Internal Revenue Service

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Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:CORP:2-PLR-107689-01
Date:
May 15, 2001

Legend:

Distributing	=
Controlled	=
Division	=
Business A	=
Business B	=
Employee T	=
Employee U	=
State X	=

This letter responds to a letter dated January 31, 2001, submitted on your behalf by your authorized representative, in which rulings were requested regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in letters dated March 15 and April 19, 2001, is substantially as set forth below.

Distributing is a State X corporation engaged in Business A. Distributing uses the accrual method of accounting and files its federal income tax return on a calendar year basis. Distributing currently has five shareholders.

Division is engaged in Business B. Division has been operated as a separate division since its acquisition more than ten years ago.

Employee T is the general manager and sales manager of Division. He is responsible for all facets of sales, vendor relations and shop methods of Division. Employee U is a salesman for Division and accounts for more than 50% of its sales. Employee T and Employee U (sometimes hereinafter “Key Employees”) desire to invest in Division. Distributing believes that it must provide Key Employees the opportunity to acquire equity in Division so that they will continue employment with Division, and so that Division may continue to attract new recruiting candidates. Management of Distributing feels that unless Key Employees are given an opportunity to become partial owners of Division, they will leave Division for other opportunities. Currently the cost of Distributing stock would be expensive for the Key Employees since its price includes assets other than Division. In addition, the stock of Distributing is not publicly traded so it is not readily available for purchase. The information submitted indicates that the objective of the proposed Distribution, which is to permit Business B to attract, retain, and motivate key management employees, can be achieved only by offering equity interests in Business B as a stand alone company, and cannot be achieved through an alternative transaction not involving the distribution of Controlled stock.

Accordingly the following transaction has been proposed:

(1) Controlled, a new State X corporation, will be formed.

(2) Distributing will contribute to Controlled all of the assets of Division in exchange for 100 percent of the outstanding common stock of Controlled and the assumption by Controlled of the liabilities relating to Division.

(3) Distributing will distribute the shares of Controlled to its shareholders pro-rata (the "Distribution").

(4) Within one year of the Distribution, Employee T and Employee U, will purchase from Controlled, shares of common stock of Controlled which will total at least 5 percent of the outstanding stock of Controlled.

Financial information has been provided showing that Distributing and Division have receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

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

(a) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

(b) The fair market value of the gross assets of the active trade or business directly conducted by Distributing will be, immediately after the Distribution, equal to or greater than 5 percent of the fair market value of all of Distributing's assets.

(c) The fair market value of the gross assets of the active trade or business directly conducted by Controlled will be, immediately after the Distribution, equal to or greater than 5 percent of the fair market value of all of Controlled's assets.

(d) The five years of financial information submitted on behalf of Distributing and Division is representative of their present operation, and with regard to each such business, there have been no substantial operational changes since the date of the last financial statements submitted.

(e) Following the proposed transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with their separate employees.

(f) The Distribution will be carried out for the following corporate business purpose: to motivate Controlled's executives to focus on and increase the growth and profitability of the business conducted by Controlled following the spinoff. The Distribution is motivated in whole or substantial part by this corporate business purpose.

(g) There is no plan or intention by any shareholder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either Distributing or Controlled after the transaction, except that some Distributing shareholders may make gifts of Distributing and/or Controlled stock to family members or charitable organizations.

(h) There is no plan or intention by either Distributing or Controlled, directly or indirectly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.

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

(j) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equal or exceed the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.

(k) The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

(l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled's stock.

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

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

(o) The Distribution is not part of a plan or series of related transactions (within the meaning of § 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50 percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock of either

Distributing or Controlled.

(p) The spinoff will not be a disqualified transaction within the meaning of § 355(d)(2) because, during the five-year holding period ending on the date of the spinoff and immediately after the spinoff, no person has held, nor will hold, disqualified stock of either Distributing or Controlled which constitutes a 50% or greater interest in either corporation.

(q) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be taxed as an S corporation on the first available date after the spinoff. There is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

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

(1) The transfer by Distributing to Controlled of the Division assets described above in exchange for all the stock of Controlled and the assumption by Controlled of liabilities associated with Division followed by the distribution of Controlled stock will qualify as a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each 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 to Controlled in exchange for Controlled stock and Controlled’s assumption of liabilities associated with the Division Assets (§§ 361(a) and 357(a)).

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

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

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

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

(7) No gain or loss will be recognized by (and no amount will be included in the income of) Distributing's shareholders upon receipt of the Controlled stock (§ 355(a)(1)).

(8) The basis of the stock of Distributing and Controlled in the hands of the Distributing shareholders after the Distribution will, in each instance, be the same

as the aggregate basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§ 358(a)(1)).

(9) The holding period of the Controlled stock in the hands of the Distributing shareholders will include the holding period of the Distributing stock with respect to which the Distribution is made, provided that such stock was held as a capital asset by such shareholder on the date of the Distribution (§ 1223(1)).

(10) 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).

(11) Controlled will be subject to § 1374 with respect to any asset transferred to it from Distributing to the same extent Distributing was subject to § 1374. Controlled's recognition period will be reduced by the portion of Distributing's recognition period that expired prior to the transfer of assets to it (§ 1374(d)(8)).

No opinion is expressed regarding the tax treatment of the transaction under any other section of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered in the above rulings.

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

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,
Associate Chief Counsel (Corporate)
By: Gerald B. Fleming
Senior Technician Reviewer, Branch 2