

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

June 6, 2000

Re:

### Legend

Grantor -  
Cousin -  
Child 1 -  
Child 2 -  
Child 3 -  
Company -  
LLC -  
Trust A1 -  
Trust A2 -  
Trust A3 -  
Trust B1 -  
Trust B2 -  
Trust B3 -  
u -  
v -

Dear :

This is in reference to your April 24, 2000, correspondence, and prior submissions, in which you requested rulings regarding the effect of the proposed transfer of assets held in trust to a newly-created entity for federal income, gift, and generation-skipping transfer tax purposes.

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The facts submitted are as follows:

Grantor established three irrevocable trusts in 1958: Trust A1, Trust A2, and Trust A3; for Child 1, Child 2, and Child 3, respectively. Child 1, 2, and 3 are the children of Grantor's cousin (Cousin). Grantor funded each trust solely with Class A and Class B common Company stock. Company is a closely-held corporation. The trustee of Trust A1 is Child 2. The trustee of Trust A2 is Child 3. The trustee of Trust A3 is Child 1. Under the terms of each trust, the individual trustee has the power to vote, in person or by proxy, shares of stock in Company held by the trust. The dispositive provisions of each trust require that the income be paid to or for the benefit of each respective niece or nephew and, upon that income beneficiary's death, the principal to be distributed to that beneficiary's issue. In the event that an income beneficiary dies without issue surviving, the principal will be divided equally between the survivors of Child 1, Child 2, and Child 3 with the income from each share paid to or for their benefit during their lives and the principal of each share distributed to the issue of each respective income beneficiary.

Grantor also established a testamentary trust for the benefit of Cousin. Grantor died in 1977 and Cousin died in 1998. Upon Cousin's death, pursuant to its terms, Grantor's testamentary trust was divided into three separate trusts; Trust B1 for the benefit of Child 1, Trust B2 for the benefit of Child 2, and Trust B3 for the benefit of Child 3. Each trust is funded with Class B common stock in Company. Child 1, Child 2, and Child 3 are the trustees of each of Trust B1, Trust B2, and Trust B3. Under the terms of Trust B1, Trust B2, and Trust B3, the income from each trust will be paid to or for the benefit of Child 1, Child 2, and Child 3, the respective beneficiaries of each trust, during their lives. Upon the deaths of Child 1, Child 2, and Child 3, the principal of their respective trusts will be distributed to each child's issue. In the event that Child 1, Child 2, or Child 3 die without issue surviving, the principal of that child's trust will be distributed pursuant to the intestacy law of the State of New York as it would pertain to Cousin. Child 1, Child 2, and Child 3, as trustees, are authorized to vote any stock in Company held by Trust B1, Trust B2, and Trust B3. In addition, Child 1, Child 2, and Child 3 each own individually shares of Class A and Class B common stock in Company.

Company has been owned by Grantor and Cousin's family for several generations. Company has preferred stock and two classes of common stock: Class A and Class B. Although Company is authorized to issue preferred stock, it has not done so. Currently, Company has issued u shares of Class A common stock and v shares of Class B common stock. The common stock of Company is traded on the New York Stock Exchange. Class A and Class B common stock normally trade at about the same price. Each share of Company's Class B common stock is convertible into one share of Class A common stock. The Class A shareholders may elect 30 percent of the Board of Directors while the remaining 70 percent is elected by the Class B shareholders. On

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all other matters, Class A shareholders have one-tenth of a vote and Class B shareholders have one vote. Generally, whenever a dividend is paid to the Class B shareholders, the company must pay an equal or greater dividend to the Class A shareholders. However, the Company may pay a dividend to the Class A shareholders without paying a dividend to the Class B shareholders.

The family of Grantor and Cousin have been actively engaged in the management and ownership of Company since its founding and are currently and always have been the controlling group of shareholders in Company. Child 1, Child 2, and Child 3 are either on the Board of Directors, Officers, and/or employees of Company.

#### The Proposed Transaction

The family seeks to maintain ownership and control of Company. Currently, the family owns approximately 20 percent of the total outstanding shares of stock and controls approximately 50 percent of the voting power. In order to avoid dilution of control of company in successor generations, the family proposes to engage in the following transactions.

The trustees of Trusts A1, A2, A3, B1, B2, and B3 will form LLC, a limited liability corporation. LLC's members represent that it will be treated as a partnership for federal tax purposes. The purpose of LLC will be to own, invest in, administer and manage the securities of Company held by LLC. Each trust will contribute all of its Class A and Class B common stock in Company to LLC in return for membership in LLC. Each trust will receive a percentage interest in LLC evidenced by a capital account equivalent to the value of its contribution. Members may only receive a return of part or all of their capital account upon either withdrawal by the member or termination and liquidation of LLC. Initially, the trustees of Trusts A1, A2, A3, B1, B2, and B3 will be the managers of LLC, under the terms of which each manager must be a descendant of Cousin. The affairs of LLC will be conducted by the managers, two-thirds of whom must consent to any action taken by LLC. The LLC can only be amended with the consent of two-thirds of the percentage interest of members. No one may be admitted to membership and no member may encumber his or her interest in LLC without unanimous consent of the members. A member or an estate of a deceased member may only transfer a member's interest to a descendant of Cousin or a trust in which all the remaindermen are descendants of Cousin. A member may only dispose of a membership interest to a transferee other than a descendant of Cousin if the interest is first offered to other members, all living descendants of Cousin, and trusts exclusively for the benefit of descendants of Cousin at a price not higher than the price at which the stock is traded on that day. The LLC can only be dissolved with: (1) the consent of two-thirds of the percentage interest of members, (2) an event that terminates the continued membership of the last survivor of the members in LLC under law, and (3) a judicial

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dissolution.

After the LLC is formed and the Company stock is transferred to it, the LLC will then transfer its Class A common stock to Child 1, Child 2, and Child 3 in exchange for all of the Class B common stock owned by each of the children. The exchange will be based on the shares' respective fair market values, as determined by stock market prices on the New York Stock Exchange on the date of the exchange. As a result of the exchange, LLC will own approximately 65 percent of the Class B common stock in Company, which represents all of the Class B common stock which was held by the family prior to the proposed transactions. LLC, together with Child 1, Child 2, and Child 3, will own approximately 8 percent of the Class A common stock.

You request the following rulings:

1. The exchange of Class A common stock in Company for Class B common stock, as proposed, will not be deemed an "addition" or "constructive addition" to the trusts within the meaning of § 2601 of the Internal Revenue Code.
2. The exchange will be a nonrecognition transaction to all parties and the basis of the Class A common stock to be received by Child 1, Child 2, and Child 3, individually, and the basis of the Class B common stock to be received by LLC will be the same as the basis of their respective Class A and Class B common stock surrendered in exchange therefor under §§ 1036(b)(2) and 1031(d).
3. The exchange of Class A common stock in Company for Class B common stock, as proposed, between LLC and Child 1, Child 2, and Child 3 will not constitute a gift to LLC or Child 1, Child 2, or Child 3 that is subject to the gift tax under § 2501.

#### Ruling Request #1: Federal Generation-Skipping Transfer Tax Consequences

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply to additions (actual or constructive) that are made to the trust after September 25, 1985.

You have represented that Trust A1, Trust A2, Trust A3, Trust B1, Trust B2, and Trust B3 were irrevocable on September 25, 1985, and no additions have been made to any of the trusts after that date. Therefore, unless the exchange of stock between

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the LLC and Trust A1, Trust A2, Trust A3, Trust B1, Trust B2, and Trust B3 is deemed an addition to the various trusts or the proposed exchange changes the quality, value, or timing of the interests or powers provided for under the terms of the trusts, Trust A1, Trust A2, Trust A3, Trust B1, Trust B2, and Trust B3 will remain exempt from the GSTT.

A modification of a trust that is otherwise exempt for GST tax purposes under the 1986 Act will generally result in a loss of its "grandfathered" exempt status if the modification changes the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust.

Trust A1, Trust A2, and Trust A3 each hold the same number of shares of Class A and Class B common stock in Company for the benefit of Child 1, Child 2, and Child 3, respectively. Likewise, Trust B1, Trust B2, and Trust B3 each hold the same number of shares of Class B common stock for the benefit of Child 1, Child 2, and Child 3, respectively. Thus, the beneficial interests of Child 1, Child 2, and Child 3 that are being transferred from the trusts to LLC are identical. In return, the trustees of each child's trust will have equal rights as managers of LLC, both as to authority and as to withdrawal and liquidation. Consequently, Child 1, Child 2, and Child 3 will each have equal beneficial interests in LLC.

Accordingly, the proposed exchange of the stock by the respective trusts for the interest in LLC does not confer any additional powers, interests, rights or expectancies upon the trustees or beneficiaries or change the quality, value or timing of any of the existing powers, interests, rights or expectancies.

Therefore, based on the facts submitted and representations made, we conclude that the proposed exchange, as described, between the LLC and Trust A1, A2, A3, B1, B2, and B3 will not be deemed an addition to any of the trusts so as to cause a portion of Trust A1, Trust A2, Trust A3, Trust B1, Trust B2, or Trust B3 to be subject to the generation-skipping transfer tax within the meaning of § 26.2601-1(b)(1)(v)(A) or (B).

#### Ruling Request #2: Federal Income Tax Consequences

Under § 1036(a) no gain or loss is recognized when common stock in a corporation is exchanged solely for common stock in the same corporation. Section 1036(c)(2) states that the rules relating to the basis of property acquired in an exchange described in § 1036(a) are found in § 1031(d). Under § 1031(d), if property is acquired in a transaction described in § 1036(a), then the basis of such property shall be the same as that of the property exchanged in the transaction.

Rev. Rul. 72-199, 1972-1 C.B. 228, holds that the nonrecognition provisions of § 1036 apply to an exchange between individual shareholders of two classes of a corporation's common stock having equal value even though the classes differed in

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voting, preemptive, and dividend rights. See also § 1.1036-1(a) of the Income Tax Regulations.

Based solely on the information provided, we rule that, under the proposed transactions, no gain or loss will be recognized by LLC and the individual shareholders on the exchange of Class A common stock in Company for Class B common stock. We also rule that the basis of the stock in Company to be received by LLC and the individuals, in each instance, will be the same as the stock in Company exchanged therefor.

### Ruling Request #3: Federal Gift Tax Consequences

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies 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 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift will be considered the amount of the gift. Section 2512(b) states that where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration received shall be deemed a gift.

In this case, the exchange of Class A common stock in Company held by LLC for all of the Class B common stock held by Child 1, Child 2, and Child 3 will be based on each shares' respective fair market value on the date of the transfer.

The interest of each child will remain the same after the proposed exchange of stock between LLC and the children. Similarly, as described above, the exchange of stock between LLC and Trust A1, Trust A2, Trust A3, Trust B1, Trust B2, and Trust B3 will not result in any change in the beneficial interests of any of the trust beneficiaries or the members of LLC.

Thus, the interests transferred between LLC and the children in addition to the interests transferred between LLC and the individual trusts will be for full and adequate consideration. Accordingly, based on the facts submitted and the representations made, the proposed transaction will not cause any beneficiary of Trust A1, Trust A2, Trust A3, Trust B1, Trust B2, or Trust B3 to have made a taxable gift for Federal gift tax purposes under § 2501.

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

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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 the 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 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.

A copy of this letter should be attached to any gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

Sincerely,  
Assistant Chief Counsel  
(Passthroughs and Special Industries)  
By Robert Honigman  
Acting Assistant to the Branch Chief,  
Branch 4

Enclosure:

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