

**Internal Revenue Service**

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Person To Contact:

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Telephone Number:

Refer Reply To:

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Date:

February 09, 2004

Distributing =

Controlled =

State X =

Date 1 =

Business A =

Business B =

Shareholder =

Dear

This letter responds to your request dated July 25, 2003, for rulings on the federal income tax consequences of a proposed transaction. You submitted additional information in letters dated September 30, 2003, November 3, 2003, December 10, 2003, December 15, 2003, and January 16, 2004. The information submitted for consideration is summarized below.

Distributing, a State X corporation, uses the accrual method of accounting and has a tax year ending on Date 1. Distributing is engaged in Business A and Business B. Distributing has one class of stock, all the shares of which are held by Shareholder.

We have received financial information which indicates that Business A and Business B have each had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Both Business A and Business B have insurance exclusions for certain liabilities. Both businesses are involved in industries where lawsuits involving the exclusions are filed regularly. Due to the potential for uninsured product liability claims against both businesses, Distributing's board of directors has determined it is in the best interests of each business to separate these risks into separate companies. Accordingly, the following transaction has been proposed:

- (i) Distributing will form a new corporation (Controlled) as a State X corporation. Controlled will use the accrual method of accounting and have a tax year ending on Date 1.
- (ii) Distributing will transfer all of the Business B assets to Controlled in exchange for all of the issued and outstanding stock of Controlled and the assumption by Controlled of the liabilities associated with Business B.
- (iii) Distributing will distribute all of the Controlled stock to Shareholder.

Distributing has demonstrated that any other structure or non-taxable transaction would be impractical or unduly expensive.

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

- (a) No part of the consideration to be distributed by Distributing will be received by Shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (b) The five 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) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, except that certain employees will be shared for reasons of efficiency and cost effectiveness. If any employee is shared by the two corporations, such employee's compensation will be shared by the two corporations based upon the amount of time spent in each business.
- (d) The distribution of the stock of Controlled is carried out for the following corporate business purpose: risk reduction related to uninsured product liability exposure. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (e) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available date after the distribution and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.
- (f) There is no plan or intention by Shareholder to sell, exchange, transfer by gift, or otherwise dispose of any of Shareholder's stock in either Distributing or Controlled after the transaction, except that Shareholder may consider making gifts of Controlled stock to Shareholder's child. Such transfers would involve less than 50 percent of the Controlled stock. However, it is not contemplated that either individual would sell, exchange or further transfer this stock.
- (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.
- (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) The total adjusted bases and the fair market value of the assets to be transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities to be assumed (as determined under § 357(d)) by Controlled.
- (j) The liabilities to be assumed (as determined under § 357(d)) in the transaction were incurred in the ordinary course of business and are associated with the assets being transferred.

- (k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (l) 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.
- (m) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (n) The distribution of Controlled stock 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 entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.
- (o) No investment credit has been (or will be) claimed with respect to the transferred property.

Based solely on the information submitted and representations made, we hold as follows:

- (1) The transfer by Distributing of the Business B assets to Controlled in exchange for all of the issued and outstanding stock of Controlled and the assumption by Controlled of the liabilities associated with Business B, followed by the distribution of the Controlled stock to Shareholder will qualify as a reorganization under § 368(a)(1)(D). Distributing and Controlled each will be a "party to a reorganization" under § 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Business B assets to Controlled in exchange for Controlled stock and the assumption of liabilities (§§ 361(a) and 357(a)).
- (3) Controlled will recognize no gain or loss on the receipt of the Business B assets in exchange for Controlled stock (§ 1032(a)).
- (4) Controlled's basis in each asset received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transfer (§ 362(b)).
- (5) Controlled's holding period for each asset received from Distributing will include the period during which Distributing held such asset (§ 1223(2)).

- (6) Distributing will recognize no gain or loss on the distribution of the Controlled stock (§ 361(c)(1)).
- (7) Shareholder will recognize no gain or loss (and no amount will be included in the income of Shareholder) upon Shareholder's receipt of the Controlled stock, as described above (§ 355(a)(1)).
- (8) The aggregate basis of the Distributing and Controlled stock in the hands of Shareholder immediately after the distribution will equal Shareholder's aggregate basis in Shareholder's Distributing stock 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), (b) and (c)).
- (9) Shareholder's holding period of the Controlled stock received in the distribution will include the holding period of the Distributing stock on which the distribution is made, provided that such Distributing stock is held by Shareholder as a capital asset on the date of the distribution (§ 1223(1)).
- (10) Earnings and profits will be allocated between Distributing and Controlled in accordance with § 1.312-10(a).

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. Specifically, no opinion was requested and no opinion is expressed concerning the "S Corporation" status or the application of § 1374 to either Distributing or Controlled.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code 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 representatives.

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

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.

Sincerely,

*Ken Cohen*

Ken Cohen

Senior Technician Reviewer, Branch 3

Office of Associate Chief Counsel

(Corporate)