

Internal Revenue Service

Department of the Treasury

Index Number: 0355.00-00

Washington, DC 20224

Number: **199917026**

Person to Contact:

Release Date: 4/30/1999

Telephone Number:

Refer Reply To:

CC:DOM:CORP:5 PLR-118578-98

Date:

January 27, 1999

Re:

Distributing =

Controlled =

Business A =

Business B =

Shareholder N =

Shareholder M =

P percent =

Q percent =

R percent =

State Z =

Dear

This is in reply to a letter dated September 21, 1998, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was received on December 4, 1998, January 11 and 26, 1999. The material submitted for consideration is summarized below.

Distributing is a State Z corporation, the stock of which is held by Shareholders N and M, owning P and Q percent respectively. Shareholders N and M have owned Distributing for more than five years. Distributing is currently engaged in the conduct of both Business A and Business B.

Distributing has submitted data indicating that both Business A and Business B have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years. Controlled will be formed to effectuate the transaction described below. After the transaction Controlled will engage in Business B and Distributing in Business A.

There are presently seven key employees in Distributing's Business B who are important to its ongoing success. They possess technical skills that are highly sought after by Distributing's competitors. These key employees would like to acquire an equity interest in Business B and direct the future development of Business B. The key employees cannot afford to purchase shares in Distributing because Distributing's value is comprised of both Business A and B. Also, the key employees do not want their equity interest in Business B to be affected by the success or failure of Business A. Distributing has provided information showing that transferring the Business B division to a subsidiary, limited liability corporation or partnership is impractical and will cause conflict between the two businesses and their respective managements.

Accordingly, the following transaction is proposed:

- (i) Distributing will transfer its Business B assets to newly formed Controlled in exchange for all the outstanding Controlled stock and the assumption by Controlled of the liabilities associated with the transferred assets.
- (ii) Distributing will distribute its Controlled stock pro rata to its shareholders.
- (iii) The key employees of Controlled will acquire R percent of Controlled common stock. They will receive their shares ratably over a five year period beginning with the formation of Controlled. Approximately half of these shares will be provided to the key employees pursuant to a stock ownership incentive program as part of their compensation benefits, the remainder will be purchased by the key employees.

The taxpayer has made the following representations with respect to the proposed transaction:

- (a) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- (b) No part of the consideration to be distributed by the Distributing corporation will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (c) The five years of financial information submitted on behalf of the Distributing corporation is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (e) The distribution of the stock of Controlled is being carried out for the corporate business purpose of providing a substantial equity interest in Business B to its key employees. The distribution of the stock of Controlled is motivated by this purpose.
- (f) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after this transaction.
- (g) There is no plan or intention by Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction.
- (h) 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 after the transaction, except in the ordinary course of business.
- (i) The total adjusted bases and fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.
- (j) 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.

- (k) 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 arms length. Distributing, until such time that it is practical to change, will lease space to Controlled.
- (l) No two parties to the transaction are investment companies or defined in § 368(a)(2)(F)(iii) and (iv).
- (m) The Distributing corporation is not an S corporation (within the meaning of § 1361 (a)), and there is no plan or intention by the Distributing or Controlled corporations to make an S corporation election pursuant to § 1361(a).
- (n) 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.

Based solely on the information submitted and on the representations set forth above, we hold as follows with respect to the proposed transaction:

- (1) The transfer by Distributing to Controlled of all of the Business B assets, solely in exchange for all the stock of Controlled, plus the assumption by Controlled of liabilities associated with the Business B assets, followed by the distribution of the Controlled stock, as described above, will qualify as a reorganization within the meaning of § 368(a)(i)(D) of the Internal Revenue Code. 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 to Distributing upon the transfer of assets, subject to liabilities, to Controlled in exchange for Controlled stock (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized to Controlled upon the receipt of Distributing’s Business B assets in exchange for Controlled stock (§ 1032(a)).

- (4) The basis of the Distributing assets received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately before such transfer (§ 362(b)).
- (5) The holding period of the Distributing 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 to Distributing upon the distribution of all of the Controlled stock (§ 361(c)(1)).
- (7) No gain or loss will be recognized to (and no amount will be included in the income of) Distributing's shareholders upon the receipt of 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 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) of the Income Tax Regulations (§ 358(a)(1)).
- (9) The holding period of the Controlled stock received by each Distributing shareholder will include the holding period of the Distributing stock with respect to which the distribution was made, provided that such Distributing stock is held as a capital asset 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 in accordance with § 1.312-10(a) of the Regulation.

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by penalties of perjury statements executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the information, representations and other data may be required as part of the audit process.

No opinion is expressed concerning the federal income tax treatment under 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 transaction that are not specifically covered by the above rulings.

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3)

provides that it may not be used or cited as precedent. Each affected taxpayer must attach a copy of this letter to the federal income tax return for the taxable year in which the transaction covered by this letter ruling is consummated.

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

Sincerely yours,

Assistant Chief Counsel (Corporate)

By _____
Filiz A. Serbes
Assistant to the Chief, Branch 5