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Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:9-PLR-112522-00
Date:
June 21, 2001

LEGEND:

Partnership

T

S1

S2

a

b

Dear

This is in response to your letter dated June 19, 2000, in which you request rulings under sections 707 and 2701 of the Internal Revenue Code with respect to the proposed family limited partnership.

You represent the following to be true:

The parties propose to create a family limited partnership ("Partnership"). The initial partners will be T and her two sons, S1 and S2. Upon execution of the proposed partnership agreement, the partners will transfer to the partnership cash and other property in exchange for their respective partnership interests.

Partnership will have three classes of partners: (1) Class A General Partner, (2) Class B General Partner, and (3) Limited Partner. In exchange for her initial contribution, T will receive a five percent interest in the partnership as a Class A General Partner, and a ninety-three percent interest in the partnership as a limited partner. S1 and S2 will each receive in exchange for their initial contribution a one percent interest in the partnership as

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the Class B General Partners.

The Class A General Partner shall have the right to receive and Partnership shall have the cumulative obligation to pay annual distributions equal to the first a dollars of the net profits of Partnership (the "Preferred Return"), plus five percent of the remaining net profits. The payment of the Preferred Return to the Class A General Partner shall have preference over distributions to other partners. In no year shall the Class A General Partner be entitled to receive less than c dollars ("Guaranteed Preferred Return") as the Preferred Return.

The Preferred Return payment, or the Guaranteed Preferred Return payment, if lower, is to be paid to the Class A General Partner annually, provided that Partnership may prepay the Preferred Return at any time during the year if determined to be more convenient for Partnership. If the Preferred Return is not timely made, the payment will accrue on behalf of the Class A General Partner at the prime interest rate, or the rate required by section 2701, whichever is higher, and will be paid at the earliest of three occurrences set forth in the partnership agreement.

After allocation to the Class A General Partner of the Preferred Return payment, the remaining amount of net profits and losses are to be allocated to the partners based on their proportionate partnership interests.

The Class A General Partner may withdraw from Partnership at any time, and upon 90 days notice, Partnership shall distribute to the Class A General Partner the "Liquidation Value" of the Class A General Partner interest, plus any share of the Class A General Partner's accrued but unpaid portion of the net profits and losses, as through the date of liquidating distribution. The Liquidation Value is equal to the amount contributed in exchange for the Class A General Partner interest.

Partnership may not be terminated prior to the expiration of the twenty-year term set by the agreement except upon (a) the unanimous vote of the partners, or (b) generally, the death, withdrawal, or adjudication of bankruptcy of the last then-serving General Partner.

Upon termination of Partnership, Partnership is required to first distribute to the Class A General Partner the Liquidation Value of her Class A General Partner interest, plus any accrued and unpaid Preferred Return (or Guaranteed Preferred Return amount, if less), then distribute the remaining assets to the partners in accordance with their respective partnership interests in Partnership.

Subsequent to formation and funding of Partnership, T anticipates selling and/or gifting some or all of her Limited Partner interest to S1 and S2 or to trusts for their benefit.

You have requested the following rulings:

(1) The transfer of property to the proposed Partnership will be a transaction subject

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to section 2701.

(2) T's retention of the Class A General Partner Interest is an applicable retained interest under section 2701 comprised of a qualified payment right equal to the Guaranteed Preferred Return and an extraordinary payment right equal to the Liquidation Value.

(3) The subtraction method will be used in determining the value of any gift from T to S1 and S2 (collectively, Sons) on the formation or of any gift or sales that T may make of the Limited Partner interests to S1, S2, or a trust for the benefit of any family member.

(4) Distributions to the Class A General Partner will not be treated as guaranteed payments under section 707(c) in years when net profits exceed the Guaranteed Preferred Return.

Rulings 1, 2, and 3:

Section 2701(a)(1) provides, in general, that, solely for purposes of determining whether 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 of the value of such transfer), the value of any right that is described in section 2701(b)(1)(A) or (B), and that is with respect to any applicable retained interest that is held by the transferor or an applicable family member immediately after the transfer, is determined under section 2701(a)(3). Section 25.2701-1(a)(1) of the Gift Tax Regulations.

Section 2701(a)(3)(A) provides that the value of any right described in section 2701(a)(1), other than a distribution right that consists of a right to receive a qualified payment, shall be treated as being zero.

Section 2701(a)(3)(B) provides that if: (i) any applicable retained interest confers a distribution right which consists of the right to a qualified payment, and (ii) there are one or more liquidation, put, call, or conversion rights with respect to such interest, then the value of all such rights shall be determined as if each liquidation, put, call, or conversion right were exercised in the manner resulting in the lowest value being determined for all such rights.

Section 2701(a)(3)(C) provides that in the case of an applicable retained interest that is described in section 2701(a)(3)(B)(i) but not section 2701(a)(3)(B)(ii), the value of the distribution right shall be determined without regard to section 2701.

Section 2701(b)(1) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is—

- (A) a distribution right, but only if, immediately before the transfer described in section 2701(a)(1), the transferor and applicable family members hold (after application of subsection (e)(3)) control of the entity, or

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

Section 2701(b)(2)(B)(ii) provides that, for purposes of section 2701(b)(1)(A), in the case of a partnership, the term "control" means, in the case of a limited partnership, the holding of any interest as a general partner.

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

Section 2701(c)(1)(A) provides that the term "distribution right" means: (i) a right to distributions from a corporation with respect to its stock, and (ii) a right to distributions from a partnership with respect to a partner's interest in the partnership.

Section 2701(c)(1)(B) provides that the term "distribution right" does not include: (i) a right to distributions with respect to any interest which is junior to the rights of the transferred interest, (ii) any liquidation, put, call, or conversion right, or (iii) any right to receive any guaranteed payment described in section 707(c) of a fixed amount.

Section 2701(c)(2)(A) provides that the term "liquidation, put, call, or conversion right" means any liquidation, put, call, or conversion right, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.

Section 2701(c)(3)(A) provides that the term "qualified payment" means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate.

Section 2701(e)(1) provides that the term "member of the family" means, with respect to any transferor: (A) the transferor's spouse, (B) a lineal descendant of the transferor or the transferor's spouse, and (C) the spouse of any such descendant. Section 25.2701-1(d)(1).

Section 2701(e)(2) provides that the term "applicable family member" means, with respect to any transferor: (A) the transferor's spouse, (B) an ancestor of the transferor or the transferor's spouse, and (C) the spouse of any such ancestor. Section 25.2701-1(d)(2).

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 partnership shall be treated as a transfer of an interest in such entity to which this section 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) shall not apply to any transaction (other than a

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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(a)(2) provides that if section 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation (described in section 25.2701-3).

Section 25.2701-1(b)(1) provides that section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code.

Section 25.2701-1(b)(2)(i)(A) provides that a transfer to which section 2701 applies includes a contribution to the capital of a new or existing entity.

Section 25.2701-2(a) provides that in determining the amount of a gift under section 25.2701-3, the value of any applicable retained interest held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by section 25.2701-2.

Section 25.2701-2(a)(1) provides that any extraordinary payment right is valued at zero. Section 25.2701-2(a)(2) provides that any distribution right in a controlled entity is valued at zero, unless it is a qualified payment right.

Section 25.2701-2(a)(3) provides a special rule for valuing a qualified payment right held in conjunction with an extraordinary payment right. If an applicable retained interest confers a qualified payment right and one or more extraordinary payment rights, the value of all these rights is determined by assuming that each extraordinary payment right is exercised in a manner that results in the lowest total value being determined for all the rights, using a consistent set of assumptions and giving due regard to the entity's net worth, prospective earning power, and other relevant factors. This is known as the "lower of" valuation rule.

Section 25.2701-2(a)(4) provides that any other right (including a qualified payment right not subject to section 25.2701-2(a)(3)) is valued as if any right valued at zero does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule but otherwise without regard to section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value.

Section 25.2701-2(b)(1) provides that the term "applicable retained interest" means any equity interest in a corporation or partnership with respect to which there is either: (i) an extraordinary payment right, or (ii) in the case of a controlled entity, a distribution right.

Section 25.2701-2(b)(2) provides that, except as provided in section 25.2701-2(b)(4), the term "extraordinary payment right" means any put, call, or conversion right, any

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right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.

Section 25.2701-2(b)(3) provides that the term “distribution right” means the right to receive distributions with respect to an equity interest. A distribution right does not include: (i) 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; (ii) any extraordinary payment right; or (iii) any right described in section 25.2701-2(b)(4).

Section 25.2701-2(b)(4) provides that mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

Section 25.2701-2(b)(4)(ii) provides that a liquidation participation right is a right to participate in a liquidating distribution. If the transferor, members of the transferor’s family, or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation: (A) did not exist, or (B) if the lower of rule applies, is exercised in a manner that is consistent with that rule.

Section 25.2701-2(b)(4)(iii) provides that the right to a guaranteed payment of a fixed amount under section 707(c) is the right to a guaranteed payment the amount of which is determined at a fixed rate. A payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount.

Section 25.2701-2(b)(5) provides that, for purposes of section 2701, a controlled entity is a corporation or partnership controlled, immediately before the transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor’s spouse. In the case of a limited partnership, control means the holding of any equity interest as a general partner. Section 25.2701-2(b)(5)(iii).

Section 25.2701-2(b)(6) provides that a qualified payment right is a right to receive qualified payments. A qualified payment is a distribution right that is –

- (A) A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;
- (B) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or
- (C) Any distribution right for which an election has been made pursuant to section 25.2701-2(c)(2).

Section 25.2701-3(a)(1) provides that the amount of the gift resulting from any transfer to which section 2701 applies is determined by a subtraction method of valuation. In the case of a contribution to the capital of a new or existing entity, special rules are

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provided to determine the amount of the gift under section 25.2701-3(b).

In the instant case, T proposes to contribute cash and other property to a newly-formed partnership. The transfer will constitute a contribution to the capital of Partnership. The interest T will receive as a Class A General Partner in the exchange will be an applicable retained interest, since it will be an equity interest in a partnership controlled by T and members of T's family (S1 and S2) with respect to which there is a distribution right as well as two extraordinary payment rights. T will hold a distribution right, *i.e.*, the right to receive distributions from the partnership with respect to the Class A General Partner interest. T will hold two extraordinary payment rights, *i.e.*, the ability to withdraw from Partnership upon 90 days notice and the ability to compel the liquidation of Partnership (following attribution of S1's and S2's voting rights). Since T will receive an applicable retained interest pursuant to the formation of Partnership, T's contribution to the capital of Partnership will be treated as a transfer of an interest to which section 2701 applies.

In determining the value of the applicable retained interest for purposes of section 2701, the Guaranteed Preferred Return is a distribution right that is a qualified payment right because it is a right to receive a distribution that is: 1) payable on a periodic basis (at least annually); 2) with respect to T's partnership interest; and 3) determined as a fixed amount to the extent of the Guaranteed Preferred Return.

Since the applicable retained interest confers a qualified payment right and one or more extraordinary payment rights, the "lower of" rule must be applied in determining the value of the applicable retained interest for purposes of section 2701. Under the "lower of" rule, the value of the applicable retained interest for purposes of section 2701 is the lowest value of the values determined for the qualified payment right, the ability to withdraw from Partnership upon 90 days notice, and the ability to compel liquidation.

Since section 2701 applies to the transfer, the amount of T's gift, if any, is determined using the subtraction method of valuation and following the special rules in the case of a contribution to the capital of a new or existing entity (further described in section 25.2701-3). See section 25.2701-5 for appropriate adjustments to mitigate double taxation for subsequent gifts.

We conclude as follows:

1. The transfer to the proposed family limited partnership will be subject to section 2701.
2. After the transfer, T, as holder of the Class A General Partner interest, will hold an applicable retained interest that includes a qualified payment right and two extraordinary payment rights.
3. The subtraction method will be used in determining the value of the gift from partner T to partners S1 and S2 on the formation or of any gift or sales that T may make of the Limited Partner interests to S1, S2, or a trust for the benefit of any family member.

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Ruling 4:

Section 707(c) provides that to the extent determined without regard to the income of the partnership, payments to a partner for services or use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

Section 1.707-1(c) of the Income Tax Regulations provides, in part, that guaranteed payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. Example 2 of section 1.707-1(c) provides as follows: Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than \$10,000. The income of the partnership is \$60,000, and C is entitled to \$18,000 (30 percent of \$60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of \$20,000 instead of \$60,000, \$6,000 (30 percent of \$20,000) would be partner C's distributive share, and the remaining \$4,000 payable to C would be a guaranteed payment.

Accordingly, we conclude the distributions to the Class A General Partner will not be treated as guaranteed payments under section 707(c) in years when net profits exceed the Guaranteed Preferred Return.

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. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. 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.

Sincerely,
Lorraine E. Gardner
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Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

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