

## Internal Revenue Service

## Department of the Treasury

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Date:

August 1, 2000

Distributing =

Controlled =

Controlled Sub 1 =

Sub 1 =

Sub 2 =

Sub 3 =

FSub 1 =

FSub 2 =

FSub 3 =

FSub 4 =

FSub 5 =

FSub 6 =

Business X =

Activity X1 =

Activity X2 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

A =

B =

Consultant =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Country 1 =

Country 2 =

Country 3 =

Country 4 =

Country 5 =

Country 6 =

Country 7 =

a =

b =

c =

d =

e =

f =

This letter responds to your January 31, 2000 request for rulings on certain federal income tax consequences of a proposed and partially completed transaction. The information submitted in that letter and in later correspondence is summarized below.

The rulings in this letter are based on 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 ruling request. Verification of the facts, information, and other data in this ruling letter may be required as part of the audit process.

### **Summary of Facts**

Publicly traded Distributing is the common parent of a corporate group whose includible affiliates join in filing a consolidated return. The Distributing group conducts Business X, which consists of Activity X1 and Activity X2. Based on filings with the Securities and Exchange Commission, Distributing believes that shareholders A and B, both of whom are investment advisors, are the only shareholders who own five percent or more of the outstanding Distributing stock.

Distributing began Activity X1 in Year 1 and Activity X2 in Year 2. Later in Year 2, Distributing transferred Activity X2 to newly formed Sub 1. In Year 3, Distributing acquired Controlled Sub 1, a developer of products related to Activity X2 ("Acquisition 1"). Shortly after Acquisition 1, Sub 1 merged into Controlled Sub 1 ("Merger 1"). Also in Year 3, Distributing formed wholly owned Sub 2 to develop and market Activity X2 for the In Year 4, Distributing acquired Controlled in a transaction the taxpayer represents qualified as a reorganization under both § 368(a)(1)(B) and § 368(a)(1)(A) and (a)(2)(E) of the Internal Revenue Code ("Acquisition 2"). Controlled develops and markets products related to Activity X2. On Date 1, Sub 2 merged into Distributing ("Merger 2"), and, soon after Date 1, Distributing contributed part of the Sub 2 assets to newly formed Sub 3 (the "Retransfer").

After these transactions, and before the transactions described below, Distributing wholly owned Controlled, Controlled Sub 1, and Sub 3. In addition, Controlled Sub 1 wholly owned FSub 2 (Country 1), FSub 3 (Country 2), FSub 4 (Country 3), FSub 5 (Country 4), and FSub 6 (Country 5). FSub 6 has a branch office in Country 6 and recently closed a branch office in Country 7.

Distributing and Controlled have issued, and expect to continue issuing, stock options as compensation (the "Compensatory Options"). In addition, Distributing has issued convertible subordinated notes due in Year 5. The conversion feature of the notes may require Distributing to retain shares of Controlled stock if Distributing's stock trades at a discount to the value of its interest in Controlled. If 10 days before the

Distribution described below, Distributing's stock trades at a discount to the value of its interest in Controlled, Distributing will delay the Distribution until such time as no retention of Controlled stock is necessary.

Distributing has submitted financial information indicating that Activity X1 (as conducted by Distributing) and Activity X2 (as conducted by Controlled) each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

The operation of Activity X1 and Activity X2 within the same affiliated group creates management, systemic, and other problems that prevent these corporations from realizing their full potential. Detailed and reasoned affidavits have been submitted by executives of Distributing and Controlled together with a letter and other information from Consultant that describe the situation in specific terms. Consultant has advised Distributing that separating these activities by distributing the stock of Controlled to the Distributing shareholders (the "Separation") would resolve these problems. Further, Controlled needs additional capital to pursue certain growth opportunities available to its Activity X2 (the "Opportunities") that Distributing is unwilling to authorize or provide while Controlled remains an affiliate. Consultant has advised Distributing in a detailed and reasoned letter that the Separation would allow Controlled to raise significantly more capital in a public offering of the Controlled stock.

### **The Transaction**

To accomplish the Separation, Distributing has proposed and partially undertaken the following series of steps (collectively, the "Transaction"):

(i) On Date 2, Distributing transferred to Controlled Sub 1 an option to acquire all the stock of unrelated FSub 1 (Country 5) (the "Option Transfer"). Shortly thereafter, Controlled Sub 1 exercised the option and issued notes to the FSub 1 shareholders in exchange for their FSub 1 stock (the "Exchange"). One of the notes was later converted into a percent of Controlled's stock (the "Conversion").

(ii) On Date 3:

(a) To obtain the capital needed to fund the Opportunities, Controlled sold b percent of its stock (less than 20 percent) to the general public (the "Offering").

(b) Distributing granted Controlled licenses to use certain of its technology in Activity X2 (the "Licenses").

(c) Distributing transferred its Controlled Sub 1 stock to Controlled in constructive exchange for additional Controlled stock (the "Contribution").

(iii) On Date 4, Controlled transferred c dollars to Distributing in satisfaction of a pre-existing debt owed to Distributing.

(iv) On Date 5, Distributing will distribute its Controlled stock pro rata to the Distributing shareholders (the "Distribution") but will not issue fractional shares. Instead, the distribution agent will aggregate and sell on the open market all fractional shares and distribute the proceeds to those shareholders otherwise entitled to fractional shares.

In connection with the Transaction, Distributing and Controlled have entered into a shared services agreement, a tax sharing agreement, and a separation agreement. In addition, Controlled has adopted various employee benefit plans similar to the existing employee benefit plans of Distributing.

### **Representations**

Distributing has made the following representations regarding the Transaction:

(a) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

(b) The five years of financial information submitted on behalf of Distributing (for Activity X1) and Controlled (for Activity X2) represents each corporation's present operations, and there have been no substantial operational changes to these corporations since the date of the last submitted financial statements.

(c) Immediately after the Distribution, the gross assets of the trade or business relied on by Distributing to satisfy the active trade or business requirement of § 355(b) (Activity X1) will have a fair market value equal to at least five percent of the total fair market value of Distributing's gross assets.

(d) Immediately after the Distribution, the gross assets of the trade or business relied on by Controlled to satisfy the active trade or business requirement of § 355(b) (Activity X2) will have a fair market value equal to at least five percent of the total fair market value of Controlled's gross assets.

(e) Following the Distribution, Distributing and Controlled each will continue the active conduct of its business, independently and with its own employees, except for the sharing of certain administrative services for a limited period.

(f) The Distribution will (i) enhance the success of Activity X1 and Activity X2 by resolving certain problems associated with operating the two activities within the same corporate group and (ii) allow Controlled to pursue the Opportunities with capital generated by the public offering of its stock. The Distribution is motivated, in whole or

substantial part, by these corporate business purposes and other business reasons.

(g) No liabilities will be assumed (within the meaning of § 357(d)) by Controlled in the Transaction.

(h) Neither Distributing nor Controlled is an investment company as defined in § 368(a)(2)(F)(iii) and (iv).

(i) 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 Transaction, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.

(j) 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 Transaction, except in the ordinary course of business, and except for Distributing's transfer of d percent of its Activity X1 assets to wholly owned Sub 3.

(k) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to dispose of any of its stock after the Distribution, except that Distributing may use e percent of its stock, and Controlled may use f percent of its stock, to acquire unrelated corporations in the two-year period following the Distribution.

(l) There is no plan or intention by A or B, and the management of Distributing, to its best knowledge, is not aware of any plan or intention on the part of any other shareholder or security holder of Distributing, to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either Distributing or Controlled after the Transaction.

(m) Immediately before the Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (see §§ 1.1502-13 and 1.1502-14 of the Income Tax Regulations as in effect before the publication of T.D. 8597, 1995-2 C.B. 147, and as currently in effect; § 1.1502-13 as published by T.D. 8597). Further, any excess loss account Distributing may have in Controlled stock will be included in income immediately before the Distribution to the extent required by applicable regulations (see § 1.1502-19).

(n) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 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 § 355(d)(5) and (8)) during the five-year period

(determined after applying § 355(d)(6)) ending on the date of the Distribution.

(o) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 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 § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(p) 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 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.

(q) No debt will exist between Distributing and Controlled at the time of, or after, the Distribution, other than debt that may arise after the Distribution as trade accounts payable created in the ordinary course of business, debt created by the sharing of certain technology, and debt on potential claims under the separation agreement and the tax sharing agreement. None of this debt will constitute "stock or securities" for § 355 purposes.

(r) Payments made in connection with any continuing transactions 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.

(s) 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 fractional shares and does not represent separately bargained for consideration. The total cash consideration to be paid to the Distributing shareholders in lieu of fractional shares will not exceed one percent of the total consideration issued in the Transaction. The fractional share interests will be aggregated, and no Distributing shareholder will receive cash in an amount equal to or greater than the value of one full share of Controlled stock.

(t) The Compensatory Options issued or to be issued by Distributing or Controlled (i) contain or will contain customary terms and conditions, (ii) were or will be granted in connection with the performance of services for Distributing or Controlled or a person related to the grantor under § 355(d)(7)(A), (iii) were not and will not be excessive by reference to the services performed, (iv) will not be transferable within the meaning of § 1.83-3(d) immediately after the Distribution or within six months

thereafter, and (v) will not have a readily ascertainable fair market value as defined in § 1.83-7(b) immediately after the Distribution and within six months thereafter.

(u) Neither A nor B is (or will become) a director of either Distributing or Controlled, and neither is (or will be) involved in the day-to-day management of either Distributing or Controlled.

(v) No gain or loss was recognized on any aspect of Acquisition 2 that caused a shift of Controlled stock ownership from a shareholder of Controlled to Distributing or any member of the Distributing affiliated group.

(w) The Distribution will occur no later than the later of six months after the Offering or three months after receipt of this private letter ruling.

(x) Neither Distributing nor Controlled has been or will be a United States real property holding corporation ("USRPHC"), as defined in § 897(c)(2), at any time during the five-year period ending on the date of the Distribution, and neither Distributing nor Controlled will be a USRPHC immediately after the Distribution.

(y) FSub 1, FSub 2, FSub 3, FSub 4, FSub 5, and FSub 6 are corporations within the meaning of § 7701(a)(3).

(z) FSub 1, FSub 2, FSub 3, FSub 4, FSub 5, and FSub 6 are controlled foreign corporations ("CFC's") as defined in § 957(a), and they will continue to be CFC's after the Distribution.

(aa) FSub 1, FSub 2, FSub 3, FSub 4, FSub 5, and FSub 6 are not passive foreign investment companies as defined in § 1297.

(bb) No United States person who is currently a member of the Distributing group will transfer property, directly or indirectly, to a foreign corporation in connection with the Transaction.

(cc) No United States person who is currently a member of the Distributing group will transfer intangible property within the meaning of § 367(d) to a foreign corporation in connection with the Transaction.

(dd) The Distributing group has no members that are subject to tax under §§ 882 and 884.

## **Rulings**

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

(1) The Contribution, followed by the Distribution, will be a reorganization under



§ 368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" under § 368(b).

(2) No gain or loss will be recognized by Distributing on the Contribution (§§ 361(a) and 357(a)).

(3) No gain or loss will be recognized by Controlled on the Contribution (§ 1032(a)).

(4) The basis of each asset received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing immediately before the Contribution (§ 362(b)).

(5) The holding period of each asset received by Controlled in the Contribution will include the period during which Distributing held that asset (§ 1223(2)).

(6) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the Distributing shareholders upon their receipt of Controlled stock in the Distribution (§ 355(a)(1)). Section 355(a)(3)(B) will not treat as "other property" any part of the Controlled stock considered constructively issued by Controlled to Distributing in exchange for the Licenses.

(7) The aggregate basis of the Distributing stock and the Controlled stock in the hands of each Distributing shareholder (including any fractional share interest to which the shareholder may be entitled) will equal the aggregate basis of the Distributing stock held by that shareholder immediately before the Distribution, allocated between the Distributing stock and the Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a) (§ 358(a)(1), (b), and (c)).

(8) The holding period of the Controlled stock received by each Distributing shareholder in the Distribution will include the holding period of the Distributing stock on which the Distribution is made, provided the Distributing stock is held as a capital asset on the date of the Distribution (§ 1223(1) and (1)(B)).

(9) No gain or loss will be recognized by Distributing on the Distribution (§§ 361(c) and 355(e)).

(10) Earnings and profits will be allocated between Distributing and Controlled in accordance with §§ 312(h), 1.312-10(a), and 1.1502-33(e)(3).

(11) The payment of cash, if any, in lieu of fractional shares of Controlled stock will be treated for federal income tax purposes as if the fractional shares had been distributed as part of the Distribution and then had been sold by the holders. Accordingly, a shareholder will recognize gain or loss equal to the difference between the cash received and the basis of the fractional share as determined in ruling (7) above (§ 1001). If the Controlled stock is held by the shareholder as a capital asset,

the gain or loss will be subject to the provisions and limitations of Subchapter P of Chapter 1 of the Code (§§ 1221 and 1222).

(12) Payments made by Distributing to Controlled, or by Controlled to Distributing, under the tax sharing agreement regarding tax liabilities that (i) have arisen or will arise for a taxable period ending on or before the Distribution, or for a taxable period beginning before and ending after the Distribution and (ii) do not become fixed or ascertainable until after the Distribution, will be treated as occurring immediately before the Distribution (cf. Arrowsmith v. Commissioner, 344 U.S. 6 (1952)) (tax character of later transaction will derive from earlier, related transaction); Rev. Rul. 83-73, 1983-1 C.B. 84).

(13) Following the Distribution, Controlled and its direct and indirect subsidiaries that are “includible corporations” (under § 1504(b)) and satisfy the ownership requirements of § 1504(a)(2) will be an affiliated group of corporations entitled to file consolidated federal income tax returns with Controlled as the common parent.

### **Caveats**

No opinion is expressed about the tax treatment of the Transaction under other provisions 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. Specifically, no opinion is expressed concerning the federal income tax effects of (i) Acquisition 1, Acquisition 2, Merger 1, Merger 2, the Retransfer, the Option Transfer, the Exchange, or the Conversion and (ii) Distributing’s grant of the Licenses to Controlled, including whether the Licenses are “assets” (see Rev. Rul. 69-156, 1969-1 C.B. 101).

Further, no opinion is expressed regarding whether any or all of the above-referenced foreign corporations are passive foreign investment companies (within the meaning of § 1297(a) and the regulations to be promulgated thereunder). If it is determined that any or all of the above-referenced foreign corporations are passive foreign corporations, no opinion is expressed with respect to the application of §§ 1291 through 1298 to the Transaction. In particular, in a transaction in which gain is not otherwise recognized, regulations under § 1291(f) may require gain recognition notwithstanding any other provision of the Code.

Temporary or final regulations pertaining to one or more issues addressed in this ruling letter have yet to be adopted. Therefore, this letter may be revoked or modified by the issuance of such temporary or final regulations (or a notice with respect to their future issuance). See section 12.04 of Rev. Proc. 2000-1, 2001-1 I.R.B. 4, 46, which discusses the revocation and modification of ruling letters. However, when the criteria in section 12.05 of Rev. Proc. 2000-1 are satisfied, a ruling will not be revoked or modified retroactively, except in rare or unusual circumstances.

### **Procedural Statements**

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

Each taxpayer affected by the Transaction should attach a copy of this ruling letter to its, his, or her federal income tax return for the taxable year in which the Transaction is completed.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely,  
Associate Chief Counsel (Corporate)  
By: Wayne T. Murray  
Senior Technician/Reviewer  
Branch 4