

**Internal Revenue Service**

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Person to Contact:

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LEGEND:

Distributing =

Controlled =

Sub 1 =

Business X =

Business Y =

Distribution =

Contribution =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

State =

Outside Investors =

New Investors =

Amount A =

Amount B =

Amount C =

Amount D =

Amount E =

Amount F =

Amount G =

Amount H =

Amount I =

Amount J =

Amount K =  
 Amount L =  
 Amount M =  
 Amount N =  
 Shareholder W =  
 Shareholder X =  
 Shareholder Y =  
 Shareholder Z =  
 Country Y =  
 Financial Advisor =

This letter replies to your November 27, 2000, request for rulings on the federal income tax consequences of a proposed and partially consummated series of transactions concerning section 355 of the Internal Revenue Code. We received additional information in letters dated February 14, March 14, and March 16, 2001. The information submitted for consideration is summarized below.

#### Summary of Facts

Distributing is a domestic corporation organized under the laws of State on Date 1 (well over 5 years ago). At the time of its origin, Distributing operated both Business X and Business Y. It continued to operate both businesses until Date 2 when it contributed Business X to Sub 1 in an I.R.C. § 351 transaction in exchange for 100% of Sub 1's stock. On or around Date 2, domestic and foreign investors (collectively referred to as "Outside Investors"), invested cash in Sub 1 in exchange for Amount A common stock of Sub 1 and Amount B of convertible debt of Sub 1. Distributing continued to own over 95% of Sub 1's outstanding stock, even after the investment by Outside Investors.

Sometime after Date 2, Distributing's management determined that Distributing needed a significant amount of additional capital to commercialize certain new technology being developed in Business X. Distributing anticipates that the commercialization of the new technology would require an investment of approximately Amount L. These costs relate only to direct expenditures and do not include indirect costs such as overhead or allocated general and administrative expenses. Distributing has provided a spending forecast as to the projected costs of developing the new technology.

Distributing obtained advice from Financial Advisor regarding the raising of capital through an equity offering. In a detailed analysis, the Financial Advisor set forth its reasons for concluding that Distributing could raise significantly more funds per share (net of transaction costs) in an offering if Distributing completely separated Business Y from Business X. First, as a stand alone corporation, Distributing's capital structure would be easier to understand and thus would be viewed positively by the capital markets. Second, potential investors would focus on Distributing's primary business (i.e., Business X) without having to evaluate and value the financial risks involved in its

association with Business Y. Third, as a stand-alone entity, Distributing would be able more clearly to present its future growth prospects and thus would increase its perceived value to potential investors. Finally, Business X and Business Y tend to appeal to different investor groups.

Based in part on the Financial Advisor's opinion, Distributing's management concluded that separating Controlled from Distributing would facilitate a stock offering by Distributing. To that end, Distributing adopted a plan to distribute all of the shares of Controlled.

For what is represented to be a valid business purpose, the following series of transactions has been proposed, and partially consummated, by Taxpayer:

#### Transactions Already Consummated –

On Date 3, Distributing formed Controlled, under the laws of State.

On Date 4, Distributing amended its Articles of Incorporation and recapitalized its common stock (the only class of stock outstanding) into two new classes of stock: Class A common and Class B common. Each share of common stock outstanding was converted into one share of Class A common and one share of Class B common. The Class A common stock relates to the economic results of Business X and the Class B common stock relates to the economic results of Business Y.

Both Class A common and Class B common entitle the holder to one vote per share in all matters relating to Distributing. Holders of Class B common are entitled to receive equally dividends from Distributing, when and if declared by the Board of Directors of Distributing, in an amount equal to the net profit of Controlled. Upon redemption or sale of Controlled stock by Distributing, the Class B common stockholders are entitled to receive equally from Distributing any resulting proceeds. Upon liquidation of Controlled, Class B common stockholders are entitled to liquidation proceeds equal to the proportionate relative fair market value of Controlled to Distributing at the time of such liquidation. The Class B common stockholders do not, however, have any direct rights against Controlled. At its option, Distributing can require the holders of the Class B common stock to surrender such stock in exchange for the Controlled common stock.

Holders of Class A common are entitled to receive equally dividends from Distributing, when and if declared by the Board of Directors of Distributing, subject to the rights of the holders of the Class B common stock as described above. Upon liquidation of Distributing, Class A common stockholders are entitled to receive any proceeds available for distribution, subject to the above rights of the Class B common stockholders.

On Date 5, Distributing transferred Business Y to newly-formed Controlled in exchange

for 100% of Controlled's stock (the "Contribution"). As a result of the transfer of Business Y, Distributing temporarily became a holding company. On Date 5, the Distributing consolidated group consisted of Distributing, as the common parent of the group, and subsidiaries, Sub 1 and Controlled.

On Date 6, Sub 1 merged with and into Distributing. Distributing survived the merger and reacquired Business X. Distributing also changed its name. (Distributing will hereinafter continue to be referred to as "Distributing"). As a result of the merger, the Outside Investors received: (a) Class A common stock of Distributing in exchange for their Sub 1 stock; and (2) convertible debt in Distributing in exchange for their convertible debt in Sub 1 in the same principal amount.

On Date 7, Distributing made a private Offering of Distributing's Series A convertible preferred stock. The consideration it received for the stock was Amount C, consisting of Amount D of cash and Amount E of technology and trademarks. The terms of the private placement Offering, which are set forth in a Stock Purchase Agreement, were negotiated between Distributing and the private investors. Due to the size of the issuance, the private investors purchased a portion of the Series A convertible preferred stock on Date 7, and the remainder shortly thereafter on Date 9. The staggering of the purchase dates enabled the investors to raise additional venture capital to complete the purchase.

Under the terms of the Stock Purchase Agreement, holders of Distributing's Series A convertible preferred stock are entitled to: (1) convert, at their option, each share of the preferred stock into one share of Class A common stock, subject to anti-dilution protection; (2) a number of votes equal to the number of shares of Class A common stock into which such preferred stock is convertible; (3) receive an annual noncumulative dividend per share in an amount equal to Amount F, which amount must be paid or declared and set aside for payment prior to any dividends being declared and paid upon the Class A common and Class B common; and (4) certain rights upon liquidation of Distributing. Additionally, Distributing warranted that the shares of Controlled would be distributed to the Class B shareholders. Further, the Stock Purchase Agreement notified potential investors that they could not participate in the Distribution of Controlled.

On Date 8, Distributing redeemed Amount G and Amount H of Class A common stock from Shareholder W and Shareholder X, respectively, in exchange for promissory notes in the Amount I and Amount J, respectively. Distributing took this action to facilitate the Offering. Prior to the Offering, certain potential investors had notified Distributing that they required a dilution of the Class A common stock holdings of Distributing's controlling group of investors. This group consisted of Shareholders W, X, and Y. Neither Distributing nor Controlled is presently under an obligation to redeem additional shares.

On or around Date 9, Distributing converted Amount A of the convertible debt held by the Outside Investors into Amount M shares of Class A common. Presently, Distributing does not have any bonds, debentures or notes outstanding.

On Date 10, Controlled changed its name. (Controlled will hereinafter continue to be referred to as "Controlled").

#### Transactions Yet to Be Consummated –

Just prior to the split off, certain Outside Investors will transfer their Distributing stock to newly created domestic corporations, Holdco#1 and Holdco#2, in exchange for all the outstanding stock of these two corporations. Specifically, one of the Outside Investor (a resident of Country Y) will transfer its Class A common and Class B common stock to HoldCo#1. Some of the other Outside Investors (who also reside in Country Y) will transfer their Class B common stock to HoldCo#2. These transfers are necessary to enable the Country Y residents to avoid negative tax consequences under the laws of Country Y. These shareholders will continue indirectly to own the same percentage interest in Distributing that they owned prior to these transfers.

Distributing will distribute the stock of Controlled to its Class B common shareholders. The Controlled Distribution will occur within the later of 3 months after the receipt of a favorable ruling and 12 months after the Offering is completed.

Distributing supplied financial information which indicates that Business X (currently conducted by Distributing) and Business Y (currently conducted by Controlled) each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

#### THE REPRESENTATIONS:

With respect to the proposed and partially consummated transaction, the taxpayer has made the following representations:

1. Neither Distributing nor Controlled has been or will be a United States real property holding corporation ("USRPHC"), as defined in section 897(c)(2), at any time during the five-year period ending on the date of the Distribution, and neither Distributing nor Controlled will be a USRPHC immediately after the Distribution.
2. The fair market value of the Controlled common stock to be received by each Class B shareholder of Distributing will be approximately equal to the fair market value of the Class B common stock surrendered by the shareholder in the Distribution.
3. 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.

4. The five years of financial information submitted on behalf of Distributing (for Business X) and Controlled (for Business Y) represents each corporation's present operations, and there have been no substantial operational changes since the date of the last submitted financial statements.
5. Immediately after the Distribution, the gross assets of the trade or business relied on by Distributing to satisfy the active trade or business requirement of section 355(b) (Business X) will have a fair market value equal to at least five percent of the total fair market value of Distributing's gross assets.
6. Immediately after the Distribution, the gross assets of the trade or business relied on by Controlled to satisfy the active trade or business requirement of section 355(b) (Business Y) will have a fair market value equal to at least five percent of the total fair market value of Controlled's gross assets.
7. Following the Distribution, Distributing and Controlled each will continue the active conduct of its business, independently and with its own employees, except for the sharing of certain administrative services for a limited period.
8. The Distribution is carried out for the corporate business purpose of facilitating the Offering. The Distribution is motivated, in whole or substantial part, by this corporate business purposes.
9. There is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either corporation after the Distribution.
10. Except for the Surrender Obligation, 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 Distribution, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705. (The Surrender Obligation means that upon the exercise of certain employee stock options, Shareholder Z, must surrender up to Amount N shares of Class A common stock and Controlled common stock to Distributing and Controlled, respectively, and Distributing and Controlled, respectively, must issue such shares to the exercising employee or employees. The Surrender Obligation exists solely for the purpose of vesting Shareholder Y with the voting power of the shares underlying the employee stock options prior to the exercise of such options. As such, Shareholder Y will receive only nominal consideration upon the surrender of such shares. It is presently uncertain whether such employee stock options will be exercised at any time).
11. Distributing and Controlled have no accumulated earnings and profits at the beginning of their respective taxable years. Distributing and Controlled will have no current earnings and profits as of the date of the Distribution. No distribution of

property by Distributing immediately before the transaction would require recognition of gain resulting in current earnings and profits for the taxable year of the Distribution.

Also, Distributing is not aware of, nor is it planning or intending, any event that will result in Distributing or Controlled having positive current or accumulated earnings and profits after the Distribution.

12. 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 any of the assets of either corporation subsequent to the proposed transaction, except in the ordinary course of business.

13. The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject. The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

14. Indebtedness owed by Controlled to Distributing, if any, after the Distribution of Controlled stock will not constitute stock or securities.

15. 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. Further, Distributing's excess loss account, if any, with respect to the Controlled stock will be included in income immediately before the Distribution.

16. Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on terms and conditions determined by the parties bargaining at arm's length.

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

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

19. The Class A and Class B tracking common stock is stock of Distributing for federal income tax purposes.

20. Distributing will complete the Distribution within the later of 3 months after the

receipt of a favorable ruling or 12 months of the date of the Stock Offering.

21. No cash will be distributed in lieu of fractional shares in connection with the Distribution.

22. The shareholders of Distributing will not be entitled to dissenters' rights in connection with the Distribution.

THE RULINGS:

Based solely on the facts submitted and representations made, we rule as follows on the Transaction:

1. The Contribution, followed by the Distribution, will be a reorganization under section 368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" under section 368(b).

2. No gain or loss will be recognized by Distributing on the Contribution (sections 361(a) and 357(a)).

3. No gain or loss will be recognized by Controlled on the Contribution (section 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 the Contribution (section 362(b)).

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

6. No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the shareholders of Distributing upon the exchange of the Class B common stock for the Controlled common stock pursuant to the Distribution (section 355(a)(1)).

7. No gain or loss will be recognized by Distributing on the Distribution (section 361(c)(1)).

8. The basis of the Controlled common stock in the hands of the holders of the Class B common stock immediately after the Distribution will be the same as the basis of the Class B common stock surrendered in exchange therefore (section 358(a)(1)).

9. The holding period of Controlled common stock received by holders of the Class B common stock will include the holding period of the Class B common stock on which



the Distribution is made, provided such Class B common stock is held as a capital asset on the date of the Distribution (section 1223(1)).

10. The earnings and profits of the Distributing and Controlled will be allocated as provided in Section 312(h), and Treas. Reg. §§ 1.312-10(a) and 1.1502-33(e)(3).

11. Distributing will recognize no gain or loss under section 367(e) (1) on the Distribution. (Treas. Reg. section 1.367(e)-1(c)).

#### PROCEDURAL STATEMENTS

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. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, we express no opinion about the tax treatment of Distributing's: (1) Recapitalization; (2) merger with Sub 1; (3) redemptions of Class A common stock; (4) issuance of Series A Convertible Preferred Stock; or the (5) Name Change. Further, we express no opinion about the tax treatment of Controlled's name change or the transfer of the foreign shareholders' Class A and Class B common stock into Holdco#1 and Holdco#2.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Each taxpayer affected by the Proposed Transaction should attach a copy of this ruling letter to such taxpayer's federal tax return for the taxable year in which the Proposed Transaction is completed.

Pursuant to a power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely,  
Associate Chief Counsel  
By: Steven J. Hankin  
Senior Technician Reviewer, Branch 6