

**Internal Revenue Service**

**Department of the Treasury**

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:B03 - PLR-143782-02  
Date:  
April 24, 2003

Corporation =

GP Sub =

Partnership =

Business A =

State A =

State B =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

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a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

PLR-2 =

PLR-1 =

Dear :

This letter responds to your letter dated August 6, 2002, and subsequent correspondence, written on behalf of Corporation and Partnership as their authorized representative, requesting a ruling under § 7704 of the Internal Revenue Code.

**FACTS**

The information submitted provides that Corporation was incorporated in State A. Corporation is the parent of an affiliated group of corporations engaged (directly and through various joint ventures) primarily in Business A. Corporation is an accrual method taxpayer and accounts for long-term contracts on the percentage completion method. Corporation has a 52-53 week taxable year that ends on the last Saturday in December.

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Corporation has one class of common stock ("Common Stock") owned by approximately a shareholders, of which approximately b shares are expected to be outstanding at the end of Year 1. Pursuant to Corporation's restated certificate of incorporation and amended and restated by-laws, Common Stock generally may only be owned by employees and directors of Corporation, its subsidiaries and joint ventures (although not all employees are eligible to purchase Common Stock). A relatively small number of shares of Common Stock is owned by current employees of a business previously affiliated with Corporation. Corporation has a management arrangement with the previously affiliated business and, therefore, the efforts of the employees of this business indirectly benefit Corporation. All purchasers who acquire shares of Common Stock must sign a stock repurchase agreement that contains buy-sell and permanent transfer restrictions with respect to the Common Stock.

Corporation sells shares of Common Stock annually to eligible purchasers at a formula price based upon Corporation's adjusted book value (the "Common Stock Formula Price"). Common Stock cannot be traded on any established securities market, and holders of Common Stock are prohibited from transferring their shares of Common Stock in any manner except in a sale back to Corporation at the Common Stock Formula Price or in certain limited transfers to the following types of Permitted transferees, subject to the prior approval of Corporation's board of directors: (i) a tax-exempt charitable organization; (ii) a fiduciary for the benefit of the employee's spouse and/or children; (iii) a corporation 100 percent owned by the employee or by the employee together with such employee's spouse and/or children (a "Family Corporation"); and (iv) a fiduciary for the benefit of a Family Corporation or charity. Transferees in any such permitted transfers are subject to the same buy-sell and permanent transfer restrictions to which the original holder of the transferred shares was subject. In addition, employees are permitted to pledge shares of Common Stock as collateral for recourse loans in connection with the ownership of such shares, and many employees have done so.

Holders of Common Stock are permitted to offer to sell some or all of their shares of Common Stock back to Corporation during the first c days of each calendar month and except in unusual circumstances, Corporation must acquire and pay for the tendered shares within d days after the receipt of notice from the shareholder. When an employee retires, dies or otherwise terminates his employment with Corporation, Corporation issues a written notice requiring that all shares of Common Stock then owned by the employee and any Permitted transferees of such employee be sold back to Corporation at the Common Stock Formula Price (and Corporation is required to purchase all of such shares within d days after the date of the written notice). Corporation also has the right to purchase shares of Common Stock from an employee (and any Permitted transferee of such employee) in the event of (i) a voluntary sale of a

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portion of the Common Stock owned by the employee or such employee's permitted transferee, (ii) an attempted prohibited transfer of the Common Stock owned by the employee or such employee's permitted transferee, (iii) a determination by Corporation's board of directors that the employee or such employee's permitted transferee owns an excessive amount of Common Stock relative to the employee's contributions to the growth and performance of Corporation's business and (iv) a determination that an employee directly or indirectly owns more than e percent of the fully diluted shares of Common Stock on Date 1 of any year. The Common Stock Formula Price, as well as the buy-sell and permanent transfer restrictions described above, have been an integral part of the capital structure of Corporation for many decades.

The management of Corporation has determined that it is in the best interests of Corporation and its shareholders to convert Corporation into a limited partnership which will continue Business A. This conversion will be effectuated pursuant to the following transactions, some of which have already been completed (collectively, such transactions are referred to as the "Restructuring"):

(i) GP Sub was incorporated in State A on Date 2. On Date 3, an historic, indirect wholly-owned subsidiary of Corporation incorporated in State B merged with and into GP Sub with GP Sub surviving the merger.

(ii) Corporation will, under applicable state law, convert or merge most of its existing corporate subsidiaries into limited liability pass-through or disregarded entities for federal income tax purposes.

(iii) Corporation and GP Sub formed Partnership, a limited partnership organized under the laws of State A, on Date 4. GP Sub contributed cash to Partnership in exchange for the sole general partner interest in Partnership (which will represent an approximately f percent interest in the capital and profits of Partnership immediately after the Merger described in step (iv) below) and the assumption by Partnership of all of GP Sub's liabilities.

(iv) Corporation will merge with and into Partnership (the "Merger"), with Partnership surviving. In connection with the Merger, Corporation's shareholders will receive 100 percent of the limited partner interests in Partnership (which in the aggregate will represent an approximately g percent interest in the capital and profits of Partnership) and 100 percent of the shares of GP Sub, *pro rata*, in respect of their shares of Common Stock. Corporation has received a private letter ruling, PLR-2, from the Internal Revenue Service (the "Service"), modifying and supplementing an earlier private letter ruling that Corporation received from the Service, PLR-1, to the effect that Corporation will be treated as (1) directly transferring all of its assets (other than its stock in GP Sub), subject to its liabilities, to Partnership in exchange for the Partnership interests, and (2) distributing all of its Partnership interests and GP Sub shares to its

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shareholders in exchange for their Common Stock in a complete liquidation of Corporation.

Immediately following the Merger, GP Sub will be the sole general partner of Partnership and the former shareholders of Corporation will be the only limited partners of Partnership. Partnership and its lower tier entities will continue Business A which is currently being conducted by Corporation and its subsidiaries. It is anticipated that the employees who are currently employed directly by Corporation at its home office will perform services for GP Sub following the Restructuring, and the remaining employees who are currently employed by Corporation's lower tier operating entities (including joint ventures in which a lower tier entity of Corporation is a partner) will perform services for the lower tier corporation, partnership, joint venture or disregarded entity corresponding to the existing lower tier operating entity in Corporation's current structure. With respect to periods following the Restructuring, such employees, together with persons who join GP Sub, Partnership or Partnership's lower tier entities as employees after the Restructuring, employees of the business previously affiliated with Corporation, referred to above, and persons serving on the board of directors, are collectively referred to as "Employees," and individually as "Employee."

Immediately after the Restructuring, Partnership will have one class of limited partner interests outstanding (the "Common Interests"). Following the Restructuring, Partnership expects to issue additional Common Interests to eligible Employees for cash on an annual basis in a manner that is substantially similar to the annual sales of Common Stock that Corporation has undertaken for several decades, as described above. In addition, Partnership expects to issue for cash, on an annual basis, convertible preferred limited partner interests (the "Preferred Interests" and, together with the Common Interests, the "Partnership Interests") to certain key Employees (as determined by the board of directors and/or management of GP Sub) in exchange for cash. The purchase price for Common Interests (the "Formula Price") will be determined based on the book equity of Partnership, subject to certain adjustments.

Under the terms of Partnership's amended and restated agreement of limited partnership that govern the issuance, transfer and redemption of the Partnership Interests (the "Redemption/Repurchase Agreement"), an Employee is permitted to transfer (subject to the prior approval of GP Sub's board of directors/management) Common Interests to: (i) a fiduciary for the benefit of the Employee's spouse and/or children, (ii) a corporation, partnership or limited liability company or other entity 100 percent owned by the Employee and/or such Employee's spouse and/or children (a "Family Company") or (iii) a fiduciary for the benefit of a Family Company (each of the transferees described in clauses (i) through (iii), an "Authorized Transferee"). Such Authorized Transferees are subject to the same Formula Price buy-sell and permanent transfer restrictions applicable to the transferor Employees. Except as described herein, Preferred Interests are not transferable to any person except Partnership. The general partner interest held by GP Sub is non-transferable. Authorized Transferees

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may transfer Common Interests back to the original transferor Employee without the prior approval of GP Sub's board of directors, but subject to the e percent limitation of the Redemption/Repurchase Agreement safe harbor if no other safe harbor applies to such transfers.

An Employee or Authorized Transferee may pledge Common Interests or Preferred Interests as collateral for recourse loans in connection with the ownership of such interests, and many Employees are expected to do so. However, a creditor of an Employee or Authorized Transferee who has pledged Partnership Interests cannot become the beneficial owner of the pledged interests. In the event that an Employee or Authorized Transferee defaults on a loan with respect to which a Partnership Interest has been pledged, the Employee or Authorized Transferee may be required to sell such Partnership Interest back to the Partnership at the applicable Formula Price or Preferred Unit Price (as defined below), to the extent provided in the loan agreement entered into between the lender and the Employee or Authorized Transferee.

The Redemption/Repurchase Agreement further provides that Partnership will redeem (i) Common Interests from continuing Employees (*i.e.*, Employees who are not terminating their service providing relationship) or any Authorized Transferees of such continuing Employees upon request during the first c days of each month and (ii) Preferred Interests from continuing Employees upon request at any time. The Common Interests will be redeemed at the Formula Price and the Preferred Interests will be redeemed for the "Preferred Unit Price" which means, with respect to any Preferred Unit, the applicable purchase price as determined by the General Partner in its discretion at the time of issuance of such Preferred Unit, provided that such purchase price shall not be less than the Common Unit Price. The Preferred Unit Price will be reduced by the amount of any extraordinary distributions received with respect to such Preferred Interests and increased by any accrued and unpaid amount of the fixed return on such interests. Continuing Employees (and any Authorized Transferees of such continuing Employees) wishing to have Partnership Interests redeemed will be required to provide a written notice (a "Redemption Notice") and tender to Partnership the certificates for the interests to be redeemed. Except in unusual circumstances where such rights may be suspended, Partnership will repurchase and pay for the Partnership Interests to be redeemed no earlier than d days and no later than i days after the date on which Partnership receives the Redemption Notice and certificates. Partnership will not redeem Partnership Interests from continuing Employees (or any Authorized Transferees of such continuing Employees) to the extent that more than e percent of the total beneficial interests in partnership capital or profits (determined in accordance with § 1.7704-1(k) of the Procedure and Administration Regulations) would be transferred during that taxable year as a result of such redemption (taking into account the applicability of certain safe harbors from publicly traded partnership status under § 1.7704-1).

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Pursuant to the Redemption/Repurchase Agreement, Partnership will issue a written notice (a "Call Notice") indicating Partnership's intention to redeem Common Interests at the Formula Price and/or Preferred Interests at the Preferred Unit Price from an Employee (and any Authorized Transferees of such Employee) upon termination of the Employee's service providing relationship for any reason. Except in the case of the death of an Employee, Partnership will issue the Call Notice within j days of the date of termination. In the case of the death of an Employee, Partnership will issue the Call Notice to the estate, successor or personal representative of the deceased Employee (and any Authorized Transferee of such Employee) within k days of the date of death of the Employee. The person(s) receiving the Call Notice must sell the Partnership Interests then owned by such person(s) back to Partnership at the Formula Price or the Preferred Unit Price, as applicable. In each case, Partnership will repurchase and pay for the interests to be redeemed no later than d days after the date on which it issues the Call Notice. However, the estate, successor or personal representative of a deceased Employee (and any Authorized Transferee of such Employee) may elect to defer the redemption until Date 5 of the year following the year of the Employee's death in the case of Common Interests. In the case of Preferred Interests which would otherwise convert into Common Interests after the Employee's death but during the same year as the Employee's death, the estate, successor or personal representative of a deceased Employee (or any Authorized Transferee of such Employee) may elect to defer the redemption until either the normal conversion date for such Preferred Interests or until Date 5 of the year following the Employee's death.

Partnership will permit certain Employees who own significant amounts of Partnership Interests to have their Partnership Interests redeemed over the l-year period ending with the termination of their service providing relationship. Partnership may redeem Partnership Interests under the circumstances described in this paragraph even if more than e percent of the total beneficial interests in partnership capital or profits (determined in accordance with § 1.7704-1(k)) would be transferred during that taxable year as a result of such redemptions (taking into account the applicability of certain safe harbors from publicly traded partnership status under § 1.7704-1).

The Redemption/Repurchase Agreement also provides that if an Employee (or any Authorized Transferee of an Employee) attempts to make a prohibited transfer of any of such person's Partnership Interests, or voluntarily sells back to Partnership a portion of his Partnership Interests, Partnership has the option to purchase all or any part of the remaining Partnership Interests owned by such person at the Formula Price and/or the Preferred Unit Price, as applicable. For this purpose a prohibited transfer includes a transfer by operation of law to a person that is not an Authorized Transferee (such as a transfer to a former spouse in connection with a divorce). In the case of an attempted prohibited transfer, Partnership may exercise the call option and repurchase the Partnership Interests no later than d days after the date on which Partnership issues a Call Notice to an Employee (or any Authorized Transferee of the Employee).

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In the case of a voluntary sale of a portion of the Partnership Interests owned by an Employee or an Authorized Transferee of such Employee, Partnership may exercise the call option by issuing a Call Notice requiring the Employee or Authorized Transferee to tender all or a portion of the certificates relating to such person's remaining Partnership Interests (as specified by Partnership in the Call Notice). Partnership will then repurchase and pay for the specified Partnership Interests no later than d days after the date on which Partnership receives such Redemption Notice and certificates. In addition, any Employee whose ownership of Partnership Interests exceeds, on a fully diluted basis, e percent of the outstanding Partnership Interests on Date 1 of any year (taking into account Common Interests owned by any Authorized Transferee of such Employee) will be required to sell Common Interests back to Partnership at the Formula Price to the extent of such excess (although the Employee has the option to defer such redemption until Date 1 of the following calendar year). Partnership also has the right to require an Employee (or any Authorized Transferee of such Employee) to sell some or all of his Common Interests back to Partnership at the Formula Price if GP Sub's board of directors/management determines that the Employee (and any Authorized Transferee of such Employee) owns an excessive amount of Common Interests relative to the Employee's contributions to the growth and performance of the Partnership business. Partnership also has the right to require either or both of an Employee (or any Authorized Transferee of such Employee) to sell some or all of its Partnership Interests if either such Employee (or any Authorized Transferee of such Employee) fails to comply in any material respect with a tax return preparation program that Partnership will implement to provide for the preparation of tax returns of Partnership's limited partners. In each case, Partnership will issue a Call Notice to the Employee (or Authorized Transferee) whose Partnership Interests are to be redeemed, and will repurchase and pay for the interests to be redeemed no later than d days following the date on which Partnership issues the Call Notice.

Partnership may redeem Partnership Interests under the circumstances described in the immediately preceding paragraph even if more than e percent of the total beneficial interests in partnership capital or profits (determined in accordance with § 1.7704-1(k)) would be transferred during that taxable year as a result of such redemptions (taking into account the applicability of certain safe harbors from publicly traded partnership status under § 1.7704-1). However, Partnership will not redeem Partnership Interests under the circumstances described in the immediately preceding paragraph in any taxable year during which Partnership consummates redemptions made pursuant to voluntary redemption requests by continuing Employees (or Authorized Transferees of such continuing Employees) that would only qualify under the safe harbors of § 1.7704-1(f), if the total beneficial interests in partnership capital or profits transferred as a result of such voluntary redemptions and the redemptions described in the immediately preceding paragraph would exceed the percentage limitations of § 1.7704-1(f).

## **REPRESENTATIONS**



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Corporation has made the following representations:

- (a) Partnership has not elected and will not elect to be treated as an association taxable as a corporation pursuant to § 1.7701-3.
- (b) Except to any extent described herein, Partnership will not participate in any attempts to establish a market for Partnership Interests or to include any Partnership Interests on any market and will not recognize any attempted transfers of Partnership Interests that may be made on any market.
- (c) The Formula Price applicable to Common Interests will be established once for each taxable year of Partnership for purposes of § 1.7704-1(f)(2)(ii). The Formula Price will be adjusted downward one or more times during a taxable year to reflect certain distributions made to partners. The Preferred Unit Price applicable to any particular Preferred Interest will be established once during the h-year period in which each Preferred Interest is outstanding, subject to adjustment to reflect any extraordinary distributions.

## **ANALYSIS**

Section 7704(a) provides that a publicly traded partnership will be treated as a corporation.

Section 7704(b) provides that for purposes of § 7704, a publicly traded partnership means any partnership if interests in the partnership are (1) traded on an established securities market or (2) readily tradable on a secondary market or the substantial equivalent thereof.

Section 1.7704-1(b) provides that for purposes of § 7704(b), an established securities market includes: (1) a national securities exchange registered under § 6 of the Securities Exchange Act of 1934 (the "1934 Act"); (2) a national securities exchange exempt from registration under § 6 of the 1934 Act because of the limited volume of transactions; (3) a foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the 1934 Act; (4) a regional or local exchange; and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

Section 1.7704-1(c)(1) provides that for purposes of § 7704(b) and § 1.7704-1(c), interests in a partnership that are not traded on an established securities market are readily tradable on a secondary market or the substantial equivalent thereof if,

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taking into account all of the facts and circumstances, the partners are readily able to buy, sell or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

Section 1.7704-1(c)(2) further clarifies that for purposes of § 1.7704-1(c)(1), interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if: (i) interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests; (ii) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others; (iii) the holder of an interest in the partnership has a readily available, regular and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests in the partnership; or (iv) prospective buyers and sellers otherwise have the opportunity to buy, sell or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other provisions of § 1.7704-1(c)(2).

Section 1.7704-1(d) provides that for purposes of § 7704(b) and § 1.7704-1(c), interests in a partnership are not traded on an established securities market and are not readily tradable on a secondary market or the substantial equivalent thereof unless (1) the partnership participates in the establishment of the market or the inclusion of its interests thereon or (2) the partnership recognizes any transfers made on the market by (i) redeeming the transferor partner (in the case of a redemption or repurchase by the partnership) or (ii) admitting the transferee as a partner or otherwise recognizing any rights of the transferee, such as a right of the transferee to receive partnership distributions (directly or indirectly) or to acquire an interest in the capital or profits of the partnership.

Section 1.7704-1 provides certain safe harbors (described in paragraphs (e), (f), (g), (h) and (j) of § 1.7704-1) that allow certain types of transfers of partnership interests to be disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

Section 1.7704-1(c)(3) provides that the fact that a transfer of a partnership interest is not within one or more of the safe harbors described in paragraphs (e), (f), (g), (h) and (j) of § 1.7704-1 is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

Section 1.7704-1(e) provides a safe harbor for certain private transfers of partnership interests. Section 1.7704-1(f) provides a safe harbor for certain transfers of partnership interests made pursuant to a redemption or repurchase agreement as defined in § 1.7704-1(e)(3). Section 1.7704-1(j) provides a safe harbor for certain

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transfers of partnership interests if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in § 1.7704-1(e), (f) or (g)) do not exceed two percent of the total interests in partnership capital or profits, as determined in accordance with § 1.7704-1(k).

## **CONCLUSION**

Based solely on the facts submitted and the representations made, we conclude that Partnership will not, by reason of (i) the Restructuring and (ii) Partnership's issuance, permitted transfer and redemption arrangements, be treated as a publicly traded partnership within the meaning of § 7704(b).

Except as specifically ruled upon above, no opinion is expressed as to the federal tax consequences of the transactions described above under other provisions of the Internal Revenue Code.

This ruling is directed only to Corporation and Partnership. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to Corporation.

Sincerely yours,  
CHRISTINE ELLISON  
Chief, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter

Copy for section 6110 purposes