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Person to Contact:

Telephone Number:

Refer Reply To:

CC:CORP:1-PLR-135510-02

Date:

October 24, 2002

LEGEND:

Distributing =

Controlled =

Corporation M =

Business X =

Business Y =

Applicable Federal Rules =

State A =

F =

Dear :

This letter responds to your letter dated June 25, 2002, in which you requested rulings regarding the federal income tax consequences of certain transactions. You submitted additional information in letters dated August 30 and September 16, 2002. The relevant information is summarized below.

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Distributing, a State A corporation, is the common parent of an affiliated group of corporations that files a consolidated federal income tax return. Distributing has issued and outstanding two classes of voting common stock: Distributing Class A Stock and Distributing Class B Stock. Distributing Class A Stock is publicly traded, and Distributing Class B Stock is privately held. The Distributing Class A Stock entitles shareholders to one vote per share, while the Distributing Class B Stock entitles shareholders to F votes per share. The Distributing Class B Stock is subject to certain limitations on transfer, but is convertible at any time to Distributing Class A Stock on a share-for-share basis. The Distributing Class A and Class B Stock are identical in all other material respects.

Distributing is a holding company that is engaged in Business X through Corporation M and its subsidiaries. Controlled, which is also a State A corporation, is engaged in Business Y. Controlled currently has one class of common stock outstanding (Controlled Common Stock), all of which is owned by Distributing.

We have received financial information indicating that Distributing, through its ownership of Corporation M, and 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.

Distributing has proposed separating Distributing and Controlled in order to qualify Corporation M as a small business supplier under the Applicable Federal Rules for government procurement. Corporation M presently does not qualify as a small business supplier under the Applicable Federal Rules because its affiliation with Controlled has caused Corporation M to exceed the maximum number of employees for Corporation M's industry. We have received information indicating that Corporation M's failure to qualify as a small business supplier has harmed Business X, and that the separation of Distributing and Controlled would enhance the success of Business X by enabling Corporation M to immediately qualify as a small business supplier under the Applicable Federal Rules.

To accomplish the separation of Distributing and Controlled, Distributing has proposed the following transactions:

- Step 1. Controlled will amend its certificate of incorporation to authorize the issuance of shares of Controlled Class A Stock and Controlled Class B Stock. The terms of the Controlled Class A and Class B Stock will be substantially similar to the terms of the Distributing Class A and Class B Stock, respectively. Immediately before Step 2, Distributing will exchange its Controlled Common Stock for all of Controlled's Controlled Class A and Class B Stock (the "Recapitalization").

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- Step 2. Distributing will distribute to its shareholders on a pro rata basis all of the Controlled Class A and Class B Stock (the “Spin-off”). Each Distributing shareholder will receive one share of Controlled Class A Stock with respect to each share of Distributing Class A Stock held by the shareholder, and one share of Controlled Class B Stock with respect to each share of Distributing Class B Stock held by the shareholder.

The following representations have been made with respect to the Recapitalization:

- (a) At the time of the Recapitalization, there will be no outstanding stock options, warrants, convertible securities, or any other right that is convertible into any class of stock or securities of Controlled.
- (b) Controlled has no plan or intention to redeem or otherwise acquire any of the stock to be issued in the proposed transaction.
- (c) Controlled will continue to conduct its business operations after the Recapitalization.
- (d) Controlled and Distributing will each pay their own expenses, if any, incurred in connection with the Recapitalization.
- (e) The fair market value of the stock to be received by Distributing will be equal to the fair market value of the stock surrendered in the exchange.

The following representations have been made with respect to the Spin-off:

- (a) Controlled and Distributing will each pay their own expenses, if any, incurred in connection with the transaction.
- (b) 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 Distributing shareholder.
- (c) The five years of financial information submitted on behalf of the active businesses of Corporation M and Controlled is representative of each business's present operations. With regard to each corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Immediately after the distribution, at least 90% of the fair market value of the gross assets of Distributing will consist of the stock of Corporation M, which is actively engaged in the conduct of Business X.

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- (e) Following the Spin-off, Corporation M and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (f) The distribution of the stock of Controlled is carried out for the corporate business purpose of qualifying Corporation M as a small business. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (g) There is no plan or intention by any shareholder who owns five percent or more of the stock of Distributing, and the management of Distributing, to its best knowledge, is not aware of any plan or intention on the part of any remaining shareholder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any stock in either Distributing or Controlled after the transaction.
- (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 section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.
- (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) Payments made in connection with all continuing transactions 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.
- (k) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock, except that Controlled will continue to be responsible for its share of benefits under a non-qualified retirement plan.
- (m) 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. See Treas. Regs. § 1.1502-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and Treas. Regs. § 1.1502-13 as published by T.D. 8597. Further, Distributing's excess loss account, if any with respect to the Controlled stock will be included in income immediately before the distribution. See Treas. Regs. § 1.1502-19.

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- (n) Neither Distributing nor Corporation M will cause Corporation M to lose its status as a small business supplier under the Applicable Federal Rules during the three-year period following the Spin-off.

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

- (1) The exchange by Distributing of its Controlled Common Stock for Controlled Class A Stock and Controlled Class B Stock will qualify as a reorganization under section 368(a)(1)(E). Controlled will be a “party to a reorganization” within the meaning of section 368(b).
- (2) No gain or loss will be recognized by Distributing on the exchange of its Controlled Common Stock for Controlled Class A Stock and Controlled Class B Stock. Section 354(a).
- (3) The basis of the Controlled Class A and Class B Stock received in the Recapitalization will equal the basis of the Controlled Common Stock surrendered in exchange therefor. Section 358(a)(1).
- (4) The holding period of the Controlled Class A Stock and Controlled Class B Stock received in the Recapitalization will include the period during which Distributing held the Controlled Common Stock surrendered in the exchange, provided that the surrendered stock is held as a capital asset on the date of the exchange. Section 1223(1).
- (5) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders on their receipt of Controlled stock. Section 355(a).
- (6) No gain or loss will be recognized by Distributing on the distribution of Controlled stock to Distributing shareholders. Section 355(c).
- (7) The aggregate basis in Distributing and Controlled stock held by each Distributing shareholder will equal the aggregate basis of such shareholder’s Distributing stock immediately before the distribution, allocated in proportion to the fair market value of each in accordance with Treas. Reg. § 1.358-2(a). Sections 358(a)(1), (b), and (c).
- (8) The holding period of the Controlled stock received by each Distributing shareholder will include the holding period for the Distributing stock with respect to which the distribution is made, provided that the Distributing stock is held as a capital asset on the date of the distribution. Section 1223(1).

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- (9) The earnings and profits of Distributing and Controlled will be allocated and adjusted as provided in section 312(h) and Treas. Regs. §§ 1.312-10(b) and 1.1502-33(e)(3).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as part of the examination process. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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. A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Michael J. Wilder
Senior Technician Reviewer, Branch 1
Office of Associate Chief Counsel (Corporate)