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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

21 July 2000

Distributing =

Controlled =

Business A =

Industry M =

Lead Underwriter =

LLC1 =

Service B =

Shareholder A =

State A =

Dear :

This letter responds to a letter dated March 17, 2000, requesting a ruling as to the federal income tax consequences of a proposed transaction. The information submitted in that letter and subsequent correspondence is summarized below.

Distributing, a State A corporation, is an S corporation (previously it was a C corporation) that uses the cash method of accounting and a fiscal year. For many years

Distributing has been engaged in Business A serving a wide variety of clients and industries. Distributing has outstanding solely common stock, voting and nonvoting, and is closely held. A Stock Purchase Agreement requires Distributing to purchase and shareholders to sell their Distributing stock under certain circumstance and imposes limits on a shareholder's transfer of the stock.

Controlled is an S corporation being formed under the laws of either State A or Delaware. It will use the accrual method and a calendar year. Controlled will have outstanding solely common stock, voting and nonvoting, all of which will initially be held by Distributing.

LLC1 is a State A limited liability company engaged in providing Service B to various clients. Part of LLC1's business is performed for clients operating in Industry M. The members of LLC1 are identical to the shareholders of Distributing.

The financial information received indicates that Business A has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

In recent years, Industry M has greatly expanded, and the part of Distributing's Business A that serves Industry M has been growing especially rapidly. To best serve its customers, Distributing has been expanding its facilities using money obtained from operating profits, and by using cash saved through the use of promissory notes to pay for redemptions and dividends. Distributing needs additional capital in order to further expand existing facilities and/or open new facilities, to purchase additional equipment, to pay existing obligations, and to be in a position to make strategic acquisitions. After discussion with accounting firms, investment bankers, and legal counsel, Distributing decided to raise capital through an initial public offering ("IPO") and selected Lead Underwriter as the lead manager for the IPO. Lead Underwriter has advised Distributing that because of investors' strong preference for Industry M, and businesses supporting Industry M, and their preference for companies involved in a single industrial sector, an IPO of the part of Distributing's Business A involved with Industry M would be more cost effective than an IPO involving all of Distributing's Business A. In addition, it is believed that an IPO of Distributing will be more attractive to investors if the portion of the LLC1 business dealing with Industry M also is transferred to Distributing. Accordingly, the following steps are proposed:

- (I) Distributing will transfer to Controlled its assets (and employees) related to clients other than Industry M in exchange for all the outstanding stock in Controlled and the assumption by Controlled of Distributing's liability under certain leases and other payables related to the assets transferred to Controlled. Distributing will retain the assets (and liabilities) related to Industry M (approximately one quarter of its total present operations).

Then, Controlled and Distributing will each be able to conduct Business A with their respective clients.

- (II) Distributing will distribute all the outstanding stock in Controlled pro rata to its shareholders. The Distributing shareholders will receive voting and nonvoting stock in Controlled in the exact same proportions as they hold such stock in Distributing.
- (III) The Distributing shareholders will transfer to Distributing those LLC1 assets that are used to provide Service B to Industry M clients in exchange for additional shares of Distributing stock and the assumption by Distributing of liabilities related to the transferred assets.
- (IV) Distributing will change its method of accounting from a cash method to a cash method combined with a percentage of completion method for certain items.
- (V) Prior to the planned IPO, it is possible (or probable) that Distributing will:
 - (i) recapitalize so as to eliminate its present nonvoting stock and, thus, have outstanding solely voting common stock;
 - (ii) adopt an employee stock option plan covering an amount of stock equal to about 5 to 15 percent of its outstanding stock;
 - (iii) change its name;
 - (iv) terminate the Stock Purchase Agreement; and
 - (v) change to a calendar year.
- (VI) Distributing will sell in an IPO an amount of stock to the public equal to about 10 to 20 percent of its outstanding stock. (Distributing and its underwriters plan and intend to undertake this Step (VI) IPO within the next 12 months. Whether and when the IPO actually takes place will, however, depend on various factors including market conditions at that time.)
- (VII) Following Step (VI), Distributing will have a greater number of shareholders such that it will no longer be eligible to be an S corporation, and its S election will terminate. In accord with § 448 of the Internal Revenue Code, Distributing will be required to change from the cash method to an accrual method of accounting.

The following representations have been made in connection with the transactions:

- (a) A distribution of the LLC1's assets used to provide Service B to Industry M clients to the Distributing shareholders may occur either before or after Step (I) and may occur even if Steps (I) and (II) do not occur. This distribution of LLC1 assets to the Distributing shareholders is being

considered independently of the transaction described in Steps (I) and (II) above.

