

INTERNAL REVENUE SERVICE

Index Nos.: 2703.00-00
2703.01-00

Washington, DC 20224

Number: **200010015**
Release Date: 3/10/2000

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:7:PLR-120632-98

Date:

November 30, 1999

Legend: Corporation:

Date 1:

State:

A:

B:

C:

D:

E:

Individual 1:

Spouse:

Child 1:

Child 2:

Husband:

Date 2:

Individual 2:

\$F:

Date 3:

Date 4:

G:

H:

Date 5:

I:

J:

Dear

We received the , request for rulings concerning the application of § 2703 of the Internal Revenue Code to certain transactions. This letter responds to that request.

The facts and representations submitted are as follows. Corporation was formed on Date 1 in State. Corporation has A shares of authorized stock, divided into B shares of voting

common stock and C shares of non-voting common stock. There are currently D shares of voting common stock and E shares of non-voting common stock outstanding.

All of the outstanding shares are owned by Individual 1, Spouse (the spouse of Individual 1), Child 1, Child 2, and Husband (Child 2's husband). It is represented that, aside from the differences in voting rights, all shares of Corporation common stock have the same rights and preferences.

It is represented that all of the outstanding shares are subject to a shareholder's agreement (Agreement) dated Date 2, which date is before October 9, 1990. The original parties to Agreement are Individual 1, Individual 2, Child 1, and Child 2.

Agreement imposes a broad restriction on transfer of shares of stock of Corporation. A shareholder may, however, gift all or any portion of his shares to his spouse, children, or issue, or to a trust for the benefit of the shareholder, his spouse, children or issue, provided that, simultaneously with such transfer, the donee, or trustee, as the case may be, executes a counterpart of Agreement agreeing to its terms.

Agreement also allows a shareholder to sell shares to a third party after giving Corporation a right of first refusal to purchase the shares at the price specified in Agreement. Agreement provides that upon the death of any shareholder, the estate of the deceased shareholder has the option to cause Corporation to redeem the deceased shareholder's shares of stock, up to a maximum price of \$F.

It is represented that, since the adoption of Agreement, Corporation repurchased the shares of Individual 2, one of the original parties to Agreement. In addition, shares have been transferred among the original parties to Agreement by gift by Individual 1 to Spouse, and by sale by Child 1 to Husband, the spouse of Child 2. It is also represented that Agreement has not been otherwise amended or modified by the parties since its adoption.

More specifically, it is represented that the following transactions have taken place since the date of the Agreement:

- (1) On Date 3, Corporation redeemed and canceled all of Individual 2's shares of voting and nonvoting stock for a redemption price arrived at by the parties with reference to the terms and provisions of Agreement;
- (2) On Date 4, Individual 1 transferred by gift G shares of voting stock in Corporation to Spouse, and H shares of voting stock each to Child 1 and Child 2. It is represented that, following the transfer, Spouse became a party to Agreement and the transferred stock continued to be subject to the rights and restrictions set forth in Agreement. In addition, Child 1 and Child 2 were each original parties to Agreement and the transferred stock continued to be subject to Agreement; and,

(3) On Date 5, Child 1 sold I shares of voting stock and J shares of nonvoting stock in Corporation to Husband. Corporation did not exercise its right of refusal to redeem the offered stock prior to the sale, and the purchase price was determined in accordance with the valuation procedure set forth in Agreement. Following the transfer, Husband became party to Agreement, and the transferred stock continued to be subject to Agreement.

Corporation now proposes to adopt a plan that would benefit key employees, none of whom would be an existing shareholder or family member of an existing shareholder. The proposed plan would include providing stock options, stock appreciation rights (SAR's) or a combination of the two to certain employees of Corporation.

The stated purpose for the transaction is: (i) to provide key employees with the opportunity to participate in the appreciation of Corporation's value; (ii) to improve the alignment of management interests with the interests of the shareholders; (iii) to attract and retain key executives; and, (iv) to compensate key executives for leadership in creating value for Corporation.

The Stock Option Plan

Under the proposed stock option plan, participating employees would have the right to purchase shares of Corporation's nonvoting stock at a specified price for up to ten years after the date the stock option is awarded. At the time the participating employees exercise the stock options, the participating employees will obtain shares of nonvoting stock of Corporation, with the same rights and preferences as the nonvoting stock currently outstanding, including the right to share dividend distributions.

The shares acquired upon exercise of the stock options would be issued from authorized but unissued shares of its nonvoting common stock. It is represented that none of the shares currently held by the shareholders would be used to implement the stock option aspect of the plan.

It is represented that the option shares would not be subject to Agreement, but would be subject to the restrictions on transfer and redemption set forth in the plan documents. In addition, it is represented that, as a general rule, a stock option would be issued with an exercise price (strike price) equal to the value of Corporation's stock at the time the option is granted. Such value would be determined in accordance with the valuation procedures established under Agreement. Corporation may offer discounted strike prices to one or more participating employees.

Broad restrictions would be imposed on both the transfer of the stock options and the transfer of any option shares acquired pursuant to the exercise of the stock options. It is represented that the stock options would be nontransferable, with the exception of transfer upon the death of the option holder pursuant to the terms of his or her will or by the laws of descent

and distribution. It is represented that all option shares acquired pursuant to the exercise of the stock options would also be nontransferable, with the exception of (1) redemptions of such stock by Corporation, and (2) transfers upon the death of the employee pursuant to the terms of his or her will or by the laws of descent and distribution.

It is represented that, beginning one year after the issuance of an option share, a participating employee may require Corporation to redeem such share for its value at that time, determined in accordance with Agreement. If an employee is terminated for cause or for violation of a non-competition, non-solicitation, confidentiality, or other restrictive covenant with Corporation, Corporation would have the right to redeem all of that employee's option shares at a price equal to the lesser of: (i) the price at which the employee purchased the option shares, or (ii) the value of the option shares as of the date of such termination or violation, with such value to be determined in accordance with the valuation procedure set forth in Agreement.

It is represented that both incentive stock options and non-qualified stock option awards would be permitted under the plan. In addition, it is represented that it may be necessary or desirable for Corporation to authorize additional shares of nonvoting stock in order to implement the stock option aspect of the plan, which would require an amendment to the Articles of Incorporation.

The SAR's

It is represented that under this aspect of the proposed plan, the participating employees would be provided with a right to receive an amount equal to the appreciation in value of Corporation for up to ten years after the date the SAR is awarded.

It is represented that no shares of stock would be awarded under this aspect of the proposed plan and no current or future rights of ownership of stock in Corporation would be conferred upon participating employees. Under the SAR, the participating employees would not be entitled to any voting rights, would not be entitled to receive cash, property or other dividend distributions with respect to Corporation's common stock, and would not have any of the rights or benefits which accompany the ownership of common stock under either state or federal law or as a result of acquiring the SAR's.

It is represented that at the time the SAR is granted, the base value would be set equal to the value of a share of Corporation's non-voting stock at that time, with such value to be determined in accordance with the valuation procedure set forth in Agreement. At the time the participating employee exercises the SAR, such employee will be entitled to payment from Corporation of an amount equal to the appreciation, if any, between the base value of the SAR and the value of a share of Corporation's nonvoting stock at the time of the exercise, with such value to be determined in accordance with the valuation procedures in Agreement.

It is represented that the SAR's would not be transferable, except upon the participating employee's death, pursuant to the terms of his or her will or by the laws of descent and distribution.

The SAR may be exercised at any time upon giving formal notice to Corporation, which would have the right to structure the redemption as either a lump sum payment or as a payment over a specified time. Upon exercise of a SAR, all rights to future appreciation would be forfeited. At the end of the ten-year period, Corporation would automatically exercise all unexercised SAR's.

The following rulings are requested:

(1) The prior transfers and redemptions of stock in Corporation subsequent to the effective date of Agreement did not constitute substantial modifications of any of the rights or restrictions imposed by Agreement for purposes of § 25.2703-1(c), and, therefore, Agreement is not currently subject to § 2703;

(2) The adoption and implementation of the stock option aspect of the proposed plan will not constitute a substantial modification of any of the rights or restrictions imposed by Agreement for purposes of § 25.2703-1(c), and, therefore, Agreement will not be subject to § 2703; and,

(3) The adoption and implementation of the SAR aspect of the proposed plan will not constitute a substantial modification of any of the rights or restrictions imposed by Agreement for purposes of § 25.2703-1(c), and, therefore, Agreement will not be subject to § 2703.

Ruling Request 1:

(a) Redemption of Individual 2's stock.

Section 2703 of the Code provides that for transfer tax purposes, the value of any property is 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 Public Law 101-508, § 11602(e)(1)(A), § 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 the 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 a party to the right or restriction.

In the present case, Agreement among the shareholders of Corporation was in effect prior to October 8, 1990, and has not been amended after that date. As such, Agreement is not subject to § 2703, as long as it is not substantially modified as set forth in § 25.2703-1(c).

Based on the facts and representations submitted, we conclude that the redemption of Individual 2's stock in Corporation did not constitute a substantial modification for purposes of § 25.2703-1(c), because neither the quality, value, or timing of the rights of the parties currently subject to Agreement were substantially modified.

(b) Prior transfers among family members

In the present case, we conclude that the transfer by gift of shares of Corporation to Child 1 and Child 2 were not substantial modifications of Agreement, because each is an original party to Agreement. Further, the transfer to two new family member shareholders, Spouse and Husband, were not substantial modifications to Agreement, because neither were members of a generation lower than the lowest generation already party to Agreement (i.e., the generation including Child 1 and Child 2).

Ruling Requests 2 and 3:

It is represented that the proposed plan would be implemented to benefit certain key employees of Corporation, none of whom would be an existing shareholder or a family member of an existing shareholder. Consequently, the participating employees would be individuals who are not family members with respect to any of the existing shareholders of the Corporation. The implementation of the proposed plan and issuance of stock options and SAR's would be in consideration for services rendered to Corporation in transactions in the ordinary course of business (i.e., bona fide, at arms-length, and free from any donative intent).

Provided the final plans comport with the representations made, we conclude that the adoption and implementation of the proposed plan would not cause substantial modifications to

Agreement for purposes of § 25.2703-1(c), and, thus, would not affect the exempt status of Agreement for purposes of § 2703.

Except as specifically ruled herein, we express or imply no opinion under the cited provisions or under any other provisions of the Code. This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

James C. Gibbons

James C. Gibbons
Badge #: 50-02622
Assistant to the Chief, Branch 7
Office of Assistant Chief Counsel
(Passthroughs & Special Industries)

Enclosures: Copy for § 6110 purposes