

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200934013**
Release Date: 8/21/2009

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 311.00-00, 311.02-00,
721.00-00

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:CORP:06
PLR-149559-08

Date:
May 20, 2009

Legend:

CORP =

LLC =

Shareholder A =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

State X =

\$n1 =

n2 =

n3 =

n4 =

\$n5 =

p% =

q% =

r% =

Dear :

This letter responds to your November 19, 2008 request for certain rulings regarding the federal income and gift tax consequences of a proposed transaction. The information submitted in that request and later correspondence is summarized below.

SUMMARY OF FACTS

CORP was incorporated in Year 1 as a State X subchapter C corporation and elected subchapter S corporation status in Year 2. CORP is a calendar year taxpayer on the accrual method of accounting.

Prior to Date 1, CORP owned 100% of the membership interests in LLC, which was formed in Year 3 and disregarded as an entity separate from CORP for federal tax purposes. LLC's operations consist solely of investing in a diversified portfolio of passive investment assets, including hedge funds, mutual funds, and private equity funds. LLC has no outstanding liabilities.

Shareholder A and CORP reached an agreement pursuant to which Shareholder A was admitted as a new member of LLC on Date 1. Specifically, Shareholder A contributed \$n1 in cash to LLC in exchange for a newly issued, non-voting, preferred interest in LLC. The terms and pricing of the preferred interest were based on an independent appraiser's determination of market rate terms for similar equity investments.

In general, in accordance with Article VIII of the LLC Agreement, and subject to certain adjustments for operating and capital losses, Operating and Capital profits are allocated to the preferred interest up to an amount equal to the "Priority Allocation Amount." The term "Priority Allocation Amount" is defined in Article I as follows:

“Priority Allocation Amount” shall mean, with respect to the Preferred Interest, an amount equal to \$n1 multiplied by the Preferred Interest Return Rate; it being agreed that the Priority Allocation Amount shall accrue on the Preferred Interest from the date of the original issuance of the Preferred Interest on a daily basis, whether or not declared, and shall be compounded annually with respect to any unpaid Priority Allocation Amount as of the end of each fiscal year of Company.

Under Article I of the LLC Agreement the Preferred Interest Return Rate is defined as follows:

“Preferred Interest Return Rate” shall mean (i) through Date 2, p% per annum, and (ii) thereafter, the annual interest rate determined for each subsequent three-year period by an independent appraiser mutually agreeable to the Preferred Member and the Board.

CORP has n2 issued and outstanding shares of common voting and n3 shares of common non-voting stock issued and outstanding. Other than voting rights, each share of CORP common stock has rights equal to each other share of common stock with respect to dividends and distributions upon liquidation. CORP’s common stock is held by n4 related-party stockholders, which are comprised of Shareholder A, Shareholder A’s adult children and trusts established for the benefit of Shareholder A’s children and grandchildren.

For what have been represented to be valid business purposes the following steps have been proposed (the “Proposed Transaction”): (i) CORP will distribute q%, and possibly up to r%, of its membership interests in LLC pro-rata to its stockholders (the “Distributed LLC Interests”) and (ii) the operating agreement of LLC will be amended to provide CORP with a share of LLC’s profits disproportionate to capital in exchange for CORP providing future management services to LLC with respect to LLC’s ongoing activities.

REPRESENTATIONS

CORP has made the following representations with respect to this ruling request:

(a) The principal purpose of the Shareholder A contribution to LLC in exchange for a preferred membership interest was to allow Shareholder A to invest his excess cash directly in a diversified portfolio of investment assets managed by a team of experienced professionals, in a manner that allows Shareholder A to enjoy a high rate of preferred return and a priority on distributions. The principal purposes of the Proposed Transaction are to: (1) increase flexibility with respect to the allocation of profits, losses, and cash distributions associated with the LLC asset pool through issuance of various classes of interests in LLC, (2) provide increased liability protection

to the LLC asset pool from the ongoing business operations of CORP, (3) facilitate estate planning and charitable objectives of CORP shareholders with respect to their investment in LLC, and (4) facilitate continued co-investment amongst family members outside of CORP.

(b) Shareholder A cannot independently cause CORP to distribute its interest in LLC. Additionally, Shareholder A's contribution to LLC was not dependent upon the consummation of the Proposed Transaction and the CORP stockholders had not ratified the Proposed Transaction as of the date of the ruling request.

(c) Following the Proposed Transaction, it is intended that LLC will continue to carry on the operations that were carried on by LLC before the Proposed Transaction.

(d) At the time of the Proposed Transaction, there will be no amounts payable or receivable between LLC and CORP or LLC and Shareholder A.

(e) For purposes of measuring the § 311(b) gain to CORP on the Proposed Transaction, if any, the Distributed LLC interests will be valued as a percentage of the value of the assets held by LLC. Cf. Pope & Talbot, Inc. v. Commissioner, 104 T.C. 574 (1995), aff'd, 162 F.3d 1236 (9th Cir. 1999).

(f) To the best of CORP's knowledge and belief, there is no plan or intention for any transferor to transfer assets to LLC other than cash and/or a diversified portfolio of stocks and securities. For this representation, a portfolio of stocks and securities is diversified under § 1.351-1(c)(6)(i) if it satisfies the 25 and 50 percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F)(ii), except that in applying § 368(a)(2)(F)(iv), government securities are included in determining total assets unless government securities are acquired to satisfy the requirements of § 368(a)(2)(F)(ii).

(g) The assets of LLC immediately prior to the admission of Shareholder A consisted of a diversified portfolio of stocks and securities as defined under § 1.351-1(c)(6)(i).

(h) There is no intention following the Proposed Transaction to dispose of any material assets of LLC (other than dispositions in the ordinary course of business).

(i) To the best of CORP's knowledge and belief, the CORP stockholders have no plan or intention to dispose of any portion of the distributed LLC interests except for the potential transfer to irrevocable trusts which will be taxed as grantor trusts to the respective grantor.

(j) LLC has not, and will not, elect to be classified as an association under Treas. Reg. § 301.7701-3.

(k) No property, other than cash, has ever been contributed by CORP to LLC, and LLC has never made a distribution of property to CORP.

LAW

Section 2701 provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest in a corporation or partnership to a member of the individual's family. In order for § 2701 to apply, the transferor or an applicable family member must, immediately after the transfer, hold an applicable retained interest in the entity. Section 25.2701-2(b)(1) defines an applicable retained interest as any equity interest in a corporation or partnership with respect to which there is either an "extraordinary payment right" or, in the case of a controlled entity, a "distribution right."

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. See § 25.2701-3(a). Under this method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of family-held interests in the corporation or partnership. Section 25.2701-2(a)(1) and (2) provide generally, that in determining the value of any applicable retained interest held by the transferor or an applicable family member, any put, call, or conversion right, any right to compel liquidation, or any similar right is valued at zero, and any distribution right in a controlled entity (e.g., a right to receive dividends) is valued at zero unless the right is a "qualified payment right" (as defined in § 25.2701-2(b)(6)). Any other right (including a qualified payment right) is valued as if any right valued at zero did not exist but otherwise without regard to § 2701.

Section 25.2701-1(b)(2) provides that a transfer includes a contribution to the capital of a new or existing entity.

Section 25.2701-1(b)(3) provides that a distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include any right to receive distributions with respect to an interest that is of the same class or a class that is subordinate to the transferred interest, any extraordinary payment right, mandatory payment rights, rights to guaranteed payments of a fixed amount under § 707(c), or non-lapsing conversion rights.

Section 25.2701-2(b)(5) provides that, for purposes of § 2701, a controlled entity is a corporation or partnership controlled, immediately before the transfer, by the transferor, applicable family members, or lineal descendants of the parents of the transferor or the transferor's spouse. In the case of a partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership.

Section 25.2701-2(b)(6) provides, in part, that a qualified payment right is a right to qualified payments. A qualified payment is a distribution that is 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, or 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. A qualified payment right includes any distribution right for which an election has been made pursuant to § 25.2701-2(c)(2).

Section 25.2701-2(c)(2) provides that a transferor holding a distribution right in a controlled entity that is not qualified payment right may elect to treat the distribution right as a qualified payment right, to be paid in the amounts and at the times specified in the election. 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. See section 25.2701-2(d)(Example 5). The election is effective only with respect to the payments specified in the election. Further, the payments specified in the election must be permissible under the instrument giving rise to the right, and the payment must be consistent with the legal right of the entity to make the payment.

If the transferor makes the election, then in determining the value of the transferor's gift, the distribution rights with respect to the applicable retained interest are not valued at zero. However, because the distribution right is treated as qualified payment right, the right is subject to the recapture rules applicable to all qualified payment rights.

Section 25.2701-4(a) provides that, in general, if a taxable event occurs with respect to any applicable retained interest conferring a distribution right that was previously valued as a qualified payment right, the taxable estate or taxable gifts of the individual holding the interest are increased by the amount determined under § 25.2701-4(c).

Section 25.2701-4(b)(1) defines a taxable event, generally, as the transfer of a qualified payment interest, either during life or at death. Further, any termination of an individual's rights with respect to a qualified payment interest is a taxable event.

Section 25.2701-4(c)(1) provides that the increase to an individual's taxable estate or taxable gifts is the excess, if any, of the sum of the amount of qualified payments payable during the period (plus the earnings on those payments, determined hypothetically based on a specified discount rate, as if each payment were paid on its due date), over the amount of the qualified payments actually paid during the same period plus the hypothetical earnings on those payments, determined as if each payment were reinvested as of the date actually paid at a yield equal to the appropriate discount rate.

In the present case Shareholder A transferred \$n1 in cash to LLC, a controlled entity, in exchange for a nonvoting "Preferred Interest." The transfer constitutes a contribution to the capital of LLC that is subject to the rules of § 2701 pursuant to § 25.2701-1(b)(3). The Preferred Interest that Shareholder A received in exchange for the transfer is an

applicable retained interest, since it is an equity interest in a controlled entity with respect to which there is a distribution right. Thus, the transaction is subject to § 2701.

In order for the dividend attendant upon the Preferred Interest to constitute a qualified payment right, the dividend must be determined at a fixed rate or as a fixed amount. In this case, the dividend does not meet this standard. Rather, the dividend will be \$n5 per year ($p\% \times \$n2$) through Year 4. Thereafter, the dividend will be redetermined for each subsequent three-year period based on an unspecified rate to be determined in the future. Thus, the dividend is payable neither at a fixed rate nor in a fixed amount. This is not a qualified payment right within the meaning of § 25.2701-2(b)(6).

RULINGS

Based solely on the information submitted and on the representations set forth above, we rule as follows:

(1) Shareholder A proposes to elect to treat the distribution right as a qualified payment right consisting of the right to receive \$n5 annually, to be paid at the times specified in the election. Assuming that the election is timely made, Shareholder A will be treated as holding a qualified payment right with respect to the Preferred Interest, within the meaning of § 25.2701-2(b)(6).

(2) The admission of Shareholder A to LLC caused LLC to convert to a partnership for U.S. federal income tax purposes. Pursuant to Rev. Rul. 99-5, CORP, as the sole owner of LLC prior to the admission of Shareholder A, is deemed to contribute the existing assets of LLC to the newly-formed LLC partnership in exchange for a membership interest in LLC. This deemed transaction is treated as a contribution of property to LLC by CORP within the meaning of § 721(a). Additionally, because the assets of LLC are represented to be a diversified portfolio of assets within the meaning of § 1.351-1(c)(6)(i), CORP's contribution of these assets, when combined with Shareholder A's contribution of cash, does not cause LLC to be treated as an investment company within the meaning of § 351(e) if LLC were incorporated. Therefore, § 721(b) does not apply to Shareholder A's contribution of cash and to CORP's deemed contribution of property to LLC.

(3) CORP's adjusted basis in the Distributed LLC Interests is equal to the product of (A) the amount of CORP's adjusted tax basis in its entire membership interest in LLC and (B) a fraction, the numerator of which is the fair market value of the Distributed LLC Interests on the date of the distribution, and the denominator of which is the fair market value of CORP's entire membership interest in LLC as of that date.

(4) CORP will recognize gain, if any, on the pro-rata distribution of the Distributed LLC Interests to its stockholders to the extent the fair market value of the Distributed LLC

Interests exceeds their adjusted tax basis in the hands of CORP on the date of the distribution. (§ 311(b)).

CAVEAT

No opinion is expressed about the tax treatment of the Proposed Transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the Proposed Transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding whether CORP is eligible to be an S corporation.

PROCEDURAL STATEMENTS

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.

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.

A copy of this letter must be attached to the federal income tax return of each taxpayer involved in the taxable year in which the transaction is consummated.

Pursuant to a power of attorney on file in this office, we have sent the original of this letter to the taxpayer's representative and a copy of this letter to the taxpayer.

Sincerely,

Alfred C. Bishop, Jr.
Branch Chief, Branch 6
(Corporate)