INTERNAL REVENUE SERVICE

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October 12, 2001

LEGEND:

LLC #1 =
LLC #2 =
Company =

This is in reply to your letter of March 26, 2001, submitted on behalf of LLC #1, in which rulings are requested regarding certain federal income tax consequences of the transactions described below.

The facts submitted are that LLC #1, which is a holding company that is considered a partnership for federal income tax purposes, owns real estate and 100 percent of two operating businesses, LLC #2 and LLC #3, both of which are "disregarded entities" for federal income tax purposes. LLC #1 is contemplating reorganizing this structure in order to facilitate a public offering of a portion of the restructured business.

Specifically, LLC #1 will contribute LLC #2's assets and their related liabilities into a newly formed C corporation ("Company") in exchange for 100 percent of the stock of Company. The resulting transaction, which would be a merger for state law corporate purposes, is intended to comply with the requirements of section 351 of the Internal Revenue Code and to be a tax-free reorganization. As such, it is anticipated that no gain or loss will be recognized on the transaction. LLC #1 will retain its real estate, its ownership of LLC #3, and their related liabilities.

Prior to the formation of Company, LLC#1 will amend its Operating Agreement to provide LLC #1 the right to redeem an LLC #1-owner's ("Owner") capital if the Owner ceases to provide services for LLC #1 or Company. Currently, there are no such provisions or any other restrictions on an Owner's capital account balances, other than those applying if an Owner resigns LLC #1 and then goes to work for one of its competitors. The Owner's redemption amount will be computed under a specified formula (to be determined), which will result in the Owner receiving substantially less than the fair market value of his or her capital account ("the below-market call provision"). The below-market call provision will lapse with respect to one-fourth of an Owner's capital account on each of the first four anniversaries of the public offering.

Imposing the below-market call provision will accord with both the advice of an investment banking firm and the judgment of LLC# 1’s management that such a provision would facilitate the public offering: *i.e.*, that the public offering will be more attractive to investors if key people in LLC #1 and Company are retained for a significant period thereafter. To that end, the below-market call provision would adversely affect Owners who leave the LLC #1 group within four years of the public offering, because they would resultantly forfeit a substantial portion of the value of their capital accounts.

After the corporate restructuring and the amendment of LLC #1’s Operating Agreement (as described above), Company intends to sell not more than 19.9 percent of its stock in a public offering of *new* Company stock, which would, thereby, dilute LLC #1’s then-current ownership of Company to that extent. Put another way, following the public offering, the public will own not more than 19.9 percent of Company’s stock, and LLC #1 will own the balance.

LLC #1 will retain the Company stock for at least one year following the public offering. Subject to various considerations including applicable securities law and lock-up restrictions (for example, the investment bankers may limit the amount of stock the Owners may sell so as not to disrupt the market for Company stock), LLC #1 intends to ultimately distribute its Company stock to the Owners. Because it is contemplated that such distributions may take as long as four years, it is anticipated that, when the Owners receive the Company stock, it will no longer be subject to the below-market call provision.

Under section 83(a) of the Code, if, in connection with the performance of services, property is transferred to any person other than the service recipient, *the excess of* the fair market value of the property (determined without regard to any "lapse restriction") on the first day that the transferee’s rights in the property are not subject to a substantial risk of forfeiture *over* the amount paid for the property is included in the service provider’s gross income for the taxable year which includes that day.

Stated differently, property is not taxable under section 83 until it is transferred to and substantially vested in the service provider (or beneficiary thereof). Until the property becomes substantially vested, the transferor of the property is considered to be the owner of the property, and any income from the property received by the service provider (or beneficiary thereof) constitutes additional compensation to the service provider for the taxable year in which it is received. See section 1.83-1(a)(1) of the regulations.

A "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction," as defined in section 1.83-3(i) of the regulations). See section 1.83-3(a)(1). The grant of an option to purchase property does not constitute a transfer of such property. See section 1.83-3(a)(2). Similarly, no "transfer" may occur where property is transferred under conditions that require its return upon the happening of an event that is certain to occur, such as the termination of employment.

Section 1.83-3(f) of the regulations provides that property transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance (or the refraining from performance) of services is considered "transferred in connection with the performance of services" within the meaning of section 83. The transfer of property is subject to section 83 if it is in respect of past, present, or future services.

For purposes of section 83 of the Code, property is "substantially *non*vested" when it is both subject to a "substantial risk of forfeiture" and is "nontransferable," within the meaning of sections 1.83-3(c) and (d) of the regulations, respectively. Property is substantially vested when it is either transferable or is not subject to a substantial risk of forfeiture. See section 1.83-3(b).

For purposes of section 83 of the Code, whether a risk of forfeiture is "substantial" depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person or the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Property is not subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture. See section 1.83-3(c)(1) of the regulations.

For purposes of section 83 of the Code, the rights of a person in property are "transferable" if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the transferee's rights in the property are not subject to a substantial risk of forfeiture. Accordingly, property is "transferable" if: (1) the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of the property, *and* (2) the transferee is not required to give up the property or its value in the event that the substantial risk of forfeiture materializes.
See section 1.83-3(d) of the regulations.

Here, it is represented that, at the time of the proposed transactions, each Owner of LLC #1 will already own a substantially-vested interest in his or her LLC #1 capital account. Accordingly, we conclude that the subsequent imposition of the below-market call provision on such accounts must necessarily be accomplished in the *absence of* a section 83 "transfer" (*i.e.*, the capital accounts are *already owned* for section 83 purposes), and, therefore, section 83 is not triggered as a result of those transactions.

Section 735(b) of the Code provides that, in determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of determining the five-year period under section 735(a)(2)), the holding period of the partnership with respect to such property (as determined under section 1223) is included.

Accordingly, applying the above law to the facts submitted, we rule as follows:

(1) Because, before the below-market call provisions are imposed on an Owner's capital account, his or her rights in the account will already be substantially vested, the addition of those provisions to LLC #1's Operating Agreement will not result in a "transfer of property" for section 83 purposes. Thus, the lapse of those provisions will not be a taxable event under the rules of that section.

(2) The Owners' holding periods of the Company stock that will be distributed to them by LLC #1 include LLC #1's holding period of such stock.

Except as ruled above, no opinion is expressed regarding the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. In particular, no opinion is expressed regarding application of the rules of section 731(c) of the Code to any distributions made by LLC#1. This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to Company's federal income tax return for the year in which the above rulings are granted. A copy is enclosed for that purpose.

Sincerely yours,
ROBERT B. MISNER
Acting Chief, Executive Compensation Branch
Office of the Division Counsel /
Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures (2):
Copy of this letter
Copy for 6110 purposes