Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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CC:PSI:B01 – PLR-150490-02
Date:
Nov 5 2003

Legend:

Company 1 =

Company 2 =

Company 3 =

State =

Y =

D1 =

D2 =

B =

C =

D =

E =

F =

g =

h =

i =

j =

m =

n =

p =

q =

r =

Dear :

This responds to a letter dated July 23, 2002, together with related documents, submitted on behalf of Company 1, Company 2, and their shareholders, requesting rulings under §§ 1361, 2701, 2703, and 2704 of the Internal Revenue Code ("Code").

FACTS

The information submitted discloses that, Company 1 and Company 2, both engaged in the retail sales of Y, are located in State.

Company 1 was incorporated under the laws of State on D1. D1 is prior to October 8, 1990. Company 1 has four shareholders, B, and B's children, C, D, and E. Company 1 is an S corporation. Company has a single class of common voting stock, all of the shares of which are held by the four shareholders. There are currently g shares of Company 1 authorized and m shares have been issued. B holds h percent of the shares of Company 1 and C, D, and E each holds i percent of the shares.

Company 2 was incorporated under the laws of State on D2. D2 is prior to October 8, 1990. Company 2 has one shareholder, F (B's wife). Company 2 is an S

corporation. Company 2 has a single class of common voting stock. There are currently i shares of Company 2 authorized and n shares have been issued.

It is represented that, previously, Company 1 and Company 2 were required to be separate under the Y regulations of State. Since separation is no longer required under State law, Company 1 and Company 2 propose to consolidate. After the consolidation of Company 1 and Company 2 into Company 3, Company 1 and Company 2 will terminate. In the consolidation, the shareholders of Company 1 and Company 2 will receive voting stock in Company 3 equivalent in value to stock given up.

It is represented that Company 3 will be incorporated under the laws of State. The purpose of Company 3's business will be the retail sales of Y. After the consolidation, the shareholders will exchange each share of common voting stock for 20 non-voting common shares of Company 3 and one share of voting common shares of Company 3. Company 3 will be authorized to issue p shares of stock. Of this amount, q shares will be voting shares and r shares will be non-voting shares. This transaction is intended to qualify as a § 368(a)(1)(E) recapitalization. It is represented that the voting and nonvoting shares received by each shareholder will have similar shareholder rights as those voting shares given up. Additionally, the only distinction between the two types of common stock received in the proposed recapitalization will be as to voting rights; all shares of stock will have identical rights to distribution and liquidation proceeds.

RULINGS REQUESTED

1. The voting and non-voting stock, which will be identical in all other respects, will not be treated as different classes of stock within the meaning of § 1361(b)(1)(D), and the existing S election will not terminate; and

2. Sections 2701, 2703, and 2704 do not apply to the proposed consolidation.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under §1362(a) is in effect for such year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(4) indicates that a corporation shall not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, subject to certain exceptions, a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

It is represented that § 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)(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(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 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 section 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 is 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).

In this case, the shareholders of Company 1 and Company 2, propose to consolidate and form Company 3 in a transaction intended to qualify under § 368(a)(1)(A). Then, the companies will engage in stock exchanges, intended to qualify as a recapitalization under § 368(a)(1)(E). After the exchanges, each shareholder of Company 1 and Company 2 will hold 20 shares of nonvoting common

stock and one share of voting common stock for each share of common stock previously owned.

Additionally, the rights with respect to the stock transferred by each shareholder will be identical to the rights with respect to the stock received by each shareholder. Therefore, in accordance with § 25.2701-1(b)(3) and § 25.2701-1(c)(3), § 2701 will not apply to the proposed recapitalization. Therefore, the proposed exchange of shares in Company 1 and Company 2 for one share of voting common stock and 20 shares of nonvoting common stock in Company 3 is not a transfer of an interest that is subject to § 2701.

Section 2703(a) provides that, for purposes of the estate, gift and generation-skipping transfer (GST) tax, the value of any property is to be determined without regard to: (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such agreement, or right), or (2) any restriction on the right to sell or use the property.

Section 2703(b) provides that § 2703(a) will not apply to any option, agreement, right or restriction if (1) It is a bona fide business arrangement; (2) It is not a devise to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

Under Public Law 101-508, § 11602(e)(a), § 2703 applies to agreements, options, rights, or restrictions entered into or granted after October 8, 1990, and agreements, options, rights, or restrictions in existence prior to October 8, 1990, that are "substantially modified" after that date. See also § 25.2703-2.

Section 25.2703-1(c)(1) provides that a right or restriction that is substantially modified is treated as a right or restriction created on the date of the modification. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial restriction. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification, unless the addition is mandatory under the terms of the right or restriction or the added family member is assigned to a generation (determined under the rules of § 2651) no lower than the lowest generation occupied by individuals already party to the right or restriction.

In this case, the shareholder agreements among the shareholders of Company 1 and Company 2 were in effect prior to October 8, 1990, and have not been amended after that date. The shareholders of Company 1 and Company 2 propose to merge into Company 3 in a recapitalization in which the shareholders of Company 1 and Company 2 will exchange their common stock in those companies for stock in Company 3. The merger agreement will prohibit Company 3 from transferring shares of Company 3 in a manner inconsistent with the current shareholder agreement. In addition, the merger agreement entered into with respect to Company 3 will be virtually identical to the shareholder agreements that bind the shareholders of Company 1 and Company 2. The recapitalization and execution of the merger agreement will not result in a more than a de minimis change to the quality, value, or timing of the rights of the parties to the current shareholder agreements. Accordingly, the proposed merger of Company 1 and Company 2, with Company 3 surviving, will not constitute a substantial modification of the shareholder agreement for purposes of § 25.2703-1(c).

Section 2704(a)(1) provides that for purposes of the estate, gift and GST tax if- (A) there is a lapse of any voting or liquidation right in a corporation or a partnership, and (B) the individual holding such right immediately before the lapse and members of such individual's family holds, both before and after the lapse, control of the entity, such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate of the decedent, whichever is applicable, in the amount determined under § 2704(a)(2).

Section 2704(b)(1) provides that if there is a transfer of an interest in a corporation or partnership to a member of the transferor's family and the transferor's family controls the entity immediately before the transfer, then any "applicable restriction" is disregarded in determining the value of the transferred interest. An "applicable restriction" is defined in § 2704(b)(2) as any restriction which effectively limits the ability of the corporation or partnership to liquidate.

Under Public Law 101-508, § 11602(e)(1)(iii), and § 25.2704-3, § 2704 applies to restrictions or rights (or limitations on rights) created after October 8, 1990.

In this case, the shareholder agreement of Company 1 and Company 2 were executed prior to October 8, 1990. The shareholders of Company 1 and Company 2 propose to merge those companies into Company 3. The proposed merger effectuates a continuation of the original shareholders' interests in the underlying entity. Any restrictions and rights (or limitations on rights) in the original shareholder agreement and corporate by-laws will be applied on the same basis and to the same extent, under the shareholder agreement and by-laws of Company 3. The transaction does not involve the creation of any new restrictions or rights (or limitations on rights) after October 8, 1990. Thus, § 2704(b) will not apply to any restrictions or rights (or limitations on rights) contained in the shareholder agreements of Company 1 and Company 2 or the merger agreement and shareholder agreement of Company 3.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that:

1. The voting and nonvoting common stock that will be issued in the proposed transactions will not be considered different classes of stock within the meaning of § 1361(b)(1)(D), terminating an otherwise valid existing S election.

2. Sections 2701, 2703, and 2704 will not apply to the proposed transactions.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether the proposed exchange of voting common stock for a combination of voting common stock and non-voting common stock constitutes a corporate recapitalization within the meaning of § 368(a)(1)(E) of the Code; and (2) whether Company 1, Company 2, or Company 3 are valid S corporations.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(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 mailed to your authorized representative.

Sincerely,

/s/ Dan Carmody

Dan Carmody
Branch 1
Senior Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes