

Internal Revenue Service

Department of the Treasury

Number: **200311002**
Release Date: 3/14/2002
Index Number: 305.00-00; 306.00-00;
368.05-00

Washington, DC 20224

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Refer Reply To:
CC:CORP:B04-PLR-116823-02
Date:
September 29, 2002

LEGEND

Company =

Business X =

Statute =

Regulator =

Year 1 =

the Act =

Shareholder(s) =

Target Index =

Stated Dividend =

N =

P =

Q =

R =

S =

T =

U =

V =

W =

Dear :

This letter responds to your authorized representative's letter dated March 20, 2002 requesting rulings on certain federal income tax consequences of a proposed transaction. The information submitted for consideration is summarized below.

Company, a federally chartered corporation, is engaged in Business X. Business X is a highly regulated business, which is subject to Statute. Regulator is responsible for oversight of Company and its finances.

Currently, Company has a single class of outstanding stock (hereinafter "Company Stock"), which is widely-held by its Shareholders, subject to specific membership requirements. Company Stock has a par value of \$N per share and voting rights. Company Stock is not freely transferrable, but may be redeemed with 6 months written notice to Regulator. Company Stock can be issued, redeemed, and liquidated only at par value. Dividends on Company Stock are non-cumulative and subject to the discretion of the board of directors. Company traditionally declares quarterly dividends on Company Stock.

In Year 1, Congress issued the Act, which amended Statute by imposing new risk-based and leverage-capital requirements on Company and required Company to submit its new capital plan to Regulator for approval (hereinafter "Plan"). Company submitted Plan to Regulator and Regulator has approved it.

In order to maintain the new capitalization requirements the Act compels Company to maintain Permanent Capital and Total Capital. Permanent Capital is defined as Company's amounts paid in for Class B stock ("Class B Stock) and retained earnings. Total Capital is defined as Permanent Capital, plus the amounts paid in for Class A stock ("Class A Stock) and any general loss allowance. The Act provides for Class B Stock and also permits, but does not require, Class A Stock. In addition, the Act and Plan require each Shareholder to maintain a minimum investment in the stock

of Company. Under Plan, a Shareholder's minimum investment in stock of Company is based on a percentage of Shareholder's assets or advances.

PROPOSED TRANSACTION

Company proposes to recapitalize, in accordance with Plan submitted to Regulator, as follows:

(A) Exchange 1: Company will issue Class B Stock in exchange for all of its outstanding shares of Company Stock.

(B) Exchange 2: Following Exchange 1, Company will allow the Class B Shareholders a one-time opportunity to exchange some of their Class B Stock for Class A Stock. The amount of time available for Exchange 2 will be limited to a period of no more than P consecutive days after the commencement of Exchange 1.

After Exchange 2, some Shareholders will only own Class B Stock and others will own a combination of Class A Stock and Class B Stock. Company expects that after Exchange 2, Class A Stock will represent no more than Q - R % of its Total Capital.

Section 3.01(30) of Rev. Proc. 2002-3, 2002-1 I.R.B. 117, 119, states that the Service will not rule on whether a transaction qualifies under section 368(a)(1)(E) of the Internal Revenue Code for nonrecognition treatment and whether various consequences result from the application of that section, unless the Service determines that there is a significant issue that must be resolved in order to decide those matters. Company has requested rulings on §§ 305, 351(g)(3), and 306, with respect to the transaction.

The two new classes of stock, Class A Stock and Class B Stock (collectively "New Company Stock") that Company will issue in the proposed transaction have the following characteristics:

(A) The Class A Stock has a \$N par value and is issued, transferrable, redeemable, and liquidated only at par value. The Class A Stock has no voting rights (except where Company is in default on the payment of dividends), has a Stated Dividend that is cumulative, and has preference (over Class B shares) to dividends and liquidation proceeds. The board of directors also has the option, at its discretion, to declare a dividend that exceeds the stated dividend. Under the proposed dividend policy (see below), Company will pay to the Class A Shareholders 20% of the excess dividend (defined below) paid to the Class B Shareholders. A Class A Shareholder may redeem its Class A Stock with 6 months written notice to Company.

(B) The Class B Stock has a \$N par value and is issued, transferrable and redeemable only at par value. The Class B Stock has a discretionary

quarterly dividend (see below) and voting rights. A Shareholder may redeem its Class B Stock with 5 years written notice to Company. The retained earnings, paid-in surplus, undivided profits, and equity reserves of Company are owned by the Class B Shareholders in an amount proportional to each owner's share of the total issued and outstanding shares of Class B Stock. However, the Class B Shareholders have no right to receive any portion of such items except by means of a dividend or capital distribution authorized by the board of directors, or upon liquidation of Company. The likelihood that Company will liquidate is remote.

Certain characteristics of the Class A Stock and the Class B Stock are provided pursuant to the Act. The Act outlines the liquidation rights of both Class A Stock and Class B Stock. In addition, the Act provides that the Class A Stock shall be redeemable at par with 6 months written notice to Company and the Class B Stock shall be redeemable at par with 5 years written notice to Company. However, under the Act and Plan, no New Company Stock may be redeemed, if the redemption will impair the minimum regulatory capital requirements of Company or the minimum investment requirements of Shareholders.

Company will also adopt the following dividend policy for its New Company Stock:

Company intends to pay dividends on the Class B Stock that will be S basis points over Target Index. To the extent Company pays a dividend on the Class B Stock that exceeds Target Index ("Excess Dividend"), the Class A Stock will share in 20% of such Excess Dividend. Company has historically distributed most of its net income (after meeting certain assessment obligations) as dividends to its Shareholders. If Plan had been in place for the last T quarters, the board of directors would have paid dividend amounts that exceeded Target Index and Stated Dividend in U of the last T quarters.

Under the Plan, any Excess Stock, which is New Company Stock in excess of Shareholder's minimum investment requirement, may be redeemed or repurchased by Company, at its discretion, with V written notice. In addition, Shareholder may request that Company redeem Excess Stock with W written notice. Company must first redeem all Class A Stock that is Excess Stock before redeeming any Class B Stock that is Excess Stock.

Similar to providing for the redemption of Class A Stock and Class B Stock (see above), the Act provides for the redemption and repurchase of Excess Stock. However, as above, no Excess Stock may be redeemed, if the redemption will impair the minimum regulatory capital requirements of Company or the minimum investment requirements of Shareholders.

REPRESENTATIONS

The following representations have been made regarding the proposed transaction:

- (a) The proposed exchange (see Ruling 2) will be undertaken for the corporate business purpose of facilitating Company's ability to satisfy the new risk-based capital requirements imposed by the Act while permitting Company to access short-term capital.
- (b) The fair market value of New Company Stock to be received by each Shareholder pursuant to the proposed exchange will approximately equal the fair market value of Company Stock surrendered in exchange therefor.
- (c) At the time of the proposed exchange, Company will not have outstanding any stock options, warrants, convertible securities, or any other right that is convertible into any class of stock or securities of Company.
- (d) The proposed exchange will be a single, isolated transaction and not part of a plan to periodically increase the proportionate interest of any Shareholder in the assets or earnings and profits of Company.
- (e) Company has no dividends in arrears on Company Stock. Additionally, no New Company Stock will be issued pursuant to the proposed exchange for dividend or interest arrearages.
- (f) Shareholders will not retain any rights in Company Stock transferred to Company pursuant to the proposed exchange.
- (g) Each share of Company Stock will be exchanged for a whole share of New Company Stock. Accordingly, no Shareholder will be entitled to fractional shares as a result of the proposed exchange.
- (h) After the proposed exchange, some Shareholders will hold only Class B Stock and some Shareholders will hold a combination of Class A Stock and Class B Stock. In no event, will the Class A Stock be held on a pro-rata basis among Shareholders.
- (i) Company has no plan or intention to redeem or otherwise reacquire Class B Stock issued pursuant to the proposed exchange, other than: (a) isolated requests by Shareholders in accordance with Statute; or (b) with respect to Class B Excess Stock, as permitted under Plan.
- (j) Company has no plan or intention to redeem or otherwise reacquire Class A Stock issued pursuant to the proposed exchange, other than (a) isolated requests of Shareholders in accordance with Statute; or (b) with respect to Class A Excess Stock, as permitted under Plan.
- (k) No convertible Company Stock will be received pursuant to the proposed

exchange.

(l) There will be no securities of Company issued or exchanged pursuant to the proposed exchange, other than New Company Stock.

(m) None of New Company Stock issued pursuant to the proposed exchange will be placed in escrow and no stock will be issued later under a contingent stock arrangement.

(n) No property, other than New Company Stock, will be issued or exchanged in the proposed exchange.

(o) Following the proposed exchange, Company will continue as a corporation engaged in Business X, i.e., the same business that Company conducted prior to Plan.

(p) Each party to the proposed exchange will pay its own expenses, if any, in connection with the proposed exchange.

(q) Company Stock is not "section 306 stock" within the meaning of §306(c).

(r) Company Stock is not limited and preferred as to dividends and participates in the growth of Company to a significant extent. Company Stock has no rights upon liquidation beyond its par value.

(s) Company is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of §368(a)(3)(A).

(t) Company will be the same entity before and after the proposed exchange.

(u) The Shareholders will not have an election to receive cash or other stock or property pursuant to the proposed exchange.

(v) To the best of the knowledge of the management of Company, there is no plan or intention on the part of the Shareholders to sell, exchange, or otherwise dispose of New Company Stock to be issued pursuant to the proposed exchange.

RULINGS

Based solely on the information submitted and the representations made, and given the particular facts and circumstances surrounding the proposed exchange (including the enactment of the Act) as well as the nature of Company's business, we rule as follows:

(1) For Federal income tax purposes, the receipt by Shareholders of Class B Stock for Company Stock followed by the exchange by some of the

Shareholders of some of their Class B Stock for Class A Stock will be disregarded and will be viewed as the exchange by the Shareholders of all of their Company Stock for Class A Stock and/or Class B Stock. Thus, Shareholders that receive solely Class B Stock will be treated as having exchanged their Company Stock for Class B Stock. Shareholders that elect to receive some Class A Stock will be treated as having exchanged their Company Stock for Class B Stock and Class A Stock.

(2) The proposed exchange by Shareholders of all of their Company Stock for Class A Stock and/or Class B Stock, as described above, will constitute a recapitalization and, therefore, a reorganization under § 368(a)(1)(E). Additionally, Company will be “a party to a reorganization” under § 368(b).

(3) No gain or loss will be recognized by Company on the issuance of New Company Stock in exchange for Company Stock, as described above (§ 1032(a)).

(4) No gain or loss will be recognized by Shareholders upon the exchange of Company Stock for New Company Stock, as described above (§ 354(a)(1)).

(5) Neither the Class A Stock nor Class B Stock will be “preferred stock” within the meaning of § 351(g)(3)(A). New Company Stock will not constitute other property for the purposes of §§ 354 and 356(a)(1)(B) (§§ 351(g)(2) and 354(a)(2)(C)).

(6) The basis of Class B Stock to be received by each Shareholder receiving solely Class B Stock will be the same as the basis of Company Stock surrendered in exchange therefor (§ 358(a)(1)). The basis of Class A Stock and Class B Stock to be received by each Shareholder receiving both Class A Stock and Class B Stock will be the same as the basis of Company Stock surrendered in exchange therefor (§ 358(a)(1)), allocated between Class B Stock and Class A Stock held immediately after the transaction in proportion to the fair market values of the stock of each class (Treas. Reg. § 1.358-2(a)(2)).

(7) The holding period of New Company Stock to be received by Shareholders will include the period during which Shareholders held Company Stock exchanged therefor, provided Company Stock is held as a capital asset at the time of such exchange (§ 1223(1)).

(8) The proposed exchange, as described above, will not be treated as a distribution of property to which § 301 applies by reason of the application of § 305(b) and (c).

(9) No opinion is expressed concerning whether the Class A Stock will be “section 306 stock” within the meaning of § 306(c). However, if the Class A Stock is “section 306 stock,” § 306(a) will not apply where Shareholder sells or otherwise disposes of (including redeems) such Class A Stock, since the distribution, and the disposition or redemption of such stock will not be in

pursuance of a plan having as one of its principal purposes the avoidance of federal income tax (§ 306(b)(4)).

CAVEATS

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. § 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your 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.

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

Sincerely,
Mary E. Goode
Senior Counsel, Branch 4
Office of Chief Counsel (Corporate)