

**Internal Revenue Service**

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Department of the Treasury

Washington, DC 20224

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CC:CORP:B03 – PLR-111804-03

Date:

July 08, 2003

Distributing 2 =

Distributing 1 =

Controlled =

Sub 1 =

Sub 2 =

Sub 3 =

State A =

Business =

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Segment 1 =

Segment 2 =

Shareholder A =

Consultant =

Year 1 =

Date 2 =

Date 3 =

Year 4 =

Date 5 =

Year 6 =

a =

Dear :

This letter responds to your February 14, 2003, request for rulings on certain federal income tax consequences of a series of proposed transactions. The information provided in that request and in later correspondence is summarized below.

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. 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 2 is a publicly traded State A corporation and the common parent of an affiliated group whose includible members join in filing a consolidated Federal income tax return (the "Distributing 2 Group"). Distributing 2 is engaged, through direct

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and indirect subsidiaries, in all aspects of the Business. The Business is divided into two market segments: Segment 1 and Segment 2. Shareholder A holds more than five percent of the outstanding Distributing 2 stock but does not actively participate in the management or operation of the Distributing 2 Group.

Distributing 2 wholly owns Sub 1 and Sub 2. Sub 1 wholly owns Distributing 1 and owns a percent (more than 80) of Sub 3.

Distributing 2 and Sub 1 were formed in Year 1 (less than five years ago) to acquire the Business in a series of partially taxable transactions. Sub 1 is directly involved in Segment 1 and Segment 2. Sub 3 was formed by Sub 1 on Date 2 and currently holds most of the intellectual property associated with Segment 1 and Segment 2 (the "Intellectual Property").

On Date 3 (less than three years ago), Distributing 2 acquired Distributing 1 in a reverse merger intended to qualify under § 368(a)(1)(A) and (a)(2)(E) of the Internal Revenue Code ("Acquisition 1"). Following Acquisition 1, Distributing 2 contributed the stock of Distributing 1 to Sub 1 in constructive exchange for additional stock of Sub 1 in a transaction intended to qualify under § 351. Distributing 1 has been engaged only in Segment 2 since Year 4 (more than five years ago).

On Date 5 (less than two years ago), Distributing 2 acquired Sub 2 in a transaction intended to qualify as partially tax-free under § 368(a)(1)(A) and (a)(2)(D) ("Acquisition 2"). Sub 2 has been engaged only in Segment 1 since Year 6 (more than five years ago).

Segment 1 and Segment 2 differ significantly in terms of economic development. As a result, management has had to devote disproportionately more attention to Segment 2 than is justified by its contribution to the entire Business. To eliminate this problem, Consultant has recommended that the two Business Segments end their affiliation (the "Separation").

### **Proposed Transactions**

To effect the Separation, Distributing 2 has proposed the following series of transactions (the "Proposed Transactions"):

- (i) Sub 1 will merge with and into Sub 1 LLC, a single-member limited liability company formed by Distributing 1 ("Merger 1"). It is intended that Sub 1 LLC be disregarded as an entity separate from Distributing 1 for federal tax purposes under § 301.7701-3 of the Procedure and Administrative Regulations (a "disregarded entity"). Immediately following this step, Distributing 2 will wholly own Distributing 1.

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(ii) Sub 3 will merge with and into Sub 3 LLC, a single-member limited liability company formed by Distributing 1 ("Merger 2"). It is intended that Sub 3 LLC be a disregarded entity.

(iii) Distributing 2 will transfer the stock of Sub 2 to Distributing 1 in constructive exchange for additional Distributing 1 stock (the "Transfer").

(iv) Distributing 1 will incorporate Controlled and, in actual or constructive exchange for Controlled stock, (a) Distributing 1 and Sub 1 LLC will transfer their Segment 2 assets to Controlled and (b) Sub 3 LLC will transfer to Controlled all rights in certain of the Intellectual Property relating to Segment 2 ((a) and (b) together, the "Contribution"). The Intellectual Property not transferred by Sub 3 LLC in the Contribution will be licensed to Controlled on an arm's-length basis. In what are expected to be taxable transactions, foreign subsidiaries of Distributing 1 will transfer their Segment 2 assets to foreign subsidiaries formed by Controlled (the "Foreign Transfers").

(v) Distributing 1 will distribute all of the Controlled stock to Distributing 2 ("Distribution 1").

(vi) Distributing 2 will distribute all of the Controlled stock to its shareholders, pro rata ("Distribution 2").

## **Representations**

### **Distribution 1**

Distributing 2 makes the following representations regarding the Contribution (described above in step (iv)) and Distribution 1 (described above in step (v)). For these representations and the rulings that follow, the transfers made by Sub 1 LLC and Sub 3 LLC as part of the Contribution will be treated as made by Distributing 1.

(a) Any indebtedness owed by Controlled to Distributing 1 after Distribution 1 will not constitute stock or securities.

(b) No part of the consideration distributed by Distributing 1 will be received by Distributing 2 as a creditor, employee, or in any capacity other than that of a shareholder of Distributing 1.

(c) Apart from the integration of Distributing 1's employee functions with those of the Distributing 2 Group following Acquisition 1, the financial information submitted on

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behalf of Distributing 1 represents the present operation of Segment 1 by Sub 1, and regarding Segment 1 of Sub 1, there have been no substantial operational changes since the date of the last financial statements submitted.

(d) Apart from the integration of Distributing 1's employee functions with those of the Distributing 2 Group following Acquisition 1, the five years of financial information submitted on behalf of Controlled represent the present operation of Segment 2 by each of Distributing 1 and Sub 1, and regarding both, there have been no substantial operational changes since the date of the last financial statements submitted.

(e) Apart from services provided under a transitional agreement to be entered into by the Distributing 2 Group and Controlled, following Distribution 1, Distributing 1 and Controlled each will continue the active conduct of its business, independently, with its separate employees.

(e1) Immediately after Distribution 1, the gross assets of the trade or business directly conducted by Distributing 1 that is relied upon by Distributing 1 to satisfy the active trade or business requirement of § 355(b) (the less than five-year Segment 1 business now conducted by Sub 1 that will become a more than five-year business on its acquisition by Distributing 1 in Merger 1) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Distributing 1.

(e2) Immediately after Distribution 1, the gross assets of the trade or business directly conducted by Controlled that is relied upon by Controlled to satisfy the active trade or business requirement of § 355(b) (the Segment 2 business now conducted by Distributing 1 and by Sub 1) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Controlled.

(f) Distribution 1 will be carried out to facilitate Distribution 2, which will enhance the success of Segment 1 and Segment 2 by resolving management, systemic, or other problems that arise from (or are exacerbated by) the operation of both Segments within the Distributing 2 Group. Distribution 1 is motivated, in whole or substantial part, by this corporate business purpose.

(g) Except for Distribution 2, there is no plan or intention by Distributing 2 to sell, exchange, transfer by gift, or otherwise dispose of any of its stock in, or securities of, either Distributing 1 or Controlled after Distribution 1.

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

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(i) There is no plan or intention to liquidate either Distributing 1 or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after Distribution 1, except in the ordinary course of business.

(j) (i) The total adjusted basis and the fair market value of the assets to be transferred to Controlled by Distributing 1 each equals or exceeds the sum of the liabilities assumed (within the meaning of § 357(d)) by Controlled, plus the fair market value of any property and the amount of any money distributed by Controlled to Distributing 1 that is distributed to the shareholders of Distributing 1, or transferred to the creditors of Distributing 1, pursuant to the plan of reorganization; and (ii) the liabilities to be assumed (within the meaning of § 357(d)) in the Proposed Transactions were incurred in the ordinary course of business and are associated with the assets being transferred.

(k) The income tax liability for the taxable year in which investment credit property (including any building to which § 47(d) applies), if any, is transferred in the Contribution will be adjusted under § 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.

(l) Except for debt that may arise under a transitional services agreement to be entered into by the Distributing 2 Group and Controlled in connection with Distribution 2, no intercorporate debt will exist between Distributing 1 or any other member of the Distributing 2 Group and Controlled at the time of, or after, Distribution 1.

(m) Immediately before Distribution 1, 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 of the Income Tax Regulations and § 1.1502-14 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).

(n) Payments made in any continuing transactions between Distributing 1 and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

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

(p) For purposes of § 355(d), immediately after Distribution 1, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of

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

(q) For purposes of § 355(d), immediately after Distribution 1, 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 Distribution 1 or (ii) attributable to distributions on Distributing 1 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 Distribution 1.

(r) Distribution 1 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 stock of either Distributing 1 or Controlled or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing 1 or Controlled.

(r1) Distributing 2 has no plan or intention to cause an election under § 301.7701-3 that would result in Sub 1 LLC or Sub 3 LLC being classified as other than a disregarded entity.

### Distribution 2

Distributing 2 makes the following representations regarding Distribution 2 (described above in step (vi)):

(s) Any indebtedness owed by Controlled to Distributing 2 after Distribution 2 will not constitute stock or securities.

(t) Except for restricted stock that Controlled may issue to management as compensation (which will constitute less than five percent of the outstanding Controlled stock following Distribution 2), no part of the consideration to be distributed by Distributing 2 will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing 2.

(u) Immediately after Distribution 2, at least 90 percent of the fair market value of the gross assets of Distributing 2 will consist of the stock and securities of Distributing 1,

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a controlled corporation that is engaged in the active conduct of a trade or business as defined in § 355(b)(2).

(v) Apart from the integration of Distributing 1's employee functions with those of the Distributing 2 Group following Acquisition 1, the financial information submitted on behalf of Distributing 1 (for Distributing 2) represents the present operation of Segment 1 by Sub 1, and regarding Segment 1 of Sub 1, there have been no substantial operational changes since the date of the last financial statements submitted.

(w) Apart from services provided under a transitional agreement to be entered into by the Distributing 2 Group and Controlled, following Distribution 2, Distributing 2 (through its ownership of all the stock of Distributing 1) and Controlled each will continue the active conduct of its business, independently, with its separate employees.

(w1) Immediately after Distribution 2, the gross assets of the trade or business directly conducted by Distributing 1 that is relied upon by Distributing 2 to satisfy the active trade or business requirement of § 355(b) (the less than five-year Segment 1 business now conducted by Sub 1 that will become a more than five-year business on its acquisition by Distributing 1 in Merger 1) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Distributing 1.

(w2) Immediately after Distribution 2, the gross assets of the trade or business directly conducted by Controlled that is relied upon by Controlled to satisfy the active trade or business requirement of § 355(b) (the Segment 2 business now conducted by Distributing 1) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Controlled.

(x) Distribution 2 will be carried out to enhance the success of Segment 1 and Segment 2 by resolving management, systemic, or other problems that arise from (or are exacerbated by) the operation of both Segments within the Distributing 2 Group. Distribution 2 is motivated, in whole or substantial part, by this corporate business purpose.

(y) There is no plan or intention by any shareholder who owns five percent or more of the Distributing 2 stock, and the management of Distributing 2, to its best knowledge, is not aware of any plan or intention on the part of any particular remaining shareholder or security holder of Distributing 2 to sell, exchange, transfer by gift, or otherwise dispose of any of its stock in, or securities of, either Distributing 2 or Controlled after Distribution 2.

(z) There is no plan or intention by either Distributing 2 or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after

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Distribution 2, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.

(aa) There is no plan or intention to liquidate either Distributing 2 or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after Distribution 2, except in the ordinary course of business.

(bb) Except for debt that may arise under a transitional services agreement to be entered into by the Distributing 2 Group and Controlled in connection with Distribution 2, no intercorporate debt will exist between any member of the Distributing 2 Group and Controlled at the time of, or after, Distribution 2.

(cc) Immediately before Distribution 2, 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 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 2 may have in the Controlled stock will be included in income to the extent required by applicable regulations (see § 1.1502-19).

(dd) Payments made in any continuing transactions between Distributing 2 or Distributing 1 and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

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

(ff) For purposes of § 355(d), immediately after Distribution 2, 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 2 stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing 2 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 Distribution 2.

(gg) For purposes of § 355(d), immediately after Distribution 2, 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 Distribution 2 or (ii) attributable to distributions on Distributing 2 stock that was acquired by purchase (as

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defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of Distribution 2.

(hh) Distribution 2 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 stock of either Distributing 2 or Controlled or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing 2 or Controlled.

## **Rulings**

### **Distribution 1**

Based solely on the information submitted and the representations set forth above, we rule as follows on the Contribution (described above in step (iv)) and Distribution 1 (described above in step (v)):

(1) The Contribution, followed by Distribution 1, will qualify as a reorganization under § 368(a)(1)(D). Distributing 1 and Controlled each will be a “party to a reorganization” under § 368(b).

(2) No gain or loss will be recognized by Distributing 1 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 in the Contribution will equal the basis of that asset in the hands of Distributing 1 immediately before the Contribution (§ 362(b)).

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

(6) No gain or loss will be recognized by Distributing 1 on Distribution 1 (§ 361(c)(1)).

(7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) Distributing 2 on its receipt of the Controlled stock in Distribution 1 (§ 355(a); Rev. Rul. 62-138, 1962-2 C.B. 95).

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(8) The aggregate basis of the Distributing 1 stock and the Controlled stock in the hands of Distributing 2 immediately after Distribution 1 will equal the aggregate basis of the Distributing 1 stock held by Distributing 2 immediately before Distribution 1. The total basis will be allocated between the shares of Distributing 1 stock and Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§ 358(b)).

(9) The holding period of the Controlled stock received by Distributing 2 will include the holding period of the Distributing 1 stock on which Distribution 1 is made, provided the Distributing 1 stock is held as a capital asset on the date of Distribution 1 (§ 1223(1)).

(10) Earnings and profits will be allocated between Distributing 1 and Controlled in accordance with § 312(h), § 1.312-10(b), and § 1.1502-33(f)(2).

### Distribution 2

Based solely on the information submitted and the representations set forth above, we rule as follows on Distribution 2 (described above in step (vi)):

(11) No gain or loss will be recognized by Distributing 2 on Distribution 2 (§ 355(c)).

(12) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the shareholders of Distributing 2 on their receipt of Controlled stock in Distribution 2 (§ 355(a); Rev. Rul. 62-138).

(13) The aggregate basis of the Distributing 2 stock and the Controlled stock in the hands of each shareholder of Distributing 2 immediately after Distribution 2 will equal the aggregate basis of the Distributing 2 stock held by that shareholder immediately before Distribution 2. The total basis will be allocated between the shares of Distributing 2 stock and Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§ 358(b)).

(14) The holding period of the Controlled stock received by each shareholder of Distributing 2 will include the holding period of the Distributing 2 stock on which Distribution 2 is made, provided the Distributing 2 stock is held as a capital asset on the date of Distribution 2 (§ 1223(1)).

(15) Earnings and profits will be allocated between Distributing 2 and Controlled in accordance with § 312(h), § 1.312-10(b), and § 1.1502-33(e)(3).

### **Caveats**

No opinion is expressed about the tax treatment of the Proposed Transactions 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 Transactions that are not specifically covered by the above rulings. In particular, no opinion is expressed on:

- (a) The tax treatment of Acquisition 1 (described above in the Summary of Facts);
- (b) The tax treatment of Acquisition 2 (described above in the Summary of Facts);
- (c) The tax treatment of Merger 1 (described above in step (i));
- (d) The tax treatment of Merger 2 (described above in step (ii));
- (e) The tax treatment of The Transfer (described above in step (iii));
- (f) The tax treatment of The Foreign Transfers (described above in step (iv)); and
- (g) Whether Sub 1 LLC and Sub 3 LLC each will qualify as a disregarded entity.

For a discussion of the circumstances under which a ruling letter will be revoked or modified, see § 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B.1. However, when the criteria in § 12.05 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

### **Procedural Statements**

**This ruling letter is directed only to the taxpayers who requested it and applies only to the facts of the Proposed Transactions. Section 6110(k)(3) provides that it may not be used or cited as precedent.**

A copy of this ruling letter must be attached to the federal income tax return of each taxpayer involved in the Proposed Transactions for the taxable year in which the Proposed Transactions are completed.

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

Sincerely yours,  
Associate Chief Counsel (Corporate)

Wayne T. Murray  
By: Wayne T. Murray  
Special Counsel to the  
Associate Chief Counsel

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cc: