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- Distributing =
- Controlled =
- Business A =
- Business B =
- Business C =
- Business D =
- Shareholder A =
- Shareholder B =
- Financial Advisor =
- a =
- b =

This letter responds to your November 23, 1999 request for rulings on certain federal income tax consequences of a proposed series of transactions. The information submitted is summarized below.

The rulings given 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.

Summary of Facts

Publicly traded Distributing is the common parent of a consolidated group. Distributing conducts Business A, Business B, and Business C directly and Business D

through a wholly owned subsidiary. Shareholder A and Shareholder B each owns more than five percent of the Distributing stock.

We have received financial information indicating that Business A and Business B each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Business A and Business B wish to raise capital through an initial public offering of stock in a corporation holding Business B. In a detailed and reasoned letter, Distributing's Financial Advisor has concluded that this offering would yield a significantly greater return if Business B were separated from the Distributing group.

Proposed Transactions

To accomplish this separation, Distributing proposes the following series of transactions:

(i) Distributing will contribute its Business B assets, including cash and an undivided interest in all substantial rights to certain patents, to newly formed, wholly owned Controlled in exchange for Controlled stock and the assumption by Controlled of related liabilities (together with the distributions of Offering proceeds and Borrowing proceeds referred to in steps (iv) and (v), the "Contribution").

(ii) Using the cash contributed in step (i), Controlled will purchase certain Business B assets from Distributing foreign affiliates.

(iii) Distributing and Controlled will enter into certain transitional agreements, including a tax sharing agreement (the "Transitional Agreements" and the "Tax Sharing Agreement").

(iv) Controlled will offer to sell less than a percent of its common stock in an initial public offering (the "Offering"). Controlled may distribute some part of the Offering proceeds to Distributing for use in repaying Distributing debt and repurchasing Distributing stock.

(v) Controlled may borrow funds from an unrelated third party lender (the "Borrowing") and distribute the Borrowing proceeds to Distributing for use in repaying Distributing debt and repurchasing Distributing stock.

(vi) Distributing will distribute the Controlled stock to its shareholders pro rata (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.

(vii) Prior to the Offering, Controlled will adopt a stock award plan (the "Controlled Equity Incentive Plan") and reserve shares sufficient to cover grants of stock

awards for a reasonable period of time after the Offering and Distribution. The Controlled Equity Incentive Plan will provide for the grant of stock options and restricted stock in a manner similar to that of the Distributing equity incentive plans. The Controlled Equity Incentive Plan will include provisions limiting the total number of shares for which options may be granted to any individual in a calendar year and will provide that options granted to a “covered employee,” as defined in § 162(m) of the Internal Revenue Code, will be made by a committee of two or more “outside directors,” also as defined in § 162(m).

(viii) On the Distribution, outstanding Distributing nonqualified options (the “Current Distributing Options”), other than the unvested Current Distributing Options held by Controlled employees, will convert into adjusted nonqualified options to purchase Distributing stock (the “Adjusted Distributing Options”). The Adjusted Distributing Options will reflect the Distribution by adjusting the strike price and number of options as necessary to maintain the option holder’s pre-distribution economic position. Each Adjusted Distributing Option will be identical, in all other respects, to the Current Distributing Option being adjusted.

(ix) On the Distribution date, each Controlled employee holding an unvested Current Distributing Option may exchange that option for a Controlled nonqualified option (a “Substituted Controlled Option”). The Substituted Controlled Option would maintain the option holder’s pre-distribution economic position. The Substituted Controlled Options will have the same aggregate in-or-out-of-the-money amount, the same ratio of exercise price to fair market value of the stock, and the same vesting schedule as the Current Distributing Options for which the Substituted Controlled Options are exchanged.

(x) Concurrently with the Distribution, Distributing and Controlled employees holding Distributing restricted stock will receive Controlled stock in the same manner as any holder of Distributing stock. However, this Controlled stock will be subject to the same vesting schedule and restrictions as the Distributing restricted stock upon which the distribution is received, consistent with the original terms of the award.

(xi) Immediately before the Offering, under the Controlled Equity Incentive Plan, Controlled will grant Controlled stock options to (i) Distributing employees who were instrumental in the formation and development of Business B and (ii) key employees of another Distributing corporation business that will continue to supply materials used by Controlled. These employees will remain with Distributing after the Distribution. The options are intended to recognize past contributions to Business B and to encourage a high level of continuing customer service to Controlled. In addition, certain Controlled employees will be awarded Controlled options under the Controlled Equity Incentive Plan. Controlled options granted to Controlled employees will vest ratably over a two-year period, while Controlled options granted to Distributing employees will vest immediately on grant. Vested options are not exercisable until the earlier of the Distribution or months after the Offering.

Representations

Contribution and Distribution

Distributing makes the following representations concerning the Contribution and Distribution:

(a) Except for restricted Controlled shares issued to holders of restricted Distributing shares, no part of the consideration distributed by Distributing will be received by a Distributing shareholder as a creditor, employee, or in any capacity other than that of a Distributing shareholder.

(b) The five years of financial information submitted on behalf of Business A and Business B represents, in each case, its present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.

(c) Following the Distribution, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees, except for (i) certain directors who will serve on both boards and (ii) cooperative efforts under the Transitional Agreements.

(d) The Distribution is being carried out to facilitate an initial public offering of Controlled stock. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.

(e) There is no plan or intention on the part of Shareholder A or Shareholder B, and, to the best of the knowledge of Distributing's management, there is no 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, either Distributing or Controlled after the Distribution.

(f) 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 Distribution, other than through (i) stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705, (ii) de minimis stock repurchases from employees who are vested in their restricted shares and sell sufficient shares to cover their federal and state tax liabilities and loan payment obligations stemming from the vesting, and (iii) de minimis purchases by Distributing or Controlled of restricted unvested shares of Distributing and Controlled from employees who leave Distributing or Controlled before vesting. The repurchases and purchases under (ii) and (iii) will be made pursuant to plans or practices adopted more than five years before the Distribution.

(g) Apart from the possible disposition of Business C or Business D, 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 Distribution, except in the ordinary course of business.

(h) The income tax liability for the taxable year in which investment credit property, if any (including any building to which § 47(d) applies), is transferred will be adjusted pursuant to § 50(a)(1) or (a)(2) (or § 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

(i) The total adjusted basis and the fair market value of the assets to be transferred by Distributing to Controlled each equals or exceeds the liabilities assumed (within the meaning of § 357(d)) by Controlled.

(j) The liabilities to be assumed (within the meaning of § 357(d)) in the Contribution were incurred in the ordinary course of business and are associated with the assets being transferred.

(k) Other than trade account debt, no intercorporate debt will exist between Distributing and Controlled at the time of, or after, the Distribution.

(l) Immediately before the Distribution, any 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). Any excess loss account Distributing may have in the Controlled stock will be included in income immediately before the Distribution as required by applicable regulations (see § 1.1502-19).

(m) Other than certain payments under the Transitional Agreements, payments made in 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 arms' length.

(n) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

(o) The Distribution will occur within 6 to 12 months from the date of the issuance of this private letter ruling.

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

(q) 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.

(r) 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.

(s) The payment of cash in lieu of fractional shares 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 that will be paid in the transaction to the Distributing shareholders will not exceed one percent of the total consideration that will be distributed in the proposed transaction. The fractional share interests in Controlled of each Distributing shareholder 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 number of Controlled restricted shares distributed on Distributing restricted shares will represent less than 20 percent of the Controlled stock.

Compensation

Distributing makes the following representations concerning certain compensation issues:

(u) Distributing restricted stock is nontransferable and subject to a substantial risk of forfeiture.

(v) No elections under § 83(b) have been made for any of the Distributing restricted shares owned by employees who will become Controlled employees.

(w) None of the options previously issued (or to be issued in the future) have (or will have) a “readily ascertainable fair market value” at grant as defined in § 1.83-7(b).

(x) All new grants to any “covered employee” (as defined in § 162(m)) will be made by a compensation committee composed solely of two or more “outside directors” (as defined in § 162(m)).

(y) All previous grants of Distributing stock options to any “covered employee” have been made by the Distributing compensation committee, which is, and has been, composed solely of two or more outside directors.

