Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 - PLR-156262-02
Date:
February 13, 2003

Legend:

X =

D1 =

Year 1 =

Company =

Dear :

This letter responds to your letter dated October 2, 2002, and subsequent correspondence, submitted by you on behalf of X as X's authorized representative, requesting certain rulings regarding the proposed transfer of Company stock to a charitable remainder unitrust (CRUT).

The information submitted states that X is a retired executive officer of Company and currently serves on its board of directors. X was a participant in Company's executive stock purchase plan (the Plan) and has substantial net worth in the Company stock acquired under the Plan while employed at Company. X has entered into fourteen different stock restriction agreements in connection with purchases of stock under the Plan. One stock restriction agreement, as amended, dated D1 between Company and X pertains to stock purchases made before Year 1. Section 2 of this agreement provides that Company shall have the exclusive right to purchase any or all of the stock if: (1) X "sells, assigns, transfers, hypothecates, encumbers, pledges or otherwise disposes of all or any part of Company's stock...without complying with the agreement;" (2) X "ceases, for any reason whatsoever (with or without cause) other than retirement, to be employed by at least one of Company [or its affiliates and their subsidiaries];" or (3) X "dies without a surviving spouse." Under Section 4, Company has the right to exercise its option commencing on the date on which the event occurred giving rise to Company's right to exercise its option and continuing until two months after X has given the required notice of the occurrence of such event to Company. Section 7 provides that if Company does not timely exercise its option, X

may sell or otherwise dispose of the shares during the two-month period after the expiration of the option period, but that any transferee will be subject to all of the provisions of the agreement. Section 9 contains a formula for determining the purchase price of any shares Company purchases under its option.

In subsequent years, X entered into thirteen further stock restriction agreements with Company governing stock purchased in those years. Each agreement contains provisions substantially the same as the initial agreement regarding the events that trigger Company's exclusive option to purchase the shares if X wants to transfer such shares and the method and timing of the exercise of Company's option. Accordingly, all of the stock purchased by X from Company pursuant to the Plan in each of these years remains subject to the Company's "right of first refusal" to acquire the stock from X.

X proposes to establish a CRUT (as defined in § 664 of the Internal Revenue Code). Upon establishment of the CRUT, X will notify Company of X's intent to transfer a portion of X's Company stock purchased under the Plan to the CRUT, thereby triggering Company's option to purchase the stock for the formula price set forth in the stock restriction agreements applicable to such stock. Taxpayer represents that Company will likely decline to purchase the stock for the formula price set forth in the stock restriction agreements and thus X will be free to transfer the stock to the CRUT. The stock transferred to the CRUT will continue to be subject to the terms of the stock restriction agreements under the Plan in accordance with the terms of the stock restriction agreements. Therefore, if the trustee of the CRUT wishes to sell or otherwise dispose of the stock, Company will have a right to purchase the stock for the formula price set forth in the stock restriction agreements. The trustee will notify Company that the CRUT wishes to sell Company stock prior to any proposed sale or disposition. X represents that Company has always exercised its option under the stock restriction agreements in the past for the formula price set forth therein.

Each of the annual restricted stock agreements also contains provisions to the effect that any outstanding promissory notes given by X to Company with respect to financing the acquisition of the restricted stock will be satisfied from the proceeds of the purchase of the restricted stock by Company pursuant to the exercise of its rights of first refusal under the restricted stock agreements. These provisions would carry over to successors in interest in the stock, including the CRUT. X represents that all encumbrances shall be removed from the restricted stock prior to the time such stock is transferred to CRUT by X.

In Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on other grounds, 523 F. 2d 1308 (8th Cir. 1975), acq., 1978-1 C.B. 2, a shareholder in control of a corporation gifted stock of that corporation to a charitable foundation also controlled by the donor shareholder. Subsequent to the gift, and as part of the same plan, the shareholder caused the corporation to redeem the gifted stock from the donee foundation the next

day. The Tax Court respected the form of the transaction, and did not recharacterize the transaction as a redemption of the stock by the donor shareholder followed by a gift of the redemption proceeds to the charitable foundation, because it found that a gift of stock had in fact been made to the foundation and the foundation was not legally obligated to redeem the stock at the time it received title to the shares. In reaching its decision the Court noted:

> "... there were two paths which the [donor shareholder] could have taken -- he could have had the stock redeemed and then made a contribution of the [proceeds], or he could have contributed the stock and let the donee arrange for the redemption. The tax consequences to the donor turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way [citation omitted].

Palmer v. Commissioner, supra at 693.

The Service has acquiesced in the Palmer decision. See 1978-1 C.B. 2. In Rev. Rul. 78-197, 1978-1 C.B. 83, the Service concluded that it will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. The Tax Court has characterized the "legally bound" standard in Rev. Rul. 78-197 as a "bright line" test for determining if a contribution of stock to a charity followed by a redemption of that stock from that charity should be respected in form or recharacterized as a redemption of the stock from the donor followed by a contribution of the proceeds by the donor to the charity. See generally, Rauenhorst v. Commissioner, 119 T.C. No. 9 (October 7, 2002).

Consequently, the test for purposes of this ruling request, is whether the CRUT will be legally bound or can be compelled by Company to surrender the stock for redemption at the time of the donation. Here, X proposes to transfer the Company stock to the CRUT. Under the restrictions contained in each year's stock restriction agreement, the CRUT must first offer the stock to Company at a set formula price should the CRUT propose to dispose of the shares. This provision amounts to a right of first refusal. However, it does not mean that the CRUT is legally bound or can be compelled by Company to surrender the stock to Company at the time of the donation. The information submitted contains no indication that the CRUT will be legally bound, or could be compelled by Company, to redeem or sell the gifted stock. That all or a portion of the gifted stock was subject to restrictions upon transfer to a third party by X, and thus by the CRUT following the transfer, does not give Company the ability to compel its redemption or sale from the CRUT. The CRUT is free to retain title to and ownership of the stock indefinitely.

Because the CRUT is not legally bound and cannot be compelled by Company to redeem or sell the stock, we conclude that the transfer of the Company stock by X to

the CRUT, followed by any subsequent redemption of the stock by Company, will not be recharacterized for federal income tax purposes as a redemption of the stock by Company from X followed by a contribution of the redemption proceeds to the CRUT. See Palmer v. Commissioner, supra, and Rev. Rul. 78-197, supra. The same principles apply if the stock is sold by the CRUT rather than redeemed by Company. Thus, provided there is no prearranged sale contract whereby the CRUT is legally bound to sell the stock upon the contribution, we conclude that any subsequent sale will not be recharacterized for federal income tax purposes as a sale of the stock by X, followed by a contribution of the sale proceeds to the CRUT. Accordingly, any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income received by X.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the proposed transaction. Specifically, we express no opinion (1) as to whether the CRUT will meet the requirements of § 664 and the regulations thereunder; (2) as to the tax consequences if Company exercises its rights to acquire the Company stock which X proposes to transfer to the CRUT; and (3) as to the tax consequences if the stock is transferred to the CRUT subject to any encumbrance arising from obligations from X to Company or the use of the stock to satisfy any such encumbrances.

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

Pursuant to a power of attorney on file with this office, copies of this letter are being forwarded to X and to X's other authorized representative.

Sincerely yours,

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

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes