

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: June 17, 2014

to: Associate Area Counsel (Washington, D.C., Group 2)
(Small Business/Self-Employed)

from: Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

subject: Transfer by Recapitalization

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Donor =
Child A =
Child B =
Company =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
X =
Y =
Z =

ISSUE

Whether the recapitalization of Company was a transfer from Donor to Child A and Child B for purposes of § 2701(e)(5).

CONCLUSION

Yes, the recapitalization of Company was a transfer from Donor to Child A and Child B for purposes of § 2701(e)(5). The amount of the transfer is determined pursuant to § 25.2701-3(b).

FACTS

On Date 2, Donor and her sons, Child A and Child B, formed Company, a limited liability company, effective as of Date 1. Company has a 20-year term and, if not sooner terminated, is to terminate on Date 4. Donor's capital contribution consisted of real property. Donor, who was the sole member to make a capital contribution, thereafter made gifts of membership interests to her sons and their children.

Under Company's operating agreement, each member's capital account is credited with the amount of the member's capital contribution. Profits and losses are then allocated to a member's capital account pro rata based on the member's ownership interest. A member's ownership interest is the proportion that a member's capital account bears to the aggregate positive capital accounts of all members. Distributions are made based on a member's ownership interest. No member has priority over any other member as to participation in profits, losses and distributions or the return of capital contributions. No member has the right to withdraw a capital contribution.

In the event that an asset is distributed in kind, the asset is deemed to have been sold as of the distribution date, and each member's capital account adjusted to reflect the member's share of the deemed gain or loss.

In the event of Company's dissolution, its assets will be sold and each member's capital account adjusted to reflect the member's share of gain or loss. In the event that an asset is distributed in kind, the asset is deemed to have been sold as of the dissolution date, and each member's capital account adjusted to reflect the member's share of the deemed gain or loss. Upon completion of dissolution, the balance of each member's capital account is then distributed to the member.

On Date 3, at a time when Donor held an X percent ownership interest, Child A and Child B each held a Y percent ownership interest and Donor's grandchildren collectively held the remaining Z percent ownership interest, Company was recapitalized. In exchange for the agreement of Child A and Child B to manage Company, the operating agreement was amended to provide that henceforth all profit and loss, including all gain or loss attributable to Company's assets, would be allocated equally to Child A and Child B. After the recapitalization, Donor's and the grandchildren's sole equity interest in Company was the right to distributions based on their capital account balances as they existed immediately prior to the recapitalization.

The gift tax liability of the grandchildren is not at issue herein, and will not be further discussed.

LAW

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift by any individual. Section 2511 provides that the tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(a) of the Gift Tax Regulations provides that the gift tax applies to a transfer by way of gift whether direct or indirect and whether the property is real or personal, tangible or intangible. Section 25.2511-1(c)(1) provides that the gift tax also applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred on another, regardless of the means or device employed constitutes a gift subject to gift tax.

The committee reports which accompanied the enactment of the gift tax provide as follows:

The terms “property,” “transfer,” “gift,” and “indirectly” are used in the broadest and most comprehensive sense; the term “property” reaching every species of right or interest protected by law and having an exchangeable value.

The words “transfer * * * by gift” and “whether * * * direct or indirect” are designed to cover and comprehend all transactions (subject to certain express conditions and limitations) whereby, and to the extent * * * that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment. For example, (1) a transfer of property by a corporation without a consideration, or one less than adequate and fully in money or money’s worth, to B would constitute a gift from the stockholders of the corporation to B; (2) a transfer by A to a corporation owned by his children would constitute a gift to the children * * *

H. R. Rep. No. 72-708 (1932), 1939-1 C.B. (Part 2) 457, 476-77; S. Rep. No. 72-665 (1932), 1939-1 C.B. (Part 2) 496, 524. Thus, the capitalization of an entity may constitute a gift. See, e.g., Kincaid v. United States, 682 F.2d 1220 (5th Cir.1982); Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121; Estate of Higgins v. Commissioner, T.C. Memo. 1991-47. Similarly, the recapitalization of an entity may constitute a gift. Estate of Bosca v. Commissioner, T.C. Memo. 1998-251.

Section 25.2511-1(g)(1) provides that donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.

Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon the ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

Section 25.2511-2(b) provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.

