

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Distributing =

Controlled =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6 =

Sub 7 =

Sub 8 =

Sub 9 =

Business A =

Segment A1 =

Segment A2 =

A =

B =

Date A =

a =

b =

c =

d =

e =

We respond to your January 10, 2000 request for rulings on certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondence is summarized below.

The rulings in this letter are based on the facts and representations submitted under penalties of perjury in support of the request. Verification of that information may be required as part of the audit process.

Summary of Facts

Distributing is the common parent of an affiliated group that conducts Business A and files a consolidated federal income tax return. Distributing wholly owns Controlled, which wholly owns Sub 1, Sub 2, and Sub 3. Distributing also wholly owns Sub 4, which wholly owns Sub 5, Sub 6, and Sub 7. Controlled's ownership of Sub 1, Sub 2, and Sub 3 came about through a restructuring that was completed on Date A (the "Restructuring").

Controlled conducts Segment A1 of Business A through its three subsidiaries, and Sub 4 conducts Segment A2 of Business A through its three subsidiaries. We have received financial information indicating that Sub 1, Sub 2, Sub 3, Sub 5, and Sub 6 each had gross income and operating expenses representing the conduct of an active business during each of the past five years.

Distributing has one class of common stock outstanding (the "Distributing Stock"). The Distributing Stock generally may be owned only by or for the benefit of active employees and directors of Distributing and its subsidiaries. On the retirement, death, or other termination of employment of a stockholder, the stock must be sold to Distributing at a formula price based primarily on book values (a "formula price"). Individuals A and B each will own more than five percent of the Distributing Stock at the time of the transaction described below.

Distributing also has outstanding three series of a-year, fixed market rate convertible debentures issued in year c through year d that are held by b current employees (the "Distributing Debentures"). Holders are entitled to convert their Distributing Debentures into Distributing Stock during a one-month period in the fifth year after the debentures' issuance.

Currently, the Distributing Stock held by key employees of Segment A1 reflects the operations of Business A as a whole. Distributing now wishes to further reward and motivate these employees by allowing them to acquire a direct (and meaningfully larger) ownership interest in Segment A1 alone, so that the value of their stock will reflect the operations of Segment A1 unaffected by those of Segment A2.

Proposed Transaction

To achieve this direct ownership of Segment A1, Distributing proposes the following transaction:

(i) Before the record date (the "Record Date"), shareholders who are employees in Segment A1 will choose whether to exchange their Distributing Stock for Controlled stock (the "Controlled Stock") in the transaction. Segment A1 employees who choose not to exchange their Distributing Stock for Controlled Stock will be required to sell the Distributing Stock to Distributing for cash (at a formula price) on or about the Record Date.

(ii) Also before the Record Date, holders of Distributing Debentures will choose whether to retain their debentures or exchange each debenture for either (a) a convertible debenture issued by Controlled with substantially the same terms except that it will be convertible into Controlled Stock and may be convertible on an early basis in certain limited circumstances (a "Controlled Debenture") or (b) shares of Controlled Stock and a new convertible debenture issued by Distributing with substantially the same terms except with a proportionately reduced principal amount (a "New Distributing Debenture"). Controlled Debentures and New Distributing Debentures each will bear interest at the higher of the applicable federal rate or the rate of the Distributing Debentures for which they are exchanged.

(iii) Distributing will contribute e dollars of cash or property used in Segment A1 to Controlled for use in Segment A1 (the "Contribution").

(iv) On or about the Record Date, Segment A1 employees owning shares of Distributing Stock will exchange the stock for Controlled Stock or sell the stock to Distributing for cash (the "Share Exchange"). Distributing expects each key employee of Segment A1 to exchange all of his Distributing Stock for Controlled Stock, the result being a meaningful increase in the key employees' aggregate ownership of Segment A1.

(v) On or about the Record Date, holders of Distributing Debentures (other than those electing to retain their debentures) will exchange their debentures for either (a) Controlled Debentures or (b) Controlled Stock and New Distributing Debentures (the "Debenture Exchange").

(vi) Distributing then will redeem any Distributing Debentures or New Distributing Debentures held by Segment A1 employees, and Controlled will redeem any Controlled Debentures held by Segment A2 employees.

(vii) Distributing will distribute all remaining shares of Controlled Stock pro rata to its remaining shareholders (the "Distribution" and, together with the Share Exchange and the Debenture Exchange, the "Separation"). The Controlled Stock distributed in the Separation will be transferable only for estate planning purposes or to Controlled for a formula price.

Representations

The taxpayers have made the following representations concerning the proposed transaction:

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

(b) The fair market value of the Controlled Stock and any other consideration received by each shareholder of Distributing pursuant to the Share Exchange will approximately equal the fair market value of the Distributing Stock surrendered by the shareholder in the exchange.

(c) The principal amount of the Controlled Debentures and the New Distributing Debentures received in the Debenture Exchange will in each case be equal to or less than the principal amount of the Distributing Debentures surrendered in exchange therefor.

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

(e) No part of the consideration distributed by Distributing will be received by a security holder as an employee or in any capacity other than that of a security holder of Distributing.

(f) Immediately after the Separation, at least 90 percent of the fair market value of the gross assets of Distributing will consist of the stock of Sub 4.

(g) Immediately after the Separation, at least 90 percent of the fair market value of the gross assets of Sub 4 will consist of the stock of Sub 5 and Sub 6, each of which is engaged in the active conduct of a trade or business under § 355(b) of the Internal Revenue Code.

(h) The five years of financial information submitted on behalf of Distributing,

Sub 4, Sub 5, and Sub 6 represents the present operations of each corporation and, with respect to each, there have been no substantial operational changes since the date of the last financial statements submitted.

(i) Immediately after the Separation, at least 90 percent of the fair market value of the gross assets of Controlled will consist of the stock of Sub 1, Sub 2, and Sub 3, each of which is engaged in the active conduct of a trade or business under § 355(b).

(j) The five years of financial information submitted on behalf of Controlled, Sub 1, Sub 2, and Sub 3 represents the present operations of each corporation and, with respect to each, there have been no substantial operational changes since the date of the last financial statements submitted.

(k) Following the Separation, Sub 1, Sub 2, Sub 3, Sub 5, and Sub 6 each will continue the active conduct of its business, independently and with its separate employees.

(l) The Separation is being carried out to allow certain key employees of Controlled to acquire a meaningfully increased equity interest in Segment A1 that reflects solely the performance of Segment A1. The Separation is motivated, in whole or substantial part, by this corporation business purpose and other business reasons.

(m) There is no plan or intention by A or B, and the management of Distributing, to its best knowledge, is not aware of any plan or intention on the part of any remaining shareholder or security holder of Distributing, to sell, exchange, transfer by gift or otherwise dispose of any stock in, or securities of, either Distributing or Controlled after the Separation (apart from sales of Distributing Stock or Distributing Debentures to Distributing in connection with a holder's termination of employment with Distributing and possible future conversions of Distributing Debentures, New Distributing Debentures or Controlled Debentures into Distributing Stock or Controlled Stock, respectively).

(n) 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 Separation, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Revenue Procedure 96-30, 1996-1 C.B. 696, 705, and/or pursuant to Distributing's long-standing repurchase obligations or the similar repurchase obligations that will be undertaken by Controlled.

(o) There is no plan or intention to liquidate any of Distributing, Sub 4, Sub 5, Sub 6, Controlled, Sub 1, Sub 2, or Sub 3, to merge any of these corporations with any other corporation or to sell or otherwise dispose of the assets of any of these corporations after the Separation, except for the possible distribution by Sub 5 of all of the stock of two of its subsidiaries, Sub 8 and Sub 9, to Sub 4.

(p) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing each will equal or exceed the liabilities assumed (as

determined under § 357(d)) by Controlled.

(q) The liabilities of Distributing assumed (as determined under § 357(d)) by Controlled were incurred by Distributing in the ordinary course of its business and are associated with the assets transferred.

(r) No intercorporate debt will exist between Distributing and Controlled at the time of, or after, the Separation, other than the receivables or payables incurred in connection with Distributing's provision of certain cash management or other administrative services to Controlled and trade receivables incurred in the ordinary course of business.

(s) Immediately before the Separation, 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 the Controlled stock will be included in income immediately before the Separation to the extent required by the applicable consolidated return regulations (see § 1.1502-19).

(t) Payments made in 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.

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

(v) The Separation 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 or Controlled entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

(w) For purposes of § 355(d), immediately after the Separation, 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 Separation.

(x) For purposes of § 355(d), immediately after the Separation, 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 the Separation 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 Separation.

Rulings

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

(1) The Contribution, followed by the Separation, will be a reorganization under §§ 368(a)(1)(D) and 355(a). 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)).

(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 immediately before its transfer (§ 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 (§ 1223(2)).

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

(7) No gain or loss will be recognized by Distributing's shareholders on their receipt of Controlled Stock in exchange for Distributing Stock in the Share Exchange (§ 355(a)).

(8) The basis of the Controlled Stock received by a shareholder in the Share Exchange will equal the basis of the Distributing Stock surrendered in exchange therefor (§ 358(a)).

(9) The holding period for the Controlled Stock received by a shareholder in the Share Exchange will include the holding period of the Distributing Stock surrendered in exchange therefor, provided the Distributing Stock is held as a capital asset on the Share Exchange date (§ 1223(1)).

(10) No gain or loss will be recognized by Distributing's shareholders on their receipt of Controlled Stock in the Distribution (§ 355(a)).

(11) The aggregate basis of the Distributing and Controlled stock in the hands of

each shareholder who receives Controlled Stock in the Distribution will equal the basis of the Distributing stock held by the shareholder immediately before the Distribution, allocated between the two classes in proportion to the relative fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a)(1), (b), and (c)).

(12) The holding period for the Controlled Stock received by a shareholder 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)).

(13) No gain or loss will be recognized by Distributing or Controlled on the Debenture Exchange (§§ 361(a) and 361(c)).

(14) No gain or loss will be recognized by holders of Distributing Debentures on their retention of Distributing Debentures or their exchange of Distributing Debentures in the Debenture Exchange, except to the extent that retained Distributing Debentures or Controlled Debentures or New Distributing Debentures are redeemed by Distributing or Controlled in connection with the Separation (§§ 355(a) and 356(d)(2)(A); § 1.356-3(c), Ex. 3).

(15) The basis of a Controlled Debenture received by a holder of a Distributing Debenture will equal the basis of the Distributing Debenture surrendered in exchange therefor (§ 358(a); § 1.358-1(a)).

(16) The holding period of a Controlled Debenture received by a holder of a Distributing Debenture will include the holding period of the Distributing Debenture surrendered in exchange therefor, provided the Distributing Debenture is held as a capital asset on the Debenture Exchange date (§ 1223(1)).

(17) The basis of the Controlled Stock and New Distributing Debenture received by a holder of a Distributing Debenture will equal the basis of the Distributing Debenture surrendered in exchange therefor, allocated in proportion to the relative fair market value of each on the Debenture Exchange date (§ 358(a); § 1.358-2(a)(3)).

(18) The holding period of the Controlled Stock and New Distributing Debenture received by a holder of a Distributing Debenture will include the holding period of the Distributing Debenture surrendered in exchange therefor, provided the Distributing Debenture is held as a capital asset on the Debenture Exchange date (§ 1223(1)).

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

Procedural Statements

We express no opinion about the tax treatment of the proposed transaction under any other provision 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 in the above rulings. In particular, no opinion is expressed on whether the Restructuring gave rise to intercompany items under the intercompany transaction regulations that must be taken into account on the Separation.

This 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.

A copy of this letter must be attached to the federal income tax return of each taxpayer involved for the taxable year in which the proposed transaction is consummated.

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

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