

INTERNAL REVENUE SERVICE  
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March 24, 1999

Re:

Distributing =

Controlled =

Date 1 =

State X =

Shareholder A =

Shareholder B =

A% =

B% =

Business M =

Brand A =

Brand B =

Brand C =

Brand D =

Dear \_\_\_\_\_ :

This is in response to a letter dated January 20, 1999, requesting a ruling as to the federal income tax consequences of a proposed transaction. Additional information was submitted in a letter dated March 3, 1999.

The rulings contained in this letter are predicated upon facts and representations submitted by your authorized representatives and accompanied by a penalties of perjury statement executed by you. This office has not verified any of the material submitted in support of this request for ruling. Verification of the factual information, representations, and other data may be required as part of the audit process. The information submitted for our consideration is summarized as follows.

Distributing, a State X corporation, has been engaged in Business M for more than five years. Distributing elected to be taxed as an S corporation for federal income tax purposes on Date 1. Distributing has only one class of outstanding common stock. Shareholder A owns A% of the outstanding common stock and Shareholder B owns the remaining B% of the outstanding common stock. Distributing is engaged in the manufacture and sale of a variety of branded Business M products, including Brands A and B (the "Branded Products Business"). In addition, Distributing manufactures and sells Brands C and D, and manufactures non-branded Business M products for third parties (collectively, the "Non-branded Products Business"). Financial information has been submitted that reflects that the Branded Products Business and the Non-branded Products Business 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.

Significant disputes have arisen concerning the management, direction, and growth of Distributing. Shareholder A is predominately interested in the creation and marketing of branded products (*i.e.*, the Branded Products Business). Shareholder A believes the best business strategy for Distributing is to focus on high-margin branded products rather than the manufacture of non-branded products for third parties. Shareholder A's strategy would involve extensive spending on advertising and promotions, and production would be outsourced. Shareholder B is primarily interested in the manufacturing of the Business M products for third parties (*i.e.*, the Non-branded Products Business). Shareholder B believes the best business strategy is to pursue manufacturing of other non-branded products at higher volume levels. Shareholder B's strategy would require less spending on advertising and promotions and would permit the sales force to focus on obtaining additional non-branded production. The successful operation of Distributing requires that Shareholder A and Shareholder B agree on the strategic direction of Distributing. Due to these continuing shareholder disputes, Shareholder A and Shareholder B have proposed to separate the businesses

of Distributing in the following manner:

- (1) Distributing will form Controlled, and will initially receive all of the outstanding shares of Controlled in exchange for property and equipment of Distributing necessary for the operation of the Non-branded Products Business.
- (2) Distributing will distribute the shares of stock of Controlled to Shareholder B in exchange for all of Shareholder B's shares of Distributing stock. Shareholder A will be the sole remaining shareholder of Distributing.

The following representations have been made in connection with the proposed transaction:

- (a) Any intercorporate debt outstanding between Distributing and Controlled after the proposed transaction, see (m) below, will not constitute stock or securities.
- (b) The fair market value of the Controlled stock to be received by each shareholder of the Distributing corporation will be approximately equal to the fair market value of the Distributing stock surrendered by such shareholder in the exchange.
- (c) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that as a shareholder of Distributing.
- (d) 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.
- (e) The five years of financial information submitted on behalf of Controlled is representative of the corporation's present operations on a pro forma basis, and with regard to such corporation, there have been no substantial operations changes since the date of the last financial statements submitted.
- (f) Following the 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.
- (g) The distribution of the stock of Controlled is carried out for the following corporate business purposes: (i) resolution of shareholder disputes and (ii) allowing the individual shareholders to separately manage their respective businesses. The distribution of the stock of Controlled is motivated in whole or in substantial part by one or more of these corporate business purposes.

- (h) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 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.
- (i) There is no plan or intention by the shareholders of Distributing to sell, exchange, or transfer by gift or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction.
- (j) 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 § 4.05(1)(b) of Rev. Proc. 96-30.
- (k) 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.
- (l) 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. 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.
- (m) 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 accounts payable resulting from the purchase of existing inventory by Controlled from Distributing, and (b) any accounts payable arising under the co-packing agreement.
- (n) 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.
- (o) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (p) 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.

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

- (1) The transfer by Distributing to Controlled of the assets of the Non-branded Products Business in exchange for all of the stock of Controlled, followed by the distribution of all of the stock of Controlled to Shareholder B in exchange for all of the Distributing stock owned by Shareholder B, will be a reorganization within the meaning of § 368(a)(1)(D). 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 assets to Controlled in exchange for the stock of Controlled. § 361(a) and § 357(a).
- (3) No gain or loss will be recognized by Controlled upon the receipt of the assets from Distributing in exchange for the stock of Controlled. § 1032(a).
- (4) The basis of each of the assets received by Controlled in the transaction will equal the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled. § 362(b).
- (5) The holding period of each of the assets to be received by Controlled in the transaction 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 Controlled stock held by Distributing to Shareholder B in exchange for Shareholder B’s stock in Distributing. § 361(c).
- (7) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder B upon receipt of Controlled stock in exchange for all of the Distributing stock held by Shareholder B. § 355(a)(1).
- (8) The basis of the Controlled stock to be received by Shareholder B will be the same as the basis of the Distributing stock surrendered by Shareholder B in exchange therefor. § 358(a)(1).
- (9) The holding period of the Controlled stock received by Shareholder B will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the exchange. § 1223(1).

- (10) Proper allocation of earnings and profits between Distributing and Controlled will be made under § 312(h) and § 1.312-10(a) of the Income Tax Regulations.
- (11) The momentary affiliation of Distributing and Controlled will not make Controlled ineligible under § 1361(b) to elect to be treated as an S corporation for its first taxable year.
- (12) Controlled will be subject to § 1374 with respect to any asset transferred to Controlled to the same extent Distributing was subject to § 1374 with respect to such asset. For purposes of § 1374, the recognition period for Controlled will be reduced by the portion of Distributing's recognition period that expired prior to the transfer of these assets to Controlled. § 1374(d)(8).

No opinion is expressed or implied concerning the validity of Distributing's S corporation election at any time during its existence, including any time in the future. In addition, no opinion is expressed or implied concerning the eligibility of Controlled to make an S corporation election, or its status as an S corporation if such election is made.

Further, 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 transactions that are not specifically covered by the above rulings

This ruling is directed only to the taxpayer who requested it. Section 6610(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this ruling are consummated.

Sincerely yours,  
Assistant Chief Counsel (Corporate)

By \_\_\_\_\_  
Alfred C. Bishop, Jr.  
Chief, Branch 1