- (b) Step (II) will occur immediately after Step (I). Step (III) will occur in conjunction with Step (II). Step (VI) will occur shortly after Step (II). In no event will the Step (II) Distribution be undertaken unless it is certain that the Step (VI) IPO will be undertaken shortly thereafter.
- (c) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will equal or exceed the sum of the liabilities assumed (as determined under § 357(d)) by Controlled.
- (d) The liabilities to be assumed by Controlled in the transfer in Step (I) were incurred in the ordinary course of business and are associated with the assets transferred.
- (e) It is not expected that any of the property transferred from Distributing to Controlled will be property with regard to which any investment credit under § 46 has or will be claimed or with regard to which any investment credit is required to be recaptured. However, in the event that any of the property transferred is such property, then the investment tax credit previously computed with respect to such property transferred (including any building to which § 47(d) applies) will be adjusted in the year of transfer to reflect an early disposition of the property pursuant to § 50(a)(1) or (2) (or pursuant to § 47(a)(1) and (5) as previously in effect, if applicable), or pursuant to any applicable successor statute.
- (f) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of this transaction. In addition, no income items (including accounts receivable or any item resulting from a sale, exchange, or disposition of property, that would have resulted in income to Distributing) and no items of expense will be transferred to Controlled, if Distributing has earned the right to receive the income or could claim a deduction for the expense under the accrual or similar method of accounting.
- (g) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, Step (II), except: (i) Controlled may be indebted to Distributing for a portion of the expenses related to Steps (I) and (II); and (ii) Distributing may be indebted to Controlled for the costs of certain equipment, infrastructure, and leasehold improvements that are retained by Distributing. All debts between Distributing and Controlled will be paid within 90 days of completing Step (II).

- (h) No two parties to Step (I) (that is, Distributing and Controlled) are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (I) Neither Distributing nor Controlled has, or at the time of the transactions will have, any securities, warrants, or options outstanding, with the sole exception of Distributing's employee stock option plan.
- (j) The Step (II) distribution will not constitute a disqualified distribution within the meaning of § 355(d). There will have been no substantial changes in ownership (within the meaning of § 355(d)) of either the voting or nonvoting stock of either Distributing or Controlled in the 5-year period prior to Step (II). Shareholder A who formerly was the largest shareholder, has transferred substantial amounts of Distributing stock to trusts; these trusts, however, are for the benefit of Shareholder A or persons related to him and, under the attribution rules of § 355(d)(8) and the aggregation rules of § 355(d)(7), Shareholder A and these trusts are treated as "one person." Taking into account the § 355(d) attribution and aggregation rules, in the 5-year period prior to Step (II) neither the voting stock nor the nonvoting stock will have had changes in ownership totaling more than 10 percent in either Distributing or Controlled.
- (k) In the whole overall transaction, Distributing's shareholders will receive nothing other than common stock in Controlled (and in Step (III) common stock in Distributing and the assumption by Distributing of any related liabilities).
- (l) Distributing, Controlled, and the shareholders will each pay their own expenses incurred in connection with the transaction.
- (m) The fair market value of the stock of Controlled and Distributing held by the shareholders immediately after Step (II) will approximately equal the fair market value of the Distributing stock held by such shareholders immediately prior to Step (II) (except to the extent separation into two entities increases market valuation).
- (n) No part of the stock in Controlled received by the shareholders is being received as a creditor, employee, or in any capacity other than as a shareholder of Distributing.
- (o) The 5 years of financial information submitted on behalf of Distributing for Business A is representative of such business' present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.

- (p) In the transaction, the shareholders of Distributing will not transfer or surrender any property (other than the transfer of LLC1 assets to Distributing in Step (III)).
- (q) Following the proposed transactions, Distributing will continue, independently and with its separate employees, to be directly engaged in the active conduct of Business A which Distributing will have actively conducted within the meaning of § 1.355-3(b)) throughout the 5-year period immediately prior to the Step (II) stock distribution. In each of the preceding 5 years, Business A will have employed more than fifty full-time employees: some employees primarily managerial and the others primarily operational. Following Step (II), Distributing's Business A will continue to have more than fifty full-time employees who will continue to conduct the operational and managerial activities of Business A, with some employees primarily managerial and other employees primarily operational.
- (r) Following the proposed transactions, Controlled will continue, independently and with its separate employees, to be directly engaged in the active conduct of Business A which previously was actively conducted (within the meaning of § 1.355-3(b)) by Distributing throughout the 5-year period immediately prior to Step (II). Following Step (II), Controlled's Business A will have more than fifty full-time employees who will continue to conduct the operational and managerial activities of Business A, with some employees primarily managerial and other employees primarily operational.
- (s) During a transition period, Distributing and Controlled will probably provide each other with various services, Payment for all such services will be determined under the same formula Business A currently uses for charges to unrelated third parties. This formula is similar to what would be arrived at by unrelated parties bargaining at arm's length.
- (t) The distribution of the stock of Controlled in Step (II) is being carried out for the following corporate business purpose: to provide the most attractive investment vehicle for the planned IPO in accord with the oral and written advice of Lead Underwriter. The distribution of Controlled stock is motivated, in whole or substantial part, by this corporate business purpose.
- (u) There is no plan or intention to liquidate either Distributing or Controlled, to merge either Distributing or Controlled with any other corporation, or to sell or otherwise dispose of the assets of either Distributing or Controlled,

subsequent to the transactions, except for dispositions of assets in the ordinary course of business.

- (v) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary, to purchase any of its outstanding stock after the transactions.
- (w) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any of their stock in Distributing or Controlled subsequent to the transactions.
- (x) Step (II), above, is not part of a plan or series of related transactions (within the meaning of § 355(e)), including investments in Distributing or Controlled, pursuant to which one or more persons will acquire (except as allowed by § 355(e)) 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.
- (y) There have not been, and there will not be, any other transactions that are related to Steps (I) and (II), above, except for the transactions described in Steps (III) through (VII) above.

The following representations have been made with regard to Step (III):

- (a) The amount of Distributing stock that definitely will be issued under the employee stock option plan (except stock to be issued to persons who are currently shareholders of Distributing) will, in total, constitute no more than 20 percent of the total number of shares of each class of voting and each class of nonvoting stock in Distributing outstanding. The step (VI) IPO will constitute a “qualified underwriting transaction” within the meaning of § 1.351-1(a)(3) of the Income Tax Regulations so that the IPO shareholders will be viewed as transferring cash directly to Distributing. The Step (III) transfer and the Step (VI) IPO will be undertaken at approximately the same time and in conjunction with each other and the Step (III) transferors and the IPO shareholders will constitute a single transferor group. There will be no plan or intent for this transferor group to hold less than 80 percent of every class and type of stock outstanding in Distributing.
- (b) In exchange for the transfer of the LLC1 assets to Distributing the shareholders will receive nothing other than common stock of Distributing and the assumption by Distributing of liabilities associated with the assets transferred.

- (c) The fair market value of the Distributing stock to be received by each shareholder in exchange for the transfer of assets will, for each shareholder, approximately equal the net fair market value of the assets transferred to Distributing in this exchange.
- (d) No part of the Distributing stock being received by the shareholders in Step (III) is being received by them in exchange for their creditor interest in Distributing or in their capacity as an employee of Distributing or for any reason other than in exchange for the LLC1 assets.
- (e) For each shareholder transferring LLC1 assets to Distributing, the total adjusted basis and fair market value of the assets transferred will each equal or exceed the sum of the liabilities assumed (as determined under § 357(d)) by Distributing.
- (f) The liabilities to be assumed by Distributing in these transfers were incurred by LLC1 in the ordinary course of business and are associated with the LLC1 assets being transferred.
- (g) None of the assets being transferred to Distributing will be property with regard to which any investment credit under § 46 has or will be claimed or with regard to which any of the recapture provisions of the Code apply.
- (h) With regard to the LLC1 assets transferred, neither LLC1 nor the Distributing shareholders will have either accumulated receivables or made extraordinary payments of payables in anticipation of the transaction.
- (i) With regard to the LLC1 assets it receives, Distributing will report items which, but for the transfer, would have resulted in income or deduction to either LLC1 or the Distributing shareholders in a period subsequent to the transfer and such items will constitute income or deductions to Distributing. Any income items will be included as ordinary income in computing the taxable income of Distributing.
- (j) The LLC1 assets being transferred do not include licenses or leases.
- (k) There is no plan or intention for Distributing to redeem or otherwise reacquire any of the stock to be issued to the Distributing shareholders in exchange for the LLC1 assets.
- (l) There is no plan or intention for distributing to sell or otherwise dispose of the LLC1 assets, other than in the normal course of business.

- (m) Distributing and the shareholders will each pay their own expenses incurred in connection with the transaction.

Based solely on the information submitted and on the representations set forth above, and provided that the Step (VI) IPO does take place, we rule as follows as to Steps (I) and (II):

- (1) The transfer in Step (I) by Distributing to Controlled of assets, as described above, in exchange for all the outstanding stock in Controlled, followed by the distribution in Step (II) by Distributing of all of the Controlled stock to the Distributing shareholders will be a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled each will be a "party to a reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing upon the transfer of assets, subject to liabilities, to Controlled in exchange for Controlled stock, as described above (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the receipt of Distributing assets in exchange for Controlled stock (§ 1032(a)).
- (4) The basis of each asset received by Controlled will be the same as the basis of such asset in the hands of Distributing immediately prior to the transfer (§ 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 by Distributing upon the distribution to its shareholders of all the Controlled stock (§ 361(c)(1)).
- (7) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon receipt of the Controlled stock (§ 355(a)(1)).
- (8) The total of (i) the basis of the Controlled stock plus (ii) the basis of the Distributing stock held by each shareholder immediately after the Step (II) distribution will be the same as the basis of the Distributing stock held by such shareholder immediately prior to the distribution. The total basis will be allocated in proportion to the relative fair market values of the Controlled stock and Distributing stock in accordance with § 1.358-2(a)(2).

- (9) The holding period of the Controlled stock received by the shareholders will include the holding period of the Distributing stock with respect to which it is received, provided that the Distributing stock is held as a capital asset by the shareholder on the date of the exchange (§ 1223(1)).
- (10) Proper allocation of earnings and profits will be made between Distributing and Controlled under § 1.312-10(a) of the Income Tax Regulations (§ 312(h)).
- (11) As provided by § 1.1368-2(d)(3), the “accumulated adjustments account” (as defined in § 1368(e)(1)) of Distributing immediately prior to the Step (II) 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 (10) above).
- (12) Provided that the Step (I) transfer of assets to Controlled is followed immediately by the Step (II) distribution of the stock of Controlled to the shareholders of Distributing, Distributing’s momentary ownership of the Controlled stock will not cause Controlled to be treated as having an ineligible shareholder for purposes of § 1361(b)(1)(B). Therefore, Controlled will be eligible to make a timely election, without the consent of Distributing, to be an S corporation for its first taxable year, provided Controlled meets the requirements of § 1361(b).
- (13) Controlled will be subject to § 1374 with respect to any asset transferred to it from Distributing to the same extent Distributing was subject to § 1374. Controlled’s recognition period will be reduced by the portion of Distributing’s recognition period that expired prior to the transfer of the assets to Controlled (Ann. 86-128, 1986-51 I.R.B. 22, and § 1374(d)(8)).

Based solely on the information submitted and on the representations set forth above, we rule as follows with regard to Step (III):

- (1) No gain or loss will be recognized to the Distributing shareholders on the transfer of LLC1 assets to Distributing and the assumption of associated liabilities, if any, in exchange for additional shares of Distributing stock (§ 351(a) and 357(a)).
- (2) No gain or loss will be recognized to Distributing on the receipt of LLC1 assets and the assumption by Distributing of associated liabilities, if any, in exchange for Distributing stock (§ 1032(a)).

- (3) The basis of the LLC1 assets in the hands of Distributing will be equal to their basis in the hands of the shareholders immediately prior to the transfer (§ 362(a)).
- (4) The holding period of the LLC1 assets in the hands of Distributing will include the period during which such assets were held by the shareholders (§ 1223(2)).
- (5) The basis of the Distributing stock received by the shareholders in exchange for the LLC1 assets transferred to Distributing will be the same as the basis of the assets transferred (§ 358(a)(1)).
- (6) The shareholders' holding period for the Distributing stock will include their holding period in the LLC1 assets transferred immediately prior to the transfer, provided that the LLC1 assets were held by the shareholders as capital assets (§ 1223(1)).

No opinion is expressed about the tax treatment of the proposed transactions under any other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transactions not specifically covered by the above rulings. Furthermore, no opinion is requested or expressed as to the tax treatment of the probable distribution of assets from LLC1 to its members, as to the tax treatment of the changes in method of accounting indicated in Steps (IV) and (VII), or as to the tax treatment of the transactions that are planned as indicated in Steps (V) and (VI) (recapitalization, creation of employee stock option plan, name change, termination of Stock Purchase Agreement, change to a calendar year, and IPO).

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that this private letter ruling 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 transactions covered by this letter are consummated.

Pursuant to the power of attorney on file in this matter, a copy of this letter is being sent to the taxpayer.

Sincerely yours,
Associate Chief Counsel (Corporate)
By Gerald B. Fleming
Acting Senior Technician Reviewer
Branch 1