

INTERNAL REVENUE SERVICE

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Distributing =

Founder =

Sub 1 =

Target 1 =

Target 2 =

Partnership 1 =

Partnership 2 =

Corp X =

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Corp Y = Corp Z =

Buyer =

Date 4 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

L =

m =

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n =

asset o =

asset p =

segment A =

segment B =

segment C =

business D =

business E =

business F =

This is in response to your request dated August 21, 1998 for rulings on the federal income tax consequences of completed and proposed transactions. Additional information was submitted in letters dated November 12, December 4, December 8, and December 31, 1998, and January 13, 1999. The information submitted for consideration is summarized below.

Distributing is a closely held, domestic corporation and the parent of a consolidated group of corporations. Sub 1 is a wholly owned subsidiary of Distributing and, prior to Date 4, Target 1 and Target 2 were wholly owned subsidiaries of Sub 1. Distributing's businesses are classified into three segments, segment A, segment B and segment C. Distributing has actively conducted each of its businesses for more than five years. Other than the three "Terminated Businesses" (business D, business E and business F (discussed below)), the remaining businesses in segment A, segment B and segment C which are conducted directly by Distributing (the "Retained Businesses") will continue to be actively conducted by Distributing.

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At Date 8 Distributing had outstanding b shares of Common Stock, c shares of Special Preferred Stock, d shares of Management Stock, e shares of Series A Employee Stock Ownership Plan ("ESOP") Common Stock, and f shares of Retiree Stock. While Distributing had authorized Preferred Stock and Special Management Stock, none were issued and outstanding at Date 8 (the Preferred Stock having been redeemed on such date). Each share of stock in all classes described above except Special Management Stock and Retiree Stock is entitled to one vote.

All c shares of Special Preferred Stock are held by Corp Z. All d shares of Management Stock are held, directly or indirectly, by more than g current officers, directors, and employees of Distributing or related corporations and members of their families. All f shares of Retiree Stock are held, directly or indirectly, by approximately h former officers, directors, and employees of Distributing or related corporations and members of their families. Founder's lineal descendants and their spouses and ex-spouses own, directly or indirectly through corporations or trusts of which they are the primary beneficiaries, all b outstanding shares of Common Stock of Distributing. All e outstanding shares of the Series A ESOP Common Stock are held by the Distributing ESOP, which is an employee stock ownership plan qualified under sections 401(a) and 4975(e)(7) of the Internal Revenue Code.

Distributing has determined to terminate three of its distinct businesses, business D, business E and business F. These three businesses were conducted by Target 1 and Target 2. Target 1 also owned an i percent limited partnership interest in Partnership 1, which was also engaged in business E. The remaining j percent interest in Partnership 1 was owned by an unrelated third party who acted as general partner.

The following transactions have been proposed and partially consummated:

- (i) On Date 4, Sub 1 distributed to Distributing all of the outstanding stock of Target 1 and Target 2.
- (ii) On Date 6, each of Target 1 and Target 2 adopted a plan of complete liquidation.
- (iii) On Date 7, Target 1 sold its interest in Partnership 1 to Corp X for \$ k million. Target 1 immediately distributed the \$ k million to Distributing.
- (iv) Prior to the Date 9 closing of the stock sale to Buyer (see step (v), below), Target 1 distributed to Distributing the following assets: (1) asset o; (2) its partnership interest in Partnership 2; (3) asset p; and (4) a minority interest in Corp Y (together, the "Retained Assets"). None of the Retained Assets were used by Target 1 as part of its active conduct of its business D, business E or business F.

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- (v) On Date 9, Distributing sold to Buyer, an unrelated party, all the outstanding stock of Target 1 and Target 2 for \$ L million. Distributing and Buyer will make an election under § 338(h)(10) to treat the stock sale as a sale of assets.
- (vi) Distributing adopted a plan of partial liquidation on Date 10.
- (vii) Distributing will make a non-pro rata distribution to certain non-corporate holders of its common stock of the net proceeds from the sale of the stock of Target 1 and Target 2 in the amount described in representations (h) and (n), below (the "Distribution"), in a transaction intended to qualify as a "partial liquidation" under § 302(b)(4) and 302(e) of the Code.
- (viii) For the tax year in which the proposed transaction occurs, Distributing will file with its federal consolidated corporate income tax return a statement electing the application of § 1.1502-13(f)(5)(ii)(C) of the Income Tax Regulations to the deemed liquidations of Target 1 and Target 2.

The taxpayer has made the following representations in connection with the proposed transaction:

- (a) Other than Target 2's business of holding the loans originated by business D, which was initiated during the past five years, though business D itself has been in operation since 1990, the businesses were continuously and actively conducted for the five-year period immediately preceding the date of the sale of assets of the Terminated Business and the Retained Business will continue to be actively operated.
- (b) The assets which were sold were actively used in business D, business E and business F.
- (c) All of the assets, the proceeds from the sale of which will be distributed to the shareholders, were actively used in operations at the time of the termination of business D, business E and business F. Such assets had been actively used for the past five years or were replacements of assets actively used for such period. No significant quantity of idle, passive or investment assets were sold.
- (d) The sale proceeds are from the sale of business D, business E and business F 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 a loss business.
- (e) As part of Distributing's long term strategy, Distributing has decided to exit business D, business E and business F. Distributing has determined that this business activity is no longer a good strategic fit with Distributing's other

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businesses. As capital constraints grow, Distributing has determined to reallocate capital to other areas of operations.

- (f) The non-pro rata partial liquidation allows Distributing's common shareholders the flexibility of deciding whether to liquidate a portion of their investment or to retain their current interests in Distributing.
- (g) All distributions pursuant to the plan of partial liquidation will be made in United States cash.
- (h) The proceeds to be distributed in partial liquidation will equal approximately \$ m million, which represents the proceeds from the sale of the stock of Target 1 and Target 2, less any losses on the temporary investment of the sales proceeds, less any amount allocated to a covenant not to compete with Buyer, less all expenses and taxes incurred on the sale and those incurred in connection with the distribution. The amount of cash distributed will be limited to the net proceeds from the sale of assets of the Terminated Businesses less all liabilities attributable to those assets retained or distributed in kind. No working capital will be distributed in the transaction.
- (i) All distributions pursuant to the plan of partial liquidation will be made within the taxable year in which the plan is adopted or within the succeeding taxable year.
- (j) The proceeds will be segregated in a special account and will not be used in Distributing's continuing business. The proceeds will be temporarily invested in savings accounts, money market certificates, certificates of deposit, mutual fund accounts or other similar liquid short-term investments.
- (k) No assets representing income earned on the short term investment of the proceeds will be distributed pursuant to the plan of partial liquidation.
- (l) All net proceeds from the sale of business D, business E and business F will be distributed.
- (m) The cash distributed represents the proceeds from the sale of business D, business E and business F, the assets of which were being actively used in a business and were not substituted assets.
- (n) The proceeds being distributed represent the proceeds from the sale of the stock of Target 1 and Target 2 (as to which an election under § 338(h)(10) will be made); thus, the proceeds from these sales are net of the liabilities of Target 1 and Target 2 (the "Sales Proceeds"). As of Date 9, Target 1 and Target 2's liabilities totaled approximately \$ n million. However, pursuant to the Stock

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Purchase Agreement, there may be adjustments made to the amount of Target 1 and Target 2's liabilities.

- (o) Distributing will not distribute any assets which represent earned income to shareholders, such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, or other assets resulting in an anticipatory assignment of income.
- (p) Distributing will not distribute any receivables to its shareholders.
- (q) Distributing will not distribute to the shareholders in partial liquidation any installment obligations, property described in former § 48, §§ 341(f), 617(d), 1245(a), 1248, 1250(c), 1252(a), or 1254, or LIFO inventory distributed pursuant to a plan adopted after December 31, 1981, or other assets the cost of which had previously been deducted for federal income tax purposes.
- (r) There are no declared but unpaid dividends on any of the stock to be redeemed by Distributing.
- (s) The cash distributed to each redeemed shareholder will be approximately equal to the fair market value of the stock surrendered by each shareholder in the exchange.
- (t) Distributing will receive consideration for an agreement not to compete with Buyer. The amount of consideration allocated to the covenant not to compete will be determined by Distributing and Buyer as part of the purchase price allocation to which the parties have agreed. The consideration allocated to the covenant not to compete will reduce the proceeds distributed pursuant to the plan of liquidation.
- (u) There is no plan or intention to completely liquidate Distributing or to sell or otherwise dispose of the assets of Distributing except in the ordinary course of business or as set out in this request for a ruling.
- (v) Distributing has no plan or intention to reenter business D, business E or business F or to expand its continuing business operations other than through normal internal growth.
- (w) The partial liquidation of Distributing will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation (Recipient) of any of the business or assets (other than cash) of Distributing, if persons holding more than 20 percent in value of the stock in Distributing also hold more than 20 percent in value of the stock in the Recipient.

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- (x) None of the consideration from Distributing will be received by a shareholder as a debtor, creditor, employee, or in some capacity other than that of a shareholder of Distributing.

Based solely on the information submitted and the representations set forth above, we hold as follows:

- (1) The Distribution will be treated as a distribution in partial liquidation under §§ 302(b)(4) and (e)(1), provided the Distribution is made in the taxable year in which the plan of partial liquidation is adopted or in the next succeeding year (§ 1.346-1(a)(2) and 1.346-1(b); Rev. Rul. 75-223, 1975-1 C.B. 109).
- (2) The maximum amount considered distributed in the partial liquidation will equal the Sales Proceeds from the sale of the stock of Target 1 and Target 2 (see step (v), above), reduced by all taxes and expenses of Distributing incurred in connection with the sale of Target 1 and Target 2. This amount will not include any earned or accrued investment earnings on the Sales Proceeds.
- (3) The Distribution will be treated as in full payment in exchange for the stock redeemed (§ 302(a)). Gain or loss will be recognized to Distributing's non-corporate shareholders to the extent of the difference between the amount distributed in the partial liquidation and the adjusted basis of the shares surrendered in exchange therefor. Provided that the Distributing stock is a capital asset in the hands of the Distributing shareholders and that § 341(a) (relating to collapsible corporations) is not applicable, gain or loss, if any, will be considered capital gain or loss subject to the provisions and limitations of Subchapter P of Chapter 1 of the Code.
- (4) Any amount distributed to the shareholders that exceeds the amount specified in ruling (2), above, or otherwise fails to constitute a distribution in partial liquidation under § 302(b)(4) may constitute a distribution in redemption under § 302(b)(1),

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- (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.
- (5) No gain or loss will be recognized to Distributing on the distribution to its shareholders of solely cash.
 - (6) Sub 1's intercompany gains, if any, from the distribution of the Target 1 and Target 2 stock will be taken into account upon the deemed liquidations of Target 1 and Target 2 pursuant to the § 338(h)(10) election (§ 1.1502-13(c)).
 - (7) Distributing's election under § 1.1502-13(f)(5)(ii)(C) will cause it to recognize losses, if any, from the deemed liquidations of each of Target 1 and Target 2. These losses, if any, to the extent allowed by § 1.1502-13(f)(5)(ii)(C)(2), will offset the intercompany gains, if any, taken into account by Sub 1 under ruling (6), above.
 - (8) Section 1.1502-20(a)(1) will not apply to Distributing's losses, if any, from the deemed liquidations of each of Target 1 and Target 2 to the extent the losses offset Sub 1's gains, if any, from the distribution of Target 1 and Target 2, respectively (§ 1.1502-20(a)(4)).

No opinion was requested and none is expressed as to whether, for federal income tax purposes, the granting of a covenant not to compete should be considered a separate transaction from the sale of Target 1 and Target 2 and, if separate, the fair market value of this covenant and the portion of the \$ i million properly allocable to this covenant. See § 4.02(1) of Rev. Proc. 98-3, 1998-1 I.R.B. 100, 108. The tax treatment of any portion of the \$ i million so allocable is not governed by the rulings in this letter, and no opinion is expressed as to the federal tax consequences to Buyer, Distributing, or the Distributing shareholders with regard to any amount allocable to this covenant.

No opinion is expressed about the tax treatment of the partial liquidation 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, these transactions that are not specifically covered by the above rulings. In addition, no opinion was requested and none is expressed as to whether Distributing's plan of partial liquidation should be considered adopted at the time it was formally adopted on Date 10, or should be considered to have been informally adopted at an earlier time. See Rev. Rul. 65-235, 1965-2 C.B. 88.

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

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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,

Assistant Chief Counsel (Corporate)

By Ken Cohen

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