

Internal Revenue Service

Department of the Treasury

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March 28, 2000

Legend

Corporation =

State =

D1 =

D2 =

Shareholders =

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Dear

This responds to your letter dated March 18, 1999, as supplemented, submitted on behalf of Corporation requesting rulings under §§ 1361 and 2701 of the Internal Revenue Code.

FACTS

The following facts have been represented. Corporation was incorporated under the laws of State on D1. Corporation elected to be taxed as an S corporation on D2. Corporation currently has a single class of common voting stock, all of the shares of which are held by Shareholders. For business reasons, Corporation proposes to undergo a recapitalization intended to qualify as a tax-free reorganization under § 368(a)(1)(E). Pursuant to the recapitalization, the Shareholders will receive one share of voting and 10 shares of nonvoting common stock for every share of voting common stock currently held. It is represented that the voting and nonvoting shares received by each shareholder will have shareholder rights similar to those voting shares given up. Additionally, the only distinction between the two types of common stock received in the proposed recapitalization will be as to voting rights; all shares of stock will have identical rights to distributions and liquidation proceeds.

RULINGS REQUESTED

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1. The voting and non-voting stock, which will be identical in all other respects, will not be treated as different classes of stock within the meaning of § 1361(b)(1)(D), and the existing S status will not terminate; and
2. Section 2701 does not apply to the proposed recapitalization.

LAW AND ANALYSIS

Section 1361(a)(1) provides that, for purposes of the Code, the term “S corporation” means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term “small business corporation” means a domestic corporation that is not an ineligible corporation and that does not, among other things, have more than one class of stock. Section 1361(c)(4) indicates that a corporation shall not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock. Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, subject to certain exceptions, a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. It has been represented that the sole difference between the voting and nonvoting common stock that Corporation will issue pursuant to the recapitalization will be voting rights. Therefore, the voting and nonvoting stock will not be considered two classes of stock for purposes of § 1361(b)(1)(D).

Section 2701 contains special valuation rules to determine the amount of the gift when an individual transfers an equity interest in a corporation or a partnership to a member of the individual’s family. Section 2701(a)(1) provides that solely for purpose of determining if a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor’s family is a gift (and the value of such transfer), the value of any right - -

(A) that is described in § 2701(b)(1)(A) or § 2701(b)(1)(B), and

(B) that is with respect to any applicable retained interest that is held by the transferor or an applicable family member immediately after the transfer,

shall be determined under § 2701(a)(3).

Section 2701(a)(2) provides that § 2701(a)(1) does not apply to any right with respect to an applicable retained interest if - -

(A) market quotations are readily available (as of the date of the transfer) for

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such interest on an established securities market,

(B) such interest is of the same class as the transferred interest, or

(C) such interest is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations in liability).

Section 2701(b)(1) defines an “applicable retained interest” as any interest in an entity for which there is - -

(A) a distribution right, but only if, immediately before the transfer, the transferor and applicable family members hold (after application of § 2701(e)(3)) control of the entity, or

(B) a liquidation, put, call, or conversion right.

Section 2701(b)(2)(A) provides that, for purposes of § 2701(b)(1), in the case of a corporation, the term “control” means the holding of at least 50 percent (by vote or value) of the stock of the corporation.

Section 2701(b)(2)(C) provides that, for purposes of § 2701(b), the term “applicable family member” includes any lineal descendant of any parent of the transferor or the transferor’s spouse.

Section 25.2701-2(b)(1) of the Gift Tax Regulations provides that an applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either an extraordinary payment right (as defined in § 25.2701-2(b)(2)) or, in the case of a controlled entity as defined in § 25.2701-2(b)(5) a distribution right (as defined in § 25.2701-2(b)(3)). An extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A distribution right is the right to receive distributions with respect to an equity interest, but does not include - -

(1) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest,

(2) Any extraordinary payment right, or

(3) Certain other rights as described in § 25.2701-2(b)(4).

Section 2701(e)(5) provides that, except as provided in regulations, a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a

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corporation or a partnership is treated as a transfer of an interest in such entity to which § 2701 applies if the taxpayer or an applicable family member:

- (A) receives an applicable retained interest in such entity pursuant to such transaction, or
- (B) under regulations, otherwise holds, immediately after such transaction, an applicable retained interest in such entity.

Section 2701(e)(5) does not apply to any transaction (other than a contribution to capital) if the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical.

Section 25.2701-1(b)(2)(B) provides that, except as provided in § 25.2701-1(b)(3), a transfer subject to the rules of § 2701 includes a redemption, recapitalization or other change in the capital structure of an entity (a "capital structure transaction"), if - -

- (1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;
- (2) 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; or
- (3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

Section 25.2701-1(b)(3) provides that, for purposes of § 2701, a transfer does not include the following transactions:

- (i) A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction. For this purpose, common stock with nonlapsing voting rights and nonvoting common stock are interests that are substantially the same;
- (ii) A shift of rights occurring upon the execution of a qualified disclaimer described in § 2518;

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(iii) A shift of rights occurring upon the release, exercise, or lapse of a power of appointment other than a general power of appointment described in § 2514, except to the extent the release, exercise, or lapse would otherwise be a transfer under chapter 12.

Section 25.2701-1(c)(3) provides that § 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for nonlapsing differences in voting rights (or, for a partnership, nonlapsing differences with respect to management and limitations on liability).

In this case, the Shareholders of Corporation propose to exchange all of their stock in Corporation for new stock in Corporation pursuant to a plan of recapitalization intended to qualify as a tax-free reorganization under § 368(a)(1)(E). As discussed above, pursuant to the plan of recapitalization, for each voting share that a shareholder currently owns, the shareholders will receive one new share of voting common stock and 10 new shares of nonvoting common stock. In all cases, the rights with respect to the stock transferred by each shareholder will be identical to the rights with respect to the stock received by each shareholder. Therefore, in accordance with § 25.2701-1(b)(3) and § 25.2701-1(c)(3), § 2701 will not apply to the proposed recapitalization.

CONCLUSION

Based solely on the facts submitted and the representations made, we hold that:

1. The voting and nonvoting common stock that will be issued in the recapitalization will not be considered different classes of stock within the meaning of § 1361(b)(1)(D). Therefore, assuming Corporation's S election is otherwise valid, the issuance of the voting and nonvoting common stock will not terminate Corporation's S election.
2. Section 2701 will not apply to the proposed recapitalization.

This ruling expresses no opinion about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or any effects resulting from, the transaction that are not specifically covered by the above rulings. In particular, this ruling expresses no opinion as to (1) whether the proposed exchange of voting

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common stock for a combination of voting common stock and non-voting common stock constitutes a corporate recapitalization within the meaning of § 368(a)(1)(E) of the Code. Rev. Proc. 2000-3, 2000-1 I.R.B. 107 (section 3.01(26)); and (2) whether Corporation is, in fact, an eligible S corporation.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

William P. O'Shea
Branch Chief
Branch 3
Office of Assistant Chief Counsel
(Passthroughs and Special
Industries)

Enclosures: 2
Copy of letter
Copy for section 6110 purposes