



State of California
Franchise Tax Board
 Legal Division MS A390
 PO Box 2229
 Sacramento, CA 95812-2229

Legend - Chief Counsel Ruling 2009-02

08.28.09

Distributing 1	=	*****	Sub 25	=	*****
Distributing 2	=	*****	Sub 26	=	*****
Distributing 3	=	*****	Sub 27	=	*****
Distributing 4	=	*****	Sub 28	=	*****
Distributing 5	=	*****	Sub 29	=	*****
Controlled 1	=	*****	Sub 30	=	*****
Controlled 2	=	*****	Sub 31	=	*****
Controlled 3	=	*****	Sub 32	=	*****
Controlled 4	=	*****	Sub 33	=	*****
Controlled 5	=	*****	Sub 34	=	*****
			Sub 35	=	*****
Sub 1	=	*****	Sub 36	=	*****
Sub 2	=	*****	Sub 37	=	*****
Sub 3	=	*****	Sub 38	=	*****
Sub 4	=	*****	Sub 39	=	*****
Sub 5	=	*****	Sub 40	=	*****
Sub 6	=	*****	Sub 41	=	*****
Sub 7	=	*****	Sub 42	=	*****
Sub 8	=	*****	Sub 43	=	*****
Sub 9	=	*****	Sub 44	=	*****
Sub 10	=	*****	Sub 45	=	*****
Sub 11	=	*****	Sub 46	=	*****
Sub 12	=	*****			
Sub 13	=	*****	Business A	=	*****
Sub 14	=	*****	Business B	=	*****
Sub 15	=	*****	Business C	=	*****
Sub 16	=	*****	Business D	=	*****
Sub 17	=	*****	Business E	=	*****
Sub 18	=	*****	Business F	=	*****
Sub 19	=	*****	Business G	=	*****
Sub 20	=	*****	Business H	=	*****
Sub 21	=	*****	Business I	=	*****
Sub 22	=	*****	Business J	=	*****
Sub 23	=	*****	Business K	=	*****
Sub 24	=	*****	Business L	=	*****

Distributing 2
Contributed Businesses = *****
Distributing 3
Contributed Businesses = *****
Division A = *****
Division B = *****
Asset A = *****

Date 1 = *****
Date 2 = *****
Date 3 = *****
Date 4 = *****
Date 5 = *****
Date 6 = *****

Stock Exchange 1 = *****
aa = *****
bb = *****
cc = *****
dd = *****
ee = *****
ff = *****
gg = *****
hh = *****
ii = *****
jj = *****
kk = *****
ll = *****
mm = *****
nn = *****
oo = *****
pp = *****
qq = *****
rr = *****
ss = *****
tt = *****
uu = *****
vv = *****
ww = *****
xx = *****
yy = *****
zz = *****

Country A = *****
Country B = *****
Country C = *****
Country D = *****
Country E = *****
Country F = *****
Country G = *****
Country H = *****
Country I = *****
Country J = *****
Country K = *****
Country L = *****
Country M = *****
Country N = *****
Country O = *****
Country P = *****
Country Q = *****
Country R = *****
Country S = *****
Country T = *****

08.28.09

CHIEF COUNSEL RULING 2009-02

Subject: Request of Distributing 1, Inc. (and its Shareholders and Affiliates) for Chief Counsel Rulings

Dear *****,

On behalf of Distributing 1, all taxpayer members of its California combined unitary group, all non-taxpayer members of its California combined unitary group, and its shareholders, you requested advice from the California Franchise Tax Board (“FTB”) in the form of a Chief Counsel Ruling, regarding a series of transactions (the “Proposed Transaction”), involving sections 355 and 368 of the Internal Revenue Code of 1986, as amended (the “Code” or “IRC”), and certain other provisions of the Code, California’s conformity thereto, and the application of section 19774 of the California Revenue and Taxation Code (the “CR&TC”) to the Proposed Transaction.

I. RULINGS REQUESTED

- A. Whether each of the Distributing 5, the Distributing 4 Distribution, the Controlled 3 Distribution, the Controlled 4 Distribution, the Distributing 2 Distribution and the External Distribution will satisfy the active trade or business requirement of IRC section 355(b) for California franchise tax purposes, as adopted in the CR&TC as of the date of this CCR.
- B. Whether, for California franchise tax purposes, FTB will respect the form and substance of the Relevant Transactions, as described below, and will otherwise apply the CR&TC to the Relevant Transactions in a manner that is consistent with such characterization as otherwise represented by Distributing.
- C. Whether the Relevant Transactions will constitute a noneconomic substance transaction under CR&TC section 19774(c)(2), and thus the noneconomic substance transaction (“NEST”) understatement penalty under CR&TC section 19774 will not apply to any of the Relevant Transactions.

II. FACTS

A. Federal Procedural Background

Distributing, an **** corporation, submitted a private letter ruling request (“IRS Ruling Request”) to the Internal Revenue Service (“IRS”) with respect to the Proposed

Transaction described below. On June 30, 2009, the IRS issued a favorable private letter ruling (the "IRS PLR") to Distributing in response to the IRS Ruling Request. To the extent the CR&TC conforms to the IRC sections discussed in the IRS PLR, FTB will follow the IRS' application of those sections to the Proposed Transaction. Specifically, the IRS PLR concludes, among other things, that each Distribution qualifies for non-recognition treatment under IRC section 355, as applicable for federal purposes.

B. Corporate Background and Capital Structure

Distributing is a publicly traded corporation and the common parent of an affiliated group of corporations that files a consolidated federal income tax return. Distributing has a single class of voting common stock outstanding (the "Distributing Common Stock") which trades on the Stock Exchange 1. Distributing, through its subsidiaries, engages in the Business A Business and the Business B Business. Based on recent filings with the Securities and Exchange Commission, Distributing may have three shareholders that own five percent or more of the outstanding Distributing Common Stock. Such shareholders do not actively participate in the management of Distributing.

Distributing owns all of the outstanding stock of Distributing 3, Sub 1, Sub 3 and Sub 4, all of the outstanding equity interests of Sub 2 and Sub 5 (a limited liability company treated as a corporation for federal income tax purposes), as well as approximately cc percent of the stock of Distributing 2 and mm percent of the stock of Sub 6 (an Country A corporation.) Sub 7, a wholly-owned subsidiary of Distributing, owns the remainder of the stock of Distributing 2. Sub 3 is engaged in the Business J Business (a component of the Business A Business).

Distributing 3 owns aa percent of the stock of Sub 8 and bb percent of the common stock and all of the non-voting preferred stock of Distributing 4.

Sub 2 (a Country B limited liability partnership treated as a corporation for federal income tax purposes) wholly owns Sub 37 (a Country S corporation) and aa percent of the stock of Sub 9 (a Country B corporation treated as an entity disregarded from its owner for federal income tax purposes). Sub 9, in turn, owns aa percent of the stock of Sub 10 (a Country C corporation), Sub 11 (a Country B corporation), Sub 12 (a Country C corporation), and Sub 13 (an Country D corporation). Each of Sub 10, Sub 11 and Sub 12 is treated as an entity disregarded from its owner for federal income tax purposes.

Sub 4 owns aa percent of the membership interests in Sub 14 (a liability company treated as an entity disregarded from its owner for federal income tax purposes).

Distributing 2 owns aa percent of the stock of Sub 15, aa percent of the membership interests of Sub 16 (a limited liability company treated as a corporation for federal income tax purposes) and mm percent of the common stock of Distributing 4, as well as certain assets related to the Business C Business (a component of the Business A Business). Sub 15, in turn, owns aa percent of the stock of Sub 17 as well as certain assets related to the Business C Business and the Distributing 2 Contributed Business (collectively "the Distributing 2 Contributed Businesses"). Distributing 2 is and has been directly engaged in the Business D Business (a component of the Business C Business) and the Business E Business (a component of the Business B Business) for the past five years.

Sub 8 owns the Distributing 3 Contributed Businesses (collectively “the Distributing 3 Contributed Businesses”) (a component of the Business B Business), aa percent of the membership interest of Sub 18 (a limited liability company treated as an entity disregarded from its owner for federal income tax purposes), kk percent of the stock of Sub 19 (a Country E corporation), mm percent of the stock of Sub 20 (a Country F corporation), and mm percent of the stock of Sub 21 (a Country F corporation). Sub 8 is and has been directly engaged in the Business H Business (a component of the Business A Business) and the Business I Business (a component of the Business B Business) for the past five years.

Distributing 4 owns aa percent of the stock of Distributing 5, aa percent of the stock of Sub 22 (a Country H corporation), bb percent of the stock of Sub 20, bb percent of the stock of Sub 21, aa percent of the stock of Sub 23 (a Country I corporation), jj percent of the stock of Sub 24 (a Country J corporation), ee percent of the stock of Sub 19 and hh percent of the stock of Sub 25 (a Country K corporation). Sub 24 wholly owns Sub 34 (a Country J corporation treated as an entity disregarded from its sole owner for federal income tax purposes).

Prior to Date 6, Sub 45, a Country F corporation, had two classes of stock outstanding; pp shares of Series A stock and qq shares of Series B stock. Distributing 4 held aa percent of the outstanding Series B shares and rr shares of the outstanding Series A stock. Sub 8 owned the remaining ss shares of outstanding Series A stock. Sub 45 was engaged in the Business K Business (a component of the Business A Business).

Distributing 5 (a Country G corporation) owns aa percent of the stock of Sub 26 (a Country I corporation), Sub 27 (a Country L corporation), Sub 28 (a Country K corporation), Sub 29 (a Country M corporation), Sub 30 (a Country N corporation), Sub 31 (a Country O corporation), Sub 32 (a Country P corporation), as well as gg percent of the stock of Sub 24. Each of Sub 26, Sub 27, Sub 29, Sub 30, Sub 31 and Sub 32 is treated as an entity disregarded from its owner for federal income tax purposes. Distributing 5 is and has been directly engaged, as in the Business F Business (a component of the Business A Business) and the Business G Business (a component of the Business B Business) for the past five years.

Distributing’s U.S. cash management system is centrally managed. Cash generated by Distributing’s various domestic subsidiaries, through a sweeping process, is loaned by each subsidiary to Distributing. To meet the cash needs of the subsidiaries, the subsidiaries are deemed to draw on their receivable from Distributing or, to the extent their cash requirements exceed the receivable, the subsidiaries borrow funds from Distributing. Given the commercial relationships that exist among Distributing and its subsidiaries, intercompany trade payables and receivables are regularly created in the ordinary course of business. Pursuant to Distributing’s policies, trade payables and receivables among U.S. entities are settled according to the terms of the underlying transactions, employing the Distributing cash management system described above.

In connection with the Proposed Transactions, the following entities were formed or acquired: (i) Controlled 5 (a Country G corporation) was a shelf company that was acquired on Date 3 by Distributing 5 (ii) Controlled 1 Corporation (“Controlled”) was formed on Date 1 by Distributing, (iii) Controlled 4 was formed on Date 1 by Distributing 4, (iv) Controlled 3 was formed on Date 1 by Distributing 3, and (v) Controlled 2 (a limited liability company)

was formed on Date 5 by Distributing 2 and has elected to be treated as a corporation for federal income tax purposes.

Distributing has represented that the Business D, the Business E Business, the Business F Business, the Business G Business, the Business H Business, the Business I Business, the Business K Business and the Sub 3 Business A Business each have had gross receipts and operating expenses representing the active conduct of a trade or business for each for the past five years.

In connection with the External Distribution, Distributing has represented that Distributing, Controlled, and certain of their respective subsidiaries will enter into certain agreements relating to the Separation, as described below, and certain continuing business relationships between Distributing and Controlled (all such agreements and the subject matter thereof collectively referred to as the "Intercompany Agreements"). The Intercompany Agreements will include, among others, agreements related to the Proposed Transactions (primarily the Separation Agreement) (described below), the Tax Matters Agreement (described below), a transition services agreement, and agreements relating to ongoing arrangements between entities engaged in the Business A Business and the Business B Business. The Intercompany Agreements will include: (i) the provision of services such as distribution, manufacturing and packaging the terms and conditions which will be determined at arm's length, (ii) lease payments determined at arm's length and in some instances on terms similar to those contained in the primary lease agreement, and (iii) royalty-free and royalty bearing licenses.

Distributing has represented that Distributing and Controlled will enter into the Separation Agreement, which will contain the key provisions required to effectuate the External Distribution. The Separation Agreement will obligate the parties thereto to transfer assets and liabilities between Distributing and Controlled in order to achieve the desired allocation of assets and liabilities in the External Distribution, and will describe when and how these transfers, assumptions, and assignments have occurred or will occur. The Separation Agreement will also provide for cross-indemnities principally designed to place financial responsibility for the obligations and liabilities of the Business B Business with Controlled and financial responsibility for the obligations and liabilities of the Business A Business with Distributing, in each case with respect to obligations and liabilities that arose in or relate to periods (or portions thereof) ending on or before the date of the External Distribution.

Distributing has represented that Distributing and Controlled will enter into a Tax Matters Agreement (the "Tax Matters Agreement"), which will govern the parties' respective rights, responsibilities and obligations with respect to taxes, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings, and assistance and cooperation in respect of tax matters. The Tax Matters Agreement will also contain restrictions on Controlled's ability (and the ability of any member of its group) to take actions that could cause certain steps of the Proposed Transactions to fail to qualify as tax-free for federal income tax purposes.

C. Business Purpose for the Distributions

Distributing's management has represented that the separation of the Business A Business from the Business B Business (the "Separation") will serve a number of

corporate business purposes, including (i) reducing the competition for capital that currently exists between the Business A Business and the Business B Business, (ii) improving management “fit and focus,” including sharpening management focus and strategic vision, providing the flexibility needed to respond more effectively to customer needs and a changing economic environment and enhancing the success of the businesses by enabling them to resolve management, systemic or other problems that arise or are exacerbated by Distributing’s operation of the Business A Business and the Business B Business within a single affiliated group, and (iii) enhancing employee hiring, retention and morale by, among other things, improving the alignment of management and employee incentives with performance and growth objectives.

Distributing has represented for purposes of obtaining this Chief Counsel Ruling that the business purposes described above are for real and substantial non-federal and non-California tax purposes that are germane to the business of Distributing and its affiliates. Furthermore, Distributing has represented the business purposes will satisfy (i) the requirement that the reorganizations under IRC section 368 be carried out for a business purpose under Treas. Reg. §1.368-1(b), and (ii) the requirement that the Distributions be carried out for one or more corporate business purposes within the meaning of Treas. Reg. §1.355-2(b)(2) (“Corporate Business Purpose”).

Distributing has further represented for purposes of this Chief Counsel Ruling that none of the steps of the Proposed Transaction will be undertaken to reduce the California franchise tax liability of Distributing and/or any of its subsidiaries, except to the extent that certain steps (the “Relevant Transactions”) enable Distributing and/or its subsidiaries to qualify for nonrecognition treatment under IRC section 355 as adopted in the CR&TC for California franchise tax purposes as of the date of this Chief Counsel Ruling.

D. Proposed Transaction

1. The Preliminary Restructuring

In order to facilitate the External Distribution and to separate the relevant entities and operations that comprise the Business A and the Business F Business from the Business B Business, it has been represented that the following series of preliminary restructuring steps will be undertaken:

a. The Country B Stock Transfer

Sub 9 will sell all of the stock of Sub 10, Sub 11, Sub 12 and Sub 13 (collectively, the “Sub 9 Subsidiaries” and the sale of Sub 13, the “Stock Transfer”) to Sub 34 for cash in an amount equal to the fair market value of such stock.

b. The Distributing 5 Restructuring

i. In connection with the Distributing 5 restructuring, on Date 2, Sub 26 formed Sub 35 as a wholly-owned Country I corporation and elected to treat Sub 35 as an entity disregarded from its sole owner for federal income tax purposes. Sub 26 will contribute the assets and liabilities of the Division A division, operating in Country Q, to Sub 35.

ii. Sub 27 is in the process of being liquidated pursuant to Country L law and in connection with such liquidation the stock of Sub 26 owned by Sub 27 was transferred to Distributing 5.

iii. Sub 26 will distribute, under applicable Country I law, the stock of Sub 35 to Distributing 5.

iv. Sub 28 will sell its oo percent interest in Sub 33 to Distributing 5 for cash in an amount equal to the fair market value of such interest.

v. On Date 4, Distributing 5 formed Sub 36 as a direct wholly-owned subsidiary in Country K. Sub 28 will transfer to Sub 36 approximately 3 of its employees that perform functions related to the Business B Business.

vi. Sub 26, through its Division B division, holds outstanding loan receivables (the "Division B Receivables") from Sub 2 in the amount of approximately \$tt million and from Sub 37 in the amount of approximately \$uu million. Sub 26 will distribute the Division B Receivables to Distributing 5, its direct parent.

vii. Sub 34 holds an outstanding loan receivable (the "Sub 34 Receivable") from Sub 38 (a Country R corporation and an indirect subsidiary of Distributing 4) in the amount of approximately Country R currency of \$vv million. Sub 34, in turn, is indebted to Distributing 5 in the approximate amount of Country G currency of \$ww million (the "Distributing 5 Receivable"). Distributing 5 will acquire the Sub 34 Receivable from Sub 34 in exchange for cancellation of the Distributing 5 Receivable plus cash or a note (or both) that will, in total, equal the fair market value of the Sub 34 Receivable.

viii. Distributing 5 will contribute all the stock of Sub 28, Sub 29, Sub 30, Sub 31, Sub 32 and Sub 35, as well as the Division B Receivables and the Sub 34 Receivable, to Controlled 5 in exchange for additional shares of Controlled 5 stock (the "Distributing 5 Contribution").

ix. In connection with the Distributing 5 Contribution, Controlled 5 will establish a representative office in Country T that will be treated as a branch of Controlled 5 for federal income tax purposes. An indirect foreign subsidiary of Distributing 5 will transfer approximately 35 employees to the representative office.

x. Distributing 5 will distribute, under applicable Country G law, the stock of Controlled 5 to its sole shareholder, Distributing 4 (the "Distributing 5 Distribution").

c. The Sub 8 Conversion

Sub 8 will convert under relevant state law to a limited liability company (the "Sub 8 Conversion") and will be treated as an entity disregarded from its sole owner,

Distributing 3, for California franchise tax purposes, effective as of the date of the Sub 8 Conversion.

d. The Distributing 4 Restructuring

- i. Distributing 4 will contribute the stock that it owns in Distributing 5, Sub 19, Sub 20, Sub 21, Sub 22, Sub 23, Sub 24 and Sub 25 to Controlled 4 in actual or constructive exchange for additional shares of Controlled 4 stock (the “Distributing 4 Contribution”).
- ii. Controlled 4 will contribute the stock of Sub 24 owned by it to Distributing 5 in actual or constructive exchange for additional shares of Distributing 5 (the “Controlled 4 Contribution”).
- iii. It has been represented that, on or about Date 6, Sub 45 was converted (the “Sub 45 Conversion”) into an “Private Limited Company” (i.e., Sub 46) in a transaction qualifying as a tax-free reorganization under IRC section 368(a)(1)(F) as described herein. Pursuant to the Sub 45 Conversion, Distributing 4 received one quota with a value of xx Country F currency and Sub 8 received one quota with a value of yy Country F currency. Sub 8 will transfer its one quota to a disregarded entity held by Distributing 4.¹ After such transfer, Distributing 4 will own aa percent of the quotas of Sub 46 for California franchise tax purposes.² An election (the “Sub 46 Election”) will be made to treat Sub 46 as a disregarded entity for California franchise tax purposes.
- iv. Distributing 4 will distribute a number of shares (to be determined based on fair market value) of the stock of Controlled 4 to Distributing 2 in exchange for all of the stock of Distributing 4 held by Distributing 2. Distributing 4 will distribute the balance of the shares of the stock of Controlled 4 to Distributing 3 in respect of the stock of Distributing 4 held by it. (Such distributions to Distributing 2 and Distributing 3, collectively, are referred to herein as the “Distributing 4 Distribution”.) In the Distributing 4 Distribution, Distributing 4 will distribute all of the stock of Controlled 4. Following the Distributing 4 Distribution, Distributing 3 will hold stock of Controlled 4 representing ownership of more than dd percent of the single outstanding class of stock.

e. The Distributing 3 Restructuring

- i. Distributing 3 will form Sub 39 as a limited liability company that will be treated as an entity disregarded from its sole owner for California franchise tax purposes. Sub 4 will merge under applicable state law into

¹ Distributing 4 will form a single member LLC (Sub 44) that will be disregarded for federal income tax and California franchise tax purposes. Sub 8 will transfer its quota to Sub 44. Thus, for federal income tax and California franchise tax purposes, Distributing 4 will be the sole owner of Sub 46.

² Because Sub 8 is treated as a disregarded entity after the Sub 8 Conversion, the sole owner of Sub 8 (i.e., Distributing 3) will be treated as contributing the one quota to the capital of its wholly owned subsidiary, Distributing 4.

Sub 39 in a transaction that qualifies as a reorganization under IRC section 368(a)(1)(A). Thereafter, Sub 39 will distribute all of the membership interests of Sub 14 to Distributing 3.

ii. Distributing 3 will contribute the Distributing 3 Contributed Businesses together with all of the membership interests in Sub 18 and Sub 14, a kk percent interest in Sub 19, a mm percent interest in Sub 20, and a nn percent interest in Sub 21, as well as certain intellectual property owned by Distributing 3 and related to the Business B Business, to Controlled 3 in actual or constructive exchange for additional shares of Controlled 3 stock (the “Distributing 3 Contribution”).

iii. Distributing 3 will distribute all of the stock of Controlled 3 (the “Controlled 3 Distribution”) and all of the stock of Controlled 4 (the “Controlled 4 Distribution”) owned by it (representing in excess of dd percent of the outstanding stock of Controlled 4), to its sole shareholder, Distributing.

f. The Distributing 2 Restructuring

i. Sub 5 will form Sub 40, as a limited liability company that will be treated as an entity disregarded from its sole owner for California franchise tax purposes. Sub 5 will contribute the Asset A Assets to Sub 40. Sub 5 will sell its membership interests in Sub 40 to Sub 15 for cash in an amount equal to the fair market value of such interest.

ii. Sub 15 will convert under applicable state law to a limited liability company (the “Sub 15 Conversion”) that will be treated as an entity disregarded from its sole owner, Distributing 2, for California franchise tax purposes, effective as of the date of the Sub 15 Conversion.

iii. Distributing 2 will contribute the assets related to the Business C directly owned by it, its interests in Sub 16 and Sub 17, and the Distributing 2 Contributed Businesses, to Controlled 2 in actual or constructive exchange for additional membership interests in Controlled 2 (the “Distributing 2 Contribution”).

iv. Sub7 will convert under applicable state law to a limited liability company (the “Sub7 Conversion”) that will be treated as an entity disregarded from its sole owner, Distributing, for California franchise tax purposes, effective as of the date of the Sub7 Conversion. Prior to the Sub7 Conversion, Sub7 will contribute its mm percent membership interest in (i) Sub 41 (a limited liability company treated as a partnership for federal income tax purposes) and (ii) Sub 42 (a limited liability company treated as a partnership for federal income tax purposes), to Sub 43 (a wholly owned subsidiary of Sub7). After the Sub7 Conversion, Sub7 will distribute its nn percent interest in the stock of Distributing 2 to Distributing.

v. Distributing 2 will distribute all of the membership interests of Controlled 2 to Distributing (the “Distributing 2 Distribution”).

2. The External Distribution

a. Sub 3 will convert under applicable state law to a limited liability company (the “the Sub 3 Conversion”) that will be treated as an entity disregarded from its sole owner, Distributing, for California franchise tax purposes.

b. In connection with the External Distribution, the Business B Business cash management system will be separated from Distributing’s central cash management system and the intercompany debt accounts receivable and payable balances between the Business B Business and the Business A Business that arose from the operation of that system will be settled. Further, a centralized cash management system managed by Distributing 2 will be created which will include all U.S. entities engaged in the Business B Business. To effect such separation, in connection with the Distributing Contribution (defined below), Distributing will contribute to Controlled its intercompany debt accounts receivable balances with each applicable U.S. entity engaged in the Business B Business (the “Business B Business Receivables”) and Controlled will assume Distributing’s intercompany debt account payable balances with each applicable U.S. entity engaged in the Business B Business (the “Business B Business Payables”). Immediately thereafter, Controlled will contribute to Distributing 2 the Business B Business Receivables and Distributing 2 will assume the Business B Business Payables. Further, prior to the External Distribution, except with respect to the Division B Receivables and the Sub 34 Receivable, any non-U.S. intercompany debt accounts receivable or payable balances between entities engaged in the Business B Business and entities engaged in the Business A Business will be paid in full or otherwise settled.

c. Distributing will contribute to Controlled (the “Distributing Contribution”), in actual or constructive exchange for additional shares of Controlled Common Stock, the assumption of the Business B Business Payables and the Controlled Cash Distribution (defined below), the Business B Business Receivables as well as all of the stock it owns in the following subsidiaries: (i) Controlled 3, (ii) Controlled 4, (iii) Distributing 2, (iv) Sub 1, and (v) Sub 6. The Controlled Common Stock will be subdivided and converted into that number of shares of Controlled Common Stock necessary to effectuate the External Distribution.

d. In connection with the Distributing Contribution, Controlled will incur approximately \$zz billion of indebtedness by entering into and borrowing under a bridge bank credit facility. Such amount will be transferred to Distributing (the “Controlled Cash Distribution”) in connection with the Distributing Contribution. Pursuant to the plan of reorganization that includes the Distributing Contribution and the External Distribution, following the External Distribution, Distributing will use the Controlled Cash Distribution to make payments to Distributing’s creditors in repayment of Distributing Debt. The Controlled Cash Distribution will be used to repurchase a portion of Distributing Debt from its current holders in a tender offer (or series of tender offers). Pending use of the Controlled Cash Distribution to repay

Distributing Debt, Distributing will deposit the Controlled Cash Distribution in a segregated account. Distributing will use a reasonable method to distinguish funds representing the Controlled Cash Distribution from funds representing earnings attributable thereto. In all events, Distributing will use the entire amount of the Controlled Cash Distribution to repay Distributing Debt as promptly as practicable, but in no event later than one year after the External Distribution. Following the External Distribution, Controlled expects to refinance the bridge loan on a permanent basis in the public markets. Alternatively, if market and other conditions permit, Controlled may access the public markets, in the first instance, and thereby avoid a portion of the cost and expense of a bridge loan followed by a refinancing.

e. Controlled will contribute the stock of Sub 1 to Controlled 3 (the “Controlled Contribution”).

f. Distributing will distribute pro rata to the holders of Distributing Common Stock at least ff percent of the Controlled Common Stock (the “External Distribution”) and retain (the “Retention”) up to jj percent of the Controlled Common Stock (the “Retained Stock”). The Retention is motivated primarily by the need to reduce the debt load and enhance liquidity for both Distributing and Controlled in order to ensure investment grade debt ratings for both companies, provide capital flexibility to enable both companies to achieve their strategic objectives, avoid increased future financing costs, and avoid raising equity capital.

g. Distributing, pursuant to the plan that includes the Distributing Contribution and the External Distribution, may seek to transfer, in the manner described below, some or all of the Retained Stock to its creditors in one or more exchanges for existing Distributing Debt (the “Debt-for-Equity Exchange”). Any such Debt-for-Equity Exchange will in no event be completed later than 24 months after the External Distribution. Alternatively, or in addition, Distributing may seek to sell the Retained Stock. In any event, any Retained Stock not disposed of in Debt-for-Equity Exchanges will be disposed of by Distributing as soon as a disposition is warranted consistent with the business purposes of the Retention described above, but in no event later than five years after the External Distribution.

In order to facilitate any Debt-for-Equity Exchange, Distributing expects that at least 14 days prior to the exchange described below, one or more financial institutions, acting as principals for their own account, would acquire Distributing Debt in the marketplace. No sooner than five days after the financial institutions have acquired the Distributing Debt and at least nine days prior to the exchange, Distributing expects that it would enter into an exchange agreement with the financial institutions. Pursuant to the exchange agreement, a financial institution would agree to exchange an amount of Distributing Debt for some or all of the Retained Stock at a time when the financial institution has held the Distributing Debt as principal for its own account for at least 14 days. The exchange agreement would require the financial institution to deliver Distributing Debt with an aggregate fair market value that approximates the fair market value of the Retained Stock to be transferred in exchange therefore on the date of the exchange. The value of the Retained Stock exchanged would be determined based on the public prices of the Controlled Common Stock. The value of the Distributing Debt would be determined

based on objective standards agreed upon by Distributing and the financial institution. Distributing further expects that the financial institutions would receive registration rights in connection with their receipt of the Retained Stock and will seek to sell in a public offering or otherwise the Retained Stock received in the Debt-for-Equity Exchange. The financial institutions may enter into other arrangements with respect to the Distributing Debt, but neither Distributing nor any member of its affiliated group will be a party to such arrangements.

III. REPRESENTATIONS

A. General Representations

1. The identical issues in this ruling request are not in a prior California franchise tax return of the taxpayer or an affiliate for a previous year, and are not the subject of an existing California audit, protest, appeal or litigation concerning the taxpayer or an affiliate.

2. Immediately before the Proposed Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable inter-company transaction regulations (see Treas. Reg. sections 1.1502-13 and 1.1502-14 as in effect before the publication of T.D. 8597, 1995-2 C.B. 147, and as currently in effect; Treas. Reg. section 1.1502-13 as published by T.D. 8597). Furthermore, Distributing's excess loss account, if any, with respect to Controlled common stock or the excess loss account that Distributing may have in the stock of another member that is required to be taken into account by Treas. Reg. section 1.1502-19 will be included immediately before the Proposed Distribution.

3. Immediately before the Proposed Distribution, items of income, gain, loss, and deduction will be taken into account as required by the applicable intercompany transaction regulations (as determined under Cal. Code of Regs., tit. 18, section 25106.5-1). Likewise, any deferred intercompany stock accounts ("DISAs") will be taken into account as required by the applicable DISA regulations (as determined under Cal. Code of Regs., tit. 18, section 25106.5-1(f)).

4. The description of the Proposed Transaction herein and in the Supplemental Submissions is true, correct and complete, and there are no other agreements or arrangements, written or oral, that change the Proposed Transaction or result in any additional transactions not described in such documents or herein that may be relevant to the California franchise tax consequences of the Proposed Transaction.

B. IRC section 355(b) Representations

1. For California franchise tax purposes, the Sub 46 Election will be treated as a complete liquidation of Sub 46 (under IRC sections 332 and 337(a)) in which no gain or loss will be recognized in whole or in part by any party to the deemed liquidation.

2. Immediately prior to the Sub 46 Election, Sub 45 will have been engaged in a five-year active trade or business within the meaning of IRC section 355(b) and Sub 46 (as a disregarded entity held by Distributing 4) will continue such active trade or business following the Sub 46 Election. The five years of financial information submitted on

behalf of Distributing 4 with respect to the Business K Business conducted by Sub 45 is representative of the present operations of the Business K Business to which there have been no substantial operational changes since the date of the last financial statements submitted. As a result of the Sub 46 Election, Distributing 4 will be treated as directly engaged in the active conduct of a trade or business within the meaning of IRC section 355(b).

3. Except for a nominal interest held by Sub 8, the outstanding stock of Sub 45 has been continuously held by Distributing 4 during the five-year period prior to the Distributing 4 Distribution.

4. Following the Distributing 4 Distribution, Distributing 4 (through Sub 46) will continue the active conduct of its business independently and with its separate employees.

5. Immediately after the Distributing 4 Distribution, at least ee percent of the fair market value of the gross assets of Controlled 4 will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in IRC section 355(b)(2).

6. Immediately after the Controlled 4 Distribution, at least ee percent of the fair market value of the gross assets of Controlled 4 will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in IRC section 355(b)(2).

7. Immediately prior to the Sub 3 Conversion, Sub 3 will have been engaged in a five-year active trade or business within the meaning of IRC section 355(b) and Sub 3 (as a disregarded entity held by Distributing) will continue such active trade or business following the Sub 3 Conversion. The five years of financial information submitted on behalf of Distributing with respect to the Business J Business conducted by Sub 3 is representative of the present operations of the Business J Business to which there have been no substantial operational changes since the date of the last financial statements submitted. As a result of the Sub 3 Conversion, Distributing will be treated as directly engaged in the active conduct of a trade or business within the meaning of IRC section 355(b).

8. Distributing has continuously owned aa percent of the stock of Sub 3 during the five-year period prior to the External Distribution.

9. Following the External Distribution, Distributing (through Sub 3) will continue the active conduct of its business independently and with its separate employees.

10. Immediately after the External Distribution, at least ee percent of the fair market value of the gross assets of Controlled will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in IRC section 355(b)(2).

C. CR&TC Section 19774 Representations

1. Each step of the Proposed Transaction will be carried out primarily to facilitate the External Distribution or its corporate business purpose within the meaning of Treas. Reg. §1.355-2(b)(2).
2. None of the steps of the Proposed Transaction will be undertaken to reduce the California franchise tax liability of Distributing and/or any of its subsidiaries, except to the extent that certain steps (the "Relevant Transactions") enable Distributing and/or its subsidiaries to qualify for nonrecognition treatment under IRC section 355 as adopted in the CR&TC for California franchise tax purposes as of the date of this Chief Counsel Ruling.

IV. RULINGS

Based on the accuracy and completeness of the facts and representations provided by Distributing, and subject to field examination by FTB of the facts relating to the Proposed Transaction, the Chief Counsel rules as follows:

- A. The Distributing 5 Distribution, the Distributing 4 Distribution, the Controlled 3 Distribution, the Controlled 4 Distribution, the Distributing 2 Distribution and the External Distribution will satisfy the active trade or business requirement of IRC section 355(b) for California franchise tax purposes.
- B. FTB will respect the form and substance of the Relevant Transactions.
- C. None of the Relevant Transactions will constitute a noneconomic substance transaction under CR&TC section 19774(c)(2), and thus the noneconomic substance transaction ("NEST") understatement penalty under CR&TC section 19774 will not apply to any of the Relevant Transactions.

V. LAW AND ANALYSIS

A. Lack of Conformity with Recent Federal Legislation

IRC section 355(b)(2)(A) provides that immediately after a distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business. Such trade or business must have been actively conducted for the five-year period ending on the date of the distribution and must not have been acquired within such five-year period in a transaction in which gain or loss was recognized in whole or in part.³

Distributing has represented that each of the Distributions will constitute a tax-free distribution under IRC section 355. Distributing is permitted to satisfy the IRC section 355(b) active trade or business requirement indirectly through the active conduct of a trade or business by one or more of its affiliates. This is because section 202 of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) ("TIPRA") effectively replaced the "holding company" test in IRC section 355(b)(2)(A), described below, as in

³ See generally IRC section 355(b).

effect prior to TIPRA, with a test that permits a distributing or controlled corporation to indirectly satisfy the "active trade or business" requirement of IRC section 355(b)(2)(A) if the "separate affiliated group" (of which the distributing or controlled corporation is the common parent) is engaged in the active conduct of a trade or business.

As of the date hereof, California has not conformed to, or adopted for purposes of income and franchise tax laws (in the CR&TC), the amendments to IRC section 355(b) made by section 202 of TIPRA. Thus, for example, a distributing corporation would not satisfy the IRC section 355(b) requirement in effect prior to TIPRA and currently adopted by the CR&TC if, immediately after the distribution, the distributing corporation is not engaged directly in the active conduct of a trade or business or otherwise satisfies the "holding company" test of IRC section 355(b)(2)(A) as in effect prior to TIPRA. As such, in order to qualify the distribution as an IRC section 355 nonrecognition transaction for California franchise tax purposes, it was necessary for Distributing to engage in certain steps of the Proposed Transaction (the "Relevant Transactions") to cause either a distributing or controlled corporation to become directly engaged in the active conduct of a trade or business (e.g., by way of a liquidation of a subsidiary of such corporation) or otherwise satisfy the holding company test.

B. California Adoption of "Subchapter C"

Pursuant to CR&TC sections 24451 and 17321, California specifically adopts by reference subchapter C of Chapter 1 of subtitle A of the Code, without any modifications that are relevant to the legal analysis herein. These subchapter C provisions include, but are not limited to, IRC sections 312, 332, 337, 351, 355, 358, 361, 367, and 368. California conforms to these provisions, however, only as of the "specified date" of January 1, 2005. Furthermore, the related Treasury Regulations with respect to these federal statutes are also adopted by California pursuant to CR&TC sections 23051.5(d) and 17024.5(d). California also conforms to all Federal procedures and rulings unless otherwise noted. FTB Notice No. 89-277 provides:

Where the provisions of the Personal Income Tax Law and the Bank and Corporation Tax Law are in substantial conformity with the Internal Revenue Code, the Franchise Tax Board will generally follow federal regulations, procedures and rulings. However, federal rulings and procedures will not be binding on the Franchise Tax Board for California purposes if an authorized officer or employee of the Franchise Tax Board has publicly indicated in writing that the ruling or procedure will not be followed.⁴

C. Subchapter C Provisions Applicable to the Distributions

The Distributions will qualify for nonrecognition treatment under IRC section 355. As discussed above, California adopts by reference IRC section 355 and the related Treasury Regulations through CR&TC sections 24451 and 23051.5(d) for corporate franchise tax purposes, and CR&TC sections 17321 and 17024.5(d) for personal income tax purposes. Additionally, as discussed above, FTB Notice 89-277 provides that California follows federal procedures and rulings where California law is in conformity to federal law, as long as FTB has not publicly indicated it will not follow the ruling or procedure.

⁴ California Franchise Tax Board Notice No. 89-277, May 10, 1989.

D. IRC Section 355(b) “Active Trade or Business” Requirement Applicable for California Corporation Tax Law Purposes

Both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business.⁵ To satisfy the active trade or business requirement of IRC section 355(b):⁶

1. Both the distributing and controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution.⁷ A corporation is treated as engaged in the active conduct of a trade or business if it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock or securities of a corporation controlled by it which is so engaged.⁸ “Substantially all” requires 90 percent of the aggregate fair market value of the corporation’s gross assets to be stock or securities of controlled corporations that were engaged in the active conduct of a trade or business (i.e., the “holding company” test);⁹

2. Such trade or business has been actively conducted throughout the five-year period ending on the date of the distribution;¹⁰

3. The assets comprising such trade or business were not acquired within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized in whole or in part;¹¹ and

4. Control of a corporation which (at the time of acquisition of control) was actively conducting the trade or business was not acquired directly or indirectly (through one or more corporations) by the distributing corporation or any distributee corporation within the five-year period ending on the date of the distribution in a transaction in which gain or loss was recognized in whole or in part.¹²

A corporation is treated as engaged in the active conduct of a trade or business immediately after a distribution if a specific group of activities are being carried on by such corporation for the purpose of earning income or profit, and the activities conducted by such corporation include every operation that forms a part of, or step in, the process of earning income or profit. These activities must ordinarily include the collection of income and the payment of expenses. The determination whether a trade or business is actively conducted is made based on all facts and circumstances. The corporation itself is generally required to perform active and substantial management and operational functions.¹³

⁵ IRC sections 355(a)(1)(C) and (b)(1).

⁶ See *also* section 4.03(5) of Rev. Proc. 96-30, 1996-19 I.R.B. 8.

⁷ IRC section 355(b)(1)(A).

⁸ IRC section 355(b)(2)(A).

⁹ See *also* section 3.04 of Rev. Proc. 77-37, 1977-2 C.B. 568.

¹⁰ IRC section 355(b)(2)(B).

¹¹ IRC section 355(b)(2)(C).

¹² IRC section 355(b)(2)(D).

¹³ Treas. Reg. §1.355-3(b)(2)(ii) and (iii).

Treas. Reg. §1.355-3(b)(4)(iii) provides an exception to the application of IRC sections 355(b)(2)(C) and (D). This regulation states that the requirements of IRC section 355(b)(2)(C) and (D) are intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a distribution by the corporation of that trade or business in a distribution to which IRC section 355 would otherwise apply. The regulations further explain that a direct or indirect acquisition of a trade or business by one member of an affiliated group¹⁴ from another member of the group is not the type of transaction to which IRC section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying IRC section 355(b)(2)(C) or (D), such an acquisition is disregarded even though taxable.

California has not adopted, for purposes of California's franchise and income tax laws, the amendments to IRC section 355(b), as described above. These amendments effectively replaced the "holding company" test of IRC section 355(b)(2)(A) (as in effect prior to TIPRA) with a test that permits a distributing or controlled corporation to satisfy the "active trade or business" requirement of IRC section 355(b)(2)(A) if the "separate affiliated group", of which the distributing or controlled corporation is the common parent, is engaged in the active conduct of a trade or business.¹⁵

Importantly, under both current IRC section 355(b)(2)(A) and former IRC section 355(b)(2)(A) (i.e., as in effect prior to TIPRA, and thus current California law), a corporation is treated as engaged in the active trade or business if it itself is directly engaged in the active conduct of a trade or business. Each of the Distributions will satisfy the "active trade or business" requirement of IRC section 355(b). Because California has not adopted the post-2004 amendments to IRC section 355(b), the Distributions must also satisfy the IRC section 355(b) requirements as in effect on January 1, 2005.

E. Distributions

1. The Distributing 5 Distribution

a. *Active Trade or Business of Distributing 5.* Distributing 5 will be treated as directly engaged in the active trade or business of manufacturing and selling ***** conducted by its Division B division operating in the Country Q (the "Business G Business") through Sub 26, which is a Country I corporation treated as an entity disregarded from its owner, Distributing 5, for California franchise tax purposes. Distributing 5, through its disregarded subsidiary Sub 26, has been conducting the Division B business for the past five years.

b. *Active Trade or Business of Controlled 5.* Controlled 5 will be treated as directly actively engaged in the trade or business of manufacturing ***** products, such as ***** and ***** , conducted by Sub 29 and the Division A division of Sub 26 (collectively, the "Business F Business"). Sub 29 is a Country M corporation treated as an entity disregarded from its owner,

¹⁴ Treas. Reg. §1.355-3(b)(4)(iv) provides that the term "affiliated group" means an affiliated group as defined in IRC section 1504(a) (without regard to IRC section 1504(b)), except that the term "stock" includes nonvoting stock described in IRC section 1504(a)(4).

¹⁵ IRC section 355(b)(3).

Distributing 5, for California franchise tax purposes. Distributing 5, through its disregarded subsidiary Sub 29, has been conducting its business for the past five years. Sub 26 will transfer its Division A division to Sub 35. Sub 35 was formed on Date 2, in connection with the Proposed Transaction, and is a Country I corporation. An election will be made to treat Sub 35 as an entity disregarded from its owner for federal income tax purposes. Such election will automatically cause Sub 35 to be a disregarded entity for federal income tax and California franchise tax purposes. Distributing 5, through its disregarded subsidiary, Sub 26, has been conducting the Division A business for the past five years. Sub 29 and Sub 35 will be transferred to Controlled 5 in the Distributing 5 Contribution.¹⁶

Because Distributing 5 and Controlled 5 will be directly engaged in the Business G Business and the Business F Business, respectfully, the Distributing 5 Distribution simultaneously satisfies the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

2. The Distributing 4 Distribution

a. *Active Trade or Business Conducted by Sub 45 and to be Conducted by Distributing 4.*

Distributing 4 will be directly engaged in the active trade or business of producing ***** , ***** , ***** and ***** (the “Business K Business”), as described below. Distributing 4 will be deemed to acquire the Business K Business pursuant to the election (the “Sub 46 Election”) of Sub 46, into an entity that is disregarded from its aa percent owner, Distributing 4, for federal income tax and California franchise tax purposes. As represented by Distributing, above, for federal income tax and California franchise tax purposes, the Sub 46 Election will be treated as a complete liquidation of Sub 46 (under IRC sections 332 and 337(a)) in which no gain or loss will be recognized in whole or in part by any party to the deemed liquidation. Accordingly, Distributing 4’s acquisition of the Business K Business within the 5-year period of the Distributing 4 Distribution will satisfy the requirement of IRC section 355(a)(2)(C) that the Business K Business not be acquired in a transaction in which gain or loss is recognized in whole or in part. A company may engage in a tax-free restructuring transaction, such as the Sub 45 Conversion and Sub 46 Election, in order to satisfy the active trade or business requirement.¹⁷

¹⁶In each of the Distributing 5 Distribution, the Distributing 4 Distribution, the Controlled 3 Distribution, the External Distribution, and the Distributing 2 Distribution, the distributing corporation will transfer an active trade or business or stock of a corporation conducting an active trade or business to the controlled corporation prior to the distribution of the controlled corporation stock to the shareholders of the distributing corporation. The transfers to the controlled corporations will qualify as tax-free reorganizations under IRC sections 368(1)(D) and 355. Accordingly, neither IRC section 355(b)(2)(C) nor (D) will adversely affect qualification under the active trade or business requirement with respect to such transfers. See *also* Rev. Rul. 78-442, 1978-2 C.B. 143 (IRC section 355(b)(2)(C) was not intended to apply to an acquisition of a trade or business by the controlled corporation from the distributing corporation).

¹⁷ See Rev. Rul. 74-79, 1974-1 C.B. 81 (holding that a parent corporation with the intent of satisfying the active trade or business requirement of IRC section 355(b) by itself being directly engaged in the active trade or business, liquidated its wholly owned subsidiary that conducted the active trade or

As a result of the Sub 46 Election, the Business K Business will be treated as directly held by Distributing 4 for California franchise tax purposes such that Distributing 4 will be treated as engaged directly in the active conduct of a trade or business, thereby simultaneously satisfying the active trade or business requirement of IRC section 355(b)(2)(A) for franchise tax purposes.

b. Active Trade or Business Conducted by Controlled 4 Pursuant to the Holding Company Test.

Controlled 4 will not directly conduct an active trade or business after the Distributing 4 Distribution. For California franchise tax purposes, Controlled 4 will satisfy the holding company test also by relying on the Business G Business directly conducted by Distributing 5. In that regard, Distributing has represented that, immediately after the Distributing 4 Distribution, at least ee percent of the fair market value of the gross assets of Controlled 4 will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in IRC section 355(b)(2).¹⁸ Accordingly, Controlled 4 will simultaneously satisfy the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

3. The Controlled 3 Distribution

a. Active Trade or Business Conducted by Sub 8 and to be Conducted by Distributing 3.

Distributing 3 will be directly engaged in the active trade or business of ***** manufacturing and distribution conducted by its Business L Business and Division A businesses (the “Business H Business”). Distributing 3 will acquire the Business H Business pursuant to the Proposed Transaction whereby Sub 8 converts (the “Sub 8 Conversion”) into a limited liability company that will be treated as an entity that is disregarded from its owner, Distributing 3, for California franchise tax purposes. The IRS PLR concludes that the Sub 8 Conversion will qualify as a complete liquidation of Sub 8 (under IRC sections 332 and 337(a)) in which no gain or loss will be recognized in whole or in part by any party to the Sub 8 Conversion. Accordingly, Distributing 3’s acquisition of the Business H Business within the 5-year period of the Controlled 3 Distribution will satisfy the requirement of IRC section 355(a)(2)(C) that the Business H Business not be acquired in a transaction in which gain or loss is recognized in whole or in part. As stated above, prior to TIPRA a company may engage in a tax-free restructuring transaction, such

business in a transaction in which no gain or loss was recognized in whole or in part under IRC section 332); Chief Counsel Ruling 2007-3 (July 17, 2007) (following Rev. Rul. 74-79); PLR 200109027 (Nov. 30, 2000) (same); PLR 200101006 (Oct. 5, 2000) (same); PLR 9447023 (Aug. 23, 1994) (same); and PLR 9809035 (Nov. 25, 1997) (check-the-box elections made to treat wholly owned subsidiaries as disregarded entities in transactions intended to qualify as complete liquidations under IRC section 332, thereby enabling the corporate distributee to satisfy the active trade or business requirement).

¹⁸ Controlled 4 will contribute its ii percent interest in Sub 24 to Distributing 5, which will then own aa percent of the outstanding Sub 24 stock, in a transaction that the IRS PLR concludes will qualify as tax-free exchange under IRC section 351. This transaction is expected to clean up the ownership structure of Sub 24, thereby improving management and cost efficiencies.

as the Sub 8 Conversion, in order to satisfy the active trade or business requirement.¹⁹

Absent the Sub 8 Conversion, at the time of the Controlled 3 Distribution, Distributing 3 would not be engaged directly in the active conduct of a trade or business and might not satisfy the holding company test of IRC section 355(b)(2)(A) as in effect prior to TIPRA. As a result, while Distributing 3 would be treated for federal income tax purposes as satisfying the active trade or business requirement of IRC section 355(b)(2)(A), by reason of IRC section 355(b)(3), Distributing 3 might not satisfy the active trade or business requirement.

As a result of the Sub 8 Conversion, the Business H Business will be treated as directly held by Distributing 3 for California franchise tax purposes. Thus, Distributing 3 will be treated as engaged directly in the active conduct of a trade or business, thereby simultaneously satisfying the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

b. Active Trade or Business of Controlled 3.

After the Distributing 3 Contribution, Controlled 3 will be treated as engaged directly in the active conduct of the medical manufacturing trade or business conducted by its Distributing 3 Contributed businesses (the "Business I Business").²⁰ Because Controlled 3 will be directly engaged in the Business I Business, Controlled 3 simultaneously satisfies the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

4. The Controlled 4 Distribution

a. Active Trade or Business Conducted by Sub 8 and to be Conducted by Distributing 3.

As stated above under the section entitled "The Controlled 3 Distribution," Distributing 3 will be directly engaged in Business H Business after the Sub 8 Conversion, thereby simultaneously satisfying the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.²¹

b. Active Trade or Business Conducted by Controlled 4 Pursuant to the Holding Company Test.

Controlled 4 will not directly conduct an active trade or business after the Controlled 4 Distribution. For California franchise tax purposes, Controlled 4 will

¹⁹ See Rev. Rul. 74-79 and accompanying authorities cited in footnote 17, above.

²⁰ Controlled 3 will acquire the Business I Business from Distributing 3 pursuant to the Distributing 3 Contribution. Along with the acquisition of the Business H Business described above, Distributing 3 will acquire the Business I Business pursuant to the Sub 8 Conversion. For the reasons stated above, Distributing 3's acquisition of the Business I Business pursuant to the Sub 8 Conversion will not adversely affect Controlled 3's satisfaction of the active trade or business requirement under IRC section 355(b).

²¹ See Rev. Rul. 74-79 and accompanying authorities cited in footnote 17.

satisfy the holding company test by relying on the Business G Business directly conducted by Distributing 5. In that regard, Distributing has represented that, immediately after the Controlled 4 Distribution, at least ee percent of the fair market value of the gross assets of Controlled 4 will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in IRC section 355(b)(2). Accordingly, Controlled 4 will simultaneously satisfy the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.²²

5. The Distributing 2 Distribution

a. *Active Trade or Business Conducted by Sub 15 and to be Conducted by Distributing 2.*

Distributing 2 will be engaged directly in the trade or business of marketing, sales, distribution, installation and servicing relating to its Business E line of products (the "Business E Business"). Distributing 2 will acquire the Business E Business pursuant to the conversion of Sub 15 into a limited liability company that will be treated as an entity that is disregarded from its owner, Distributing 2, for California franchise tax purposes. Sub 15 Conversion will qualify as a complete liquidation of Sub 15 (under IRC sections 332 and 337(a)) in which no gain or loss will be recognized in whole or in part by any party to the Sub 15 Conversion. Accordingly, Distributing 2's acquisition of the Business E Business within the 5-year period of the Distributing 2 Distribution will satisfy the requirement of IRC section 355(a)(2)(C) that the Business E Business not be acquired in a transaction in which gain or loss is recognized in whole or in part. As stated above, prior to TIPRA, the IRS had consistently ruled that a company may engage in a tax-free restructuring transaction, such as the Sub 15 Conversion, in order to satisfy the active trade or business requirement.²³

Absent the Sub 15 Conversion, at the time of the Distributing 2 Distribution, Distributing 2 would not be engaged directly in the active conduct of a trade or business and might not satisfy the holding company test of IRC section 355(b)(2)(A) as in effect prior to TIPRA. As a result, while Distributing 2 would be treated for federal income tax purposes as satisfying the active trade or business requirement of IRC section 355(b)(2)(A), by reason of IRC section 355(b)(3), Distributing 2 might not satisfy the active trade or business requirement of IRC

²² Distributing 3 will receive the Controlled 4 stock pursuant to the Distributing 4 Distribution. The Distributing 4 Distribution will qualify as a tax free distribution (under IRC sections 355 and 368(a)) in which no gain or loss will be recognized in whole or in part to any party to the transaction. Accordingly, Distributing 3's acquisition of Controlled 4 within the 5-year period of the Controlled 4 Distribution will satisfy the requirement of IRC section 355(a)(2)(D) that control of Controlled 4 not be acquired directly or indirectly in a transaction in which gain or loss is recognized in whole or in part. See *also* Treas. Reg. §1.355-3(b)(4)(iii) (because Distributing 3 and Distributing 4 are members of the same affiliated group for purposes of this section, Distributing 3's acquisition of Controlled 4 is not the type of transaction to which IRC section 355(b)(2)(D) is intended to apply even if gain or loss were recognized on the Distributing 4 Distribution); Rev. Rul. 69-461, 1969-2 C.B. 52 (a distribution of stock from one corporation to another, where the distributee is in control of distributor, is not the type of transaction that IRC section 355(b)(2)(D) was designed to prevent).

²³ See Rev. Rul. 74-79 and accompanying authorities cited in footnote 17.

section 355(b)(2)(A) as in effect prior to TIPRA, and therefore might not be so treated for California franchise tax purposes.

As a result of the Sub 15 Conversion, the Business E Business will be treated as directly held by Distributing 2 for federal income tax and California franchise tax purposes such that Distributing 2 will be treated as directly engaged in the active conduct of a trade or business, thereby satisfying the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

b. Active Trade or Business of Controlled 2.

After the Distributing 2 Contribution, Controlled 2 will be directly actively engaged in the ***** Management and ***** businesses (collectively, the “Business D Business”).²⁴ Because Controlled 2 will be directly engaged in the Business D Business, Controlled 2 simultaneously satisfies the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

6. The External Distribution

a. Active Trade or Business Conducted by Sub 3 (and to be Conducted by Distributing).

Distributing will be directly engaged in the active trade or business of ***** repackaging services (the “Business J Business”), described below. Distributing will acquire the Business J Business pursuant to the Proposed Transaction whereby Sub 3 converts (i.e., the Sub 3 Conversion) into a limited liability company that will be treated as an entity that is disregarded from its owner, Distributing, for California franchise tax purposes. The Sub 3 Conversion will qualify as a complete liquidation of Sub 3 (under IRC sections 332 and 337(a)) in which no gain or loss will be recognized in whole or in part by any party to the Sub 3 Conversion. Accordingly, Distributing’s acquisition of the Business J Business within the 5-year period of the External Distribution will satisfy the requirement of IRC section 355(a)(2)(C) that the Business J Business not be acquired in a transaction in which gain or loss is recognized in whole or in part. Prior to TIPRA, the IRS had consistently ruled that a company may engage in a tax-free restructuring transaction, such as the Sub 3 Conversion, in order to satisfy the active trade or business requirement.²⁵

Absent the Sub 3 Conversion, at the time of the External Distribution, Distributing would not be engaged directly in the active conduct of a trade or business, nor would it satisfy the holding company test of IRC section 355(b)(2)(A) as in effect

²⁴ Controlled 2 will acquire the Business D Business from Distributing 2 pursuant to the Distributing 2 Contribution. Along with the acquisition of the Business E Business described above, Distributing 2 will acquire the Business D Business pursuant to the Sub 15 Conversion. For the reasons stated above, Distributing 2’s acquisition of the Business D Business pursuant to the Sub 15 Conversion will not adversely affect Controlled 2’s satisfaction of the active trade or business requirement under IRC section 355(b).

²⁵ See Rev. Rul. 74-79 and accompanying authorities cited in footnote 17.

prior to TIPRA. As a result, while Distributing would be treated for federal income tax purposes as satisfying the active trade or business requirement of IRC section 355(b)(2)(A), by reason of IRC section 355(b)(3), Distributing would not satisfy the active trade or business requirement of IRC section 355(b)(2)(A) as in effect prior to TIPRA, and therefore would not be so treated for California franchise tax purposes.

As a result of the Sub 3 Conversion, the Sub 3 Business A Business will be treated as directly held by Distributing for California franchise tax purposes such that Distributing will be treated as engaged directly in the active conduct of a trade or business, thereby simultaneously satisfying the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.

b. Active Trade or Business Conducted by Controlled Pursuant to the Holding Company Test

Controlled will not directly conduct an active trade or business after the External Distribution. Instead, Controlled will rely on the Business I Business, the Business G Business and the Business E Business to meet the active trade or business requirement for the External Distribution.

Immediately after the Distributing Contribution and the Controlled Contribution, respectively, Controlled will own all of the outstanding stock of Controlled 3 and Distributing 2. Controlled will also own approximately dd percent²⁶ of the sole class of outstanding stock of Controlled 4, with the remaining approximately ll percent owned by Distributing 2.²⁷ As described above, Controlled 3 will directly conduct an active trade or business (the Business I Business), Distributing 2 will directly conduct an active trade or business (the Business E Business) and Controlled 4 will be treated as conducting an active trade or business indirectly (pursuant to the holding company test) through its wholly owned subsidiary, Distributing 5 (the Business G Business).

For California franchise tax purposes, Controlled will satisfy the holding company test for the External Distribution also by relying on the active trade or business conducted by each of Controlled 3, Distributing 2 and Controlled 4. In that regard, it has been represented that, immediately after the External Distribution, at least ee percent of the fair market value of the gross assets of Controlled will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in IRC section 355(b)(2).²⁸ Accordingly,

²⁶ Because there is only one class of stock outstanding, Controlled will “control” Controlled 4 within the meaning of IRC section 368(c).

²⁷ Distributing will transfer to Controlled its intercompany debt account receivable balances with each applicable domestic entity engaged in the Business B Business. It is expected that Controlled will contribute some or all of such receivables to Distributing 2 prior to the External Distribution.

²⁸ Because Controlled 4 is treated as engaged in an active trade or business through the holding company test, Controlled itself can rely on Controlled 4’s active trade or business in order to satisfy the holding company test. See Rev. Rul. 74-382, 1974-2 C.B. 120 (holding the distributing corporation, X, satisfies the active trade or business requirement of IRC section 355(b) where, immediately after the distribution, all of X’s assets consist of the stock of Z, a corporation treated as

Controlled will simultaneously satisfy the active trade or business requirement of IRC section 355(b)(2)(A) for California franchise tax purposes.²⁹

D. Noneconomic Substance Transactions (NEST) Under CR&TC Section 19774

CR&TC section 19774, as originally enacted, is effective for penalties assessed on or after January 1, 2004. CR&TC section 19774 states that if a taxpayer has a noneconomic substance transaction understatement, a penalty is imposed for an understatement attributable to any noneconomic substance transaction. The penalty is 40 percent of the understatement of tax.³⁰ If the transaction is adequately disclosed by a taxpayer in a return (or a statement attached to the return) the penalty is decreased to 20 percent of the understatement of tax.³¹

A noneconomic substance transaction includes the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance, including a transaction or arrangement in which an entity is disregarded as lacking economic substance.³² A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose in entering into the transaction.³³

For taxable years beginning on or after January 1, 2005, the penalty imposed under Cal. Rev. and Tax. Code section 19774 relates to "noneconomic substance transaction understatements". The term "noneconomic substance transaction understatement" means an understatement arising from any transaction that does not have a valid nontax California business purpose. This penalty is imposed at a rate of 40 percent of

engaged in the active conduct of a trade or business through the operations of subsidiaries controlled by Z); PLR 200209047 (Immediately after the distribution, at least 90 percent of the gross assets of Distributing consists of the stock of Corp 2 and Corp 3, a controlled corporation that is engaged in the Active Conduct of a Trade or Business. Also, at least 90 percent of the gross assets of Corp 2 will consist of the stock of Corp 4 and Corp 5, each controlled corporations engaged in the Active Conduct of a Trade or Business.)

²⁹ Controlled will receive the stock of Controlled 3, Distributing 2 and Controlled 4 from Distributing pursuant to the Distributing Contribution. Distributing will have received the stock of Controlled 3 and Controlled 4 pursuant to the Controlled 3 Distribution and the Controlled 4 Distribution, respectively. The Controlled 3 Distribution and the Controlled 4 Distribution will each qualify as a tax free distribution (under IRC sections 355 and 368(a)) in which no gain or loss will be recognized in whole or in part to any party to the transaction. Accordingly, Distributing's acquisition of Controlled 3 and Controlled 4 within the 5-year period of the External Distribution will satisfy the requirement of IRC section 355(a)(2)(D) that control of Controlled 3 and Controlled 4 not be acquired directly or indirectly in a transaction in which gain or loss is recognized in whole or in part. See also Treas. Reg. §1.355-3(b)(4)(iii) (because Distributing and Distributing 3 are members of the same affiliated group for purposes of this section, Distributing's acquisition of Controlled 3 and Controlled 4 are not the type of transactions to which IRC section 355(b)(2)(D) is intended to apply even if gain or loss were recognized on the Controlled 3 Distribution or Controlled 4 Distribution); Rev. Rul. 69-461, 1969-2 C.B. 52 (a distribution of stock from one corporation to another, where the distributee is in control of distributor, is not the type of transaction that IRC section 355(b)(2)(D) was designed to prevent).

³⁰ CR&TC §19774(a).

³¹ CR&TC §19774(b)(1).

³² CR&TC §19774(c)(2).

³³ *Id.*

any understatement that occurs as a result of a noneconomic substance transaction.³⁴ In instances where the taxpayer adequately disclosed the relevant facts affecting the tax treatment of the item on the return, however, the penalty can be reduced in half.³⁵

Distributing has represented that the Distributions are motivated, in whole or in substantial part, by one or more of the valid nontax Corporate Business Purposes described above.³⁶ In addition, the taxpayer has represented that the Distributions will not be undertaken to reduce the California franchise tax liability of Distributing and its subsidiaries, except to the extent that certain steps of the Proposed Transaction enable the Distributions to qualify as tax-free transaction for California franchise tax purposes.

Each of the Relevant Transactions, which are principally intended to further the relevant corporate business purposes described herein and/or to facilitate qualification of the Distributions under IRC section 355(b) for California franchise tax purposes, will be considered to have a valid nontax California business purposes such that no steps in the Relevant Transactions will be treated as lacking economic substance for purposes of CR&TC section 19774(c)(2). Moreover, the form of the Relevant Transactions will be respected and none will be disregarded or recharacterized as a "sham" because each of the Relevant Transactions has been undertaken to facilitate the Distributions, which have a valid nontax California business purpose. Accordingly, none of the Relevant Transactions will constitute a noneconomic substance transaction and, as a result, the noneconomic substance transaction understatement penalty will not apply to any of the foregoing transactions for California franchise tax purposes.

VI. SCOPE OF RULING

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayers and are based upon and limited to the facts you have submitted. FTB has not verified any of the materials submitted in support of the request for this Chief Counsel Ruling, has provided no ruling or opinion with respect to whether the Relevant Transactions have a valid business purpose as described herein above, and is relying on the private letter ruling issued by the IRS regarding the Relevant Transactions. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to the request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur and to promptly notify FTB should these changes occur.

³⁴ CR&TC §19164(a)(4).

³⁵ CR&TC §19164(b).

³⁶ See PLR 200532011 (April 29, 2005) and PLR 200114002 (April 9, 2001) (ruling that a number of internal proposed restructuring transactions that were carried out to facilitate a tax-free spin-off under section 355 were tax-free reorganizations under IRC section 368).

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Sincerely,

Shane J. Hofeling
Tax Counsel III

cc: *****