

**Internal Revenue Service**

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:CORP:3-PLR-162125-02  
Date:  
March 13, 2003

Distributing =

Controlled I =

Controlled II =

Controlled III =

State X =

business a =

business b =

business c =

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business d =

a =

Agency =

Dear :

This letter responds to a request dated November 8, 2002, submitted on your behalf by your authorized representative, for rulings on the federal income tax consequences of a proposed transaction. The ruling request supplements a previous request for rulings dated November 14, 2001, subsequently withdrawn, including additional information that was submitted in letters dated January 17 and March 13, 2002. Additional information has been submitted in letters dated December 12 and December 27, 2002, and January 23, February 28, and March 11, 2003. The information submitted is summarized below.

### Summary of Facts

Distributing, a State X corporation, is the common parent of an affiliated group of corporations that file a consolidated federal income tax return. Distributing has a single class of voting common stock outstanding which is held by a individuals. Distributing's three wholly-owned subsidiaries, Controlled I, Controlled II, and Controlled III (collectively, the "Controlleds") join in the Distributing consolidated return. Distributing, Controlled I, Controlled II, and Controlled III conduct business a, business b, business c, and business d, respectively. Distributing and the Controlleds have submitted financial information indicating that Distributing's business a, Controlled I's business b, Controlled II's business c, and Controlled III's business d, respectively, 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.

Distributing's business a, which involves government contracting, is subject to the strict regulatory rules of Agency. These rules govern Distributing's reporting method of accounting and method of employee compensation. Because the Controlleds are part of the Distributing affiliated group, they are also subject to Agency's required method of reporting as well as Agency's method of employee compensation. Because the Agency system of reporting and operation is more complex and expensive than

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needed by the Controlled entities, the Controlled entities currently are incurring unnecessary costs that they would not otherwise incur if they operated outside the Distributing affiliated group of corporations.

Distributing and an independent consulting firm, in a detailed opinion, state that if the Controlled entities are separated from Distributing and each of the Controlled entities conduct its respective business as a stand-alone corporation, significant cost savings will result. The projected cost savings, both with respect to each of the three proposed distributions, and in the aggregate, will be in excess of one percent of the base period net income of the Distributing consolidated group for the five year base period. That is, each of the proposed distributions of the stock of Controlled I, Controlled II, and Controlled III will meet the business purpose requirement under the cost savings analysis set forth in Rev. Proc. 96-30, Appendix A, § 2.04, because Controlled I, Controlled II, and Controlled III will contribute to the overall post-spin off cost savings of more than one percent of the base period net income of Distributing's affiliated group, and Controlled I, Controlled II, and Controlled III each will meet the one percent test on a separate basis without taking into account the cost savings of the other Controlled entities.

Detailed analysis has been submitted which explains why the cost savings cannot be achieved through a nontaxable transaction that does not involve the distribution of the stock of Controlled I, Controlled II, and Controlled III, and which is neither impractical nor unduly expensive. The alternative transactions considered include both the use of a holding company structure and the spin-off of various combinations of Controlled I, Controlled II, and/or Controlled III. Only by spinning off each of the Controlled entities, simultaneously, is a one percent or greater cost savings achieved. If the three Controlled entities are not simultaneously spun off, the projected overall cost savings fall below the one percent threshold.

Accordingly, in order to achieve the above cost savings, it is proposed that Distributing will distribute to its shareholders, pro rata, all the stock of Controlled I, Controlled II, and Controlled III (collectively, the "Distributions").

### **Representations**

The taxpayers have made the following representations:

- (a) No part of the shares of the Controlled entities to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (b) The five years of financial information submitted on behalf of Distributing and each of the Controlled entities are representative of each corporation's present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.

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- (c) Following the transaction, Distributing and each of the Controlled entities will continue the active conduct of its businesses, independently and with its separate employees.
- (d) The distribution of the stock of each of the Controlled entities is carried out for the following corporate business purpose: cost savings. The distribution of the stock of each of the Controlled entities is motivated, in whole or substantial part, by this corporate business purpose.
- (e) 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 any of the Controlled entities after the transaction, except for sales of Distributing stock or one of the Controlled entities' stock back to the applicable corporation by a terminating employee under the respective corporation's stock plan. A shareholder terminating employment with Distributing or a Controlled entity must offer all of his or her shares for sale to Distributing and the Controlled entities at the same time as he or she offers shares in the employing corporation, thus preventing termination of interest in one of the corporations, but not all of them.
- (f) There is no plan or intention by Distributing or any of the Controlled entities, 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 § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.
- (g) Distributing and the Controlled entities had no accumulated earnings and profits at the beginning of their respective taxable years. Distributing and the Controlled entities will have no current earnings and profits as of the date of the distribution. No distribution of property by Distributing immediately before the proposed transaction would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.
- (h) There is no plan or intention to liquidate Distributing or any of the Controlled entities, to merge any of them into any other corporation, or to sell or otherwise dispose of the assets of any of these corporations after the transaction, except in the ordinary course of business.
- (i) No property will be transferred and no liabilities will be assumed in the proposed transaction.
- (j) No intercorporate debt will exist between Distributing and any of the Controlled entities or between any Controlled entities inter sese at the time of, or subsequent to, the distribution of the Controlled entities' stock.

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- (k) Immediately before the distribution of the stock of the Controlled. items of income, gain, loss, deduction and credit will be taken into account as required by the applicable intercompany transaction regulations. Further, Distributing's excess loss account with respect to stock of the Controlled, if any, will be included in income immediately before the distribution.
- (l) Payments made in connection with all continuing transactions, if any, between Distributing and any Controlled or between any of the Controlled inter sese will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (m) The distributions are 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 entitled to vote or stock possessing 50 percent or more of the total value of all classes of stock of Distributing or the Controlled.
- (n) Distributing is not an S corporation (within the meaning of § 1361(a)), and there is no plan or intention by Distributing or any of the Controlled to make an S corporation election pursuant to § 1362(a).

### **Rulings**

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

- (1) No gain or loss will be recognized by Distributing upon the distribution of all the stock of Controlled I, Controlled II, and Controlled III, pro rata, in the Distributions (§ 355(c)(1)).
- (2) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon the receipt of the stock of Controlled I, Controlled II, and Controlled III (§ 355(a)(1)).
- (3) The aggregate basis of the Distributing, Controlled I, Controlled II, and Controlled III shares in the hands of the Distributing shareholders immediately after the Distributions will be the same as the aggregate basis of the Distributing stock in the hands of the Distributing shareholders immediately before the Distributions, allocated between the Distributing and the Controlled I, Controlled II, and Controlled III shares in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a), (b), and (c)).
- (4) The holding period of the Controlled I, Controlled II, and Controlled III shares in the hands of the Distributing shareholders will include the holding period of the

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Distributing shares with respect to which the Distributions are made, provided the Distributing shares are held as a capital asset by such shareholder on the date of the Distributions (§ 1223(1)).

- (5) Earnings and profits will be allocated between Distributing and Controlled I, Controlled II, and Controlled III in accordance with § 312(h) and §§ 1.312-10(b) and 1.1502-33(e).

We express no opinion 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 transaction that are not specifically covered by the above rulings.

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for a ruling. Verification of the information, representations, and other data may be required as part of the audit process. See §§ 12.04 and 12.05 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 44, which discusses in greater detail the revocation or modification of ruling letters. However, when the criteria in § 12.06 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

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.

It is important that a copy of this ruling letter be attached to the federal income tax return of each party involved for the taxable year in which the transaction covered by this letter is consummated. Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely,

*Richard E. Coss*

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Richard E. Coss  
Senior Counsel, Branch 3  
Office of Associate Chief Counsel (Corporate)