

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

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### Legend:

A =

B =

Son =

Daughters =

Company =

Revocable

Trust =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

\$X =

This is in response to your March 10, 1998 letter, submitted by your authorized representative, in which you request several rulings on the application of §§ 2703 and 2057 of the Internal Revenue Code to the transactions described below.

You have represented the facts to be as follows:

Company was formed on Date 1 by A and his spouse, B. On Date 2, A and B created Revocable Trust and transferred their shares of Company stock, which they owned as community property, to the trust. Also on Date 2, the Revocable Trust, Company, and Son, who also owned Company stock, entered into a buy-sell agreement (Agreement). The Agreement was later amended on Date 3. In general, the Agreement restricts the transferability of Company shares. Company is given the right of first refusal in the event a shareholder wishes to sell or otherwise dispose of his or her shares. If for any reason the Company is unable to purchase the

shares when offered for sale by a shareholder during life, the remaining shareholders have the right to purchase the shares pro rata. The Agreement requires the Company or the surviving shareholders to purchase the shares of a shareholder upon the death of a shareholder. The Agreement also provides for a stated purchase price of \$X per share.

A is the trustee of the Revocable Trust. During the joint lives of both grantors, the trustee is authorized in his sole and absolute discretion to pay the net income to or among the grantors, the children of the grantors, and the living issue of the children of the grantors.

Upon the death of the first grantor to die, the Revocable Trust corpus is to be divided into two trusts. One trust will hold A's community one-half interest in the trust property, and the other trust will hold B's community one-half interest in the trust property. The trust holding the property of the first spouse to die will become irrevocable, while the trust holding the property of the surviving spouse will remain revocable. Each grantor has a testamentary general power of appointment with respect to the trust holding his or her community one-half interest. Unless otherwise directed in the will of the deceased grantor by the exercise of the general power of appointment, the income from the trust holding the deceased grantor's community property is to be paid to the surviving grantor for life. In addition, the trustee is authorized to distribute corpus to the surviving grantor for the health, education, support, and maintenance of such surviving grantor. Upon the death of the surviving grantor, both trusts will terminate and the property is to be divided with one share for each living child and one share for a deceased child with living issue. The property is to be distributed outright, per stirpes. If a beneficiary is under age 21, the share will remain in trust.

On Date 4, A and B created four separate trusts for the benefit of their daughters and transferred 1,427 shares from the Revocable Trust to each daughter trust. Son is the trustee of the daughter trusts. The parties to the buy-sell Agreement waived their right to purchase the shares of stock transferred to the daughter trusts and also waived the requirement of the buy-sell Agreement that a transferee of the shares expressly acknowledge that the shares continue to be subject to the terms of the Agreement.

On the same date that the daughter trusts were funded, Son, in his individual capacity and in his capacity as trustee of daughter trusts, entered into a stockholders agreement with Company concerning the shares transferred to the daughter

trusts. In general, the stockholders agreement restricts the transfer of these shares. As amended on Date 5, the agreement provides that on the death of A, Company shall purchase the shares held by the daughter trusts at a stated price of \$X per share. If Company does not purchase the shares, Son has an option to purchase the shares at the same price per share.

The Revocable Trust currently holds 40,865 shares, or 68.11 percent of the outstanding shares of Company. The remaining shares are held by Son, 13,427 (22.38 percent), and the four separate daughter trusts, 5,708 (9.52 percent).

A, as trustee of the Revocable Trust, proposes to transfer 409 shares of Company stock to A and 409 shares to B. A and B will transfer these shares to a newly created family limited partnership (Partnership), and A and B will each receive a one percent general partnership interest in the Partnership. The trustee of the Revocable Trust will then transfer the balance of the Company stock to the Partnership for a 98% limited partnership interest in the Partnership. The parties to the buy-sell Agreement will consent to the transfers to the Partnership. The buy-sell Agreement will be amended to make the Partnership a party to the Agreement. The Partnership will continue for 30 years, unless otherwise terminated.

It is represented that A and Son actively participate in the operation of Company. A has participated since 1970 and Son has participated since 1972.

You have requested the following rulings:

1. Section 2703 does not apply to the buy-sell Agreement, as amended on Date 3.
2. The proposed amendment of the buy-sell Agreement to add the Partnership as a party to the agreement is not a substantial modification for purposes of § 2703.

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 such property.

Under section 11602(e)(1)(A) of P.L. 101-508, Section 2703 applies to agreements, options, rights, or restrictions entered

into or granted after October 8, 1990, and agreements, options, rights, or restrictions which are substantially modified after that date.

Section 25.2703-1(c)(1) of the Gift Tax Regulations 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. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that the updating would not have resulted in a substantial modification. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification, unless the addition is mandatory under the terms of the right or restriction or the added family member is assigned to a generation (determined under the rules of § 2651) no lower than the lowest generation occupied by individuals already party to the right or restriction.

In the present case, the buy-sell Agreement among the shareholders of Company was in effect prior to October 8, 1990, and has not been amended after that date. As such, the buy-sell Agreement, as amended on Date 3, is not subject to § 2703. The trustee of the Revocable Trust will transfer 2 percent of its shares in Company to A and B, who will transfer those shares for a 2-percent general partnership interest in the Partnership. The Revocable Trust will then transfer its remaining shares (98 percent of its original holdings) to the Partnership for a 98-percent limited partnership interest. Under the proposed amendment to the buy-sell Agreement, the Partnership will be added as a party to the original buy-sell Agreement in place of the Revocable Trust. Accordingly, we conclude that under the specific facts of this case, the addition of the Partnership, which is owned in its entirety by A and B, as a party to the original buy-sell Agreement will not result in more than a de minimis change to the quality, value, or timing of the rights of the parties to the current buy-sell Agreement.

Except as we have ruled herein, we express no opinion about the tax consequences of the proposed transaction under the cited

provisions or under any other provisions of the Code.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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

Sincerely yours,

Assistant Chief Counsel  
(Passthroughs and Special  
Industries)

By \_\_\_\_\_  
Katherine A. Mellody  
Assistant to the Branch Chief  
Branch 4

Enclosure  
Copy for 6110 purposes