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PLR-149411-05

Date:

March 24, 2006

In re

Parent =

Sub1 =

Purchaser =

State X =

State Y =

DivisionA =

BusinessA =

DivisionB =

BusinessB =

ShareholderA =

ShareholderB =

DateA =

DateB =

p =

pp =

ppp =

q =

r =

s =

d =

e =

Dear :

This letter responds to a letter dated 22 September 2005, requesting rulings concerning the federal income tax consequences of two proposed transactions. Additional information was provided in letters dated October 21 and December 12, 22, 28, and 29, 2005, and January 5 and February 22 and March 6, 2006. The information submitted for consideration is summarized below.

Parent, a State X corporation, uses the accrual method of accounting and a calendar year and files a consolidated return with its subsidiary ("Sub1"). Parent is itself directly engaged in BusinessA through DivisionA and, up until the time of the transactions described herein, was also directly engaged in BusinessB through DivisionB. Parent is, indirectly, still engaged in BusinessB through Sub1. Parent has outstanding common stock, which is closely held. ShareholderA and ShareholderB ("ShareholdersAB") are estates. Other shareholders are beneficiaries of these estates. The stock in Parent held by ShareholdersAB was acquired by them over 5 years ago.

Sub1, a State Y corporation, uses the accrual method of accounting and a calendar year. Sub1 is directly engaged in BusinessB. All the outstanding stock in Sub1 is held by Parent.

Parent is undertaking two transactions. In Transaction A, Parent sold its DivisionB assets to Purchaser and now plans to distribute part of the proceeds to ShareholdersAB. In Transaction B, Parent will distribute its stock in Sub1 to all its

shareholders. Parent is undertaking Transactions A and B by means of the eight steps indicated below (“Steps (I) through (VIII)”).

Transaction A. Assets sale and cash distributions.

In conjunction with Parent’s sale of DivisionB assets to Purchaser and the distribution of proceeds from the sale, the following Steps have been completed, commenced, or are planned:

- (I) In DateA, Parent sold the assets of DivisionB (the “Assets Sale”) to Purchaser for a total of p million dollars in cash and a promissory note (“Sales Proceeds Cash and Promissory Note”). The majority of the sales proceeds was cash (pp million dollars). The Promissory Note was ppp million dollars. In addition, in conjunction with the Assets Sale, Parent agreed not to enter into a competitive business with, or poach employees from, Purchaser for a period of e months (“Covenant Not To Compete”).
- (II) Parent placed some or all of the Sales Proceeds Cash in an existing general account (“General Account”).
- (III) Subsequent to DateA, Parent has used, or will use, q million dollars of the Sales Proceeds Cash to pay state and federal income taxes related to the gain from the Assets Sale.
- (IV) Subsequent to DateA, Parent used r million dollars of the Sales Proceeds Cash to pay part of Parent’s overall long term debt (“Overall Debt”).
- (V) On DateB, Parent formally adopted a plan of partial liquidation (“Partial Liquidation Plan”) providing for distribution of the remaining Sales Proceeds Cash and the Promissory Note to ShareholdersAB in exchange for part of their stock in Parent. The pp million dollars cash received by Parent on the sale of DivisionB assets has been decreased because a substantial amount has been, or will be, used by Parent for federal tax, state tax, and other expenses incident to the Assets Sale and incident to the distributions to the shareholders of Sales Proceeds Cash and Promissory Note. The remaining total amount is s million dollars including both the remaining Sales Proceeds Cash and the Promissory Note. Part of this s million dollars remaining may be used to pay any remaining obligations of Parent to the extent such obligations clearly relate to Parent’s BusinessB (and not to BusinessA) and, also, any remaining costs and expenses associated with the Assets Sale and with these proposed distributions of Sales Proceeds Cash and the Promissory Note.

- (VI) In accord with the Partial Liquidation Plan above, Parent will distribute Sales Proceeds Cash and the Promissory Note (“Cash Distributions and Promissory Note Distributions”) to ShareholdersAB in exchange for their surrender of part of the Parent Stock they hold.

#### Transaction B. Distribution of subsidiary stock.

In conjunction with Parent’s distribution of stock in its subsidiary, the following Steps have been completed, commenced, or planned:

- (VII) On DateB, Parent adopted a plan to distribute all the stock in Sub1 to its shareholders
- (VIII) Subsequent to the completion of Step (VI) above, in accord with the stock distribution plan, Parent will distribute all the Sub1 stock (“Stock Distribution”) to Parent’s shareholders, pro rata in relation to the number of shares of Parent stock held by each shareholder at such time.

#### Representations.

The following representations have been made in connection with Transaction A:

- (a) Parent does not have a history of paying dividends to its shareholders as Parent has been subject to dividend payment restrictions pursuant to the provisions of a long-term loan agreement.
- (b) Transaction A (the Assets Sale and the Cash Distributions and Promissory Note Distributions) was partly motivated by the need of ShareholdersAB to pay debts. However, a significant motivation for Transaction A was Parent’s desire to exit BusinessB in order to simplify its business operations, so it can focus on BusinessA, and in order to achieve various other corporate business purposes.
- (c) Transaction A will result in a contraction in Parent’s business [not including the business of Sub1]. Not taking into account the Step (IV) payment of Overall Debt [that is, considering only Steps (II), (III), (V), and (VI)], Transaction A will result in Parent having a reduction of over d percent which is significantly more than 20 percent in each of the three following items: (i) gross income from directly held assets and operations, (ii) the fair market value of directly held business operating assets, and (iii) the number of persons employed directly by Parent.
- (d) The assets sold by Parent to Purchaser in the Assets Sale were BusinessB operating assets which were being actively used in BusinessB

and were not passive, investment, or substituted assets. Parent had been directly engaged in BusinessB for many years and all these sold assets were assets that had been actively used in Parent's BusinessB throughout the past 5 years (or were replacement assets of such actively used assets). (See Rev. Rul. 79-275, 1979-2 C.B. 137.)

- (e) There is no plan or intention to completely liquidate Parent and it is planned that Parent will continue to be engaged directly in BusinessA.
- (f) There is no plan to expand the assets or the business activity of Parent, Sub1, or any related corporation except for expansion through normal internal growth. Furthermore, there is no plan or intention for Parent to re-enter BusinessB, or, once Transaction B is consummated, for Parent to either directly, or indirectly (for instance, by holding stock in subsidiaries) engage in BusinessB.
- (g) If appropriate business opportunities were to occur, it is possible that Parent would purchase additional BusinessA operating assets. However, at the time of the Step (VI) distributions, no plans, agreements, or negotiations will have been prepared or entered into with regard to the acquisition of any assets (except for minor routine acquisitions in the normal course of business). In addition, at such time, there will be no plan or intention to make any such nonroutine acquisition or for there to be any increase in assets or market capitalization except as a result of normal internal growth. Moreover, it is expected that any acquisitions made within the 5-year period subsequent to Step (I) would be sufficiently small so that, factoring out inflation and routine internal growth, any such acquisitions would still leave Parent operating at levels at least 20 percent smaller than its operations prior to the Step (I) Assets Sale.
- (h) Parent and Purchaser are unrelated. None of the shareholders of Parent holds stock in Purchaser.
- (i) Transaction A will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation ("Recipient") of any of the businesses or assets held directly or indirectly by Parent prior to the Step (I) Assets Sale, if persons holding more than 20 percent in value of the stock in Parent also hold more than 20 percent in value of the stock in Recipient. For purposes of this representation, ownership is determined by application of the constructive ownership rules of § 318 as modified by § 304(c)(3).
- (j) There is no plan or intention on the part of Parent's shareholders to transfer any assets to Parent, Sub1, or any related corporation

(except the transfers described above of Parent stock to Parent in Step (VI) as part of Transaction A and, subsequent to Transaction A, the payment of cash by ShareholdersAB to Parent to settle their debt obligations to Parent that were already outstanding prior to Transaction A).

- (k) The Promissory Note and cash to be distributed to ShareholdersAB are proceeds from the sale of a business actively conducted by Parent. The Promissory Note and distributed cash are not from an expansion reserve, nor are they attributable to a mere business decline, a mere decrease in needed working capital, or the sale of either a nominal or loss business.
- (l) The only assets received by ShareholdersAB in the Step (VI) distributions will be the Promissory Note and cash from the Sales Proceeds Cash. At all times from the Step (II) placement of the Sales Proceeds Cash in General Account until the Step (VI) Cash Distributions to ShareholdersAB, the amount of cash in General Account has never been less than the amount of cash that will be distributed in the proposed Cash Distributions, except to the extent that such cash may have been placed in short-term limited-risk investments such as those in representation (m) below.
- (m) All of the cash being distributed in the Cash Distributions can, at all times during the period from Step (II) to Step (VI), be traced to the sale of BusinessB assets and such cash has not been and will not be used in any business activities of Parent. The entire amount of this cash that is being distributed by Parent to its shareholders in the Step (VI) distributions is cash that can be shown to have never been used by Parent in any way, other than being placed in Treasury Bills and/or Notes, savings accounts, money market accounts, certificates of deposit, Federal National Mortgage Association notes, and similar short-term limited-risk investments. (See Rev. Rul. 79-275, 1979-2 C.B. 137, indicating that substituted assets do not qualify for partial liquidation treatment.)
- (n) All the Step (VI) distributions will be commenced subsequent to adoption of a plan of partial liquidation and will be completed in the taxable year in which a plan of partial liquidation was first adopted or in the succeeding taxable year. No prior formal or informal plans of contraction or of complete or partial liquidation have ever been adopted by Parent.
- (o) There will be no unreasonable delay in making the Step (VI) distributions. The period between the Step (I) proceeds receipt and the Step (VI) distributions is time reasonably needed: for making informed decisions; for obtaining legal guidance and governmental rulings; for appraisals, and cost and liability determinations; and for other actions such that the transaction proceeds in an orderly and businesslike manner.

- (p) Except to the extent that any part of the Step (VI) Cash and Promissory Note Distributions or the Step (VIII) Stock Distribution may be determined to be dividends, there are no declared but unpaid dividends on the stock being redeemed, and no dividend has been, or will be, declared prior to the completion of the Step (VIII) distributions.
- (q) For each shareholder, the amount of cash plus the value of the interest in the Promissory Note being distributed by Parent to the shareholder will be equal to the fair market value of the Parent stock surrendered by such shareholder in exchange therefor.
- (r) None of the stock to be redeemed is "section 306 stock" within the meaning of section 306(c).
- (s) In the 5 years preceding DateB, there were no substantial acquisitions of assets by Parent or Sub1.
- (t) The amount of inventory included in the BusinessB assets sold to Purchaser was reasonable for this type of business and in the 24 month period prior to the assets sale any increase in this BusinessB inventory was consistent with prior practice.
- (u) The fair market value of Parent's assets did, and will, exceed its liabilities and the liabilities to which its assets are subject both on DateB (the plan adoption date) and on the date the Step (VI) distributions are completed.
- (v) The proceeds to be distributed in partial liquidation will be limited to the Sale Proceeds Cash and Promissory Note (not including any interest earned on the Promissory Note), less all taxes and expenses applicable to the transaction and less any income, gains or losses on any temporary investment of the Sales Proceeds Cash.
- (w) No shareholder of Parent has been or will be obligated to purchase any of the stock in Parent that is being redeemed.
- (x) No shareholder of Parent will assume any liability of Parent in connection with Transaction A.

The following representations have been made with regard to Transaction B.

- (aa) The active business conducted by Sub1 (Sub1's BusinessB) will have been continuously and actively conducted within the meaning of § 1.355-1(c) of the Income Tax Regulations throughout the five-year period

immediately preceding the Step (VIII) Stock Distribution. The active business conducted by Parent (BusinessA) will have been continuously and actively conducted by Parent within the meaning of § 1.355-1(c) throughout the five-year period prior to the Stock Distribution. Parent's BusinessA and Sub1's BusinessB each have 50 or more employees.

- (bb) The 5 years of financial information submitted on behalf of Parent's BusinessA and Sub1's BusinessB is representative of each corporation's present operations, and with regard to each of these two businesses there have been no substantial operational changes since the date of the last financial statements submitted.
- (cc) Following the transaction, Parent and Sub1 will each continue the active conduct of its business, independently and with its own separate employees. For both Parent and Sub1, common employees who are working for both companies will constitute no more than 5 percent of the total number of employees of the company.
- (dd) Parent is not an S corporation (within the meaning of § 1361(a)) and there is no plan for Parent or Sub1 to make an S corporation election pursuant to § 1362(a).
- (ee) The Transaction B distribution of Sub1 stock will be pro rata in relation to the ownership of Parent stock at the time of this Transaction B distribution.
- (ff) Except for the shareholders' surrender of Parent stock to Parent in conjunction with Transaction A, as described above, there is no plan for any of Parent's shareholders to sell, exchange, transfer by gift, or otherwise dispose of any of the stock in either Parent or Sub1.
- (gg) Except as described above with regard to Transactions A and B and except for stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705, there is no plan or intent by either Parent or Sub1 to purchase, either directly or indirectly, any of its outstanding stock.
- (hh) Except as described above with regard to Transactions A and B, there is no plan or intention to liquidate either Parent or Sub1, to merge either corporation with any other corporation, or to sell or otherwise dispose of assets of either corporation, except in the ordinary course of business.
- (ii) No intercorporate debt will exist between Parent and Sub1, at the time Transaction B is consummated, or subsequent thereto.

- (jj) Payments made in connection with any continuing transactions between Parent and Sub1 will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (kk) Transaction B is carried out for corporate business purposes that include: streamlining operations; simplification of administrative, regulatory, and financial matters; cost savings; and to enable management of each business to focus on its own operations. Transaction B is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (ll) Transaction B is not being used principally as a device for the distribution of the earnings and profits of Parent or Sub1.
- (mm) Transactions A and B are not part of a plan or series of related transactions (within the meaning of § 355(e) of the Code or § 1.355-7 of the regulations) 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 Parent or Sub1 (or any predecessor or successor of these corporations), or stock possessing 50 percent or more of the total value of all classes of stock of either Parent or Sub1 (or any predecessor or successor of these corporations).
- (nn) Immediately before the Step (VIII) stock distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (see § 1.1502-13 of the regulations). Further, Parent's excess loss account with respect to the Sub1 stock will be included in income immediately before the stock distribution (see § 1.1502-19).

Representations with regard to both Transaction A and Transaction B.

- (aaa) Each party (Parent, Sub1, and each shareholder) involved in Transactions A and B will pay his, her, or its own expenses in the transaction.
- (bbb) There are no outstanding options or warrants to purchase either Parent stock or Sub1 stock, nor are there any outstanding debentures or other obligations that are convertible into, or that would be considered to be, Parent stock or Sub1 stock
- (ccc) No shareholder is assuming any obligation of Parent or Sub1 in conjunction with Transactions A or B.
- (ddd) Within the past 5 years, there have been no redemptions, issuances, or

exchanges by either Parent or Sub1 of their own stock or of stock in any related corporation.

- (eee) Neither Parent nor Sub1 has any plan or intention to issue, redeem or exchange any of its own stock or any stock in any related corporation, except as described above with regard to Transactions A and B, and except for any issuances of Parent stock or Sub1 stock that may be required by preexisting employee stock option plans.
- (fff) There will have been no transfers of assets or liabilities between Sub1 and Parent in conjunction with, or in anticipation of, either Transaction A or B.
- (ggg) None of the distributions by Parent to its shareholders will be received by any of the shareholders as a debtor, creditor, employee, or in any capacity other than as a shareholder.

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

Transaction A. Assets sale and cash distributions.

- (1) The rulings that follow regarding Transaction A address only the question of whether the Cash and Promissory Note Distributions constitute redemptions in partial liquidation treated as exchanges under subsection (4) of § 302(b). They do not address whether these distributions, or a portion thereof, could constitute redemptions either under § 303 or under subsections (1), (2), or (3) of § 302(b).
- (2) The proposed Cash Distributions and Promissory Note Distributions by Parent in cancellation of a portion of its stock pursuant to a plan of partial liquidation, will be treated as distributions in partial liquidation under §§ 302(b)(4) and 302(e)(1) to the extent provided in rulings (6) and (7) below, provided that the conditions specified in ruling (3) below are met.
- (3) These distributions to shareholders will not qualify as partial liquidation redemptions treated as § 302(b)(4) exchanges, unless each of the three following conditions applies: (i) the redeemed shareholder is not a corporation (or certain pass-thru entities with a corporation as a beneficiary (§ 302(e)(5))); (ii) the distributed items are proceeds from the sale of operating assets ("Operating Asset Proceeds"); and (iii) the distribution occurs within the taxable year of Parent in which the plan of partial liquidation is adopted, or within the succeeding taxable year. For purposes of this ruling (3): (i) the estates in this case are not considered "corporations," provided their beneficiaries are solely individuals; and (ii)

“Operating Asset Proceeds” includes that portion of the Sales Proceeds Cash and Promissory Note that was received with regard to Parent’s business operations (including an appropriate amount of working capital), but does not include any portion of the Sales Proceeds Cash and/or Promissory Note received with regard to a reserve for expansion, investment assets, or working capital in excess of that reasonably needed for business operations. The cash received will retain its character as Sales Proceeds Cash to the extent provided in rulings (4) and (5) below.

- (4) For purposes of determining whether the cash distributed has retained its character as Sales Proceeds Cash, the fact that this cash was placed in General Account when the cash was received from Purchaser will not prevent this cash from being traceable as Sales Proceeds Cash, but only in an amount no greater than the lowest cash balance maintained in such account throughout the period from the time the Sales Proceeds Cash was first placed in the account until the time the cash is taken from the account. The amount of cash that is traceable as proceeds from the Assets Sale includes the lowest cash balance in General Account plus any amount simultaneously invested in limited risk investments as described in ruling (5) below.
- (5) If any of the Sales Proceeds Cash was temporarily invested, such investment will not prevent the Cash Distribution from being considered proceeds received by Parent from the Step (I) Assets Sale, provided these temporary investments are limited risk short-term investments such as described in representation (m) above.
- (6) The maximum amount of the Sales Proceeds Cash and Promissory Note that will be treated as being distributed in partial liquidation with respect to the sale of BusinessB assets equals the total amount of the Sales Proceeds Cash and Promissory Note reduced by: (i) any liabilities of Parent’s BusinessB that are still outstanding and still owed by Parent); (ii) all taxes and expenses incurred by Parent in conjunction with the Step (I) Assets Sale and/or the Step (VI) distributions; (iii) any income, gain or losses on the investment of any Sales Proceeds Cash; and (iv) any portion of the Sales Proceeds Cash that does not result from the sale of operating assets. This maximum amount will not include any earned or accrued investment earnings on the Sales Proceeds Cash and/or Promissory Note or amounts attributable to any covenant not to compete between Parent and Purchaser including the Step (I) Covenant Not To Compete. (See Rev. Rul. 60-262, 1960-2 C.B. 115; Rev. Rul. 71-250, 1971-1 C.B. 112; Rev. Rul. 76-279, 1976-2 C.B. 99; Rev. Rul. 76-289, 1976-2 C.B. 100.)

- (7) For each shareholder, the amount of the Transaction A distributions received that constitutes a distribution in partial liquidation under § 302(b)(4) will be treated as received by the shareholder as full payment in exchange for the shares of stock redeemed by the shareholder, as provided by § 302(a). Gain or loss will be recognized by the shareholder to the extent of the difference between the amount received in the partial liquidation distributions and the adjusted basis of the stock redeemed. Provided that the redeemed stock is a capital asset in the hands of the exchanging shareholder, gain or loss will be considered capital gain or loss subject to the provisions and limitations of Subchapter P of Chapter 1 of the Code.

Transaction B. Distribution of subsidiary stock.

- (8) No gain or loss will be recognized by Parent upon the Stock Distribution (§ 361(c)(1)).
- (9) No gain or loss will be recognized by (and no amount will be included in the income of) Parent's shareholders upon the receipt of Sub1 stock in the Stock Distribution (§ 355(a)(1)).
- (10) For each shareholder, the shareholder's total basis in the Parent stock and Sub1 stock held after the Stock Distribution will be the same as the basis of the Parent stock held by such shareholder immediately prior to the distribution. Each shareholder's total basis will be allocated between the Parent stock and Sub1 stock in proportion to the relative fair market values of the Parent stock and Sub1 stock in accordance with § 1.358-2(a)(2).
- (11) The holding period of the Sub1 stock received by a shareholder will include the period during which such shareholder held the Parent stock with regard to which the Sub1 stock is received, provided that the Parent stock is a capital asset in the hands of such shareholder on the date of the exchange (§ 1223(1)).
- (12) As provided in § 312(h), proper allocation of earnings and profits between Parent and Sub1 will be made under § 1.312-10(b) of the regulations.

No opinion is expressed about the tax treatment of the transactions 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 transactions that are not specifically covered by the above rulings.

No opinion is expressed as to whether the number of shares of stock proposed to be surrendered by ShareholdersAB in Transaction A is the amount of stock that should be surrendered in order for this redemption to be at fair market value. The market value of property is a factual matter on which the Service ordinarily does not issue letters. See section 4.02(1) of Rev. Proc. 2006-3, 2006-1 I.R.B. 122, 129.

In addition, no opinion is requested or expressed as to whether Parent's plan of partial liquidation should be considered adopted at the time the Partial Liquidation Plan was formally adopted on DateB (Step (V)) or should be considered to have been informally adopted at an earlier time. See Rev. Rul. 65-235, 1965-2 C.B. 88. Note the requirement in condition (iii) of ruling (3) above as to the time period during which the Transaction A distribution must take place.

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

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. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this letter are consummated. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of this letter ruling.

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

Sincerely,

*Debra Carlisle*

Debra Carlisle  
Chief, Branch 5  
Office of Associate Chief Counsel  
(Corporate)

cc: