

Internal Revenue Service

Department of the Treasury

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Date:

December 21, 2001

LEGEND

Distributing =

Controlled =

DSub A =

Controlled Sub 1 =

Controlled Sub 2 =

Controlled Sub 3 =

New Controlled =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Business A =

Business B =

Date A =

Date B =

Date C =

State A =

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State B	=
Year 1	=
Year 2	=
Year 3	=
R	=
S	=
T	=
U	=
V	=
W	=
aa	=
bb	=
cc	=

This letter responds to your August 23, 2001 request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondence is summarized below.

SUMMARY OF FACTS

Distributing was incorporated in Year 1 in State A and was redomiciled as a State B corporation in Year 2. Distributing is a publicly traded company with only one class of common stock outstanding. Shareholder 1, an individual, directly and indirectly, owns aa percent of the outstanding stock of Distributing. Shareholder 2, an individual, directly owns bb percent of the outstanding stock of Distributing. There are also R institutional shareholders that through various funds and entities own more than 5 percent of Distributing's stock. To the best knowledge of Distributing, the remainder of Distributing's stock is held by less than 5 percent shareholders.

Distributing is the common parent of wholly owned subsidiary corporations that file a consolidated return for federal income tax purposes. Distributing, a holding company, directly owns all of the outstanding stock of DSub A and Controlled. Distributing conducts Business A indirectly through DSub A.

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Controlled, a holding company, was incorporated in Year 3 in State B. Controlled owns all of the outstanding stock of Controlled Sub 1, Controlled Sub 2 and Controlled Sub 3. Controlled conducts Business B indirectly through Controlled Sub 2.

Financial information has been received indicating that Business A (as conducted by Distributing through DSubA) and Business B (as conducted by Controlled through Controlled Sub 2) each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Key Employees of Controlled hold stock options in Distributing. Controlled wishes to motivate its key employees through an incentive equity participation program tied to the market performance of Controlled's common stock.

Accordingly, Distributing proposes the following transaction:

- (1) On Date A, the authorized capital of Controlled was increased to S shares consisting of T shares of common stock and U shares of preferred stock. The number of outstanding shares of Controlled common stock were subsequently increased on Date B to V shares. No shares of preferred stock have been or will be issued. The number of shares of common stock of Controlled will be further adjusted immediately prior to the Public Distribution so as to equal the number of outstanding shares of Distributing common stock on the date of the Public Distribution.
- (2) Pursuant to state law, DSub A will convert into a single member LLC that will elect not to be treated as a corporation and that is disregarded as an entity separate from its owner for federal income tax purposes. For federal income tax purposes, this step will be treated under section 332(a) as a complete tax-free liquidation of DSub A into Distributing.
- (3) Distributing will distribute all of the shares of stock of Controlled to the shareholders of Distributing on a pro rata one-to-one basis (the "Public Distribution"). The management of Distributing is not aware of any fractional shares outstanding, and it is not expected that fractional shares of Controlled stock will be involved in the Public Distribution.
- (4) Distributing will transfer an amount of cash to Controlled based upon a determination immediately prior to the proposed spin off of the forecasted operating losses that will be incurred by Controlled until operating income is earned, together with an amount of cash to cover an average one quarter's operating expenses and certain minor assets. The transfer of the assets will be in constructive exchange for additional shares of Controlled stock. Distributing also will extend a line of credit to Controlled in the amount of approximately T dollars. The line of credit will expire on Date C at which date all outstanding principal and interest will be due and payable. Interest on the line of credit will accrue monthly at the prime rate

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of interest. Controlled will only draw down on this line of credit if it requires part or all of the amount available as consideration for operating expenses or for an acquisition of a related business.

- (5) Controlled will adopt a stock option plan substantially identical to that of Distributing's. All of the employees of Controlled will exchange all of their outstanding Distributing stock options solely for new Controlled stock options. The Controlled stock options will vest on the same vesting schedule set forth in Distributing's Equity Participation Plan. Further, certain designated officers and key employees will also receive additional Controlled stock options in connection with the transaction. The shares of Controlled stock subject to the additional stock options to be received by the Controlled designated officers and key employees plus the number of shares of Controlled stock subject to the Controlled stock options received that are in excess of the number of Distributing options exchanged by these officers and key employees will represent in the aggregate at least cc percent of the outstanding shares of stock of Controlled on a fully diluted basis.
- (6) Controlled has changed its corporate name to New Controlled.

REPRESENTATIONS

- (a) The indebtedness owed by Controlled to Distributing after the Public Distribution will not constitute "stock or securities" within the meaning of section 355.
- (b) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Public Distribution except for any indebtedness incurred in the ordinary course of business, pursuant to the line of credit, or for obligations resulting from arm's length agreements for shared services or facilities for a brief transitional period.
- (c) No part of the consideration 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.
- (d) The five years of financial information submitted on behalf of DSub A is representative of DSub A's present operations, and with regard to DSub A, 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 Controlled Sub 2 is representative of Controlled Sub 2's present operations, and with regard to Controlled Sub 2, there has been no substantial operational changes since the date of the last financial statements submitted.

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- (f) Immediately after the Public Distribution, at least 90 percent of the fair market value of the gross assets of Controlled will consist of stock and securities of Controlled Sub 2, which is a controlled corporation engaged in the active conduct of a trade or business, as defined in section 355(b)(2).
- (g) Immediately after the Public Distribution, the gross assets of the active business conducted by DSub A (as defined in section 355(b)(2)) will have a fair market value that is at least 5 percent of the total fair market value of the gross assets of Distributing.
- (h) Immediately after the Public Distribution, the gross assets of the active business conducted by Controlled Sub 2 (as defined in section 355(b)(2)) will have a fair market value that is at least 5 percent of the total fair market value of the assets of Controlled Sub 2.
- (i) Following the Public Distribution, Distributing will continue the active conduct of the business previously conducted by DSub A, independently and with its separate employees. Subsequent to the Public Distribution, it is anticipated that DSub A and Controlled Sub 2 will share a number of administrative services for a transitional period not to exceed W months.
- (j) Following the Public Distribution, Controlled Sub 2 will continue the active conduct of its business, independently and with its separate employees. Subsequent to the Public Distribution, it is anticipated that DSub A and Controlled Sub 2 will share a number of administrative services for a transitional period not to exceed W months.
- (k) The Public Distribution is carried out for the corporate business purpose of enhancing Controlled's ability to motivate, reward, attract and retain key officers and employees of Controlled. The Public Distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (l) 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 in, or securities of, Distributing or Controlled after the Public Distribution. Notwithstanding the foregoing, Shareholder 3 may in the future determine to dispose of or purchase any such stock in the normal course of its business as an investment advisor based upon decisions as to existing market conditions and the needs of investors it represents.

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- (m) 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 Public Distribution, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.
- (n) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the Public Distribution, except in the ordinary course of business. However, existing or newly formed subsidiaries of Distributing (or Distributing itself) or of Controlled (or Controlled itself) may at some later date seek to acquire related businesses, and some of these acquisitions may be structured as mergers.
- (o) No Distributing shareholder or shareholders will hold immediately after the Public Distribution disqualified stock within the meaning of section 355(d)(3), which constitutes a 50 percent or greater interest in Distributing or Controlled.
- (p) For purposes of section 355(d), immediately after the Public Distribution, no person (determined after applying the aggregation rules of section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote or 50 percent or more of the total value of shares of all classes of Distributing stock that was acquired by purchase (as defined in sections 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Public Distribution.
- (q) For purposes of section 355(d), immediately after the Public Distribution, no person (determined after applying the aggregation rules of section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote or 50 percent or more of the total value of shares of all classes of Controlled stock that was either (i) acquired by purchase (as defined in sections 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Public Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in sections 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Public Distribution.
- (r) The Public Distribution is not part of a plan or a series of related transactions (within the meaning of section 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

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of either Distributing or Controlled entitled to vote, or stock possessing 50 percent or more of the total value of shares of all classes of stock of either Distributing or Controlled.

- (s) Distributing will transfer cash and other minor assets to Controlled in connection with the Public Distribution.
- (t) No liabilities are being assumed in connection with the Public Distribution.
- (u) Distributing and Controlled neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Public Distribution.
- (v) Immediately before the Public Distribution, items of income, gain, loss, deduction, and credit, if any, will be taken into account as required by the applicable intercompany transaction regulations. (See sections 1.1502-13 and 1.1502-14 as in effect before the publication of T.D.8597, 1995-2 C.B. 147, and as currently in effect, section 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account, if any, with respect to Controlled's stock will be included in income, if any, immediately before the Public Distribution. (See section 1.1502-19).
- (w) Subsequent to the Public Distribution, it is anticipated that Distributing and Controlled will share a number of administrative services for a brief transitional period of up to W months. Payments made in connection with all other 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.
- (x) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).

RULINGS

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

- (1) The transfer by Distributing to Controlled of the cash and minor assets in exchange for the constructive issuance to Distributing of stock of Controlled, followed by the pro rata distribution by Distributing of all of the stock of Controlled to the Distributing shareholders will qualify as a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be "a party to a reorganization" within the meaning of section 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of assets to

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Controlled in exchange for the stock of Controlled (sections 361(a) and 357(a)).

- (3) No gain or loss will be recognized by Controlled upon the receipt of the assets of Distributing in exchange for stock of Controlled (section 1032(a)).
- (4) The basis of the assets received by Controlled will be the same as the basis of the assets in the hands of Distributing immediately prior to the transaction (section 362(b)).
- (5) The holding period of the Distributing assets received by Controlled will include the holding period during which these assets were held by Distributing (section 1223(2)).
- (6) No gain or loss will be recognized by Distributing upon the pro rata distribution of the shares of stock of Controlled to the Distributing shareholders (section 361(c)).
- (7) No gain or loss will be recognized by the Distributing shareholders upon their receipt of the Controlled common stock pursuant to the Public Distribution (section 355(a)).
- (8) The aggregate basis of the Distributing common stock and the Controlled common stock in the hands of the Distributing shareholders after the Public Distribution will be the same as the basis in the Distributing common stock held by the Distributing shareholders immediately prior to the Public Distribution, allocated in proportion to the fair market values of the Distributing and the Controlled common stock in accordance with sections 358(a)(1), (b) and 1.358-2(a)(2).
- (9) The holding period of the Controlled common stock received by the Distributing shareholders will, in each instance, include the holding period of the Distributing common stock with respect to which the distribution of the Controlled common stock is made, provided that the Distributing common stock is held as a capital asset on the date of the Public Distribution (section 1223(1)).
- (10) As provided in section 312(h), proper allocation of earnings and profits between Controlled and Distributing will be made in accordance with section 1.312-10(a).
- (11) Payments made by Distributing to Controlled or by Controlled to Distributing under the Tax Sharing Agreement that (a) have arisen or will arise for a taxable period ending before the Public Distribution or for a taxable period beginning on or before and ending after the Public

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Distribution, and (b) will not become fixed and ascertainable until after the Public Distribution, will be treated as occurring immediately before the Public Distribution.

- (12) Following the Public Distribution, Controlled and its direct and indirect subsidiaries, if any, that are “includible corporations” under section 1504(b) and satisfy the ownership requirements of section 1504(a)(2) will be an affiliated group of corporations entitled to file consolidated federal income tax returns with Controlled as the common parent. But if there are any excess loss accounts (“ELA”) or deferred intercompany transactions with respect to Controlled and Controlled subsidiaries, the ELAs or deferred intercompany transactions must be taken into income to the extent required immediately before the Public Distribution.

CAVEATS

No opinion is expressed about the tax treatment of the transaction under any other provision of the Code or Regulations, or the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed concerning the tax consequences associated with:

- (a) the exchange of stock options in Distributing for stock options in Controlled;
- (b) the distribution of additional stock options to officers and key employees of Controlled;
- (c) whether Controlled and subsidiaries of Controlled may be subject to § 1.1502-21; or
- (d) whether the conversion of DSub A into a single member LLC, which will elect not to be treated as a corporation and which is disregarded as an entity separate from its owner for federal income tax purposes, will be treated as a tax-free liquidation. See Rev. Proc. 2001-3, § 3.01(29).

PROCEDURAL STATEMENTS

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.

This ruling letter is directed only to the taxpayer who requested it. Section

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

A copy of this letter must be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction is consummated.

Pursuant to a power of attorney on file in this office, we have sent a copy of this letter to the taxpayer.

Sincerely yours,
Alfred C. Bishop, Jr.
Branch Chief, Branch 6
Associate Chief Counsel (Corporate)

cc: