

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:CORP:B06-PLR-138879-01

Date:

December 20, 2002

LEGEND

Corporation 1 =

Corporation 2 =

Distributing =

Controlled =

Sub 1 =

Sub 2 =

Sub 3 =

Company 1 =

Company 2 =

Country X =

Country Y =

Product 1 =

Product 2 =

Individual A =

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Individual B =
 v =
 w =
 x% =
 y% =
 z% =
 Bank =
 Fund =
 Date =

This letter responds to your letter, dated July 17, 2001, requesting rulings under I.R.C. §§ 368(a)(1)(D) and 355. Additional information was received in letters dated September 12, and November 25, 2001. The information submitted in your letters is summarized below.

Individual A and Individual B each own v shares (z%) of the outstanding stock of Corporation 1, which owns all of the stock (w shares) of Corporation 2, which owns all of the stock of Distributing. Distributing is engaged in the manufacturing and sale of Product 1 and Product 2.

During the year ending on Date, Distributing moved the production of Product 1 to Country X. Company 1, an unrelated Country X corporation, will assemble Product 1 for Distributing. Distributing continues to be involved in all other aspects of the management and operation of its Product 1 business, including product and process engineering, the scheduling of production, the purchase of parts for the production operation, the provision of manufacturing equipment, the receipt of the finished product and the sale of the finished product to the customers of Distributing.

Distributing owns all of the stock of Sub 1 and Sub 2 and z% of the stock of Sub 3. Sub 3 is a Country Y company. The remaining z% of Sub 3 is owned by a Country Y company ("Company 2"). None of the shareholders of Company 2 are U.S. citizens or residents. Sub 1, Sub 2 and Sub 3 are each engaged in the Product 2 business.

Bank proposes to offer the Product 2 business more favorable loan terms than it currently enjoys. Specifically, Bank proposes to offer both an additional loan amount and a reduced interest rate. However, this more favorable loan is specifically conditioned upon Distributing separating its Product 2 business from its Product 1 business. Accordingly, Distributing has proposed the following transaction:

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- (1) For valid business reasons, Corporation 1 will merge into Corporation 2 and the former Corporation 1 shareholders, Individual A and Individual B, will each receive z% of the Corporation 2 stock.
- (2) Fund will loan money to Corporation 2. In consideration for the loan, Corporation 2 will pay interest and issue x% of its stock (less than 50%) to Fund, resulting in the stock interest of each of Individual A and Individual B in Corporation 2 dropping from z% to y%.
- (3) Distributing will transfer the assets of the Product 2 business to a newly formed corporation, Controlled, as well as all of the stock of Sub 1, Sub 2 and Sub 3, in exchange for all of the Controlled stock and the assumption by Controlled of the liabilities associated with the transferred assets (of the Product 2 business).
- (4) Distributing will distribute all of the Controlled stock to Corporation 2 (the "First Distribution"), and Corporation 2 will distribute the Controlled stock it received from Distributing to Individual A, Individual B and Fund (the "Second Distribution"). The First Distribution and the Second Distribution are sometimes referred to as the "Distributions."

The following representations have been made in connection with the proposed transaction:

- (a) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled (within the meaning of section 357(d)) plus any liabilities to which the transferred assets are subject.
- (b) The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- (c) The transfer of assets and liabilities to Controlled will not result in a situation in which one party recognizes income but another party recognizes the deductions associated with such income or one party owns property but another party recognizes the income associated with such property.
- (d) No intercorporate debt will exist between Distributing and Controlled at the time or, or subsequent to, the distribution of the Controlled stock.
- (e) Distributing and Controlled have no accumulated earnings and profits at the beginning of their respective taxable years.

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- (f) Distributing and Controlled will have no current earnings and profits as of the date of the distribution.
- (g) No distribution of property by Distributing immediately before the transaction would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.
- (h) Distributing is not aware of, nor is Distributing planning or intending, any event that will result in Distributing or Controlled having positive current or accumulated earnings and profits after the distribution.
- (i) The distribution is not a part of a plan or series of related transactions (within the meaning of 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.
- (j) No part of the consideration to be distributed by Distributing in the First Distribution is being received by a shareholder of Distributing as a creditor, employee or in any capacity other than that of a shareholder of Distributing.
- (k) The five years of financial information provided on behalf of Distributing is representative of Distributing's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted, except that Company 1 will assemble Product 1 for Distributing in Country X. As discussed above, Distributing continues to be involved in all other aspects of the management and operation of its Product 1 business.
- (l) The five years of financial information provided on behalf of Controlled is representative of Controlled's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (m) The financial information provided on behalf of Corporation 2 is representative of Corporation 2's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (n) Following the Distributions, Distributing and Corporation 2, on the one hand, and Controlled on the other hand will each continue the active conduct of their respective trades or businesses, independently and with their separate employees.
- (o) The distribution of Controlled Common Stock by Distributing to

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Corporation 2 in the First Distribution is carried out for the corporate business purpose of enhancing Controlled's borrowing ability. Specifically, Bank proposes to offer both an additional loan amount and a reduced interest rate to Controlled only if the Distributions occur. Thus, the distribution of Controlled Common Stock in the First Distribution is motivated, in whole or substantial part, by this corporate business purpose.

- (p) No part of the consideration to be distributed by Corporation 2 in the Second Distribution is being received by a shareholder of Corporation 2 as a creditor, employee or in any capacity other than that of a shareholder of Corporation 2.
- (q) The distribution of Controlled Common Stock by Corporation 2 to Individual A, Individual B and Fund in the Second Distribution is carried out for the corporate business purpose of enhancing Controlled's borrowing ability. Specifically, Bank proposes to offer both an additional loan amount and a reduced interest rate to Controlled only if the Distributions occur. Thus, the distribution of Controlled Common Stock in the Second Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (r) Immediately after the Distributions, at least 90 percent of the fair market value of the gross assets of Corporation 2 will consist of stock of controlled corporations that are engaged in the active conduct of a trade or business as defined in section 355(b)(2).
- (s) There is no plan or intention by the shareholders of Corporation 2 to sell, exchange, transfer by gift or otherwise dispose of any of their stock in either Corporation 2 or Controlled after the Distributions.
- (t) There is no plan or intention by either Corporation 2 or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the Distributions.
- (u) There is no plan or intention to liquidate Distributing, Corporation 2, or Controlled, to merge Distributing, Corporation 2, or Controlled with any other corporation, or to sell or otherwise dispose of the assets of any of these corporations after the Distributions, except in the ordinary course of business.
- (v) Neither Corporation 2 nor any of its subsidiaries have accumulated their receivables or made extraordinary payment of their payables in anticipation of the Distributions.
- (w) Immediately before the Distributions, items of income, gain, loss, deduction and credit will be taken into account as required by the

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applicable intercompany transaction regulations under Treasury Regulation sections 1.1502-13 and 1.1502-14 as in effect at the time of the Distributions.

- (x) Immediately before and immediately after the Distributions, neither Distributing nor Corporation 2 will have an excess loss account with respect to the stock of any subsidiary.
- (y) Distributing, Corporation 2, Controlled, and their respective shareholders will each pay their own expenses, if any, incurred in connection with the Distributions.
- (z) Except as described below, payments made in connection with all continuing transactions, if any, between Corporation 2 or its subsidiaries and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length. Only certain computer equipment will be shared. Distributing will continue to own the computers used to operate the financial systems of both companies. One or two employees will continue to manage this administrative function for the foreseeable future. Equipment and service cost will be charged to Controlled at cost.
- (aa) No party to the Distributions is an investment company as defined in section 368(a)(2)(F)(iii) and (iv).
- (bb) For purposes of section 355(d), immediately after the First Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power 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 section 355(d)(5) and (8)) during the five year period (determined after applying section 355(d)(6)) ending on the date of the First Distribution.
- (cc) For purposes of section 355(d), immediately after the First Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power or 50 percent or more of the total value of shares of all classes of Controlled stock, that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five year period (determined after applying section 355(d)(6)) ending on the date of the First Distribution.
- (dd) For purposes of section 355(d), immediately after the Second Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power or 50 percent or more of the total value of shares of all classes of Corporation 2 stock, that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five year period (determined after applying section

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355(d)(6)) ending on the date of the Second Distribution.

- (ee) For purposes of section 355(d), immediately after the Second Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power or 50 percent or more of the total value of shares of all classes of Controlled stock, that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five year period (determined after applying section 355(d)(6)) ending on the date of the Second Distribution.

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 2 business, as well as the stock of Sub 1, Sub 2 and Sub 3, to Controlled in exchange for all of the Controlled voting common stock and the assumption by Controlled of the liabilities associated with the transferred assets (of the Product 2 business), 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, and the assumption of liabilities by, Controlled of the Product 2 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 2 business, as well as the stock of Sub 1, Sub 2 and Sub 3, in exchange for its issuance of shares of Controlled stock. Section 1032.
- (4) Controlled's basis in each asset of the Product 2 business, as well as the stock of Sub 1, Sub 2 and Sub 3, received from 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 2 business, as well as the stock of Sub 1, Sub 2 and Sub 3, received by Controlled from Distributing will include the period during which Distributing held such asset. Section 1223(2).
- (6) Distributing will not recognize gain or loss upon the First Distribution (of the stock in Controlled to Corporation 2). Sections 355(c), 355(d), 355(e), and 361(c)(1).

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- (7) No gain or loss will be recognized to (and no amounts will be included in the income of) Corporation 2 upon its receipt of Controlled stock in the First Distribution. Section 355(a)(1).
- (8) The aggregate basis of the Distributing stock and the Controlled stock in the hands of Corporation 2 after the First Distribution will equal the aggregate adjusted basis of the Distributing stock held immediately before the First 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 Corporation 2 will, in each instance, include the holding period of the Distributing stock with respect to which the First Distribution will be made, provided that the Distributing stock is held as a capital asset by Corporation 2 on the day of the First 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 Treas. Reg. sections 1.312-10 and 1.1502-33.
- (11) Corporation 2 will not recognize gain or loss upon the Second Distribution (of the stock of Controlled to Individual A, Individual B and Fund). Sections 355(c), 355(d), 355(e), and 361(c)(1). Rev. Rul. 62-138, 1962-2 C.B. 95.
- (12) No gain or loss will be recognized (and no amounts will be included in the income of) Individual A, Individual B and Fund upon their receipt of Controlled stock in the Second Distribution. Section 355(a)(1).
- (13) The aggregate basis of the Corporation 2 stock and the Controlled stock in the hands of each of Individual A, Individual B and Fund after the Second Distribution will equal the aggregate adjusted basis of the Corporation 2 stock held immediately before the Second Distribution, allocated in proportion to the fair market value of each under Treas. Reg. section 1.358-2(a)(2).
- (14) The holding period of the Controlled stock received by Individual A, Individual B and Fund will, in each instance, include the holding period of the Corporation 2 stock with respect to which the Second Distribution will be made, provided that the Corporation 2 stock is held as a capital asset by its shareholders on the day of the Second Distribution. Section 1223(1).
- (15) As provided in section 312(h), proper allocation of earnings and profits between Corporation 2 and Controlled will be made in accordance with Treas. Reg. sections 1.312-10 and 1.1502-33.

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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 concerning the tax consequences of steps (1) and (2) of the proposed transaction.

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.

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,
Alfred C. Bishop, Jr.
Chief, Branch 6
Office of Associate Chief Counsel
(Corporate)