

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP-PLR-101223-03
Date:
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Distributing =
Controlled =
Business 1 =
Business 2 =
Shareholder A =
Shareholder B =
Shareholder C =
Shareholder D =
State A =
Date XXXX =
#a =
#b =
#c =
#d =
#e =
#f =

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#g =

aa =bb =cc =dd =ee =

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This letter responds to your December 12, 2002, request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondences dated March 18, 2003, March 26, 2003 and April 23, 2003 is summarized below.

The taxpayer, Distributing, was incorporated as a Subchapter C corporation in State A on Date XXXX. Distributing directly conducts Business 1 and Business 2.

Distributing has one class of voting common stock issued and outstanding.

Distributing currently has #a shares of voting common stock issued and outstanding. This stock is owned by Shareholders A, B, C, and D. Shareholder A owns #b shares Shareholder B owns #c shares, Shareholder C owns #d shares, Shareholder D owns #e shares.

Financial information has been received indicating that Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Business 1 has several key employees who wish to obtain an equity interest in Distributing. In order to increase the motivation and retain the services of these key employees, Distributing wishes to compensate these employees with Distributing stock.

The transfer of Distributing's stock to the key employees will accomplish a real and substantial business purpose germane to a business of Distributing. Each key employee provides unique and valuable services to Business 1. The key employees will be substantially motivated to increase the profitability and value of Business 1 if they are granted stock in Distributing, due to the fact that they will directly benefit from this increase in profitability and value through the ownership of the equity interest in Distributing.

In addition, only one current shareholder takes an active part in the management of

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Distributing. This shareholder recently has spent minimal time managing Business 1 due to his lobbying efforts for Business 2. Therefore, Distributing has been completely dependent on the services of these key employees. It is vital to the ongoing success of Distributing that the services of the key employees be retained, otherwise the time and expense that will have to be expended to replace them would be great. It would be extremely difficult to find individuals with similar experience, reputation, knowledge and reputation within the Business 1 industry.

Each key employee shall receive his shares of newly issued Distributing stock as additional compensation, and each key employee shall be liable for all tax consequences attributable to the receipt of common stock.

The objective of compensating key employees of Distributing cannot be accomplished by transferring Business 2 to a wholly owned subsidiary or LLC of Distributing. Business 2 is focused on long-term investments of capital because the growth cycle of aa is generally anywhere between #f to #g years. This results in a lack of cash flow from Business 2. In order to make up for the lack of cash flow of Business 2, Business 1 must make capital contributions to Business 2. This cash drain prevents Business 1 from maximizing revenue by reinvesting such revenue in Business 1. As a result, the potential for growth in the value of the stock in Distributing to be received by key employees would be substantially lower if Distributing holds the stock of a subsidiary containing Business 2 rather than separating Business 2 from Business 1 completely. Merely dropping Business 2 into a wholly owned subsidiary of Distributing will not sufficiently separate Business 2 from Business 1 to prevent the operation of Business 2 from adversely affecting the value of the Distributing stock to be issued to the key employees.

In addition, Distributing wishes to reduce and isolate the risk implicit in Business 1 from Business 2. The bb process used in connection with Business 1 poses significant, hazardous, environmental risks because of the chemicals used in connection with the bb process. The bb process involves the penetration and impregnation of cc with chemical preservatives to resist attack from dd.

The hazardous nature of Business 1 subjects Business 1 and Distributing to possible significant environmental liabilities under various state and federal statutes, including the Comprehensive Environmental Response Compensation and Liability Act. (CERCLA). The insurance policies of Distributing do not include coverage with respect to these environmental liabilities. Distributing has provided evidence that the cost of insurance to protect Distributing's assets from the environmental risks associated with Business 1 would be prohibitively expensive.

In addition the bb industry has recently become the subject of class action law suits filed on behalf of customers purchasing the ee. The filing of these law suits are due to the alleged health problems connected with the ee.

Based upon the opinion of taxpayer's environmental law counsel, the only way to legitimately protect Business 2 from the environmental risks of Business 1 is for

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Distributing to form a wholly owned subsidiary and contribute either Business 1 or Business 2 to that subsidiary and then spin that subsidiary to the Distributing shareholders.

If Distributing were to simply contribute Business 1 to a wholly owned subsidiary or LLC, there is a possibility that under state law, the wholly owned subsidiary or LLC would be considered an alter ego of Distributing, and that therefore, Distributing's assets would be subject to attack from creditors. Distributing's assets would include Business 2.

Accordingly, in order to protect Business 2 from the risks of Business 1 and properly motivate and retain key employees of Distributing, the taxpayer has proposed the following transaction:

- (i) Distributing will form Controlled as a State A corporation.
- (ii) Distributing will transfer to Controlled all of the assets and liabilities of Business 2 in exchange for all the Controlled stock. Distributing will then hold all the stock of Controlled.
- (iii) Distributing will distribute all of the Controlled voting stock pro rata to the common shareholders of Distributing.
- (iv) Within one year of the proposed distribution of the Controlled stock, the key employees, as a group, will receive five percent of the common stock of Distributing directly from Distributing, which is a significant amount in terms of percentage and value of the stock of Distributing. The key employees will receive the stock of Distributing pursuant to the Equity Incentive Compensation Agreements executed between Distributing and each key employee. Each key employee shall receive shares of common stock that carries with them the same rights and privileges as all the current outstanding shares of common stock of Distributing, including the right to vote.

The taxpayer has made the following representations in connection with the proposed transaction:

- (a) 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.
- (b) The 5 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.
- (c) The distribution of the stock, or stock and securities, of the Controlled corporation is carried out for the following corporate business purposes: (1) To

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increase the motivation and retain the services of key employees. (2) To reduce and isolate the risk implicit in Business 1 from Business 2.

- (d) There is no plan or intention by the shareholders or security holders of the Distributing corporation to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either the Distributing or Controlled corporation after the transaction.
- (e) There is no plan or intention by either the Distributing corporation or the Controlled corporation, 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.
- (f) There is no plan or intention to liquidate either the Distributing or Controlled corporation, 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.
- (g) 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 Section 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the distribution date.
- (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 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 Section 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the distribution date, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in Section 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the distribution date.
- (i) 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 fifty percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing fifty percent or more of the total value of all classes of stock of either Distributing or Controlled.
- (j) The total adjusted bases and the fair market value of the assets transferred to

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- the Controlled corporation by the Distributing corporation each equals or exceeds the sum of the liabilities assumed by the Controlled corporation (as determined under section 357(d)).
- (k) The liabilities assumed in the transaction (as determined under section 357(d)) were incurred in the ordinary course of business and are associated with the assets being transferred.
 - (l) The Distributing corporation neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
 - (m) Payments made in connection with all continuing transactions, if any, between the Distributing and Controlled corporation, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
 - (n) Except for receivables arising in the ordinary course of business, no intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled corporation stock.
 - (o) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
 - (p) The gross assets of the trades or businesses that will be relied upon by Distributing and Controlled to satisfy the active trade or business requirement of § 355(b) will, in the aggregate, have a fair market value that is not less than five percent of the total fair market value of the gross assets of the company directly operating such trades or businesses.
 - (q) 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 corporation to make an S corporation election pursuant to §1362(a).
 - (r) Except for certain administrative employees that Distributing and Controlled will share for a period of no more than one year from the date of distribution, following the transaction, the Distributing and Controlled corporation will each continue the active conduct of its business, independently and with its separate employees.
 - (s) The indebtedness owed by the Controlled corporation to the Distributing corporation after the distribution of the Controlled corporation stock will not constitute stock or securities.
 - (t) The income tax liability for the taxable year in which investment credit property (including any building to which section 47(d) applies) is transferred will be

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adjusted pursuant to section 50(a)(1) or (a)(2) (or section 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

Based solely on the information submitted and the representations made, we have concluded that:

- (1) The transfer by Distributing of Business 2 Assets to Controlled in exchange for all of the Controlled stock and the assumption by Controlled of certain liabilities associated with the Business 2 assets transferred, followed by the pro rata distribution by Distributing of all of the Controlled stock to the Distributing shareholders, will constitute a reorganization within the meaning of section 368(a)(1)(D) of the Internal Revenue Code. Distributing and Controlled will each be a "party to the reorganization" within the meaning of section 368(b).
- (2) No gain or loss will be recognized by Distributing upon its receipt of Controlled stock in exchange for the transfer of assets to, and the assumption of liabilities by Controlled. Section 361(a) and Section 357(a).
- (3) No gain or loss will be recognized by Controlled upon its receipt of assets in exchange for its issuance of shares of Controlled stock. Section 1032.
- (4) Controlled's basis in the assets received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transfer. Section 362(b).
- (5) The holding period of each asset received by Controlled from Distributing will include the period during which Distributing held such asset. Section 1223(2).
- (6) Distributing will not recognize gain or loss upon the distribution of the stock in Controlled to the Distributing shareholders. Section 361(c)(1).
- (7) No gain or loss will be recognized to (and no amounts will be included in the income of) the Distributing shareholders upon their receipt of Controlled stock. Section 355(a)(1).
- (8) The aggregate basis of the Distributing stock and the Controlled stock in the hands of the Distributing shareholders after the distribution will equal the aggregate adjusted basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each under Treas. Reg. Section 1.358-2(a)(2).
- (9) The holding period of the Controlled stock received by the Distributing shareholders will, in each instance, include the holding period of the Distributing stock with respect to which the distribution will be made, provided that the Distributing stock is held as a capital asset on the day of the distribution. Section 1223(1).

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- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with Treas. Reg. sections 1.312-10(a).

We express no opinion about the tax treatment of the transaction under any other section 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 in the above rulings.

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 upon examination.

This ruling 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 ruling letter should be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction is consummated.

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

Sincerely yours,

Steven J. Hankin
Senior Technician Reviewer
Branch 6
Office of Associate Chief Counsel
(Corporate)

cc: