

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

October 28, 2001

Distributing =

Controlled =

State X =

Business Y =

A =

B =

C =

D =

a =

b =

c =

d =

This letter responds to your December 20, 2000 request for rulings on certain federal income tax consequences of a proposed transaction. Additional information was submitted in subsequent correspondence. The information submitted is summarized below.

### Summary of Facts

Distributing, a State X Subchapter S corporation, files its federal income tax

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return on a calendar year basis and uses the cash method of accounting. Distributing has one class of outstanding stock, which is owned a percent by A, b percent by A's wife, B, and c percent by each of A's and B's children, C and D.

Distributing has engaged directly in Business Y. A, B, C and D each have been actively involved in the operations and management of Distributing, although recently A has become less active in the management and operation of Distributing.

Distributing has submitted financial information indicating that Business Y, as operated by Distributing, has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

C and D have differed on a number of fundamental business matters relating to the management and operational activities of Distributing. The differences of opinion between C and D are having an adverse effect on the day-to-day operations of Distributing.

### **Proposed Transaction**

To alleviate the shareholder disputes, Distributing has proposed the following series of steps (collectively, the "Proposed Transaction"):

(i) Distributing will form Controlled under the laws of State X. Controlled will use the cash method of accounting and file its federal income tax return on a calendar year basis. Distributing will transfer approximately one half (based on fair market values) of its operating and investment assets to Controlled in exchange for all of Controlled's outstanding stock and the assumption by Controlled of related liabilities (the "Transfer").

(ii) Distributing will distribute all of Controlled's stock as follows: A will exchange half of his Distributing stock for a percent of Controlled's stock; B will exchange half of her Distributing stock for b percent of Controlled's stock; and D will exchange all of her Distributing stock for the remaining d percent of Controlled's stock (the "Distribution").

(iii) Controlled will elect S corporation status immediately after the Distribution.

### **Representations**

In connection with the Proposed Transaction, the following representations have been made:

(a) The fair market value of Controlled stock and other consideration to be received by A, B and D will be approximately equal to the fair market value of Distributing stock surrendered by each shareholder in the exchange.

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(b) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any other capacity other than that of a shareholder of Distributing.

(c) The five years of financial information submitted on behalf of Distributing is representative of Distributing'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.

(d) Following the Proposed Transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by Distributing prior to consummation of the transaction.

(e) The distribution of the stock of Controlled is carried out for the corporate business purpose of allowing C and D to operate independently of one another. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.

(f) Distributing is an S corporation (within the meaning of section 1361(a)). Controlled will elect to be an S corporation pursuant to section 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.

(g) There is no plan or intention by the shareholders or security holders 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 Proposed Transaction.

(h) 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 Proposed Transaction, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.

(i) 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 Proposed Transaction, except in the ordinary course of business.

(j) (i) 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; and

(ii) The liabilities assumed in the Proposed Transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of

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business and are associated with the assets being transferred.

(k) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Proposed Transaction.

(l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.

(m) 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.

(n) No two parties to the Proposed Transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).

(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 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.

### **Rulings**

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

(1) The Transfer followed by the Distribution will constitute a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be a party to a reorganization within the meaning of section 368(b).

(2) No gain or loss will be recognized by Distributing on the Transfer (sections 361(a) and 357(a)).

(3) No gain or loss will be recognized by Controlled on the Transfer (section 1032(a)).

(4) Controlled's basis in each of the assets received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the Transfer (section 362(b)).

(5) The holding period for each asset received by Controlled from Distributing will include the period during which Distributing held such asset (section 1223(2)).

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(6) No gain or loss will be recognized by Distributing upon the Distribution (section 361(c)(1)).

(7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) A, B or D in the Distribution (section 355(a)(1)).

(8) The aggregate basis of the stock of Controlled in the hands of each of A, B and D immediately after the Distribution will be the same as the aggregate basis of the Distributing stock surrendered by such shareholder in exchange therefor (section 358(a)(1)).

(9) The aggregate basis of the Distributing and Controlled stock in the hands of C immediately after the Distribution will equal the basis in the Distributing stock held by such shareholder immediately before the Distribution, allocated in proportion to the fair market value of the Distributing and Controlled stock held by such shareholder immediately after the Distribution, in accordance with section 358(b)(2), section 358(c), and section 1.358-2(a)(2).

(10) The holding period of the Controlled stock received by the Distributing shareholders will include the period during which the Distributing shareholders held the Distributing stock with respect to which the Distribution is made, provided that such Distributing stock is held as a capital asset on the date of the Distribution (section 1223(1)).

(11) As provided in section 312(h), proper allocation of Distributing's earnings and profits will be made under Treas. Reg. § 1.312-10(a).

(12) As provided in Treas. Reg. § 1.1368-2(d)(3), the "accumulated adjustments account" (as defined in section 1368(e)(1)) of Distributing immediately prior to the distribution of the Controlled stock will be allocated between Distributing and Controlled in a manner similar to the manner in which the earnings and profits of Distributing are allocated (see ruling (11) above).

(13) The momentary ownership by Distributing of the stock of Controlled in connection with the Proposed Transaction will not, in and of itself, make Controlled ineligible to elect to be an S corporation for its first taxable year, provided that Controlled meets the other requirements under section 1361(b).

### **Caveats**

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalties 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

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examination.

No opinion is expressed about the tax treatment of the Proposed Transaction under other provisions of the Code or regulations, or 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.

### **Procedural Statements**

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,  
Associate Chief Counsel (Corporate)  
By: Stephen P. Fattman  
Chief, Branch 4