

**Internal Revenue Service**

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Person to Contact:

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Distributing =

Controlled =

State A =

State B =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Business 1 =

Business 2 =

Business 3 =

Business 4 =

PLR-109886-99

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6 =

Sub 7 =

a =

b =

c =

d =

e =

f =

g =

h =

This letter responds to a request dated May 25, 1999 for rulings relating to the federal income tax treatment of a proposed transaction. We have received additional information in letters dated July 1, 1999, July 27, 1999, August 10, 1999, August 12, 1999, and September 17, 1999. The information submitted for consideration is summarized below.

Distributing is a holding company engaged, through affiliates, in the Business 1 and Business 2. Distributing has two classes of common stock issued and outstanding: its regular common stock (the "Distributing Common Stock") and its Class B common stock (the "Distributing Class B Stock"). Distributing also has one class of preferred stock outstanding, Series A Cumulative Convertible stock (the "Distributing Series A Stock"). The Distributing Common Stock and the Distributing Series A Stock are

PLR-109886-99

publicly traded. The Distributing Class B Stock is owned substantially by Shareholder 1.

Distributing has three shareholders who own 5 percent or more of the Distributing Common Stock: Shareholder 2, Shareholder 3 and Shareholder 4.

Distributing owns all of the outstanding stock of both Sub 4 and Sub 5. Sub 5 is a holding company that does not engage in any business directly. Sub 5 owns all of the outstanding stock of Sub 1, Sub 3, Sub 6, and Sub 7. Sub 4 and Sub 3 own a percent and b percent, respectively, of Sub 2. Sub 7 is directly engaged in the Business 1. Sub 1 is directly engaged in the Business 1 and Business 2. Sub 6 is directly engaged in Business 3.

Controlled is engaged, directly and through affiliates, in the Business 4. Controlled has one class of publicly traded common stock (the "Controlled Common Stock"). Sub 2 owns c shares of Controlled Common Stock (approximately d%) and Sub 4 owns e shares of Controlled Common Stock (approximately f%). Members of the public own the remaining shares (over 20%).

Financial information has been received which indicates that Controlled, Sub 1, Sub 6, and Sub 7 each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Information has also been received indicating the need for Distributing to obtain capital to grow and expand its Business 1. In order to raise capital to effectuate its plans, Distributing proposes to undertake an initial public offering ("IPO") of approximately \$g worth of Distributing's total outstanding stock. Distributing has concluded, based upon documentation provided by its investment banker, that an IPO will be significantly more effective if the Business 4 is separated from Distributing.

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

- (1) Sub 4 will be merged into Distributing under State A law, Sub 3 will be merged into Sub 5 under State B law, and Sub 5 will be merged into Distributing under State A and State B law. As a result, Distributing will directly own e shares of Controlled Common Stock and all of the outstanding shares of Sub 2.
- (2) Sub 1 will form a limited liability company ("LLC") that will elect to be treated as a corporation under § 301.7701-3. The LLC will be merged with and into Sub 2. Pursuant to the merger, Distributing will exchange its Sub 2 shares for voting common stock of Sub 1.
- (3) Sub 1 will contribute the stock of Sub 2 to a newly-formed, wholly-owned State B corporation ("Newco").

PLR-109886-99

- (4) The e shares of Controlled Common Stock owned by Distributing will be converted into Controlled Class B Stock and the remaining Controlled Common Stock (including the c shares held by Sub 2) will be converted into Controlled Class A Stock (the "Recapitalization"). The Recapitalization will be accomplished in the following steps:
- (i) Distributing will form a wholly-owned State A corporation ("Merger Sub") and transfer the e shares of Controlled Common Stock to Merger Sub in exchange for all of Merger Sub's stock;
  - (ii) Merger Sub will merge with and into Controlled, with Distributing receiving e shares of Controlled Class B Stock in exchange for its Merger Sub stock pursuant to the merger;
  - (iii) The remaining h shares of Controlled Common Stock (including the c shares held by Sub 2) will be redesignated as Controlled Class A Stock; and
  - (iv) The Controlled Class B Stock and the Controlled Class A Stock will be identical except that the Controlled Class B Stock will have the right to elect over 80 percent of the directors of Controlled.
- (5) Distributing will distribute the Controlled Class B Stock pro rata to the holders of the Distributing Common Stock and the Distributing Class B Stock (the "Distribution"). No fractional shares of Controlled will be issued. In lieu thereof, the distribution agent will aggregate all fractional share interests, sell the aggregated shares and remit the proceeds to the shareholders entitled thereto.
- (6) Sub 2 will retain the c shares of Controlled Class A Stock in order to improve Distributing's debt-equity ratio, solidify its credit rating, and to provide Distributing with a source of cash for expansion and acquisition. Sub 2 will dispose of the retained shares consistent with the above purposes, but in any event, within five years of the Distribution. During this period the shares will be voted in proportion to the votes cast by the other Controlled Class A Stock shareholders.

The taxpayer has made the following representations in connection with the proposed Recapitalization:

- (a) Controlled and its shareholders will each pay their own expenses, if any, incurred in connection with the Recapitalization.
- (b) The fair market value of the Controlled stock held by each Controlled shareholder immediately following the Recapitalization will be approximately

PLR-109886-99

equal to the fair market value of the Controlled stock held by such shareholder immediately before the Recapitalization.

- (c) Controlled is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A).
- (d) There is no plan, intention or formal or informal understanding to change the capital structure of Controlled to eliminate the two-tiered voting structure of the Controlled Class A Stock and Controlled Class B Stock established in the Recapitalization.
- (e) The Recapitalization is a single, isolated transaction and is not part of a plan to periodically increase the proportionate interest of any shareholder in the assets or earnings and profits of Controlled.

The taxpayer has made the following representations in connection with the proposed Distribution:

- (a) Distributing, Controlled and the Distributing shareholders will each pay their own expenses, if any, incurred in connection with the transaction.
- (b) The indebtedness, if any, owed by Controlled to Distributing after the Distribution of the Controlled stock will not constitute stock or securities.
- (c) No part of the Controlled Class B Stock to be distributed by Distributing will be received by a shareholder of Distributing as a creditor, employee or in any capacity other than that of a shareholder of Distributing.
- (d) The five years of financial information submitted on behalf of Controlled is representative of Controlled's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (e) The five years of financial information submitted on behalf of each of Sub 1, Sub 6 and Sub 7 is representative of the present operations of such businesses, and with regard to such corporations, there have been no substantial operational changes since the date of the last financial statements submitted.
- (f) Following the Distribution, Sub 1, Sub 6, Sub 7, and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (g) Immediately after the Distribution, at least 90 percent of the fair market value of the gross assets of Distributing will consist of the stock of controlled corporations

PLR-109886-99

that are engaged in the active conduct of a trade or business as defined in § 355(b)(2).

- (h) The Distribution is carried out for the following corporate business purposes: to increase the anticipated proceeds of an equity offering by Distributing. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (i) Distributing will complete a public offering of approximately \$g worth of Distributing's total outstanding stock within one year of the Distribution.
- (j) There is no plan or intention by any shareholder who owns 5 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 particular remaining shareholder or security holder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any stock, or securities of, either Distributing or Controlled after the Distribution, except for (i) intra-family gifts by members of Shareholder 1 to their children and grandchildren, (ii) annual transfers of Distributing stock by Grantor Retained Annuity Trusts ("GRATs") to the grantor of the GRATs to the extent necessary to satisfy annual annuity requirements, (iii) sales of fractional share interests, and (iv) dispositions by Sub 2 of the c shares of Controlled Class A Stock to be retained in the Distribution.
- (k) 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 possible purchases by Controlled of the c shares of Controlled Class A Stock to be retained by Sub 2 in the Distribution, or by Distributing or Controlled pursuant to open market stock repurchase programs meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.
- (l) There is no plan or intention to liquidate either Controlled or Distributing, 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.
- (m) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution, except for short-term receivables, if any, arising out of an intercompany services agreement.
- (n) 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.

PLR-109886-99

- (o) The payment of cash in lieu of fractional shares of Controlled stock is solely for the purpose of avoiding the expense and inconvenience to Controlled of issuing and maintaining fractional shares and will not represent separately bargained-for consideration. The total cash that will be paid in the transaction to the Distributing shareholders in lieu of fractional shares of Controlled stock will not exceed 1 percent of the total consideration that will be distributed in the transaction.
- (p) The merger of Sub 4 into Distributing will qualify as a liquidation pursuant to § 332 or as a reorganization pursuant to § 368(a)(1)(A).
- (q) There are no outstanding options or warrants to purchase Distributing or Controlled stock, nor are there any outstanding debentures, convertible securities (other than the Distributing Class B Stock and Distributing Series A Stock) or any other type of right pursuant to which any person could acquire Distributing or Controlled stock that would be considered Distributing or Controlled stock.
- (r) 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 entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

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

- (1) For federal income tax purposes, steps 4(i) through 4(iv), above, will be treated as exchanges by the Controlled shareholders of their existing Controlled Common Stock for new Controlled Class A Stock and Controlled Class B Stock and will qualify as a reorganization within the meaning of § 368(a)(1)(E). Controlled will be a “party to a reorganization” within the meaning of § 368(b).
- (2) No gain or loss will be recognized by the shareholders of Controlled Common Stock upon their exchange of the Controlled Common Stock for Controlled Class A Stock or Controlled Class B Stock. Section 354(a)(1).
- (3) The basis of the Controlled Class A Stock or Controlled Class B Stock received in the Recapitalization will be the same as 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 or Controlled Class B Stock received in the Recapitalization will include the period during which the

PLR-109886-99

Controlled Common Stock surrendered in exchange therefor was held, provided such Controlled Common Stock was 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 upon their receipt of Controlled Class B Stock. Section 355(a)(1).
- (6) No gain or loss will be recognized by Distributing upon the pro-rata distribution of the Controlled Class B Stock. Section 355(c).
- (7) The Distributing shareholders' aggregate basis in the Distributing Common Stock and/or Distributing Class B Stock, as applicable, and the Controlled Class B Stock after the Distribution will equal the aggregate basis of the Distributing Common Stock and/or the Distributing Class B Stock, as applicable, held by such shareholders immediately before the Distribution, allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2). Sections 358(a), (b) and (c).
- (8) The holding period of the Controlled Class B Stock received by the Distributing shareholders in the Distribution will include the holding period of the Distributing shares with respect to which the Distribution will be made, provided that such Distributing shares are held as capital assets on the date of the Distribution. Section 1223(1).
- (9) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(b).
- (10) Any payments of cash in lieu of fractional share interests in Controlled 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 stock 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 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.

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.



PLR-109886-99

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer and an authorized representative.

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.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By *Ken Cohen*

Ken Cohen  
Senior Technical Reviewer, Branch 3