

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:CORP:B06-PLR-137281-01

Date:

November 6, 2001

LEGEND

Distributing =

Controlled =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Individual A =

Individual B =

Investor Group =

Business C =

Business D =

Business E =

Business F =

Product G =

Product H =

Product J =

Product K =

L =

M =

N =

O =

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P	=
Q	=
R	=
S	=
T	=
U%	=
V%	=
W%	=
\$X	=
\$Y	=
\$Z	=
\$AA	=
CC	=
DD	=
Month 1	=
Year 1	=

This letter responds to your letter, dated June 20, 2001, requesting rulings under I.R.C. § 355. Additional information was received in letters dated October 9 and October 30, 2001. The information submitted in your letters is summarized below.

Distributing has T shares of the only class of stock outstanding, voting common, of which individual A owns S shares (W%) and individual B owns the remaining N shares (U%).

Distributing is engaged in Business C for each of four products: Product G, Product H, Product J and Product K.

Until Month 1 of Year 1, Distributing owned V% (less than 80%) of the stock of Sub 1. In Month 1 of Year 1, Sub 1 transferred its Business D to Sub 2, its Business E to Sub 3, and its Business F to Sub 4. Thereafter, Sub 1 distributed the stock of Sub 3 and Sub 4 to its (Sub 1's) shareholders in a transaction intended to qualify under I.R.C. § 355.

Distributing has determined that the Product G business is ready to significantly expand, provided that it can raise the large amount of capital required to fund such expansion. Distributing has only found one Investor Group willing to invest the necessary amount of capital. However, Investor Group is only willing to invest such amounts if the Product G business is completely separated from Distributing's other businesses. Accordingly, Distributing has proposed the following transaction:

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- (1) Distributing has transferred the assets of its Product G business to Controlled in exchange for all of the Controlled voting common stock (T shares).
- (2) The Investor Group has transferred \$AA to Controlled in exchange for P shares of voting convertible preferred stock of Controlled. The terms of the Controlled Preferred Stock provide that the holders of such stock will share in any dividends paid to the holders of the Controlled Common Stock on an as-converted basis. The Controlled Preferred Stock is convertible into Controlled Common Stock on a share for share basis (subject to certain anti-dilution provisions) either at the option of the holder or, automatically, upon a qualified public offering. The conversion price for these shares values the Controlled Common Stock at \$X per share. The Investor Group will also be granted a warrant to purchase M shares of Controlled Common Stock at \$Y per share. Thus, the exercise price of the warrant is significantly higher than the current fair market value of the underlying common stock.
- (3) Distributing will distribute the Controlled stock pro rata to its shareholders.
- (4) Controlled expects to issue to certain employees options to purchase shares of its common stock. Controlled expects that the number of shares underlying these options will not exceed Q shares (R shares including options issued to non-employees). Of these options, options covering L shares of Controlled common stock will be issued at a price below the then current fair market value.
- (5) Distributing will transfer all of the assets of Product H and Product J to Sub 5 in exchange T shares of Sub 5 voting common stock. Distributing will retain these shares. Thereafter, the Investor Group will invest \$Z in exchange for O shares of Sub 5 Class A common stock.
- (6) Controlled plans to raise additional capital within CC to DD months.

The following representations have been made in connection with the part of the proposed transaction described in (1), (2) and (3) above:

- (a) No liabilities were assumed in the transaction and the transferred assets were not subject to liabilities.
- (b) Distributing neither accumulated its receivables nor made extraordinary payment of its receivables in anticipation of the transaction.
- (c) No intercorporate debt will exist between Distributing and Controlled at the time or, or subsequent to, the distribution of the Controlled stock.

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- (d) Payments made in connection with all 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.
- (e) No two parties to the transaction are investment companies as defined in I.R.C. § 368(a)(2)(F)(iii) and (iv).
- (f) 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.
- (g) The five years of financial information submitted on behalf of Distributing is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (h) Except as described below, following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees. Except for certain employees of Distributing: (a) who have H-1B visas which are specific to Distributing, who will be retained by Distributing at the expense of Controlled until their new H-1B visas are approved for Controlled, and (b) who will perform certain administrative and accounting services for Controlled, no employees of Distributing or Controlled will provide services for the other entity. Any administrative or accounting services performed by Distributing for Controlled shall be billed to Controlled at cost. It is expected that the provision of such services will continue only for one or two years following the distribution. Moreover, following the distribution, Distributing and Controlled will continue to work together on certain government contracts that, by their terms, cannot be transferred to Controlled. However, with respect to these contracts, Controlled will receive all of the revenues generated and will be responsible for all expenses incurred. Distributing is attempting to obtain novation releases from the government with regard to these contracts, and when such novation is obtained the contracts will be transferred in their entirety to Controlled. The novation process generally takes six to twelve months.
- (i) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to raise equity capital that it would not otherwise be able to raise without the planned distribution. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (j) There is no plan or intention by the Distributing shareholders to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction.

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- (k) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase 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.
- (l) 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.
- (m) The Distribution is not a part of a plan or series of related transactions (within the meaning of Code section 355(e)), pursuant to which one or more persons will acquire directly or indirectly stock possessing fifty percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing fifty percent or more of the total value of all classes of stock of either Distributing or Controlled.
- (n) The P shares of Controlled stock issued to the Investor Group (as described in step (2)) and any additional shares of Controlled stock to be issued by Controlled within CC to DD months after the distribution of the Controlled stock by Distributing (as described in step (6)) will not, in the aggregate, constitute an acquisition, either directly or indirectly, of fifty percent or more of the total outstanding stock of Controlled within the meaning of section 355(e).

Based solely on the information submitted and the representations made, we have concluded that:

- (1) The transfer by Distributing of the assets of the Product G business to Controlled in exchange for all of the Controlled voting common stock, followed by the distribution by Distributing of the Controlled stock, will constitute a reorganization within the meaning of section 368(a)(1)(D) of the Internal Revenue Code. Distributing and Controlled will each be a "party to the reorganization" within the meaning of section 368(b).
- (2) No gain or loss will be recognized by Distributing upon its receipt of Controlled stock in exchange for the transfer of assets to Controlled of the Product G business. Section 361(a) and (b) and section 357(a).
- (3) No gain or loss will be recognized by Controlled upon its receipt of the assets of the Product G business in exchange for its issuance of shares of Controlled stock. Section 1032.
- (4) Controlled's basis in each asset of the Product G business received from

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Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transfer. Section 362(b).

- (5) The holding period of each asset of the Product G business received by Controlled from Distributing will include the period during which Distributing held such asset, provided such asset is a capital asset as defined in section 1221 or property described in section 1231 in the hands of Distributing. Section 1223(1).
- (6) Distributing will not recognize gain or loss upon the distribution to its shareholders of the stock in Controlled. Sections 355(c), 355(d), 355(e), and 361(c)(1).
- (7) No gain or loss will be recognized to (and no amounts will be included in the income of) the shareholders of Distributing upon their receipt of Controlled stock. Section 355(a)(1).
- (8) The aggregate basis of the Distributing stock and the Controlled stock in the hands of each Distributing shareholder after the Distribution will equal the aggregate adjusted basis of the Distributing stock held immediately before the Distribution, allocated in proportion to the fair market value of each under Treas. Reg. section 1.358-2(a)(2).
- (9) The holding period of the Controlled stock received by the shareholders of Distributing will, in each instance, include the holding period of the Distributing stock with respect to which the Distribution will be made, provided that the Distributing stock is held as a capital asset by the respective shareholder of Distributing on the day of the Distribution. Section 1223(1).
- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with section 1.312-10 of the Income Tax Regulations.

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. Specifically, no opinion is expressed: (a) whether the distribution by Sub 1 of the stock of Sub 3 and Sub 4 qualifies under section 355, and (b) concerning the tax consequences to the parties of the part of the transaction described in steps (4), (5), and (6).

This 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.

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

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

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.

Sincerely,

Steven J. Hankin

Steven J. Hankin
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel (Corporate)