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February 11, 2002

Distributing =
State X =
Shareholder A =
Employee B =
Employee C =
Controlled =
Main Business =
! =
m =
n =
p =
Equipment Business =

Dear

This letter responds to your letter dated June 28, 2001, requesting rulings concerning the federal income tax consequences of a proposed transaction. The information submitted for consideration is summarized below.

Distributing is an accrual basis State X corporation. Distributing is engaged in two businesses, which are Main Business and Equipment Business. Distributing has a single class of common stock outstanding, all of which is held by Shareholder A. Employee B is unrelated to Shareholder A. Employee C is the son of Shareholder A.

Employees B and C each contribute significantly to the success of Main Business. They each possess specific work experience that is essential to Main Business, including over 15 years of experience in the Main Business industry. Distributing would like to provide Employee B and Employee C with a significant equity interest in Main Business. These employees presently can not afford to purchase a significant interest in Distributing, and desire to to be shareholders of a stand-alone corporation that is engaged solely in Main Business. In addition, transferring Main Business to a subsidiary would be impractical because of certain licensing and other requirements. Accordingly, the following transaction has been proposed (and partially consummated).

- (1) Distributing has formed Controlled, an accrual basis State X corporation. Controlled has a single class of common stock outstanding.
- (2) Distributing will transfer to Controlled its Equipment Business assets and liabilities in exchange for Controlled stock.
- (3) Distributing will distribute all the Controlled stock to Shareholder A (the "Distribution").
- (4) As soon as is reasonably convenient after the Distribution, and in all events within one year of the Distribution, Employee B will purchase from Distributing a significant amount of stock (constituting l percent of Distributing's outstanding stock). Within the same time period, Employee C will also purchase l percent of Distributing's outstanding stock. Employee B will pay for the stock with a 5-year \$m fully recourse promissory note and \$n of cash, and Employee C will pay for the stock with a \$p fully recourse promissory note.

Employees B and C will each enter into multi-year senior-position employment agreements with Distributing and become members of Distributing's board of directors. It is anticipated that Employees B and C will subsequently each acquire an additional l percent interest in Distributing (depending in part on the bonuses they earn in the course of their employment and Distributing's gross profits).

Distributing has submitted financial and employee information indicating that both Main Business and Equipment Business have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

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

- (a) Distributing, Controlled, Shareholder A, Employee B, and Employee C will each pay their own expenses in connection with the transaction.
- (b) The 5 years of financial information submitted on behalf of Distributing's

Main Business and Equipment Business is representative of the corporation's present operations, and with regard to each of these two businesses 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 its business, independently and with its separate employees.
- (d) The Distribution is being carried out for the purpose of enabling Employees B and C to receive a significant equity interest in Main Business. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (e) Distributing is not an S corporation (within the meaning of §1361(a)) and there is no plan or intention by Distributing or Controlled to make an S corporation election pursuant to § 1362(a).
- (f) There is no plan or intention by Shareholder A to sell, exchange, transfer by gift, or otherwise dispose of any of his stock in 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.
- (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, except in the ordinary course of business.
- (x) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will each equal or exceed the sum of the liabilities assumed by Controlled (within the meaning of § 357(d)).
- (j) The liabilities of Distributing assumed by Controlled (within the meaning of § 357(d)) and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets transferred.
- (k) Although investment tax credits were claimed with respect to certain of the properties being transferred to Controlled, the recapture periods for such credits have expired (except with respect to one property). The income tax liability for the taxable year in which such investment credit property is transferred will be adjusted in accordance with applicable law to reflect an early disposition of the property.

- (l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the transaction.
- (m) Payments made in connection with any continuing transactions 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) Neither Distributing nor Controlled is an investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (a) 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 the representations set forth above, we hold as follows:

- (1) The transfer in Step (2) above by Distributing to Controlled of Equipment Business assets in exchange for all the stock in Controlled and the assumption by Controlled of associated liabilities followed by the distribution in Step (3) above of all the Controlled stock to Shareholder A constitutes a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled will each be "party to a reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing on the transfer of assets to Controlled in exchange for all the stock of Controlled and the assumption of liabilities (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on its receipt of assets in exchange for Controlled stock (§ 1032(a)).
- (4) Controlled's basis in the assets received from Distributing will equal the basis of such assets in the hands of Distributing immediately prior to the transfer (§ 362(b)).
- (5) Controlled's holding period for the assets received from Distributing 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)(1)).

- (7) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder A upon the receipt of Controlled stock in the Distribution (§ 355(a)(1)).
- (8) Shareholder A's total basis in the Controlled stock and the Distributing stock held after the Distribution will be the same as the basis of this Distributing stock immediately before the Distribution allocated in proportion to the relative fair market values of the Controlled stock and Distributing stock in accordance with § 1.358-2(a)(2).
- (9) The holding period of the Controlled stock received by Shareholder A will include the period during which he held the Distributing stock provided that the Distributing stock is a capital asset in the hands of Shareholder A on the date the Distribution is consummated (§ 1223(1)).
- (10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with § 1.312-10(a).

No opinion is expressed about the tax treatment of the proposed transactions 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 taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this letter are consummated.

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