IN THE MATTER OF THE PETITION OF A and D
("The Petitioners")
FOR A DECLARATORY RULING
Doc. No. 7654, Effective 2/15/02

Pursuant to RSA 541-A:1, IV, RSA 541-A:16, II(b) and administrative rule Rev 209.01, the Petitioners request a declaratory ruling which finds:

(1) the receipt of a note (or a combination of a note and cash) pursuant to a stock redemption transaction is an "amount received from the sale, exchange or transfer of a share of corporate stock by way of a redemption" under RSA 77-A:4-c and therefore does not result in receipt of any amount taxable as income under RSA 77; and

(2) entities commonly-owned by a single individual satisfy the unity of ownership prong of the three unities test for a determination of a "unitary business" within the meaning of RSA 77-A:1, XVI.

Pursuant to N.H. Code of Admin. Rules Rev 209.02, this declaratory ruling is issued to the petitioners, A and D , with respect to the particular transactions and facts discussed herein and represents a holding of the department on those transactions and facts for those petitioners only.

Determination Requested by the Petitioners

Under a proposed transaction, B proposes to redeem all or substantially all of the outstanding Class B non-voting shares and possibly some portion of the outstanding Class A voting shares owned by D in exchange for a note or a combination of a note and cash from B in the principal amount of approximately $X. All other shares of the Class A voting interests and the class B non-voting interests shall not be redeemed and shall remain outstanding.

C was organized on Date as the legal entity that A would use to participate in a transaction to purchase the Business. The ownership structure of C is the same as B. Its membership interests consist of Class A and Class B membership interests. Only the Class A interests are entitled to vote. The shareholders are the same as in B. D owns 100 percent of the outstanding voting Class A interests in both B and C.

Petitioners request a response to the following questions:

(1) Will the proposed stock "redemption" transaction between D and B be characterized for purposes of the interest and dividends tax as "an amount received from the sale, exchange or transfer of a share of corporate stock by way of a redemption" under RSA 77:4-c, or as "an amount of property distributed, with respect to their ownership interest, other than in liquidation of the organization, to shareholders or interest-holders of an organization" under Rev 901.07 and therefore potentially taxable as a dividend under RSA 77?

(2) Will B, A, and C be regarded as satisfying the unity of ownership prong of the three unities test for the determination of a " unitary business" within the meaning of RSA 77-A:1, XVI?

Facts Presented by the Petitioners

A is owned 100 percent by B, which in turn is owned by individual D and three irrevocable trusts. D owns 100 percent of the Class A voting stock in B. D, together with the three trusts, own all the Class B non-voting stock in the following proportions:

D 1,973 shares

Trust 1 2,000 shares

Trust 2 2,000 shares

Trust 3 2,000 shares

C is a Delaware limited liability company organized on Date, to acquire, own, operate, manage and dispose of the Business. The Business has been acquired through independent limited liability companies, each of which is wholly-owned by C. The transaction was completed in 2001. C is owned by D and the same three irrevocable trusts which own B in the same proportion and with the same voting rights.

For federal income tax purposes B and A have elected to be "S" corporations.

Revised Statutes Annotated (RSA) at Issue

The following New Hampshire statutes are relevant to the Petitioners' request for a declaratory ruling:

RSA 77:4, IV RSA 77-A:1, I RSA 77-A:1, XV

RSA 77:4-c RSA 77-A:1, XIV RSA 77-A:6, IV

Rules at Issue

The following administrative Rules are relevant to the Petitioners' request for a declaratory ruling:

Rev 209.01 Rev 901.06

Rev 301.33 Rev 901.07

Petitioners' Representations

To the best knowledge of the Petitioners and the Petitioners' representative, identical or similar issues:

(1) Have not been included in a ruling request that is currently under examination by the New Hampshire Department of Revenue Administration;

(2) Have not been previously examined by the New Hampshire Department of Revenue Administration;

(3) Have not been under consideration by the New Hampshire Department of Revenue Administration in connection with a return for a prior period; or

(4) Are not pending in litigation.

Findings

I. Redemption of Shares

Under the proposed transaction, D intends to sell all or substantially all of the outstanding Class B non-voting shares and possibly some portion of the outstanding Class A voting shares in B back to B in exchange for a note or a combination of a note and cash. D owns all the voting shares in B and approximately 1/4 of the Class B shares. The remaining Class B shares are owned equally by the three irrevocable trusts. As a result of the proposed transaction, it is estimated that D's ownership interest in B will be reduced from 33.1% to approximately 14 to 16% after the transaction. The proportionate share of the other three shareholders will increase from 22.29% to approximately 28 to 29%. After the redemption is completed, D will continue to hold 100 percent of the then-outstanding Class A voting shares.

The issue to be decided in this ruling is whether the transaction is a sale, exchange, or transfer of shares of stock by way of redemption resulting in a non-taxable transfer under RSA 77, or whether the payment is actually a distribution to a shareholder from earnings and profits resulting in a taxable dividend under RSA 77.

RSA 77:4, IV states that "dividends, other than that portion of a dividend declared by corporations to be a return of capital and considered by the federal internal revenue service to be such, the exemption of which is permitted by RSA 77:7" is taxable under the interest and dividends tax. The Department's rules define a "dividend" as "an amount of property distributed, <u>with respect to their ownership interest</u>, other than in liquidation of the organization, to shareholders or interest-holders of an organization; (a) from the current year profit; or (b) from the accumulated profits of such entity." Rev 901.07 (emphasis added). A "distribution" is defined to be "a transfer of property from an organization to its shareholders or interest-holders <u>solely as a result of their ownership interest in such organization</u>." Rev 901.06 (emphasis added.)

The Petitioners cite RSA 77:4-c as authority for their proposition that the contemplated transaction is not a distribution resulting in a dividend subject to interest and dividends tax. That provision states that:

No provision of RSA 77:4 or RSA 77:7 shall be construed to include within any class of property otherwise taxable as income, any amount received from the sale, exchange or transfer of either a share of corporate stock or any other transferable share under this chapter, whether by way of liquidation, redemption or otherwise, and irrespective of the identity of the parties to the sale, exchange or transfer.

RSA 77:4-c.

In order for a payment by a business organization to a shareholder to be characterized as a redemption the shareholder must demonstrate that he is actually giving up a portion of his ownership interest in the organization. Under the proposed transaction, D is to transfer a percentage of his non-voting ownership interest, and perhaps some of his voting stock, back to B in exchange for a note or a combination of a note and cash from the trust. The other outstanding ownership interests in B will be increased accordingly. This transaction is not a distribution resulting in a dividend as there will be a significant reduction in D's percentage interest relative to the other shareholders. The payment of the note or a combination of a note and cash is made not solely as a result of D's ownership interest, but in exchange for his actually giving up a portion of his ownership interest in B. Therefore, under the facts presented by the Petitioners, the transaction is a non-taxable redemption under RSA 77.

II. Unity of Ownership

It appears from the facts presented by Petitioners that several transactions took place during the 2001 tax year at the behest of D as the sole voting shareholder of all the entities concerned. On Date, C was organized for the purpose of acquiring, owning, managing and disposing of the Business. The acquisition was completed in 2001. In 2001, ownership of A was restructured so that all of A's stock is now owned by B, a business trust. B and C are now both owned by D and the three irrevocable trusts.

A's tax year ended September 2001. Petitioners have requested a declaratory ruling declaring that A and the new entities, C and B, have unity of ownership, an element in a test for the existence of a unitary business.

The unitary method is a principle of taxation in which the several elements of a business are treated as one unit for taxation purposes in order to achieve fair taxation. Under the New Hampshire statutes there are two methods of establishing a unitary business. One method is through the existence of unity of ownership, operation, and use. The other method is through an interdependence in the functions of the related business organizations.

The Petitioners raise concerns over whether an individual, such as D, in combination with the trusts, may be considered a business organization for the purposes of a unitary business given that the term "business organization," as defined in RSA 77-A:1, I, does not include an individual who does not carry on a business activity. The statute, however, provides that a business organization is "any enterprise whether a corporation, partnership,. . . or other form of organization." RSA 77-A:1, I. Further, the state constitution requires that all business entities be treated uniformly and equally. Opinion of the Justices, 128 N.H. 1, 8 (1986). To interpret the definition of "business organization" to exclude certain business arrangements despite the fact that they are clearly organized for gain or profit and are carrying on business activity within the state would be inconsistent with the constitutional principles of uniformity and equality.

There must be some bond of ownership or control uniting a purported "unitary business." A.M. Castle & Co. v. Cal. Fran. Tax Bd., 43 CRptr. 340 (Cal. App., 1 st

Dist. 1995). As the only owner of B, C, and A with voting rights, D is the controlling member of an enterprise organized for gain or profit and carrying on business activity within the state. Moreover, it appears that D is not simply a passive investor in these organizations. D is intimately involved in their functioning and control. D's role is primary and active in all three entities regardless of whether his ownership and activity is labeled with one of the traditional forms of business or not. See Appeal of Mole-Richardson Co., Cal. Bd. of Equalization, No. 83-SBE-231, (Oct. 26, 1983)(although manufacturing group and farm group were found to be non-unitary because of lack of operational integration, common ownership did exist where sister corporations were owned by trusts and individuals of the same family).

The Department's rules define "unity of ownership" as meaning that "the activities outside the taxing jurisdiction, together with the in-state activities are owned either directly or indirectly by the same economic entity or group of economic entities." Rev 301.33. A is owned by B, which in turn is owned by D and the three irrevocable trusts, with D as the controlling shareholder. C is also owned by D and the three irrevocable trusts in the same proportion as B, again with D as the controlling shareholder. The reality of the situation is that D is the controlling owner operating a single economic unit. See In the Matter AMP Inc., Cal. Bd. of Equalization, No. 96-SBE-017, (Oct. 10, 1996)(because statute did not require that ownership be held by a single entity or individual, board looked to the business realities to determine if a group of owners acting in concert to operate two or more corporations are operating as a single economic entity). Based on the facts presented in the petition, B, A and C satisfy the "unity of ownership" prong of the three unities test because they are owned directly by the same economic entity or group of entities.

Ruling

Based on the facts as presented by the Petitioners and the statutory provisions and administrative rules discussed above, the Department makes the following rulings:

(1) The proposed transaction for the redemption of all or substantially all of the outstanding Class B non-voting shares and possibly some portion of the outstanding Class A voting shares of B owned by D in exchange for a note or a combination of a note and cash from B is a redemption of shares not taxable under RSA 77.

(2) The relationship between and among A, C, and B, in relation to D and the three irrevocable trusts, satisfies the unity of ownership prong of the three unities test for purposes of establishing the existence of a unitary business.

Stanley R. Arnold, Commissioner