

Internal Revenue Service

Department of the Treasury

Number: **200129007**
Release Date: 7/20/2001
Index Number: 355.00-00, 368.05-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP:1- PLR-120938-00

Date:
April 16, 2001

RE:

Distributing =

Controlled =

Father =

Mother =

Son A =

Daughter =

Son B =

Shareholder =

GRAT 1 =

GRAT 2 =

GRAT 3 =

ESOP =

Business 1 =

Business 2 =

Year 1 =

Year 2 =

This is in response to your letter dated October 13, 2000, in which you requested rulings on the federal income tax treatment of the transactions described below. Specifically, you requested rulings under section 355 of the Internal Revenue Code. Additional information regarding your request has been submitted in subsequent letters dated January 11, March 12, March 28, and April 9, 2001. The information submitted for our review is summarized below.

Distributing is an accrual basis corporation that is the common parent of a consolidated group. Distributing engages in Business 1 and Business 2. Distributing has outstanding 1,000,000 shares of "Class A" voting common stock that are owned by Father (43.2%); Mother (15%); GRAT 1 (4.2%); GRAT 2 (3.5%); GRAT 3 (4.1%); and ESOP (30%). Distributing also has outstanding 1,016,778 shares of "Class B" nonvoting common stock that are held by Father (0.4%); Mother (15%); Son A (4.5%); Daughter (3.2%); Son B (3.2%); Shareholder (3.7%); GRAT 1 (10.7%); GRAT 2 (12.7%); GRAT 3 (12.1%); and ESOP (34.5%).

Controlled is an accrual basis State X corporation formed to effectuate the proposed transaction. Controlled has initially outstanding 100 shares of voting common stock ("Controlled Common Stock"), all of which is held by Distributing.

Financial information has been received which indicates that Business 1 (Distributing's active business) and Business 2 (Controlled's active business) have had gross receipts and operating expenses representative of the active conduct of a trade or business.

Son A has been the President and Chief Executive of Distributing's Business 2 division since Year 2 and has directed Business 2 from its inception in Year 1. Son A's many years of specialized research and professional experiences represent the basis for the Business 2 technology. Son A's insight and experience is critical for determining Business 2's future focus and direction. As President and CEO of the Business 2 division, Son A directs the daily development of all new research and technologies, and oversees the operation of Business 2. Son A has made key decisions up to this point and Business 2's future is largely tied to the identification of productive new research areas and technologies. In Son A's absence, these critical tasks and the direction of Business 2 would be significantly diminished.

To enable the key employee of Distributing (Son A) to receive a significant equity interest in Business B, Distributing intends to separate Businesses A and Business B in the following transactions:

- Step 1: In anticipation of this transaction, Distributing transferred to Controlled all of the assets of Business B, subject to liabilities, in exchange for Controlled stock.

- Step 2: The outstanding capital stock of Controlled will be recapitalized (“Recapitalization”) to increase the number of authorized shares of Controlled Common Stock and to authorize issuance of a new class of preferred stock (“Controlled Preferred Stock”). The Controlled Preferred Stock will have liquidation and dividend preference. After payment of the preferences, each share of Controlled Preferred Stock will have (i) the same voting rights as one share of Controlled Common Stock and (ii) the same rights as to dividends and liquidation distributions (after its preferred payment) as one share of Controlled Common Stock. There is no redemption, exchange or conversion rights associated with the Controlled Preferred Stock. After the Recapitalization, Distributing will own more than 80% of each class of Controlled stock.
- Step 3: Distributing will distribute a portion its Controlled Common Stock to Son A in exchange for all of Son A’s Class B nonvoting common stock. As to the remaining Controlled stock, Father , GRAT 2, and GRAT 3 will exchange a portion of their Class A voting stock and Class B nonvoting stock for Controlled Preferred Stock. Mother, Daughter , Son B, and Shareholder will exchange a portion of their Class B nonvoting stock for Controlled Preferred Stock. GRAT 1 and ESOP will exchange a portion of their Class A voting stock and Class B nonvoting stock for Controlled Common Stock and Controlled Preferred Stock.

Following the completion of the proposed transactions, Son A’s Controlled Common Stock will represent approximately 55% of the voting power of all shares of Controlled stock and approximately 38% of the value.

The following representations have been made in connection with the proposed and partially consummated transactions:

- (a) The fair market value of the Controlled stock to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder as an employee, or in any capacity other than that of a shareholder of the corporation.
- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing’s present operation, and with respect to such corporation, there has been no substantial operational changes since the date of the last financial statements submitted.

- (d) Following the distribution, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, except to the extent that certain administrative services will be furnished by Distributing to Controlled for a temporary period.
- (e) The distribution of stock of Controlled is being carried out for the following corporate business purposes: (i) to resolve differences among shareholders and management of Distributing relating to the future operation of Business 1 and Business 2; (ii) to enable a key shareholder to receive a significant equity interest in Business 2; and (iii) to enable Controlled to attract and retain other key employees necessary to carry out the business objectives of Controlled. The distribution is motivated, in whole or substantial part, by these corporate business purposes.
- (f) Distributing is not an S corporation (within the meaning of section 1361(a)) and there is no plan or intention by Distributing or Controlled to make an S corporation election pursuant to section 1362(a).
- (g) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction except in connection with distributions required under the governing instruments of the grantor retained annuity trusts, in which trust beneficiaries are shareholders of Distributing.
- (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, except for in connection with transactions of the Distributing ESOP made in the ordinary course of business.
- (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 to be transferred to Controlled by Distributing each exceed the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject. The liabilities assumed in the transaction and the liabilities to which the assets transferred are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- (k) No property is being transferred between Distributing and Controlled in which an

investment tax credit determined under section 46 of the Code has been (or will be) claimed with respect to such property.

- (l) Distributing neither accumulated its receivables nor make extraordinary payment of its payables in anticipation of the transaction.
- (m) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- (n) 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 section 1.1502-13 and section 1.1502-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and as currently in effect; section 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account with respect to the Controlled stock will be included in income immediately before the distribution (see section 1.1502-19).
- (o) 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.
- (p) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (q) The distribution will not be a disqualified distribution within the meaning of 355(d)(2) because, during the five-year period ending on the date of the distribution and immediately after the distribution, no person has held, nor will hold, disqualified stock of either Distributing or Controlled which constitutes a 50% or greater interest in either corporation.
- (r) The distribution is not part of a plan or series of related transactions (within the meaning of section 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of either Distributing or Controlled.
- (s) Immediately after the distribution, the gross assets of the active trade or business directly conducted by Distributing (as defined in section 355(b)(2)) will have a fair market value equal to at least 5% of the total fair market value of the gross assets of Distributing.
- (t) Immediately after the distribution, the gross assets of the active trade or business directly conducted by Controlled (as defined in section 355(b)(2)) will

have a fair market value equal to at least 5% of the total fair market value of the gross assets of Controlled.

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

- (1) The transfer of the assets and liabilities of Business 2 by Distributing to Controlled followed by Distributing's distribution of all the stock of Controlled to the participating shareholders, will constitute a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be a "party to a reorganization" within the meaning of section 368(b).
- (2) No gain or loss will be recognized by Distributing as a result of the transfer of the Business 2 assets and liabilities to Controlled in exchange for the stock of Controlled (sections 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled upon the receipt of the assets from Distributing in exchange for the stock of Controlled (section 1032(a)).
- (4) The basis of each of the assets received by Controlled in the transaction will equal the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled (section 362(b)).
- (5) The holding period of each of the assets received by Controlled in the transaction will include the period during which such assets were held by Distributing (section 1223(2)).
- (6) No gain or loss will be recognized by Distributing upon the distribution of all of the stock of Controlled as described above (section 361(c)(1)).
- (7) No gain or loss will be recognized by (and no amount will be included in the income of) the participating shareholders of Distributing upon the receipt of the stock of Controlled (section 355(a)(1)).
- (8) The aggregate basis of the stock of Distributing and Controlled in the hands of the participating shareholders immediately following the distribution will be the same as the basis in their Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with section 1.358-2(a)(2) (section 358(b)(2)).
- (9) The holding period of the stock of Controlled received by the participating shareholders will include the holding period of the Distributing stock provided that the Distributing stock was held as a capital asset on the date of the proposed transaction (section 1223(1)).

- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under section 1.312-10(a) of the Income Tax Regulations.
- (11) The Controlled Preferred Stock will not be "section 306 stock" within the meaning of section 306(c) (Rev. Rul. 81-91, 1981 C.B. 123).

No opinion is expressed 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 transactions that are not specifically covered by the above rulings. In particular, no ruling was requested and no opinion is expressed about the federal income tax consequences with respect to the Recapitalization and whether it constitutes a reorganization under section 368(a)(1)(E) See Rev. Proc. 2001-3, 2001-1 I.R.B. 114.

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. A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this ruling is consummated.

The rulings contained in this letter are predicated upon facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the 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 audit process.

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

Sincerely Yours,

Associate Chief Counsel
(Corporate)

By _____
Christopher W. Schoen
Assistant to the Chief, CC:CORP:1