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Legend

Taxpayer	=
Spouse	=
Corporation	=
Date 1	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=
Limited Partnership	=

Accounting Firm	=
Attorney 1	=
Attorney 2	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Date 2	=

Dear :

This is in response to correspondence requesting a ruling under § 2701 of the Internal Revenue Code.

Facts

Taxpayer is the president and a shareholder in Corporation, a privately held company. Taxpayer's parents founded Corporation. Taxpayer and his brother each received gifts of stock from their parents between Year 1 and Year 2. In Year 3 (prior to 1990), Taxpayer's parents exchanged their remaining shares of common stock for preferred stock. This left Taxpayer and his brother with equal ownership of the common stock of Corporation. Taxpayer's father died in Year 4, and his mother died in Year 5. Taxpayer and his brother each inherited 50 percent of their parent's preferred stock.

On Date 1, Taxpayer and his brother each exchanged X shares of common voting stock (representing Z percent of their respective shares of common voting stock) for Y non-cumulative preferred shares of stock. The purpose of the transaction was to provide Taxpayer and his brother with an additional preferential right to receive Corporation's earnings before the holders of common shares could receive dividend distributions.

After the transaction, Taxpayer and his brother each continued to control 50 percent of Corporation's common voting stock. At the time of the exchange, Taxpayer's son held common non-voting stock individually and all of Taxpayer's children held common non-voting stock by attribution through their ownership interests in Limited Partnership.

Accounting Firm provided no advice to Taxpayer, Spouse, or Corporation with regards to the transaction. Taxpayer and Spouse did not consult with legal counsel prior to undertaking the transaction. Taxpayer had consulted with Attorney 1 about exchanges on other occasions but did not consult Attorney 1 regarding the Date 1 transaction.

On Date 2, Taxpayer and Spouse retained Accounting Firm to prepare their respective Forms 709 United States Gift (and Generation-Skipping Transfer) Tax Returns for Year 6. Taxpayer and Spouse elected to gift-split their Year 6 gifts under § 2513. At the time the returns were prepared, Taxpayer and Spouse failed to inform Accounting Firm about the transaction, so they were not aware that Taxpayer and his brother had exchanged voting stock for non-cumulative preferred stock. As a result, the transaction was not reported on Taxpayer's and Spouse's Year 6 return and no elections were made pursuant to § 25.2701-2(c)(2) of the Gift Tax Regulations to treat the distribution right in the preferred stock as a qualified distribution right. The Year 6 returns were timely filed.

In Year 7, Accounting Firm was engaged to assist Taxpayer and Spouse with additional estate planning. In connection with this project, Accounting Firm raised the issue of whether Taxpayer's exchange of common voting stock for non-cumulative preferred stock was a transaction subject to § 2701. After discussion with accountants and their new attorney (Attorney 2), it was determined that the transaction was subject to § 2701 and should have been reported on the Year 6 gift tax returns.

Taxpayer and Spouse intend to file amended Year 6 Forms 709 to report the exchange of the common voting stock for the shares of non-cumulative preferred stock. In addition, on the amended returns, Taxpayer and Spouse intend to elect, under § 25.2701-2(c)(2), to treat the distribution right in the preferred stock as a qualified payment right. Taxpayers and Spouse will each attach a statement to the amended returns signifying their intent to elect under § 25.2701-2(c)(2).

You have requested a ruling that the elections attached to the amended Forms 709 United States Gift (and Generation-Skipping Transfer) Tax Return satisfy the requirements of § 25.2701-2(c)(2) and, as such, will be a valid election under § 2701(c)(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 § 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, shall be determined under § 2701(a)(3).

Section 2701(a)(3)(A) provides that the value of any right described in § 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(b)(1)(A) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is a distribution right, but only if, immediately before the transfer described in § 2701(a)(1), the transferor and applicable family members hold (after application of subsection (e)(3)) control of the entity.

Section 2701(b)(2)(A) provides that 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(c)(1)(A)(i) provides that the term "distribution right" means a right to distributions from a corporation with respect to its stock.

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

Section 25.2701-1(b)(1) provides that § 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 25.2701-2(a) provides that in determining the amount of a gift under § 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 § 25.2701-2.

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 § 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 § 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 § 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)(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 § 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 § 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

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 § 25.2701-2(c)(2).

Section 2701(c)(3)(A) provides that except as otherwise provided in § 2701(c)(3), 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(c)(3)(C)(ii) provides that a transferor or applicable family member holding any distribution right which (without regard to this subparagraph) is not a qualified payment may elect to treat such right as a qualified payment, to be paid in the amounts and at the times specified in such election. The preceding sentence shall apply only to the extent that the amounts and times so specified are not inconsistent with the underlying legal instrument giving rise to such right.

Section 2701(c)(3)(C)(iii) provides that any election under this subparagraph with respect to an interest shall, once made, be irrevocable.

Section 25.2701-2(c)(2) provides that any individual may elect to treat a distribution right held by that individual in a controlled entity as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made. An election under § 25.2701-1(c)(2) will not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to § 2701). The election is effective only to the extent: (i) specified in the election, and (ii) that the payments elected are permissible under the legal instrument giving rise to the right and are consistent with the legal right of the entity to make the payment.

Section 25.2701-2(c)(5) provides that the election is made by attaching a statement to the Form 709, Federal Gift Tax Return, filed by the transferor on which the transfer is reported. An election filed after the time of the filing of the Form 709 reporting the transfer is not a valid election. This regulation provides the requirements for the statement to be attached to the return and further provides that if payments are not made as provided in the election, the individual's subsequent taxable gifts or taxable estate will, upon the occurrence of a taxable event (as defined in § 25.2701-4(b)), be increased by an amount determined under § 25.2701-4(c).

In § 25.2701-2(d), Example 5, L holds 10-percent non-cumulative preferred stock and common stock in a corporation that is a controlled entity. L transfers the common stock to L's child. L holds no extraordinary payment rights with respect to the preferred stock. L elects under § 25.2702-2(c)(2) to treat the non-cumulative dividend right as a qualified payment right consisting of the right to receive a cumulative annual dividend of 5 percent. Under § 25.2701-2(c)(2), the value of the distribution right pursuant to the election is the lesser of: (A) the fair market value of the right to receive a cumulative 5-percent dividend from the corporation, giving due regard to the corporation's net worth, prospective earning power, and dividend-paying capacity; or (B) the value of the distribution right determined without regard to § 2701 and without regard to the terms of the qualified payment election.

Section 2701 provides rules for transfers of interests in corporations to family members. At the time of the Date 1 exchange, Taxpayer's son and other children held interests in Corporation. Taxpayer and his brother each exchanged X shares of common voting stock for Y shares of non-cumulative preferred stock. After this transaction, each of them remained in control of 50 percent of Corporation's common voting shares of stock. Corporation is a controlled entity (within the meaning of § 25.2701-2(b)(5)), and therefore, Taxpayer's dividend right in the preferred stock is a retained distribution right that is subject to § 2701. Moreover, because the preferred stock is non-cumulative, the distribution right retained by Taxpayer is not a qualified

payment right. Thus, the value of the preferred stock held by Taxpayer is deemed to be zero under § 25.2701-2(a). See § 25.2701-2(d), Example 2.

Section 2701(c)(3)(C)(ii), however, provides for an election to have a distribution right treated as a qualified payment right. An election under §25.2701-2(c)(2) is made on the gift tax return reporting the transfer. The regulations specify that the election must be made by attaching a statement to the Form 709 filed by the transferor on which the transfer is reported. In this case, neither Taxpayer nor Spouse reported the transfer on the gift tax returns filed in Year 6. They now propose to file amended Forms 709, report the transfer, and make the election under § 25.2701-2(c)(2). Under these circumstances, the election under § 25.2701-2 will be treated as a valid election to treat the distribution right in the preferred stock as a qualified payment right under § 2701(c)(3).

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 requesting it. Section 6110(k)(3) 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 your authorized representative.

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,

James F. Hogan
Senior Technician Reviewer
Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes

cc: