Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-101726-03

Date:
August 14, 2003

Re:

LEGEND:
Corporation =
Assets =

Limited Partnership =
Company =
Agreement I =

Addendum =

Agreement II =

Merger Agreement =

Agreement III =

Members' Agreement =

x% =
y% =
Date =

Dear :

This is in response to your December 30, 2002 letter in which you request a ruling on the application of § 2703 of the Internal Revenue Code to the proposed transaction.

Facts

Corporation owned Assets. On Date (before October 9, 1990), in preparation for Corporation's liquidation, Corporation's shareholders executed Agreement I to provide for the disposition of their interests in Corporation. Agreement I states that substantially all of the Corporation-held Assets would be held by Limited Partnership. Art. IV, § 4.1, of Agreement I provides that the provisions set forth in the Addendum, which is a part of Agreement I, apply to all interests held in Limited Partnership.

The Limited Partnership Agreement ("Agreement II") was also executed on Date. Subsequently, the agreement was amended. A private letter ruling was issued concluding that the amendments would not constitute a substantial modification of a right or restriction contained in Agreement I or Agreement II.

There are three classes of units (or interests) in Limited Partnership. The General Partner Units constitute approximately x% of all outstanding Partnership units. The Limited Partner Units and Special Limited Partner Units constitute approximately y% of all outstanding Partnership units. The Addendum to Agreement I and Agreement II set forth the rights and restrictions applicable to interests in Limited Partnership, as follows.

Under Art. VI, § 6.01 of Agreement II, the overall management and control of the business and affairs of Limited Partnership is vested in the General Partner.

Allocations of income with respect to Partnership Units are made as follows. Under Art. III, § 3.01 of Agreement II, during a 20 year period beginning on Date 2, each Special Limited Partner Unit is entitled to an allocation ("Preference Allocation") of income equal to twice its pro rata share (based on the total number of all units) of gross income from dividends, interest and royalties and net operating profit of any operating business. The remaining income of Partnership (other than income from capital transactions) is allocated to the Limited Partner Units and General Partner Units on a pro rata basis. Income from capital transactions is allocated pro rata among all units.

Distributions with respect to partnership units are to be made as follows. Under § 3.02, mandatory annual distributions of cash are to be made in the following order of priority. Pro rata distributions are to be made to the Special Limited Partner Units in an amount equal to the Preference Allocation. Next, pro rata distributions are to be made to Limited Partner and General Partner Units in an amount sufficient for the holders to pay their income taxes on noncapital transaction income allocated to these units. Next, distributions are to be made pro rata with respect to all units in an amount sufficient to enable the holders to pay their income taxes on any capital transactions.

Under § 3.03, any additional distributions are to be made at the discretion of the general partners. However, if discretionary distributions are made, the distributions must first be made on a pro rata basis to holders of the Limited Partner Units and General Partner Units until the holders have received aggregate distributions equal to

the aggregate amount of noncapital transaction income allocated to them during the 20 year term commencing on Date 2. Thereafter, all discretionary distributions are to be made with respect to all units on a pro rata basis.

Under Art. II, § 2.1 of the Addendum, no partner may transfer any unit during life to a person other than a "Permissible Transferee", as defined in Agreement II, or a charitable organization (as a donation) without first complying with Art. II. Under Art. II, § 2.5, a permissible transferee or charitable organization will take units subject to the provisions of the Addendum.

Under Art. II, §§ 2.2 through 2.4 of the Addendum, a partner proposing to accept a bona fide offer of purchase from someone other than a Permissible Transferee must notify Limited Partnership. During the following 30-day period, Limited Partnership may purchase those units on the same terms and conditions as the offer. If Limited Partnership fails to exercise the purchase right, the partner may sell the units to the purchaser, but the units will remain subject to the provisions of the Addendum.

Under Art. III, § 3.1 of the Addendum, on the death of an individual, the individual's estate or the trust, as the case may be, may sell to Limited Partnership a specified amount of units, at fair market value, as finally determined for federal estate tax purposes. Under Art. IV, § 4.1, Limited Partnership has the continuing option to purchase any units held by any person other than a permissible transferee.

Under Art. IX, § 9.02(b) of Agreement II, upon liquidation of Limited Partnership, the net assets of the partnership are to be distributed to the partners in accordance with each partner's percentage interest in Limited Partnership.

Under the proposed transaction, Limited Partnership will merge with and into Company, a newly formed limited liability company. The unit holders of Limited Partnership will execute three documents: (1) the Merger Agreement, (2) Agreement III, and (3) the Members' Agreement. Together, these documents will set forth the rights and restrictions applicable to interests in Company.

There will be three classes of units (or interests) in Company: (1) Managing Member Units, (2) Regular Member Units, and (3) Special Member Units. Under Art. II, §§ 2.1 through 2.3 of the Merger Agreement, the outstanding Limited Partnership units will be transferred to Company. Each person who held General Partner Units will receive a one-quarter (.25) Managing Member Unit and a three-quarters (.75) Regular Member Unit for each General Partner Unit theretofore held. Each person who held Limited Partner Units will receive one Regular Member Unit for each Limited Partner Unit theretofore held; and each person who held Special Limited Partner Units will receive one Special Member Unit for each Special Limited Partner Unit theretofore held.

Under Art. VI, § 6.01 of Agreement III, the management and control of the

business and affairs of Company's is vested in the Managing Members.

Under Art. III, § 3.01 of Agreement III, allocations of income with respect to Member Units will be made as follows. During the 20 year period beginning on Date 2, each Special Member Unit will be entitled to an allocation (Preference Allocation) of income equal to twice its pro rata share (based on the total number of all units) of gross income from dividends, interest and royalties and net operating profit of any operating business. The remaining income of Company (other than income from capital transactions) is allocated to the Regular Member Units and Managing Member Units on a pro rata basis. Income from capital transactions is allocated pro rata among all units.

Distributions with respect to Member Units will be made as follows. Mandatory annual distributions of cash are to be made in the following order of priority. Pro rata distributions are to be made to the Special Member Units in an amount equal to the Preference Allocation. Next, pro rata distributions are to be made to Regular Member Units and Managing Member Units in an amount sufficient for the holders to pay their income taxes on noncapital transaction income allocated to these units. Next, distributions are to be made pro rata with respect to all units in an amount sufficient to enable the holders to pay their income taxes on any capital transactions.

Any additional distributions are to be made at the discretion of the Managing Members. However, if discretionary distributions are made, the distributions must first be made on a pro rata basis to holders of Regular Member Units and Managing Member Units until the holders have received aggregate distributions equal to the aggregate amount of noncapital transaction income allocated to them during the 20 year term commencing on Date 2. Thereafter, all discretionary distributions are to be made with respect to all units on a pro rata basis.

Under Art. II, § 2.1 of the Members' Agreement, no member may transfer any unit during life to someone other than a "Permissible Transferee", as defined in the agreement, or a charitable organization (as a donation) without first complying with Art. II. Under Art. II, § 2.5, a permissible transferee or charitable organization will take the units subject to the provisions of the Members' Agreement. The definition of the term "Permissible Transferee"contained in the Members' Agreement is identical to that definition contained in Agreement II.

Under Art. II, §§ 2.2 through 2.4 of the Members' Agreement, a Member proposing to accept a bona fide offer of purchase from a person other than a Permissible Transferee must notify Company. During the following 30-day period, Company may purchase those units on the same terms and conditions as the offer. If Company fails to exercise the purchase right, the Member may sell the shares to the purchaser, but the units will remain subject to the provisions of the Members' Agreement.

Under Art. III, § 3.1 of the Members' Agreement, on the death of an individual, the individual's estate or the trust, as the case may be, may sell to Company a specified amount of units, at fair market value, as finally determined for federal estate tax purposes. Under Art. IV, Company has the continuing option to purchase any units held by any person other than a permissible transferee.

Under Art. IX, § 9.02(b) of Agreement III, on liquidation of Company, the net assets of Company are to be distributed to the Members in accordance with each member's percentage interest in Company.

Requested Rulings

You have asked us to rule that, for purposes of § 2703, the proposed merger of Limited Partnership with and into Company, with the Member Units being subject to the Members' Agreement, will not constitute a "substantial modification of a right or restriction" with respect to Agreement I and Agreement II.

Law and Rationale

Section 2703(a) provides that, for purposes of the estate, gift, and generation-skipping transfer taxes, the value of any property shall 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 option, agreement, or right), or

(2) any restriction on the right to sell or use the property.

Under §11602(e)(1)(A)(ii) of Public Law 101-508, § 2703 shall apply 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.

Section 25.2703-1(c)(2) provides that a substantial modification does not include -

(i) a modification required by the terms of a right or restriction;

(ii) a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction;

(iii) a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and

(iv) a modification that results in an option price that more closely approximates fair market value.

In this case, Agreement I (including the Addendum) and Agreement II were executed before October 8, 1990. Agreement II was thereafter amended in a manner that did not constitute a substantial modification of a right or restriction**.**

In the proposed transaction, Company is structured to replicate Limited Partnership. In the merger, each holder of General Partner Units will receive that number of Managing Member Units of Company equal to twenty-five percent of his or her General Partner Units. In addition, he or she will receive that number of Regular Member Units of Company equal to seventy-five percent of his or her General Partner Units. Thus, the number of voting units will be reduced proportionately, and the relative voting rights of the unit holders will remain the same.

Likewise, the provisions for income allocations and cash distributions with respect to General Partner, Limited Partner, Managing Member, and Regular Member Units are identical. Thus, an exchange of seventy-five percent of a holder's General Partner Units for an equal number of Regular Member Units will not affect the economic rights of the holders of General Partner Units.

Every provision with respect to allocation of income now applicable with respect to the General, Limited and Special Limited Partnership Units in Limited Partnership will be applicable with respect to the Managing, Regular and Special Member Units. Further, provisions identical to those governing Limited Partnership distributions with respect to General, Limited and Special Limited Partnership Units, will apply to Company distributions with respect to Managing, Regular and Special Member Units. Finally, every right and restriction regarding the transfer, sale or testamentary disposition of General, Limited and Special Limited Partnership Units will also apply to Managing, Regular and Special Member Units in Company. No additional rights will be conferred, or restrictions imposed, on the Member Units that are not already provided for with respect to the Limited Partnership Units.

Consequently, based on the information submitted and representations made, the proposed transaction will not constitute a substantial modification of a right or restriction contained in Agreement I (including the Addendum) or Agreement II, for

purposes of § 2703.

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

George Masnik
Chief, Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes