

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:CORP:1- PLR-107629-00
Date:
August 3, 2000

In Re:

Legend

- Distributing =
- Controlled =

- Subsidiary 1 =
- Subsidiary 2 =
- Subsidiary 3 =
- Subsidiary 4 =

- LLC =

- Business 1 =
- Business 2 =

- State A =
- State B =
- State C =

- Country A =

- O =
- P =
- Q =
- R =
- X =
- Y =
- Z =

- Investment Banker =

- Date A =

- Date B =

Date C	=
Date D	=
Software Agreement	=
Division	=
Fund	=

We respond to your letter dated March 31, 2000, in which you requested rulings as to the federal income tax consequences of a proposed transaction. Additional information was provided in letters dated May 8, 2000, June 14, 2000 and July 19, 2000. Specifically you requested rulings under § 355 and other code sections of the Internal Revenue Code. The information you submitted is summarized below.

Distributing is a publicly held corporation organized under the laws of State A. Distributing is indirectly engaged, through its subsidiaries, in Business 1 and Business 2. Distributing's capital structure consists of O shares of common stock, of which P are outstanding. To the best of its knowledge, Distributing has one shareholder, Fund, which holds more than 5% of its stock. Additionally, Distributing has five different stock option plans pursuant to which employees and directors may acquire stock in Distributing ("Old Options").

Controlled is a corporation that was organized under the laws of State B. Prior to the transactions described herein, Distributing owned 100 percent of the stock of Controlled. Controlled is directly engaged in Business 2. Controlled's capital structure consists of Q shares of common stock, of which R are outstanding.

Subsidiary 1 is a wholly owned subsidiary of Distributing organized under the laws of State A that is, through Subsidiary 2, engaged in Business 1.

Subsidiary 2 is a wholly owned subsidiary of Subsidiary 1 organized under the laws of State C that is directly engaged in Business 1. Until Date D, Subsidiary 2 also operated Division. On Date D, prior to contemplating the transaction described herein, Subsidiary 2 sold Division.

Subsidiary 3 is a wholly owned subsidiary of Controlled organized under the laws of State A. Subsidiary 3 is directly engaged in Business 2.

Subsidiary 4 is a wholly owned subsidiary of Subsidiary 1 organized under the laws of State A. Subsidiary 4 is directly engaged in Business 1.

Management of the Distributing group has determined that, to compete effectively in the Business 2 industry, it needs to grow and expand Business 2 beyond its present status. Distributing foresees the growth to be achieved through a combination of internal growth, joint ventures, and acquisitions. Consequently,

Controlled will need a substantial amount of capital (approximately X amount) in order to fund its growth initiatives, which Controlled plans to raise through an equity offering. However, Distributing has been advised by its financial advisor, Investment Banker, that Controlled could raise significantly more funds per share if Distributing and Controlled are separated in connection with the public offering. Consequently, Distributing and Controlled propose to restructure its Business 2 subsidiaries into a single entity. Distributing then proposes to separate Controlled from its corporate structure.

In order to complete the separation, the following steps have been or will be completed (the "Transaction"):

1. Subsidiary 1 formed LLC, all of the interests of which were issued to Subsidiary 1. LLC will be disregarded as an entity for federal income tax purposes under Treasury Regulation § 301.7701-3.
2. On or about Date A, Distributing contributed to Controlled all of Distributing's equity interests in entities conducting, directly or indirectly, Business 2 (including all of Distributing's equity interests in the Country A disregarded entities) along with certain notes receivable from those entities, in actual or constructive exchange for additional shares of Controlled stock and for the constructive assumption by Controlled of liabilities of the Country A disregarded entities (the "Contribution"). The Contribution was made in accordance with the terms provided in the Assignment and Assumption Agreement entered into between Distributing and Controlled.
3. Controlled effected a stock split in order to increase the total number of outstanding shares as is necessary to facilitate the Transaction.
4. Controlled offered less than 15% of its outstanding shares of common stock for sale to the public in an initial public offering (the "Public Offering"). The prospectus for the Public Offering states that Distributing plans to engage in the transactions described in step 9 below.
5. Subsidiary 2 will be reincorporated in State B. The taxpayer has represented that, to the best of its knowledge and belief, the reincorporation of Subsidiary 2 will constitute a reorganization within the meaning of § 368(a)(1)(F). Subsidiary 1 will subsequently cause Subsidiary 2 to merge with and into LLC (the "Liquidation").
6. Distributing will transfer its intercompany receivables and payables relating to Business 1 to Subsidiary 1.
7. Certain intercompany payables and receivables among Distributing and entities, directly or indirectly, conducting Business 2 may be canceled and others

will be repaid.

8. Old Distributing Options will be converted into separately exercisable options to acquire shares of Distributing (the "New Distributing Options") and Controlled (the "Controlled Options" and together with the New Distributing Options, the "Substituted Options"). The number of New Distributing Options and Controlled Options received will be determined based on a conversion formula designed to preserve the option holder's net economic benefit. The Substituted Options will have the same terms as the Old Distributing Options.

9. Distributing will consummate an exchange whereby tendering shareholders will exchange shares of Distributing common stock for shares of Controlled owned by Distributing (the "Exchange"). Any remaining shares of Controlled held by Distributing after the Exchange will be distributed pro rata to the remaining shareholders of Distributing (the "Spin-Off" and together with the Exchange, the "Distribution").

The Exchange will be conducted using a "Dutch Auction" format and the Exchange will be made at prices determined by the market contemporaneously with the Exchange. However, the Exchange may be conducted by a fixed ratio format determined by Distributing based on the analysis of market prices.

To avoid administrative difficulties associated with issuing fractional shares of Controlled, Distributing will instead issue fractional shares to a distribution agent. The distribution agent will bundle the fractional shares, sell whole shares in the open market, and remit the proceeds to the Distributing shareholders, net of transaction costs, in proportion to their ownership of fractional shares.

Currently, as part of Controlled's Business 2, Controlled is performing services for state and local governments under certain long term contracts (the "Contracts"), which were entered into on Date C. However, due to certain economic conditions, the value of the Contracts have fallen, producing substantial losses. Investment Banker has advised that Controlled's ability to raise capital through the Public Offering will be impaired if potential investors are not assured that the losses under the Contracts will not adversely affect earnings. Because Controlled is not able to assign the Contracts, Controlled has created an offsetting reserve in the amount of Y to which Controlled charges the losses from the Contracts. However, there is no assurance that the Contracts may not be devalued further and produce losses in excess of the reserve, and it is feared that this risk may have a negative effect on the price of the Controlled stock in the Public Offering. Because Distributing feels that the success of the Public Offering is critical to the long term success of Controlled, it has entered into an indemnification agreement ("Government Services Agreement") with Controlled whereby Distributing will indemnify Controlled if the losses under the Contracts exceed the amount in the reserve. Distributing's indemnification is subject to a limit in the amount of Z.

After the Distribution, various services will be provided by Controlled to Distributing and by Distributing to Controlled. The services will be provided through four separate agreements: 1) the Master Agreement; 2) the Software Agreement; 3) the Transitional Services Agreement; and 4) the Real Estate Agreement.

Under the Master Agreement, Controlled's Subsidiary 3 will provide information technology development services to Distributing in connection with Business 1. The Master Agreement has an initial term five of years from the date of the Public Offering, although Distributing has the right to terminate the agreement after three years.

Under the Software Agreement, Distributing will license the use of software to Controlled. The Software Agreement will commence on the date of the Public Offering and end less than two years later on Date B.

Under the Transitional Services Agreement, Distributing or its subsidiaries and Controlled or its subsidiaries have agreed to provide various services to each other for specified time periods.

Under the Real Estate Agreement, (1) Distributing or one of its subsidiaries will lease to Controlled seven different sites for a period of 12-18 months; (2) Subsidiary 4 will lease a building to Controlled for a period of 12 months; (3) Distributing or one of its subsidiaries will transfer an office building to Controlled; and (4) Distributing will assign its rights as tenant under various leases to Controlled or one of its subsidiaries.

The taxpayer has represented that all of the payments under these agreements will be for fair market value.

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

- a. Subsidiary 1, on the date of the adoption of the Agreement and Plan of Merger constituting the plan of complete liquidation, and at all times until the final deemed liquidating distribution is completed, will be the owner of at least 80% of the single outstanding class of Subsidiary 2 stock.
- b. No shares of Subsidiary 2 will have been redeemed during the three years preceding the adoption of the Agreement and Plan of Merger constituting the plan of complete liquidation of Subsidiary 2.
- c. All deemed distributions from Subsidiary 2 to Subsidiary 1 pursuant to the Agreement and Plan of Merger constituting the plan of complete liquidation will be made within a single taxable year of Subsidiary 2.
- d. As soon as the first deemed liquidating distribution has been made, Subsidiary 2 will cease to be a going concern and its activities will be limited to winding up

its affairs, paying its debts, and distributing its remaining assets to its shareholder.

e. Subsidiary 2 will not retain any assets following its final deemed liquidating distribution.

f. Subsidiary 2 will not have acquired assets in any non-taxable transaction at any time, except for acquisitions occurring more than 3 years prior to the date of adoption of the Agreement and Plan of Merger constituting the plan of liquidation of Subsidiary 2.

g. Except for the sale of Division, no assets of Subsidiary 2 have been, or will be disposed of by either Subsidiary 2 or Subsidiary 1, except for dispositions in the ordinary course of business and dispositions occurring more than 3 years prior to the adoption of the Agreement and Plan of Merger constituting the plan of liquidation.

h. The deemed liquidation of Subsidiary 2 will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation ("Recipient") of any of the businesses or assets of Subsidiary 2, if persons holding, directly or indirectly, more than 20% in value of Subsidiary 2 stock also hold, directly or indirectly, more than 20% in value of the stock of Recipient. For purposes of this representation, ownership will be determined by application of the constructive ownership rules of section 318(a) as modified by section 304(c).

i. Prior to the adoption of the Agreement and Plan of Merger constituting the plan of liquidation, no assets of Subsidiary 2 will have been distributed in kind, transferred, or sold to Subsidiary 1, except for (i) transactions occurring in the normal course of business and (ii) transactions occurring more than 3 years prior to the adoption of the Agreement and Plan of Merger constituting the plan of liquidation.

j. Subsidiary 2 will report all earned income represented by assets that will be distributed to its shareholders such as receivables being reported on the cash basis, unfinished construction contracts, commissions due, etc.

k. The fair market value of the assets of Subsidiary 2 will exceed its liabilities, both at the date of the adoption of the Agreement and Plan of Merger constituting the plan of complete liquidation and immediately prior to the time the first deemed liquidating distribution is made.

l. Subsidiary 1, and all other organizations within its affiliated group, are not organizations that are exempt from U.S. federal income tax under section 501 or any other provision of the Code.

m. All other transactions undertaken contemporaneously with, in anticipation of, in conjunction with, or in any way related to, the proposed merger of Subsidiary 2 with and into LLC, have been fully disclosed.

The following representations have been made in connection with the Distribution:

a. The indebtedness owed by Controlled to Distributing after the Distribution will not constitute stock or securities.

b. The payment of cash in lieu of fractional shares of Controlled stock is solely for the purpose of avoiding the expense and inconvenience of issuing fractional shares and does not represent separately bargained for consideration. The method used for handling fractional shares is designed to limit the amount of cash received by any one shareholder to less than the value of one full share of Controlled stock. The total amount of cash paid in lieu of fractional shares will not exceed 1% of the fair market value of Controlled stock distributed to Distributing's shareholders in the Distribution.

c. The fair market value of the Controlled stock and other consideration to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the Exchange.

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. Immediately after the Distribution, the gross assets of Subsidiary 1's active trade or business (as defined in section 355(b)(2)) will have a fair market value equal to at least 5% of the total fair market value of the gross assets of Subsidiary 1.

f. Immediately after the Distribution, the gross assets of Controlled's active trade or business (as defined in section 355(b)(2)) will have a fair market value equal to at least 5% of the value of the total fair market value of the gross assets of Controlled.

g. The five years of financial information submitted on behalf of Subsidiary 1 (including the former Subsidiary 2's business) is representative of what such corporation's operations will be at the time of the Distribution and, with regard to such corporation, there has not been, and will not have been, any substantial operational changes since the date of the last financial statement submitted.

h. The five years of financial information submitted on behalf of Controlled is representative of what Controlled's operations will be at the time of the

Distribution and, with regard to such corporation, there has not been, and will not have been, any substantial operational changes since the date of the last financial statement.

i. Immediately after the Distribution, at least 90% of the fair market value of the gross assets of Distributing will consist of the stock of Subsidiary 1.

j. Following the Distribution, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.

k. The Distribution is being carried out, in whole or substantial part, for the following corporate business purpose: to facilitate an offering of Controlled stock to raise capital on a more cost effective basis.

l. Except for the receipt of cash in lieu of fractional shares, there is no plan or intent by any shareholder who owns 5% or more of the stock of Distributing, and the management of Distributing, to the best of its knowledge, 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 Distribution.

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

n. 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 their assets after the Distribution, except in the ordinary course of business.

o. The total adjusted bases and fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of any liabilities assumed (within the meaning of section 357(d)).

p. The liabilities assumed in the transaction (within the meaning of section 357(d)) were incurred in the ordinary course of business and are associated with the assets being transferred.

q. No property is being transferred between Distributing and Controlled in connection with the Distribution for which any investment credit determined under section 46 has been (or will be) claimed.

r. Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

s. Other than obligations incurred in the ordinary course of business, no intercorporate debt will exist between Distributing or any related party, on the one hand, and Controlled, or any related party, on the other hand, at the time of or after the Distribution.

t. Immediately 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 sections 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; section 1502-13 as published in 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 Exchange (see § 1.1502-19).

u. For purposes of section 355(d), immediately after the Distribution, no person will hold disqualified stock (under section 355(d)(3)) in Distributing or Controlled possessing 50% or more of the total combined voting power of all classes of Distributing or Controlled stock entitled to vote or 50% or more of the total value of shares of all classes of Distributing or Controlled stock.

v. The Distribution is not 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 50% 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% or more of the total value of all classes of stock of either Distributing or Controlled. Any stock issued upon the exercise of any stock option that (1) is or will be an option to acquire stock in a corporation with customary terms and conditions provided to employees or directors in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed); (2) immediately after the distribution and within six months thereafter are nontransferable within the meaning of section 1.83-3(d) (other than with respect to certain limited transfers to family members for estate planning purposes permitted within the non-transferability requirements for eligibility for use of SEC registration Form S-8, which is designed for compensatory options); and (3) does not have a readily ascertainable fair market value as defined in section 1.83-7(b), either before or after the distribution, will not be taken into account.

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

x. Except for payments made under a tax sharing agreement between Distributing and Controlled, indemnity payments made under the Assignment and Assumption Agreement governing the Contribution, any payments made under the Government Services Indemnity Agreement, and certain payments for

services under the Transitional Services Agreement, payments made in connection with all continuing transactions between Distributing or any other related party, on the one hand, and Controlled, or any related party, on the other hand, will be for fair market value based on terms and conditions that are consistent with those that would be arrived at by the parties bargaining at arm's length.

Y. The Distribution will occur within the later of (i) the last day of the sixth month beginning after the date of the Public Offering, or (ii) the last day of the third month beginning after the receipt of a favorable private letter ruling.

Based solely on the facts submitted and the representations made above, it is held as follows as to the Liquidation:

1. The Liquidation will be treated as a distribution by Subsidiary 2 to Subsidiary 1 in complete liquidation of Subsidiary 2.
2. No income, gain, or loss will be recognized by Subsidiary 1 on the Liquidation. Section 332(a).
3. No income, gain, or loss will be recognized by Subsidiary 2 on the Liquidation. Section 337(a).
4. The basis of each asset of Subsidiary 2 received by Subsidiary 1 in the Liquidation will equal the basis of that asset in the hands of Subsidiary 2 immediately before the Liquidation. Section 334(b)(1).
5. The holding period of each asset received by Subsidiary 1 from Subsidiary 2 in the Liquidation will include the period during which Subsidiary 2 held such asset, provided such asset is a capital asset as defined in Section 1221 or property described in Section 1231 in the hands of Subsidiary 2. Section 1223(1).

Based solely on the facts submitted and the representations made above, it is held as follows as to the Distribution:

1. The Contribution followed by the Distribution will constitute a reorganization within the meaning of Section 368(a)(1)(D). Distributing and Controlled will each be a "party to a reorganization" within the meaning of section 368(b).
2. Distributing will recognize no gain or loss on the Contribution. Sections 361(a) and 357(a).
3. Controlled will recognize no gain or loss on the Contribution. Section 1032(a).
4. The basis of each asset received by Controlled from Distributing in the Contribution will be equal to the basis of such asset in the hands of Distributing

immediately before the Contribution. Section 362(b).

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

6. No income, gain, or loss will be recognized by Distributing upon the exchange of all of its Controlled stock for Distributing stock pursuant to the Exchange or on the distribution of Controlled stock to shareholders of Distributing in the spin-off. Section 361(c)(1).

7. No gain or loss will be recognized by (and no amounts will be included in the income of) the shareholders of Distributing upon their exchange of Distributing stock for Controlled stock pursuant to the Exchange, or upon their receipt of Controlled stock pursuant to the Spin-Off. Section 355(a)(1).

8. The basis of the Controlled stock received in the Exchange will be the same as the basis of the Distributing stock surrendered in exchange therefor. Section 358(a).

9. If any Controlled stock is received in the Spin-off, the basis of the Distributing stock and the Controlled stock in the hands of the shareholders of Distributing after the Spin-Off will, collectively, be the same as the aggregate basis of the Distributing stock held immediately before the Spin-Off and such basis will be allocated between Distributing stock and Controlled stock in proportion to their relative fair market values at the time of the Spin-Off. Section 358(b) and section 1.358-2.

10. The holding period of the Controlled stock received by the shareholders of Distributing in the Exchange will include the holding period of the Distributing stock exchanged therefor, provided that the Distributing stock is held as a capital asset by the respective shareholders of Distributing on the date of the Exchange. Section 1223(1).

11. If any Controlled stock is received in the Spin-Off, the holding period of those shares will include the holding period of the Distributing stock retained, provided that such Distributing stock is held as a capital asset by the respective shareholder of Distributing on the date of the Spin-Off. Section 1223(1).

12. If cash is received by a Distributing shareholder as a result of a sale of a fractional share of Controlled stock by the distribution agent, the shareholder will have gain or loss measured by the difference between the basis of the fractional share, as determined in ruling (8) above or allocated thereto as determined in ruling (9) above, and the amount of cash received. Section 1001(a). If the Controlled stock is held by the shareholder as a capital asset, the gain or loss will be capital gain or loss subject to the provisions and limitations of Subchapter P of

Chapter 1 (sections 1221 and 1222).

13. As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with section 1.312-10(a).

14. Any payments under the Tax Sharing Agreement, indemnity payments made under the Assignment and Assumption Agreement, or any Government Services Indemnity payments made by Distributing to Controlled or by Controlled to Distributing that (i) relate to a period ending on or before the date of the Distribution and (ii) will not become fixed and ascertainable until after the Distribution will be treated as occurring immediately before the Distribution.

15. The holders of Old Distributing Options will not recognize any income, gain, or loss upon the receipt of New Distributing Options and Controlled Options pursuant to the Distribution.

16. Neither Distributing nor any subsidiary thereof will recognize any gain or loss upon the transfer of Controlled stock to an employee of Distributing or any subsidiary thereof who exercises a Controlled Option.

17. Neither Controlled nor any subsidiary thereof will recognize any gain or loss upon the transfer of Distributing stock to an employee of Controlled or any subsidiary thereof who exercises a New Distributing Option.

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.

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.

This ruling is directed only to the taxpayer(s) requesting 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 or the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely,
Assistant Chief Counsel (Corporate)
By: Christopher Schoen
Assistant to the Chief, Branch 1