

**Internal Revenue Service**

Department of the Treasury

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CC:CORP:3 PLR-100119-02  
Date:  
June 11, 2002

Distributing =  
Controlled =  
Sub 1 =  
Sub 2 =  
Joint Venture =  
Sub 3 =  
Sub 4 =  
Sub 5 =  
Business A =  
Business B =  
Business C =  
State X =  
Date Y =  
Act =  
a =  
b =  
C =  
D =  
E =

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F =

Agency =

Dear :

This letter responds to your request dated December 26, 2001, for rulings on the federal income tax consequences of a proposed transaction. You submitted additional information in letters dated February 15, 2002, March 27, 2002, April 3, 2002, April 11, 2002, April 30, 2002, and May 13, 2002. The information submitted for consideration is summarized below.

Distributing, a State X corporation, is a closely held holding company and the common parent of an affiliated group of corporations filing a consolidated federal income tax return. It has three first tier subsidiaries, Controlled, Sub 1, and Sub 2. Distributing also holds an a percent interest in Joint Venture which is taxed as a partnership for federal income tax purposes. The other interest in Joint Venture is owned by an unrelated third party.

Controlled, a State X corporation, has one class of voting common stock outstanding. Controlled has been engaged in Business B in two locations in State X for more than five years. Sub 2 is engaged in a business activity directly related to Business B conducted by Controlled. Joint Venture is engaged in Business C, a business activity also directly related to Controlled's Business B.

The outstanding stock of Sub 1 is owned b percent (at least 80 percent) by Distributing. The remaining outstanding shares of Sub 1 stock are held by unrelated shareholders. For more than five years Sub 1, together with its wholly owned subsidiaries, Sub 3, Sub 4, and Sub 5, has been engaged in Business A as a C in various locations in State X. The Business A conducted by Sub 1 and its subsidiaries is governed by the provisions of the Act. Further, the activities of Sub 1 and its subsidiaries are subject to regulatory oversight by the D.

We have received financial information which indicates that Business A conducted by Sub 1 and Business B conducted by Controlled each has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Business A engaged in by Sub 1 and its wholly owned subsidiaries is subject to certain E limitations under the Act. While Sub 1 and its wholly owned subsidiaries have not exceeded these limitations at this time, Business A is approaching the limitations. Management of Sub 1 believes the greatest growth potential for Business A is in the part of Business A that is now subject to the E limitations of the Act. Further, Sub 1's management projects that unless action is taken soon, the E limitations would be exceeded by Date Y (within a year). In order to achieve the business growth objectives of Sub 1 without being subject to

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the E limitations of the Act, management desires to have Sub 1 change from being a C to an F. However, Sub 1 has been advised in writing by Agency, the department that would have the authority to review the operations of an F, that, in order for Agency to permit the conversion of Sub 1 from a C to an F, Distributing must first divest itself of Business B conducted by Controlled. We have received financial information demonstrating that the business growth will result in significant additional income.

Accordingly, in order to permit Sub 1 to convert its operations from a C to an F and thereby provide it with relief from the inhibiting E limitations and allow it to continue to expand its business operations, the following transaction has been proposed:

- (i) The stock of Controlled will be recapitalized and increased so that the number of shares of Controlled stock will equal the number of shares of Distributing outstanding. It has been represented that the recapitalization will qualify under § 368(a)(1)(E).
- (ii) Distributing will transfer the outstanding shares of stock of Sub 2 together with its a percent equity interest in Joint Venture to Controlled in constructive exchange for additional shares of Controlled stock.
- (iii) Distributing will distribute all of its Controlled stock pro rata to the Distributing shareholders (the "Distribution").
- (iv) Sub 1 will convert from a C to an F.

The following representations have been submitted in connection with the proposed transaction:

- (a) The Distribution is not part of a plan or series of related transactions (within the meaning of § 355(e)) pursuant to which one or more persons will acquire, directly or indirectly, stock possessing 50 percent or more of the total combined voting power of all classes of stock of Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.
- (b) The indebtedness owed by Controlled to Distributing after the Distribution will not constitute stock or securities.
- (c) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

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- (d) The five years of financial information submitted on behalf of Sub 1 is representative of Sub 1's present operation, and with regard to Sub 1, there have been no substantial operational changes since the date of the last financial statements submitted.
- (e) Immediately after the Distribution, the gross assets of the active business conducted by Sub 1 (as defined in § 355(b)(2)), will have a fair market value that is at least five percent of the total fair market value of the gross assets of Distributing.
- (f) Immediately after the Distribution, at least 90 percent of the fair market value of the gross assets of Distributing will consist of the stock and securities of a controlled corporation, Sub 1, that is engaged in the active conduct of a trade or business as defined in § 355(b)(2).
- (g) The five years of financial information submitted on behalf of Controlled is representative of Controlled's present operations, and with regard to Controlled, there have been no substantial operational changes since the date of the last financial statements submitted.
- (h) Immediately after the Distribution, the gross assets of the active business conducted by Controlled (as defined in § 355(b)(2)), will have a fair market value that is at least five percent of the total fair market value of the gross assets of Controlled.
- (i) Following the Distribution, Controlled and Sub 1 will each continue the active conduct of its business, independently and with its separate employees. Subsequent to the Distribution, it is anticipated that Sub 1 and Controlled will share a number of administrative services for a transitional period of not more than 12 months. Controlled will pay an arm's length fee to Sub 1 for the services.
- (j) The Distribution is being carried out for the following corporate business purpose: To permit Sub 1 to obtain relief from the E limitations imposed under the Act and regulations on its ability to expand and grow its Business A in the future. The Distribution is motivated in whole or substantial part by this corporate business purpose.
- (k) There is no plan or intention by any shareholder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either Distributing or Controlled after the transaction.
- (l) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.

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- (m) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.
- (n) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled (as determined under § 357(d) and taking into account the application of Rev. Rul. 80-323, 1980-2 C.B. 124).
- (o) The liabilities assumed in the transaction (as determined under § 357(d) and taking into account the application of Rev. Rul. 80-323) were incurred in the ordinary course of business and are associated with the assets being transferred.
- (p) Other than potential trade account indebtedness created in the ordinary course of business or for indebtedness resulting from an arm's length agreement for shared services for a transitional period of up to 12 months, no intercorporate debt will exist between Distributing (or its affiliates on the one hand) and Controlled (or its affiliates on the other hand) at the time of, or subsequent to, the Distribution.
- (q) Immediately before the Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations. Further, any excess loss account with respect to Controlled or Sub 2 stock will be included in income immediately before the Distribution.
- (r) Payments made in connection with all continuing transactions, if any, between Distributing (or its affiliates on the one hand) and Controlled (or its affiliates on the other hand), will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (s) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (t) Distributing is not an S corporation (within the meaning of § 1361(a)) and there is no plan or intention by Distributing or Controlled to make an S corporation election pursuant to § 1362(a) after the Distribution.

Based solely on the information submitted and the representations made, we hold as follows:

- (1) The transfer by Distributing of the stock of Sub 2 and its a percent interest in Joint Venture to Controlled in constructive exchange for additional shares of Controlled stock and the assumption of certain liabilities,

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- followed by the Distribution, as described above, will qualify as a reorganization under § 368(a)(1)(D). Distributing and Controlled each will be a “party to a reorganization” under § 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Distributing assets to Controlled in exchange for Controlled stock and the assumption of liabilities, as described above (§§ 361(a) and 357(a)).
  - (3) Controlled will recognize no gain or loss on the receipt of the Distributing assets in constructive exchange for Controlled stock, as described above (§ 1032(a)).
  - (4) Controlled's basis in each asset received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transfer (§ 362(b)).
  - (5) Controlled's holding period for each asset received from Distributing will include the period during which Distributing held such asset (§ 1223(2)).
  - (6) Distributing will recognize no gain or loss on the Distribution (§ 361(c)(1)).
  - (7) Distributing's shareholders will recognize no gain or loss (and no amount will be included in the income of Distributing's shareholders) upon the receipt of Controlled stock, as described above (§ 355(a)).
  - (8) The aggregate basis of the Distributing and Controlled stock in the hands of each Distributing shareholder after the Distribution will equal the shareholder's aggregate basis in his or her Distributing stock immediately before the Distribution, allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a)(1), (b) and (c)).
  - (9) The Distributing shareholders holding period of the Controlled stock received in the Distribution will include the holding period of the Distributing stock on which the distribution is made, provided that such Distributing stock is held by the Distributing shareholder as a capital asset on the date of the Distribution (§ 1223(1)).
  - (10) Earnings and profits will be allocated between Distributing and Controlled in accordance with §§ 1.312-10(a) and 1.1502-33(e)(3).
  - (11) Payments made by Distributing to Controlled or by Controlled to Distributing under the Tax Sharing Agreement that (a) have arisen or will arise for a taxable period ending before the Distribution or for a taxable period beginning on or before and ending after the Distribution, and (b) will not become fixed and ascertainable until after the Distribution, will be treated as occurring immediately before the Distribution.

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No opinion is expressed about tax treatment of the proposed transaction under any other provision of the Internal Revenue Code or Income Tax Regulations, or the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically addressed by the foregoing rulings.

This letter 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.

A copy of this letter should be attached to the federal income tax return of each taxpayer involved for the taxable year in which the proposed transaction is consummated.

Pursuant to a power of attorney on file with this office, we have sent a copy of this letter to the taxpayer and an authorized representative.

Sincerely yours,

*Ken Cohen*

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Ken Cohen  
Senior Technician Reviewer, Branch 3  
Office of Associate Chief Counsel  
(Corporate)

cc: