C1 will not cause Trusts A1, B1, and C1 to violate the current income distribution requirement under § 1361(d).

RULING REQUESTS 3, 4, and 5

Section 2501(a)(1) provides for the imposition of a gift tax on the transfer of property by gift. Section 2511(a) provides that the gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2601 imposes a tax on every generation-skipping transfer as defined in § 2611(a), made by a “transferor” to a “skip person.” Section 2611(a) defines the term “generation-skipping transfer” as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2602 provides that the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate. Section 2641(a) provides that the term “applicable rate” means with respect to any GST transfer, the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is generally defined as the excess of 1 over the “applicable fraction”. The applicable fraction, as defined in § 2642(a)(2) is a fraction, the numerator of which is the amount of GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator is the value of the property transferred to the trust or involved in the direct skip.

Section 2631(a), effective in the case of decedents dying and generation-skipping transfers after December 31, 2003, provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption amount of \$1,030,000 (adjusted for inflation under § 2631(c)) which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable. Section 2631(c), effective in the case of decedents dying and generation-skipping transfers after December 31, 2003, provides that the GST exemption amount for any calendar year shall be the applicable exclusion amount under § 2010(c) for such calendar year.

Section 2642(a)(3)(A) provides, generally, that if a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter for GST tax purposes.

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Section 2642(a)(3)(B)(i) provides, generally, that for purposes of § 2642(a)(3)(A), the term "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if the single trust was divided on a fractional basis, and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Section 2642(a)(3)(B)(ii) provides that if a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1. Section 2642(a)(3)(B)(iii) provides that the term "qualified severance" includes any other severance permitted under regulations prescribed by the Secretary.

Section 2642(a)(3)(C) provides that a qualified severance may be made at any time. The Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the IRS.

In the instant case, it is represented that an amount greater than 20% of the Company assets will be distributed to the Trusts A1, B1, and C1. The trustee proposes to allocate the redemption proceeds to trust principal. Under the terms of the Trust, the trustee has broad discretion to allocate receipts between income and principal, even if the allocation is inconsistent with applicable state law that would otherwise apply. Under State law, a corporate distribution in excess of 20% of corporate assets is allocated to principal. In view of the terms of the Trust, and State law, we conclude that the allocation of the redemption proceeds to the principal of Trust A1, Trust B1, and Trust C1 will not constitute a gift by A, B, and C with respect to their respective trusts.

Trust became irrevocable after September 25, 1985. It is represented that a portion of Settlor's allowable \$1,000,000 GST exemption was allocated with respect to the initial transfers to Trust A, Trust B, and Trust C, such that each trust had an inclusion ratio of zero. After the severance of Trusts A, B, and C, as described above, Trusts A1, B1, and C1 and Trusts A2, B2, and C2 each had an inclusion ratio of zero, and therefore, distributions from the trusts will not be subject to GST tax. As discussed above, in view of the terms of the Trust, and State law, we conclude that the allocation of the redemption proceeds to the principal of Trust A1, Trust B1, and Trust C1, will not cause these trusts to lose their GST exempt status for purposes of chapter 13.

Further, Trust A1, Trust B1 and Trust C1 will be severed in accordance with applicable State law. Further, as severed, Trust A1 and new Trust A2, Trust B1 and new Trust B2, and Trust C1 and new Trust C2 provide for the same succession of

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interests and beneficiaries as are provided in Trusts A1, B1, and C1, prior to the severance. Finally, Trusts A1, B1, and C1 will be severed on a fractional basis.

Accordingly, the severance of Trusts A1, B1, and C1 as proposed, will be a qualified severance under § 2642(a)(3). Trusts A1, B1, and C1 each have inclusion ratios of zero. After the partition, Trust A1 and new Trust A2, Trust B1 and new Trust B2, and Trust C1 and new Trust C2, will retain the zero inclusion ratios. Likewise, after the merger of new Trust A2 into Trust A2, new Trust B2 into Trust B2 and new Trust C2 into Trust C2, the surviving Trusts A2, B2, and C2, will retain a zero inclusion ratio, if no additional transfers are made to the trusts.

Based upon the information submitted and representations made, we conclude the partition of Trusts A1, B1, and C1 as proposed will not subject the trustee, the trust assets, or the beneficiaries to the GST tax under § 2601. In addition, the merger of the partitioned trusts holding the redemption proceeds into Trusts A2, B2, and C2 will not cause any distributions from, or termination of any interest in Trusts A2, B2, or C2, or any successor trust or otherwise cause the assets of Trusts A2, B2, or C2 to be subject to the GST tax under § 2601.

RULING REQUEST 6

Section 61 provides that gross income includes all income from whatever source derived. Section 61(a)(3) specifically includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

An exchange of property results in the realization of gain only if the properties exchanged materially differ. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). A material difference exists when the exchanged properties embody legal entitlements “different in kind or extent” or if they confer “different rights and powers.” Id. at 565.

Based upon the information submitted and representations made, we conclude that the partition of Trust A1, Trust B1, and Trust C1 is not a sale or other disposition of

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property and does not result in a material difference in the actual legal entitlements of the original trust as compared to the contemplated partitioned administration. Consequently, no gain or loss will be realized under §§ 61 and 1001 from the partition of Trusts A1, B1, and C1 or from the merger of the trusts holding the redemption proceeds with Trusts A2, B2, and C2.

RULING REQUEST 7

Section 1015(a) provides that if property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in § 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.

Section 1015(b) provides that if property was acquired by a transfer in trust (other than a transfer in trust by gift, bequest or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer.

Section 7701(a)(43) provides that the term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

We conclude that because § 1001 will not apply to the proposed partition of Trusts A1, B1, and C1, under § 1015(b), the basis of the assets in Trusts A1, B1, and C1 and Trusts A2, B2, and C2 after the partition will be the same as the basis of those assets prior to the partition. Therefore, we conclude that the partition of Trusts A1, B1, and C1 will not alter the status of the assets held in Trusts A1, B1, and C1 prior to the proposed partition as transferred basis property under §§ 1015 and 7701(a)(43).

RULING REQUEST 8

Section 1223(2) provides that in determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Since no gain or loss is recognized on the transfer of the assets under § 1001 and the basis of the assets is the same in the hands of Trusts A1, B1, and C1 as in the hands of Trusts A2, B2, and C2, under § 1223(2), the holding period for the assets in Trusts A2, B2, and C2 will include that period in which the assets were held by Trusts A1, B1, and C1, respectively.

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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 whether Company's S corporation election is valid, the distributions qualify as redemptions under § 302(d), or the trusts qualify as QSSTs. We also express no opinion on whether the distributions are taxable to the trusts or the trusts' beneficiaries.

Under a power of attorney on file with this office, we are sending a copy of this letter to the trustee's authorized representative.

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

Sincerely,

/s/

Christine Ellison
Branch Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: