Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:TL-N-4200-01
VLHamilton

date: AUG - 1 2001

to: Examination (LMSB)
Attn: Mike Brevig, LSMB Examiner

from: Area Counsel
(Natural Resources:Houston)

subject: **Statute Question in Connection with [redacted] Sale of Warrant**

This memorandum is in response to your request for guidance in connection with the above-referenced subject. We are sending you the memorandum at this time while simultaneously sending it to the National Office for post review. In this latter regard, we have requested that such review be expedited.

ISSUE

Whether the Service should extend the [redacted] statutes of limitations for the [redacted] (hereinafter the "Trust") and the [redacted] in connection with potential adjustments resulting from [redacted] sale of a stock warrant to the [redacted].

CONCLUSION

The Service does not need to extend the taxable year [redacted] statutes of limitations for the Trust or the [redacted] for purposes of the potential adjustments resulting from the sale of the stock warrant.

FACTS

[redacted] wholly owns the [redacted], which in turn wholly owns [redacted].[1] In

[1] On [redacted], [redacted] had its initial public offering, reducing [redacted]'s ownership of [redacted] to [redacted] percent. Through [redacted], [redacted] continued to own more than [redacted] percent of [redacted]'s

[redacted], [redacted] formed the [redacted] (hereinafter the "Trust") as an irrevocable complex trust to provide for the long term security of [redacted]'s grandchildren and descendants of more remote generations, and under exceptional circumstances, for the well-being of [redacted]'s spouse and children. Also on the same day, the [redacted] was formed. The two members are the Trust, owning [redacted] percent, and [redacted], owning [redacted] percent and acting as managing partner. The [redacted] is a TEFRA partnership, having one passthrough partner.

Effective [redacted], [redacted] sold to the [redacted] a warrant to acquire [redacted] shares of [redacted] stock at an exercise price of $[redacted] per share, exercisable on [redacted]. The [redacted] paid $[redacted] in cash for this warrant. Preliminary valuations of this transaction indicate that the warrant was undervalued by approximately $[redacted].

Both the Trust and the [redacted] have statute expiry dates of [redacted].

ANALYSIS

LAW

I.R.C. § 2501(a)(1) imposes a tax on the transfer of property by gift for each calendar year by an individual. Section 2511 provides that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible. Treas. Reg. 25.2511-1(c)(1) provides that the gift tax applies to gifts indirectly made, regardless of the means or device employed.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift and shall be included in computing the amount of the gifts made during the calendar year. Treas. Reg. § 25.2512-8 provides that transfers reached by the gift tax include sales and exchanges and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given.

Treas. Reg. § 25.2511-1(h)(1) provides examples of a

---

outstanding stock.

transfer that results in an indirect taxable gift, assuming that the transfer is not made for adequate and full consideration: "A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation." Further, "[a] transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation."

DISCUSSION

The difference between the fair market value of the warrant sold to the [redacted] by [redacted] in [redacted] and the amount received for the warrant (hereinafter the "bargain portion" was a gift by [redacted] to the Trust in [redacted]. [redacted] sold the warrant to the [redacted] at approximately $[redacted] below the fair market value of the warrant. The bargain portion of such a transfer of property is a transfer reached by the gift tax of section 2501. Treas. Reg. § 25.2512-8.

Although [redacted] sold the warrant to the [redacted] for gift tax purposes, the donor of the gift of the bargain portion is [redacted]. Treas. Reg. § 25.2511-1(h)(1) provides that a gift by a corporation is considered to be made by the shareholders of the corporation. In this case, the sole shareholder of [redacted] at the time of the sale was [redacted], another corporation. Again applying the same Treasury regulation, the result is that gift apparently made by [redacted] was made by the shareholder of [redacted] or [redacted].

Although [redacted] sold the warrant to the [redacted], the actual recipient of the bargain portion was the Trust; thus, [redacted]'s gift was to the Trust. The [redacted] was one percent owned by [redacted] and [redacted] percent owned by the Trust. Under Treas. Reg. § 25.2511-1(h)(1), a transfer of property by an individual to a corporation generally represents gifts by the individual to the other shareholders of the corporation to the extent of their proportionate interests in the corporation if the value received by the donor does not compensate the donor for the contribution. Kincaid v. United States, 682 F.2d 1220, 1224 (5th Cir. 1982). Similarly, a transfer to a partnership for less than full and adequate consideration may represent an indirect gift to the other partners if the donor partner does not receive commensurate value. See Shepherd v. Commissioner, 115 T.C. 376 (2000). The same principle should apply to a limited liability company which elected to be treated as a partnership.

In this case, [redacted] was indirectly a [redacted] per cent member of the [redacted] indirectly through his sole ownership of [redacted]. The Trust was a [redacted] percent member. The beneficiaries of the Trust are [redacted]'s grandchildren and remote descendants. [redacted] did not receive a

commensurate increase in his interest in the [redacted] as a result of the gift of the bargain portion.[2] Thus, under law, [redacted] made a gift of [redacted] percent of the bargain portion of $[redacted] to the Trust. Under this conclusion, [redacted] must file a gift tax return for the year [redacted] in the amount of [redacted] percent of the $[redacted] bargain element of the sale of the warrant, or $[redacted].

With this proposed gift tax adjustment affecting [redacted]'s gift return for [redacted], there are no correlative adjustments which the Service would need to make on the books of either the [redacted] or the Trust. Nor are any income tax implications with respect to the [redacted] or the Trust in connection with this transaction.[3]

---

[2] Although the issue of the bargain sale of the warrant to the [redacted] is newly proposed, given that the obvious purpose for the formation of the [redacted] and the Trust was to develop wealth for the benefit of [redacted]'s remote descendants outside of [redacted]'s ownership, it is unlikely that [redacted] would increase its interest in the [redacted] to compensate it for [redacted]'s gift.

[3] At this time, we do not believe there are any income tax implications in this transactions, e.g., a dividend to [redacted], because [redacted] had no retained earnings at the end of its taxable [redacted] year. There may, however, be an adjustment of [redacted]'s basis in the [redacted] stock and/or of [redacted]'s basis in the [redacted] stock. With these basis adjustments, or even assuming there is a dividend to [redacted] for the bargain portion, such adjustments would similarly have no income tax implications on the [redacted] year of the [redacted] or the Trust. We will develop this analysis at a later time.

Consequently, for purposes of protecting the Service, there is no need to control the [redacted] statutes of these two entities.

DAVID J. MUNGO
Associate Area Counsel (LMSB)

By:_____
VIRGINIA L. HAMILTON
Attorney (LMSB)