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Date:
January 19, 2001

Distributing =

Controlled =

business a =

business b =

employee A =
employee B =
employee C =
employee D =
employee E =
state R =
date S =
U =
W =
X =
Trust =
Y =
state Z =

This letter responds to a letter dated July 21, 2000, 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 October 5, November 2, and November 29, 2000, and January 5 and January 10, 2001, is substantially as set forth below.

Distributing is a state R corporation engaged in business a and business b. Distributing is the common parent corporation of an affiliated group that joins in the filing of a consolidated federal income tax return. Distributing uses an accrual method of accounting with a tax year ending December 31. As of date S, Distributing had outstanding W shares of a single class of voting common stock held by X shareholders of record. While no individual owns a greater-than-five-percent beneficial interest in the stock of Distributing, Trust holds Y percent (greater than five percent) of Distributing's outstanding stock.

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Distributing will form Controlled under state Z law solely for the purpose of completing the proposed transaction. Controlled will use an accrual method of accounting and will have a tax year ending December 31.

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

Distributing has become aware that certain employees who are key to the continued success of business b are considering leaving Distributing's business b due, in part, to their lack of ownership in the company for which they work. Employee A, employee B, employee C, and employee D have informed Distributing that unless it offers them the opportunity to hold an equity interest in business b as a separate, stand-alone company they will consider terminating their employment with Distributing. Employee E, a candidate to fill the CFO position for Distributing's business b, also has requested an opportunity to hold an equity interest in business b as a separate, stand-alone company as a condition to accepting the position of CFO. 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) On the date of the Distribution (described below), Distributing will contribute to Controlled all of 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.
- (2) Distributing will distribute shares of Controlled stock to employee A in exchange for employee A's shares of Distributing, and Distributing will distribute all of the other shares of Controlled, pro rata, to its shareholders other than employee A (the Distribution). If necessary, fractional shares will be issued.
- (3) Within one year of the Distribution, employee A, employee B, employee C, employee D, and employee E will purchase from Controlled, in exchange for three-year recourse notes, an aggregate of U percent of the shares of common stock of Controlled which, when added to the shares acquired by employee A in step (2) above, will total at least 5 percent of the outstanding stock of Controlled.

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

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- (a) The fair market value of the Controlled stock to be received by employee A will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the exchange.
- (b) 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.
- (c) The fair market value of the gross assets of Distributing's business a will be, immediately after the Distribution, equal to or greater than five percent of the fair market value of all of Distributing's assets.
- (d) The fair market value of the gross assets of Controlled's business b will be, immediately after the Distribution, equal to or greater than five percent of the fair market value of all of Controlled's assets.
- (e) The five years of financial information submitted on behalf of Distributing's business a and business b 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.
- (f) Following the proposed transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with their separate employees.
- (g) The Distribution will be carried out for the following corporate business purpose: to permit Controlled to provide certain key employees with significant equity interests in business b, in order to retain and incent these employees and recruit a qualified CFO. The Distribution is motivated in whole or substantial part by this corporate business purpose.
- (h) There is no plan or intention by any shareholder who owns 5 percent or more of the stock of Distributing, and, other than the shareholders' annual gifting of Distributing shares in the ordinary course of their estate planning, the management of Distributing, to its best knowledge, is not aware of any plan or intention on the part of any other particular remaining shareholder or security holder 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.
- (i) 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.

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- (j) 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.
- (k) 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 (as determined under § 357(d)).
- (l) The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of the business and are associated with the assets being transferred.
- (m) The income tax liability for the taxable year in which investment credit property (including any building to which § 47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) to reflect an early disposition of the property.
- (n) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled's stock.
- (o) Immediately prior to the Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations. Furthermore, any excess loss account of Distributing with respect to the Controlled stock will be included in income immediately before the Distribution, and any excess loss account of Controlled with respect to any consolidated subsidiary will be included in income immediately before 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 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 §§ 368(a)(2)(F)(iii) and (iv).
- (r) The Distribution is not part of a plan or 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, 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, it is held as follows:

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- (1) The transfer by Distributing to Controlled of the business b assets described above in exchange for all the stock of Controlled and the assumption by Controlled of liabilities associated with business b 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 the assumption of liabilities (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the receipt of the business b 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 (§ 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) No gain or loss will be recognized by (and no amount will be included in the income of) employee A upon his receipt of the Controlled stock in exchange for all of his Distributing stock (§ 355(a)(1)).
- (9) The basis of the stock of Distributing and Controlled in the hands of the Distributing shareholders (other than employee A) 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)).
- (10) The basis of the Controlled stock received by employee A will equal employee A's aggregate basis in the Distributing stock surrendered in the exchange (§ 358(a)(1)).
- (11) The holding period of the Controlled stock in the hands of the Distributing shareholders (other than employee A) will include the holding period of

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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)).

- (12) The holding period of the Controlled stock received by employee A will include the holding period of the Distributing stock surrendered in the exchange, provided that such stock is held as a capital asset on the date of the exchange (§ 1223(1)).
- (13) As provided in section 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made under §§ 1.312-10(a) and 1.1502-33(e).

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and 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 is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,
Associate Chief Counsel (Corporate)
By Michael J. Wilder
Senior Technician Reviewer, Branch 1