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December 1, 1998

Re:

Distributing =

Controlled =

Newco =

Sub 1 =

Expand Business =

Turnaround Business =

State A =

Old Lender =

New Lender =

x =

y =

Dear :

This letter responds to your letter dated June 3, 1998, requesting rulings as to the federal income tax consequences of a proposed transaction. The information submitted in that letter and subsequent correspondence is summarized below.

Distributing, a State A corporation that uses the accrual method and a June 30 fiscal year, files its federal income tax return on a consolidated basis with its subsidiaries. Distributing is now a holding company that is engaged, indirectly through its subsidiaries, in two major businesses: Expand Business and Turnaround Business. Distributing has outstanding a single class of voting common stock that is publicly traded. Distributing's over 5 percent shareholders hold approximately 30 percent of its outstanding stock.

Controlled, a State A corporation that uses the accrual method and a June 30 fiscal year, is a wholly owned subsidiary of Distributing. Controlled is engaged directly and through subsidiaries in the Turnaround Business.

Newco, a State A corporation that uses the accrual method and a June 30 fiscal year, is a wholly owned subsidiary of Distributing. Newco is directly engaged in the Expand Business through its operating division and indirectly engaged through its subsidiaries.

The Expand Business produces products used by a broad spectrum of customers including many customers engaged in leading edge technology. This is a rapidly expanding business that depends on state-of-the-art technology. In order to pay the costs associated with staffing and otherwise bringing on line a new technology research center and to maximize expansion possibilities, Expand Business needs substantial additional capital.

Turnaround Business produces products for a variety of traditional industries. Its most significant customer segment has for several years been in a phase of reduced growth and limited expenditures. As a result, Turnaround Business has undergone substantial reduction in gross income and has incurred significant losses in recent years. Turnaround Business has now put in place a new business plan that emphasizes the development (or acquisition) and marketing of more technologically advanced products. Through increased efficiency and these new products, Turnaround Business expects to reach profitability. However, Turnaround Business needs significant additional capital to maintain operations, increase efficiency, and develop and/or acquire new products. Turnaround Business's current operations are marginal and without the significant additional capital necessary to implement its new business plan it is likely that Turnaround Business will be unable to recover from its losses.

As a result of Turnaround Business's losses, Distributing suffered a severe decrease in cash on hand and went into technical default with Old Lender, its major creditor. Old Lender refused to provide Distributing with the additional capital it needs, and, in addition, as a result of the default threatened loan termination and advised Distributing to refinance with a different lender. Various lenders indicated that, due to Turnaround Business's losses and uncertain prospects, they were willing to loan substantially less capital to the combined businesses than the amount the two businesses needed to expand and turnaround. However, these lenders also indicated that, because of the strong financial operating results and growth prospects of Distributing's Expand Business, Distributing will be able to obtain the significantly larger amount of financing needed by the two businesses, and on much more favorable terms, if the two businesses are separated. In addition to this financing purpose, management also believes separating the two businesses will improve employee morale. For employees of Expand Business, the knowledge that the profits of their division can be used for future expansion, rather than supporting Turnaround Business, will remove an interdivisional irritant and will significantly boost motivation.

Accordingly, the following steps have been taken or are proposed:

I. Approximately one year ago, Distributing transferred assets of the Expand Business, including stock in a subsidiary to Newco. Newco then transferred certain assets to its subsidiaries.

II. Distributing entered into an agreement with New Lender under which New Lender has provided Distributing with a restrictive "asset based" loan of $<u>x</u> to replace the default loan.

III. Distributing will transfer to Controlled assets of Turnaround Business including all the stock in Sub 1, cash of somewhat more than $<u>x</u>, and a new Distributing note ("New Note") in the amount of $<u>w</u>.

IV. Controlled will recapitalize with the number of shares outstanding being adjusted so as to be what is required and/or desirable for a stock exchange listing. Following the recapitalization, Controlled will have solely common stock outstanding.

V. The restrictive "asset based" loan arrangement will be assumed by Controlled with no change to its restrictive terms but in an amount less than $x.

VI. Distributing will distribute all the stock in Controlled pro rata to its shareholders. The shareholders will not surrender any Distributing stock. In addition, employees of Controlled who hold options to purchase Distributing stock will exchange such options for options to purchase Controlled stock.

VII. Immediately following step (VI), New Lender will provide Distributing with a line of credit of $y without any restrictions and Distributing will borrow $w against this line of credit. Distributing will transfer $w to Controlled to pay off the New Note (It is probable that Distributing will pay off the New Note on the same day as step (VI), but in all events the New Note will be paid off within 30 days of the note's issuance).

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

a. The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will each equal or exceed the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject, with the asset based loan assumed by Controlled being included in this computation.

b. The liabilities to be assumed by Controlled in the transaction (including the asset based loan) and the liabilities to which the assets transferred to Controlled in step (III) are subject, were incurred in the ordinary course of business and are associated with the assets transferred.

c. Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of this transaction.

d. The investment tax credit previously computed with respect to any investment credit property (including any building to which § 47(d) of the Internal Revenue Code applies) that is transferred from Distributing to Controlled will not be eligible for recapture because the period for recapture for all such property is now closed. No adjustment in tax will be required in the year of transfer to reflect an early disposition of the property, pursuant to § 50(a)(1) or (2) (or pursuant to § 47(a)(1) and (5) as previously in effect, if applicable), or pursuant to any applicable successor statute.

e. Controlled does not have, and at the time of the transactions will not have, any securities outstanding.

f. The transaction will not constitute a disqualified distribution within the meaning of § 355(d). Less than 10 percent of the outstanding Distributing stock was acquired by Distributing's major shareholders by purchase within the meaning of § 355(d)(5).

g. The Distributing shareholders will receive solely Controlled stock in the exchange, except that cash may be distributed in lieu of fractional share interests. Any such cash will not be separately bargained for consideration, but, instead, will merely represent a mechanical rounding-off of the fractions in the exchange.

h. Distributing, Controlled, and their shareholders will each pay their own expenses incurred in connection with the transactions.

i. No part of the stock in Controlled received by the Distributing shareholders is being received by a shareholder as a creditor, employee, or in any capacity other than as a shareholder of Distributing.

j. Following step (VI), Distributing will continue to be indirectly engaged in the active conduct of Expand Business through its wholly owned subsidiary, Newco. Newco will continue to be directly engaged in the active conduct of Expand Business through its operating division (as well as indirectly through its wholly owned subsidiaries). Immediately after the step (VI) distribution: (i) at least 90 percent of the gross assets of Distributing will consist of stock in Newco, (ii) the Expand Business of the Newco operating division will constitute at least 5 percent of Newco's gross assets; and (iii) the Expand Business of the Newco operating division will have been actively conducted within the meaning of § 1.355-3(b) by Newco or Distributing throughout the 5-year period immediately preceding step (VI). The Expand Business operated by the Newco operating division was not acquired by Newco or Distributing or any other related corporation in a transaction in which gain or loss was recognized in whole or part during the 5-year period immediately preceding step (VI). Following the distribution, Newco will continue the active conduct of the Expand Business independently and with its separate employees, and will have a minimum of 10 employees, at least two employees primarily managerial and eight employees primarily operational, working full-time in the Expand Business.

k. Following step (VI), Controlled will continue to be engaged directly through its operating divisions (as well as indirectly through its subsidiaries) in the active conduct of Turnaround Business which it will have actively conducted within the meaning of § 1.355-3(b) throughout the 5-year period immediately preceding step (VI). For each of the past 5 years, Controlled's operating divisions engaged in Turnaround Business have employed a combined total of over 50 full-time employees and, following step (VI), will continue to have over 50 full-time employees engaged in Turnaround Business.

l. The 5 years of financial information submitted on behalf of Controlled and on behalf of Newco are each representative of the corporation's present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.

m. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, step (VI), except for New Note.

n. Any transaction undertaken between Distributing and Controlled (and their subsidiaries) subsequent to step (VI) will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

o. The distribution of Controlled stock in step (VI) is being carried out for the following corporate business purposes: primarily to obtain needed financing, and, secondarily, to improve employee morale.

p. There is no plan or intention to liquidate either Distributing or Controlled, to merge either Distributing or Controlled with any other corporation, or to sell or otherwise dispose of the assets of either Distributing or Controlled, subsequent to the transaction, except in the ordinary course of business.

q. There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary, to purchase any of its outstanding stock after the transaction.

r. There is (i) no plan or intention by any of Distributing's greater than 5 percent shareholders, and (ii) to the best knowledge of Distributing's management, no plan or intention by any other shareholders of Distributing to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any of their stock in Distributing or Controlled subsequent to the transaction.

s. There is no plan or intent for the Distributing shareholders to lose control of either Distributing or Controlled (that is, to cease to hold over 50 percent of both (i) the total combined voting power and (ii) the total value of shares of all classes of stock in Distributing and Controlled). See § 355(e).

t. Neither Distributing nor Controlled is, or following the transaction is planned, intended, or expected to be, an S corporation.

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

v. Immediately before step (VI), 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, Distributing's excess loss account with respect to the Controlled stock will be included in income immediately before the spin-off (See § 1.1502-19).

w. The options to purchase Controlled stock that will be received by Controlled employees in exchange for their

Distributing stock options will parallel the options surrendered and will not provide any additional benefits.

x. The New Note will be fully enforceable, will bear a market rate of interest, will be satisfied in full with the payment of all principal and interest within 30 days of the note’s issuance, and will be comparable to a note that would have been entered into between unrelated parties.

Based solely on the information submitted and the representations set forth above, and provided that the step (IV) recapitalization constitutes a § 368(a)(1)(E) reorganization or § 1036 exchange of stock and that no gain or loss is recognized in whole or in part with regard to this step, we rule as follows:

(1) The step (III) transfer by Distributing to Controlled of assets, as described above, followed by the step (VI) distribution by Distributing to its shareholders of all of the Controlled stock is a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled each will be a "party to a reorganization" within the meaning of § 368(b).

(2) No gain or loss will be recognized by Distributing upon the transfer of assets, subject to liabilities, to Controlled in exchange for Controlled stock, as described above (§§ 361(a) and 357(a)).

(3) No gain or loss will be recognized by Controlled on the receipt of Distributing assets in exchange for Controlled stock (§ 1032(a)).

(4) The basis of each asset received by Controlled will be the same as the basis of such asset in the hands of Distributing immediately prior to the transfer (§ 362(b)).

(5) The holding period of the assets received by Controlled will include the period during which such assets were held by Distributing (§ 1223(2)).

(6) No gain or loss will be recognized by Distributing upon the distribution to its shareholders of all the Controlled stock (§ 361(c)(1)).

(7) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon receipt of the Controlled stock

(including fractional share interests) (§ 355(a)(1)).

(8) The total of the basis of the Controlled stock (including fractional share interests) plus the basis of the Distributing stock held by each shareholder of Distributing after the distribution will be the same as the basis of the Distributing stock held by such shareholder immediately before the distribution. The total basis will be allocated in proportion to the relative fair market values of the Controlled stock and Distributing stock in accordance with § 1.358-2(a)(2).

(9) The holding period of the Controlled stock (including fractional share interests) to be received by the shareholders of Distributing will include the holding period of the Distributing stock with respect to which the distribution will be made, provided that the Distributing stock is held as capital asset on the date of the exchange. Section 1223(1).

(10) The receipt of cash in lieu of a fractional share interest, as described above, will be treated under § 302 as having been paid to the shareholder in redemption of the fractional share interest.

(11) As provided in § 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a) of the regulations.

No opinion is expressed about the tax treatment of the proposed transactions under any other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transactions not specifically covered by the above rulings.

In particular, no opinion is expressed as to the tax treatment of the step (I) transfer of Expand Business assets from Distributing to Newco, the step (IV) recapitalization of Controlled, the step (V) assumption by Controlled of the restrictive "asset based" loan, or the step (VII) transfer of $w from Distributing to Controlled to pay off the New Note.

In addition, no opinion is expressed as to whether the transfer of any tradename, trademark, know-how, or similar items constitutes the transfer of property. See Rev. Rul. 69-156, 1969-1 C.B. 101.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that this private letter ruling may not be used or cited as precedent.

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this letter are consummated.

Pursuant to the power of attorney on file in this matter, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By ________________________________

Mark S. Jennings
Senior Technician Reviewer, Branch 1