

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

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Date:

February 14, 2002

LEGEND:

Distributing =

Controlled =

State X =

State Y =

Business A =

Business B =

Employee C =

Employee D =

Family 1 =

Family 2 =

e =

f =

g =

h =

i =

j =

k =

l =

Year 1 =

This letter responds to your authorized representative's letter dated May 3, 2001, requesting rulings on certain federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated October 12, 2001, January 2 and January 30, 2002. The information submitted for consideration is summarized below.

FACTS

Distributing is a State X corporation engaged in Business A. Distributing is the common parent of a consolidated group that files a federal income tax return on a calendar year basis using the accrual method of accounting. Distributing has a single class of outstanding voting common stock, e% of which is held by members of Family 1 and f% of which is held by members of Family 2.

Controlled, a State Y corporation, was incorporated in Year 1 and is a member of Distributing's consolidated group. Controlled is engaged in Business B. Controlled has a single class of outstanding voting common stock, g% of which is held by Distributing, h% of which is held by Employee C, and i% of which is held by Employee D.

Financial information has been submitted indicating that Business A and Business B has each had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Employee C and Employee D (hereinafter referred to as "Key Employees") serve as the President and Vice-President of Controlled, respectively, and are solely responsible for the day-to-day management and operational activities of Controlled. Key Employees have significantly contributed to the financial success of Controlled, and Controlled's continued financial viability is heavily dependent upon their continued services.

Key Employees have requested the opportunity to obtain an additional, substantial equity ownership interest in Controlled in order to share in the capital appreciation directly resulting from the services they render, and to increase their control over Business B. An increased equity ownership in Controlled is acceptable to Key Employees only if the remaining Controlled shares are held by multiple shareholders rather than by Distributing. Key employees have indicated they intend to seek other employment if they are not permitted to purchase a substantial amount of additional Controlled stock.

PROPOSED TRANSACTION

Accordingly, the following transaction is proposed:

(i) Distributing will distribute all of its Controlled stock pro rata to Distributing's shareholders.

(ii) Within one year of issuance this letter ruling, Key Employees will exercise in full options previously granted by Controlled, and purchase from Controlled, in exchange for cash representing $j\%$ of the purchase price and five-year recourse notes, an aggregate of $k\%$ of Controlled's common stock which, when added to the shares already held by Key Employees, will total $l\%$ of Controlled's outstanding stock.

REPRESENTATIONS

The following representations have been made regarding 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 five (5) years of financial information submitted on behalf of Distributing is representative of the corporation's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

(c) The five (5) years of financial information submitted on behalf of Controlled is representative of the corporation's present operations, 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 is carried out for the corporate business purpose of permitting Key Employees of Controlled to substantially increase their equity interest in Controlled and thereby secure and enhance the management stability of Controlled. The distribution is motivated, in whole or substantial part, by this corporate business 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, or securities of, either Distributing or Controlled after the transaction.

(g) 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

§ 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.

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

(j) Immediately before the distribution, items of income, gain, loss, deduction and credit will be taken into account as required by the applicable intercompany transaction regulations. Further, any excess loss account of Distributing with respect to the Controlled stock will be included in income immediately before the distribution.

(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 by the parties bargaining at arm's length.

(l) 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 % or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing % or more of the total value of all classes of stock of either Distributing or Controlled.

RULINGS

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

(1) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) any shareholder of Distributing on receipt of Controlled stock (§ 355(a)(1)).

(2) No gain or loss will be recognized by Distributing upon the distribution of the Controlled stock as described above (§ 355(c)).

(3) The aggregate basis of the Distributing and Controlled stock in the hands of the shareholders after the distribution will equal the aggregate basis of the Distributing stock held by the shareholders immediately before the distribution, allocated between the Distributing and Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a)(1), (b)(2), and (c)).

(4) The holding period of the Controlled stock received by the shareholders will include the holding period of the Distributing stock with respect to which the distribution is made, provided that such Distributing stock is held as a capital asset on the date of

the distribution (§ 1223(1)).

(5) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a) and § 1.1502-33(e).

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

PROCEDURAL STATEMENTS

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

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

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

Sincerely,
Sean P. Duffley
Assistant to the Chief, Branch 4
Office of Associate Chief Counsel
(Corporate)