

INTERNAL REVENUE SERVICE
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December 2, 1998

Distributing =

Controlled =

Business A =

Business B =

Distributing Financial Advisor =

Controlled Financial Advisor =

State A =

\$x =

Year 1 =

\$y =

S =

z =

Dear :

This is in response to a letter dated April 13, 1998, requesting a ruling as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated November 3, 12, 17, 20, and 23, 1998. The information provided is summarized below.

Distributing is a State A corporation. It has one class of stock outstanding, which is publicly traded on a national exchange. Distributing is engaged in Business A. Its largest shareholder is S, who owns z% of the Distributing stock. Additionally, 3 executives of Distributing each own more than 5% of the outstanding stock.

Controlled is a State A corporation. It has preferred and common stock outstanding. All of the preferred stock, which is convertible to common stock on a one-for-one basis, is held by Distributing. The outstanding common stock is currently owned by employees of Controlled.

Controlled was formed by Distributing in Year 1 in a transaction in which gain or loss was not recognized, and has engaged in Business B continuously since its formation. Prior to the formation of Controlled, a division of Distributing engaged in Business B continuously for more than five years. At the time of the transfer of the Business B business to Controlled, Distributing transferred certain patents to Controlled. Distributing and Controlled entered into a royalty free license to the patents transferred by Distributing to Controlled.

We have received financial information indicating that Business A operated by Distributing and Business B operated first by Distributing and then by Controlled each have had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Over the past two years, Distributing's stock price has been depressed. At the same time, Distributing has received significant amounts of cash as a result of litigation with another company engaged in Business A. As a result, the market valuation of Distributing's stock has not been substantially higher than its cash on hand. Distributing's management became concerned, as a result, that Distributing would become a likely candidate for a hostile takeover. As a result, in 1997 and 1998, Distributing conducted two buyback programs to support the value of its stock. Approximately \$y of Distributing's cash was used to redeem its stock.

Controlled has determined that it needs to raise capital to fund its Business B research and development expenses and to provide necessary working capital. Consequently, it intends to raise equity capital through a primary offering of additional shares of common stock. Distributing and Controlled have provided letters from the Distributing Financial Advisor and the Controlled Financial Advisor, both stating that this offering will yield a significantly better return if Controlled is separated from the Distributing group.

Accordingly, the following steps are proposed:

1. Distributing will exchange all of its Controlled preferred stock for shares of Controlled common stock (the "Recapitalization"). After the recapitalization Distributing will hold more than 80% of the only outstanding class of Controlled stock.
2. If necessary, Distributing will make a short-term bridge loan to Controlled to fund the Controlled operations. The loan will be made at commercially reasonable terms.
3. Distributing will distribute all of its Controlled stock to the shareholders of Distributing, on a pro rata basis (the "Distribution"). Shareholders of Distributing will receive cash in lieu of fractional share interests in Controlled stock. The license between Distributing and Controlled will continue in effect after the distribution.
4. As soon as practicable after the Distribution, and within one year of the Distribution, Controlled will conduct a public offering of its stock. This public offering is expected to raise \$x. These funds will be used to provide working capital and research and development funds for Controlled. If Distributing makes a bridge loan to Controlled as described in step 2, funds generated by the public offering will be used to satisfy the loan as well as to provide working capital and research and development funds for Controlled.

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

- a. To the best of the knowledge of the taxpayer, the proposed exchange by Distributing of all of its shares of Controlled preferred stock solely for shares of Controlled common stock, pursuant to the conversion privilege of the preferred stock, will be a recapitalization and, therefore, a reorganization within the meaning of section 368(a)(1)(E) of the Internal Revenue Code. To the best of the knowledge of the taxpayer, Controlled will be "a party to a reorganization" within the meaning of section 368(b) of the Code.
- b. There will be no dividends in arrears on the Controlled preferred stock surrendered in exchange for Controlled common stock.
- c. Distributing, Controlled, and the shareholders of Distributing will each pay their own expenses, if any, incurred in connection with the Distribution.
- d. No part of the consideration distributed by Distributing is being received by a shareholder of Distributing as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

- e. Following the distribution, Distributing and Controlled will each continue the active conduct of their respective businesses, independently and with their separate employees.
- f. No liabilities will be transferred to Controlled or assumed by Controlled, and no assets will be transferred to Controlled in connection with the Distribution.
- g. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock, other than receivables generated in the ordinary course of business and/or the bridge loan from Distributing to Controlled to fund Controlled's operations in the short term. The bridge loan will be repaid from funds raised on the public offering of Controlled's stock. Any indebtedness owed between Controlled and Distributing subsequent to the distribution of the Controlled stock will not constitute "stock or securities" within the meaning of section 355 of the Code.
- h. The five years of financial information submitted on behalf of Distributing and Controlled (through the period of its existence) is representative of each corporation's present operations, and, with regard to each corporation, there have been no substantial operational changes since the date the last financial statements were submitted.
- i. The distribution of the stock of Controlled is being carried out for the following corporate business purpose: to facilitate a public offering. The distribution of Controlled's stock is motivated, in whole or substantial part, by this corporate business purpose.
- j. 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 subsequent to the transaction, except in the ordinary course of business.
- k. There is no plan or intention by the shareholders of Distributing who own 5 percent or more of Distributing shares and to the best of the knowledge of the management of Distributing, there is no plan or intention on the part of the remaining Distributing shareholders to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in Distributing or Controlled after the transaction. The 5% or greater shareholders may continue to gift stock consistent with previous annual gifts of less than \$10,000 per recipient.
- l. 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.

m. The sale of fractional shares in the public market by the exchange agent effecting the transaction and distribution of the cash proceeds thereof among affected Distributing shareholders is solely for the purpose of avoiding the expense and inconvenience to Controlled of issuing fractional shares and does not represent separately bargained-for consideration. The total cash consideration that will be paid in the transaction to the shareholders of Distributing instead of issuing fractional shares of Controlled stock will not exceed one percent of the total consideration that will be issued in the transaction to the Distributing shareholders in connection with the distribution of the shares of Controlled. The fractional share interests of each Controlled shareholder interest will be aggregated, and no Distributing shareholder will receive cash in an amount equal to or greater than the value of one full share of Controlled stock.

n. 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 section 1.1502-13 and section 1.1502-14 of the Income Tax Regulations as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and currently in effect: section 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account with respect to the Controlled stock, if any, will be included in income immediately before the distribution (see § 1.1502-19).

o. No Distributing shareholder of shareholders will hold immediately after the distribution disqualified stock within the meaning of section 355(d)(3) of the Code, which constitutes a 50 percent or greater interest in Distributing or Controlled.

Based solely on the information submitted and on the representations set forth above, it is held as follows:

(1) No gain or loss will be recognized by Distributing upon the distribution of Controlled stock to the Distributing shareholders (§355(c)(1)).

(2) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon the receipt of Controlled stock (including fractional share interests of Controlled to which they may be entitled) (§355(a)).

(3) The aggregate basis of the Distributing shareholders in the stock of Distributing and Controlled (including any fractional share interests of stock to which they may be entitled) after the distribution will be the same as their basis in the Distributing stock held by each shareholder immediately before the distribution, allocated in proportion to the fair market value of each in accordance with §1.358-2(a)(2); §358(b)(2)).

(4) The holding period of the Controlled stock received by the Distributing shareholders (including any fractional share interests of stock to which they may be entitled) will include the holding period of the Distributing stock with respect to which the distribution will be made (§1223(1)).

(5) As provided in §312(h), proper allocation of earnings and profits will be made under §1.312-10(b).

(6) A holder of a fractional share interest in Controlled will recognize gain or loss on the sale of the fractional share interest equal to the difference between the cash received and the holder's basis in such interest (§1001). Provided the fractional share interest is a capital asset in the hand of the exchanging holder, such gain or loss will be capital gain or loss to such holder subject to the provisions and limitations of Subchapter P and chapter 1 of the Code.

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 specifically covered by the above rulings. No opinion is expressed about the federal income tax treatment of the transfer of patents or the royalty-free license described above. Specifically, no opinion is expressed as to whether such transfers, as set forth above, are, in fact property. See Rev. Rul. 69-156, 1969-1 C.B. 101.

This ruling is directed only to the taxpayer who requested it. Section 6610(j)(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 taxpayer year in which the transaction covered by this ruling is consummated.

Sincerely yours,

Assistant Chief Counsel (Corporate), ,

By: _____
Howard W. Staiman
Assistant to the Chief
Branch