

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact: \_\_\_\_\_, ID No.

Telephone Number:

In Re:

Refer Reply To:  
CC:PSI:B04  
PLR-135385-05  
Date: MARCH 02, 2006

**LEGEND:**

Company =  
Agreement =

Amendment =  
Date 1 =  
Husband =  
Wife =  
Child 1 =  
Child 2 =  
Child 3 =  
Child 4 =  
a =  
b =

Dear \_\_\_\_\_ :

This is in response to your letter dated June 24, 2005 and other correspondence requesting a ruling concerning the application of section 2703 of the Internal Revenue Code to the proposed transaction.

The facts submitted are as follows. Company is engaged in an active business and is currently taxable as an "S" corporation for federal income tax purposes. The outstanding stock of Company consists of Class A common stock and Class B common stock. Husband and Wife own all the shares of Class A common stock as community property, which represents a% of all outstanding stock of Company. Children 1-4 each own 25% of the Class B common stock, which represents b% of all outstanding stock of Company. The Class A common stock and Class B common stock are identical in all

respects, except that Class A common stock has voting rights and Class B common stock does not have voting rights.

On Date 1 (prior to October 8, 1990), Children 1-4 and the Company entered into the Agreement entitled "Agreement between Corporation and Shareholders of Class B Common Stock of [Company]." The Agreement recites that "the shareholders are owners of all the outstanding Class B common stock of the Corporation." Section 1 of the Agreement provides, in relevant part, that no shareholder is to give, sell, assign, transfer, or in any way dispose of his or her shares without obtaining prior written consent of the Company and the other shareholders, unless the shareholder gives written notice of his intention to do so. For 180 days following notice to the Company, the Company has the option to purchase the shares for book value or for the purchase price (and upon the terms) stated in the notice, whichever is less, provided, however, that if the proposed transfer is by gift or without consideration the Company has the option to purchase the shares for book value. If the option is not exercised as to all shares set forth in the notice, notice of the proposed transfer is to be given to all shareholders, who shall have the option to purchase any shares not purchased by the Company at the same price and on the same terms and conditions as provided to the Company. In the event any shares of stock remain unpurchased after the date of exhaustion of all of the foregoing options to purchase, the Company has one last option to purchase the remaining unpurchased shares, to be exercised by the notice thereof given to the selling or transferring shareholder within 30 days after the date of exhaustion. If the Company and the other shareholders do not elect to purchase all the shares set forth in the notice of intention to transfer, all such shares may be purchased at any time within 90 days after expiration of the last possible date for election to purchase by the Company, on the terms specified in the notice.

Section 6 provides that upon the death of a shareholder, in the event the deceased shareholder gives, devises, or bequeaths any of his shares to his children or to one or more of his siblings, such heirs have the option to elect to retain ownership of such shares or to sell them to the Company for book value. The election to retain or sell the shares must be made within 120 days of the date of death, or the right of election will terminate, and the Company can thereupon have the option to elect whether to require the heirs to retain ownership of the shares, or to sell to the Company at book value.

Section 7 provides that in the event any person acquires an interest in shares of stock owned by a party to the Agreement, notwithstanding provisions in the Agreement to the contrary, through foreclosure, execution, divorce, bankruptcy or by any operation of law, the Company has the option to purchase those shares for book value.

Section 10 provides that each shareholder agrees that all of the terms and conditions of Agreement apply not only to shares presently held by the shareholder, but also to any future shares of Company later acquired by any such shareholder.

Section 16 provides that the provisions of Agreement may not be waived or changed except by a writing signed by the parties whom enforcement of the waiver or change is sought. The Agreement was signed by Children 1-4 as "shareholders" and by Husband and Wife on behalf of Company.

The owners of the Class B Common Stock of the Company and the Company propose to execute the First Amendment to Shareholders Agreement (Amendment). Section 1 of Amendment modifies Section 10 of Agreement to provide that each shareholder agrees that all of the terms and conditions of Agreement apply only to the shares of Class B common stock now or later held by any shareholder.

Section 2 of Amendment provides, in relevant part, that Amendment is conditioned upon, and is not to be effective until, Company has received a favorable letter ruling from the Internal Revenue Service stating that Amendment does not constitute a substantial modification of Agreement under section 25.2703-1(c)(1) of the Gift Tax Regulations.

It is represented that the Agreement was intended only to apply to the shares of Class B common stock.

You have requested a ruling that Amendment does not constitute a substantial modification of the Agreement for purposes of section 25.2703-1(c) and the Agreement remains exempt from the application of Chapter 14 of the Internal Revenue Code.

## LAW AND ANALYSIS

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 the property.

Under section 11602(e)(1)(A)(ii) of Public Law 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 in existence prior to October 8, 1990, that are "substantially modified" after that date. See also, section 25.2703-2.

Section 25.2703-1(c)(1) 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 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 no lower than the lowest generation occupied by individuals already party to the right or restriction.

Section 25.2703-1(c)(2) provides that a substantial modification does not include (i) a modification required by the terms of a right or restriction; (ii) a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction; (iii) a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and (iv) a modification that results in an option price that more closely approximates fair market value.

In this case, Agreement, which will be modified, applies only to the shareholders of the Class B common stock when it was executed on Date 1. The modification to section 10 clarifies that Agreement only applies to the shares of Class B common stock and not to Class A common stock. This modification is consistent with the terms of Agreement, is clarifying in nature, does not affect the quality, value or timing of any rights under the Agreement. Therefore, this change is not a substantial modification of the Agreement for purposes of section 25.2703-1(c). Thus, Agreement remains exempt from the application of Chapter 14.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

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George L. Masnik  
Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure:  
Copy of letter for section 6110 purposes