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Distributing =
Controlled =
Business A =
Activity B =
Shareholder A =
Shareholder B =
Shareholder C =
Location A =
Location B =
State A =
Industry M =

Dear:

This letter responds to a letter dated June 7, 2000, requesting a ruling as to the federal income tax consequences of a proposed transaction. The information submitted in that letter and subsequent correspondence is summarized below.

Distributing, a State A corporation, is a C corporation that uses the accrual method of accounting and a calendar year. For many years Distributing has been engaged in Business A serving both large and smaller clients. Distributing has outstanding solely common stock, all of which is held by Shareholders A, B, and C or trusts for their benefit. Shareholders A and B are brothers. Shareholder C is their mother. Approximately 4 years ago, a trust for the benefit of Shareholder C transferred substantial amounts of Distributing stock to trusts for the benefit of Shareholder C's children; however, under the attribution rules of § 355(d)(8) and the aggregation rules of § 355(d)(7), Shareholder C and these trusts are treated as "one person." A Stock Retirement Agreement requires Distributing to purchase and shareholders to sell their Distributing stock at book value under certain circumstance and imposes limits on a shareholder's transfer of the stock.

Controlled is a C corporation being formed under the laws of State A. It will use the accrual method and a calendar year. Controlled will have outstanding solely common stock, all of which will initially be held by Distributing.

The financial information received indicates that Business A has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

Substantially all of Business A's sales are to Industry M. Industry M product price, profitability, and amount of new activity vary significantly from year to year. When Industry M is unprofitable and less active, demand for Business A products is substantially reduced. In recent years, because of Industry M's reduced profitability, many companies engaged in Business A have operated at a loss and some have gone out of business. Similarly, Distributing, for most of the past 10 years, has operated Business A at a loss. At present, however, Industry M is highly profitable and there is substantial demand for Business A products.

Distributing's Business A is split between Locations A and B. Shareholder A, Distributing's president, is in charge of operations at Location A. Shareholder B, Distributing's vice-president, is in charge of operations at Location B. Shareholders A and B have different and/or conflicting management styles and business views. Shareholder B is confident of the prospects for Business A and is modernizing using a computerized invoicing and billing system to manage sales activity to increase efficiency at location B. Shareholder A, however, still conducts these operations manually at Location A. Shareholder A is concerned about costs and does not want to increase overhead or expand operations at Location B. Because of differences over staff compensation, expansion in a recovering market, and other matters, Shareholders A and B desire to divide Distributing so that each of them can independently operate their own portion of Business A. Shareholder C will be a minority owner in each of the businesses, but will be active only in Distributing. Shareholder C will not participate in management, operations, or any aspect of the business of Controlled. Shareholder A and Shareholder B each believes he can operate his portion of Business A more effectively as a separate business with its own business plan and compensation schedule. Accordingly, the following steps are proposed:

- (I) Distributing is transferring to Controlled approximately half its assets (including receivables, inventory, and customer accounts related to or intended for use in the Location B operation of Business A) in exchange for all the outstanding stock in Controlled and the assumption by Controlled of liabilities related to the assets transferred to Controlled. (Distributing will retain assets and liabilities intended for use in or related to the operation of Business A in Location A.)
- (II) Distributing will distribute all the outstanding stock in Controlled to Shareholders B and C and/or trusts for their benefit in exchange for stock in Distributing. Following the exchange: Shareholder A and trusts for his benefit will hold a majority of the stock in Distributing and no stock in Controlled; Shareholder B and trusts for his benefit will hold a majority of

Distributing the stock in Controlled and no stock in Distributing; and Shareholder C and/or trusts for her benefit will hold a minority interest in both and Controlled.

The following representations have been made in connection with the transactions:

- (a) Neither Distributing nor Controlled has, or at the time of the transactions will have, any securities, warrants, or options outstanding.
- (b) The Distributing assets being transferred do not include licenses or leases.
- (c) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will equal or exceed the sum of the liabilities assumed (as determined under § 357(d)) by Controlled.
- (d) The liabilities to be assumed by Controlled in the transfer in Step (I) were incurred in the ordinary course of business and are associated with the assets transferred.
- (e) It is not expected that any of the property transferred from Distributing to Controlled will be property with regard to which any investment credit under § 46 has or will be claimed or with regard to which any investment credit is required to be recaptured. However, in the event that any of the property transferred is such property, then the investment tax credit previously computed with respect to such property transferred (including any building to which § 47(d) applies) will be adjusted in the year of transfer to reflect an early disposition of the property pursuant to § 50(a)(1) or (2) (or pursuant to § 47(a)(1) and (5) as previously in effect, if applicable), or pursuant to any applicable successor statute.
- (f) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of this transaction.
- (g) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, Step (II), except: (i) Controlled may be indebted to Distributing for a portion of the expenses related to Steps (I) and (II); and (ii) Distributing may be indebted to Controlled for the costs of certain equipment, infrastructure, and leasehold improvements that are retained by Distributing. All debts between Distributing and Controlled will be paid within 90 days of completing Step (II).
- (h) No two parties to Step (I) (that is, Distributing and Controlled) are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

- (i) The Step (II) distribution will not constitute a disqualified distribution within the meaning of § 355(d)(2). There will have been no substantial changes in ownership (within the meaning of § 355(d)) of stock of either Distributing or Controlled in the 5-year period prior to Step (II).
- (j) Distributing, Controlled, and the shareholders will each pay their own expenses incurred in connection with the transactions.
- (k) For each shareholder, the fair market value of the stock of Controlled and Distributing held by such shareholder immediately after Step (II) will approximately equal the fair market value of the Distributing stock held by such shareholder immediately prior to Step (II).
- (l) No part of the stock in Controlled received by the shareholders is being received as a creditor, employee, or in any capacity other than as a shareholder of Distributing.
- (m) The 5 years of financial information submitted on behalf of Distributing for Business A is representative of such business' present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.
- (n) In the transactions, the shareholders of Distributing will not transfer or surrender any property other than stock in Distributing..
- (o) Following the proposed transactions, Distributing will continue, independently and with its separate employees, to be directly engaged in the active conduct of Business A which Distributing will have actively conducted within the meaning of § 1.355-3(b) throughout the 5-year period immediately prior to the Step (II) stock distribution. In conjunction with Business A, Distributing arranges for, but does not undertake Activity B. In each of the preceding 5 years, Business A will have employed (and paid FICA and FUTA employment taxes for) at least five full-time employees: some employees primarily managerial and the others primarily operational. Following Step (II), Distributing's Business A will continue to have at least two full-time employees, for whom it will continue to pay employment taxes and who will continue to conduct the operational and managerial activities of Business A, with at least one employee primarily managerial and at least one other employee primarily operational.
- (p) Following the proposed transactions, Controlled will continue, independently and with its separate employees, to be directly engaged in the active conduct of Business A which previously was actively conducted (within the meaning of § 1.355-3(b)) by Distributing throughout the 5-year

period immediately prior to Step (II). Following Step (II), Controlled's Business A will have at least two full-time employees for whom it will continue to pay employment taxes and who will continue to conduct the operational and managerial activities of Business A, with at least one employee primarily managerial and at least one other employee primarily operational.

- (q) During a transition period, Distributing and Controlled may provide each other with some equipment or services. Payment for each of any such items will be at fair market value and comparable to charges to unrelated third parties bargaining at arm's length.
- (r) The distribution of the stock of Controlled in Step (II) is being carried out primarily for the following corporate business purpose: to enhance efficiency (i) by eliminating conflicting management styles and business strategies and (ii) by providing each of the two resultant entities with a single managing shareholder and a single operational strategy.
- (s) There is no plan or intention to liquidate either Distributing or Controlled, to merge either Distributing or Controlled with any other corporation, or to sell or otherwise dispose of the assets of either Distributing or Controlled, subsequent to the transactions, except for dispositions of assets in the ordinary course of business.
- (t) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary, to purchase any of its outstanding stock after the transactions.
- (u) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any of their stock in Distributing or Controlled subsequent to the transactions. The only exception to the prior sentence is the possible transfer from Shareholder C or a trust for her benefit of gifts in small annual amounts of (i) stock in Distributing to Shareholder A, his children, and/or trusts for their benefit, and (ii) stock in Controlled to Shareholder B, his children, and/or trusts for their benefit.
- (v) Step (II), above, is not part of a plan or series of related transactions (within the meaning of § 355(e)), including investments in Distributing or Controlled, pursuant to which one or more persons will acquire (except as allowed by § 355(e)) 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.

- (w) Distributing is not an S corporation (within the meaning of § 1361(a)) and there is no plan or intent by Shareholder A or by Shareholder B for either Distributing or Controlled to make an S corporation election pursuant to § 1362(a).

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

- (1) The transfer in Step (I) by Distributing to Controlled of assets, as described above, in exchange for all the outstanding stock in Controlled, followed by the distribution in Step (II) by Distributing of all of the Controlled stock to Distributing shareholders will be a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled each will 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, subject to liabilities, to Controlled in exchange for Controlled stock, as described above (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the receipt of Distributing assets in exchange for Controlled stock (§ 1032(a)).
- (4) The basis of each asset received by Controlled will be the same as the basis of such asset in the hands of Distributing immediately prior to the transfer (§ 362(b)).
- (5) The holding period of the assets received by Controlled will include the period during which such assets were held by Distributing (§ 1223(2)).
- (6) No gain or loss will be recognized by Distributing upon the distribution to its shareholders of all the Controlled stock (§ 361(c)(1)).
- (7) No gain or loss will be recognized by (and no amount will be included in the income of) Distributing shareholders upon receipt of the Controlled stock (§ 355(a)(1)).
- (8) The total of (i) the basis of the Controlled stock plus (ii) the basis of the Distributing stock held by each shareholder immediately after the Step (II) distribution will be the same as the basis of the Distributing stock held by such shareholder immediately prior to the distribution. For Shareholder C, the total basis will be allocated in proportion to the relative fair market values of the Controlled stock and Distributing stock in accordance with § 1.358-2(a)(2).