Section 2701 provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest in a family controlled corporation or partnership to a member of the individual's family. Section 25.2701-1(b) provides that § 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift. For example, § 2701 applies to a transfer that would not otherwise be a gift because it was a transfer for full and adequate consideration.

Section 2701(e)(5) provides, in part, 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 shall be treated as a transfer of an interest in such entity to which § 2701 applies if the taxpayer or an applicable family member receives an applicable retained interest in such entity pursuant to such transaction, or under regulations, otherwise holds, immediately after such transaction, an applicable retained interest in such entity.

Section 25.2701-1(b)(2)(B)(2) provides, in part, that for purposes of § 2701, a transfer includes a redemption, recapitalization, or other change in the capital structure of an entity, if 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 "subordinate interest") and receives property other than an applicable retained interest.

Section 25.2701-3(a)(2)(ii) defines a senior equity interest as an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

Section 25.2701-3(a)(2)(iii) defines a subordinate equity interest as an interest in the entity as to which an applicable retained interest is a senior equity interest.

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

Section 25.2701-2(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, liquidation participation rights, rights to guaranteed payments of a fixed amount under § 707(c), or non-lapsing conversion rights.

Section 25.2701-1(d)(1) defines a member of the family, with respect to any transferor, as the transferor's spouse; any lineal descendant of the transferor or the transferor's spouse; and the spouse of any such lineal descendant.

Section 25.2701-1(d)(2) defines an applicable family member, with respect to any transferor, as the transferor's spouse; any ancestor of the transferor or the transferor's spouse; and the spouse of any such ancestor.

Section 25.2701-2(b)(5)(i) and (iii) provides, in part, that for purposes of § 2701, a controlled entity is a corporation or partnership controlled, immediately before a 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 any partnership, control means the holding of at least 50 percent of either the capital or the profits interest.

TRANSFER ANALYSIS

For purposes of § 2701, a transfer includes a recapitalization or other change in the capital structure of an entity if the transferor holding an applicable retained interest before the capital structure transaction surrenders a subordinate interest and receives property other than an applicable retained interest. Section 25.2701-1(b)(2)(B)(2). An applicable retained interest is an interest in a family-controlled entity with respect to which there is a distribution right. Section 25.2701-2(b)(1)(ii). A subordinate interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). A senior interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The term "property" includes every species of right or interest protected by law and having an exchangeable value.

Here, at all relevant times, Donor and her family controlled Company. On Date 3, Company was recapitalized and Donor surrendered her right to participate in future profit and loss, including future gain or loss attributable to Company's assets. Both before and after the recapitalization, Donor held an applicable retained interest, an equity interest in Company coupled with a distribution right. Donor's interest, which carried a right to distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain. Donor received property in the form of the agreement of Child A and Child B to manage Company. Accordingly, the recapitalization constitutes a transfer by Donor for purposes of § 2701.

VALUATION METHODOLOGY

Section 25.2701-2(a)(2) provides, in part, that any distribution right in a controlled entity is valued at zero, unless it is a qualified payment right. In pertinent part, § 25.2701-2(b)(6)(i)(B) defines a qualified payment right as the right to receive cumulative distributions 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.

Section 25.2701-2(b)(4)(ii)(A) provides, in part, that if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation, a liquidation participation right is valued as if the ability to compel liquidation did not exist.

Section 25.2701-3(a)(1) provides generally that the amount of the gift resulting from any transfer to which § 2701 applies is determined by a subtraction method of valuation. Under this method, the amount of the transfer is determined by subtracting the values of all family-held senior equity interests from the fair market value of all family-held interests in the entity determined immediately before the transfer. The values of the senior equity interests held by the transferor and applicable family members generally are determined under § 2701. Other family-held senior equity interests are valued at their fair market value. The balance is then allocated among the transferred interests and other family-held subordinate equity interests. Finally, certain discounts and other reductions are factored in.

Section 25.2701-3(a)(2)(i) defines family-held as held directly or indirectly by an individual described in § 25.2701-2(b)(5)(i), *i.e.*, the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse.

Section 25.2701-3(b) provides the following methodology to determine the amount of the gift. Section 25.2701-3(b)(1)(i) provides, in part, that Step 1 is to determine the fair market value of all family-held equity interests in the entity immediately after the transfer. The fair market value is determined by assuming that the interests are held by one individual, using a consistent set of assumptions.

Section 25.2701-3(b)(2)(i) provides, in part, that Step 2 is to subtract from the amount determined in Step 1 the following amounts. Section 25.2701-3(b)(2)(i)(A) provides for the subtraction of an amount equal to the sum of the fair market value of all family-held senior equity interests (other than applicable retained interests held by the transferor or applicable family members) and the fair market value of any family-held equity interests of the same class or a subordinate class to the transferred interests held by persons other than the transferor, members of the transferor's family, and applicable family members of the transferor. The fair market value of an interest is its pro rata share of the fair market value of all family-held senior equity interests of the same class (determined, immediately after the transfer, as if all family-held senior equity interests were held by one individual). Section 25.2701-3(b)(2)(i)(B) provides, in part, for the subtraction of the value of all applicable retained interests held by the transferor or

applicable family members (other than an interest received as consideration for the transfer) determined under § 25.2701-2.

Section 25.2701-3(b)(3) provides, in part, that Step 3 is to allocate the remaining value among the transferred interests and other subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family.

Section 25.2701-3(b)(4) provides, in pertinent part, that Step 4 is to determine the amount of the gift by reducing the amount allocated to the transferred interests in Step 3 by the following amounts. Section 25.2701-3(b)(4)(ii) provides that if the value of the transferred interest (determined without regard to § 2701) would be determined after application of a minority or similar discount with respect to the transferred interest, the amount of the gift determined under § 2701 is reduced by the excess, if any, of a pro rata portion of the fair market value of the family-held interests of the same class (determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to § 2701), over the value of the transferred interest (without regard to § 2701). Section 25.2701-3(b)(4)(iv) provides, in pertinent part, that the amount of the transfer (determined under § 2701) is reduced by the amount of consideration in money or money's worth received by the transferor, but not in excess of the amount of the gift (determined without regard to § 2701).

VALUATION ANALYSIS

If § 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation. 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 the family-held interests. In determining the value of any applicable retained interest held by the transferor or an applicable family member, any distribution right in a controlled entity (e.g., a right to receive dividends) is generally valued at zero.

Step 1- Determine the fair market value of all family-held equity interests in the entity immediately after the transfer assuming that the interests are held by one individual, using a consistent set of assumptions. Here, all equity interests are held by Donor, her children, and her grandchildren, all of whom are members of Donor's family. The result of Step 1 is an amount equal to the fair market value of 100 percent of the Company interests valued as if they were held by a single holder.

Step 2- Subtract: (A) the sum of the fair market value of all family-held senior equity interests determined after the transfer as if all interests were held by a single holder; and (B) the value determined under § 25.2701-2 of all applicable retained interests held by the transferor and any applicable family members. A senior equity interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried

a right to distributions based upon an existing capital account balance, whereas the transferred interests did not. Accordingly, the amount determined in Step 1 is reduced by the fair market value of Child A's, Child B's and the grandchildren's interests. The amount determined in Step 1 is further reduced by the value of Donor's post-recapitalization applicable retained interest. In valuing Donor's interest, the distribution right, which does not constitute a qualified payment right, is valued at zero, and the liquidation participation right is valued as if the family's ability to compel liquidation did not exist.

Step 3 - Allocate the remaining amount among the transferred interest and other non-transferred subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family. A subordinate equity interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). Here, all applicable retained interests carried a distribution right based upon an existing capital account balance, whereas the interest transferred by the grandchildren did not. This interest, which was not transferred by Donor, is a subordinate equity interest. Based on Donor and the grandchildren's relative ownership percentages immediately prior to the recapitalization, $X / X+Z$ percent of the Step 2 amount is allocated to the transferred interest. Donor is treated as transferring one-half of this amount to Child A and one-half to Child B.

Step 4 - If the value of the transferred interest determined without regard to § 2701 would be determined after application of a minority discount, the Step 3 amount is reduced by a pro rata portion of the fair market value of the family-held interests of the same class determined as if they were held by one person, over the fair market value of a transferred interest. The Step 3 amount is also reduced by the amount, if any, of any consideration in money or money's worth received by the transferor. Here, Donor transferred an interest to each of two transferees, implicating a minority discount. The reduction for each gift is the excess, if any, of a pro rata portion of the fair market value of the transferred interests determined as if all voting rights were held by a single holder over the fair market value of a single transferred interest. In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

Please call (202) 317-6859 if you have any further questions.

By: _____
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