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Department of the Treasury

Washington, DC 20224

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Refer Reply To:

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Date:

October 31, 2003

Distributing =

Controlled =

A =

B =

C =

Business D =

Business E =

State X =

g =

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Date 1 =

Plans =

Dear

We respond to your request dated June 23, 2003, for rulings on the federal income tax consequences of a proposed transaction. The information submitted for consideration is summarized below.

Distributing is an accrual method State X subchapter S corporation. Distributing is engaged directly in Business D, which has been conducted for more than five years. Distributing has outstanding r shares of voting common stock that are owned in equal amounts by A and by B.

Controlled is a wholly owned qualified subchapter S subsidiary (Q Sub) of Distributing treated as a disregarded entity under §1.1361-4(a) (1) of the Income Tax Regulations. Controlled is directly engaged in Business E, which it has conducted for more than five years. Controlled has outstanding q shares of voting common stock, all of which are held by Distributing.

The taxpayer has supplied financial information that indicates that each of Business D and Business E had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Last year, in order to meet increased competition and declining earnings in its Business D, Distributing hired a key employee, C, with the talent and experience to expand the operations of Business D and improve the profitability of Distributing. Distributing's profitability was greatly improved last year. Now, in order to ensure that C remains in the employ of Distributing and Business D and to provide C with a strong

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incentive to develop Business D, so that A can hand over the management of Distributing to C and concentrate his efforts on managing Business E for Controlled, the following transaction has been proposed:

- (i) All of the outstanding stock of Controlled will be distributed in equal parts to A and to B;
- (ii) Distributing will then sell to C approximately s shares of its authorized but unissued stock, which after the sale would constitute about t percent of Distributing's total outstanding stock. C will pay Distributing for the stock with a note secured by the stock, accruing interest and requiring annual payments amortizing principal and interest over u years. This equity stake would ensure C a position on Distributing's board of directors.
- (iii) After the distribution, Controlled will elect to be an S corporation pursuant to §1362(a) of the Internal Revenue Code for its first taxable year.

The taxpayers have made the following representations in connection with 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 the corporation.
- (b) The five years of financial information submitted on behalf of Distributing and Controlled are representative of the corporations' present operations, and with regard to such corporations, there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees.
- (d) The distribution of the stock of Controlled is carried out for the corporate business purposes of providing a substantial equity interest in Distributing to C and for risk reduction. The distribution of the stock of Controlled is motivated, in whole or substantial part, by these corporate business purposes.
- (e) Controlled will elect to be an S corporation pursuant to §1362(a) effective immediately after the distribution. There is no plan or intent to revoke or

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otherwise terminate the S corporation election of either Distributing or Controlled.

- (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 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 their respective 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) No existing liabilities will be assumed in the transaction, and the total adjusted bases and the fair market value of the assets deemed transferred to Controlled by Distributing each equals or exceeds any liabilities to which the transferred assets are subject.
- (j) No existing liabilities will be assumed in the transaction, and the liabilities to which the transferred assets are subject 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, except an intercorporate debt consisting of promissory notes of Controlled payable to Distributing, with an approximate total balance of \$v, incurred by Controlled on Date 1 to buy out the remaining former shareholders of Controlled (other than Distributing).
- (l) With the exception of the provisional continuation of Plans, no continuing transactions between Distributing and Controlled are anticipated, but if there are any such transactions, 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).

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- (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 entitled to vote 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.
- (o) No Distributing shareholder or shareholders will hold immediately after the distribution disqualified stock within the meaning of §355(d)(3) which constitutes a 50-percent or greater interest in Distributing or Controlled.
- (p) The income tax liability for the taxable year in which investment credit property (including any building to which §47(d) applies) is transferred will be adjusted pursuant to §50(a)(1) or (a)(2) (or §47, as in effect before amendment by Pub. L. No. 101-508, title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

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

- (1) The distribution of all of the Controlled stock to A and to B will cause the termination of the QSub election of Controlled because Controlled will cease to be a wholly owned subsidiary of Distributing, an S corporation. As a result, Controlled will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from Distributing in exchange for stock of Controlled (§1.1361-5(b)(1)).
- (2) The deemed exchange of Distributing's Business E assets, subject to liabilities, for Controlled stock resulting from the termination of the QSub election, as set forth above, followed by the distribution of all of the Controlled stock to A and to B, will be treated as a reorganization within the meaning of §368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" within the meaning of §368(b).
- (3) Distributing will not recognize any gain or loss on the transfer of the Business E assets, subject to liabilities, to Controlled in exchange for Controlled common stock and the assumption by Controlled of the liabilities associated with the transferred assets (§§361(a) and 357(a)).

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- (4) Controlled will not recognize any gain or loss on the receipt of the Business E assets, subject to liabilities, in exchange for the Controlled common stock (§1032(a)).
- (5) The basis of each asset received by Controlled from Distributing will be equal to the basis of such asset in the hands of Distributing immediately prior to the transaction (§362(b)).
- (6) The holding period of each asset received by Controlled from Distributing will include the period during which such asset was held by Distributing (§1223(2)).
- (7) No gain or loss will be recognized by Distributing on the distribution of the Controlled stock to A and to B (§361(c)).
- (8) No gain or loss will be recognized by (and no amount will be included in the income of) A or B upon the receipt of the Controlled stock (§355(a)(1)).
- (9) The aggregate basis of the Distributing stock and the Controlled stock in the hands of A and of B immediately after the distribution will be the same as the basis of the Distributing stock in the hands of A and of B immediately prior to the distribution (§358(a)(1) and §1.358-1(a)). Such aggregate basis will be allocated between the Distributing stock and the Controlled stock in proportion to the relative fair market value of each corporation's stock in accordance with §1.358-2(a)(2) (§358(b)).
- (10) The holding period of the Controlled stock received by A and by B will 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 date of the distribution (§1223(1)).
- (11) As provided in §312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under §1.312-10(a).
- (12) Provided that Controlled meets the requirements of §1361(b) and provided that Distributing immediately distributes the stock of Controlled, Distributing's momentary ownership of the stock of Controlled will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under §1361(b)(1)(B), and Controlled is eligible to make a timely election, without the consent of Distributing, to be an S corporation for its first taxable year.

No opinion is expressed or implied about the tax treatment of the proposed transaction under other provisions of the Code and Regulations or about the tax

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treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provided 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 transaction covered by this letter is consummated.

Pursuant to the powers of attorney on file in this office, a copy of this letter has been sent to the taxpayers' authorized representative.

Sincerely,

Filiz A. Serbes

Filiz A. Serbes

Chief, Branch 3

Office of the Associate Chief Counsel
(Corporate)