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LEGEND

Distributing =

Controlled =

Business A =

Business B =

Shareholder A =

Shareholder B =

Employee A =

Employee B =

Employee C =

YY =

ZZ =

State A =

Year 1 =

aa =

bb =

cc =

dd =

ee =

ff =

gg =

This letter responds to your September 6, 2001 request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondence is summarized below.

SUMMARY OF FACTS

Distributing was incorporated in Year 1 in State A, and uses the accrual method of accounting. Distributing directly engages in Businesses A and B. Shareholder A owns aa percent of Distributing, and Shareholder B owns bb percent of Distributing.

Employee A, a child of Shareholder A and Shareholder B, is a YY manager of Business A. Employee B also is a YY manager of Business A. Employee C is a ZZ manager of Business A. All three employees are Key Employees of Business A and possess the management skills necessary for the future development and continuation of that business.

The information submitted indicates that the objective of the proposed Distribution, which is to permit Business A to retain and motivate key management employees, can be achieved only by offering equity interests in Business A 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 A corporation, will be formed.
- (2) Controlled will use the cash method of accounting, and will be engaged in Business B.
- (3) Distributing will contribute to Controlled the assets of Business B in exchange for 100 percent of the outstanding common stock of Controlled and the assumption by Controlled of the liabilities relating to Business B.
- (4) Distributing will distribute the shares of Controlled to its shareholders pro-rata (the "Distribution").
- (5) Within one year of the Distribution, Shareholder B will transfer ff percent of the stock that Shareholder B owns in Distributing as follows: (a) cc percent to Employee A; (b) dd percent to Employee B; and (c) ee percent to Employee C. The remaining ff percent of the stock of Distributing held by Shareholder B after these transfers will be subsequently transferred (in the same percentages) to the three key employees over a gg-year period.

Financial information has been received which indicates that Distributing's Business A and Business B each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

REPRESENTATIONS

- (a) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any other capacity other than that of a shareholder of Distributing.
- (b) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation, and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) Following the transaction, Distributing and Controlled will each continue the active conduct of a business, independently and with separate employees.
- (d) The Distribution is carried out for the corporate business purpose of providing an equity interest in Distributing to key employees of Distributing. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (e) Except for the transfers of Distributing stock made from Shareholder B to Employee A, Employee B and Employee C in connection with the services performed by these three key employees for Distributing, 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 the transaction.
- (f) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.
- (g) 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.
- (h) For purposes of Section 355(d), immediately after the Distribution, no person (determined after applying Section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in Sections 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the date of the Distribution.
- (i) For purposes of Section 355(d), immediately after the Distribution, no person (determined after applying Section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in Sections 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the date of the Distribution, or (ii) attributable to distributions on Distributing stock that was acquired by purchase

(as defined in Sections 355(d)(5) and (8)) during the five-year period (determined after applying Section 355 (d)(6)) ending on the date of the Distribution.

- (j) The Distribution is not part of a plan or a series of related transactions (within the meaning of section 355(e)) pursuant to which one or more persons will acquire, directly or indirectly, stock possessing 50 percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled entitled to vote, or stock possessing 50 percent or more of the total value of shares of all classes of stock of either Distributing or Controlled.
- (k) Distributing will treat as compensation the Distributing stock transfers from Shareholder B to Employee A, Employee B and Employee C. The W-2s that Distributing issues to Employee A, Employee B and Employee C will reflect this compensation.
- (l) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.
- (m) 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.
- (n) No income items, including accounts receivable or any item resulting from a sale, exchange or disposition of property, that would have resulted in income to Distributing, and no items of expense will be transferred to Controlled if Distributing has earned the right to receive the income or could claim a deduction for the expense under the accrual or similar method of accounting.
- (o) No incorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.
- (p) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on the terms and conditions arrived at by the parties bargaining at arm's length.
- (q) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).

RULINGS

Based solely on the information submitted and on the representations set forth above, we hold as follows:

- (1) The transfer by Distributing to Controlled of the assets of Business B in exchange for all of the stock of Controlled and the assumption by Controlled of liabilities, if any, associated with the assets of Business B followed by the distribution of Controlled stock will qualify as a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be a "party to a

reorganization” within the meaning of section 368(b).

- (2) No gain or loss will be recognized by Distributing upon the transfer of the assets of Business B to Controlled in exchange for Controlled stock and the assumption of liabilities, if any. Sections 361(a) and 357(a).
- (3) No gain or loss will be recognized by Controlled on the receipt of the assets of Business B in exchange for all of the shares of Controlled stock. Section 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. Section 362(b).
- (5) The holding period of the assets received by Controlled will include the period during which Distributing held such assets. Section 1223(2).
- (6) No gain or loss will be recognized by Distributing upon the Distribution. Section 361(c).
- (7) No gain or loss will be recognized by (and no amount will be included in income of) Distributing shareholders upon receipt of the Controlled stock. Section 355(a).
- (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 sections 358(a) and 1.358-2(a)(2).
- (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 was made, provided that such stock is held as a capital asset on the date of the Distribution. Section 1223(1).
- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with section 1.312-10(a).

CAVEATS

No opinion is expressed about the tax treatment of the transaction under any other provision 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 by the above rulings. For example, no opinion is expressed concerning the income tax consequences associated with whether Employee A, Employee B and Employee C are receiving compensation with respect to the stock that they receive in Distributing, and no opinion is expressed regarding whether Distributing may take an income tax deduction when Shareholder B transfers shares of stock in Distributing to Employee A, Employee B and Employee C, respectively.

PROCEDURAL STATEMENTS

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials 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.

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

A copy of this letter must be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction is consummated.

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

Sincerely yours,
Steven J. Hankin
Senior Technician Reviewer, Branch 6
Associate Chief Counsel (Corporate)

cc: