Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

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Legend

Taxpayer =

Business =

Corporation 1 =

Corporation 2 =

Corporation 3 =

Corporation 4 =

Corporation 5 =

ESOP =

Partnership =

a% =

b% =

c% =

d% =

e% =

f% =

g% =

h% =

u =

v =

w =

x =

Dear :

This letter responds to a letter dated December 12, 2002, and subsequent correspondence submitted on behalf of Taxpayer requesting rulings on certain federal income tax consequences of a proposed transaction.

Facts

Taxpayer, a closely held domestic corporation, is the parent of an affiliated group of corporations that files a consolidated return. Taxpayer owns all of the stock of Corporation 1 and Corporation 2. Corporation 2 owns a% of Partnership. Taxpayer and its affiliates and Partnership engage in Business.

Corporation 3, a publicly traded corporation, is the parent of an affiliated group of corporations that files a consolidated return. Corporation 4, a wholly owned subsidiary of Corporation 3, owns approximately b% of Taxpayer and will convert all of its non-stock interests (warrants and prepaid preemptive rights) in Taxpayer into voting common stock before the proposed series of transactions takes place. Corporation 5, another wholly owned subsidiary of Corporation 3, owns the remaining e% of Partnership. Corporation 3 and its affiliates engage in Business.

ESOP owns c% of Taxpayer and other shareholders own the remaining d% of Taxpayer. Taxpayer represents that ESOP is a qualified plan under § 401(a) of the Internal Revenue Code and meets the requirements of § 4975(e)(7).

In order to meet the statutory requirements of an S election, to promote its business expansion, and to reduce certain local tax liabilities, Taxpayer proposes to borrow $u (Debt) from an unrelated lender and to engage in the following restructuring.

Taxpayer requests rulings under §§ 311(a) and (b), 351, 358(a), 362(a), 721(a), 722, 723, 1032(a), and 1223.

Section 3.01(30) of Rev. Proc. 2002-3, 2002-1 I.R.B. 117, provides that the Internal Revenue Service will not rule on whether a transaction qualifies under § 351 and whether various consequences (such as nonrecognition and basis) 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. If the Service determines that there is a significant issue that must be resolved, the Service will rule on the entire transaction, and not just the significant issue. In this case, Taxpayer has provided information sufficient to show that the question of whether § 351 applies to a portion of the restructuring (Corporate Transfer 1, described below) presents a significant issue under § 3.01(30) of Rev. Proc. 2002-3.

1. Redemption Transactions

a. Corporate Transfer 1. Taxpayer will contribute $v and operating assets with a fair market value and adjusted basis of approximately $w (Corporation 1 assets) in constructive exchange for stock in Corporation 1. Taxpayer will not cause Corporation 1 to assume any liabilities in this exchange.

b. Partnership Transfer 1. Corporation 1 will contribute the Corporation 1 assets to Partnership in exchange for an interest in Partnership.

c. Taxpayer will distribute $x of cash and all of the Corporation 1 stock to Corporation 4 in redemption of all of Corporation 4's stock in Taxpayer and will redeem the stock of the non-ESOP shareholders with cash and notes payable.

2. Qualified subchapter S subsidiary (QSub) Transactions

a. Corporate Transfer 2. Taxpayer will contribute its remaining operating assets (Corporation 2 assets) to Corporation 2 in constructive exchange for additional common stock in Corporation 2 and assumption by Corporation 2 of related liabilities. Corporation 2 will not assume any liabilities related to Debt.

b. Partnership Transfer 2. Corporation 2 will contribute the Corporation 2 assets to Partnership in exchange for additional interests in Partnership.

c. Taxpayer will make an S election for itself and a QSub election for Corporation 2.

Following the proposed restructuring, Partnership will hold the Corporation 1 and Corporation 2 assets, and Partnership will be owned as follows: Corporations 1 and 5 (wholly owned, directly or indirectly, by Corporation 3) will own f% and g%, respectively, and Taxpayer (through Corporation 2, its QSub) will own h% of Partnership. In addition, Taxpayer will be wholly owned by ESOP.

Representations

Taxpayer has made the following representations with respect to the proposed transactions.

1. Corporate Transfer 1

(a) Corporation 1 will not issue, either actually or constructively, any stock in exchange for services rendered to, or for the benefit of, Corporation 1, and Corporation 1 will not issue any stock, either actually or constructively, in exchange for indebtedness of Corporation 1, or for an interest on indebtedness of Corporation 1.

(b) Taxpayer did not receive the assets transferred in Corporate Transfer 1 as part of a plan of liquidation of another corporation.

(c) Taxpayer neither accumulated receivables nor made extraordinary payments of payables in anticipation of Corporation Transfer 1, and Corporation 1 (or a subsequent transferee) will report items which, but for the transfer, would have resulted in income or deduction to Taxpayer in a period subsequent to the transfer and such items will constitute income or deductions to Corporation 1 (or a subsequent transferee) when received or paid by it, and Corporation 1 (or a subsequent transferee) will include as ordinary income the proceeds received in collection of these income items.

(d) Taxpayer will not transfer any patents, copyrights, franchises, trademarks, trade names, or technical “know-how”.

(e) Taxpayer will not transfer the stock of another corporation or an interest in any entity treated as a partnership for federal tax purposes.

(f) The transfer is not the result of the solicitation by a promoter, broker, or investment house.

(g) Taxpayer will not retain any rights in the assets transferred.

(h) Taxpayer will not grant any licenses or leases in exchange for stock of Corporation 1.

(i) No property that is transferred to Corporation 1 will be leased back to Taxpayer or a related party.

(j) The value of the Corporation 1 common stock constructively received in exchange for accounts receivable will be equal to the net value of the accounts transferred (i.e., the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts).

(k) Corporation 1 will not assume any liabilities of Taxpayer within the meaning of § 357(d).

(l) There is no indebtedness between Taxpayer and Corporation 1, and there will be no indebtedness created in favor of Taxpayer as a result of the transfer.

(m) None of the assets transferred by Taxpayer to Corporation 1 secure a nonrecourse liability of Taxpayer.

(n) Taxpayer will receive no property other than a constructive issuance of Corporation 1 common stock.

(o) Corporate Transfer 1 will occur under a plan agreed upon before Corporate Transfer 1 in which the rights of the parties are defined.

(p) All exchanges will occur on approximately the same date.

(q) Corporation 1 has no plan or intention to redeem or otherwise reacquire the Corporation 1 common stock owned by Taxpayer.

(r) Taking into account any issuance of additional shares of Corporation 1, any issuance of stock for services, the exercise of any Corporation 1 stock rights, warrants, or subscriptions, a public offering of Corporation 1 stock, and the sale, exchange, transfer by gift, or other disposition of any of the stock of Corporation 1, Taxpayer will be in control of Corporation 1 within the meaning of § 368(c), immediately after Corporate Transfer 1.

(s) The fair market value of the Corporation 1 common stock constructively received by Taxpayer will be approximately equal to the fair market value of the assets transferred.

(t) Except for Partnership Transfer 1, Corporation 1 has no plan or intention to dispose of the transferred property other than in the normal course of business operations, and Partnership will retain and use the Corporation 1 assets in the ordinary course of business operations.

(u) Corporation 1 and Partnership will remain in existence, and Partnership, the ultimate recipient of the Corporation 1 assets, will retain and use these assets in a trade or business.

(v) Each of the parties paid its own expenses, if any, incurred in connection with Corporate Transfer 1.

(w) Corporation 1 will not be an investment company within the meaning of § 351(e)(1) and § 1.351-1(c)(1)(ii) of the Income Tax Regulations.

(x) Corporation 1 is not under the jurisdiction of a court in a title 11 or similar case (within the meaning of § 368(a)(3)(A)) and the stock or securities received in the exchange will not be used to satisfy the indebtedness of such debtor.

(y) Corporation 1 is not a “personal service corporation” within the meaning of § 269A.

2. Partnership Transfer 1

Taxpayer has made the following representations:

(a) Partnership would not be treated as an investment company within the meaning of § 351(e)(1) and § 1.351-1(c)(1)(ii) if it were incorporated.

(b) During the two-year period following Partnership Transfer 1, Partnership will make no distributions of cash or other property to Corporation 1 other than “operating cash flow distributions” as that term is defined in § 1.707-4(b).

(c) Partnership will not assume or take property subject to any liabilities (fixed or contingent) of Corporation 1 within the meaning of § 752.

(d) Partnership has no plan or intention to dispose of the Corporation 1 assets other than in the normal course of business.

(e) Corporation 1 has no plan or intention to distribute its interest in Partnership to Taxpayer.

3. Redemption of Corporation 4's Stock in Taxpayer

Taxpayer has made the following representations:

(a) The fair market value of the Corporation 1 stock and cash distributed will be approximately equal to the value of the Taxpayer common stock surrendered by Corporation 4.

(b) Corporation 4 will completely terminate its interest in Taxpayer within the meaning of § 302(b)(3).

4. Corporate Transfer 2, Partnership Transfer 2, QSub election

Taxpayer has made the following representation:

(a) Corporate Transfer 2 and Partnership Transfer 2 will occur before the QSub election with respect to Corporation 2, but such transfers will occur no more than three months before the effective date of the QSub election, and Corporate Transfer 2, Partnership Transfer 2, and Taxpayer’s QSub election with respect to Corporation 2 will occur pursuant to a single, integrated plan.

5. Partnership Transfer 2

Taxpayer has made the following representations:

(a) Partnership would not be treated as an investment company within the meaning of § 351(e)(1) and § 1.351-1(c)(1)(ii) if it were incorporated.

(b) During the two-year period following Partnership Transfer 2, Partnership will make no distributions of cash or other property to Corporation 2 other than "operating cash flow distributions" as that term is defined in § 1.707-4(b).

(c) Any liabilities assumed by Partnership as part of Partnership Transfer 2 will be "qualified liabilities" as that term is defined in § 1.707-5(a)(6).

(d) Any deemed distribution to Corporation 2 under § 752(b) occurring as a result of Partnership Transfer 2 will not exceed Corporation 2's basis in its Partnership interest, as determined by taking into account the basis of any assets transferred in Partnership Transfer 2.

6. In General

Taxpayer has made the following representations:

(a) There is no plan or intention to liquidate Partnership.

(b) To the best of the knowledge and belief of Taxpayer, each of the liquidations deemed to occur as a result of the QSub elections will be tax-free under § 332 and 337.

(c) Corporation 4's ownership of Taxpayer stock received in exchange for its warrants and prepaid preemptive rights (warrant exchange) will be disregarded as transitory. Taxpayer will treat the warrant exchange as an exchange of cash and/or Corporation 1 stock for the warrants and rights.

Rulings

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

1. With regard to the redemption transactions:

For federal income tax purposes, each step of the redemption transactions will be respected. See § 351(a) and (c); Rev. Rul. 83-156, 1983-2 C.B. 66; Rev. Rul. 68-298, 1968-1 C.B. 139. We conclude that Corporate Transfer 1, Partnership Transfer 1, and the Redemption will be treated as (i) a transfer of the Corporation 1 assets from Taxpayer to Corporation 1, (ii) a transfer of the Corporation 1 assets from Corporation 1 to Partnership, and (iii) a distribution of 100 percent of the Corporation 1 stock and $x in complete redemption of Corporation 4.

- Corporate Transfer 1

(1) Taxpayer will not recognize gain or loss in Corporate Transfer 1. See

§ 351(a) and (c); Rev. Rul. 68-298, 1968-1 C.B. 139.

(2) Corporation 1 will not recognize gain or loss in Corporate Transfer 1 under § 1032(a).

(3) Under § 358(a), Taxpayer's basis in its Corporation 1 stock will be increased by the aggregate adjusted basis of the Corporation 1 assets transferred to Corporation 1 in Corporate Transfer 1.

(4) The basis of the Corporation 1 assets in the hands of Corporation 1 following Corporate Transfer 1 will equal the basis of such assets in the hands of Taxpayer immediately before Corporate Transfer 1 under § 362(a).

(5) The holding period of the Corporation 1 assets in the hands of Corporation 1 will include the period such assets were held by Taxpayer under § 1223.

● Partnership Transfer 1

(1) Under § 721(a), neither Corporation 1 nor Partnership will recognize gain or loss in Partnership Transfer 1.

(2) The basis in the Partnership interests received by Corporation 1 in Partnership Transfer 1 will equal the basis of the Corporation 1 assets exchanged for those interests, reduced by the liabilities assumed by Partnership and increased by Taxpayer's share of Partnership's liabilities immediately following the contribution. See §§ 722 and 752(a) and (b).

(3) The holding period in the Partnership interests received by Corporation 1 in Partnership Transfer 1 will be divided if received in exchange for property that gives rise to different holding periods under §1.1223-3(a). To the extent of the fair market value of the interests in Partnership received in exchange for property that is a capital asset or property described in § 1231, that portion of the holding period of the Partnership interests will include the Corporation 1's holding period in the capital assets or property described in § 1231 under § 1223 and § 1.1223-3(b)(1).

(4) Under § 723, Partnership's basis in the Corporation 1 assets received from Corporation 1 will equal the basis of such property in the hands of Corporation 1 immediately before Partnership Transfer 1.

(5) Partnership's holding period in the assets received from Corporation 1 will include the period during which Corporation 1 owned such property under § 1223.

● Redemption

When Taxpayer distributes cash and Corporation 1 stock to Corporation 4 in redemption of all of Corporation 4's stock in Taxpayer, Taxpayer will recognize gain as

if Taxpayer sold the Corporation 1 stock to Corporation 4 at fair market value and Taxpayer will not recognize any loss under § 311.

2. With regard to the QSub transactions:

- Corporate Transfer 2

Pursuant to the planned, integrated series of transactions, Corporation 2 will liquidate as a result of the QSub election subsequent to Corporate Transfer 2. As a result, Corporate Transfer 2 will be disregarded and Taxpayer will be treated as directly transferring the Corporation 2 assets to Partnership in Partnership Transfer 2. See § 1.1361-4(a)(2) and Rev. Rul. 68-602, 1968-2 C.B. 135.

- Partnership Transfer 2

(1) Under § 721(a), neither Taxpayer nor Partnership will recognize gain or loss in Partnership Transfer 2.

(2) The basis in the Partnership interests received by Taxpayer in Partnership Transfer 2 will equal the basis of the Corporation 2 assets exchanged by Taxpayer for those interests, reduced by the liabilities assumed by Partnership and increased by Taxpayer's share of Partnership's liabilities immediately following the contribution. See §§ 722 and 752(a) and (b).

(3) The holding period in the Partnership interests received by Taxpayer in Partnership Transfer 2 will be divided if received in exchange for property that gives rise to different holding periods under §1.1223-3(a). To the extent of the fair market value of the interests in Partnership received in exchange for property that is a capital asset or property described in § 1231, that portion of the holding period of the Partnership interests will include Taxpayer's holding period in the capital assets or property described in § 1231 under § 1223 and § 1.1223-3(b)(1).

(4) Under § 723, Partnership's basis in the Corporation 2 assets received from Taxpayer will equal the basis of such property in the hands of Taxpayer immediately before the transfer of the assets to Partnership.

(5) Partnership's holding period in the assets received from Taxpayer will include the period during which Taxpayer held such property under § 1223.

We express or imply no opinion as to the tax treatment of the transactions under other provisions of the Code or 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. In particular, we express or imply no opinion as to whether the S corporation election for Taxpayer is valid or whether the QSub election that Taxpayer makes for its subsidiary is valid. In addition, no opinion is expressed or implied concerning whether ESOP is qualified under § 401(a) or meets the requirements of § 4975(e)(7).

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by the appropriate parties. While this office has not verified any of the material submitted in support of the request for the rulings, it is subject to verification on examination.

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

Pursuant to a power of attorney on file with this office, we are sending the original of this letter to you and a copy to the taxpayer.

Sincerely,

Jeanne M. Sullivan
Senior Technician Reviewer
Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes

cc: