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Department of the Treasury

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Distributing: =
Controlled =
Business A =
Business B =
A =
Partnership A =
Partnership B =
Corp A =
B =
C =
D =
E =
F =
Date A =
a =
b =
c =

This letter responds to your August 18, 2000 request for rulings on certain federal income tax consequences of the partially completed transaction described 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.

Summary of Facts

Distributing conducts Business A and Business B and is owned by several shareholders including A, B, C, D, E, Corp A, and Partnership B. Corp A, Partnership A, and Partnership B, acting in concert, purchased over 50 percent of the Distributing stock during the five-year period ending with the distribution described below. Distributing has for its employees a nonqualified stock option plan ("NSOs") and an incentive stock option plan ("ISOs"). A holds warrants on Distributing stock.

A, B, C, D, and E wish to concentrate their efforts on Business B (the "B Group"), and the remaining shareholders, including Partnership B, wish to concentrate on Business A (the "A Group"). To permit this, the parties have undertaken the following transaction:

(i) On Date A, Distributing transferred the Business B assets to newly formed Controlled in exchange for Controlled stock and the assumption by Controlled of related liabilities (the "Contribution").

(ii) Distributing will distribute the Controlled stock (a) to A (along with a promissory note in the amount of a dollars (the "Note") and b dollars in cash) in exchange for all of his Distributing stock, (b) to B and E in exchange for all of their Distributing stock, (iii) to C and D in exchange for c percent of their Distributing stock, and (iv) A will exchange his Distributing warrants for equal value of Controlled warrants (altogether, the "Distribution"). The Distributing stock retained by C and D will represent significantly less than one percent of the outstanding Distributing stock. Thus, following the Distribution, the B Group (A, B, C, D, and E) will have full control over the operations of Business B, and the A Group will have full control over the operations of Business A, consistent with the business purpose being asserted.

(iii) All outstanding Distributing NSOs held by each person who remains an employee of Distributing immediately after the Distribution (the "Retained Employees") will be replaced with NSOs that are adjusted (the "Adjusted NSOs") to reflect the post-Distribution value of Distributing while preserving the spread between the exercise price of the Distributing NSOs and the fair market value of the underlying Distributing stock

immediately before the replacement.

(iv) All outstanding Distributing NSOs held by each person who becomes an employee of Controlled (the “Transferred Employees”) will be replaced with NSOs in Controlled (the “Controlled NSOs”). The Controlled NSOs will be exercisable on the same terms and conditions as before the Distribution except that they will reflect the post-Distribution value of Controlled and will preserve the spread between the exercise price of the Distributing NSOs and the fair market value of the underlying Distributing stock immediately before the replacement.

(v) Before the Distribution, the Controlled board of directors will adopt an incentive stock option plan (the “Controlled ISO Plan”). The Distributing shareholders will be asked to approve the Controlled ISO Plan when they approve the Distribution.

(vi) All outstanding Distributing ISOs held by Retained Employees will be replaced with new ISOs to acquire Distributing stock (the “New Distributing ISOs”). The number of shares and the exercise price of the New Distributing ISOs will be adjusted to reflect the post-Distribution value of Distributing while preserving the aggregate spread of the ISOs replaced by the New Distributing ISOs and the ratio of the fair market value of the Distributing stock immediately before the replacement to the exercise price of the ISOs replaced. Other than these changes, all terms of the New Distributing ISOs will be identical to those of the ISOs replaced.

(vii) All outstanding Distributing ISOs held by F (a Transferred Employee) will be replaced with ISOs in Controlled (the “Controlled ISOs”) issued under the Controlled ISO Plan. The Controlled ISOs will be exercisable on the same terms and conditions as before the Distribution except that they will reflect the post-Distribution value of Controlled and will preserve the aggregate spread of the ISOs replaced and the ratio of the fair market value of the Distributing stock immediately before the replacement to the exercise price of the ISOs replaced. No other Transferred Employees hold Distributing ISOs.

Representations

The taxpayer has made the following representations concerning the Contribution and Distribution:

(a) The fair market value of the Controlled stock and other consideration received by each member of Group B will approximately equal the fair market value of the Distributing stock surrendered in the exchange.

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

(c) The five years of financial information submitted on behalf of Distributing represents its present operations, and there have been no substantial operational changes since the date of the last financial statement submitted.

(d) Following the Distribution, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its business.

(e) The Distribution is being carried out to allow the A Group to concentrate on Business A and the B Group to concentrate on Business B. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.

(f) There is no plan or intention by the Distributing shareholders to sell, exchange, transfer by gift, or otherwise dispose of any of their Distributing or Controlled stock after the Distribution.

(g) 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.

(h) 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.

(i) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing in the Contribution will, in each instance, equal or exceed the liabilities assumed (as determined under § 357(d) of the Internal Revenue Code) by Controlled.

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

(k) No intercorporate debt will exist between Distributing and Controlled at the time of, or after, the Distribution.

(l) Payments made in connection with any continuing transactions between Distributing and Controlled will be provided at cost under an asset purchase agreement (the "Asset Purchase Agreement").

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

(n) Distributing is not an S corporation (within the meaning of § 1361(a)), and there is no plan or intention by Distributing or Controlled to make an S corporation

election pursuant to § 1362(a).

Rulings

Contribution and Distribution

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

(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 will equal the basis of that asset in the hands of Distributing immediately before the 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) For purposes of § 355(d), Partnership A, Partnership B, and Corp A are treated as one person (§ 355(d)(7)(B); § 1.355-6(c)(4)). Therefore, immediately after the Distribution, one person 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 Distribution date. Accordingly, Distributing will recognize gain (but not loss) on the Distribution as if it had sold the Controlled stock at its fair market value (§§ 355(d)(1) and 361(c)(2)).

(7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) A, B, C, D, or E on the Distribution (§ 355(a)(1); § 1.355-1(c)).

(8) A will recognize gain (if any) on his receipt of Controlled stock, the Note, and cash in exchange for his Distributing stock, but not in excess of the fair market value of the Note and cash received (§ 356(a)). If the exchange has the effect of a dividend (determined with the application of § 318(a)), then the amount of the gain recognized that is not in excess of A's ratable share of earnings and profits will be treated as a

dividend (§ 356(a)(2)). The determination of whether the exchange has the effect of a dividend will be made in accordance with the principles set forth in Revenue Ruling 93-62, 1993-2, C.B. 118. No loss will be recognized (§ 356(c)).

(9) The basis of Controlled stock in the hands of B and E will, in each case, equal the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).

(10) The basis of Controlled stock in the hands of A will equal the basis of the Distributing stock surrendered in exchange, (a) decreased by the fair market value of the Note and cash received and (b) increased by the amount treated as a dividend and the amount of gain A recognized on the exchange (not including any part of the gain treated as a dividend) (§ 358(a)(1)).

(11) The aggregate basis of the stock of Distributing and Controlled in the hands of C and D after the Distribution will in each case equal the basis in the Distributing stock held immediately before the exchange, allocated in proportion to the fair market value of each in accordance with § 358(b)(2) and § 1.358-2(a)(2) of the Income Tax Regulations.

(12) The holding period of Controlled stock received by A, B, C, D, and E will include the holding period of the Distributing stock surrendered in the exchange, provided the Distributing stock is held as a capital asset on the Distribution date (§ 1223(1)).

(13) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).

Stock Options

Based solely on the information submitted and representations set forth above, and provided the “spread” and the “ratio” tests of § 424(a) and § 1.425-1(a)(4) and 1.425-1(e)(5)(ii)(b) are satisfied, we rule as follows regarding the stock options:

(14) No income, gain, or loss will be recognized by the holders of Distributing NSOs upon their conversion to adjusted NSOs or Controlled NSOs pursuant to the Distribution.

(15) Neither Distributing nor Controlled will recognize income, gain, or loss upon the granting of adjusted NSOs or Controlled NSOs in replacement of the Distributing NSO Grants.

(16) Neither Distributing nor Controlled will recognize income, gain, or loss upon the exercise by either Retained Employees or Transferred Employees of adjusted NSOs or Controlled NSOs.

(17) Amounts includible in the gross income of any service provider upon the exercise of an NSO will be deductible by the corporation for whom services are performed in satisfaction of the NSO, provided the deduction meets the requirements of § 162.

(18) The substitution of Distributing ISOs for Controlled ISOs held by G will not constitute a modification, extension, or renewal of the outstanding Distributing ISOs within the meaning of § 424(h) and therefore will not constitute the grant of a new option.

(19) Provided the Distributing ISO is qualified under § 422 at the time of the Distribution, the substituted Controlled ISO will continue to be qualified under § 422.

(20) Provided the Distributing ISO is qualified under § 422 at the time of the Distribution and the requirements of § 422(a)(1) and 422(a)(2) are met, § 421 will apply to the transfer of a share of stock to a Transferred Employee pursuant to the exercise of an ISO granted under the Controlled ISO Plan in substitution for a Distributing ISO.

(21) Provided the requirements of § 424(a) and the applicable regulations are met, the adjustment to the number of shares and option price of Distributing stock subject to ISOs granted under the Distributing ISO Plan to Retained Employees to reflect the Distribution will not constitute a modification, extension, or renewal of the ISOs within the meaning of § 424(h)(3) and therefore will not constitute the grant of a new option.

(22) Provided the Distributed ISO is qualified under § 422 at the time of the Distribution, then, after the adjustment, the new Distributing ISO will continue to qualify under § 422.

(23) Provided the Distributing ISO is qualified under § 422 at the time of the Distribution and that the requirements of § 422(a)(1) and 422(a)(2) are met after the adjustment, § 421 will apply to the transfer of a share of stock to a Retained Employee pursuant to his exercise of a new Distributing Option.

Caveats and Procedural Statements

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 proposed transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding the tax effect of the non-fair market value aspects of the Asset Purchase Agreement (see representation (l) above).

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 involved in this transaction should attach a copy of this ruling letter to the taxpayer's federal income tax return for the taxable year in which the transaction covered by this letter is completed.

Under a power of attorney on file in this office, a copy of this letter is being sent to the taxpayer.

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