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Department of the Treasury  
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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:B03

PLR-138036-04

Date:

October 26, 2004

In Re:

Distributing =

Controlled =

Sub =

State X =

State Y =

Industry A =

Date 1 =

Stock Option Plan =

Dear

We respond to your letter of July 12, 2004, requesting rulings on certain federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated September 8, 2004 and September 27, 2004. The information submitted for consideration is summarized below.

The rulings contained 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 request for rulings. Verification of the information, representations, and other data may be required as part of the audit process. Moreover, no information provided by the taxpayer has been reviewed and no determination has been made regarding whether the proposed transaction: (i) satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations, (ii) is used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (see § 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)), or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation (see § 355(e)(2)(A)(ii) and § 1.355-7T).

Distributing, a State X corporation, is a widely held publicly traded corporation and the common parent of an affiliated group filing a consolidated federal income tax return. Controlled, a State Y corporation, and Sub, a State X corporation, are wholly owned subsidiaries of Distributing engaged in Industry A. All of the corporations use the accrual method of accounting and have a tax year ending on Date 1. Distributing has one class of common voting stock.

Distributing currently has outstanding stock options issued under its Stock Option Plan. The outstanding options consist of incentive stock options and nonqualified stock options (collectively known as “the Outstanding Options”). Prior to the proposed transaction described below, Controlled’s board of directors will adopt a stock option plan that will be substantially similar to Distributing’s Stock Option Plan.

We have received financial information that indicates that Controlled’s and Sub’s Industry A businesses each have had gross receipts and operating expenses representative of the active conduct of a trade or business.

To facilitate raising capital on a cost-effective and continuing basis, Distributing proposes the following transaction.

- (i) Controlled will be recapitalized to increase its outstanding shares of stock to match the total outstanding shares of stock of Distributing. Taxpayer has represented that the recapitalization will be a tax-free event under § 368(a)(1)(E).
- (ii) Distributing will distribute all of the Controlled stock pro rata to each of its shareholders (the “Distribution”).
- (iii) The Outstanding Options will be exchanged as described below. Outstanding Options that are incentive stock options will be exchanged for new incentive

stock options subject to the same terms and vesting schedule as the related Outstanding Options. Outstanding Options that are nonqualified options will be exchanged for nonqualified options subject to the same terms and vesting schedule as the related Outstanding Options. The exchange will be as follows:

(A) All persons who are directors and/or employees of Distributing only and who hold Outstanding Options in Distributing will surrender their Outstanding Options and receive, in exchange, adjusted stock options in Distributing ("New Distributing Options"). The New Distributing Options will preserve the economic value of the Outstanding Options. The exercise price of the New Distributing Options will bear the same percentage relationship to the market price of Distributing stock after the Distribution as the exercise price of the Outstanding Options bore to the market price of Distributing stock before the Distribution.

(B) All persons who are directors and/or employees of Controlled only and who hold Outstanding Options in Distributing will surrender their Outstanding Options and receive, in exchange, adjusted stock options in Controlled ("New Controlled Options"). The New Controlled Options will preserve the economic value of the Outstanding Options. The exercise price of the New Controlled Options will bear the same percentage relationship to the market price of Controlled stock after the Distribution as the exercise price of the Outstanding Options bore to the market price of Distributing stock before the Distribution.

(C) All persons who are directors and/or employees of both Distributing and Controlled and who hold Outstanding Options in Distributing will surrender their options and receive, in exchange, New Distributing Options in Distributing and New Controlled Options in Controlled. The New Distributing Options and the New Controlled Options will preserve the economic value of their Outstanding Options. The exercise price of the New Distributing Options and New Controlled Options will bear the same percentage relationship to the market price of Distributing and Controlled stock, respectively, after the Distribution as the exercise price of the Distributing options bore to the market price of Distributing stock before the Distribution.

Taxpayer has made the following representations in connection with the proposed transaction:

- (a) The indebtedness owed by Controlled to Distributing and its affiliates after the Distribution will not constitute stock or securities.

- (b) 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 Distributing.
- (c) The five years of financial information submitted on behalf of Distributing (Sub) and Controlled are representative of their present operations and with regard to Distributing (Sub) and Controlled there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Immediately after the Distribution, at least 90 percent of the fair market value of the gross assets of Distributing will consist of the stock and securities of controlled corporations (Sub) that are engaged in the active conduct of a trade or business as defined in § 355(b)(2).
- (e) Following the transaction, Distributing and its affiliates, on the one hand, and Controlled, on the other hand, each will continue the active conduct of its business, independently and with its separate employees, except that certain employees will be shared for reasons of efficiency and cost effectiveness. If any employee is shared by Distributing and its affiliates, on the one hand, and Controlled, on the other hand, such employee's compensation will be charged as an expense to Distributing, its affiliates, and Controlled in proportion to the amount of time the employee expends in each business.
- (f) The Distribution is carried out for the following corporate business purpose: to facilitate raising capital on a cost-effective and continuing basis. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (g) The transaction is not used principally as a device for the distribution of the earning and profits of Distributing or Controlled or both.
- (h) No intercorporate debt will exist between Distributing and its affiliates, on the one hand, and Controlled, on the other hand, at the time of, or subsequent to, the Distribution except for debt that arises in the ordinary course of the Industry A business.
- (i) 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. Further, Distributing's excess loss account, if any, with respect to the Controlled stock will be included in income immediately before the Distribution.

- (j) Payments made in connection with all continuing transactions, if any, between Distributing and its affiliates, on the one hand, and Controlled, on the other hand, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (k) The Distribution is not part of a plan or series of related transaction (within the meaning of §1.355-7T) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest (within the meaning of §355(d)(4)) in either Distributing or Controlled (including any predecessor or successor of any such corporation).
- (l) None of the nonqualified stock options in Distributing had a readily ascertainable fair market value within the meaning of §1.83-7(b) at the time the options were granted. In addition, none of the new nonqualified stock options in Distributing and Controlled will have a readily ascertainable fair market value within the meaning of § 1.83-7(b) at the time the options are granted.
- (m) The exercise price of, and the number of Distributing shares subject to, the Outstanding Options will be adjusted to reflect the change in value of Distributing shares as a result of the Distribution in a manner that, on a share-by-share basis, (a) preserves the aggregate spread between the exercise price of the Outstanding Options and the fair market value of the underlying Distributing stock immediately before the adjustment, and (b) produces a ratio of the exercise price of the New Distributing Options or New Controlled Options to the fair market value of the underlying Distributing or Controlled stock immediately after the Distribution that is equal to the ratio of the exercise price of the Outstanding Options to the fair market value of the underlying Distributing stock immediately before the Distribution.
- (n) The holders of Outstanding Options who receive New Distributing Options or New Controlled Options will not receive any additional benefits as part of the exchange of their Outstanding Options for New Distributing Options and/or New Controlled Options.

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

- (1) No gain or loss will be recognized by (and no amount will be included in the income of) Distributing's shareholders on their receipt of the Controlled stock (§355(a)(1)).

- (2) No gain or loss will be recognized by Distributing upon the distribution of its stock in Controlled to its shareholders (§355(c)(1)).
- (3) The basis of the Controlled stock and Distributing stock in the hands of the shareholders of Distributing after the Distribution will, in each instance, be the same as the aggregate basis of the shareholders in the Distributing stock immediately before the Distribution, allocated in proportion to the fair market value of each (§358(b)(2) and §1.358-2(a)(2)).
- (4) The holding period of the Controlled stock received by the shareholders of Distributing as a result of the Distribution will, in each instance, include the holding period of the Distributing stock with respect to which the Controlled stock was received, provided that such Distributing common stock is held as a capital asset on the date of the Distribution (§1223(1)).
- (5) Proper allocation of earnings and profits between Distributing and Controlled will be made under §§ 1.312-10(b) and 1.1502-33(e).
- (6) The holders of Outstanding Options in Distributing will not realize any income upon the receipt of New Distributing Options and/or New Controlled Options pursuant to step (iii).
- (7) Pursuant to step (iii), the exchange of the incentive stock options in Distributing for new incentive stock options in Distributing or new incentive stock options in Controlled will not constitute a “modification, extension, or renewal” of these incentive stock options within the meaning of § 424(h)(3) and therefore will not constitute the grant of new options.

No opinion is expressed about the tax treatment of the proposed 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 proposed transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding: (i) whether the Distribution satisfies the business purpose requirement of § 1.355-2(b); (ii) whether the proposed transaction is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both (see § 355(a)(1)(B) and § 1.355-2(d)); and (iii) whether the Distribution and an acquisition or acquisitions are part of a plan (or series of related transactions) under § 355(e)(2)(A)(ii). Furthermore, no opinion is expressed as to whether the recapitalization described in step (i), above, qualifies as a tax-free event under § 368(a)(1)(E). In addition, no opinion is expressed regarding the qualification of the options that are intended to qualify as incentive stock options under § 422.

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.

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

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

Sincerely,

Filiz A. Serbes  
Chief, Branch 3  
Office of Associate Chief Counsel  
(Corporate)

cc: