

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

September 30, 2002

In re:

Legend

Parent =

Acquiring =

State X =

DivisionC =

Sub0 =

Sub1 =

Sub2 =

Sub3 =

Sub4 =

Sub5 =

Sub6 =

Sub7 =

Sub8 =

Sub9 =

Partnership1 =

Partnership2 =

Partnership3 =

BusinessA =

BusinessB =

BusinessC =

BusinessD =

BusinessE =

BusinessF =

DateA =

DateB =

DateC =

DateD =

DateE =

p =

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Dear :

This letter responds to a letter dated 15 February 2002, requesting rulings concerning the federal income tax consequences of a proposed transaction. Additional information was provided in letters dated April 22, 2002, June 21, 2002 and July 17, 2002. The information submitted for consideration is summarized below.

Parent, a State X corporation, is a holding company that uses the accrual method of accounting and a calendar year and files a consolidated return with its subsidiaries. Through its subsidiaries, Parent is engaged in Businesses C, D, E, and F, and was engaged in Businesses A and B up until the time of the transactions described herein. Until fairly recently, Parent was directly engaged in BusinessC through its operation of DivisionC; however, the business and assets of DivisionC have since been transferred by Parent to Sub0. Parent has outstanding common stock, which is widely held and publicly traded.

Sub0, a State X limited liability company as to which an election pursuant to § 301.7701-3(c) of the Income Tax Regulations has been made and that uses the accrual method of accounting and a calendar year, is engaged directly in BusinessC. All the outstanding membership interests in Sub0 are held by Parent.

Sub1, at the time of the sale described herein, was a State X corporation and a holding company that used the accrual method of accounting and a calendar year. Sub1 directly or indirectly held all the stock in Sub2, Sub3, Sub4, Sub5, Sub6, Sub7, Sub8, and Sub9. (Sub1 together with Sub2, Sub3, Sub4, Sub5, Sub6, Sub7, Sub8, and Sub9 are hereafter referred to as Subs.) Subs2, 3, 4, 5, and 6 were primarily engaged in BusinessA. Subs7, 8, and 9 were primarily engaged in BusinessB, which is a smaller business than BusinessA. (BusinessA and BusinessB are together hereafter

referred to as BusinessesAB.) Sub1 also directly or indirectly held investment interests in Partnership1, Partnership2, and Partnership3, all of which engaged in business activities complementary to BusinessA. Sub1 was not engaged in day to day management of these partnerships. All the outstanding stock in Sub1 was held by Parent.

Distributing's BusinessA was subject to heavy competition and, in preference to making the significant capital investment necessary to compete more effectively in BusinessA, Parent sought and found a purchaser ("Acquiring") for BusinessesAB. In conjunction with Parent's sale of the BusinessesAB assets (including Subs) to Acquiring, the following steps ("Steps") have been completed, commenced, or are planned:

- (I) On DateA, Parent and Sub1 signed a definitive merger agreement with Acquiring as to the acquisition by a wholly owned subsidiary of Acquiring of all the outstanding stock of Subs and certain other assets in exchange for cash. The agreement provided for payment of an initial price with an adjustment after a post-closing audit. The agreement also provided that Parent would join with Acquiring in making elections under §§ 338(g) and 338(h)(10) of the Internal Revenue Code with respect to the acquisition of Sub1 and each target affiliate of Sub1.
- (II) On DateB, pursuant to the merger agreement, Parent sold the stock of Sub1 and related assets in exchange for the payment by Acquiring to Parent of p million dollars in cash ("Sales Proceeds Cash"), all of which cash Parent placed in an existing general account for the short period until DateC ("Initial Account").
- (III) In DateC, Parent moved all of the DateB Sales Proceeds Cash from Initial Account into a segregated account separate from all other accounts ("Separate Account").
- (IV) In DateD, the post-closing audit was completed and Acquiring paid Parent an additional pp million dollars in cash for a total of ppp million dollars.
- (V) In DateD, Parent deposited all of the post-closing cash (part of Sales Proceeds Cash) in Separate Account.
- (VI) On DateE, as required by the merger agreement, Parent jointly filed with Acquiring elections pursuant to §§ 338(g) and 338(h)(10) with regard to Sub1 and Sub1 target affiliates.
- (VII) SubO will merge into a newly formed State X limited liability

company ("LLC"). LLC will be wholly owned by Parent and will not elect to be treated as a corporation under § 301.7701-3(c) of the regulations.

- (VIII) Shortly after Step (VII), Parent will formally adopt a plan of contraction pursuant to which a portion of Sales Proceeds Cash will be distributed to its shareholders in one or more distributions ("Distributions of Sales Proceeds Cash") in exchange for the actual surrender, or deemed surrender, by shareholders of Parent stock. Parent plans to make the distributions by means of tender offers or open market purchases in exchange for actual surrenders of Parent stock. It is possible, however, that some distributions may be made pro rata to all shareholders without any actual surrender of Parent stock. The ppp million dollars cash received by Parent on the sales of Subs is decreased because over 40 percent of this amount has been, or will be, used by Parent for federal tax, state tax, and other expenses incident to the transaction. These taxes and other expenses for the transaction leave an amount remaining of approximately c million dollars of Sales Proceeds Cash. Of this c million dollars remaining, not less than d million dollars will be distributed to shareholders in all Distributions of Sales Proceeds Cash.

The following representations have been made in connection with the above transactions:

- (a) For the past 5 years: Parent through Subs had over 200 employees engaged in BusinessA, between 5 and 15 employees engaged in BusinessB, and (directly or indirectly through DivisionC, Sub0, and LLC) over 180 employees engaged in BusinessC.
- (b) There is no plan or intention for Parent directly, or indirectly (for instance, by holding stock in subsidiaries) to re-enter BusinessA or BusinessB.
- (c) There is no plan or intention for Parent to issue any type of Parent stock, except as may be required under employee stock option plans. Nor is there any plan or intention to increase Parent's market capitalization, except as a result of normal internal growth. In the event Parent acquires stock in other companies, it is planned and intended that such acquisitions will be made using cash, or debt, or in exchange for other Parent assets, rather than being made through the issuance of stock in Parent.
- (d) Both (i) the transaction in which Parent transferred the business

and assets of DivisionC to SubO and (ii) the Step (VII) transaction in which SubO is transferring the DivisionC business and assets to LLC are transactions that result in no change to the adjusted basis of the DivisionC assets.

- (e) If Parent's sale of Subs' stock to Acquiring were treated as a Sale of Subs assets, then the sale would consist mainly of BusinessesAB operating assets which were actively used in BusinessesAB and were not passive, investment, or substituted assets. (See Rev. Rul. 79-275, 1979-2 C.B. 137.)
- (f) If, immediately prior to the Step (II) sales, Parent were considered (i) to directly hold the businesses and assets of Subs, and to directly employ the employees of Subs and (ii) to directly hold the DivisionC business and assets held by LLC, and to directly employ the employees of LLC, then the Steps (II) and (VIII) sales and distributions would result in Parent having a reduction of over 20 percent in (a) gross income from directly held assets and operations, (b) directly held business operating assets, and (c) the number of persons employed directly by Parent. In addition, there have been comparable reductions in the business of the whole Parent affiliated group (within the meaning of § 1504(a)). For the Parent affiliated group as a whole, first, comparing the amount of net assets leaving the group (as Step (II) taxes incident to the sales and as Step (VIII) distributions to the shareholders) with the total amount of assets held by the affiliated group immediately prior to the Step (II) sales, and, second, comparing the income and employees of the affiliated group for the group's last full year prior to the year of the Step (II) sales with the group's income and employees in the period subsequent to the Step (VIII) distributions, there will be a reduction of over 20 percent in the affiliated group's (a) gross income (and also taxable income), (b) net fair market value of assets, and (c) employees.
- (g) The only assets received by Parent shareholders in the Step (VIII) distributions will be cash from the Sales Proceeds Cash held in Separate Account. The initial placement of the Sales Proceeds Cash in Initial Account (instead of being immediately placed in a separate account) and the retention of this cash in Initial Account from DateB until DateC was a temporary step that did not result in this cash being used in any business in any manner. At all times during the period between DateB and the deposit, in DateC, of the DateB Sales Proceeds Cash in the Separate Account, the DateB Sales Proceeds Cash can be traced to the contraction of

BusinessesAB and such cash has not been and will not be used in any of the remaining business activities of Parent. The entire amount of this cash that is being distributed by Parent to its shareholders in the Step (VIII) distributions is cash that can be shown to have never been used by Parent in any way, other than being placed in Treasury Bills and/or Notes, savings accounts, money market accounts, certificates of deposit, Federal National Mortgage Association notes, and similar short-term limited-risk investments. (See Rev. Rul. 79-275, 1979-2 C.B. 137, indicating that substituted assets do not qualify for partial liquidation treatment.)

- (h) The proceeds to be distributed to Parent's shareholders are from the sale of the active businesses conducted by Subs and are not attributable to an expansion reserve, a mere business decline, a mere decrease in the need for working capital, the sale of a nominal business, or the sale of a loss business.
- (i) All of the Step (VIII) Distributions of Sales Proceeds Cash will be commenced and completed during the taxable year in which the Step (VIII) plan of contraction is adopted or in the succeeding taxable year.
- (j) Except to the extent the Step (VIII) Distributions of Sales Proceeds Cash may be determined to be dividends, there are no declared but unpaid dividends on the stock being redeemed, and no cash dividend has been, or will be, declared in the period between DateA (the signing of the merger agreement) and the completion of the Step (VIII) distributions.
- (k) The amount of cash being distributed by Parent to its shareholders will be equal to the fair market value of the Parent stock surrendered (or deemed surrendered) by the shareholders in exchange therefor.
- (l) There is no plan or intention to completely liquidate Parent and it is planned that Parent will continue to be engaged directly in BusinessC by means of LLC, and to be indirectly engaged in BusinessesD and F through various subsidiaries. It is also possible that Parent will continue to be indirectly engaged in BusinessE; however, there is a possibility that BusinessE may be disposed of by Parent in a transaction unrelated to the present transaction.
- (m) Both Parent and the parent of Acquiring are widely held and there

is no shareholder who holds directly and indirectly 5% or more of the outstanding stock of both Parent and Acquiring. The contraction will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation ("Recipient") of any of the businesses or assets held directly or indirectly by Parent prior to the Step (II) sales, if persons holding more than 20 percent in value of the stock in Parent also hold more than 20 percent in value of the stock in Recipient. For purposes of this representation, ownership will be determined by application of the constructive ownership rules of § 318 as modified by § 304(c)(3).

- (n) There is no plan or intention on the part of the Parent shareholders to transfer any assets to Parent, Subs, or any related corporation (except for transfers of Parent stock to Parent in exchange for cash pursuant to Step (VIII) above).
- (o) None of the cash distributed by Parent to its shareholders pursuant to Step (VIII) will be received by any of the shareholders as a debtor, creditor, employee, or in any capacity other than as a shareholder.
- (p) In the 5 years preceding DateB, there were no substantial acquisitions of BusinessesAB assets by Parent or Subs.
- (q) Due to the nature of the businesses, there was no significant amount of inventory in BusinessesAB.
- (r) No prior formal or informal plans of contraction or of complete or partial liquidation have ever been adopted by Parent.
- (s) The fair market value of Parent's assets did, and will, exceed its liabilities and the liabilities to which its assets are subject on the date of adoption of the Step (VIII) plan and on the dates of the Step (VIII) distributions.
- (t) Each active business conducted by Subs has been continuously and actively conducted within the meaning of § 1.355-1(c) for the five-year period immediately preceding the date of the sale of Sub1 to Acquiring. The active business conducted by Parent at the time of the first contemplated distribution will have been continuously and actively conducted within the meaning of § 1.355-1(c) for the five-year period prior to the contemplated distributions and will continue to be actively conducted following the completion of all contemplated distributions.

- (u) The proceeds to be distributed in partial liquidation will be limited to the Sales Proceeds Cash, less taxes and expenses and less any income, gains or losses on the temporary investment of the Sales Proceeds Cash.
- (v) Parent will not distribute any assets that represent earned income to its stockholders, such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, or other assets resulting in an anticipatory assignment of income.

Based solely on the information submitted and the representations set forth above, and provided that the elections entered into by Parent and Acquiring with regard to the sale of Subs were valid elections under §§ 338(g) and 338(h)(10), we hold as follows:

- (1) The rulings that follow deal with the question whether Distributions of Sales Proceeds Cash by Parent to its shareholders constitute redemptions in partial liquidation treated as exchanges under subsection (4) of § 302(b). These rulings do not deal with the question whether these distributions constitute redemptions under subsections (1), (2), or (3) of § 302(b). Subsections (1), (2), (3), and (4) are not mutually exclusive, so that some distributions may qualify under more than one subsection. Also, any of the distributions that fail to qualify under subsection (4) may, nonetheless, qualify under one or more of subsections (1), (2), and (3).
- (2) With regard to each of Subs1, 2, 3, 4, 5, 6, 7, 8, and 9, provided a § 338(h)(10) election was properly and validly entered into with regard to the sale of such Sub's assets to Acquiring, then, as a result of the § 338(h)(10) election entered into by Acquiring, Parent, and Subs, each of the Subs is treated as having undergone a complete liquidation to which §§ 332 and 381 apply, with the assets (etc.) of each of the Subs being viewed as received by Parent and then sold by Parent to Acquiring in exchange for the Sales Proceeds Cash.
- (3) For purposes of making a § 302(b)(4) partial liquidation determination with regard to the Step (VIII) distributions from Parent to its shareholders, in light of the applicability of §§ 332 and 381 to Parent's receipt of Subs' assets (ruling 2, above): (i) for

each of the Subs, the separate corporate existence of the Sub will be disregarded, and the assets and activities of the Sub will be considered to be those of Parent and (ii) the transfer of Subs to Acquiring will be viewed as a transfer of the assets and activities of Subs from Parent to Acquiring (Rev. Rul. 75-223, 1975-1 C.B. 109, dealing with distributions in partial liquidation under § 346(a)(2), the predecessor of present § 302(b)(4) and (e)).

- (4) The proposed Distributions of Sales Proceeds Cash by Parent in cancellation of a portion of its stock (or under certain circumstances, a deemed surrender of stock by the shareholders), pursuant to the plan of partial liquidation, will be treated as distributions in partial liquidation under §§ 302(b)(4) and 302(e)(1) to the extent provided in rulings 7 and 8 below.
- (5) The placement by Parent of Sales Proceeds Cash in Initial Account when the Sales Proceeds Cash was received from Acquiring, and then the placement of this cash in Separate Account, with such cash being temporarily invested in limited risk assets, all as described above, will not change the identity or character of this money. For purposes of the Step (VIII) distributions, these temporary investments will not prevent the Sales Proceeds Cash from being considered the proceeds received by Parent from the Step (II) sales of Subs' assets, provided these temporary investments last, in total, no longer than 6 months.
- (6) In the event Parent distributes a portion of Sales Proceeds Cash pro rata to all its shareholders without there being an actual surrender of stock by such shareholders, then a portion of every share of Parent stock held by the shareholders will be deemed to have been surrendered by the shareholders to Parent in exchange for this distribution. The percentage of each share of stock deemed surrendered will be the amount of stock that has a fair market value equal to the amount of cash treated as received in exchange therefor. Accordingly, each shareholder will be required to decrease his, her, or its adjusted basis in each share of Parent stock held so as to reflect the amount of such stock's basis allocated to this pro rata exchange. (See Rev. Rul. 77-245, 1977-2 C.B. 105.)
- (7) Distributions of Sales Proceeds Cash by Parent to its shareholders in exchange for the surrender by the shareholders of Parent stock, pursuant to Step (VIII) and as described above, will constitute partial liquidation redemptions that are treated as exchanges under

§ 302(b)(4), provided that each of the three following conditions applies: (i) the redeemed shareholder is not a corporation, (ii) the cash distributed is the proceeds from the sale of operating assets ("Operating Asset Proceeds"), and (iii) the distribution occurs within the taxable year of Parent in which the plan of partial liquidation is adopted, or within the succeeding taxable year. For purposes of this ruling (7) the term "corporation" does not include individuals but does include "C" corporations and other appropriate entities and the term "Operating Asset Proceeds" includes that portion of the Sales Proceeds Cash that was received with regard to the Subs' business operations (including an appropriate amount of working capital), but does not include any portion of the Sales Proceeds Cash that was received with regard to a reserve for expansion, investment assets (including Sub1's interests in Partnership1, Partnership2, and Partnership3), or working capital in excess of that reasonably needed for business operations.

- (8) The maximum amount of the Sales Proceeds Cash that will be considered to be distributed in partial liquidation with respect to the sale of Parent's BusinessA and BusinessB equals the total amount of Sales Proceeds Cash, reduced by (i) all liabilities (including taxes and expenses) of Parent incurred in connection with the sale of such businesses and the proposed transaction, (ii) any income, gain or losses on the temporary investment of the Sales Proceeds Cash in the Initial Account and Separate Account, and (iii) that portion of the Sales Proceeds Cash that does not result from the sale of operating assets. This amount will not include any earned or accrued investment earnings on the Sales Proceeds Cash or amounts attributable to the covenant not to compete entered into between Parent and Acquiring. (See Rev. Rul. 60-262, 1960-2 C.B. 115; Rev. Rul. 71-250, 1971-1 C.B. 112; Rev. Rul. 76-279, 1976-2 C.B. 99; Rev. Rul. 76-289, 1976-2 C.B. 100.) Any amount distributed to the shareholders that is not considered to be distributed in partial liquidation in accordance with ruling 7 above and this ruling 8, or that otherwise fails to constitute a distribution in partial liquidation under § 302(b)(4), may constitute a distribution in redemption under § 302(b)(1), (2), or (3) that will be treated as in full payment for the stock redeemed (§ 302(a)), or, alternatively, depending on the circumstances of the particular shareholder, may be treated as a distribution of property under §§ 301 and 316.

- (9) For each shareholder, the amount of the distribution received by the shareholder that constitutes a distribution in partial liquidation under § 302(b)(4) will be treated as received by the shareholder as full payment in exchange for the shares of stock redeemed by the shareholder, as provided by § 302(a). Gain or loss will be recognized by the shareholder to the extent of the difference between the amount received in the partial liquidation distribution and the adjusted basis of the stock redeemed. Provided that the redeemed stock is a capital asset in the hands of the exchanging shareholder and that § 341(a) (relating to collapsible corporations) is not applicable, gain or loss will be considered capital gain or loss subject to the provisions and limitations of Subchapter P of Chapter 1 of the Code.

No opinion is expressed about the tax treatment of the transactions under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this letter are consummated.

Sincerely yours.

By _____
Lisa A. Fuller
Assistant Branch Chief, Branch 1
Office of Assistant Chief Counsel (Corporate)