

**Internal Revenue Service**

Department of the Treasury

Number: **200303051**  
Release Date: 1/17/03  
Index Number: 337.14-00

Washington, DC 20224

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CC:CORP:1 - PLR-133233-02

Date:

October 16, 2002

Legend

Cooperative =

Subsidiary =

Utility W =

Year X =

Year Y =

Service Z =

Dear :

This letter responds to your May 8, 2002 request for rulings on certain federal income tax consequences of a proposed transaction. The following reflects information contained in that letter and subsequent correspondence.

**Summary of Facts**

Cooperative is a cooperative company that primarily provides Utility W. Before Year X, Cooperative qualified for tax exemption as an organization described in § 501(c)(12) of the Internal Revenue Code. Beginning in Year X and in each succeeding year through 2001, Cooperative has not claimed tax exemption under § 501(c)(12) because it determined that it did not meet the requirement that 85 percent of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses (the "85-Percent Test".)

Subsidiary, a wholly owned C corporation subsidiary of Cooperative, was formed in Year Y. In that year Subsidiary acquired assets used in Utility W, which it has provided from Year Y to the present time.

Cooperative now proposes to liquidate Subsidiary by means of a statutory merger into Cooperative (the "Liquidation").

There is a possibility that Cooperative will satisfy the 85-Percent Test after the Liquidation and therefore become a tax-exempt entity. However, Cooperative has supplied information that indicates that, based on the continuation of present business conditions, it is unlikely to meet the 85-Percent Test during 2003 and 2004 even after the Liquidation. These conditions include (a) that Cooperative's percentage of member income has declined over the past four years, and it would not have satisfied the 85-Percent Test in the years 1998 through 2001 even if Subsidiary's income were included in Cooperative's income; and (b) expected continued growth in Service Z, which is provided on a non-cooperative basis and which Cooperative intends to continue as a non-cooperative business.

### Law

Section 337(d)(1) authorizes regulations to prevent avoidance of corporate level gain by the use of a tax-exempt entity. Section 1.337(d)-4(a)(1) of the Income Tax Regulations provides that if a taxable corporation transfers all or substantially all of its assets to a tax-exempt entity, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market value. Under § 1.337(d)-4(a)(2), a taxable corporation's change in status to a tax-exempt entity will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the change in status becomes effective in a transaction in which § 1.337(d)-4(a)(1) applies (the "Change in Status Rule")

Section 1.337(d)-4(a)(3)(i)(E) provides an exception from the Change in Status Rule for a corporation previously tax-exempt under § 501(c)(12) which, in a given taxable year or years before again becoming tax-exempt, is a taxable corporation solely because the 85-Percent Test is not satisfied.

An anti-abuse rule in § 1.337(d)-4(a)(3)(iii) provides that the above exception from the Change in Status Rule does not apply to a corporation that, with a principal purpose of avoiding the application of the Change in Status Rule, acquires all or substantially all of the assets of a taxable corporation and then changes its status to that of a tax-exempt entity.

## **Ruling**

Based solely on the information submitted, we rule that if Cooperative changes its status to be tax-exempt under § 501(c)(12) by meeting the 85-Percent Test after the Liquidation, the Liquidation will not be considered to have had a principal purpose of avoiding the application of the Change in Status Rule under the anti-abuse rule in § 1.337(d)-4(a)(3)(iii), and Cooperative's return to tax-exempt status will qualify for the exception from the Change in Status Rule under § 1.337(d)-4(a)(3)(i)(E).

## **Caveats**

We express no opinion on (a) whether the Liquidation qualifies for nonrecognition of gain or loss under § 332; (b) whether the change in status of Cooperative to a tax-exempt entity, if it occurs, is a reorganization under § 368(a)(1)(E) or (F); and (c) whether Cooperative is operated according to cooperative principles. We also express no opinion on the federal income tax treatment of the proposed 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 proposed transaction that are not specifically covered by the above ruling

## **Procedural Statements**

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

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

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

Sincerely,

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Mark S. Jennings  
Chief, Branch 1  
Office of Associate Chief Counsel  
(Corporate)