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Internal Revenue Service

Department of the Treasury

Index Number: 2701.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:Br.7-PLR-106227-99
Date:
August 26, 1999

LEGEND:

Taxpayer:

SSN:

Corporation:

EIN:

LLC:

State:

Date 1:

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Dear :

We received your letter date , submitted on behalf of Taxpayer. In your letter, you request a ruling concerning application of § 2701 of the Internal Revenue Code to a proposed transaction.

FACTS

Taxpayer is a shareholder of Corporation. Corporation was incorporated under the laws of State on Date 1. Corporation's Articles of Incorporation have been amended several times. All of the amendments to Corporation's Articles of Incorporation were before October 8, 1990. Corporation's stock is not listed on any securities exchange, nor is it traded on the over-the-counter market.

Article Fifth of Corporation's Articles of Incorporation provides as follows:

The aggregate number of shares which Corporation shall have the authority to issue is as follows:

(1) p shares of Class A Common Stock;

(2) q shares of Class B Common Stock;

(3) r shares of o Percent Preferred Stock;

(4) s shares of Voting Preferred Stock; and

(5) t shares of Class C Preferred Stock.

All shares shall be without par value.

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The designations, preferences, privileges and voting powers of each class of Corporation stock, and the restrictions and qualifications thereof, are as follows:

The holders of the Class A and Class B Common Stock have full and equal rights, powers and privileges, except that the holders of the Class B Common Stock, except as otherwise provided by law, have no voting rights. The holders of Class A Common Stock are entitled to one vote for each share held. The Class A Common Stock and the Voting Preferred Stock shall vote together as a single class of stock.

Each holder of the Voting Preferred Stock is entitled to one vote for each share held. The Class A Common Stock and the Voting Preferred Stock shall vote together as a single class of stock.

Except as otherwise provided by law, the holders of the o Percent Preferred Stock have no voting rights. The holders of the o Percent Preferred Stock are entitled to receive when and as declared by the Board of Directors, non-cumulative cash dividends at the rate of u dollars per share in any calendar year before any dividends are declared on the shares of Voting Preferred Stock, Class C Preferred Stock or Class A and Class B Common Stock in any such calendar year. The dividend on the o Percent Preferred Stock in any calendar year may be less than u dollars per share. If, however, the dividend on the o Percent Preferred Stock in any calendar year is less than u dollars per share, no dividend may be declared on the shares of the other classes of Corporation stock in such calendar year.

Corporation may redeem the outstanding shares of the o Percent Preferred Stock, at any time, in whole or in part, on thirty days prior written notice at a redemption price of v dollars per share, plus all dividends declared, but unpaid. Further, upon any voluntary or involuntary liquidation, dissolution or winding up of Corporation, the holders of the o Percent Preferred Stock are entitled to receive out of the assets of Corporation, before any distribution is made to the holders of the shares of the other classes of Corporation stock, the sum of v dollars per share, plus all dividends declared, but unpaid. After such distribution is made to the holders of the o Percent Preferred Stock, the holders of the shares of the other classes of Corporation stock shall share in all the remaining assets of Corporation in accordance with their respective rights. Neither the consolidation nor merger of Corporation with or into any other corporation, nor any sale, lease or conveyance of all or part of the property or business of Corporation shall be deemed to be a liquidation, dissolution or winding up of Corporation.

Except as otherwise provided by law, the holders of the Class C Preferred Stock have no voting rights. After a u dollar per share dividend is paid upon or declared and set apart for the holders of the o Percent Preferred Stock, the holders of the Class C

Preferred Stock are entitled to receive when and as declared by the Board of Directors, non-cumulative cash dividends at the rate of x dollars per share in any calendar year before any dividends are declared on the shares of Voting Preferred Stock and Class A and Class B Common Stock in any such calendar year. The dividend on the Class C Preferred Stock in any calendar year may be less than x dollars per share. If, however, the dividend on the Class C Preferred Stock in any calendar year is less than x dollars per share, no dividend may be declared on the shares of Voting Preferred Stock and Class A and Class B Common Stock in such calendar year.

The Class C Preferred Stock is non-callable and non-putable. Further, upon any voluntary or involuntary liquidation, dissolution or winding up of Corporation, the holders of the Class C Preferred Stock are entitled to receive out of the assets of Corporation, before any distribution is made to the holders of the Voting Preferred Stock and the Class A and Class B Common Stock but not until all distributions are made to the holders of the o Percent Preferred Stock, the sum of z dollars per share, plus all dividends declared, but unpaid, and the holders of the Voting Preferred Stock and the Class A and Class B Common Stock shall be entitled to share in all the remaining assets of Corporation in accordance with their respective rights. Neither the consolidation nor merger of Corporation with or into any other corporation, nor any sale, lease or conveyance of all or part of the property or business of Corporation shall be deemed to be a liquidation, dissolution or winding up of Corporation.

After a u dollar per share dividend is paid upon or declared and set apart for the holders of the o Percent Preferred Stock and an x dollar per share dividend is paid upon or declared and set apart for the holders of the Class C Preferred Stock , the holders of the Voting Preferred Stock are entitled to receive when and as declared by the Board of Directors, non-cumulative cash dividends at the rate of w dollars per share in any calendar year before any dividends are declared on the shares of Class A and Class B Common Stock in any such calendar year. The dividend on the Voting Preferred Stock in any calendar year may be less than w dollar per share, but, if so, no dividend may be declared on the Class A and Class B Common Stock.

The Voting Preferred Stock is non-callable and non-putable. Further, upon any voluntary or involuntary liquidation, dissolution or winding up of Corporation, the holders of the Voting Preferred Stock are entitled to receive out of the assets of Corporation, before any distribution is made to the holders of the Class A and Class B Common Stock, the sum of y dollars per share, plus all dividends declared, but unpaid. Further, the holders of the Class A and Class B Common Stock are entitled to share in all the remaining assets of Corporation in accordance with their respective rights.

Neither the consolidation nor merger of Corporation with or into any other corporation, nor any sale, lease or conveyance of all or part of the property or business of Corporation shall be deemed to be a liquidation, dissolution or winding up of Corporation.

Corporation proposes to convert to a limited liability company. To accomplish the proposal, Taxpayer represents that a new State limited liability company, LLC, will be formed and that LLC will be authorized to issue membership units with rights, preferences and restrictions identical to the shares of Corporation Stock that are currently authorized, issued, and outstanding. LLC will elect to be treated as an association that is taxable as a corporation for federal income tax purposes. Corporation then will be merged into LLC. Taxpayer and the other shareholders of Corporation will exchange their shares in Corporation for an identical number of units in LLC. No capital contributions will be made to LLC before the merger. The rights, preferences and restrictions of the units received by each shareholder from LLC will be identical to the rights, preferences, and restrictions of shares each shareholder held in Corporation.

Taxpayer also represents that the merger of Corporation into LLC will be an "F" reorganization under § 368(a)(1)(F).

APPLICABLE LAW AND ANALYSIS

Section 2701 contains special valuation rules to determine the amount of the gift when an individual transfers an equity interest in a corporation or a partnership to a member of the individual's family. Section 2701(a)(1) provides that solely for purposes of determining if a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any right--

(A) that is described in § 2701(b)(1)(A) or § 2701(b)(1)(B), and

(B) that is with respect to any applicable retained interest that is held by the transferor or an applicable family member immediately after the transfer,

shall be determined under § 2701(a)(3). Section 2701(a)(1) does not apply to the transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established securities market.

Section 2701(a)(2) provides that § 2701(a)(1) does not apply to any right with respect to an applicable retained interest if --

(A) market quotations are readily available (as of the date of the transfer) for such interest on an established securities market,

(B) such interest is of the same class as the transferred interest, or

(C) such interest is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability).

Section 2701(a)(2)(C) does not apply to any interest in a partnership if the transferor or an applicable family member has the right to alter the liability of the transferee of the transferred property. Except as provided by the Secretary, any differences described in § 2701(a)(2)(C) that lapses by reason of any Federal or State law shall be treated as a nonlapsing difference for purposes of § 2701(a)(2)(C).

Section 2701(b)(1) defines an "applicable retained interest" as any interest in an entity for which there is--

(A) A distribution right, but only if, immediately before the transfer, the transferor and applicable family members hold (after application of § 2701(e)(3)) control of the entity, or

(B) A liquidation, put, call, or conversion right.

Section 2701(b)(2)(A) provides that, for purposes of § 2701(b)(1), in the case of a corporation, the term "control" means the holding of at least 50 percent (by vote or value) of the stock of the corporation.

Section 2701(b)(2)(C) provides that, for purposes of § 2701(b), the term "applicable family member" includes any lineal descendant of any parent of the transferor or the transferor's spouse.

Section 25.2701-2(b)(1) of the Gift Tax Regulations provides that an applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either an extraordinary payment right (as defined in § 25.2701-2(b)(2) or, in the case of a controlled entity as defined in § 25.2701-2(b)(5) a distribution right (as defined in § 25.2701-2(b)(3). An extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or

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nonexercise of which affects the value of the transferred interest. A distribution right is the right to receive distributions with respect to an equity interest, but does not include--

(1) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest,

(2) Any extraordinary payment right, or

(3) Certain other rights as described in § 25.2701-2(b)(4).

Section 2701(e)(5) provides that, except as provided in regulations, a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or a partnership is treated as a transfer of an interest in such entity to which § 2701 applies if the taxpayer or an applicable family member

(A) receives an applicable retained interest in such entity pursuant to such transaction, or

(B) under regulations, otherwise holds, immediately after such transaction, an applicable retained interest in such entity.

Section 2701(e)(5) does not apply to any transaction (other than a contribution to capital) if the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical.

Section 25.2701-1(b)(2)(B) provides that, except as provided in § 25.2701-1(b)(3), a transfer subject to the rules of § 2701 includes a redemption, recapitalization or other change in the capital structure of an entity (a "capital structure transaction"), if--

(1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

(2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinated interest") and receives property other than an applicable retained interest; or

(3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity

interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

Section 25.2701-1(b)(3) provides that, for purposes of § 2701, a transfer does not include the following transactions:

(i) A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction. For this purpose, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same;

(ii) A shift of rights occurring upon the execution of a qualified disclaimer described in § 2518; and

(iii) A shift of rights occurring upon the release, exercise, or lapse of a power of appointment other than a general power of appointment described in § 2514, except to the extent the release, exercise, or lapse would otherwise be a transfer under chapter 12.

Section 25.2701-1(c)(3) provides that § 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for nonlapsing differences in voting rights (or, for a partnership, nonlapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (e.g. section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purpose of § 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

In this case, the shareholders of Corporation, intend to exchange all of their stock in Corporation for stock in LLC in a transaction that Taxpayer intends to qualify as a tax-free reorganization under § 368(a)(1)(F). Taxpayer represents that LLC will be authorized to issue membership units with rights, preferences, and restrictions identical to the classes of Corporation stock that are currently authorized, issued, and outstanding. After Corporation is merged into LLC, Taxpayer and the other

shareholders of Corporation will exchange their shares in Corporation for an identical number of units in LLC with rights, preferences, and restrictions identical to the rights, preferences, and restrictions each shareholder held in Corporation before the transfer.

Generally, a reorganization or other change in the capital structure of a corporation is treated as a transfer of an interest in the entity for purposes of § 2701. Section 2701, however, does not apply to reorganizations or other capital changes if each family member holds substantially the same interest after the transaction as the individual held before the transaction. In addition, § 2701(a)(1) does not apply to any right with respect to an applicable retained interest if such interest is of the same class as the transferred interest. Accordingly, we conclude that the proposed exchange of shares in Corporation for membership units in LLC is not a transfer of an interest that is subject to § 2701.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, we express or imply no opinion about whether the transaction described is a tax-free reorganization under § 368(a)(1)(F).

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

(signed) Christine Ellison

Christine E. Ellison
Chief, Branch 7
Assistant Chief Counsel (Passthroughs and Special Industries)

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