

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Telephone Number:

Re:

Refer Reply To:

CC:DOM:CORP:1-PLR-113251-98

Date:

December 18, 1998

Legend

Distributing =

Controlled =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Shareholder F =

State X =

Business A =

Business B =

Date 1 =

Government Agency =

Dear :

We respond to a letter dated June 18, 1998, requesting a ruling as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated October 27, 1998 and December 14, 1998. The information submitted for consideration is substantially as set forth below:

Distributing is a State X corporation that was incorporated in 1981. Shareholders A and B each currently own 46.5 percent of the outstanding Distributing stock. Shareholder A and Shareholder B together have held more than 90 percent of the Distributing stock for more than five years. Further, there has been less than a 10 percent shift in their ownership of stock. Shareholders C, D, and E each own 2 percent of the Distributing stock, while Shareholder F owns 1 percent of the outstanding Distributing stock. These shareholders acquired this stock more than two years ago.

Distributing has operated both Business A and Business B for more than five years. While all of the shareholders of Distributing engage in both businesses to some extent, Shareholder A is predominantly interested in the management of Business A, while Shareholders B, C, D, E, and F ("the Group") are predominantly interested in the management of Business B. Financial information has been received that reflects that Business A and Business B each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Distributing is currently the subject of an investigation by Government Agency. To that end, Distributing has already reimbursed its customers for certain amounts received. However, Distributing will continue to incur costs associated with the investigation, and may incur fines levied by Government Agency.

Significant disputes have arisen concerning the management, direction, and growth of Distributing. These disputes have been principally between Shareholder A and the Group. Among the major items of contention include issues such as the emphasis to be placed upon each business, the increased managerial role of certain members of the Group, and what approach should be taken to capitalize the ongoing

businesses. Such disputes have become irreconcilable, and are having an adverse effect on the day-to-day operations of Distributing.

In order to resolve these problems, on Date 1, Shareholder A entered into a binding agreement with Distributing (The Agreement) and the Group. The Agreement provided that Shareholder A would redeem a substantial portion of his interest in Distributing for cash. The Agreement also provided that Shareholder A could not market to any new business for a period of time. As part of the Agreement, Shareholder A also had an option to separate Business A and Business B, and continue to own and control the Business A business only.

Shareholder A exercised this option in accordance with the Agreement. In order to effectuate the exercise of this option, the following transaction is proposed:

- i. Distributing formed Controlled in connection with this transaction.
- ii. Distributing will transfer property to Controlled, consisting of the assets of Business B. Controlled will also assume certain Distributing liabilities.
- iii. Distributing will distribute all of the stock of Controlled to the Group in exchange for all of their stock in Distributing.
- iv. In order to properly capitalize Controlled, Controlled will immediately offer its stock to certain of its key employees in exchange for cash. After the offering, Controlled will have 1,000 shares outstanding. Of this amount, 40 percent will be owned by Shareholder B, 35 percent will be owned by Shareholder C, 10 percent will be owned by Shareholders D, E, and F, and 15 percent will be held by employees of Controlled who were not formerly shareholders of Distributing.
- v. In order to properly capitalize Distributing, Distributing will offer its stock to certain of its employees in exchange for cash. After the offering, Shareholder's A's percentage interest in Distributing will decrease. In no event will Shareholder A's percentage interest decrease below 51 percent of the outstanding stock of Distributing.
- vi. Any costs in connection with the investigation by Government Agency will be shared by Distributing and Controlled.

In connection with the proposed transaction, the following representations are made:

1. The fair market value of the Controlled stock to be received by Shareholders B, C, D, E, and F, respectively, will be approximately equal to the fair market value of the Distributing stock surrendered respectively by the five shareholders in the exchange.

2. No part of the distribution 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.
3. 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.
4. Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
5. The distribution of the stock of Controlled is carried out for the following corporate business purpose: To eliminate a conflict between Distributing's shareholders and resolve management, systemic, or other problems that arise therefrom. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
6. 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, or securities of, either Distributing or Controlled after the transaction.
7. 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.
8. 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.
9. The total adjusted bases and 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. 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.
10. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock, except (a) any costs incurred in connection with the Government Agency investigation will be shared by the two corporations, and (b) Distributing's profit-sharing contributions for the year ended December 31, 1998, and other miscellaneous year-end accruals may be shared by the two corporations.

11. 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.
12. No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
13. The gross assets of the business relied upon to satisfy the active trade or business requirement of § 355(b) will have a fair market value equal to or greater than five percent of the total fair market value of the gross assets of the corporation conducting such trade or business.
14. Distributing, Controlled, Shareholder A, Shareholder B, and Shareholder C represent that the Distribution 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, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.
15. Shareholder A and Distributing represent that neither he nor Distributing have any plan or intention to reduce Shareholder A's ownership interest in Distributing below 51 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Distributing.
16. Shareholder B and Controlled represent that neither he nor Controlled have any plan or intention to reduce Shareholder B's ownership interest in Controlled below 40 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Controlled.
17. Shareholder C and Controlled represent that neither he nor Controlled have any plan or intention to reduce Shareholder C's ownership interest in Controlled below 3.7 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Controlled (prior to his interest increasing to 35 percent). Once his stock interest has increased to 35 percent, Shareholder C and Controlled represent that neither Shareholder C nor Controlled have any plan or intention to reduce Shareholder C's ownership interest in Controlled below 35 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Controlled.
18. Shareholder D represents that he has no plan or intention to take any action, including a disposition, to reduce his ownership interest in Controlled below 2 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Controlled.

19. Shareholder E represents that he has no plan or intention to take any action, including a disposition, to reduce his ownership interest in Controlled below 4 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Controlled.
20. Shareholder F represents that she has no plan or intention to take any action, including a disposition, to reduce her ownership interest in Controlled below 4 percent of the total combined voting power of all classes of stock and the total value of all classes of stock of Controlled.
21. Shareholder B represents that he has no plan or intention to take any action which would cause or facilitate the ownership interests of Shareholder D, Shareholder F, or Shareholder E in Controlled to decrease below 2 percent, 4 percent, or 4 percent, respectively.
22. Shareholder C represents that he has no plan or intention to take any action which would cause or facilitate the ownership interests of Shareholder D, Shareholder F, or Shareholder E in Controlled to decrease below 2 percent, 4 percent, or 4 percent, respectively.
23. Controlled represents that it has no plan or intention to take any action which would cause or facilitate the ownership interests of Shareholder D, Shareholder F, or Shareholder E in Controlled to decrease below 2 percent, 4 percent, or 4 percent, respectively.

Based solely on the information submitted and on the representations set forth above, it is held as follows:

- (1) The transfer of assets by Distributing to Controlled, solely in exchange for all of the stock of Controlled and the assumption of liabilities by Controlled, followed by the distribution of the stock of Controlled to Shareholder B, Shareholder C, Shareholder D, Shareholder E, and Shareholder F in exchange for all of the stock of Distributing held by each, in each instance, will be a reorganization within the meaning of § 368(a)(1)(D) of the Code. Distributing and Controlled will each be a "party to a reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized to Distributing upon the transfer of assets, subject to liabilities, to Controlled in constructive exchange for Controlled stock, as described above (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized to Controlled on the receipt of assets in constructive exchange for Controlled stock, as described above (§ 1032(a)).

- (4) The basis of the assets received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction described above (§ 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 to Distributing upon the distribution of all of the Controlled stock, as described above (§ 361(c)(1)).
- (7) No gain or loss will be recognized to (and no amount will be included in the income of) Shareholder B, Shareholder C, Shareholder D, Shareholder E, and Shareholder F, upon the receipt of Controlled stock, respectively (§ 355(a)(1)).
- (8) The basis of the Controlled stock in the hands of Shareholder B, Shareholder C, Shareholder D, Shareholder E, and Shareholder F will be the same as the basis of their Distributing stock surrendered in exchange therefor. (§ 358(a)(1)).
- (9) The holding period of the Controlled stock received by Shareholder B, Shareholder C, Shareholder D, Shareholder E, and Shareholder F, will include the holding period of the Distributing stock surrendered in the exchange, provided that such stock is held as a capital asset on the date of the exchange. (§ 1223(1)).
- (10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax 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(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 representative.

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

Sincerely yours,
Assistant Chief Counsel (Corporate)

By _____
Alfred C. Bishop, Jr.
Chief
Branch 1