Rulings

Contribution and Distribution

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

(1) The Contribution, followed by the Distribution, will qualify as 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, provided all of the Offering proceeds and Borrowing proceeds are used by Distributing to retire Distributing outstanding debt or acquire Distributing stock (§§ 357(a), 361(a), 361(b)(1)(A), and 361(b)(3)).

(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 its transfer (§ 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 Distributing on the Distribution (§ 361(c)(1)).

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

(8) The holding period of the Controlled stock received by each Distributing shareholder (including any fractional share interest in Controlled to which the shareholder may be entitled) will include the period during which the Distributing shareholder has held the Distributing stock on which the Distribution is made, provided the Distributing stock is held as a capital asset on the date of Distribution (§ 1223(1) and (1)(B)).

(9) The aggregate adjusted basis of the Distributing and Controlled stock in the hands of each Distributing shareholder after the Distribution (including any fractional

share interest in Controlled to which the shareholder may be entitled) will equal the aggregate adjusted basis of the Distributing stock held by that shareholder immediately before the Distribution, allocated between the two in proportion to the fair market value of each under § 1.358-2(a)(2) (§ 358(b)(2) and (c)).

(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) 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) will not become fixed and 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).

(12) 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 (9) 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).

Compensation

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

(13) No income, gain, or loss will be recognized by the holders of Current Distributing Options on the adjustment of Current Distributing Options into Adjusted Distributing Options.

(14) No income, gain, or loss will be recognized by employees who exchange their Current Distributing Options for Substituted Controlled Options.

(15) No income, gain, or loss will be recognized by Distributing or Controlled employees when they receive new nonqualified Controlled stock options.

(16) The grant of new Controlled stock options by Controlled to Distributing employees will not cause the new Controlled stock options granted to Controlled employees by Controlled to be other than options transferred in connection with the performance of services under § 83.

(17) On the exercise or disposition of an Adjusted Distributing Option, a

Substituted Controlled Option, a new Controlled option granted to Distributing employees by Controlled, or a new Controlled option granted to Controlled employees, the optionee will recognize compensation income equal to the excess of the fair market value of the shares covered by the option over the amount paid for such shares.

(18) Compensation received by a “covered employee” (as defined in § 162(m)) either upon the exercise of an Adjusted Distributing Option or upon the exercise of a Substituted Controlled Option granted to a “covered employee” of Controlled will constitute “qualified performance-based compensation” under § 1.162-27(e)(2)(iii)(C).

(19) Assuming no election under § 83(b) has been made, the distribution of Controlled restricted stock to holders of Distributing restricted stock will not result in income, gain, or loss to these holders at the time of the distribution. Rather, compensation will be recognized only upon vesting of the Controlled restricted stock.

(20) Distributing will not recognize gain or loss upon the transfer of Controlled stock to a Distributing employee who exercises a Controlled option, and Controlled will not recognize gain or loss upon the transfer of Distributing stock to a Controlled employee who exercises an Adjusted Distributing Option.

Caveats

We express no opinion on the tax treatment of the transactions under other sections of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above rulings. In particular, no opinion is expressed concerning:

(i) The international tax implications (and other tax effects) of the asset purchases described in step (ii);

(ii) Payments under the Transitional Agreements (in particular those referred to in representation (m));

(iii) The application of § 482 to the transactions;

(iv) The federal employment tax aspects of the transactions, including the application of § 3121(v);

(v) Whether the new Controlled options issued Distributing employees meet the requirement of § 162(m)(4)(C);

(vi) The appropriate allocation between Distributing and Controlled of the deduction under § 83(h) for the amounts includible in the gross income of each holder of an Adjusted Distributing Option or a Substituted Controlled Option; and

(vii) The appropriate allocation between Distributing and Controlled of the

deduction under § 83(h) for the vesting of Distributing restricted stock or Controlled restricted stock distributed to holders of Distributing restricted stock.

Procedural Statements

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.

A copy of this ruling letter should be attached to the federal income tax return of each affected taxpayer for the taxable year in which the transactions covered by this letter are completed.

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

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