

Internal Revenue Service

Department of the Treasury

Number: **200103037**
Release Date: 1/19/2001
Index Number: 355.01-00

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:CORP:3-PLR-112054-00
Date:
October 20, 2000

Distributing =
Controlled =
Holding =
State L =
State M =
business x =
business y =

Shareholder C =
Date 1 =
Date 2 =

a =

This letter responds to a letter dated June 12, 2000 requesting rulings about the federal income tax treatment of a proposed and partially consummated transaction. We have received additional information in letters dated August 16, September 28, and October 18, 2000. The information submitted for consideration is summarized below.

Distributing is a publicly traded State L corporation and the common parent of an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis using an accrual method of accounting. Distributing has one class

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of voting common stock outstanding which is widely held and publicly traded. There are currently no shareholders who own five percent or more of the outstanding shares of Distributing common stock. Distributing directly, and indirectly through its subsidiaries, engages in business x.

Distributing owns all of the stock of Holding, a State M corporation which functions as a holding company. Holding, in turn, owns most of the stock of Controlled, a state M corporation. On Date 2, Holding transferred business y to Controlled.

At the time of the distribution, Controlled will have two classes of voting common stock authorized and outstanding: Class A and Class B. Holding owns all of the Class A common stock. Ownership of all of the Class A stock represents "control" as described in § 368(c). The Class B common shares are held by employees of Controlled. In addition to Holding, Controlled has one five percent shareholder, Shareholder C. Controlled uses the accrual method of accounting.

Financial information has been received which indicates that business x and business y 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 believes that Controlled must obtain capital to meet the needs of business y. In order to raise capital to effect its plans, Controlled proposed to undertake an equity offering of Class B common stock. The management of Distributing concluded, based upon documentation provided by its investment banker, that an equity offering would be significantly more effective if, as part of the offering, investors were informed that Controlled would be separated from Distributing.

To accomplish these objectives, the taxpayer has proposed, and partially consummated, the following transaction (the "Proposed Transaction"):

- (i) Controlled amended its Certificate of Incorporation to increase the number of authorized shares of Class A and Class B common stock and to effect a stock split with respect to all of the issued and outstanding shares of Class A and Class B common stock in a transaction intended to qualify under § 368(a)(1)(E).
- (ii) On Date 1, Controlled sold a shares of Class B common stock to the public (the "IPO"). Holding continued to hold shares of Controlled representing "control" as described in § 368(c) after the IPO. The proceeds will be used solely to fund the expansion of business y.
- (iii) Distributing will effectuate the liquidation of Holding through a merger of Holding with and into Distributing in a transaction intended to qualify under §§ 332 and 337.

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- (iv) As soon as practicable after receipt of this ruling letter, Distributing will distribute all of its stock of Controlled to its shareholders on a pro rata basis, except Distributing will not distribute fractional share interests of Controlled common stock. Instead, cash in lieu of fractional shares will be paid to the shareholders entitled to fractional shares of Controlled stock. Distributing's distribution agent will aggregate fractional share interests into whole shares and the agent will sell these shares on the open market. The agent will then remit the cash to the Distributing shareholders otherwise entitled to receive fractional share interests of Controlled common stock (the "Distribution").

With respect to the Proposed Transaction, the taxpayer has made the following representations:

- (a) No part of the consideration to be distributed by Distributing will be received by any Distributing shareholder as a creditor, employee or in any capacity other than that of a shareholder of the corporation.
- (b) The five years of financial information submitted on behalf of Distributing with respect to business x are representative of its present operation of such business, and there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) The five years of financial information submitted on behalf of Controlled with respect to business y are representative of its present operation of such business, and there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) The liquidation of Holding will qualify for tax-free treatment under §§ 332 and 337.
- (e) Following the Distribution, Distributing and Controlled will each continue the active conduct of its respective business, independently and with its separate employees.
- (f) The Distribution is carried out for the following corporate business purpose: to allow Controlled to issue equity on significantly enhanced terms. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (g) No person 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 by any particular Distributing shareholder to sell, exchange, transfer by gift or otherwise dispose of any of its stock of either Distributing or Controlled after the Distribution.

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- (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 Distribution, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.
- (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 Distribution, except in the ordinary course of business.
- (j) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution of the stock of Controlled other than accounts payable incurred in the ordinary course of business.
- (k) The IPO of Controlled Class B common stock resulted in the deconsolidation of Controlled and its subsidiaries from the Distributing group. Immediately before the IPO, items of income, gain, loss, deduction, and credit, if any, will be taken into account as required by the applicable intercompany transaction regulations. Further, any excess loss account with respect to the Controlled stock, or stock in Controlled direct or indirect subsidiaries will be included in income immediately before the IPO.
- (l) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled or their affiliates, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (m) Cash will be distributed in lieu of fractional shares. The cash will be provided through a sale by a distribution agent of aggregated fractional shares of Class A common stock. The sale of fractional shares is merely a method of rounding off fractional share interests, and is undertaken solely for the purpose of avoiding the expense and inconvenience of issuing and transferring fractional shares and does not represent separately bargained for consideration. The method used for handling fractional share interests is intended to limit the amount of cash received by any one shareholder to less than the value of one full share of Class A common stock.
- (n) The Distribution will be consummated within the later of (i) six months following the IPO or, (ii) three months after the date of this letter.
- (o) The Distribution 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, or stock

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possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

- (p) The transfer of property from Holding to Controlled on Date 2 qualified as a tax-free § 351 exchange in which no gain or loss was recognized.
- (q) No property will be transferred and no liabilities will be assumed in the Proposed Transaction.

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

- (1) No gain or loss will be recognized by Distributing upon the distribution of the Controlled stock to the Distributing shareholders (§ 355(c)).
- (2) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon their receipt of Controlled stock in the Distribution (§ 355(a)(1)).
- (3) The aggregate basis of the Distributing stock and the Controlled stock (including fractional interests in Controlled to which a Distributing shareholder may have been entitled if cash were not distributed in lieu thereof) in the hands of each Distributing shareholder immediately after the Distribution will be the same as the shareholder's basis in his or her stock of Distributing immediately before the Distribution, allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a)(1), (b) and (c)).
- (4) The holding period of the Controlled stock (including fractional shares, if any, to which the Shareholder would otherwise have been entitled) received by the Distributing shareholders in the Distribution will include the holding period of the Distributing stock with respect to which the Distribution is made, provided that such shares of Distributing stock are held as a capital asset on the date of the Distribution (§ 1223(1)).
- (5) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(b) of the Income Tax Regulations.
- (6) Any payment of cash in lieu of fractional shares of Controlled stock will be treated for federal income tax purposes as if the fractional shares were issued in the Distribution and then were redeemed by Controlled. The cash payments will be treated as having been received as a distribution in full payment in exchange for the shares redeemed as provided in § 302(a). Provided the fractional share interest is a capital asset in the hands of the recipient shareholder, the gain or

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loss will constitute capital gain or loss subject to the provisions and limitations of Subchapter P of Chapter 1. Rev. Rul. 66-365, 1966-2 C.B. 116; Rev. Proc. 77-41, 1977-2 C.B. 574.

No opinion was requested and no opinion is expressed about 1) the recapitalization of Controlled stock described in paragraph (i), above, 2) the liquidation of Holding described in paragraph (iii), above, or 3) the transfer of business y to Controlled on Date 2. Additionally, we express no opinion about the tax treatment of the Proposed Transaction 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 Proposed Transaction that are not specifically covered by the above rulings.

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 rulings. It is subject to verification on examination.

This ruling letter 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 affected taxpayer must attach a copy of this letter to the taxpayer's federal income tax return for the tax year in which the transaction covered by this ruling letter is consummated.

We have sent a copy of this letter to Distributing and the authorized representative designated on the power of attorney on file in this office.

Sincerely yours,
Associate Chief Counsel (Corporate)

By: *Ken Cohen*

Acting Chief, Branch 3