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Department of the Treasury

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Date:

December 21, 2000

Distributing	=
<u>X</u>	=
Shareholder 1	=
Shareholder 2	=
Employee 1	=
Employee 2	=
State A	=
<u>a</u>	=

Dear:

This is in reply to a letter dated September 8, 2000, in which rulings were requested as to the federal income tax consequences of a proposed transaction. Additional information was submitted in separate letters. The facts submitted for considered are substantially as set forth below.

Distributing is a State A corporation that has elected to be treated as a subchapter S corporation under Internal Revenue Code § 1361(a). Distributing is engaged in the business of operating X franchises in State. Shareholder 1 and his wife, Shareholder 2 (together the "Shareholders"), each own 50% of Distributing's outstanding stock.

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

The X franchiser requires that the franchisee be an individual. Shareholder 1, individually, is the franchisee for the franchises operated by Distributing. The franchise agreement does not allow the franchise agreement to be assigned except for assignments qualifying under the terms of the franchise agreement and subject to the approval by the franchiser. Excepted in limited situations, such as the situation described below, the franchiser only allows the franchisee to operate the business in corporate form where the shares of the corporation are wholly owned and controlled by the franchisee.

Employee 1, the Shareholder's son, and Employee 2, the Shareholder's daughter, currently own their own X franchises in Shareholders' market (trade) area. Each are approved by the franchiser to obtain additional franchises in their respective trade area. Franchiser has a policy not to grant a franchise right to an individual in another franchisee's trade area. Because part of the franchises operated by Distributing are within the same trade area as Employee 1, Employee 1 could and would object to the franchiser granting the franchises to another individual. Likewise, because the other franchises operated by Distributing are within the same trade area as Employee 2, Employee 2 could and would object to the franchiser granting the X franchises to another individual.

Due to Shareholder 1's serious health conditions and the Shareholders advanced age, Shareholder 1 cannot continue to fulfil his obligations under the franchise agreement. The franchiser has agreed to allow Shareholder 1 to retain the franchises provided that Employee 1 and Employee 2; (a) conduct the business of each of the franchises in their respective trade area in accordance with the terms and conditions of the franchise agreement, (b) currently obtain equity interests in a corporation operating the business in their respective trade area, and (c) will subsequently receive all of the remaining equity interest in the respective corporations.

To satisfy the franchiser's requirements and retain the franchises, the Shareholders and Distributing propose the following transactions:

- i. Distributing will transfer the assets and liabilities associated with the franchises located in Employee 2's trade area (the "Transferred Property") to a newly formed corporation, Controlled, in exchange for all of Controlled's stock.
- ii. Distributing will distribute all of the newly acquired Controlled stock to Distributing's shareholders, Shareholder 1 and Shareholder 2.
- iii. Shareholder 1 and Shareholder 2 will then transfer by gift up to approximately a % of the Distributing stock to Employee 1 and up to approximately a % of the Controlled stock to Employee 2.

In connection with the proposed transaction, it has been represented that:

- a. No part of the consideration to be distributed by Distributing will be received by any person as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- b. The five (5) years of financial information submitted on behalf of Distributing 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. Following the distribution, Distributing and Controlled each will continue the active conduct of its respective businesses, independently and with its separate employees.
- d. The distribution of the stock of Controlled is carried out for the corporate business purpose of providing an equity interest in each corporation, Distributing and Controlled, to the prospective key employee of each corporation.
- e. 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, except for the proposed gifting of shares to Employee 1 and Employee 2.
- f. 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 section 4.05(1)(b) of Rev. Proc. 96-30.
- g. 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.
- h. The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.
- i. The liabilities 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.
- j. Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- k. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- l. Payments made in connection with all continuing transaction, 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. Neither Distributing nor Controlled is an investment company as defined in section 368(a)(2)(F)(iii) and (iv).
- n. Distributing is an S corporation (within the meaning of section 1361(a)). Controlled will elect to be an S corporation pursuant to section 1361(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.
- o. 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 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.

Section 1361(a) defines "S corporation" as, with respect to any taxable year, a small business corporation that has an effective § 1362(a) election. A small business corporation may make a § 1362(a) election for any taxable year at any time during the preceding tax year, or at any time during the tax year on or before the 15th day of the third month of the tax year. Section 1362(b)(1). If the corporation makes an election on or before the 15th day of the third month of the tax year, that election is treated as made for the next taxable year if the corporation did not meet the definition of a small business corporation for the entire tax year before the date of the election. Section 1362(b)(2)(B).

Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, certain trusts, and certain organizations) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1362(d)(2)(A) states that a § 1362(a) election is terminated whenever (at any time on or after the first day of the first tax year for which the corporation is an S corporation) the corporation ceases to be a small business corporation.

Section 1.1368-2(d)(3) of the Income Tax Regulations provides that if an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which § 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which § 355 (or so much of § 356 as relates to § 355) applies, the AAA of the distributing corporation

immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under § 312(h). See § 1.312-10(a).

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

1. The transfer by Distributing to Controlled of the Transferred Property to newly created Controlled in exchange for Controlled common stock and the assumption by Controlled of certain related liabilities, followed by a distribution of the Controlled common stock by Distributing, as described above, will be a reorganization within the meaning of § 368(a)(1)(D) of the Code and Distributing and Controlled will each be “a party to the reorganization” within the meaning of § 368(b).
2. No gain or loss will be recognized by Distributing upon the transfer of the Transferred Property to Controlled in exchange for Controlled common stock. Sections 361(a) and 357 of the Code.
3. No gain or loss will be recognized by Controlled upon receipt of the Transferred Property from Distributing in exchange for Controlled common stock. Section 1032(a) of the Code.
4. The basis of the Transferred Property received by Controlled will be the same as the basis of such property in the hands of Distributing immediately prior to the transfer. Section 362(b) of the Code.
5. The holding period of the Transferred Property received by Controlled will include the period during which such property was held by Distributing. Section 1223(2) of the Code.
6. No gain or loss will be recognized to (and no amount shall be includible in the income of) the Shareholders upon receipt of the Controlled stock in the distribution described above. Section 355(a)(1) of the Code. See Rev. Rul. 75-337, 1975-2 C.B. 124.
7. No gain or loss will be recognized by Distributing upon the distribution of all of its stock of Controlled as described above. Section 361(c) of the Code.
8. The aggregate basis of the Controlled and Distributing common stock in the hands of the Shareholders immediately after the distribution of Controlled stock to the Shareholders will equal the aggregate basis of the Distributing common stock held by the Shareholders immediately prior to

such distribution, allocated in proportion to the fair market value of each in accordance with §§ 358(b) and (c) of the Code and the regulations promulgated thereunder.

9. The holding period of the Controlled stock received by the Shareholders in the transaction will include their holding period of the Distributing stock, provided that such stock is held as a capital asset on the date of the distribution. Section 1223(1) of the Code.
10. As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a) of the regulations.
11. Distributing's AAA immediately before the transaction will be allocated between Distributing and Controlled in a manner similar to the manner in which Distributing's earnings and profits will be allocated under § 312(h).
12. Provided that Distributing immediately distributes the stock of Controlled, Distributing's momentary ownership of Controlled's stock as part of a divisive reorganization under § 368(a)(1)(D) will not cause Controlled to have an ineligible shareholder under § 1361(b)(1)(B). Therefore, Controlled will be eligible to make an S corporation election under § 1362(a) for its first taxable year, provided that Controlled otherwise meets the requirements under § 1361(b).

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, we express no opinion as to whether Distributing's S corporation election is otherwise valid or whether an election of S corporation treatment by Controlled will be otherwise valid. Moreover, we express no opinion on the estate and gift tax consequences of any part of the transaction.

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.

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

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

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,
Jasper L. Cummings
Associate Chief Counsel
By: Lewis K Brickates
Assistant to the Branch Chief