

Internal Revenue Service

Department of the Treasury

Number: **200234021**
Release Date: 8/23/2002
Index Numbers: 0355.01-00, 0368.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP:4 PLR-102683-02
Date:
May 14, 2002

Distributing =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6 =

Sub 7 =

Sub 8 =

Business X =

Business Y =

Activity Y1 =

Activity Y2 =

Asset Z1 =

Asset Z2 =

Year 1 =

Year 2 =

Year 3 =

Consultant =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

a =

b =

c =

State A =

Type Q =

Dear

This letter responds to your January 11, 2002 request for rulings on certain federal income tax consequences of a proposed and partially completed transaction. The information submitted in that letter and in later correspondence is summarized below.

The rulings 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 ruling request. Verification of the facts, information, and other data in this ruling letter may be required as part of the audit process.

Summary of Facts

Publicly traded Distributing is the common parent of an affiliated group of corporations that files a consolidated federal income tax return. Distributing conducts Business X and Business Y (which includes Activity Y1 and Activity Y2) in divisional form as well as through corporate subsidiaries and joint venture agreements.

Distributing began Activity Y1 in Year 1 and Activity Y2 in Year 2. On Date 1, Distributing transferred Activity Y2 to newly formed Sub 1, and Sub 1 transferred Activity Y2 to wholly owned Sub 2 (the "Activity Y2 Transfers"). The Activity Y2 Transfers were intended to qualify for nonrecognition treatment under § 351(a) of the Internal Revenue Code. Also on Date 1, Distributing contributed Activity Y1 to Sub 3.

On Date 2, Sub 1 issued shares of its Class A common stock in an initial public offering (the "Class A common stock" and the "IPO"). The Class A common stock represents less than twenty percent of the outstanding Sub 1 stock by value and less than five percent of the Sub 1 stock by voting power. After the IPO, Distributing owned and continues to own all of the Sub 1 Class B common stock, the only other class of Sub 1 stock outstanding.

On Date 4, Distributing acquired Sub 4 in a transaction intended to qualify as a reorganization under § 368(a)(1)(A) and (a)(2)(E) in which no gain or loss was recognized in whole or in part ("Acquisition 1"). Sub 4 wholly owns Sub 5 and Sub 6. On Date 5, Distributing acquired in a taxable purchase all the stock of Sub 7. In Year 3,

Distributing transferred a portion of Business X to wholly owned Sub 8 in a transaction intended to qualify for nonrecognition treatment under § 351 (the "Sub 8 Transfer").

Distributing has submitted financial information indicating that Business X, and Business Y each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

The operation of Business X and Activity Y2 within the same affiliated group creates management, systemic, and other problems that prevent these businesses from realizing their full potential. Consultant has advised Distributing in a detailed and reasoned report that separating these activities by distributing the stock of Sub 1 to the Distributing stockholders (the "Separation") would resolve these problems. Further, Sub 1 and Sub 2 are in need of capital to invest in the growth of Activity Y2. To that end, Sub 1 and Sub 2 are actively attempting to find an investor, with the assistance of an investment advisor, to raise capital through a private placement or follow-on offering of Sub 1 stock. Sub 1's investment advisor has informally indicated that Sub 1 would be unable to obtain the needed participation of private equity investors or to raise the necessary capital proceeds under acceptable terms absent the Separation.

The Transaction

To accomplish the Separation, Distributing has proposed and partially undertaken the following series of steps (collectively, the "Transaction"):

(i) On Date 6, Distributing exchanged Asset Z1 for additional Sub 1 Class B common stock (the "Asset Z1 Exchange"). On Date 3, Distributing exchanged Asset Z2 for a shares of additional Sub 1 Class B common stock and b shares of Sub 1 Class A common stock (the Asset Z2 Exchange). The Asset Z1 Exchange coupled with the Asset Z2 Exchange will be referred to as the "Contribution."

(ii) Sub 2 (which conducts Activity Y2) will convert into a limited liability company ("LLC") under State A law. It is intended that the Sub 2 LLC be disregarded as an entity separate from Sub 1 under § 301.7701-3 of the Administrative and Procedure Regulations and that the conversion be treated as a liquidation under § 332.

(iii) Sub 4 will merge with and into Distributing in a transaction intended to qualify as a liquidation under § 332 (the Sub 4 Merger). Following the Sub 4 Merger, Sub 5 and Sub 6 each will merge with and into Distributing in a transaction intended to qualify as a liquidation under § 332.

(iv) Sub 7 will convert into an LLC under State A law. It is intended that the Sub 7 LLC be disregarded as an entity separate from Distributing under § 301.7701-3 and that the conversion be treated as a liquidation under § 332.

(v) Sub 8 will convert into an LLC under State A law. It is intended that the Sub

8 LLC be disregarded as an entity separate from Distributing under § 301.7701-3 and that the conversion be treated as a liquidation under § 332. After steps (iii) through (v), Distributing will be treated for federal tax purposes as directly conducting Business X.

(vi) Immediately before the Distribution (described below in step (vii)), Distributing will convert some or all of its Sub 1 Class B common shares into Sub 1 Class A common shares in accordance with rights granted under the Sub 1 Certificate of Incorporation, provided the conversion will not prevent Distributing from being in “control” of Sub 1 (as that term is defined under § 368(c)) immediately before the Distribution (the “Class B Conversion”).

(vii) Distributing will distribute all of its Sub 1 stock to its common stockholders (the “Distribution”). In lieu of issuing fractional shares of Sub 1 stock, Distributing will cause its exchange agent to aggregate the fractional interests, sell them in the public market, and distribute the proceeds to stockholders otherwise entitled to receive the fractional interests.

In connection with the Transaction, Distributing and Sub 1 have entered into various agreements (the “Transaction-Related Agreements”), including but not limited to (a) an agreement under which Sub 1 will be the exclusive contract manufacturer through Date 7 and integration service provider through Date 8 for Type Q products marketed by Distributing, (b) an agreement under which Distributing acquired an exclusive perpetual license for certain intellectual property rights in exchange for c dollars payable in installments beginning on Date 9 and ending on Date 8, and (c) a transitional agreement under which Distributing will provide or make available to Sub 1 a variety of corporate services for a discrete period following the Distribution (the “Transitional Services Agreement”).

Representations

Distributing has made the following representations regarding the Transaction:

(a) Any debt owed by Sub 1 to Distributing after the Distribution will not constitute stock or securities.

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

(c) The five years of financial information submitted by Distributing for Business X represents the present operations of Business X, and there have been no substantial operational changes since the date of the last financial statements submitted.

(d) Immediately after the Distribution, taking into account the potential sale of part of Business X, the gross assets of the trades or businesses conducted by

Distributing that will be relied upon to satisfy the active trade or business requirement of § 355(b), in the aggregate (i) will have a fair market value of not less than five percent of the total fair market value of the gross assets of Distributing or (ii) will represent at least (a) 8 percent of the total number of employees of Distributing's consolidated group and (b) 7.5 percent of the aggregate gross revenues of Distributing's consolidated group or (iii) will satisfy both (i) and (ii). Consequently, immediately after the Distribution, Business X, will not be de minimis compared with the other assets or activities of Distributing at that time.

(e) The five years of financial information submitted on behalf of Sub 1 and Sub 2 (for Activity Y2) represents the present operations of Sub 1 and Sub 2, and there have been no substantial operational changes since the date of the last financial statements submitted.

(f) Immediately after the Distribution, the gross assets of the trade or business relied on by Sub 1 to satisfy the active trade or business requirement of § 355(b) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Sub 1.

(g) Following the Distribution, Distributing and Sub 1 each will continue, independently and with its separate employees, the active conduct of its business, except for services provided by Distributing to Sub 1 under the Transitional Services Agreement.

(h) The Distribution is carried out for the following corporate business purposes: (i) to resolve management, systemic, and other problems that arise from, and are exacerbated by, operating Business X and Activity Y2 within the same affiliated group and (ii) to engage in raising capital by issuing stock to investors. The Distribution is motivated, in whole or substantial part, by these corporate business purposes.

(i) There is no plan or intention by any stockholder who owns five percent or more of the stock of Distributing, and the management of Distributing, to its best knowledge, is not aware of any plan or intention on the part of any particular remaining stockholder or security holder of Distributing, to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either Distributing or Sub 1 after the Transaction.

(j) There is no plan or intention by either Distributing or Sub 1, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the Transaction, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.

(k) There is no plan or intention to liquidate either Distributing or Sub 1, 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, and except for the possible sale of part of Business X.

(l) No liabilities will be assumed (within the meaning of § 357(d)) by Sub 1 in the Transaction.

(m) No debt will exist between Distributing and Sub 1 at the time of, or after, the Distribution, other than possible obligations resulting from one or more of the Transaction-Related Agreements. None of any such debt will constitute stock or securities.

(n) Immediately before the Distribution (or immediately before a potential deconsolidation, should it occur before the Distribution), 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). Further, any excess loss account Distributing may have in Sub 1 stock will be included in income immediately before the Distribution to the extent required by applicable regulations (see § 1.1502-19).

(o) Except for payments under certain post-distribution agreements, payments made in connection with any continuing transactions between (i) Distributing or any of its subsidiaries and (ii) Sub 1 or Sub 2 will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(p) Neither Distributing nor Sub 1 is an investment company as defined in § 368(a)(2)(F)(iii) and (iv).

(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 Sub 1 stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Sub 1 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 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 combined voting power of all classes of stock of either Distributing or Sub 1 entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Sub 1.

(t) The payment of cash in lieu of fractional shares of Sub 1 common stock is solely for the purpose of avoiding the expense and inconvenience to Distributing of distributing fractional shares and does not represent separately bargained-for consideration. The method used for handling fractional share interests is intended to limit (i) the total cash consideration that will be paid in the transaction to the Distributing stockholders to no more than one percent of the total consideration that will be issued in the transaction and (ii) the amount of cash received by any one of the stockholders to less than the value of one full share of Sub 1 common stock.

Rulings

Based solely on the facts submitted and representations made, we rule as follows on the Transaction:

(1) The Contribution, followed by the Distribution, will be a reorganization under § 368(a)(1)(D). Distributing and Sub 1 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)).

(3) No gain or loss will be recognized by Sub 1 on the Contribution (§ 1032(a)).

(4) The basis of each asset received by Sub 1 in the Contribution will equal the basis of that asset in the hands of Distributing immediately before the Contribution (§ 362(b)).

(5) The holding period of each asset received by Sub 1 in the Contribution will include the period during which Distributing held that asset (§ 1223(2)).

(6) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the Distributing stockholders upon their receipt of Sub 1 stock in the Distribution (§ 355(a)(1)).

(7) The aggregate basis of the Distributing stock and the Sub 1 stock in the hands of each Distributing stockholder (including any fractional share interest to which the stockholder may be entitled) will equal the aggregate basis of the Distributing stock held by that stockholder immediately before the Distribution, allocated between the

Distributing stock and the Sub 1 stock in proportion to the fair market value of each in accordance with § 1.358-2(a) (§ 358(b) and (c)).

(8) The holding period of the Sub 1 stock received by each Distributing stockholder (including any fractional share interest) in the Distribution will include the holding period of the Distributing stock on which the Distribution is made, provided the Distributing stock is held as a capital asset on the date of the Distribution (§ 1223(1)).

(9) No gain or loss will be recognized by Distributing on the Distribution (§§ 355(c) and 361(c)).

(10) Earnings and profits will be allocated between Distributing and Sub 1 in accordance with §§ 312(h), 1.312-10(a), and 1.1502-33(e)(3).

(11) The payment of cash, if any, in lieu of fractional shares of Sub 1 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 stockholder will recognize gain or loss equal to the difference between the cash received and the basis of the fractional share as determined in ruling (7) above (§ 1001). If the Sub 1 stock is held by the stockholder 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).

Caveats

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 Transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding:

(i) Whether the Activity Y2 Transfers described above in the Summary of Facts qualified under § 351(a);

(ii) Whether Acquisition 1 described above in the Summary of Facts qualified as a reorganization under § 368(a);

(iii) Whether the Sub 8 Transfer described above in the Summary of Facts qualified under § 351(a);

(iv) Whether the mergers described above in step (iii) and the conversions described in steps (ii), (iv), and (v) will qualify as liquidations under § 332;

(v) The tax treatment of the Class B Conversion; and

(vi) The treatment of the non-arm's length payments described in representation

(o).

Procedural Statements

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 affected by the 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 is completed.

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

Sincerely,

Lewis K Brickates
Acting Branch Chief, Branch 4
Office of Associate Chief Counsel
(Corporate)

cc: