

# Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
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Date:  
November 30, 2000

## LEGEND:

Taxpayer =

Spouse =

Son =

Daughter =

Company =

Partnership =

a =

b =

c =

d =

e =

LLC =

State =

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<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=

Dear Sir:

In a letter, dated August 31, 1999, you requested rulings concerning the application of the “qualified payment” requirement of § 2701 of the Internal Revenue Code. This letter responds to your request.

The information submitted and the representations made are summarized as follows: Prior to a, Taxpayer, Spouse, Son, and Daughter were the limited partners of the Partnership. Company, which is wholly-owned by Taxpayer, was the sole general partner. The partnership interests of the Partnership were owned as follows:

Company	<u>b</u> percent
Taxpayer	<u>c</u> percent
Spouse	<u>d</u> percent
Son	<u>e</u> percent
Daughter	<u>e</u> percent

On a, as a part of a spin-off reorganization, the Partnership transferred its interests into the LLC and other entities. The members of the Partnership deemed the various entities necessary to facilitate financing.

The LLC was formed for the primary purpose of engaging in all aspects of real estate ownership, development, and management. The ownership percentages of the members of the LLC, Taxpayer, Spouse, Son, Daughter, and Company, are identical to their ownership percentages in the Partnership.

Article 1, Section 1.3 of the Operating Agreement provides that the LLC will be perpetual unless otherwise stated in the Articles or until the LLC dissolves and its affairs are wound up in accordance with the State Limited Liability Company Act or the Operating Agreement.

Article 2, Section 2.4 of the Operating Agreement provides that Preferred Members are entitled to annual preferred distributions as described in Sections 5.2.1 and 5.2.2. Preferred members are entitled to a preference in liquidation as described in

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Section 9.2. It is the intention of the LLC and the members that preferred members receive “qualified payments” as described in § 2701(a)(3) and (d)(3)(A) of the Internal Revenue Code of 1986, as amended, and similar successor provisions.

Article 3, Section 3.1 of the Operating Agreement provides, in part, that except as otherwise provided for in the Operating Agreement, the property, affairs, and business of the LLC are to be managed in all respects by the manager or if more than one, the managers. The managers may fully and completely exercise all the powers of the LLC, whether derived from law, the Articles, this Operating Agreement, or otherwise. When this Operating Agreement requires the LLC to take any action, the manager(s) are to take the required action. The members are to act only as members, and the members are to have no management power nor are they to act as managers unless explicitly authorized by a majority of the managers. If more than one manager is acting then all actions are to require a majority vote of the managers, but following a vote or consent, each manager is to be able to implement the action. Each manager has the power, on behalf of the LLC, to do all things necessary and convenient to carry out the business and affairs of the LLC, at the LLC’s expense.

Article 3, Section 3.2 of the Operating Agreement provides that the initial manager is to be the Company. The Company is to serve as manager until removed by a f percent vote or is unable or unwilling to serve as manager. Thereafter, the manager(s) and the number of manager(s) of the LLC will be determined from time to time by a majority vote of the members. Son is to serve as interim manager until a majority of the members elect a new manager. A manager is to hold office for the term elected, until a successor is elected and qualified or until death, resignation, or removal. The managers are to be elected on an annual basis. However, if an election does not take place, then existing manager(s) at that time are to remain as manager(s), until an election for new manager(s) occurs, if ever.

Article 3, Section 3.4 of the Operating Agreement provides that no member (other than a manager) has the authority or power to act for or on behalf of the LLC, to do any act that would be binding on the LLC or incur any expenditures on behalf of the LLC.

Article 5, Section 5.1 of the Operating Agreement provides that except as provided in Article 5, the Internal Revenue Code of 1986, as amended, or the Operating Agreement, the LLC’s net profits, net losses, and other items of income, gain, loss, deduction, and credit are to be allocated among the members in accordance with each member’s sharing ratio.

Under Section 5.2.1 of Article 5 of the Operating Agreement, the manager is required to distribute to each preferred member on each g, an amount equal to h percent of each preferred member’s initial value. Section 5.2.2 provides that in the event the manager fails to make the full required distribution on a timely annual basis to preferred members required by Section 5.2.1, then the manager is to increase the

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required distribution to the extent the required distribution was not paid, at an annual rate of h percent of all undistributed required distributions (“additional required distributions”).) The additional required distributions are to be computed and compounded annually. Partial years are to be prorated.

Section 5.2.3 of Article 5 of the Operating Agreement provides that in the event any required distribution or additional required distribution is not made within i years of g of the year to which the required distribution relates, the manager shall pursue one or more of the following before the expiration of the i year grace period provided by § 2701(d)(2)(C): (a) the manager shall sell assets or (b) the manager shall borrow money. Upon the fulfillment of (a) or (b) above, the manager shall then make the required distribution and additional required distribution described. In addition, in such circumstances the preferred member may remove the manager, and in addition or as an alternative, solely at the election of the preferred member, the preferred member may convert its preferred member’s membership interest to a membership interest which is not that of a preferred member. THE FAILURE TO MAKE A REQUIRED DISTRIBUTION FOR i YEARS MAY RESULT IN A GIFT OR AN ADJUSTMENT OF VALUE FOR A PREFERRED MEMBER’S INTEREST. SUCH EVENTS ARE SUBJECT TO PARTIAL RELIEF FROM DOUBLE TRANSFER TAXATION AND PHANTOM ASSET TAXATION UNDER INTERNAL REVENUE CODE SECTIONS 2701(d)(2)(B) and 2701(e)(6). PREFERRED MEMBERS AND THE MANAGER SHOULD CONSULT WITH TAX ADVISORS FAMILIAR WITH THESE PROVISIONS IF PAYMENTS ARE NOT MADE ON A TIMELY BASIS.

Section 5.2.4 of the Operating Agreement provides that in the event Company refinances or sells real estate which it owns and in order to assure the Preferred Members of their future required distributions in the event that the manager determines that a distribution or part or all of the proceeds of such refinancing or sale is in the members best interest, the manager may elect to make all or any portion of the required distributions to preferred members described in § 5.2.1 before the time set for such distribution, provided that said prepayment to preferred members does not exceed a period of j year determined from the date of payment. In such event, the manager is to decrease the amount of the distribution by discounting the distribution, prorata, based on a 365 day year to yield a distribution equal to the annual rate of h.

You requested a ruling that the prepayment of the annual distribution payments constitutes a “qualified payment” under § 2701(c)(3) and § 25.2701-2(b)(6)(i)(B) of the Special Valuation Rules.

Section 2701(a)(1) provides that, solely for purposes of determining whether 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 the transfer), the value of any right –

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

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(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,

is determined under § 2701(a)(3). Section 2701(a)(1) does not apply to the transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established securities market.

Section 2701(a)(3)(A) provides that the value of any right described in § 2701(a)(1), other than a distribution right which consists of a right to receive a qualified payment, shall be treated as being zero.

Section 2701(a)(4)(A) provides that in the case of a transfer described in § 2701(a)(1) of a junior equity interest in a corporation or partnership, such interest shall in no event be valued at an amount less than the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of --

(i) the total value of all of the equity interests in such entity, plus

(ii) the total amount of indebtedness of such entity to the transferor (or an applicable family member).

Section 2701(a)(4)(B)(i) provides that the term "junior equity interest" means common stock or, in the case of a partnership, any partnership interest under which the rights as to income and capital (or, to the extent provided in regulations, the rights as to either income or capital) are junior to the rights of all other classes of equity interests.

Section 2701(a)(4)(B)(ii) provides that the term "equity interest" means stock or any interest as a partner, as the case may be.

Section 2701(b)(1) provides that the term "applicable retained interest" means any interest in an entity with respect to which there is --

(A) a distribution right, but only if, immediately before the transfer described in § 2701(a)(1), 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)(B) provides that in the case of a partnership, the term "control" means --

(i) the holding of at least 50 percent of the capital or profits interests in the partnership, or

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(ii) in the case of a limited partnership, the holding of any interest as a general partner.

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 2701(c)(1)(A) provides that the term "distribution right" means: (i) a right to distributions from a corporation with respect to its stock; and (ii) a right to distributions from a partnership with respect to a partner's interest in the partnership.

Section 2701(c)(1)(B) provides that the term "distribution right" does not include: (i) a right to distributions with respect to any interest that is junior to the rights of the transferred interest; (ii) any liquidation, put, call, or conversion right; or (iii) any right to receive any guaranteed payment described in § 707(c) of a fixed amount.

Section 2701(c)(3)(A) provides that the term "qualified payment" means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate.

Section 2701(d) generally provides rules applicable to the transfer tax treatment of cumulative but unpaid distributions.

Section 2701(e)(1) provides that the term "member of the family" means, with respect to any transferor: (A) the transferor's spouse; (B) a lineal descendant of the transferor or the transferor's spouse; and (C) the spouse of any such descendant.

Section 2701(e)(2) provides that the term "applicable family member" means, with respect to any transferor: (A) the transferor's spouse; (B) an ancestor of the transferor or the transferor's spouse; and (C) the spouse of any such ancestor.

Section 2701(e)(6) provides that under regulations prescribed by the Secretary, if there is any subsequent transfer, or inclusion in the gross estate, of any applicable retained interest which was valued under the rules of § 2701(a), appropriate adjustments will be made for purposes of chapter 11, 12, or 13 to reflect the increase in the amount of any prior taxable gift made by the transferor or decedent by reason of such valuation or to reflect the application of § 2701(d).

Section 25.2701-1(b)(2)(i) provides, in relevant part, that, except as provided in § 25.2701-1(b)(3), for purposes of § 2701, transfer includes: a contribution to the capital of a new or existing entity; or, a redemption, recapitalization, or other change in the capital structure of an entity (a "capital structure transaction"), if the transferor or an

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applicable family member receives an applicable retained interest in the capital structure transaction.

Section 25.2701-1(b)(3)(i) provides that for purposes of § 2701, a transfer does not include 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.

Section 25.2701-1(c)(3) provides, in relevant part, 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 non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of § 25.2701-1, non-lapsing provisions necessary to comply with partnership allocation requirements of the Code (e.g., § 704(b)) are non-lapsing differences with respect to limitations on liability. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

Section 25.2701-1(d)(1) provides that a "member of the family" is, with respect to any transferor: (i) the transferor's spouse; (ii) any lineal descendant of the transferor or the transferor's spouse; and (iii) the spouse of any such lineal descendant.

Section 25.2701-1(d)(2) provides that an "applicable family member" is, with respect to any transferor: (i) the transferor's spouse; (ii) any ancestor of the transferor or the transferor's spouse; and (iii) the spouse of any such ancestor.

Section 25.2701-2(a)(1) provides that any extraordinary payment right is valued at zero.

Section 25.2701-2(a)(2) provides that any distribution right in a controlled entity is valued at zero, unless it is a qualified payment right.

Section 25.2701-2(b)(1) provides that an applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either: (i) an extraordinary payment right; or (ii) in the case of a controlled entity, a distribution right.

Section 25.2701-2(b)(3) provides that a distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include: (i) 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; (ii) any extraordinary payment right; or (iii) any right described in § 25.2701-2(b)(4).

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Section 25.2701-2(b)(4) provides that mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under § 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.

Section 25.2701-2(b)(5)(i) provides that, for purposes of § 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse.

Section 25.2701-2(b)(5)(iii) provides, in relevant part, that in the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner.

Section 25.2701-5(a)(1) states that section 25.2701-5 provides rules under which an individual (the initial transferor) making a transfer subject to § 2701 (the initial transfer) is entitled to reduce his or her taxable gifts or adjusted taxable gifts (the reduction). The amount of the reduction is determined under § 25.2701-5(b).

Based on the information submitted and the representations made, we conclude that the prepayment of the annual distribution payments is a cumulative distribution payable on a periodic basis, determined at a fixed rate. Accordingly, the prepayment of the annual distribution payments constitutes "qualified payment" under § 2701(c)(3) and § 25.2701-2(b)(6)(i)(B).

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions of the Code or any other provision of the Code.

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,  
Christine E. Ellison  
Chief, Branch 7  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)