

**Internal Revenue Service**

Department of the Treasury

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December 14, 1999

RE:

Distributing =

Controlled =

Sub Holding 1 =

Sub 1 =

FSub 1 =

FSub 2 =

Bank X =

M Trust =

Business A =

Business B =

Manufacturer =

- a =
- b =
- c =
- d =
- f =
- g =
- h =
- State A =

Dear :

We respond to your letter dated June 22, 1999, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated September 6, September 29, October 19, October 29, November 16, November 24, and December 13, 1999. The information submitted for consideration is summarized below.

Distributing is an accrual basis State A corporation and the common parent of an affiliated group of corporations filing a consolidated federal income tax return. Distributing is indirectly engaged in various businesses through its wholly owned subsidiaries, including Sub Holding 1. Sub Holding 1, among other domestic and foreign subsidiaries, owns Sub 1, which is engaged in Business A. Approximately i% of the Distributing stock is owned by four family trusts, which include the M Trust. The M Trust has pledged a portion of its Distributing stock to secure a loan by an unrelated third party. If the parties are unable to satisfactorily renegotiate the M Trust debt, the lender may foreclose on the pledge.

In an internal restructuring occurring prior to the described transaction, FSub 1 and FSub 2, which are wholly owned foreign subsidiaries of Sub 1, will distribute all of their assets to Sub 1. The taxpayer has represented that these transactions qualify as complete liquidations under section 332.

Controlled, which is a wholly owned subsidiary of Distributing, is directly engaged in Business B.

Financial information has been received which indicates that Sub 1 and Controlled have each had gross receipts and operating expenses representative of the

active conduct of a trade or business for each of the past five years.

Controlled's management has determined that consolidating acquisitions are essential to the continued growth and success of Business B. Manufacturer, a major customer, informed Controlled that it wanted a number of its suppliers consolidated as quickly as possible. Controlled believes that it could grow its business with Manufacturer from less than a \$f account to well over \$g if it consolidates many of the targeted suppliers. Over the course of the past year, Controlled has acquired two targeted suppliers and unsuccessfully bid on a third target because of an inability to borrow acquisition capital. The two successful acquisitions have already led to substantial revenue growth for Controlled with Manufacturer. Currently, Controlled is actively engaged in the acquisition process with two other acquisition targets.

To continue this supplier consolidation strategy, Controlled requires substantial additional acquisition capital. However, the Distributing group, and correspondingly Controlled, has reached its borrowing limits to fund acquisitions. Bank X, Controlled's lender, has agreed to provide a line of credit of approximately \$h for Controlled, on the condition that Controlled become a stand-alone corporation.

The following proposed transaction is planned so that Controlled will become a stand-alone corporation engaged in Business B:

- Step 1           Distributing will transfer various assets to Controlled.
  
- Step 2           Distributing will distribute all the stock in Controlled pro rata to its shareholders. Fractional shares, if any, will not be issued, but will be paid in cash. The shareholders will not surrender any Distributing stock in such transaction. In addition, certain employees of Controlled who hold options to purchase Distributing stock will exchange such options for options to purchase Controlled stock.

In anticipation of the separation of Controlled from Distributing, Controlled will establish a line of credit with Bank X in the amount of \$h. Prior to the spinoff, Controlled will draw down approximately \$b on its line of credit. Approximately \$d of such borrowed proceeds will be used to satisfy Controlled's existing indebtedness to Distributing. The remaining \$a will be paid to Distributing as a dividend. Distributing will use this amount to satisfy Controlled's allocable share of the indebtedness of the Distributing group. Within one year of the spinoff, Controlled will draw down an approximately additional \$c of its credit line with Bank X and use the proceeds to acquire targets as part of its supplier consolidation strategy.

The following representations have been made in connection with proposed transactions described in Step 1 and Step 2, above:

- (a) Distributing, Controlled and their respective shareholders will each pay their respective expenses incurred in connection with the proposed spin-off transaction.
- (b) No part of the stock of Controlled is being received by a shareholder as a creditor, employee or in any other capacity other than that of a Distributing shareholder.
- (c) Following the spin-off transaction, at least 90% of the fair market value of the gross assets of Distributing will consist of the stock of Sub Holding 1, and at least 90% of the fair market value of the gross assets of Sub Holding 1 will consist of the stock of Sub 1, which is directly engaged in the active conduct of a trade or business and will continue as such following the spin-off transaction within the meaning of § 355(b)(2) of the Code.
- (d) The five years of financial information submitted on behalf of Sub 1 and Controlled is generally representative of each corporation's present operations. With regard to each corporation, there has been no substantial operational changes since the date of the last financial statements submitted.
- (e) Following the spin-off transaction, Distributing and Controlled will each continue the conduct of its active trade or business, independently and with separate employees.
- (f) The distribution of the stock of Controlled is carried out for the following business purpose: to facilitate a substantial borrowing by Controlled, the proceeds of which will be used to fund acquisitions. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this business purpose.
- (g) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the spin-off transaction.
- (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 spin-off transaction, except in the ordinary course of business.
- (i) Other than the potential foreclosure on the pledge of certain Distributing stock owned by the M Trust (totaling less than 4% of Distributing's outstanding stock), there is no plan or intention on the part of any shareholder who owns 5% or more of the stock of Distributing and, to its best knowledge, the management of Distributing is not aware of any plan or intention on the part of any particular remaining shareholder of Distributing, to sell, exchange, transfer by gift, or otherwise dispose of any stock in either Distributing or Controlled after the spin-

off transaction.

- (j) Payments made in connection with 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 arm's length. Administrative services provided by one corporation to the other may be provided for a transitional period, not to exceed one year, at a price that reflects fair market value.
- (k) The payment of cash in lieu of fractional shares of Controlled stock will be solely for the purpose of avoiding the expense and inconvenience to Controlled of issuing fractional shares and does not represent separately bargained for consideration.
- (l) The total amount of cash distributed in lieu of fractional shares will constitute less than 1% of the total consideration distributed in the spin-off transaction. The fractional share interests of each Distributing shareholder will be aggregated and no Distributing shareholder will receive cash in the amount equal to or greater than the value of one full share of Controlled stock.
- (m) 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 spin-off transaction, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.
- (n) Immediately before the spin-off transaction, items of income, gain, loss, deduction, and credit, if any, will be taken into account as required by the applicable intercompany transaction regulations (See Treasury regulations §§ 1.1502-13 and 1.1502-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and as currently in effect; § 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account, if any, with respect to the Controlled stock will be included in income immediately before the spin-off transaction (See § 1.1502-19).
- (o) No two parties to the spin-off transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (p) The spin-off transaction 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% or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of either

## Distributing or Controlled.

- (q) No Distributing shareholder or shareholders will hold immediately after the spin-off transaction disqualified stock within the meaning of § 355(d)(3), which constitutes a 50% or greater interest in Distributing or Controlled.
- (r) FSub 1 and FSub 2 are the only foreign corporations involved in the restructuring associated with the proposed spin-off in this ruling request.
- (s) Upon the liquidation of the foreign corporations, taxpayer will recognize gain pursuant to the provisions of § 7.367(b)-5(b).
- (t) To the extent the liquidation of FSub 1 and FSub 2 are transactions described in § 367(b) and the regulations thereunder, Distributing will comply with the requirements of the regulations including the notice requirements.
- (u) Neither Distributing or Controlled was a United States real property holding corporation (as defined in section 897(c)(2)) at any time during the five year period ending on the date of the spinoff, and neither Distributing or Controlled will be a United States real property holding corporation immediately after the spinoff.

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

- (1) The transfer by Distributing to Controlled of assets in constructive exchange for Controlled stock, followed by the pro rata distribution of Controlled stock to the shareholders of Distributing, will qualify as a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be a “party to a reorganization” within the meaning of § 368(b).
- (2) No gain or loss will be recognized to Distributing upon the transfer of assets to Controlled in exchange for Controlled stock (§ 361(a)).
- (3) No gain or loss will be recognized by Controlled on the receipt of the assets from Distributing in constructive exchange for additional shares of Controlled stock (§ 1032(a)).
- (4) The basis of the assets received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (§ 362(b)).
- (5) The holding period of each Distributing asset received by Controlled will include the period during which that asset was held by Distributing (§ 1223(2)).

- (6) No gain or loss will be recognized by Distributing upon the distribution of all of its stock in Controlled (§ 361(c)).
- (7) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with § 1.312-10(a).
- (8) No gain or loss will be recognized by (and no amount will be included in the income of) the distributee shareholders upon receipt of Controlled stock in the spin-off transaction (§ 355(a)(1)).
- (9) The basis of the Controlled stock and the Distributing stock in the hands of the distributee shareholders after the spin-off transaction will be the same as the aggregate basis of the Distributing stock held immediately before the spin-off transaction, allocated among the shares of Distributing and Controlled in proportion to the fair market value of each in accordance with §§ 358(a) and (b)(2) and § 1.358-2(a)(2).
- (10) The holding period of the Controlled stock received by the distributee shareholders in the spin-off transaction will include the period during which the distributee shareholders held shares of Distributing stock, provided that such shares of Distributing stock are held as a capital asset on the date of the spin-off transaction (§ 1223(1)).
- (11) Any payments of cash in lieu of fractional share interests in Controlled will be treated for federal tax purposes as if the fractional shares were issued in the spin-off transaction and then were redeemed by Controlled. The cash payments will be treated as having been received as distributions in full payment in exchange for the stock redeemed as provided in § 302(a).
- (12) The liquidation of FSub 1 and FSub 2 is subject to, to the extent applicable, the rules of paragraph (c) of § 1.367(b)-1 of the Income Tax Regulations, paragraphs (c) and (d) of § 7.367(b)-1 of the Temporary Regulations, and § 7.367(b)-5 of the Temporary Regulations.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not directly covered by the above rulings. In particular, we express no opinion regarding the tax treatment of the options described in Step 2, above.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is

consummated.

The rulings contained in this letter are predicated on upon the facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as part of the audit process.

Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to the taxpayer.

Sincerely yours,  
Assistant Chief Counsel (Corporate)

By \_\_\_\_\_  
Christopher W. Schoen  
Assistant to Branch Chief,  
CC:DOM:CORP:1