

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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CC:CORP:2 – PLR-130001-03

Date:

September 30, 2003

Legend

Distributing =

Controlled =

State X =

Date 1 =

Date 2 =

Business A =

Business B =

S =

T =

U =

V =

W =

X =

Y =

Z =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Shareholder 5 =

Shareholder 6 =

Shareholder 7 =

Shareholder 8 =

Shareholder 9 =

a =

b =

c =

d =

e =

f =

g =

h =

i	=
j	=
k	=
l	=
m	=
Class R	=
Class S	=
Service A	=
Service B	=
Service C	=
X Period	=

Dear

This letter responds to your May 9, 2003 letter requesting rulings on certain federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated July 15, 2003, September 5, 2003 and September 30, 2003. The information submitted in such request and subsequent correspondence is summarized below.

Summary of Facts

Distributing, incorporated in State X on Date 1, files its federal income tax return on a 52/53-week fiscal year basis and uses the accrual method of accounting. Distributing, the parent corporation of Controlled, owns approximately S percent of Controlled's outstanding voting stock. Distributing does not join in the filing of a consolidated federal income tax return. Distributing is engaged in Business A.

Controlled, a subsidiary of Distributing, was incorporated in State X on Date 2. Controlled files its federal income tax return on a 52/53-week fiscal year basis and uses the accrual method of accounting. Controlled is engaged in Business B.

Distributing has T shares outstanding of common voting stock, which are owned by Shareholder 1 (a shares), Shareholder 3 (b shares), Shareholder 4 (c shares), Shareholder 5 (c shares), and Shareholder 6 (b shares). Distributing has U shares outstanding of common nonvoting stock, which are owned by Shareholder 1 (d shares), Shareholder 2 (d shares), Shareholder 3 (e shares), Shareholder 4 (f shares), Shareholder 5 (g shares), Shareholder 6 (h shares), Shareholder 7 (i shares), Shareholder 8 (j shares), and Shareholder 9 (k shares).

Controlled has outstanding V shares of voting common stock, which are owned by Distributing (l shares), Shareholder 3 (m shares), and Shareholder 7 (m shares).

Shareholder 1 is the chairman of the board of directors of Distributing and Controlled. Shareholder 3 is president of Distributing and Controlled. Shareholder 7 is vice president of Distributing and Controlled. Shortly after the Distribution, Shareholder 1 will relinquish his position on the board of directors of Controlled, Shareholder 3 will relinquish his position as president of Controlled, and Shareholder 7 will relinquish his position as vice president of Distributing.

Financial information has been submitted which indicates that Distributing and Controlled each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

The Proposed Transaction

Controlled has experienced a loss of business from customers who object to doing business with Controlled while Controlled is a subsidiary of Distributing. Controlled has submitted information indicating that its customer orders have significantly decreased due to Distributing's ownership of Controlled. Accordingly, to address these issues, the following transaction is proposed (the "Transaction"):

- (i) Distributing will contribute to Controlled an intercompany note receivable owed to Distributing by Controlled in exchange for Controlled stock and cash equal to the adjusted issue price of the note (the "Contribution").
- (ii) Controlled will amend its Articles of Incorporation to create two classes of stock, Class S with super-voting rights (W votes per share) and Class R with regular voting rights (1 vote per share) (the "Recapitalization"). In the Recapitalization, Controlled will issue X shares of Class S and Y shares of Class R. Immediately following the Recapitalization, Distributing will own approximately Z percent of the combined voting power of the outstanding stock of Controlled.
- (iii) Distributing will distribute all of its Class S shares to Shareholder 6, and Class R shares to Shareholder 5, Shareholder 6, and Shareholder 7 in proportion to their existing stock ownership of Distributing's nonvoting stock. In exchange for all of Controlled's Class S shares, Shareholder 6 will surrender all of her voting shares in Distributing. In exchange for the Controlled Class R shares,

Shareholder 5, Shareholder 6, and Shareholder 7 will surrender all of their nonvoting shares of Distributing stock (the "Distribution").

(iv) Shortly after the Distribution, Controlled will redeem all of the Controlled stock held by Shareholder 3 in exchange for an arms-length promissory note (the "Redemption").

Representations

The taxpayer has made the following representations concerning Distributing, Controlled, and the Transaction:

(a) The fair market value of the stock of Controlled received by Shareholder 5, Shareholder 6, and Shareholder 7 will be approximately equal to the fair market value of the Distributing stock surrendered by Shareholder 5, Shareholder 6, and Shareholder 7 in the exchange.

(b) No part of the consideration to be distributed by Distributing will be received by a Distributing shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

(c) The five years of financial information submitted on behalf of Distributing and Controlled represents their present operations, and with regard to Distributing and Controlled, there have been no substantial operational changes since the date of the last financial statement submitted.

(d) Following the Distribution, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, except with regard to Services A, B, and C. Within X Period of the Distribution, Distributing and Controlled will each perform Services A, B, and C independently and with separate employees.

(e) The Distribution will be carried out to eliminate customer conflicts arising from the perception of Controlled's customers and potential customers that Distributing's direct ownership of Controlled creates a conflict of interest. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.

(f) There is no plan or intention by the shareholders of either Distributing or Controlled to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after the Distribution, except by gifting shares of Distributing, as part of a well-established gifting program, to subsequent generations in an amount equal to the annual gift tax exclusion.

(g) There will be no cross gifting of shares that would result in Shareholder 6 or Shareholder 7 receiving Distributing shares or Shareholder 3 receiving Controlled shares.

(h) 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, 1996-1 C.B. 696, 705, except for the Redemption.

(i) 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.

(j) 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 plus any liabilities to which the transferred assets are subject. Controlled will not assume any liabilities of Distributing in connection with the Contribution.

(k) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Distribution.

(l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Transaction.

(m) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(n) Shareholder 5, Shareholder 6, and Shareholder 7 will not acquire any Distributing stock after the Transaction. Shareholder 5, Shareholder 6, and Shareholder 7 will not be shareholders, employees, officers, or directors of Distributing after the Transaction. Shareholder 1, Shareholder 2, Shareholder 3, Shareholder 4, Shareholder 8, and Shareholder 9 will not acquire any Controlled stock after the Transaction. Shareholder 1, Shareholder 2, Shareholder 3, Shareholder 4, Shareholder 8, and Shareholder 9 will not be shareholders, employees, officers, or directors of Controlled after the Transaction.

(o) Following the Distribution, the gross assets of Business A that Distributing relies on to satisfy the active trade or business requirement of § 355(b) will have a fair market value that is equal to at least 5 percent of the total fair market value of the gross assets of Distributing.

(p) Following the Distribution, the gross assets of Business B that Controlled relies on to satisfy the active trade or business requirement of § 355(b) will have a fair market value that is equal to at least 5 percent of the total fair market value of the gross assets of Controlled.

(q) Distributing is not an S corporation (under § 1361(a)), and neither Distributing nor Controlled expects or plans to make an S corporation election under § 1362(a) after the Transaction.

(r) For purposes of § 355(d), immediately after the Transaction, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(s) For purposes of § 355(d), immediately after the Transaction, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(t) The Transaction 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 either Distributing or Controlled entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

(u) Distributing and Controlled will allocate earnings and profits in accordance with § 312(h) and Treas. Reg. § 1.312-10(a).

Rulings

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

- (1) The Recapitalization will constitute a reorganization under § 368(a)(1)(E). Accordingly, no gain or loss will be recognized by Controlled on the Recapitalization.
- (2) No gain or loss will be recognized by the shareholders of Controlled on the Recapitalization. (§ 354(a)).
- (3) The basis of Controlled Class R and Class S stock received in the Recapitalization will equal the basis of the Controlled stock surrendered in the exchange. (§ 358(a)(1)).
- (4) The holding period for Controlled Class R and Class S stock received in the Recapitalization will include the period during which the shares of Controlled stock surrendered in the exchange were held, provided that the surrendered shares were held as a capital asset on the date of the exchange. (§ 1223(1)).
- (5) The Contribution and the Distribution will constitute a reorganization under § 368(a)(1)(D). Distributing and Controlled will each be a “party to a reorganization” within the meaning of § 368(b).
- (6) No gain or loss will be recognized by Distributing on the Contribution. (§ 361(a)).
- (7) No gain or loss will be recognized by Controlled on the Contribution. (§ 1032(a)). Controlled will not realize any discharge of indebtedness income on the Contribution. (§ 108(e)(8)).
- (8) No gain or loss will be recognized by Distributing on the Distribution. (§ 361(c)).
- (9) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) Shareholder 5, Shareholder 6, or Shareholder 7 on the receipt of Controlled stock in exchange for their Distributing stock. (§ 355(a)(1)).
- (10) The aggregate basis of the Controlled stock in the hands of Shareholder 5, Shareholder 6, and Shareholder 7 will, in each instance, equal the aggregate basis of the respective Distributing stock surrendered by the shareholder in the exchange. (§ 358(a)(1)).
- (11) The holding period of the Controlled stock received by Shareholder 5, Shareholder 6, and Shareholder 7 will, in each instance, include the holding period of the respective Distributing stock surrendered by the shareholders,

provided such stock is held as a capital asset on the date of the exchange.
(§ 1223(1)).

Caveats and Procedural Statements

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

This 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.

Each taxpayer involved in this transaction should attach a copy of this ruling letter to the taxpayer's federal income tax return for the taxable year in which the transaction covered by this letter is completed.

The rulings contained in this letter are based upon facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of this ruling request. Verification of the information, representations, and other data may be required as part of the audit process.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Gerald Fleming

Gerald Fleming
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel
(Corporate)

CC: